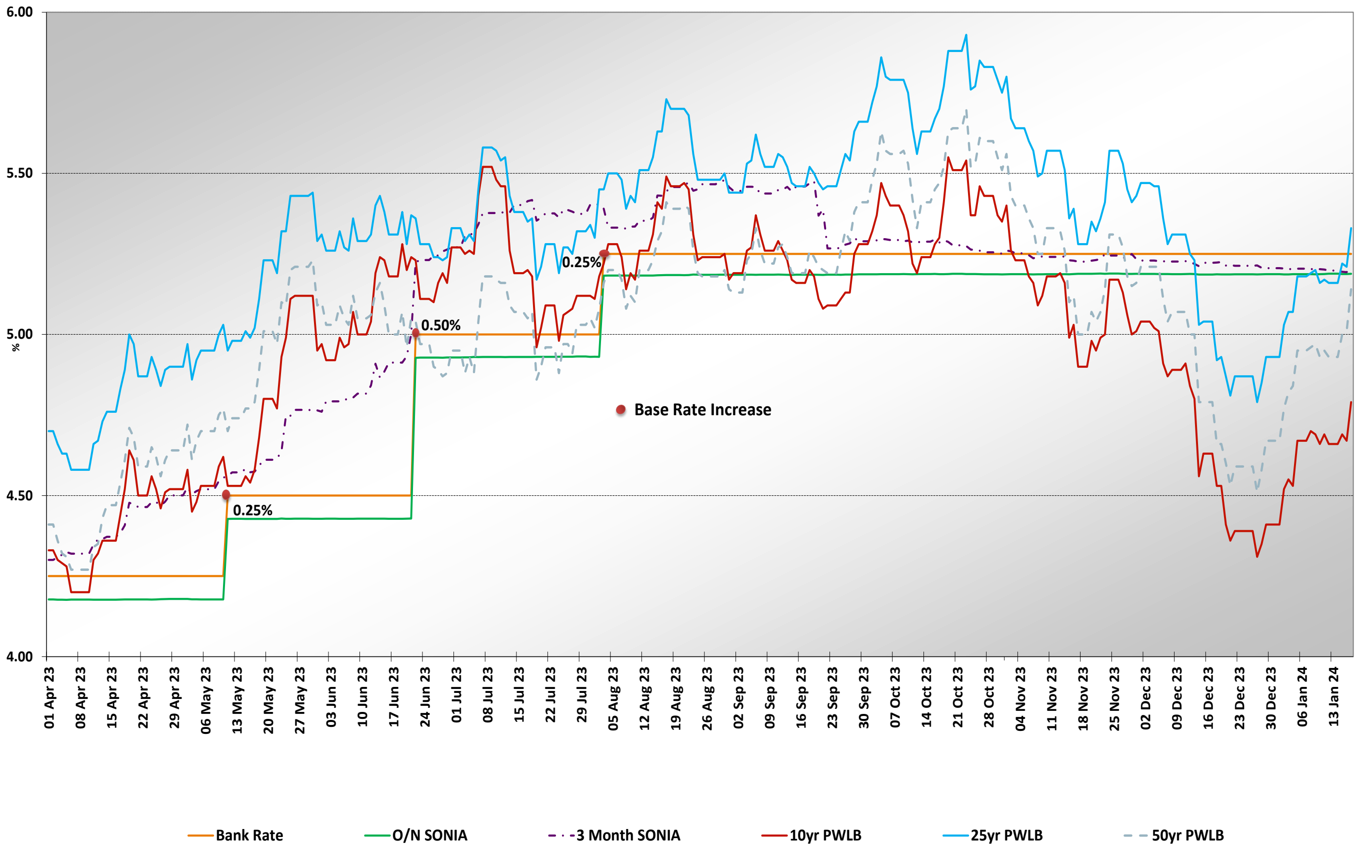
Appendix A

Movement of Key Interest Rates During 2023/24



Interest Rate Forecast – Link Asset Services Ltd (8 January 2024)

