REVIEW OF ECONOMIC CONDITIONS FROM APRIL TO SEPTEMBER 2018 AND FUTURE OUTLOOK

This section has been prepared by the Council's Treasury Advisors, Link Asset Services, and includes their forecast for future interest rates.

1 ECONOMIC PERFORMANCE TO DATE 2018/19

1.1 The first half of 2018/19 has seen UK economic growth post a modest performance, but sufficiently robust for the Monetary Policy Committee to unanimously (9-0) vote to increase Bank Rate on 2nd August from 0.5% to 0.75%. Although growth looks as if it will record no more than 1.5% for 2018, the Bank of England's Quarterly Inflation Report, also released in August, suggests that growth will pick up to 1.8% in 2019, albeit there are several caveats – mainly related to whether or not the UK achieves an orderly withdrawal from the European Union in March 2019.

1.2 In particular, some Monetary Policy Committee (MPC) members have expressed concerns about inflation threatening price stability (a similar theme to this time last year), particularly with the £ weak against both the US dollar and the Euro. The Consumer Price Index (CPI) measure of inflation is currently running at 2.5% but is expected to fall back towards the 2% inflation target over the next two years if minimal increases in Bank Rate materialise. The MPC has indicated Bank Rate would need to be in the region of 1.5% by March 2021 for inflation to stay on track. The market is currently pricing in the next increase in Bank Rate for the second half of 2019.

1.3 With regard to unemployment, on the Independent Labour Organisation measure this is now at a 43 year low of 4%, but there is not much in the way of wage pressure at present. This is a global theme for the major economic power houses of the world. Indeed, with UK wages running in line with the CPI measure of inflation, real earnings are, in effect, neutral. Given the UK economy is very much services sector driven, any weakness in household spending power is likely to materialise in the form of tepid growth. This is another reason why the MPC must tread cautiously before increasing Bank Rate further. Additionally, business sentiment surveys, such as the Purchasing Managers Index collated by Markit, suggest the UK is set for growth of no more than 0.8% in the second half of 2018, whilst the housing market is going through a weak phase – with UK-wide house price growth in the region of 2% to 3%, but with areas of London and the south-east experiencing price falls.

1.4. From a political perspective, there is always the possibility of the Conservative minority government imploding over Brexit issues, but our central position is that Prime Minister May's government will muddle through despite various setbacks along the route to Brexit. If, however, we find ourselves facing a General Election in the next 12 months, there could be a potential loosening of monetary policy as a consequence, whilst medium to longer dated gilt yields could rise on the expectation of a weak £ and concerns of inflation picking up.

1.5 Looking at the US, President Trump's massive easing of fiscal policy has led to a (temporary) boost in consumption which has fuelled strong growth, upwards of 1% in Q2 2018, but also inflationary factors. With inflation moving towards 3%, the Fed has already tightened the Fed Funds interest rate to between 1.75% and 2%, and a further two increases to 2.25% - 2.5% is expected before the end of 2018 with the prospect of another increase or two next year. The dilemma, however, is what to do when the temporary boost to consumption wanes, particularly as the recent imposition of tariffs on a number of countries' exports to the US (China in particular) could see a switch to US production of some of those goods but at higher prices. Such a scenario would invariably make any easing of monetary policy harder for the Fed in the second half of 2019.

1.6 In respect of the Eurozone, growth has undershot early forecasts for a strong economic performance in 2018. In particular, data from Germany has been mixed – and they too could be negatively impacted by US tariffs on a significant part of their manufacturing exports e.g. cars. For that reason, although growth is still expected to be in the region of 2% for 2018, the horizon is less clear than it seemed just a short while ago.

1.7 Interest Rate Summary

In summary, our forecasts assume a modest and careful set of increases in Bank Rate over the next three years, with the next increase pencilled in for May 2019, but much of any monetary policy tightening will be dependent on an orderly Brexit. We forecast Bank Rate to be at 1.5% at March 2021. We also believe that where the Bank of England has stated that the neutral rate for Bank Rate will be in the range of 2% to 3% in the medium term, the fragility of consumer confidence and the current housing market, paired with little evidence of a substantive real wages increase occurring, suggests Bank Rate would settle at the lower end of this spectrum in the current economic cycle.

1.8 Our central view also assumes only a modest upward movement in gilt yields through to 2021 as the economy performs broadly in line with the levels forecast by the Bank of England. Our PWLB Certainty Rate forecasts are set out below.

Link Asset Services Interest Rate View											
	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21
Bank Rate View	0.75%	0.75%	0.75%	0.75%	1.00%	1.00%	1.00%	1.25%	1.25%	1.50%	1.50%
3 Month LIBID	0.75%	0.80%	0.80%	0.90%	1.10%	1.10%	1.20%	1.40%	1.50%	1.60%	1.60%
6 Month LIBID	0.85%	0.90%	0.90%	1.00%	1.20%	1.20%	1.30%	1.50%	1.60%	1.70%	1.70%
12 Month LIBID	1.00%	1.00%	1.00%	1.10%	1.30%	1.30%	1.40%	1.60%	1.70%	1.80%	1.80%
5yr PWLB Rate	2.00%	2.00%	2.10%	2.20%	2.20%	2.30%	2.30%	2.40%	2.50%	2.50%	2.60%
10yr PWLB Rate	2.40%	2.50%	2.50%	2.60%	2.70%	2.70%	2.80%	2.90%	2.90%	3.00%	3.10%
25yr PWLB Rate	2.80%	2.90%	3.00%	3.10%	3.10%	3.20%	3.30%	3.30%	3.40%	3.50%	3.50%
50yr PWLB Rate	2.60%	2.70%	2.80%	2.90%	2.90%	3.00%	3.10%	3.10%	3.20%	3.30%	3.30%

1.9 Naturally, uncertainties abound and chief amongst those from an international perspective are the following:

- The degree to which the various on-going trade and geopolitical spats involving the US impact investor confidence on a global scale. In recent months, we have seen verbal confrontation, with economic policy implications, involving North Korea, the Eurozone, Canada, Russia and Turkey to name but a few.

- In addition, Italy has a populist government comprising the Northern Alliance and the Five Star Movement. There is the possibility that an anti-EU/austerity policy snowballs in the coming months with repercussions for the EZ bloc as a whole.

- Oil prices have risen substantially over the course of the last 12 months, any further protracted increases in oil or other core commodity prices could have a destabilising effect on global growth.