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Business Planning Assumptions

In this issue we highlight the potential for negative interest rates and the likelihood of short term negative inflation.

This Update	**July 2020**
Next Update	**October 2020**

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EXECUTIVE SUMMARY

We are very pleased to introduce the first issue of our quarterly Economic Outlook for Business Planning. Each quarter we will analyse a range of sources and current economic data to offer our own perspective on the prospects for inflation and interest rates and the UK economy.

Although COVID-19 is impacting on the whole UK economy, especially GDP growth, employment, inflation and interest rates, it would be easy to get carried away on this one issue. The UK has other serious issues to contend with, for example Brexit negotiations rumble on and political issues with China have emerged. One crisis would normally be bad enough but this time we have entered a perfect storm where the UK's reliance on services, international exposure to imports and lack of a manufacturing base has been exposed and shown to be lacking.

We are still relatively early in the midst of a deep crisis with no clear exit to normality. The latest industry forecasts for growth, inflation and interest rates already take into account most of what we already know about the current COVID-19 impact and Brexit. Even so a key problem is that economic forecasts are swiftly overtaken by events and quickly become dated. The chancellor's July announcements including a surprise VAT cut is a good example of this. For that reason, this quarter's forecasts should be read with extra caution.

Interest Rates

Globally, the world economies have experienced unprecedented contraction over the second quarter of 2020. In the UK, this has already led to colossal Government support and low interest rates, which were, prior to the pandemic close to historically low levels. The fiscal response to the crisis has prompted a complete reversal of policy. Instead of austerity we have prolificacy; a wall of money has been committed by the Chancellor to support the economy and head off an even worse crisis.

Bank Rate dropped to 0.1% on 19 March and looks set to stay there. A stampede to safety, plus Government bond purchases through Quantitative Easing have squashed long term fixed rates; bonds are in strong demand and some bond issuers have tapped the market at all-inclusive interest rates below 2%. In May the Government even issued a bond with a small negative overall return. On the plus side low interest rates will aid recovery and are fortunate for the Government because, despite the estimated £330 billion cost of the Government's largesse, the interest burden on the public purse will be lower. Total Government borrowing will hit £2 trillion in August; exactly how long we can continue to borrow such vast sums is open to question.

With the chancellor forecasting 4 million unemployed, further stimulation is inevitable. We see no prospect of this low interest rate environment unwinding any time soon and not before a pattern of recovery is firmly established. Overall, we consider negative interest rates to be unlikely but more QE is a good odds-on bet.

Inflation

CPI Inflation is currently well below the Monetary Policy Committee core target of 2%. It was 0.6% for the 12 months to June 2020, only fractionally higher than the 0.5% for May and well below the 1.8% in January. The figures for May and June could be an aberration. The reliability of CPI based on the basket of goods and services has been affected because the prices of 13% of weighted goods and services were unreliable under lockdown. In early July the Chancellor announced a cut in VAT for the hospitality industry, which although not all organisations will pass on, should influence a further fall in prices.

The uptick in June was unexpected; the trend has to be down. Whether or not inflation falls further is difficult to gauge for certain. Most published forecasts predate the VAT cut; generous public sector pay rises just announced and Government spending on infrastructure will take time to work through. The true jobs situation is masked by the furlough scheme and daily announcements of job cuts makes the outlook dire; continued social distancing will only reinforce our collective anxiety. The natural reaction in these circumstances is to rein in spending and that can only lead to continued falling prices in the short term.

Overall, over the next 3 months (to September 2020) economic forecasters are not expecting any material change in CPI. We expect CPI to reach 0% or even go slightly negative by September 2020 before it responds to stimulus in 2021. The September 2020 CPI rate will drive rent increases that take effect in 2021.

