LINK Asset Services

Updated Interest Rate Forecast

7th November 2017

Part of **Link Group**

Monetary Policy Committee (MPC) meeting 2 November 2017

Our previous interest rate forecasts, updated on 9 August, contained this paragraph: -

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, and there has probably been some increase in this risk, that the MPC could muster a majority to simply reverse both and then pause for a further period 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.

Last week we saw two major developments: -

1. After the MPC painted themselves into a corner with their words following their previous meeting on 14 September, it was a virtual certainty that Bank Rate would go up by 0.25% this time around. The MPC duly delivered on those words by a vote of 7-2 to remove the post EU referendum emergency monetary stimulus implemented in August 2016 by reversing the cut in Bank Rate at that time from 0.5% to 0.25%, (with no change in QE this time). In view of the robust rate of growth in the second half of 2016 which confounded the Bank's August 2016 forecasts for a sharp slowdown, many commentators subsequently held the view that that emergency action was unnecessary. On the face of it, to now increase Bank Rate when economic growth in 2017 in quarters 1 and 2 was so disappointingly weak, (0.2% and 0.3% respectively), can appear to be perverse.
2. The MPC also gave forward guidance that they expected to increase Bank Rate only twice more in the next three years to reach 1.0% by 2020. This is, therefore, not quite the 'one and done' scenario but is, nevertheless, a very relaxed rate of increase prediction in Bank Rate in line with previous statements that Bank Rate would only go up very gradually and to a limited extent.

The markets viewed this result as being more dovish than they had expected and sterling duly responded by falling 0.8% against the dollar and euro on the day. As this was the first increase in Bank Rate for a decade, the MPC was right to avoid alarming consumers and financial markets, and to be very reassuring about the pace of future increases.

The quarterly Inflation Report itself, was notably downbeat about economic growth based on a view that the trend rate of growth for the economy has now fallen from 2.2% to only 1.5%, (whereas in the decade before the financial crash it grew at 2.9% p.a.). One of the main focuses for this was a view that productivity growth would remain very weak at about only 1% p.a. This does not augur well for increases in wage rates. This, in turn, is likely to feed through into weak domestically generated, (i.e. excluding the one off post referendum imported inflation through the fall in the value of sterling), price pressures underpinning CPI inflation. Overall, the Inflation Report was little changed from the August report and again forecast that inflation would be barely above the 2% target at the three year time horizon; it is also expected to peak very soon at 3.2%, (September was 3.0%), before falling thereafter as the devaluation effect gradually falls out of the 12 month statistics. As for forecasts for GDP growth, these also barely changed with growth falling from 1.7% to 1.6% for 2017 and being unchanged for 2018 (1.6%) and 2019 (1.8%). The MPC was also quite concerned about the situation over Brexit as there has been little significant agreement so far in terms of moving towards giving UK firms some confidence of what sort of trade terms the UK is likely to have with the EU from 2019. They felt that this uncertainty was holding back investment. The MPC's forecasts are predicated on an assumption that households and companies base their decisions on a smooth adjustment to a new trading relationship with the EU.

It has to be said that overall, this is really a quite pessimistic outlook for the UK economy. For some commentators, raising Bank Rate with such a weak outlook, did not sit easily together. However, the MPC's main justification for taking action now to raise Bank Rate was that because unemployment was at the lowest rate for 42 years at only 4.3%, there was little spare capacity left in the economy, especially when increases in productivity were expected to be so weak and taking account of Brexit caused expected falls in net immigration. They also noted that consumer confidence has remained resilient and the global economy was growing strongly which would help UK exports. In addition, financial conditions were highly accommodative through the current level of monetary policy.

Accordingly, despite this weak outlook for GDP growth, they needed to take action now to ward off the potential for inflationary pressures to start building up.

Link Asset Services forecasts

The MPC made some obvious comments around the fact that the UK is going through a period of heightened uncertainty due, particularly, to the unknowns around how the Brexit negotiations will proceed and the likely effect on households and companies. They will adjust their responses according to how these turn out and in the light of how the economy progresses over the next two to three years. We would agree with these qualifications. Obviously, if the negotiations are very difficult and end up being disappointing, this could put in jeopardy even two Bank Rate increases over the next three years.

We can only forecast given the current situation and have to flag up that there is a wide spread of potential outcomes during this forecast period. There is, therefore, a likelihood of heightened volatility as events actually unfold. We would, however, refer clients back to our previous newsflash on 18 September which explained how the strong causal link in western economies between falling unemployment and rising inflation, appears to be broken. This has led some commentators to raise the question as to whether we are now moving into a new paradigm of low unemployment at the same time as low inflation, where central bank policy targets of focusing primarily on inflation are beginning to be called into fundamental question. The example of Japan, which has struggled for some two decades to get inflation up to 2% despite massive repeated rounds of QE, is just one example. What will actually happen to wage inflation, therefore, remains a key issue. If wage inflation continues to remain very subdued over the next two to three years, this will act as a significant headwind to the MPC justifying further increases in Bank Rate due to inflationary threats building up. However, it has in the past ‘looked through’ e.g. one off increases in inflation which it saw as a temporary occurrence; the MPC could, therefore, be flexible in implementing its mandate of focusing primarily on inflation. Alternatively, they could justify increases in Bank Rate as being primarily due to the need to simply remove monetary policy stimulus as this has caused massive distortions in the economy with asset prices e.g. share prices and house prices have been the main beneficiaries while savers have been the major losers through low interest rates.

