Appendix B

Detailed commentary on interest rate forecasts

Capita Asset Services have provided us with the following update to their interest rate forecasts.

May quarterly inflation report review

- Following the latest Bank of England quarterly Inflation Report on 11 May, we have reviewed the forecasts we did on 8 February after the previous quarterly Inflation Report for February 2017. However, we would draw your attention to our newsflash on 3 April where we made an interim adjustment to our forecasts for PWLB rates by reducing our forecasts for quarter 2 2017 by 20 bps to reflect the fact that gilt yields had settled lower since February. Today's forecasts incorporate that interim adjustment and we have lowered following quarters in keeping with the continuing lower gilt yields. We have also made some minor adjustments by lowering a few 25 and 50 year PWLB rate forecasts by 10 bps in later quarters. We have left our forecasts for Bank Rate unchanged.

- The key points from the latest Inflation Report are as follows: -

- Forecast for GDP growth for 2017 shaved from 2.0% to 1.9% to reflect a weak start in quarter 1 of only +0.3%, (but the Bank expects that figure to be revised to +0.4%); 2018 and 2019 upped from 1.8% to 1.9%. (2016 was 1.8%.)

- Little change in inflation forecasts; inflation to fall back to 2.2% in just over 2 years' time and to pick up slightly going into 2020.

- In February, the Bank cut the equilibrium rate of unemployment from 5.0% to 4.5%. This potentially means that the MPC could wait longer before taking action to combat rising inflation.

- Some MPC members were clearly more concerned about the degree to which they could look through increases in inflation caused by the effective devaluation of the pound since the referendum and the consequent feed through into the CPI measure on inflation.

- Our forecasts assume that there is no cancellation of the emergency cut in Bank Rate in August 2016 from 0.50% to 0.25% and a stop to the Quantitative Easing (QE) programme in the shorter-term. There is a potential risk that the MPC could muster a majority to reverse both before reaching a time when there is a progression to a sustained trend of gentle increases in Bank Rate. Our forecasts for both Bank Rate and PWLB rates would then need revision if both were to occur.

- Our overall view is that there is now need for some caution over forecasts for GDP growth as quarter 1 2017 GDP growth was noticeably weaker; this can be explained by the rise in inflation eating into consumers' disposable income and spending power. The Inflation Report stated that the Bank expected a continuation of strong growth near to 2% on the assumption that foreign trade and business investment would counteract a fall back in consumer spending. The Bank also made a major assumption that there would be a smooth adjustment of the UK's relationship with the EU. Again, we feel some caution around both assumptions.

- The Bank also warned that markets were too pessimistic in thinking Bank Rate would not start rising until towards the end of 2019 as the Bank expects wage growth to accelerate due

to continuing falls in unemployment and rising vacancy levels. Again, we do feel some caution on this area as wage growth has been remarkably benign despite continuing falls in unemployment; this may reflect hidden levels of unemployment e.g. people wanting to move from part time to full time employment. We do feel that the MPC will focus on inflation risks, ahead of protecting growth, if inflation looks like rising to levels significantly above current forecasts. However, it is very difficult to be at all certain about risks around this, especially when currency movements in the pound, dollar and euro will be very hard to predict and are subject to major unknowns. It is notable that sterling has now recovered from around $1.20 to the pound after the referendum to around $1.30. However, the Fed is expected to embark on quarterly increases in interest rates and this should cause the dollar to strengthen, i.e. the value of sterling against the dollar is likely to fall back again over the next couple of years.

- Capital Economics' forecasts for UK economic growth are as follows: 2017 +2.0%; 2018 +2.3%; 2019 +2.0%. 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. They are forecasting that the first increase in Bank Rate will occur in quarter 2 2018 whereas our first increase is in quarter 2 2019 - after the end of Brexit negotiations.

- One major uncertainty is the degree to which there will be a major financial stimulus programme in the US - depending on the degree of agreement, or otherwise, between President Trump and Congress. If this stimulus programme is substantial, this is likely to have, in turn, a significant impact on the rise in inflation pressures and the speed of increases in the Fed. Rate. There are also concerns as to whether the US will enter into a trade and currency value conflict with other major trading nations. The value of the dollar against other currencies has been subject to major volatility since the Presidential election and this is likely to continue. It is to be noted that after 6 months of Trump's presidency, there has been little substantial progress on a fiscal stimulus so this will weaken world growth expectations in the near future. In addition, it now appears there is a significant weakening in Chinese economic growth. However, the risk of a trade war between America and China appears to have evaporated as China has become a vital partner to the US in curbing North Korea's nuclear ambitions.