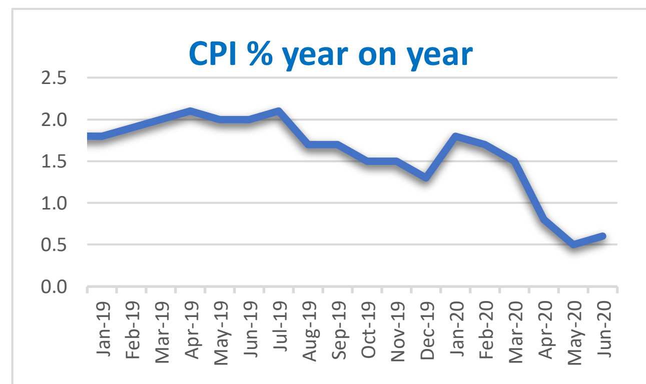
IMPORTANT NOTE - This quarterly update has been brought together from a range of external sources and compiled in the light of the latest economic data, as provided by the Office of Budget Responsibility ('OBR'); the Office of National Statistics ('ONS') and the Monetary Policy Committee ('MPC') of the Bank of England ('BoE'). It is intended to offer guidance to clients on reasonable and prudent levels of inflation and interest rate assumptions, for long-term business plans.

RECOMMENDED RATES FOR BUSINESS PLANNING

These are the current indicative business plan economic assumptions from 2TIX LTD.

INFLATION (Consumer Prices Index - CPI)

Current below-target CPI inflation can in large part be accounted for by the effects of the pandemic. CPI was showing an upward movement at the end of 2019 but this was been dramatically reversed due to COVID-19. The collapse in global oil prices in early 2020 had direct effects on inflation, via the prices of motor fuels, and indirect effects by reducing input costs in other sectors of the economy. The sharp fall in domestic activity is also adding to downward pressure on inflation through increased spare capacity in most sectors of the economy.



As a result of big contractions in previous months, the UK economy is now 24.5% smaller than it was in February 2020. The UK's economy rebounded more slowly than expected in May 2020, growing just 1.8% from the previous month, as the gradual easing of lockdown had a modest impact. Manufacturing and house building showed signs of recovery in May as some firms saw staff return to work.

Most business plans pre-COVID-19 were assuming inflation for 2021 of around 2% (give or take a little). The impact of the current crisis on world economies means this now needs to be revised down significantly in the short term, hence the 0.0% rate indicated. Like the OBR we expect a rebound in 2022 as the cost of Brexit and Government reaction to unemployment works through.

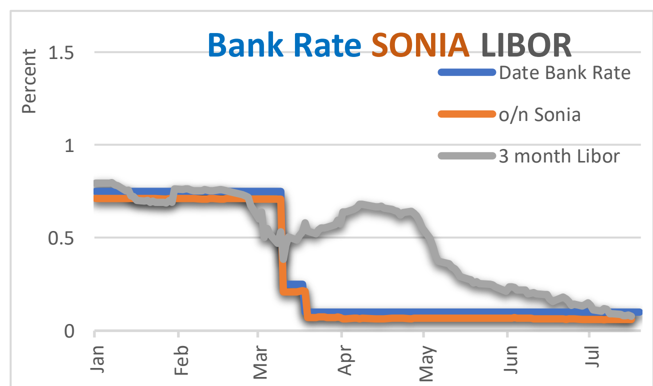
Recommended maximum CPI inflation assumptions:

For year ending:	Mar 21	Mar 22	Mar 23	Mar 24	Mar 25	Mar 26	Long Term
OBR Central Economic Scenario	0.3%	1.7%	n/a	n/a	n/a	n/a	n/a
2TIX LTD - CPI (based on preceding median Q3 - September)	**0.0%**	**1.5%**	**2.0%**	**2.0%**	**2.0%**	**2.0%**	**2.0%**

Estimated annual growth in average weekly earnings for employees in Great Britain in the three months to April 2020 was 1.0% for total pay (including bonuses) and 1.7% for regular pay (excluding bonuses). Annual growth has slowed sharply for both total and regular pay compared with the period prior to introduction of the coronavirus lockdown measures (December to February 2020), when it was 2.9%. At the start of the year there was increasing pressure for social housing landlords to consider real wage cost inflation in their business planning. The impact of COVID-9 on the wider economy has removed this threat and is likely to be replaced with inflation only increases.

