Economic and Interest Rate Forecast (Link Group)

1 Prospect for Interest Rates

1.1 The Council has appointed Link Group (Treasury Solutions) as its treasury advisor and part of their service is to assist the Council in formulating a view on interest rates. The following table gives their central view (updated November 2020) and reflects the conclusion of the review of PWLB borrowing and the resulting 0.80% margin over gilt yields (PWLB Certainty Rate) available to local authorities:

Rate (%)	**Mar 2021**	**Jun 2021**	**Sep 2021**	**Dec 2021**	**Mar 2022**	**Jun 2022**	**Sep 2022**	**Dec 2022**	**Mar 2023**	**Jun 2023**	**Sep 2023**	**Dec 2023**	**Mar 2024**
Bank Rate	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
3-Month (i)	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
6-Month (i)	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
12-Month (i)	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20
5-Yr PWLB	0.80	0.80	0.80	0.80	0.90	0.90	0.90	0.90	0.90	1.00	1.00	1.00	1.00
10-Yr PWLB	1.10	1.10	1.10	1.10	1.20	1.20	1.20	1.20	1.20	1.30	1.30	1.30	1.30
25-Yr PWLB	1.50	1.60	1.60	1.60	1.60	1.70	1.70	1.70	1.70	1.80	1.80	1.80	1.80
50-yr PWLB	1.30	1.40	1.40	1.40	1.40	1.50	1.50	1.50	1.50	1.60	1.60	1.60	1.60

(i) Link Group's forecast for average investment earnings (replacing previous LIBID forecasts)

1.2 As shown in the table above, no increase in Bank Rate is expected over the forecast period (up to March 2024) as UK economic recovery is expected to be only gradual and therefore prolonged. The coronavirus outbreak has done huge economic damage to the UK and economies around the world. After the Bank of England took emergency action in March 2020 to cut Bank Rate to first 0.25% and then to 0.10%, it left Bank Rate unchanged at its subsequent meetings to November 2020, although some forecasters had suggested that a cut into negative territory could happen. However, the Governor of the Bank of England made it clear that he currently thought that such a move would do more damage than good and that more quantitative easing was the favoured tool if further action became necessary.

1.3 Additionally, interest rate forecasts provided by Link Group are predicated on an assumption of a reasonable agreement being reached on trade negotiations between the UK and the EU by 31 December 2020. However, as the differences between a Brexit deal and a no deal are not as big as they once were, the economic costs of a no deal have diminished. Indeed, since the Withdrawal Agreement laid down the terms of the break-up, both the UK and the EU have made substantial progress in granting financial services equivalence and the UK has replicated the bulk of the trade deals it previously had with non-EU countries via the EU. In a no deal under these circumstances (a "cooperative no deal") UK Gross Domestic Product (GDP) in 2021 may be only 1% lower than if there were a deal. In this situation, financial services equivalence would probably be granted during 2021 and if necessary, the UK and the EU would probably rollover any temporary arrangements in the future. The bigger risk is that relations between the UK and the EU deteriorate to such an extent that both sides start to unravel the agreements already put in place. In such an "uncooperative no deal" UK GDP could be 2.5% lower in 2021 than if there was a deal, with acrimony continuing beyond 2021.

1.4 **Borrowing Rates:** As the interest forecast table for PWLB certainty rates above shows, there is expected to be little upward movement in PWLB rates over the next two years as it will take global economies (including the UK) a prolonged period to recover all the momentum they have lost in the sharp recession caused during the coronavirus shut down period. From time to time gilt yields, and therefore PWLB rates, can be subject to exceptional levels of volatility due to geo-political, sovereign debt crisis, emerging market developments and sharp changes in investor sentiment (as shown on 9 November 2020 when the first results of a successful Covid-19 vaccine trial were announced). Such volatility could occur at any time during the forecast period.

1.5 **Balance of risks to the UK:** The overall balance of risks to economic growth in the UK is probably now skewed to the upside but is subject to major uncertainty due to the coronavirus and how quickly successful vaccines may become available and widely administered to the population. It may also be affected by what, if any, trade deal the UK agrees with the EU as part of Brexit. There is relatively little UK domestic risk of increases or decreases in Bank Rate or significant movement in shorter term PWLB rates. The Bank of England has effectively ruled out the use of negative interest rates in the near term (up to six months) and increases in Bank Rate are likely to be some years away given the underlying economic expectations. However, it is always possible that safe haven flows due to unexpected domestic developments and those in other major economies could impact UK gilt yields (and so PWLB rates).

1.6 A summary of downside/upside risks to the current forecasts for UK gilt yields, and therefore corresponding PWLB borrowing rates, include:

Downside Risks	Upside Risks
• **Covid** – risks of further national lockdowns or severe regional restrictions during 2021. • **Brexit** – if UK/EU trade negotiations were to cause significant economic disruption and downturn in the rate of growth. • **Bank of England** acts too quickly, or too far, over the next three years to raise Bank Rate and causes UK economic growth, and increases in inflation, to be	• **Post Covid** – stronger than currently expected recovery in UK economy, especially if effective vaccines are administered quickly to the UK population and lead to a resumption of normal life and a return to full economic activity across all sectors of the economy. • **Post Brexit** – if an agreement is reached that removes most threats of economic disruption between the EU and the UK.