- **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. A crunch point is imminent this summer when Greece needs to make major repayments it will not be able to make unless there is a new bail out which is very unlikely ahead of the general election due in Germany before late October. However, in the usual EU approach, another fudge looks probable so as to avoid a crisis ahead of the imminent German general election.

  - 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. Progress has been made in sorting out the dire under capitalisation of a few very small banks but this leaves major issues still to be dealt with.

- Italian general election; the latest possible date for a general election in Italy is 20 May 2018. The constitutional referendum last December, on reforming the Senate and reducing its powers, became a confidence vote on Prime Minister Renzi who duly resigned when he lost the vote. The rejection of these proposals stopped progress 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, 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. This means there is now major uncertainty about the road ahead for Italy and its ability to tackle the needed major reform. Italy has the third biggest government debt mountain in the world.

- German Federal election 22 October 2017. Chancellor Merkel currently looks in a strong position to retain power. However, 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.

- Austria general election 15 October. What could be more problematic is this general election in Austria where a major front runner is the Freedom Party which is strongly anti-immigration and anti EU. If it gains substantial power, or influence in a coalition, this could create waves for the core EU policy, (note, not just the Eurozone currency area), of free movement of people – which is also a key issue for Brexit negotiations and with the Visegrad bloc of former communist states.

- Economic growth in the EU, (the UK's biggest trading partner), has been lacklustre for a long time despite the ECB cutting its main policy rate to -0.4% and embarking on a massive programme of quantitative easing during 2016. However, growth has picked up during 2016 to reach an overall figure of 1.7% for the year for the Eurozone. Current forecasts are for growth to improve to 1.9% in 2017.

- US. GDP growth has been highly volatile in 2016 but overall mediocre, at an average of 1.6% for the year. Quarter 1 in 2017 has also been mediocre at 1.4% but current indications are that growth could rebound strongly in quarter 2. The disappointment so far has been the lack of decisive action from President Trump to make progress with his promised fiscal stimulus package. The Fed has, therefore, started on the upswing in rates now that the economy is at or around "full employment" and inflationary pressures have been building to exceed its 2% target. It has, therefore, raised rates four times, with the last three following quickly on one another in December 2016 and March and June 2017. One or two more increases are expected in 2017 and possibly four in 2018.

- Japan is struggling to stimulate consistent significant growth to get inflation up to its target of 2% despite huge monetary and fiscal stimulus. It is also 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. A world economic recovery will likely 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 and recent events have not changed that view, just that the timing of such increases may well have been deferred somewhat during 2016. While there is normally a high degree of correlation between the two yields, we would expect to see a growing decoupling of yields 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 of Brexit.
- The balance of risks to increases in Bank Rate and shorter term PWLB rates are to the upside and are dependent on how quickly inflation pressures rise and how high the peak will be.
- Our forecasts are 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, which have a major impact on international trade and world GDP growth.

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 causing an increase in the inflation premium inherent to gilt yields.

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 quarter 2 2019 and then will only rise slowly.

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.

Appendix B

	Bank Rate %		PWLB Borrowing Rates % (including 0.20% certainty rate adjustment)							
			5 year		10 year		25 year		50 year	
	Aug 17	Feb 17	Aug 17	Feb 17	Aug 17	Feb 17	Aug 17	Feb 17	Aug 17	Feb 17
Sep-17	0.25	0.25	1.40	1.60	2.10	2.30	2.80	2.90	2.80	2.70
Dec-17	0.25	0.25	1.50	1.60	2.20	2.30	2.90	3.00	2.70	2.80
Mar-18	0.25	0.25	1.60	1.70	2.30	2.30	2.90	3.00	2.70	2.80
Jun-18	0.25	0.25	1.70	1.70	2.30	2.40	3.00	3.00	2.80	2.80
Sep-18	0.25	0.25	1.70	1.70	2.40	2.40	3.00	3.10	2.90	2.90
Dec-18	0.25	0.25	1.80	1.80	2.40	2.40	3.10	3.10	2.90	2.90
Mar-19	0.25	0.25	1.80	1.80	2.50	2.50	3.10	3.20	2.90	3.00
Jun-19	0.50	0.50	1.90	1.90	2.50	2.50	3.20	3.20	3.00	3.00
Sep-19	0.50	0.50	1.90	1.90	2.60	2.60	3.30	3.30	3.00	3.10
Dec-19	0.75	0.75	2.00	2.00	2.60	2.60	3.30	3.30	3.10	3.10
Mar-20	0.75	0.75	2.00	2.00	2.70	2.70	3.30	3.40	3.10	3.20