Link Group Interest Rate View 08.01.24													
	Mar-24	Jun-24	Sep-24	Dec-24	Mar-25	Jun-25	Sep-25	Dec-25	Mar-26	Jun-26	Sep-26	Dec-26	Mar-27
BANK RATE	5.25	5.25	4.75	4.25	3.75	3.25	3.00	3.00	3.00	3.00	3.00	3.00	3.00
3 month ave earnings	5.30	5.30	4.80	4.30	3.80	3.30	3.00	3.00	3.00	3.00	3.00	3.00	3.00
6 month ave earnings	5.20	5.10	4.60	4.10	3.70	3.30	3.10	3.10	3.10	3.10	3.10	3.10	3.10
12 month ave earnings	5.00	4.90	4.40	3.90	3.60	3.20	3.10	3.10	3.10	3.10	3.10	3.20	3.20
5 yr PWLB	4.50	4.40	4.30	4.20	4.10	4.00	3.80	3.70	3.60	3.60	3.50	3.50	3.50
10 yr PWLB	4.70	4.50	4.40	4.30	4.20	4.10	4.00	3.90	3.80	3.70	3.70	3.70	3.70
25 yr PWLB	5.20	5.10	4.90	4.80	4.60	4.40	4.30	4.20	4.20	4.10	4.10	4.10	4.10
50 yr PWLB	5.00	4.90	4.70	4.60	4.40	4.20	4.10	4.00	4.00	3.90	3.90	3.90	3.90

Economic and Interest Rate Commentary– Link Asset Services Ltd- Quarter Ended 31st December 2023

- The third quarter of 2023/24 saw:
  - **A 0.3% m/m decline in real GDP in October**, potentially partly due to unseasonably wet weather, but also due to the ongoing drag from higher interest rates. Growth for the second quarter, ending 30th September, was revised downwards to -0.1% and **growth on an annual basis was also revised downwards, to 0.3%;**
  - **A sharp fall in wage growth**, with the headline 3myy rate declining from 8.0% in September to 7.2% in October, although the ONS "experimental" rate of unemployment has remained low at 4.2%;
  - **CPI inflation continuing on its downward trajectory**, from 8.7% in April to 4.6% in October, then again to 3.9% in November;
  - Core CPI inflation decreasing from April and May's 31 years' high of 7.1% to 5.1% in November, the lowest rate since January 2022;
  - **The Bank of England holding rates at 5.25% in November and December**;
  - A steady fall in 10-year gilt yields as investors revised their interest rate expectations lower.

- At its 14th December meeting, the Bank of England's Monetary Policy Committee (MPC) kept rates on hold for the third time in a row, pushing back against the prospect of near-term interest rate cuts. The vote in favour of keeping rates on hold was 6-3.

- However, recent softer wage and inflation data (annual CPI is currently 3.9%) mean that markets have moved significantly in the direction of Link's November interest rate forecast, pricing in a first rate cut in Q2 2024, a full quarter earlier than our own forecast which has only undergone a little fine-tuning today**. Link now expects Bank Rate to be cut to 4.25% by the end of 2024 (4.5% previously) and 3% by the end of 2025.** The low point of the interest rate cycle is also expected to be 3%.

- Regarding the Bank of England, it continued to sound hawkish last month. Indeed, the evidence of subsiding price pressures did not dissuade the more hawkish members of the Monetary Policy Committee (MPC) – Catherine Mann, Megan Greene and Jonathan Haskel – from again voting to raise interest rates by 25 basis points (bps). The MPC maintained its tightening bias saying that "further tightening in monetary policy would be required if there were evidence of more persistent inflationary pressures". And it reiterated that policy will be "sufficiently restrictive for sufficiently long" and that "monetary policy is likely to need to be restrictive for an extended period of time".

