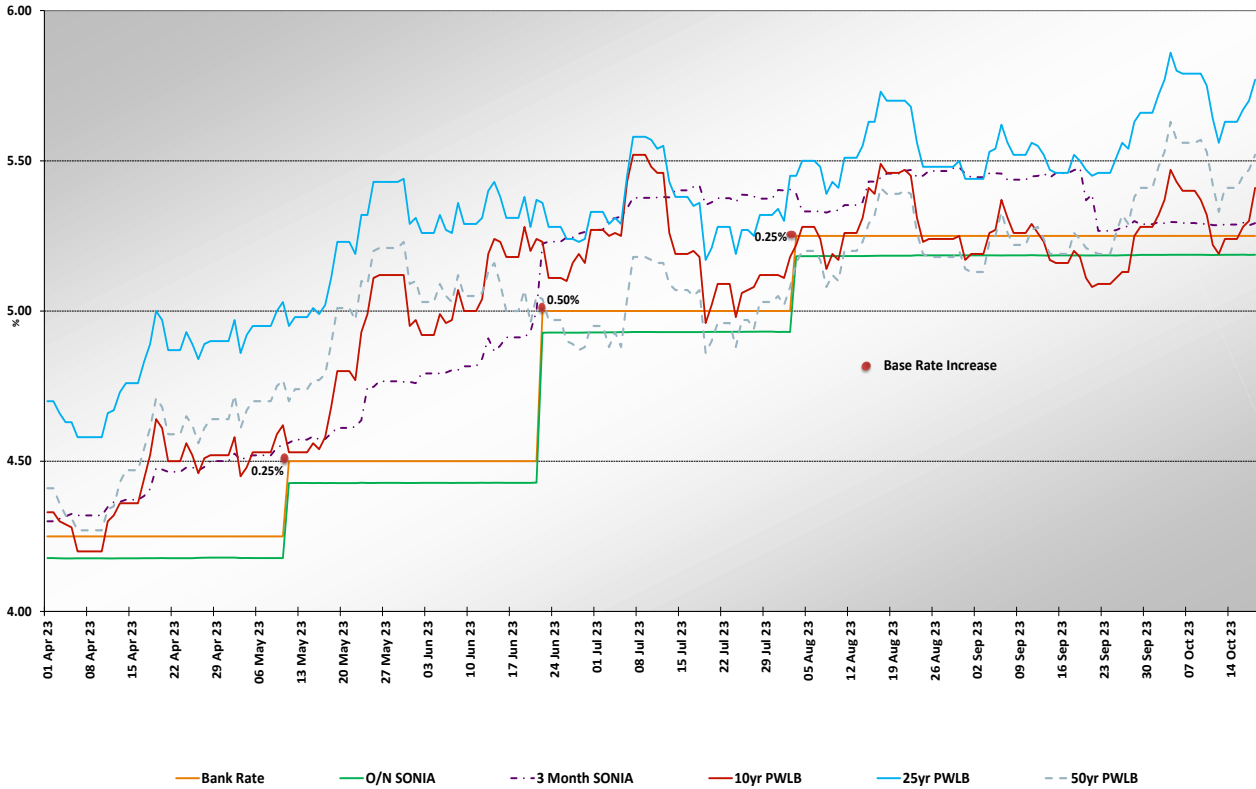


Movement of Key Interest Rates During 2023/24



Interest Rate Forecast – Link Asset Services Ltd (7 November 2023)

Link Group Interest Rate View 07.11.23													
	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	3.25	3.00	3.00	3.00	3.00	3.00
3 month ave earnings	5.30	5.30	5.30	5.00	4.50	4.00	3.50	3.30	3.00	3.00	3.00	3.00	3.00
6 month ave earnings	5.60	5.50	5.40	5.10	4.60	4.10	3.60	3.40	3.10	3.10	3.10	3.10	3.10
12 month ave earnings	5.80	5.70	5.50	5.20	4.70	4.20	3.70	3.50	3.30	3.30	3.30	3.30	3.30
5 yr PWLB	5.00	4.90	4.80	4.70	4.40	4.20	4.00	3.80	3.70	3.60	3.50	3.50	3.50
10 yr PWLB	5.10	5.00	4.80	4.70	4.40	4.20	4.00	3.80	3.70	3.70	3.60	3.60	3.50
25 yr PWLB	5.50	5.30	5.10	4.90	4.70	4.50	4.30	4.20	4.10	4.10	4.00	4.00	4.00
50 yr PWLB	5.30	5.10	4.90	4.70	4.50	4.30	4.10	4.00	3.90	3.90	3.80	3.80	3.80

