Detailed commentary on interest rate forecasts

Our treasury management advisers, Capita Asset Services have provided us with the following update to their interest rate forecasts.

November quarterly inflation report and post US Presidential election review

- We updated our forecasts to take into account the Bank of England quarterly Inflation Report for November 2016, the decision of the MPC meeting of 3 November, and the US Presidential election of 8 November. We also felt that we should allow financial markets to settle down for a few days after the result of that election, which provided a surprise outcome. We therefore undertook a review of our forecasts on 14 November.
- Despite many ominous warnings that there could be significant turbulence in financial markets if Donald Trump won the election, markets have surprised by their lack of such a reaction. In fact, stock markets in America hit a new record high in the first few days after the election and have reached further highs since then. However, Treasury yields have risen sharply in expectation of a significant rise in inflation, as an economy which is already working near to full capacity could be in line for a significant boost to economic growth if Trump's expansion of infrastructure expenditure plans become a reality.
- His plans to cut taxes, at the same time as boosting expenditure, could also lead to a sharp rise in total debt issuance from the current level of around 72% of GDP towards 100% during his term in office. However, although the Republicans now have a monopoly of power for the first time since the 1920s, in having a President and a majority in both Congress and the Senate, there is by no means any certainty that the politicians and advisers he has been appointing to his team, and both houses, will implement the more extreme policies that Trump outlined during his election campaign. Indeed, Trump may even rein back on some of those policies himself.
- The MPC meeting of 3 November left Bank Rate unchanged at 0.25% and other monetary policy measures also remained unaltered. This was in line with market expectations, but a major change from the previous quarterly Inflation Report MPC meeting of 4 August, which had given a strong steer in its forward guidance that it was likely to cut Bank Rate again, probably by the end of the year if economic data turned out as forecast by the Bank.
- The November MPC decision included a forward view that Bank Rate could go either up or down depending on how economic data evolve in the coming months. Our central view remains that Bank Rate will remain unchanged at 0.25% until the first increase to 0.50% in June 2019, (unchanged from our previous forecast). However, we would not, as yet, discount the risk of a cut in Bank Rate if economic growth were to take a significant dip downwards, though we think this is unlikely, especially given the run of strong economic data since then. We would also point out that forecasting as far ahead as mid 2019 is highly fraught as there are many potential economic headwinds which could blow the UK economy one way or the other as well as political developments in the UK, (especially over the terms of Brexit), EU, US and beyond, which could have a major impact on our forecasts.

- The pace of Bank Rate increases in our forecasts has been slightly increased beyond the three year time horizon to reflect higher inflation expectations.

- The August quarterly Inflation Report was based on a pessimistic forecast of near to zero GDP growth in quarter 3 of 2016 i.e. a sharp slowdown in growth from +0.6% in quarter 2, in reaction to the shock of the result of the referendum in June. However, consumers have very much stayed in a 'business as usual' mode and there has been no sharp downturn in spending; it is consumer expenditure that underpins the services sector which comprises about 75% of UK GDP. After a fairly flat three months leading up to October, retail sales in October surged at the strongest rate since September 2015 before levelling off in November. In addition, the GfK consumer confidence index has recovered moderately to -7 in December after an initial sharp plunge in July to -12 in reaction to the referendum result. GDP growth in quarter 3 of 2016 has therefore come in at a robust +0.6% q/q, +2.2% y/y while business surveys are indicating reasonable continuing strength into quarter 4 and into the start of 2017.

- Bank of England GDP forecasts in the November quarterly Inflation Report were as follows, (August forecasts in brackets) - 2016 +2.2%, (+2.0%); 2017 1.4%, (+0.8%); 2018 +1.5%, (+1.8%). There has, therefore, been a sharp increase in the forecast for 2017, a marginal increase in 2016 and a small decline in growth, now being delayed until 2018, as a result of the impact of Brexit.

- Capital Economics' forecasts for economic growth are as follows: 2016 +2.0%; 2017 +1.5%; 2018 +2.5%. They feel that pessimism is still being overdone by the Bank and Brexit will not have as big an effect as initially feared by some commentators.