- At the time of the meeting, the Bank did not appear to have taken any comfort from subsiding price pressures in the US and the Eurozone either, saying that measures of inflation persistence are higher in the UK than in other major advanced economies. And its statement that relative to developments in the US and the Eurozone "measures of wage inflation were considerably higher in the UK and services price inflation had fallen back by less so far". Nonetheless, even if the Bank would prefer to cut interest rates after the Fed and the ECB, **Capital Economics' forecast for the CPI measure of inflation to drop below 2% by April, and for core inflation to drop below 2% only three months later, further convinces us that rates will be cut sharply in the second half of 2024 if not before.**

- Since the December rate decision, the Bank's hawkish bias has also not prevented the markets from forming a view that rates will be falling soon. Accordingly, swap rates and gilt yields have reduced significantly over the past month despite a partial rebound upwards since the turn of the year. This will have the effect of ensuring upcoming mortgage rate resets (c400k per quarter) will be somewhat lower than they were through the second half of 2023. Indeed, it is noteworthy that the Halifax house price index has recently moved into positive territory after registering only a slight fall in house prices from their peak in the summer of 2022.

- Looking further afield, we suspect the **wider economy may only endure the lightest of recessions or, possibly, not at all.** Clients will recall that the Bank's November Quarterly Monetary Policy Report saw it revise down its Q3 and Q4 GDP forecasts for 2023 and its annual forecast for 2024 from 0.4% to 0.0% (2023 stayed at 0.5%). But it could be this outlook underestimates the robustness and resilience of the UK economy, particularly considering upward revisions to GDP stemming from the pandemic years.

- As outlined in November, there are, of course, significant risks to our central forecast. First, we are probably still in the early days of the Gaza-Israel conflict, and a meaningful and prolonged shift up in oil prices from $75 per barrel to something closer to $120 would keep inflation higher for longer. Furthermore, the UK domestic labour market is still having to contend with very low unemployment (4.2%) and the total number of job vacancies is only a little below one million. Even if Labour takes over the governmental reins in the next year or so, it is unlikely that a fundamental overhaul of immigration policy, with a view to addressing staff shortages in various sectors of the economy, is going to be a priority, so keeping a lid on wages is going to be a tough challenge even if some of the more recent signs are that wage growth is moderating (still c7% y/y).

- Regarding PWLB rates, movement in the **short part of the curve has reflected the revised 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 by the market's appetite for significant gilt issuance.** Indeed, although we have a slightly lower starting point for the envisaged reduction in short and medium dated gilts, **we now forecast the 10, 25 and 50 years part of the curve to not fall quite as low as we thought in November.**

- Furthermore, a General Election is expected in the 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. That may mean that Bank Rate stays elevated for a little longer than our central forecast.

- Of course, what happens outside of the UK remains critical to movement in gilt yields as well. The ECB 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%.

A SUMMARY OVERVIEW OF THE FUTURE PATH OF BANK RATE

- Our central forecast for interest rates was previously updated on 7 November and reflected a view that the MPC would be keen to further demonstrate its anti-inflation credentials by keeping Bank Rate at 5.25% until at least H2 2024. **We expect rate cuts to start when both the CPI inflation and wage/employment data are supportive of such a move, and when there is a likelihood of the overall economy enduring at least a slowdown or mild recession** over the coming months (although most recent GDP releases have surprised with their on-going robustness).

- Naturally, timing on this matter 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, and Gaza and Israel.

PWLB RATES

- The short and medium part of the gilt curve has rallied since the start of November as markets price in a quicker reduction in Bank Rate through 2024 and 2025 than held sway back then. This reflects market confidence in inflation falling back in a similar manner to that already seen in the US and the Euro-zone. At the time of writing there is c70 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 even**.

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.

- **Geopolitical risks,** for example in Ukraine/Russia, the Middle East, China/Taiwan/US, Iran and North Korea, which could lead to increasing safe-haven flows.

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

- Despite the tightening in Bank Rate to 5.25%, the **Bank of England allows inflationary pressures to remain elevated** for a long 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, which may prove inflationary, resulting in investors pricing in a risk premium for holding UK sovereign debt.

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

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