Economic and Interest Rate Commentary– Link Asset Services Ltd- Mid Term Report Ended 30th September 2023

- The first half of 2023/24 saw:
 - Interest rates rise by a further 100bps, taking Bank Rate from 4.25% to 5.25% and, possibly, the peak in the tightening cycle.
 - Short, medium and long-dated gilts remain elevated as inflation continually surprised to the upside.
 - A 0.5% m/m decline in real GDP in July, mainly due to more strikes.
 - CPI inflation falling from 8.7% in April to 6.7% in August, its lowest rate since February 2022, but still the highest in the G7.
 - Core CPI inflation declining to 6.2% in August from 7.1% in April and May, a then 31 years high.
 - A cooling in labour market conditions, but no evidence yet that it has led to an easing in wage growth (as the 3myy growth of average earnings rose to 7.8% in August, excluding bonuses).
- The 0.5% m/m fall in GDP in July suggests that underlying growth has lost momentum since earlier in the year. Some of the weakness in July was due to there being almost twice as many working days lost to strikes in July (281,000) than in June (160,000). But with output falling in 10 out of the 17 sectors, there is an air of underlying weakness.
- The fall in the composite Purchasing Managers Index from 48.6 in August to 46.8 in September left it at its lowest level since COVID-19 lockdowns reduced activity in January 2021. At face value, it is consistent with the 0.2% q/q rise in real GDP in the period April to June, being followed by a contraction of up to 1% in the second half of 2023.
- The 0.4% m/m rebound in retail sales volumes in August is not as good as it looks as it partly reflected a pickup in sales after the unusually wet weather in July. Sales volumes in August were 0.2% below their level in May, suggesting much of the resilience in retail activity in the first half of the year has faded.
- As the growing drag from higher interest rates intensifies over the next six months, we think the economy will continue to lose momentum and soon fall into a mild recession. Strong labour demand, fast wage growth and government handouts have all supported household incomes over the past year. And with CPI inflation past its peak and expected to decline further, the economy has got through the cost-of- living crisis without recession. But even though the worst of the falls in real household disposable incomes are behind us, the phasing out of financial support packages provided by the government during the energy crisis means real incomes are unlikely to grow strongly. Higher interest rates will soon bite harder too. We expect the Bank of England to keep interest rates at the probable peak of 5.25% until the second half of 2024. Mortgage rates are likely to stay above 5.0% for around a year.

