APPENDIX 2

LINK Group

Updated Interest Rate Forecast 25 September 2023

LINK GROUP UPDATED INTEREST RATE FORECAST

Updating of our forecasts 25 September 2023

Comparison of forecasts for Bank Rate today v. previous forecast

Bank Rate	Dec-23	Mar-24	Jun-24	Sep-24	Dec-24	Mar-25	Jun-25	Sep-25	Dec-25	Mar-26	Jun-26	Sep-26	Dec-26
25.09.23	5.25	5.25	5.25	5.00	4.50	4.00	3.50	3.00	2.75	2.75	2.75	2.75	2.75
26.06.23	5.50	5.50	5.50	5.25	4.75	4.25	3.75	3.25	2.75	2.75	2.50	2.50	2.50
Change	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	0.00	0.00	0.25	0.25	0.25

- At its meeting that concluded last week, the Bank of England's Monetary Policy Committee (MPC) kept rates on hold for the first time in 15 meetings. It was certainly a close decision, with Governor Bailey's vote being the determining factor in a 5-4 split vote.

- In the days leading up to the vote, the MPC would have noted that average earnings (excluding bonuses) are rising by 7.8%, whilst the private sector gauge stood at 8.5%. [Remember that some of the upside shift in wages was caused by the NHS bonus payment…they account for a lot of the UK workforce…so maybe seen as a temporary lift, especially given that the minutes stated that the figures did not tally with other wage releases] Neither of these numbers are commensurate with a low level of inflation, so it was somewhat surprising to see not only the annual CPI measure of inflation drop from 6.8% to 6.7% (for August), but also for core inflation to fall substantially from 6.9% to 6.2%, whilst services inflation came in at sub-7%.

- Moreover, the composite Purchasing Manager Index data was available to the MPC ahead of its release on Friday. Dropping from 48.6 to 46.8 for August (50 is the dividing line between expansion and contraction in activity), this probably suggested to some of the MPC members that the monetary policy tightening undertaken to date is beginning to have a more material impact on the economy than has been suggested to date. But, having said that, although rates are on hold for now, there is still a risk that data releases between now and the next vote (2nd November) point to further tightening being required before the "terminal rate" is reached. Indeed, the policy guidance is for rates to be "sufficiently restrictive for sufficiently long" and that if inflation starts to push upwards, or even remains overly-sticky, then "further tightening in policy would be required".

- November will see the publication of the quarterly monetary policy report from the Bank of England, so we will then be a lot wiser as to what the inflation outlook looks like according to the Bank's analysts and researchers. We have seen in recent publications the Bank is not averse to making sweeping changes to its forecasts, and with oil prices buoyant at $90 per barrel at present, and the ONS due to publish revised GDP data for the period starting Q1 2022, there is always the possibility of sizeable revisions to the assumptions underpinning the Bank's policy decisions.

- In the immediate aftermath of the decision, markets have concluded that rates have more than likely peaked at 5.25% although there remains an outside chance of one more increase to come before the tightening cycle is concluded. Interestingly, the markets are also pricing in a rate cut before the end of 2024. That is to be expected in so far as typically the "terminal rate" remains in situ for some ten months or so before an easing in rates is undertaken.

- As noted in the table above, we have fine-tuned our own expectations, and while we do not now foresee Bank Rate hitting 5.5%, we do see Bank Rate staying on hold for the best part of a year at 5.25%. However, the pace of any future decreases will very much be determined by the wage and inflation data.

- Regarding PWLB rates, movement in the short part of the curve is expected to be driven by Bank Rate expectations to a large degree, whilst medium to longer-dated PWLB rates will remain influenced not only by the outlook for inflation, but also by the market's appetite for significant gilt issuance, as commented upon by RLAM's Craig Inches at our recent Strategic Issues Webinars.

- In addition, we will also keep an eye on what is happening in the housing market. Whilst household rents continue to increase apace, it is estimated that less than half of households with a mortgage have been subject to a new higher fixed rate. Many households locked into cheap five-year mortgages before the current up-cycle in interest rates and have, therefore, been protected from that significant element of increase in household outgoings. The latest estimates suggest that there are another 500k households whose current fixed term deal are due to expire this year, and a further 1.6m coming to an end by the close of 2024. Thus, the impact of past decisions could have a more sizeable impact on activity as more households face up to an increasingly limited number of (re)mortgage options at likely far greater cost than they have been paying under their current deals.

- Furthermore, there is the small matter of a General Election coming into sight on the far horizon (late next year), so Government fiscal policy may potentially loosen at the same time as the Bank's monetary policy is still trying to take momentum out of the economy.

- Of course, what happens outside of the UK remains critical to movement in gilt yields as well. The European Central Bank has made it clear that policy tightening is at, or close to, the terminal rate (currently 4%), whilst the US FOMC has held its Bank Rate equivalent in the range of 5.25% - 5.5%.

