

ECONOMIC BACKGROUND PROVIDED BY LINK ASSET SERVICES

COVID-19 vaccines.

These were a significant development during 2021 which raised high hopes that life in the UK would be able to largely return to normal in the second half of the year. However, the emergence of the Omicron mutation at the end of November dampened this.

The economy, therefore, faces significant headwinds although some sectors have learned how to cope well with Covid.

The big question still remains as to whether any further mutations could emerge.

MPC MEETING 16^H DECEMBER 2021

- The Monetary Policy Committee (MPC) voted 8-1 to raise Bank Rate by 0.15% from 0.10% to 0.25% and unanimously decided to make no changes to its programme of quantitative easing purchases due to finish in December 2021 at a total of £895bn.
- The MPC did not raise the Bank Rate at its November meeting. Until the Omicron variant emerged, most forecasters, viewed a Bank Rate increase as being near certain at this December meeting due to the way that worldwide inflationary pressures have been building in both producer and consumer prices, and in wage rates. However, at the November meeting, the MPC decided it wanted to have assurance that the labour market would get over the end of the furlough scheme on 30th September without unemployment increasing sharply; their decision was, therefore, to wait until statistics were available to show how the economy had fared at this time.
- **On 10th December we learnt that the rise in GDP in October was just 0.1% m/m**, Early evidence suggests growth in November might have been marginally better.
- **On 14th December, the labour market statistics** for the three months to October and the single month of October were released. The fallout after the furlough scheme was smaller than the Bank of England had feared. The single-month data were more informative and showed that LFS employment fell by 240,000, unemployment increased by 75,000 and the unemployment rate rose from 3.9% in September to 4.2%. However, the weekly data suggested that unemployment was falling again by the end of October. What's more, the 49,700 fall in the claimant count and the 257,000 rise in the PAYE measure of company payrolls suggests that the labour market strengthened again in November. The other side of the coin was a further rise in the number of vacancies from 1.182m to a record 1.219m in the three months to November which suggests that the supply of labour is struggling to keep up with demand, although the single-month figure for November fell for the first time since February, from 1.307m to 1.227m.
- These figures by themselves, would probably have been enough to give the MPC the assurance that it could press ahead to raise Bank Rate at this December meeting. However, the advent of Omicron complicated matters as it poses a risk to the economy. The financial markets again swung round to expecting no change in Bank Rate.
- **On 15th December we had the CPI inflation** figure for November which rose from 4.2% to 5.1%, confirming again how worldwide inflationary pressures have been building. However, Omicron also caused a sharp fall in world oil and other commodity prices; (gas and electricity inflation has generally accounted on average for about 60% of the increase in inflation in advanced western economies).

- **Other elements of inflation are also transitory** e.g., prices of goods being forced up by supply shortages, and shortages of shipping containers due to ports being clogged have caused huge increases in shipping costs. But these issues are likely to clear during 2022, and then prices will subside back to more normal levels. Gas prices and electricity prices will also fall back once winter is passed and demand for these falls away.
- This is the adverse set of factors against which the MPC had to decide on Bank Rate. For the second month in a row, the MPC increased the **Bank Rate from 0.10% to 0.25%**. Indications are that the MPC is now concerned that inflationary pressures are building and need concerted action by the MPC to counter. This indicates that there will be more increases to come with financial markets predicting 1% by the end of 2022.
- It did also comment that **“the Omicron variant is likely to weigh on near-term activity”**. But it stressed that at the November meeting it had said it would raise rates if the economy evolved as it expected and that now “these conditions had been met”. It also appeared more worried about the possible boost to inflation from Omicron itself. It said that “the current position of the global and UK economies was materially different compared with prior to the onset of the pandemic, including elevated levels of consumer price inflation”.
- On top of that, there were no references this month to inflation being expected to be below the **2% target in two years’ time**, which at November’s meeting the MPC referenced to suggest the markets had gone too far in expecting interest rates to rise to over 1.00% by the end of the year.
- These comments indicate that there has been a material reappraisal by the MPC of the inflationary pressures since their last meeting and the Bank also increased its forecast for inflation to peak at 6% next April, rather than at 5% as of a month ago. However, as the Bank retained its guidance that only a **“modest tightening”** in policy will be required, it cannot be thinking that it will need to increase interest rates that much more. As such, the Bank could be thinking about raising interest rates two or three times next year to 0.75% or 1.00%.
- In as much as a considerable part of the inflationary pressures at the current time are indeed **transitory**, and will naturally subside, this would appear to indicate that this tightening cycle is likely to be comparatively short.
- As for the timing of the next increase in Bank Rate, the MPC dropped the comment from November’s statement that Bank Rate would be raised “in the coming months”. That may imply another rise is unlikely at the next meeting in February and that May is more likely. However, much could depend on how adversely, or not, the economy is affected by Omicron in the run up to the next meeting on 3rd February. Once 0.50% is reached, the Bank would act to start shrinking its stock of QE, (gilts purchased by the Bank would not be replaced when they mature).
- **The MPC’s forward guidance on its intended monetary policy** on raising Bank Rate versus selling (quantitative easing) holdings of bonds is as follows: -
 - Raising Bank Rate as “the active instrument in most circumstances”.
 - Raising Bank Rate to 0.50% before starting on reducing its holdings.
 - Once Bank Rate is at 0.50% it would stop reinvesting maturing gilts.
 - Once Bank Rate had risen to at least 1%, it would start selling its holdings.

