Detailed commentary on interest rate forecasts

Our treasury management advisers, Link Asset Services provided us on 1 July with the following update to their interest rate forecasts.

We normally update our interest rate forecasts after the Bank of England releases its quarterly interest rate forecast. However, these are far from being normal times! What we have seen since our previous forecasts on 7 May is a sharp deterioration of economic growth news, and expectations for growth, in the major economies of the world – the US, EU and China. This has led to a sharp downturn in government bond yields, lower than we previously anticipated. We, therefore, felt that we could not wait until the next quarterly Inflation Report on 1 August to take account of this sharp movement in financial markets.

As for the UK itself and forecasts for Bank Rate, we have moved back our forecast for the first increase from quarter 1 2020 to quarter 3 2020. Our central assumption is that there will be a reasonable form of muddle through Brexit. But it is clear to all that there are very many uncertainties around this central assumption.

In addition, we now also have a greater number of uncertainties around our Bank Rate and PWLB rate forecasts e.g.:

- when / whether Brexit will occur
- hard Brexit / deal Brexit
- will there be an extension of the Brexit deadline / would the EU agree to an extension?

There are also a great number of uncertainties around the political situation and the Tory leadership contest e.g.:-

- the fiscal policy changes proposed by both candidates to counter the effects of a hard Brexit through tax cuts etc.
- how MPs will vote on Brexit and these fiscal proposals
- how would the Bank of England respond to a major fiscal loosening
- could MPs vote to revoke article 50 (withdrawal from EU)
- whether there could be a general election if the Commons ends up in stalemate
- the chances of a no deal Brexit increasing, as negotiating a deal before 31 October looks challenging

In order to make any forecast we have, as previously mentioned, had to make one central assumption – a reasonable muddle-through outcome for Brexit. If the facts change, our forecasts will also change. As events unfold it is possible we may see 50bps movement in rates and yields at any time e.g. a hard Brexit could result in an immediate 50 bps cut in Bank Rate. But that is not our central assumption.

Our key advice to clients in the midst of such large-scale uncertainties is to focus on managing risk, rather than making a bet on one outcome or the other.

A key issue facing all central banks, except the US Fed, is that they have very little ammunition, in terms of normal monetary policy measures, to take action to counter the next economic downturn. The Bank of England and the MPC will have an agenda to restock their ammunition by raising Bank Rate as soon as is feasible, and, at a later time, possibly unwinding quantitative easing.

On the international scene, after the Fed raised central rates to 2.25% – 2.50% on 19 December, it now appears that the chance of any further increases has probably ended and markets are now forecasting cumulative cuts of 1% to 1.25% over the next year or so.

The ECB has had to change tack to committing to put more monetary stimulus into the economy in order to stimulate lack lustre economic growth. Core inflation is likely to stay well below its target rate. It is becoming increasingly likely that there could be some marginal change downwards in the current negative central rates and a resumption of quantitative easing in order to stimulate economic growth and so encourage a rise in inflation towards its target of near to, but under, 2%.

Economic growth prospects in China have also cooled despite various monetary policy measures to stimulate economic growth.

The balance of risks to the UK

- The overall balance of risks to economic growth in the UK is probably to the downside due to the weight of all the uncertainties over Brexit.
- The balance of risks to increases in Bank Rate and shorter term PWLB rates are broadly similarly to the downside.

One risk that is both an upside and downside risk is that all central banks are now working in very different economic conditions than before the 2008 financial crash as there has been a major increase in consumer and other debt due to the exceptionally low levels of borrowing rates that have prevailed for eleven years since 2008. This means that the neutral rate of interest in an economy, (i.e. the rate that is neither expansionary nor deflationary), is difficult to determine definitively in this new environment, although central banks have made statements that they expect it to be much lower than before 2008. Central banks could therefore over or under-do increases in central interest rates.

Downside risks to current forecasts for UK gilt yields and PWLB rates currently include:

- **Brexit** – if it were to cause significant economic disruption and a major downturn in the rate of growth.

- **Bank of England** takes action 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 weaker than we currently anticipate.