- The other key factor in forecasts for Bank Rate is inflation where the MPC aims for a target for CPI of 2.0%. The November Inflation Report included an increase in the peak forecast for inflation from 2.3% to 2.7% during 2017; (Capital Economics are forecasting a peak of 3.2% in 2018). This increase was largely due to the effect of the sharp fall in the value of sterling since the referendum, though the December MPC meeting reported a 6% recovery on a trade weighted basis since its 3 November meeting to leave sterling 15%, (was 16%), down against the US dollar and 8%, (was 11%), down against the euro; this will feed through into a sharp increase in the cost of imports and materials used in production in the UK. However, the MPC is expected to look through the acceleration in inflation caused by external, (outside of the UK), influences, although it has given a clear warning that if wage inflation were to rise significantly as a result of these cost pressures on consumers, then they would take action to raise Bank Rate. The MPC also commented that the partial recovery in the value of sterling, if maintained, would cause a small reduction in their November forecast rise in CPI inflation above the 2% target rate.

- What is clear is that consumer disposable income will come under pressure if CPI rises to exceed wage inflation. The CPI figure for November of 1.2% was the highest for over two years, but is expected to rise rapidly above 2% in Q1 of 2017. On the other hand, wage inflation excluding bonuses came in at 2.6% in October. However, growth in real disposable income in Q3 was negative so the robust increase in retail sales was only achieved by consumers running down their savings and increasing borrowing; this looks unsustainable in the longer term and makes consumer expenditure increasingly vulnerable to rises in interest rates on borrowing when they do occur.

- Gilt yields, and consequently PWLB rates, have risen sharply since hitting a low point in mid-August. There has also been huge volatility during 2016 as a whole. The year started with 10 year gilt yields at 1.88%, fell to a low point of 0.53% on 12 August, and finished at the end of December at 1.49% after some peaks higher during that month. The rebound since August reflects the initial combination of the yield-depressing effect of the MPC's new round of quantitative easing on 4 August, together with expectations of a sharp downturn in expectations for growth and inflation as per the pessimistic Bank of England Inflation Report forecast, followed by a sharp rise in growth expectations since August when subsequent business surveys, and GDP growth in quarters 2 and 3 at +0.6% q/q, confounded the pessimism. Inflation expectations also rose sharply as a result of the continuing fall in the value of sterling.

- The Chancellor has said he will do 'whatever is needed' i.e. to promote growth; there are two main options he can follow – fiscal policy e.g. cut taxes, increase investment allowances for businesses and/or increase government expenditure on infrastructure, housing etc. While the Autumn Statement contained only moderate measures, the PSBR deficit elimination timetable did slip further into the future, as expected, so as to place the priority on promoting economic growth, (and ultimately boosting tax revenues / reducing the budget deficit in the longer term).

- Employment had been continuing to grow weakly during 2016 but in the three months to October, there was the first small fall. House prices are also continuing to rise at a modest pace; but any downturn in prices could dampen consumer confidence and expenditure.

- **Rising EU and geopolitical risks e.g.**

- **Greece** continues to cause major stress in the EU due to its tardiness and reluctance in implementing key reforms required by the EU to make the country more efficient and to make significant progress towards the country being able to pay its way – and before the EU is prepared to agree to release further bail out funds.
- **Spain** has had two general elections in 2015 and 2016, both of which failed to produce a workable government with a majority of the 350 seats. At the eleventh hour on 31 October, before it would have become compulsory to call a third general election, the party with the biggest bloc of seats (137), was given a majority confidence vote to form a government. This is potentially a highly unstable situation, particularly given the need to deal with an EU demand for implementation of a package of austerity cuts which will be highly unpopular.
- The under capitalisation of **Italian banks** poses a major risk with state aid firmly ruled out by the EU as a potential way out. The longer that this issue remains unresolved, the greater the likelihood that exposed banks will suffer an outflow of liquidity and so the bigger the cost will become to remedy the situation.
- **4 December Italian constitutional referendum** on reforming the Senate and reducing its powers; this became a confidence vote on Prime Minister Renzi who duly resigned when the 'no' vote won. The rejection of these proposals will be an impediment to fundamental political and economic reform which is urgently needed to deal with Italy's core problems, especially low growth. They were also intended to give Italy more stable government as no western European country has had such a multiplicity of governments since the Second World War as Italy, due to the equal split of power between the two

chambers of the Parliament which are both voted in by the Italian electorate but by using different voting systems. Paolo Gentiloni has subsequently been appointed as Prime Minister but it is notable how little market reaction there has been to these events – for the time being!

