Appendix 1

Brighton & Hove City Council
Economic Overview and Interest Rate prospect 2018/19

The council has appointed Link Asset Services as its treasury advisor and part of their service is to assist the council to formulate a view on interest rates. The commentary below and the interest rate forecast at Table A below provide the treasury advisor's central view.

Economic Background

The Monetary Policy Committee (MPC) delivered a 0.25% increase in Bank Rate at its meeting on 2 November. This removed the emergency cut in August 2016 after the EU referendum. The MPC also gave forward guidance that they expected to increase Bank rate only twice more by 0.25% by 2020 to end at 1.00%. At its February 2018 meeting, there was no change in Bank Rate but the forward guidance changed significantly to warn of "earlier, and greater than anticipated" rate of increases in Bank compared to their previous forward guidance. The forecast at Table A includes increases in Bank Rate of 0.25% each in May and November 2018, November 2019 and August 2020.

The overall longer trend is for gilt yields and therefore PWLB rates to rise, albeit gently. It has long been expected, that at some point, there would be a more protracted move from bonds to equities after a historic long-term trend, over about the last 25 years, of falling bond yields. Since the financial crash of 2008, the action of central banks in implementing substantial Quantitative Easing amplified this downward trend in bond yields and rising bond prices. Quantitative Easing has also directly led to a rise in equity values as investors searched for higher returns and took on riskier assets. There was a sharp rise in bond yields after the US Presidential election in November 2016 and further increases in as a result of an agreement to a significant increase in the US government deficit aimed at stimulating economic growth and some reversing of monetary policy by the US Central Bank (The Fed). We have also seen a sharp selloff in equities and bonds in February 2018 that has given further impetus to a rise in bond yields.

Until 2015, monetary policy was focused on providing stimulus to economic growth but has since started to refocus on countering the threat of rising inflationary pressures as stronger economic growth becomes more firmly established. The Fed has started raising interest rates and this trend is expected to continue during 2018 and 2019. These increases will make holding US bonds much less attractive and cause their prices to fall, and therefore bond yields to rise. Rising bond yields in the US are likely to cause an increase in bond yields in the UK and other developed economies. However, the degree of influence is likely to be offset by the prospects for economic growth and inflation in each country, and on the degree of progress towards the reversal of monetary policy away from quantitative easing and other credit stimulus measures.

From time to time, gilt yields – and therefore PWLB rates - can be subject to exceptional levels of volatility due to geo-political, sovereign debt crisis, emerging market developments and changes in investor sentiment. Such volatility could occur at any time during the forecast period.

Borrowing & Investment Rates

Economic and interest rate forecasting remains difficult with so many external influences weighing on the UK. Forecasts (and MPC decisions) will be liable to further amendment depending on how economic data and developments in financial markets transpire over the next year. Geopolitical developments, especially in the EU, could also have a major impact. Forecasts for average investment earnings beyond the three-year time horizon will be heavily dependent on economic and political developments.

The overall balance of risks to economic recovery in the UK is probably to the downside (i.e. pushing rates downwards), particularly with the current level of uncertainty over the final terms of Brexit.

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

- The Bank of England 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 which could lead to increasing safe haven flows.
- A resurgence of the Eurozone sovereign debt and/or weak capitalisation of some European banks
- Potential challenges over the leadership and direction of the EU as a result of a combination of a number of factors. Germany is still without a fully agreed and stable coalition government after the inconclusive result of the general election in October, Italy's election of 4th March resulted in no majority, with the party looking to have the biggest representation in party being the anti-EU populist party of Five Star added to other election results (such as in the Czech Republic and Austria) which has seen other Anti-EU parties having strong representation.
- US domestic economic and fiscal policy
- A 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 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 Quantitative Easing, 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.
- 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, whether domestically generated or imported, returning to sustained significantly higher levels causing an increase in the inflation premium inherent to gilt yields.

Table A – Interest Rate forecasts April 2018 to March 2021 (annual averages)

	Bank Rate	Returns on liquid Investments*	Long-term borrowing rates		
			5 year	25 year	50 year
2018/19	0.88%	0.80%	2.10%	3.05%	2.85%
2019/20	1.13%	1.25%	2.35%	3.30%	3.10%
2020/21	1.44%	1.50%	2.55%	3.55%	3.35%

(Source – Capital Asset Services: Interest Rate Forecast, February 2018)

** Liquid investments are defined as those invested for less than 3 months. The council has budgeted for an average investment return of 0.90% in 2018/19.*