- From a practical standpoint those clients looking to borrow will, most probably, need to continue to focus on optimising their cashflow forecasts, and given the elevated level of rates right across the curve at present, seek to fund either temporarily from local authorities or with short-dated loans from the PWLB. You will see from our forecast that we still expect both short and longer-term rates to be somewhat lower over the duration of the forecast. Nonetheless, if certainty is paramount within your debt management strategy, we will help you to optimise any longer dated borrowing requirements you may have.

- On the flipside, if you are an authority that is fully funded or wishes to reduce its exposure to long-dated debt, the more recent increase in yields could provide further scope to repay loans prematurely (both market and PWLB) whilst the high discount rates prevail. Your Client Relationship Manager should be contacted if this is something you wish to look at.

- In terms of our forecast, our money market yield forecasts are based on expected average earnings by local authorities for 3 to 12 months. Our forecasts for average earnings are averages i.e., rates offered by individual banks may differ significantly from these averages, reflecting their different needs for borrowing short-term cash at any one point in time.

Our current and previous PWLB rate forecasts below are based on the Certainty Rate (the standard rate minus 20 bps) which has been accessible to most authorities since 1 November 2012. Please note, the lower Housing Revenue Account (HRA) PWLB rate started on the 15 June 2023 for those authorities with an HRA (standard rate minus 60 bps).

Link Group Interest Rate View	25.09.23												
	Dec-23	Mar-24	Jun-24	Sep-24	Dec-24	Mar-25	Jun-25	Sep-25	Dec-25	Mar-26	Jun-26	Sep-26	Dec-26
BANK RATE	5.25	5.25	5.25	5.00	4.50	4.00	3.50	3.00	2.75	2.75	2.75	2.75	2.75
3 month ave earnings	5.30	5.30	5.30	5.00	4.50	4.00	3.50	3.00	2.80	2.80	2.80	2.80	2.80
6 month ave earnings	5.60	5.50	5.40	5.10	4.60	4.10	3.60	3.10	2.90	2.90	2.90	2.90	2.90
12 month ave earnings	5.80	5.70	5.50	5.20	4.70	4.20	3.70	3.20	3.00	3.00	3.00	3.00	3.00
5 yr PWLB	5.10	5.00	4.90	4.70	4.40	4.20	4.00	3.90	3.70	3.70	3.60	3.60	3.50
10 yr PWLB	5.00	4.90	4.80	4.60	4.40	4.20	4.00	3.80	3.70	3.60	3.60	3.50	3.50
25 yr PWLB	5.40	5.20	5.10	4.90	4.70	4.40	4.30	4.10	4.00	3.90	3.80	3.80	3.80
50 yr PWLB	5.20	5.00	4.90	4.70	4.50	4.20	4.10	3.90	3.80	3.70	3.60	3.60	3.60

Link Group Interest Rate View	26.06.23												
	Jun-23	Sep-23	Dec-23	Mar-24	Jun-24	Sep-24	Dec-24	Mar-25	Jun-25	Sep-25	Dec-25	Mar-26	Jun-26
BANK RATE	5.00	5.50	5.50	5.50	5.25	4.75	4.25	3.75	3.25	2.75	2.75	2.50	2.50
3 month ave earnings	5.30	5.60	5.50	5.30	5.00	4.50	4.00	3.50	3.00	2.70	2.60	2.50	2.50
6 month ave earnings	5.80	5.90	5.70	5.50	5.10	4.60	4.00	3.50	3.00	2.70	2.60	2.60	2.60
12 month ave earnings	6.30	6.20	6.00	5.70	5.30	4.80	4.10	3.60	3.10	2.80	2.70	2.70	2.70
5 yr PWLB	5.50	5.60	5.30	5.10	4.80	4.50	4.20	3.90	3.60	3.40	3.30	3.30	3.20
10 yr PWLB	5.10	5.20	5.00	4.90	4.70	4.40	4.20	3.90	3.70	3.50	3.50	3.50	3.40
25 yr PWLB	5.30	5.40	5.20	5.10	4.90	4.70	4.50	4.20	4.00	3.90	3.80	3.80	3.70
50 yr PWLB	5.00	5.10	5.00	4.90	4.70	4.50	4.30	4.00	3.80	3.60	3.60	3.50	3.50