- The tightness of the labour market continued to ease, with employment in the three months to July falling by 207,000. The further decline in the number of job vacancies from 1.017m in July to 0.989m in August suggests that the labour market has loosened a bit further since July. That is the first time it has fallen below 1m since July 2021. At 3.0% in July, and likely to have fallen to 2.9% in August, the job vacancy rate is getting closer to 2.5%, which would be consistent with slower wage growth. Meanwhile, the 48,000 decline in the supply of workers in the three months to July offset some of the loosening in the tightness of the labour market. That was due to a 63,000 increase in inactivity in the three months to July as more people left the labour market due to long term sickness or to enter education. The supply of labour is still 0.3% below its pre-pandemic February 2020 level.
- But the cooling in labour market conditions still has not fed through to an easing in wage growth. While the monthly rate of earnings growth eased sharply from an upwardly revised +2.2% in June to -0.9% in July, a lot of that was due to the one-off bonus payments for NHS staff in June not being repeated in July. The headline 3myy rate rose from 8.4% (revised up from 8.2%) to 8.5%, which meant UK wage growth remains much faster than in the US and in the Euro-zone. Moreover, while the Bank of England's closely watched measure of regular private sector wage growth eased a touch in July, from 8.2% 3myy in June to 8.1% 3myy, it is still well above the Bank of England's prediction for it to fall to 6.9% in September.
- CPI inflation declined from 6.8% in July to 6.7% in August, the lowest rate since February 2022. The biggest positive surprise was the drop in core CPI inflation, which declined from 6.9% to 6.2%. That reverses all the rise since March and means the gap between the UK and elsewhere has shrunk (US core inflation is 4.4% and in the Euro-zone it is 5.3%). Core goods inflation fell from 5.9% to 5.2% and the further easing in core goods producer price inflation, from 2.2% in July to a 29-month low of 1.5% in August, suggests it will eventually fall close to zero. But the really positive development was the fall in services inflation from 7.4% to 6.8%. That also reverses most of the rise since March and takes it below the forecast of 7.2% the Bank of England published in early August.
- In its latest monetary policy meeting on 20 September, the Bank of England left interest rates unchanged at 5.25%. The weak August CPI inflation release, the recent loosening in the labour market and the downbeat activity surveys appear to have convinced the Bank of England that it has already raised rates far enough. The minutes show the decision was "finely balanced". Five MPC members (Bailey, Broadbent, Dhingra, Pill and Ramsden) voted for no change and the other four (Cunliffe, Greene, Haskel and Mann) voted for a 25bps hike.
- Like the US Fed, the Bank of England wants the markets to believe in the higher for longer narrative. The statement did not say that rates have peaked and once again said if there was evidence of more persistent inflation pressures "further tightening in policy would be required". Governor Bailey stated, "we'll be watching closely to see if further increases are needed". The Bank also retained the hawkish guidance that rates will stay "sufficiently restrictive for sufficiently long".

- This narrative makes sense as the Bank of England does not want the markets to decide that a peak in rates will be soon followed by rate cuts, which would loosen financial conditions and undermine its attempts to quash inflation. The language also gives the Bank of England the flexibility to respond to new developments. A rebound in services inflation, another surge in wage growth and/or a further leap in oil prices could conceivably force it to raise rates at the next meeting on 2nd November, or even pause in November and raise rates in December.
- The yield on 10-year Gilts fell from a peak of 4.74% on 17th August to 4.44% on 29th September, mainly on the back of investors revising down their interest rate expectations. But even after their recent pullback, the rise in Gilt yields has exceeded the rise in most other Developed Market government yields since the start of the year. Looking forward, once inflation falls back, Gilt yields are set to reduce further. A (mild) recession over the next couple of quarters will support this outlook if it helps to loosen the labour market (higher unemployment/lower wage increases).
- The pound weakened from its cycle high of \$1.30 in the middle of July to \$1.21 in late September. In the first half of the year, the pound bounced back strongly from the Truss debacle last autumn. That rebound was in large part driven by the substantial shift up in UK interest rate expectations. However, over the past couple of months, interest rate expectations have dropped sharply as inflation started to come down, growth faltered, and the Bank of England called an end to its hiking cycle.
- The FTSE 100 has gained more than 2% since the end of August, from around 7,440 on 31st August to 7,608 on 29th September. The rebound has been primarily driven by higher energy prices which boosted the valuations of energy companies. The FTSE 100's relatively high concentration of energy companies helps to explain why UK equities outperformed both US and Euro-zone equities in September. Nonetheless, as recently as 21st April the FTSE 100 stood at 7,914.

A SUMMARY OVERVIEW OF THE FUTURE PATH OF BANK RATE

- Our central forecast for interest rates was previously updated on 25 September 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 that there is a likelihood of the overall economy enduring at least a 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.
- On the positive side, consumers are still anticipated 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, as noted previously, most of those excess savings are held by more affluent households 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 broadened since our last Newsflash. The short part of the curve has not moved far but the longer-end continues to reflect inflation concerns. At the time of writing there is 60 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, 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 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. (We saw some movements of this type through October although generally reversed in the last week or so.)

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