Appendix D

Economic Background and Borrowing Update

Economic Background

The first quarter of 2025/26 saw:

- A 0.3% m/m fall in real GDP in April – the first fall since October 2024;
- The 3myy rate of average earnings growth excluding bonuses fall from 5.5% to 5.2% in May;
- Core CPI inflation ease from 3.8% in April to 3.5% in May as temporary Easter-related effects faded;
- The Bank of England cut interest rates from 4.50% to 4.25% in May, holding them steady in June;
- The 10-year gilt yield fluctuate between 4.4% and 4.8%, and end the quarter at 4.50%

The 0.3% m/m fall in real GDP in April was the first fall since October 2024 and the largest fall since October 2023. This is a significant shift from the 0.7% q/q rise in Q1 2025, probably as a result of the boosts from net exports and business investment unwinding. The decline in exports was mostly due to a reversal of US tariff front-running with export values to the US falling by 31% m/m after rising 34% in total in the five months to February. April's GDP figures also showed manufacturing output falling by 0.9% m/m along with the domestic economy showing signs of weakness in April. Despite construction output growing by 0.9% m/m, services output declined by 0.4% m/m, reversing all of March's 0.4% m/m rise. This weakness in services likely reflects higher labour costs from April's rise in National Insurance Contributions for employers. May's GDP may have fallen a bit further as the boosts in Q1 continued to unwind. Overall, GDP in Q2 is likely to have flatlined and the economy will probably be hindered by subdued overseas demand and domestic businesses cutting spending given a rise in costs due to April's increase in taxes. The Bank of England expects growth in 2025 to be around 0.8%.

The sharp 2.7% m/m drop back in retail sales volumes in May adds to other evidence that the burst of economic growth in Q1 is over. The weakness was widespread with sales falling in all seven of the major categories. This decline was partly due to the unwinding of the previous boost from April's unusually warm and dry weather along with inflationary pressures prompting consumers to cut back.

While the £17.7bn of public sector borrowing in May was higher than the Office of Budget responsibility (OBR) forecast of £17.1bn, borrowing was £2.9bn below the OBR's forecast in the first two months of the 2025/26 fiscal year. The current budget deficit was £12.8bn in May, a touch below the OBR's forecast of £13.0bn. Within that, government spending surprised to the downside. Central government expenditure was £0.5bn lower than the OBR's forecast in May, leaving it £1.6bn lower in April and May combined. That has been largely driven by debt interest payments, which were £1.1bn below the OBR's forecast in May. But if the rises in gilt yields since the Spring Statement in March are sustained, the OBR will revise up its forecast for debt interest payments in the years ahead. That of itself would knock £1.0bn off the Chancellor's

£9.9bn of headroom against her fiscal mandate and the subsequent Government U-turns on benefit and welfare spending and higher borrowing costs may mean to maintain her current £9.9bn buffer, Reeves has to raise upwards of £13bn later this year. And with the gilt market sensitive to significant increases in borrowing, all this means substantial tax rises are looking very likely.

The weakening in the jobs market is gathering pace. May's 109,000 m/m fall in the PAYE measure of employment was the largest decline (barring the pandemic) since the data began and the seventh in as many months. The monthly change was revised lower in five of the previous seven months too, with April's 33,000 fall revised down to a 55,000 drop. Overall, the payroll measure of employment has now fallen by 276,000 since the announcement of the rise in payroll taxes and the minimum wage in the October Budget.

A looser labour market is driving softer wage pressures. The 3myy rate of average earnings growth excluding bonuses fell from 5.5% to 5.2% in May. The rate for the private sector slipped from 5.5% to 5.1%, putting it on track to undershoot the Bank of England's Q2 forecast of 5.2%. And after rising in April as the 6.7% rise in the minimum wage took effect, the timelier PAYE median earnings measure fell back from 6.2% y/y in April to 5.8% in May. Softer wage growth is feeding through to lower services inflation, pointing to a slowdown from 4.7% in May to around 3.0% by the end of the year.

CPI inflation fell slightly from 3.5% in April to 3.4% in May – close to consensus. The sharp falls in services inflation from 5.4% to 4.7% and in core inflation from 3.8% to 3.5% confirmed that the previous month's jumps partly reflected an Easter-related blip. Services inflation is expected to continue to fall as wage growth slows, supporting a view that CPI inflation will fall close to 2.0% by the start of 2027. An upside risk, however, in the near term is that higher oil/gas and food prices could trigger another bout of second-round effects on wages and inflation expectations, meaning CPI inflation stays above 3.0% for longer and causes the Bank to shift to an even slower rate cutting path. CPI is expected to peak at 3.8% in September.