- A resurgence of the **Eurozone sovereign debt crisis**, possibly **Italy**, due to its high level of government debt, low rate of economic growth and vulnerable banking system, and due to the election in March 2018 of a government which has made a lot of anti-austerity noise. The EU is again in the midst of a sharp disagreement with Italy over setting a budget within the limits of EU rules. The rating agencies have already downgraded Italian debt to one notch above junk level. If Italian debt were to fall below investment grade, many investors would be unable to hold Italian debt. Unsurprisingly, investors are becoming increasingly concerned by the actions of the Italian government and consequently, Italian bond yields have risen – at a time when the government faces having to refinance over €200bn of debt maturing in 2019. However, the biggest concern is the major holdings of Italian government debt held by Italian banks and insurers. Any downgrading of such debt would cause Italian bond prices to fall, causing losses on their portfolios, so reducing their capital and forcing them to sell bonds – which, in turn, would cause further falls in their prices etc. This is the so called **'doom loop'**. Due to the Italian government's already high level of debt, it would not be able to afford to bail out the banking system. **Portugal** faces the same problem as its debt is also only one notch above junk level.

- Weak capitalisation of some **European banks**, particularly Italian banks.

- **German minority government.** In the German general election of September 2017, Angela Merkel's CDU party was left in a vulnerable minority position dependent on the fractious support of the SPD party, as a result of the rise in popularity of the anti-immigration AfD party. Then in October 2018, the results of the Bavarian and Hesse state elections radically undermined the SPD party and showed a sharp fall in support for the CDU. As a result, the SPD had a major internal debate as to whether it could continue to support a coalition that is so damaging to its electoral popularity. After the result of the Hesse state election, Angela Merkel announced that she would not stand for re-election as CDU party leader at her party's convention in December 2018. However, this makes little practical difference as she has continued as Chancellor, though more recently concerns have arisen over her health.

- **Other minority EU governments.** Sweden, Spain, Portugal, Netherlands and Belgium all have vulnerable minority governments dependent on coalitions which could prove fragile.

- **Italy, Austria, the Czech Republic and Hungary** now form a strongly anti-immigration bloc within the EU. There has also been rising anti-immigration sentiment in Germany and France.

- The increases in interest rates in the US during 2018, combined with an on-off potential trade war between the USA and China, sparked major volatility in equity markets during the final quarter of 2018 and into 2019. Some **emerging market countries** which have borrowed heavily in dollar denominated debt could be particularly exposed to investor flight from equities to safe havens, typically US treasuries, German bunds and UK gilts.
- There are concerns around the level of **US corporate debt** which has swollen massively during the period of low borrowing rates in order to finance mergers and acquisitions. This has resulted in the debt of many large corporations being downgraded to a BBB credit rating, close to junk status. Indeed, 48% of total investment grade corporate debt is rated at BBB. If such corporations fail to generate profits and cash flow to reduce their debt levels as expected, this could tip their debt into junk ratings which will increase their cost of financing and further negatively impact profits and cash flow.
- **Geopolitical risks,** for example in North Korea, but also in Europe and the Middle East, which could lead to increasing safe haven flows.

Upside risks to current forecasts for UK gilt yields and PWLB rates

- **Brexit** – if agreement was reached all round that removed all threats of economic and political disruption between the EU and the UK.
- **The Fed causing a sudden shock in financial markets** through misjudging the timing, direction and pace for the next movements in the Fed Funds Rate and in changes in levels of QE, which then leads to a fundamental reassessment by investors of the relative risks of holding bonds, as opposed to equities. This could lead to a major flight from bonds to equities and a sharp increase in bond yields in the US, which could then spill over into impacting bond yields around the world.
- 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.
- **UK inflation,** whether domestically generated or imported, returning to sustained significantly higher levels causing an increase in the inflation premium inherent to gilt yields.

LINK ASSET SERVICES' FORECASTS

We do not currently think that the MPC would increase Bank Rate before any clearing of the fog on Brexit. We have pushed back our first increase in Bank Rate from February 2020 to August 2020. Our forecast for the end of the three year forecast period has been lowered from 1.75% to 1.50%

Financial markets, (short sterling rates), are now expecting a first increase in Bank Rate towards the end of 2023.

Forecasts for average investment earnings beyond the three year time horizon will be heavily dependent on economic and political developments.

Gilt yields and PWLB rates

The general situation is for volatility in bond yields to endure as investor fears and confidence ebb and flow between favouring relatively more "risky" assets i.e. equities, or the "safe haven" of government bonds. The overall longer run trend is for gilt yields and PWLB rates to rise, albeit gently, although there are likely to also be periods of sharp volatility from time to time.