- **Dutch general election 15.3.17**; a far right party is currently polling neck and neck with the incumbent ruling party. However, the proportional voting system means that there is a multiplicity of parties so each general election results in an exercise in gathering a viable coalition after the results are in. In addition, anti-big business and anti-EU activists have already collected two thirds of the 300,000 signatures required to force a referendum to be taken on approving the EU – Canada free trade pact. This could delay the pact until a referendum in 2018 which would require unanimous approval by all EU governments before it can be finalised. In April 2016, Dutch voters rejected by 61.1% an EU – Ukraine cooperation pact under the same referendum law. Dutch activists are concerned by the lack of democracy in the institutions of the EU.
- **French presidential election**; first round 23 April; second round 7 May 2017.
- **French National Assembly election** 11 and 18 June 2017.
- **German Federal election August –** 22 October 2017. This could be affected by significant shifts in voter intentions as a result of terrorist attacks, dealing with a huge influx of immigrants and a rise in anti EU sentiment.
- The core EU, (note, not just the Eurozone currency area), principle of free movement of people within the EU is a growing issue leading to major stress and tension between EU states, especially with the Visegrad bloc of former communist states.
- Given the number and type of challenges the EU faces in the next eighteen months, there is an identifiable risk for the EU project to be called into fundamental question. The risk of an electoral revolt against the EU establishment has gained traction after the shock results of the UK referendum and the US Presidential election. But it remains to be seen whether any shift in sentiment will gain sufficient traction to produce any further shocks. The risks are increasing that voter dissatisfaction with the EU could lead to another country lining up after the UK, to leave the EU, unless the EU positively addresses the major challenges it faces over the next few years.

- **Economic growth in the EU**, (the UK's biggest trading partner), has been lack lustre at +1.7% y/y in 2016 despite the ECB cutting its main rate to -0.4% and embarking on a massive programme of quantitative easing during 2016. The latest economic statistics give some grounds for optimism that as a result of this aggressive quantitative easing programme, growth could at last be accelerating going into 2017. However, growth could be negatively impacted by adverse political developments - which could then also impact on UK exports and growth.

- The **US economy** grew strongly in quarter three of 2016 at 3.5%, (on an annualised basis), after an anaemic 1.4% in quarter 2. The election result is likely to have given the Fed added impetus to go ahead with the rate rise of 0.25%, as expected in December, due to the expansionary plans Trump has been outlining. There could well be three or four further increases in 2017 and 2018 in order to contain inflationary pressures which are expected to increase as a result of Trump's policies.

- In the first week since the US election, there was a **major shift in investor sentiment away from bonds to equities**, especially in the US. However, gilt yields in the UK and bond yields in the EU have also been dragged higher. Some commentators are saying that this rise has been an overreaction to the US election result which is likely to be reversed. Other commentators take the view that this could well be the start of the long expected eventual unwinding of bond prices propelled upwards to unrealistically high levels by the artificial and temporary power of quantitative easing.

- **Japan** has been struggling to gain consistent significant growth but has achieved an annualised rate in quarter 3 of +2.7%, (Q2 +2.6%). It has also been struggling to put deflation firmly behind it and to get inflation up to reasonable levels, despite huge monetary and fiscal stimulus. It has been making little progress on fundamental reform of the economy

- **Chinese economic growth** has been weakening despite successive rounds of central bank stimulus; medium term risks are increasing. Major progress still needs to be made to eliminate excess industrial capacity and the stock of unsold property, and to address the level of non-performing loans in the banking and credit systems.

CAPITA ASSET SERVICES' FORWARD VIEW

Economic forecasting remains difficult with so many external influences weighing on the UK. Our Bank Rate forecasts, (and also MPC decisions), will be liable to further amendment depending on how economic data and developments in financial markets transpire over the next year. Forecasts for average earnings beyond the three year time horizon will be heavily dependent on economic and political developments. Major volatility in bond yields is likely to endure as investor fears and confidence ebb and flow between favouring more risky assets i.e. equities, or the safe haven of bonds.

The overall longer run trend is for gilt yields and PWLB rates to rise, albeit gently. An eventual world economic recovery may also see investors switching from the safe haven of bonds to equities.