The yield on the 10-year gilt moved sideways in the second quarter of 2025. After rising from 4.4% in early April to 4.8% in mid-April following wider global bond market volatility stemming from the "Liberation Day" tariff announcement, gilt yields eased back as trade tensions began to de-escalate. By the end of April, the 10-year gilt yield had returned to 4.4%. In May, concerns about stickier inflation and shifting expectations about the path for interest rates led to another rise, with the 10-year gilt yield fluctuating between 4.6% and 4.75% for most of May. Thereafter, as trade tensions continued to ease and markets increasingly began to price in looser monetary policy, the 10-year yield edged lower, and ended Q2 at 4.50%. We expect this trend to continue over the next year.

The FTSE 100 fell sharply following the "Liberation Day" tariff announcement, dropping by more than 10% in the first week of April - from 8,634 on 1st April to 7,702 on 7th April. However, the de-escalation of the trade war coupled with strong corporate earnings led to a rapid rebound starting in late April. As a result, the FTSE 100 closed Q2 at 8,761, around 2% higher than its value at the end of Q1 and more than 7% above its level at the start of 2025.

A summary overview of the future path of Bank Rate

There were two Monetary Policy Committee (MPC) meetings this quarter. In May, the Committee cut Bank Rate from 4.50% to 4.25%, while in June policy was left unchanged. In June's vote, three MPC members voted for an immediate cut to 4.00%, citing loosening labour market conditions. The other six members were more cautious, as they highlighted the need to monitor for "signs of weak demand", "supply-side constraints" and higher "inflation expectations", mainly from food prices rising. By repeating the well-used phrase "gradual and careful", the MPC continued to suggest that rates will be reduced further.

At the start of June, amid escalating tensions between Israel and Iran, oil prices surged to over $75 per barrel. However, following a ceasefire agreement near the end of the month, oil prices eased back to levels prior to the conflict. Given the drop back in energy prices and the relatively muted reaction to fears of a ceasefire violation, along with a large drop in the services PMI output prices balance, our central view is that once inflation begins to trend downwards in the final months of 2025, Bank Rate reductions can begin again from November (pause in August as inflation remains close to its peak), falling to a low of 3.5% in May 2026. However, if the conflict in the Middle East were to result in higher energy prices and/or domestic inflationary pressures grow stronger, there is a risk the Bank of England may skip cutting rates further.

Borrowing

It is a statutory duty for the Council to determine and keep under review the "Affordable Borrowing Limits". The Council's approved Treasury and Prudential Indicators (affordability limits) are included in the approved Treasury Management Strategy. A list of the approved limits is shown in Appendix B. The Prudential Indicators were not breached during the first quarter of 2025/26 and have not been previously breached. The schedule at Appendix C details the Prudential Borrowing approved and utilised to date.

The Council has not undertaken any new borrowing in the first quarter of 2025/26, however it is anticipated that new borrowing will need to be undertaken during the remainder of the year. This borrowing will be required for 3 main reasons:

- Renewing short term borrowing undertaken
- New borrowing required for the capital programme
- Replacing internal borrowing undertaken in previous years which had been performed to benefit from a saving on interest costs compared to the returns that could be generated on the cash balances. This approach was effective during a period where the Council held significant cash balances.

Heading into the second quarter of 2025/26 markets seem to be comfortable with a central case of gradual monetary policy easing, leading to Bank Rate and gilt yields out to c10 years trending downwards. The Bank of England has remained cautious in stating that any Bank Rate cuts must be undertaken gradually, and the inflation outlook remains a little opaque with the CPI measure of inflation not expected to peak until September (possibly 3.8%) before falling back towards 2% by the start of 2027. Annual wage increases also remain at 5% y/y, even though the seasonally adjusted job vacancies number has fallen to 712k. Nonetheless, both the 5-year and, albeit to a lesser extent, 10-year PWLB Certainty Rates have trended lower through the quarter. Further out, however, rates have either finished close to their starting point for the quarter, if not a little higher. It remains problematic that historic buyers of longer-dated gilts – pension funds and insurance companies – have preferred the shorter-dated maturities of late, whilst there is anecdotal evidence that both foreign investors and hedge funds, who are not natural long-term holders of long-dated debt gilt issuance, as a rule, may be more active in this part of the market currently than has previously been the case. Their presence, arguably, adds even greater volatility to the equation. Consequently, and pulling all these factors together, and it is clear that any signs of public finance weakness could put even greater upward pressure on medium and longer dated gilts and, therein, PWLB rates.

The table below shows the high/low/average PWLB rates for the first quarter2025/26 financial year.

	1 Year	5 Year	10 Year	25 Year	50 Year
01/04/2025	4.82%	4.94%	5.38%	5.95%	5.63%
30/06/2025	4.50%	4.70%	5.27%	5.97%	5.71%
Low	4.46%	4.62%	5.17%	5.78%	5.46%
Low date	08/05/2025	02/05/2025	02/05/2025	04/04/2025	04/04/2025
High	4.84%	4.99%	5.56%	6.25%	5.97%
High date	02/04/2025	21/05/2025	21/05/2025	21/05/2025	22/05/2025
Average	4.61%	4.81%	5.36%	6.03%	5.72%
Spread	0.38%	0.37%	0.39%	0.47%	0.51%