CAPITA

Asset Services

Treasury solutions

Updated Interest Rate Forecast

4 July 2016

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Post EU referendum interest rate review

- *The outcome of the EU referendum has necessitated a review of our interest rate forecasts. The UK now faces a very different situation from what it was in ten days ago both politically and economically. This mix of both political and economic uncertainty makes this the most difficult interest rate review we have done in recent years due to the sheer number of known unknowns. However, the impact on financial markets in the last ten days has not been as great as some had feared.*

- *This also puts the Monetary Policy Committee (MPC), in a very difficult position in terms of knowing how much the vote for Brexit will impact the real economy. What most forecasters expect is that the first two quarters growth in 2016 of around +0.4% is likely to fall to zero in the second half of the year. However, after the initial shock, the economy may recover some momentum so Capital Economics are forecasting growth of 1.5% for 2017, (after average overall growth for 2016 of 1.5%), and then recovery back to 2.5% in 2018. In his speech last Friday, the Governor of the Bank of England, Mark Carney, made clear that the MPC will consider cutting Bank Rate in the very near future but will also give consideration to using further quantitative easing (QE) purchasing of gilts, (and possibly other assets), as a means of providing further stimulus to economic growth by lowering borrowing rates.*

- ***Our own interest rate forecast is based on a cut of Bank Rate of 0.25% in the current quarter; this could come at the next MPC meeting of July 14 or at the next quarterly Inflation Report meeting on August 4. However, we would certainly not rule out a further cut to zero or possibly 0.10%. The first increase in Bank Rate does not then occur until quarter 2 2018 and the pace of increases thereafter has also been slowed down from that in our previous forecast. However, we have to emphasise that there are so many variables over this time period that it is very likely that these forecasts will be subject to significant updating as events evolve on both the political and economic scenes.***

- *Carney's comments last Friday on the possibility of further quantitative easing caused an immediate fall in gilt yields of around 25 – 37 basis points (bps) in gilts with a duration of 10 and 50 years, so it could be said that just the threat of further QE has already achieved a significant drop in gilt yields and so borrowing costs. This, arguably, means that the benefits of <u>actually</u> implementing further QE are reduced. We have therefore revised down our forecasts for PWLB rates to take account of these movements in gilt yields since the referendum - which have fallen to all-time lows (with 2 year gilt yields even briefly turning negative!).*

- *However, Carney did make a strong point that it is not the role of the Bank of England to be the sole combatant in helping to stimulate growth of the UK economy and employment by using the monetary policy measures at its disposal. The Government has fiscal policy as a powerful tool to promote growth and it has various policy measures it could employ. Already the Chancellor of the Exchequer has said that the* *target of achieving a budget surplus in 2020 will need to be put back to avoid austerity measures creating an unwelcome headwind for growth during the near future. In addition, there are already comments in the public arena around lowering corporation tax - from falling from 20% to 17% by 2020 to falling from 20% to 15% as a stimulus to stop corporates moving out of the UK and attracting corporates to come to the UK. Fiscal policy could also include cuts in income tax, national insurance, VAT etc to stimulate consumer demand in the economy: however, such cuts may impact on the size of the budget deficit.*

- *In addition, the Government could take advantage of the plunge in gilt yields to borrow extra money to invest in infrastructure to improve the productivity of the UK economy.*

- *However, what will be vital will be to ensure that the UK retains the trust of international investors, both in terms of the fact that about 30% of all gilts are owned by overseas investors, who will want to be assured that the Government is not borrowing beyond the means of the economy to sustain the ability to pay interest and to repay the debt, and in terms of the value of sterling against other currencies. The current size of the balance of payments deficit of 6.9% of GDP is a major concern. The fall of 14% in the value of sterling since November 2015 will feed through eventually to stimulate demand for UK exports and to choke off imports into the UK by making home made goods and services more competitive. However, this will take time to feed through into reducing the size of this deficit.*

- *What will make the decision making of the MPC more difficult in the next few years is that the fall in the value of sterling will feed through over the next 3-4 years into the economy and cause an increase in inflation. But manufacturers and service providers could absorb some of the extra costs from the increased cost of imports of materials etc, or could increase productivity to offset extra costs, so there is considerable uncertainty about the timing and size of this feedthrough into inflation. Capital Economics have revised their interest rate forecast for inflation as follows: - 2016 0.6%; 2017 2.2% (was 1.5%); 2018 2.8% (was 2.1%). The MPC's target for CPI inflation is 2% but in the past they have looked through temporary spikes of imported inflation on the basis that they will drop out of the calculation of CPI after 12 months. So it is by no means certain that the MPC will, or will not, take action to counter such a rise in inflation.*