Our own forecasts are cautious and in line with this subdued path for increases in Bank Rate; we do not currently see inflation posing a significant threat over the next three years. We have 0.25% increases in November 2018 to 0.75%, 1.0% in November 2019 and 1.25% in August 2020. This is much in line with market expectations. Our central assumption is that the UK will make progress with concluding a satisfactory outcome over the Brexit negotiations with the EU by March 2019, although the UK finance sector is likely to be an area of particular concern and difficulty.

LINK 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. Volatility in bond yields is likely 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. 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. 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 any resulting effect on PWLB rates.

- The overall balance of risks to economic recovery in the UK is probably to the downside, particularly with the current level of uncertainty over the final terms of Brexit.

- The balance of risks to increases in Bank Rate and shorter term PWLB rates are probably to the upside and are dependent on how strong GDP growth turns out, how quickly inflation pressures rise and how quickly the Brexit negotiations move forward positively.
- 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 / North Korea, 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. 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:

- Bank of England monetary policy takes action too quickly 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, especially North Korea, but also in Europe and the Middle East, which could lead to increasing safe haven flows.
- 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.
- Weak capitalisation of some European banks.
- The result of the October 2017 Austrian general election is likely to result in a strongly anti-immigrant coalition government. In addition, the new Czech prime minister is expected to be Andrej Babis who is strongly against EU migrant quotas and refugee policies. Both developments could provide major impetus to other, particularly former Communist bloc countries, to coalesce to create a major block to progress on EU integration and centralisation of EU policy. This, in turn, could spill over into impacting the Euro, EU financial policy and financial markets.
- Rising protectionism under President Trump
- A sharp Chinese downturn and its impact on emerging market countries

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

- The Bank of England is too slow in its pace and strength of increases in Bank Rate and, therefore, allows inflation 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 returning to sustained significantly higher levels causing an increase in the inflation premium inherent to gilt yields.
- The Fed causing a sudden shock in financial markets through misjudging the pace and strength of increases in its Fed. Funds Rate and in the pace and strength of reversal 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.

	NOW	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21
BANK RATE	0.50	0.50	0.50	0.50	0.50	0.75	0.75	0.75	0.75	1.00	1.00	1.00	1.25	1.25	1.25
3 month LIBID	0.40	0.40	0.40	0.40	0.40	0.60	0.60	0.60	0.70	0.90	0.90	1.00	1.20	1.20	1.20
6 month LIBID	0.45	0.50	0.50	0.50	0.60	0.80	0.80	0.80	0.90	1.00	1.00	1.10	1.30	1.30	1.40
12 month LIBID	0.65	0.70	0.80	0.80	0.90	1.00	1.00	1.10	1.10	1.30	1.30	1.40	1.50	1.50	1.60
5 yr PWLB	1.50	1.50	1.60	1.60	1.70	1.80	1.80	1.90	1.90	2.00	2.10	2.10	2.20	2.30	2.30
10 yr PWLB	2.10	2.10	2.20	2.30	2.40	2.40	2.50	2.60	2.60	2.70	2.70	2.80	2.90	2.90	3.00
25 yr PWLB	2.70	2.80	2.90	3.00	3.00	3.10	3.10	3.20	3.20	3.30	3.40	3.50	3.50	3.60	3.60
50 yr PWLB	2.40	2.50	2.60	2.70	2.80	2.90	2.90	3.00	3.00	3.10	3.20	3.30	3.30	3.40	3.40

BANK RATE	now	previously
Q4 2017	0.50%	0.25%
Q1 2018	0.50%	0.25%
Q1 2019	0.75%	0.25%
Q1 2020	1.00%	0.75%
Q1 2021	1.25%	N/A

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

PWLB debt	Current borrowing rate as at 7.11.17	Target borrowing rate now (Q4 2017)	Target borrowing rate previous (Q4 2017)
5 year	1.51%	1.50%	1.50%
10 year	2.07%	2.10%	2.20%
25 year	2.70%	2.80%	2.90%
50 year	2.39%	2.50%	2.70%

Borrowing advice: although yields have risen from their low points, yields are still around 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 rise to only 1.25% by March 2021.

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
2017/18	0.40%	0.25%
2018/19	0.60%	0.25%
2019/20	0.90%	0.50%
2020/21	1.25%	0.75%
2021/22	1.50%	1.00%
2022/23	1.75%	1.50%
2023/24	2.00%	1.75%
Later years	2.75%	2.75%

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.

We will be updating our TMSS template reports to include these updated interest rate forecasts and commentary.

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