We have pointed out consistently that the Fed. Rate was likely to go up more quickly and more strongly than Bank Rate in the UK, but now it is likely to fall before the second stage of any UK monetary policy tightening.

Our forecasts are also predicated on an assumption that there is no break-up of the Eurozone or EU, (apart from the departure of the UK), within our forecasting time period, despite the major challenges that are looming up, and that there are no major ructions in international relations, especially between the US and China / North Korea and Iran, which have a major impact on international trade and world GDP growth. However, the current round of increases in tariff rates sparked by President Trump, both actual and threatened, are causing on-going concern around the potential impact on world growth and also on inflationary pressures.

We would, as always, remind clients of the view that we have expressed in our previous interest rate revision newsflashes of just how volatile PWLB rates and bond yields are at present. Our revised forecasts are based on the Certainty Rate (minus 20 bps) which has been accessible to most authorities since 1st November 2012.

Borrowing advice: since November 2018, PWLB rates have fallen significantly. As our long term forecast for Bank Rate is 2.25%, and all PWLB rates are very near to or below 2.25%, and well below 2.25% in periods up to 10 years, there is added value in most borrowing periods. Value, however, in the longer term rates could be negated or minimal, if Bank Rate does not climb to at least 2.25% over the medium term. Accordingly, clients will need to review and assess their risk appetite in terms of any underlying borrowing requirement they may have, and also project forward their position in respect of cash backed resources.

Any new borrowing should also take into account the continuing cost of carry, the difference between investment earnings and borrowing rates, especially as our forecasts indicate that

Bank Rate may rise to only 1.50% by March 2022. Please speak to your CRM to discuss opportunities available.

Our suggested **budgeted investment earnings rates for investments** up to about three months' duration in each financial year for the next six years are as follows:

	Now	**2019/20 report**
2019/20	0.75%	1.00%
2020/21	1.00%	1.50%
2021/22	1.50%	1.75%
2022/23	1.75%	1.75%
2023/24	2.00%	2.00%
2024/25	2.00%	2.50%
Later years	2.25%	

As there are so many variables at this time, caution must be exercised in respect of all interest rate forecasts. The general expectation for an eventual trend of gently rising gilt yields and PWLB rates is unchanged. Negative, (or positive), developments could significantly impact safe-haven flows of investor money into UK, US and German bonds and produce shorter term movements away from our central forecasts.

Our interest rate forecast for Bank Rate is in steps of 25 bps whereas PWLB forecasts have been rounded to the nearest 10 bps and are central forecasts within bands of + / - 25 bps.

Naturally, we continue to monitor events and will update our forecasts as and when appropriate.

Appendix I

	Bank Rate %		PWLB Borrowing Rates % (including 0.20% certainty rate adjustment)							
			5 year		10 year		25 year		50 year	
	Jul 19	Feb 19	Jul 19	Feb 19	Jul 19	Feb 19	Jul 19	Feb 19	Jul 19	Feb 19
Sep-19	0.75	1.00	1.50	2.00	1.80	2.40	2.40	2.90	2.30	2.70
Dec-19	0.75	1.00	1.60	2.10	1.90	2.50	2.50	3.00	2.40	2.80
Mar-20	0.75	1.00	1.70	2.20	2.00	2.60	2.60	3.10	2.50	2.90
Jun-20	0.75	1.25	1.80	2.30	2.10	2.60	2.70	3.20	2.60	3.00
Sep-20	1.00	1.25	1.90	2.30	2.20	2.70	2.80	3.20	2.70	3.00
Dec-20	1.00	1.25	2.00	2.40	2.30	2.80	2.90	3.30	2.80	3.10
Mar-21	1.25	1.50	2.10	2.50	2.40	2.90	3.00	3.40	2.90	3.20
Jun-21	1.25	1.50	2.10	2.50	2.50	2.90	3.00	3.40	2.90	3.20
Sep-21	1.50	1.75	2.20	2.60	2.60	3.00	3.10	3.50	3.00	3.30
Dec-21	1.50	1.75	2.30	2.60	2.60	3.00	3.20	3.50	3.10	3.30
Mar-22	1.50	2.00	2.40	2.70	2.70	3.00	3.30	3.60	3.20	3.40

The Feb 2019 forecasts were included in the Treasury Strategy 2019/20 to 2021/22.
Link Asset Services provided updated forecasts in July 2019.