Forecast for Interest Rates – September 2011

SUMMARY OUTLOOK

Sector has undertaken a review of our interest rate forecasts as a result of two major events: -

1. The decision by the MPC to expand quantitative easing over the next four months by a further £75bn which had an immediate effect of depressing gilt yields at the long end of the curve. It also clearly underlines how concerned the MPC now is about the prospects for growth of the UK economy and that recession is now decisively a much greater concern than inflation.

2. The marked deterioration of growth prospects in the US, EU and UK, especially as concerns have further increased over Greece and the potential fall out from their debt situation. This has led in turn to a further increase in safe haven flows into UK gilts since our last interest rate forecast (16.8.11) which have depressed gilt yields and PWLB rates to even lower levels.

These developments had left our short term forecasts for PWLB rates markedly out of line with actual rates. They have also substantially pushed back our expectations of the timing of the eventual start of increases in Bank Rate and the expected eventual rise in gilt yields and PWLB rates.

In summary, our concerns around a slow down in prospects for GDP growth in the western world are as follows: --

US

- Current weak GDP growth; jobless recovery
- Fed unlikely to increase central rate until mid 2013
- Latest Fed Twist operation unlikely to save US economy from weak growth in the shorter term
- Near exhaustion of major fiscal and monetary remedies
- Political gridlock ahead of Nov 2012 Presidential elections for major fiscal action
- New President unlikely to make significant impact on the US economy in 2013
- Housing market still fraught and banks face rising losses on mortgages which will lead in turn to restricted supply of credit to the economy; little hope of the housing market turning around in the near future

EU

- Sovereign debt crisis is morphing into an EU banking crisis where some weaker banks will need semi-nationalisation to cope with a major write down of Greek debt, resulting in an increase in government debt levels. This in turn could threaten (e.g.) the French AAA rating and lead to an increase in concerns for the size of the French debt to GDP ratio
- EU economy now heading into recession in 2012; increasing lack of supply of bank credit plus major fall in consumer and business confidence will inhibit economic growth

- High risk that 17 Euro zone nations will not agree on what to do about Greece ahead of financial markets losing patience and precipitating a crisis
- German elections in 2013 getting ever closer; German voters hostile to bailing out Greece and other weak peripherals

UK

- 40% of UK GDP dependent on overseas trade; high correlation of UK growth to US and EU GDP growth means that the UK economy may only barely escape recession in the next two years
- Consumers have paid down total debt to income ratio from 180% in 2008 to 160%. OBR forecasts March 2011 for GDP growth of 2.5% in 2012 and 3.0% in the following three years are predicated on an increase in consumer spending and borrowing taking that ratio back to 175% by 2015 i.e. an increase of £570bn in debt. This is highly unlikely given current consumer sentiment, job fears, high inflation eroding disposable incomes, small or no pay increases, mortgagors coming off initial cheap fixed rate deals onto higher SVR rates etc.
- Little sign of a coordinated strategy for the private sector to finance a major expansion of infrastructure investment to boost UK growth
- Little sign of a major increase in exports to boost UK growth
- QE2 likely to be too little too late to boost UK growth significantly in the near term

CHINA

- Increasing concerns that efforts to gently slowdown the economy to cool inflation could lead into a hard landing.