Appendix 3

ECONOMIC BACKGROUND

1 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.
- CPI inflation falling from 8.7% in April to 6.7% in September, its lowest rate since February 2022, but still the highest in the G7.
- Core CPI inflation declining to 6.1% in September 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 by 7.8% for the period June to August, excluding bonuses).

2 The registering of 0% GDP for Q3 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.

3 The fall in the composite Purchasing Managers Index from 48.6 in August to 46.7 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% q/q rise in real GDP in the period July to September, being followed by a contraction in the next couple of quarters.

4 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.

5 Over the next six months, the economy may slow down and possibly experience a mild recession because of higher interest rates. However, the economy has been supported by strong labour demand, fast wage growth, and government handouts over the past year. Although the cost-of-living crisis is 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. Moreover, higher interest rates will soon have a stronger impact. We expect interest rates to remain at a peak of 5.25% until the second half of 2024, and mortgage rates are likely to stay above 5.0% for around a year. On the bright side, CPI inflation has peaked and is expected to decline further.

6 Employment fell by 207,000 between May and July 2021, and job vacancies decreased from 1.017 million in July to 0.989 million in August. The job vacancy rate was 3.0% in July and is expected to have decreased to 2.9% in August, indicating slower wage growth. The labour supply is still 0.3% lower than its pre-pandemic level in February 2020.

7 The cooling in the labour market conditions hasn't yet caused a decrease in wage growth. The 3-month year-on-year rate increased by 7.8% from June to August, which means that UK wage growth is still much faster than in the US and the Eurozone. Additionally, the Bank of England's closely monitored measure of regular annual average total pay growth for the private sector was 7.1% in June to August 2023. However, for the public sector, it was 12.5%, which is the highest total pay annual growth rate since comparable records began in 2001. Nevertheless, this is influenced by the NHS and civil service one-off non-consolidated payments made in June, July,

and August 2023. The Bank of England's prediction was for private sector wage growth to fall to 6.9% in September.

8 CPI inflation declined from 6.8% in July to 6.7% in August and September, the lowest rate since February 2022. The biggest positive surprise was the drop in core CPI inflation, which declined from 6.9% to 6.1%. That reverses all the rise since March.

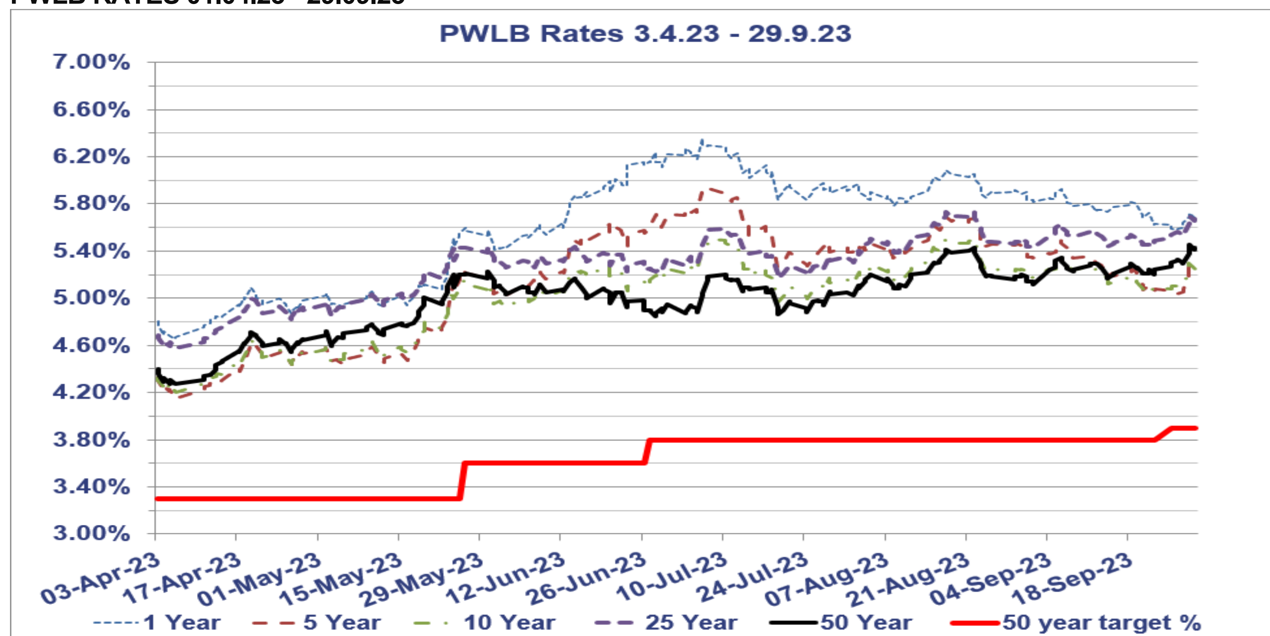
9 In its latest monetary policy meeting on 06 November, the Bank of England left interest rates unchanged at 5.25%. The vote to keep rates on hold was a split vote, 6-3. It is clear that some members of the MPC are still concerned about the stickiness of inflation.