LINK TREASURY SERVICES INTEREST RATE FORECASTS

A SUMMARY OVERVIEW OF THE FUTURE PATH OF BANK RATE

- The threat from Omicron was a matter of considerable national concern at the time of December's MPC meeting; but is now seen as much reduced.
- The MPC shifted up a gear last week in raising Bank Rate by another 0.25% and narrowly avoiding making it a 0.50% increase by a 5-4 voting margin.
- Our forecast now expects the MPC to deliver another 0.25% increase in March; their position appears to be to go for sharp increases to address the underlying issues quickly.
- The March increase is likely to be followed by an increase to 1.0% in May and then to 1.25% in November.
- The MPC is currently much more heavily focused on combating inflation than on protecting economic growth.
- The major question is whether the current spike in inflation will lead to a second-round effect in terms of labour demanding higher wages.
- If the labour market remains very tight during 2022, then wage inflation poses a greater threat to overall inflation being higher for longer, and the MPC may then feel it needs to take more action.

PWLB RATES

- The yield curve has flattened out considerably.
- We view the markets as having built in, already, nearly all the effects on gilt yields of the likely increases in Bank Rate.
- It is difficult to say currently what effect the Bank of England starting to sell gilts will have on gilt yields once Bank Rate rises to 1%: it is likely to act cautiously as it has already started on not refinancing maturing debt. A passive process of not refinancing maturing debt could begin in March when the 4% 2022 gilt matures; the Bank owns £25bn of this issuance. A pure roll-off of the £875bn gilt portfolio by not refinancing bonds as they mature, would see the holdings fall to about £415bn by 2031, which would be about equal to the Bank's pre-pandemic holding. Last August, the Bank said it would not actively sell gilts until the "Bank Rate had risen to at least 1%" and, "depending on economic circumstances at the time."
- It is possible that Bank Rate will not rise above 1% as the MPC could shift to relying on quantitative tightening (QT) to do the further work of taking steam out of the economy and reducing inflationary pressures.

MPC MEETING 4TH FEBRUARY 2022

- After the Bank of England became the first major western central bank to put interest rates up in this upswing in December, it has quickly followed up its first 0.15% rise by another 0.25% rise to 0.50%, in the second of what is likely to be a series of increases during 2022.
- The Monetary Policy Committee voted by a majority of 5-4 to increase Bank Rate by 25bps to 0.5% with the minority preferring to increase Bank Rate by 50bps to 0.75%. The Committee also voted unanimously for the following: -
 - to reduce the £875bn stock of UK government bond purchases, financed by the issuance of central bank reserves, by ceasing to reinvest maturing assets.
 - to begin to reduce the £20bn stock of sterling non-financial investment-grade corporate bond purchases by ceasing to reinvest maturing assets and by a programme of corporate bond sales to be completed no earlier than towards the end of 2023.
- The Bank again sharply increased its forecast for inflation – to now reach a peak of 7.25% in April, well above its 2% target.

- The Bank estimated that UK GDP rose by 1.1% in quarter 4 of 2021 but, because of the effect of Omicron, GDP would be flat in quarter 1, but with the economy recovering during February and March. Due to the hit to households' real incomes from higher inflation, it revised down its GDP growth forecast for 2022 from 3.75% to 3.25%.
- The Bank is concerned at how tight the labour market is with vacancies at near record levels and a general shortage of workers.
- As in the December 2021 MPC meeting, the MPC was more concerned with combating inflation over the medium term than supporting economic growth in the short term. However, what was notable was the Bank's forecast for inflation: based on the markets' expectations that Bank Rate will rise to 1.50% by mid-2023, it forecast inflation to be only 1.6% in three years' time. In addition, if energy prices beyond the next six months fell as the futures market suggests, the Bank said CPI inflation in three years' time would be even lower at 1.25%. With calculations of inflation, the key point to keep in mind is that it is the rate of change in prices – not the level – that matters. Accordingly, even if oil and natural gas prices remain flat at their current elevated level, energy's contribution to headline inflation will drop back over the course of this year. That means the current energy contribution to CPI inflation, of 2% to 3%, will gradually fade over the next year.
- So the message to take away from the Bank's forecast is that they do not expect Bank Rate to rise to 1.5% in order to hit their target of CPI inflation of 2%. The immediate issue is with four members having voted for a 0.50% increase in February, it would only take one member more for there to be another 0.25% increase at the March meeting.