We have pointed out consistently that the Fed. Rate is likely to go up more quickly and more strongly than Bank Rate in the UK. While there is normally a high degree of correlation between treasury and gilt yields, we would expect to see a growing decoupling between the two i.e. we would expect US yields to go up faster than UK yields. We will need to monitor this area closely and the resulting effect on PWLB rates.

The overall balance of risks to economic recovery in the UK remains to the downside, particularly with the current uncertainty over the final terms, and impact, of Brexit.

We would, as always, remind clients of the view that we have expressed in our previous interest rate revision newsflashes of just how unpredictable PWLB rates and bond yields are at present. We are experiencing exceptional levels of volatility which are highly correlated to geo-political and sovereign debt crisis developments. Our revised forecasts are based on the Certainty Rate (minus 20 bps) which has been accessible to most authorities since 1st November 2012.

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

- Geopolitical risks in Europe, the Middle East and Asia, which could lead to increasing safe haven flows.
- UK economic growth and increases in inflation are weaker than we currently anticipate.
- Weak growth or recession in the UK's main trading partners - the EU and US.
- A resurgence of the Eurozone sovereign debt crisis.
- Weak capitalisation of some European banks.
- Monetary policy action failing to stimulate sustainable growth and combat the threat of deflation in western economies, especially the Eurozone and Japan.

The potential for upside risks to current forecasts for UK gilt yields and PWLB rates, especially for longer term PWLB rates include: -

- The pace and timing of increases in the Fed. funds rate causing a fundamental reassessment by investors of the relative risks of holding bonds as opposed to equities and leading to a major flight from bonds to equities.
- UK inflation returning to significantly higher levels than in the wider EU and US, causing an increase in the inflation premium inherent to gilt yields.

	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20
Bank rate	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.50%	0.50%	0.75%	0.75%
5yr PWLB rate	1.60%	1.60%	1.60%	1.60%	1.70%	1.70%	1.70%	1.80%	1.80%	1.90%	1.90%	2.00%	2.00%
10yr PWLB rate	2.30%	2.30%	2.30%	2.30%	2.30%	2.40%	2.40%	2.40%	2.50%	2.50%	2.60%	2.60%	2.70%
25yr PWLB rate	2.90%	2.90%	2.90%	3.00%	3.00%	3.00%	3.10%	3.10%	3.20%	3.20%	3.30%	3.30%	3.40%
50yr PWLB rate	2.70%	2.70%	2.70%	2.80%	2.80%	2.80%	2.90%	2.90%	3.00%	3.00%	3.10%	3.10%	3.20%

BANK RATE	now	previously
Q1 2017	0.25%	0.10%
Q1 2018	0.25%	0.10%
Q1 2019	0.25%	0.25%
Q1 2020	0.75%	-

Our target borrowing rates and the current PWLB (certainty) borrowing rates are set out below.

PWLB debt	Current borrowing rate as at 4.1.17	Target borrowing rate now (Q1 2017)	Target borrowing rate previous (Q4 2016)
5 year	1.43%	1.60%	1.00%
10 year	2.16%	2.30%	1.50%
25 year	2.80%	2.90%	2.30%
50 year	2.57%	2.70%	2.10%

Borrowing advice

Although yields have risen from their low points, yields are still at historic lows and borrowing should be considered if appropriate to your strategy. We still see value in the 40yr to 50yr range at present but that view would be negated if Bank Rate does not climb to at least 2.5% over the coming years. 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 not rise from 0.25% until June 2019 and then will only rise slowly.

Proposed new PWLB Local Infrastructure Rate

At the Autumn Statement 2016, the government announced that it would consult on lending local authorities up to £1 billion at a new Local Infrastructure Rate of gilts + 60 basis points to support infrastructure projects that are high value for money. Loans at the new rate would be available for a period of three years, with a maximum term of 50 years.

The government would like further input from stakeholders before proceeding with this policy and so clients may wish to respond to this consultation exercise. Clients may also wish to consider what the potential impact could be on their capital programmes and the financing of the same.

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

Average earnings in each year	Now	Previously
2016/17	0.25%	0.25%
2017/18	0.25%	0.10%
2018/19	0.25%	0.25%
2019/20	0.50%	0.50%
2020/21	0.75%	0.75%
2021/22	1.00%	1.00%
2022/23	1.50%	1.25%
2023/24	1.75%	1.50%
Later years	2.75%	2.50%

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 expected to remain 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.