- *What we do have to emphasise at this point in time is that there are huge variables which could have a major impact on the UK economy and interest rates over the next four to five years in particular: -*

    - *Political uncertainty: the Conservative party is currently facing a leadership election and the situation in respect of the Labour party is under major stress. There is also another general election due in May 2020.*

    - *Political uncertainty in the EU if other countries hold referendums or there is a strong growth in anti EU political parties.*

- *Uncertainty about when Article 50 will be initiated to start the UK withdrawal from the EU and what form any final agreement with the EU will take over access to the single market and requirements to conform to EU rules and to contribute to the EU budget etc. This in turn, could have a major influence on corporates deciding whether, or not, to move jobs away from the UK into the EU.*

- *Whether the potential impact of all of the above could bring to the fore the question of whether Scotland remains as a part of the UK.*

- *Consumer confidence in the UK will have a major impact on consumer expenditure and so on GDP growth; many factors could affect confidence e.g. house prices, inflation rising to outweigh pay inflation and so depressing disposable income, the outcome of Brexit negotiations, etc.*

We will be undertaking a further review of our interest rate forecast following the release of the Bank of England Quarterly Inflation Report on 4th August where the Bank of England will update all its forecasts for growth, inflation etc and will explain its thinking around Bank Rate and QE.

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 and recent events have not changed that view, just that the timing of such increases may well have been deferred somewhat. While there is normally a high degree of correlation between the two yields, we would expect to see a 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. Although economic growth remains relatively steady, only time will tell whether some of the global headwinds sap some of the strength from the UK's future 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 emerging market, 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.

Apart from the uncertainties already explained above, downside risks to current forecasts for UK gilt yields and PWLB rates currently include:

- Emerging country economies, currencies and corporates destabilised by falling commodity prices and / or Fed. rate increases, causing a further flight to safe havens (bonds).
- Geopolitical risks in Europe, the Middle East and Asia, 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.
- Recapitalisation of European banks requiring more government financial support.
- 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.

	NOW	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Mar-19
BANK RATE	0.50	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.50	0.50	0.50	0.50	0.50
3 month LIBID	0.50	0.30	0.30	0.30	0.30	0.30	0.40	0.50	0.50	0.60	0.60	0.60	0.60
6 month LIBID	0.55	0.50	0.50	0.50	0.50	0.60	0.60	0.70	0.70	0.70	0.70	0.70	0.70
12 month LIBID	0.75	0.60	0.60	0.60	0.60	0.70	0.80	0.90	0.90	0.90	0.90	0.90	0.90
5 yr PWLB	1.20	1.00	1.10	1.10	1.10	1.10	1.10	1.10	1.20	1.20	1.20	1.30	1.30
10 yr PWLB	1.70	1.60	1.60	1.60	1.70	1.70	1.70	1.70	1.80	1.80	1.80	1.80	1.90
25 yr PWLB	2.50	2.40	2.40	2.40	2.50	2.50	2.50	2.50	2.60	2.60	2.60	2.70	2.70
50 yr PWLB	2.20	2.20	2.20	2.20	2.30	2.30	2.30	2.30	2.40	2.40	2.40	2.50	2.50

BANK RATE	now	previously
Q3 2016	0.25%	0.50%
Q1 2017	0.25%	0.75%
Q1 2018	0.25%	1.25%

Q1 2019	0.50%	1.75%

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

PWLB debt	Current borrowing rate as at 4.7.16	Target borrowing rate now (Q3 2016)	Target borrowing rate previous (Q3 2016)
5 year	1.19%	1.00%	2.00%
10 year	1.77%	1.60%	2.50%
25 year	2.54%	2.40%	3.30%
50 year	2.24%	2.20%	3.10%

Borrowing advice: with yields now at historic lows borrowing should be considered if appropriate to your strategy. We see particular value in the 40yr to 50yr range at present but other periods should be considered if more appropriate locally. As the outlook continues to be uncertain we would suggest borrowing is taken in tranches so as to benefit from the current rates but also to provide some flexibility if rates fall further.

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%	0.60%
2017/18	0.25%	1.25%
2018/19	0.50%	1.75%
2019/20	0.50%	2.00%
2020/21	0.75%	2.25%
2021/22	1.25%	2.50%
2022/23	1.50%	2.75%
2023/24	2.00%	2.75%
Later years	2.75%	3.00%

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.

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