Appendix D

Economic Background and Borrowing Update

Economic Background

The first quarter of 2026/27 saw:

- A 0.1% m/m fall in real GDP in April.
- The 3myy rate of average earnings growth excluding bonuses stagnate at 3.4% in April.
- CPI inflation stuck at 2.8% in May, with a rise in core CPI inflation from 2.5% to 2.6%.
- The Bank of England leave interest rates unchanged at 3.75% as the economy remains weak.
- The 10-year gilt yield fluctuate between 5.18% and 4.69%, ending the quarter at 4.76%.

The economy performed well in the early stages of the energy shock, with GDP rising by a strong 0.6% between January and March. But that will likely be the high point of the year. Indeed, the 0.1% month on month fall in real GDP in April was the first decline since August 2025 and brought the first signs that the economy is starting to crack.

Services output contracted by 0.2% month on month in April and activity fell in eight of the 14 services sub-sectors, suggesting the sector is bearing the brunt of the Iran war fallout. Consumer-facing services recorded the biggest monthly fall in output since May 2025, causing the growth rate to ease from 0.9% in March to 0.6% in April, as households cut back on non-energy spending.

Looking ahead, despite the announced ceasefire of the conflict in the Middle East, Capital Economics expect elevated prices to erode the real spending power of households and businesses, leaving growth to stagnate in Q2 and Q3 this year.

The fall in the composite Purchasing Manager Index (PMI) from 49.7 in May to a 14-month low of 49.4 in June was entirely driven by services activity. Indeed, the services activity PMI fell from 49.3 to a 41-month low of 48.7 due to rising costs and political uncertainty weighing on consumer confidence. That weakness was partly offset by a rise in the manufacturing output for a third consecutive month but that was due to fears of shortages causing businesses to build stocks. Overall, the composite PMI suggests the strong start to the year will be followed by tepid growth at best. Various prices balances have edged lower more recently as falling oil prices feed through to an easing in cost pressures. While these prices remain too high for the Bank of England, it is clear the upward pressure on prices is easing.

With most of the 1.2% month on month rise in retail sales volumes in May was driven by promotions and unusually warm weather, this surprisingly strong month is unlikely to be the start of a sustained upturn. Moreover, while the war could be over, the expected further rises in inflation and unemployment yet to come through seem consistent with the annual growth rate of retail sales volumes easing from +3.2% in May to about -1.0 this year.

The weak performance in May has come before the full impact from the energy price shock hits. The combination of further energy price support, higher inflation and the weakening economy may cause borrowing to rise from 4.2% of GDP in 2025/2026 to 4.4% in 2026/2027, above the OBR's March forecast of 3.6%.

The first quarter of 2026 saw significant weakening of the labour market. While the latest PAYE employment figure for May saw a 2,000 rise, that barely offset the big 53,000 drop in April and meant employment was still 64,000 (0.2%) lower than before the start of the Iran war and 0.4% lower than a year ago. Moreover, the number of job vacancies on the single-month measure fell for the fourth month in a row in May and the claimant count saw the largest monthly rise since July 2024.

In addition to some signs of stabilisation in the labour market figures, the recent easing in pay growth appears to have stalled. Despite some further easing in the private sector pay below the 3.25% that the Bank of England considers consistent with CPI inflation falling to target, the 3m year on year growth rate of average earnings stayed at 4.4% in April.

Like wage growth, CPI inflation held steady in May at 2.8%. There wasn't much support to inflation from energy effects. The 0.3% month on month fall in fuel prices was smaller than the 1.6% month on month drop last May and meant fuel inflation rose only a bit from 23.0% to 24.6%. After rising to 129.6%, heating oil inflation eased to 95.6%. And the 13.5% rise in the Ofgem utility price cap, which will add 0.6 percentage points (ppts) to CPI inflation, doesn't take effect until 1st July. With food & drink inflation easing to its lowest rate since late 2024, higher energy costs do not seem to be boosting other items of the CPI just yet.

The delayed rise in utility prices and the lagged indirect energy effect will lift CPI inflation over the next nine months, perhaps to around 3.6%. Even so, the weak labour market and soft economic backdrop will prevent second-round effects, allowing inflation to fall to 2.0% next year.

April to June brought more volatility for 10-year Gilt yields. After ending March at 4.92%, the 10-year Gilt shot up to 5.18% in mid-May, its highest level since 2008. While that largely reflects the surge in energy prices, sticky domestic inflation concerns and a rising UK political risk premium also put some upward pressure on the yield at the margin.

The FTSE 100 has been slowly gaining back some of the losses of the previous quarter. While the index dropped from an all-time high of around 10,900 in late February to 10,176 by the end of March as the ongoing war weighed on sentiment, the FTSE 100 regained some ground by the end of June.

A summary overview of the future path of Bank Rate

There were two monetary policy committee (MPC) meetings in Q2 2026 where Bank rate was yet again left unchanged at 3.75%. Even so, the tone in recent meetings has been increasingly hawkish, with two MPC members voting for a rate hike in June compared to just one in April. While energy prices may be falling, the MPC won't want to unwind some of the tightening in financial conditions priced into the markets. And while there is quite a difference between this energy shock and the one following the Russia-Ukraine war in 2022, the Bank of England will want to steer clear of allegations of taking too long to act. Nevertheless, we suspect a weak labour market, and soft activity will keep rates at 3.75% this year, with cuts thereafter leaving Bank rate at 3.5% by the end of next year and 3.25% by the spring of 2028.