A SUMMARY OVERVIEW OF THE FUTURE PATH OF BANK RATE

- Our central forecast for interest rates was previously updated on 26 June and reflected a view that the MPC would be keen to further demonstrate its anti-inflation credentials by delivering a succession of rate increases. Since then, rates have indeed increased to 5.25% but with data suggesting inflation is dipping, albeit slowly, and that the economy is heading for a shallow recession, further monetary policy tightening above 5.25% is not required, at least for now.
- Accordingly, although we anticipate rates staying on hold for the best part of a year, we also still anticipate the Bank of England will be keen to loosen monetary policy when the worst of the inflationary pressures are behind us – but timing on this will remain one of fine judgment: cut too soon, and inflationary pressures may well build up further; cut too late and any downturn or recession may be prolonged.
- In the upcoming months, our forecasts will be guided not only by economic data releases and clarifications from the MPC over its monetary policies and the Government over its fiscal policies, but also international factors such as policy development in the US and Europe, the provision of fresh support packages to support the faltering recovery in China as well as the on-going conflict between Russia and Ukraine.
- On the positive side, consumers are still estimated to be sitting on some excess savings left over from the pandemic, which could cushion some of the impact of the above challenges and may be the reason why the economy is performing somewhat better at this stage of the economic cycle than may have been expected. However, most of those excess savings are held by more affluent people whereas lower income families already spend nearly all their income on essentials such as food, energy and rent/mortgage payments.

PWLB RATES

- Gilt yield curve movements have narrowed, with the short part of the curve seeing yields fall through recent weeks whilst the longer-end continues to reflect inflation concerns. At the time of writing there is <30 basis points difference between the 5 and 50 year parts of the curve.

The balance of risks to the UK economy: -

- The overall balance of risks to economic growth in the UK is to the downside.

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

- **Labour and supply shortages** prove more enduring and disruptive and depress economic activity (accepting that in the near-term this is also an upside risk to inflation and, thus, could keep gilt yields high for longer).
- **The Bank of England** has increased Bank Rate too fast and too far over recent months, and subsequently brings about a deeper and longer UK recession than we currently anticipate.
- **UK / EU trade arrangements** – if there was a major impact on trade flows and financial services due to complications or lack of co-operation in sorting out significant remaining issues.
- **Geopolitical risks,** for example in Ukraine/Russia, China/Taiwan/US, Iran, North Korea and Middle Eastern countries, which could lead to increasing safe-haven flows.
- **A re-emergence of banking sector fragilities,** which have been successfully addressed in the near-term by central banks and the market generally, but which may require further intervention if short-term interest rates stay elevated for longer than is anticipated.

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

- Despite the recent tightening to 5.25%, the **Bank of England proves too timid** in its pace and strength of increases in Bank Rate and, therefore, allows inflationary pressures to remain elevated for a longer period within the UK economy, which then necessitates Bank Rate staying higher for longer than we currently project.

- **The pound weakens** because of a lack of confidence in the UK Government's pre-election fiscal policies, resulting in investors pricing in a risk premium for holding UK sovereign debt.

- Longer-term **US treasury yields** rise strongly if inflation remains more stubborn there than the market currently anticipates, consequently pulling gilt yields up higher.

- Projected **gilt issuance, inclusive of natural maturities and QT,** could be too much for the markets to comfortably digest without higher yields compensating.

LINK GROUP FORECASTS

We now expect the MPC will keep Bank Rate at 5.25% during the second half of 2023 and the first half of 2024 to combat on-going inflationary and wage pressures. We do not think that the MPC will increase Bank Rate above 5.25%, but it is possible.

Gilt yields and PWLB rates

The overall longer-run trend is for gilt yields and PWLB rates to fall back over the timeline of our forecasts, as inflation starts to fall through the remainder of 2023 and into 2024.

Our target borrowing rates are set **two years forward** (as we expect rates to fall back) and the current PWLB (certainty) borrowing rates are set out below: -

PWLB debt	Current borrowing rate as at 25.09.23 p.m.	Target borrowing rate now (end of Q3 2025)	Target borrowing rate previous (end of Q2 2025)
5 years	5.05%	3.90%	3.60%
10 years	5.10%	3.80%	3.70%
25 years	5.54%	4.10%	4.00%
50 years	5.30%	3.90%	3.80%

Borrowing advice: Our long-term (beyond 10 years) forecast for Bank Rate stands at 2.75%. As all PWLB certainty rates are currently significantly above this level, borrowing strategies will need to be reviewed in that context. Overall, better value can generally be obtained at the shorter end of the curve and short-dated fixed LA to LA monies should be considered. Temporary borrowing rates will remain elevated for some time to come but may prove the best option whilst the market continues to wait for inflation, and therein gilt yields, to drop back later in 2023 and then in 2024.

Our suggested budgeted earnings rates for investments up to about three months' duration in each financial year are rounded to the nearest 10bps and set out below. You will note that investment earnings have been revised somewhat higher for both 2023/24 and 2024/25 as Bank Rate remains higher for longer.

Average earnings in each year	Now	Previously
2023/24	5.30%	5.40%
2024/25	4.70%	4.30%
2025/26	3.00%	2.70%
2026/27	2.80%	2.50%
2027/28	3.05%	2.50%
Years 6 to 10	3.05%	2.80%
Years 10+	3.05%	2.80%

As there are so many variables at this time, caution must be exercised in respect of all interest rate 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.

Interest Rate Strategy Group