The MPC's forward guidance on its intended monetary policy on raising Bank Rate versus selling (quantitative tightening) holdings of bonds is as follows: -

1. Raising Bank Rate as "the active instrument in most circumstances".
2. Raising Bank Rate to 0.50% before starting on reducing its holdings.
3. Once Bank Rate is at 0.50% it would stop reinvesting maturing gilts.
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OUR FORECASTS

a. Bank Rate

- Covid remains a major potential downside threat as we are most likely to get further mutations. However, their severity and impact could vary widely, depending on vaccine effectiveness and how broadly it is administered.

In summary, with the high level of uncertainty prevailing on several different fronts, we expect to have to revise our forecasts again.

b. PWLB rates and gilt and treasury yields

Gilt yields. Since the start of 2021, we have seen a lot of volatility in gilt yields, and hence PWLB rates. Our forecasts show little overall increase in gilt yields during the forecast period to March 2025 but there will doubtless be a lot of unpredictable volatility during this forecast period.

While monetary policy in the UK will have a major impact on gilt yields, there is also a need to consider the potential impact that rising treasury yields in America could have on gilt yields. As an average since 2011, there has been a 75% correlation between movements in US 10-year treasury yields and UK 10-year gilt yields. This is a significant UPWARD RISK exposure to our forecasts for medium to longer term PWLB rates. However, gilt yields and treasury yields do not always move in unison.

The balance of risks to the UK economy: -

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

- **Mutations** of the virus render current vaccines ineffective
- **Labour and supply shortages** prove more enduring and disruptive and depress economic activity.
- **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 weaker than we currently anticipate.
- **Geopolitical risks**, for example in Ukraine/Russia, Iran, China, North Korea and Middle Eastern countries, which could lead to increasing safe-haven flows.

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

- **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.
- **Longer term US treasury yields** rise strongly and pull gilt yields up higher than forecast.

Comparison of Interest Rate Forecasts – Treasury Strategy 2021/22 – 2023/24 (Jan 2020), and Treasury Strategy 2022/23 – 2024/25 (Feb 2022)

	Bank Rate %			PWLB Borrowing Rates % (including 0.20% certainty rate adjustment)											
				5 year			10 year			25 year			50 year		
	Feb 22	Nov 21	Feb 21	Feb 22	Nov 21	Feb 21	Feb 22	Nov 21	Feb 21	Feb 22	Nov 21	Feb 21	Feb 22	Nov 21	Feb 21
Mar-22	0.75	0.25	0.10	2.20	1.50	1.00	2.30	1.90	1.40	2.40	2.20	2.00	2.20	2.00	1.80
Jun-22	1.00	0.50	0.10	2.30	1.60	1.00	2.40	1.90	1.40	2.50	2.30	2.00	2.30	2.10	1.80
Sep-22	1.00	0.50	0.10	2.30	1.60	1.10	2.40	2.00	1.50	2.50	2.40	2.10	2.30	2.20	1.90
Dec-22	1.25	0.50	0.10	2.30	1.70	1.10	2.40	2.00	1.50	2.60	2.40	2.10	2.40	2.20	1.90
Mar-23	1.25	0.75	0.10	2.30	1.70	1.10	2.40	2.10	1.50	2.60	2.40	2.10	2.40	2.20	1.90
Jun-23	1.25	0.75	0.10	2.30	1.70	1.20	2.40	2.10	1.60	2.60	2.50	2.20	2.40	2.30	2.00
Sep-23	1.25	0.75	0.10	2.30	1.80	1.20	2.40	2.20	1.60	2.60	2.50	2.20	2.40	2.30	2.00
Dec-23	1.25	0.75	0.10	2.30	1.80	1.20	2.40	2.20	1.60	2.60	2.60	2.20	2.40	2.40	2.00
Mar-24	1.25	1.00	0.10	2.30	1.80	1.20	2.40	2.20	1.60	2.60	2.60	2.20	2.40	2.40	2.00
Jun-24	1.25	1.00		2.30	1.90		2.40	2.30		2.60	2.60		2.40	2.40	
Sep-24	1.25	1.00		2.30	1.90		2.40	2.30		2.60	2.60		2.40	2.40	
Dec-24	1.25	1.00		2.30	2.00		2.40	2.30		2.60	2.70		2.40	2.50	
Mar-25	1.25	1.25		2.30	2.00		2.40	2.40		2.60	2.70		2.40	2.50	

The February 2021 forecasts were included in Treasury Strategy 2021/22 to 2023/24.
Link Asset Services provided an updated forecast in February 2022.