VARIABLE INTEREST RATES

The switch from LIBOR to SONIA over the next 18 months needs to accelerate and the recent path of LIBOR only reinforces the need to change. 31 December 2021 has been confirmed as the back-stop date. Although there are significant procedural differences between LIBOR and SONIA the method of calculation agreed upon means there will be no material difference in variable interest rates going forward.



The potential for using negative interest rates in a crisis was the subject of a BoE review in 2013. Other countries, notably Denmark have tried but it has never been shown to be a resounding success. It risks destabilising the banking system by people hoarding cash. Although the issue has been raised again recently

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we do not consider it to be viable for the UK.

The emergency reaction by the BoE to lockdown was a reduction in the Bank Rate to 0.1% plus £200m more QE taking the total to £745 billion. There cannot be any material uplift in Bank Rate over the short term. With the prospect of negative interest rates unlikely the BoE has no option but to use QE to stimulate the economy. If, as is generally expected, the economy rebounds then we can expect the MPC to uplift Bank Rate during the second half of 2021.

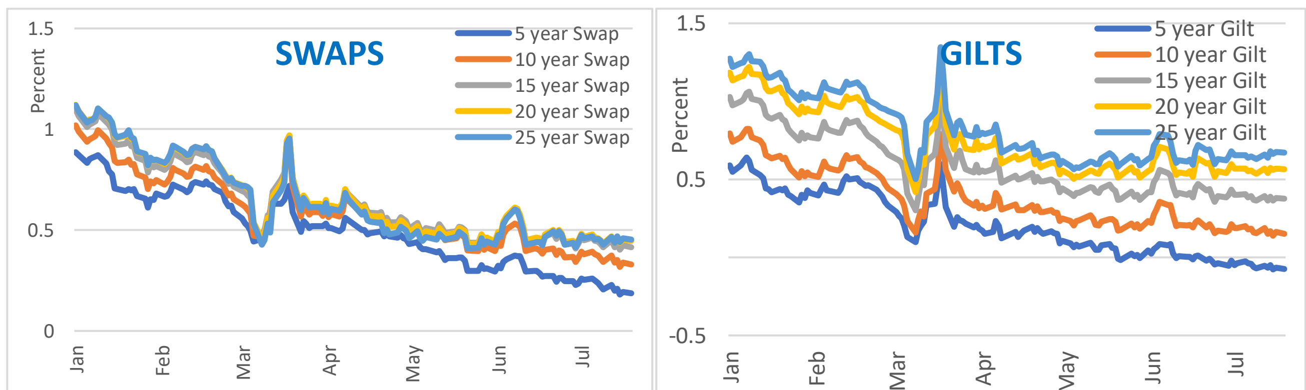
Subject to economic growth and the impacts of inflation it is expected that interest rates could rise and so, for prudence, it is recommended that rising interest be assumed for business planning purposes.

Recommended minimum variable interest rate assumptions (before margin):

For year ending:	Mar 21	Mar 22	Mar 23	Mar 24	Mar 25	Mar 26	Long Term
OBR Central Economic Scenario	0.09%	0%	n/a	n/a	n/a	n/a	n/a
2TIX LTD - Variable (pre margin)	**0.10%**	**1.00%**	**2.50%**	**3.00%**	**3.50%**	**3.50%**	**3.50%**

FIXED INTEREST RATES

The asset purchases announced by the BoE on 19 March have helped to reduce interest rates and improve liquidity in the gilt market as intended. By the end of March 2020, gilt yields across maturities were lower than their levels at the start of February 2020. Additionally, spreads between bid and offer prices, which are an indicator of market liquidity, had fallen back a little from the elevated levels seen in mid-March.



Interest rate margins (spreads) have moved out slightly and will, as always be borrower covenant dependant. Short term (less than 5 years) should be 1.2% - 1.5%; 10 year funding 1.5% - 2% and longer term – 1.75% - 2.25%.

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