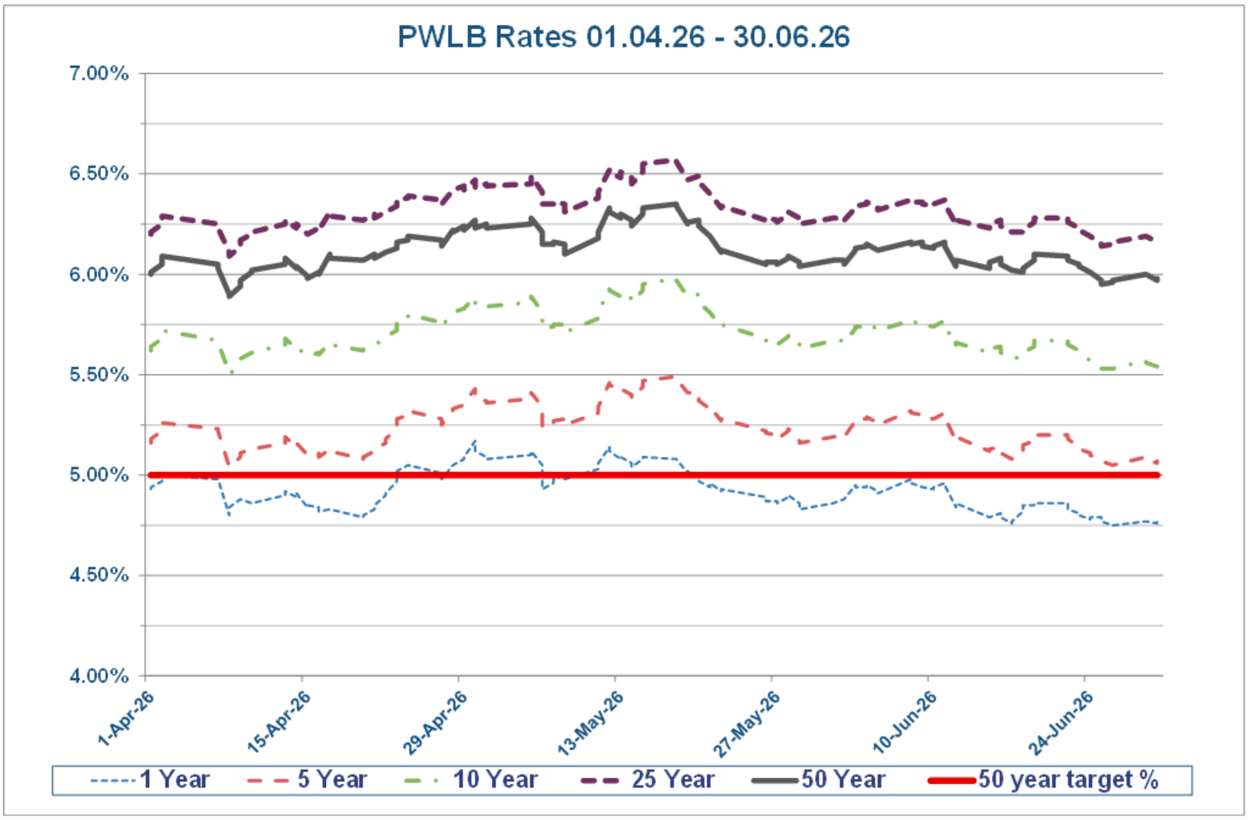
Borrowing

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 2026/27 and have not been previously breached. The schedule at Appendix C details the Prudential Borrowing approved and utilised to date.

During the first quarter of 2026/27, the Council has taken out temporary borrowing from other local authorities to the value of £35m. These loans will mature during the remainder of 2026/27, and it is anticipated that these will need to be replaced along with further borrowing required during 2026/27. The Council is actively monitoring PWLB borrowing rates, and will aim to secure longer term borrowing when PWLB rates reduce from current levels.

Heading into the second quarter of 2026/27, markets seem to have settled down to a view that Bank Rate may increase by 25 basis points to 4% later in 2026, or early in 2027, if the Bank of England's Monetary Policy Committee deems it prudent to keep any secondary round effects of inflation from flaring up. On balance, however, MUFG Corporate Markets believes that Bank Rate will remain unchanged at 3.75% for the remainder of 2026, and that the next movement will be downwards if the CPI measure of inflation gets no higher than a peak of c3.5% before trending lower towards the 2% inflation target rate. Consequently, where market sentiment has gradually moved towards that view, the chart below has captured the degree to which rates across the whole curve - having risen at the start of the quarter – have finished the quarter at a similar level to which they started.

Of course, there have been both international geo-political and domestic factors holding sway over the past three months, sometimes separately and sometimes jointly. Initially, markets focussed on the inflationary threat from a large spike upwards in fuel and energy costs emanating from the conflict in the Middle East and, more precisely, the shutting of the Strait of Hormuz to cargo ships transporting oil. Heading into July, however, there has been an outbreak – albeit tentative – of optimism that the US and Iran can reach an agreement that will either end, or at least restrict, the worst of the hostilities. As oil prices have dropped back, inflation concerns have become more muted, although gilt yields are still historically high and monetary policy tighter than it was before the start of the conflict.



The table below shows the high/low/average PWLB rates for the first three months of the financial year.

	1 Year	5 Year	10 Year	25 Year	50 Year
01/04/2026	4.93%	5.16%	5.62%	6.20%	6.00%
30/06/2026	4.77%	5.07%	5.55%	6.17%	5.98%
Low	4.75%	5.04%	5.50%	6.09%	5.89%
Low date	26/06/2026	08/04/2026	08/04/2026	08/04/2026	08/04/2026
High	5.17%	5.49%	5.98%	6.57%	6.35%
High date	30/04/2026	18/05/2026	18/05/2026	18/05/2026	18/05/2026
Average	4.92%	5.23%	5.71%	6.31%	6.11%
Spread	0.42%	0.45%	0.48%	0.48%	0.46%