Downside Risks	Upside Risks
weaker than we currently anticipate. • A resurgence of the **Eurozone sovereign debt crisis**. There remains a sharp divide between northern EU countries favouring low debt to GDP and annual balanced budgets and southern countries (e.g. Italy where the cost of the coronavirus pandemic has added to its already huge debt mountain) who want to see jointly issued Eurobonds to finance economic recovery. This divide could undermine the unity of the EU in time to come. • Weak capitalisation of some **European banks**, which could be undermined further depending on extent of credit losses resultant of the pandemic. • **Geopolitical risks,** for example in China, Iran or North Korea, but also in Europe and other Middle Eastern countries, which could lead to increasing safe haven flows.	• The **Bank of England is too slow** in its pace and strength of increases in Bank Rate and, therefore, allows inflationary pressures to build up too strongly within the UK economy, which then necessitates a later rapid series of increases in Bank Rate faster than we currently expect.

1.7 Economic and interest rate forecasting remains difficult with so many influences weighing on UK gilt yields and PWLB rates. The above forecasts (and Bank of England monetary policy decisions) will be liable to further amendment depending on how economic data and developments in financial markets transpire over the next year. Geopolitical developments, especially in the EU, could also have a major impact. Forecasts for average investment earnings beyond the three-year time horizon will be heavily dependent on economic and political developments.

1.8 Full details of economic commentaries and interest rate forecasts as provided by Link Group are held by the Director of Finance Support Services (Financial Reporting: Treasury Management Team).

2 Counterparty Creditworthiness Update

2.1 Although the credit rating agencies changed their outlook on many UK banks from Stable to Negative during the quarter ended 30 June 2020 due to upcoming risks to banks’ earnings and asset quality during the economic downturn caused by the pandemic, the majority of ratings were affirmed due to the continuing strong credit profiles of major UK financial institutions.

However, as more information emerges on actual levels of bank credit losses through quarterly earnings reports, this has the potential to cause rating agencies to revisit their initial rating adjustments from earlier in the current year. These adjustments could be negative or positive, although it should also be borne in mind that UK banks went into this pandemic with strong balance sheets. Additionally, the three rating agencies have reviewed banks from around the world with similar results in many countries of most banks being placed on Negative Outlook, but with a small number of actual downgrades.

2.2 Although bank CDS prices (these are market indicators of credit risk) spiked upwards at the end of March and into early April 2020 due to the heightened market uncertainty and ensuing liquidity crisis that affected financial markets, they have returned to more average levels since then. Nevertheless, prices are still elevated as compared to late February 2020. Pricing is likely to remain volatile as uncertainty continues however, sentiment can easily shift, so it will remain important to undertake continual monitoring of all aspects of risk and return in the current circumstances. Link Group monitor CDS prices as part of their creditworthiness service to local authorities and the Council has access to this information via its Link-provided Passport portal.

3 Investment and Borrowing Rates

3.1 Investment returns are likely to remain exceptionally low during 2021/22 with little increase in the following two years. Based on the current Link Group central assumptions for interest rates, the suggested budgeted earnings rates for returns on investments placed for periods up to about three months during each financial year are as follows:

Average Earnings per Financial Year	**Nov-20 Forecast**
2020/21	0.10%
2021/22	0.10%
2022/23	0.10%
2023/24	0.10%
2024/25	0.25%
Long-term (periods over 10 years in the future)	2.00%

3.2 **Negative Interest Rates:** While the Bank of England said in August and September 2020 that it is unlikely to introduce a negative Bank Rate (at least in the next 6 to 12 months) and in November omitted any mention of negative rates in the minutes of the meeting of the Monetary Policy Committee, some deposit accounts are already offering negative rates for shorter periods. Investor cash flow uncertainty, and the need to maintain liquidity in these unprecedented times, has meant there is a surfeit of money swilling around at the very short end of the market. This has seen several market operators, including the UK Debt Management Office (DMADF account), offer nil or negative rates for very short term maturities. This is not universal, and money market funds (MMFs) are still offering a marginally positive return (albeit by a reduction in the fees charged) as are a number of financial institutions for investments at the very short end of the yield curve.

3.3 Inter-local authority lending and borrowing rates have also declined due to the surge in the levels of cash seeking a short-term home at a time when many local authorities are probably having difficulties over accurately forecasting when disbursements of funds received will occur or when further large receipts will be received from the Government.

3.4 **Borrowing Advice:** The policy of avoiding new borrowing by running down spare cash balances has served many local authorities well over the last few years. However, borrowing interest rates fell to historically very low rates as a result of the Covid-19 crisis and the quantitative easing operations of the Bank of England; indeed, UK gilt yields up to six years were negative during most of the first half of 2020/21. Furthermore, in November 2020 HM Treasury announced the conclusion to their review of margins over gilt yields for PWLB rates; the standard and certainty margins were reduced by 1% but a prohibition was introduced to deny access to borrowing from the PWLB for any local authority which has the purchase of assets primarily for yield in its three year capital programme.

3.5 Link Group’s long-term (10-year) forecast for Bank Rate is 2.00% and all PWLB rates are currently under 2.00%. Therefore, there is now value in borrowing from the PWLB for all types of capital expenditure for all maturity periods, especially as current rates are at historic lows. However, greater value can be obtained in borrowing for shorter maturity periods (and/or the continuation of an internal borrowing policy) so that the Council can assess its risk appetite in conjunction with budgetary pressures to reduce total interest costs.

3.6 Longer-term borrowing could also be considered for the purpose of certainty, where that is desirable, or for flattening the profile of a heavily unbalanced maturity profile.