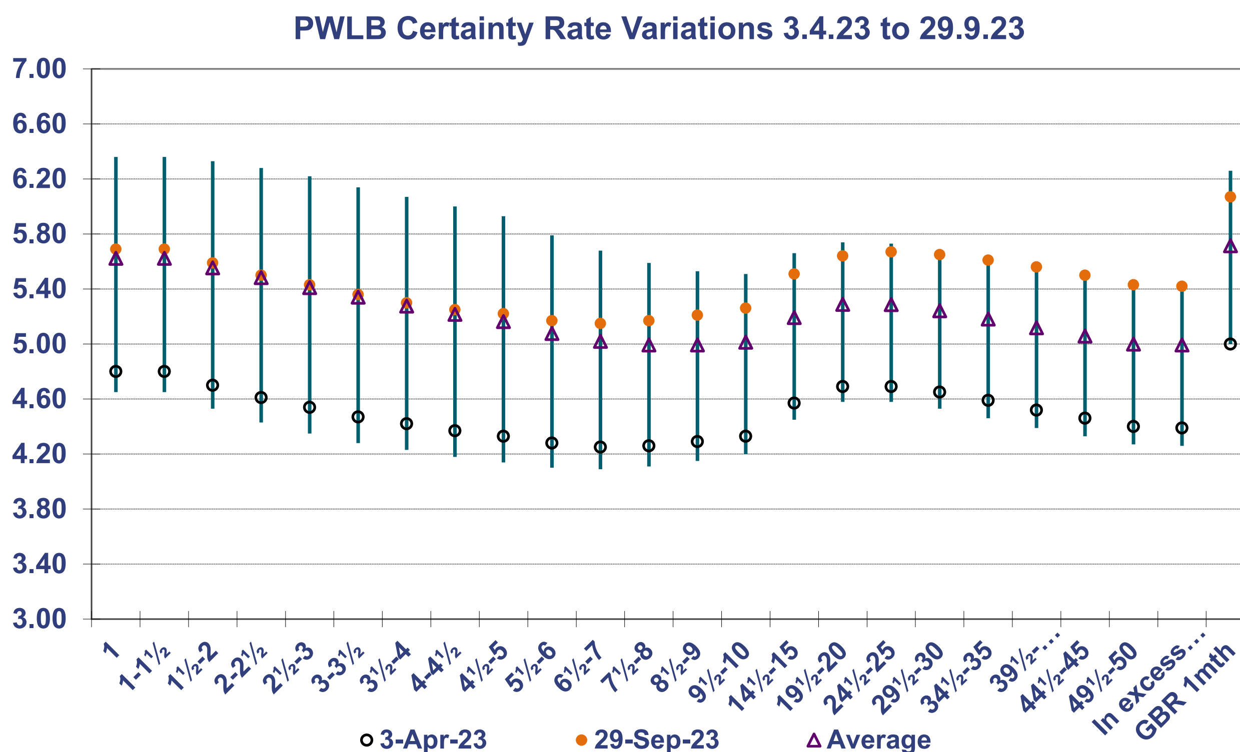
10 The Bank of England wants to keep markets believing in a higher-for-longer narrative. It hinted at further tightening in monetary policy if there are more persistent inflationary pressures. The Bank aims to squeeze inflation out of the economy and maintain a restrictive monetary policy for an extended period of time.

11 This explanation is logical because the Bank of England doesn't want the markets to assume that a peak in interest rates will be promptly followed by rate cuts. Doing so would ease financial conditions and hinder the Bank's efforts to tackle inflation. The Bank's language also allows it to be adaptable to changing circumstances. If there is a resurgence in services inflation, another increase in wage growth, or a further rise in oil prices, it could potentially be required to raise interest rates in the future.

In the table below, the rise in gilt yields across the curve as a whole in 2023/24, and therein PWLB rates, is clear to see.

PWLB RATES 01.04.23 - 29.09.23





HIGH/LOW/AVERAGE PWLB RATES FOR 01.04.23 – 29.09.23

	1 Year	5 Year	10 Year	25 Year	50 Year
Low	4.65%	4.14%	4.20%	4.58%	4.27%
Date	06/04/2023	06/04/2023	06/04/2023	06/04/2023	05/04/2023
High	6.36%	5.93%	5.51%	5.73%	5.45%
Date	06/07/2023	07/07/2023	22/08/2023	17/08/2023	28/09/2023
Average	5.62%	5.16%	5.01%	5.29%	5.00%
Spread	1.71%	1.79%	1.31%	1.15%	1.18%

The peak in medium to longer dated rates has generally arisen in August and September and has been primarily driven by continuing high UK inflation, concerns that gilt issuance may be too much for the market to absorb comfortably, and unfavourable movements in US Treasuries.

The S&P 500 and FTSE 100 have struggled to make much ground through 2023.

CENTRAL BANK CONCERNS

Currently, the Fed has pushed up US rates to a range of 5.25% to 5.5%, whilst the MPC followed by raising Bank Rate to 5.25%. EZ rates have also increased to 4%, with further tightening a possibility.

Ultimately, however, from a UK perspective it will not only be inflation data but also employment data that will mostly impact the decision-making process, although any softening in the interest rate outlook in the US may also have an effect (just as, conversely, greater tightening may also).