

Appendix 1

Economic Background – 2025/26 Financial Year

The financial year was largely dominated by two periods of significant uncertainty and volatility. The first being the US trade tariff ‘Liberation Day’ in April 2025 and the second was the US/Israel war with Iran at the end of February 2026.

After the initial fallout from US trade tariffs, the following months saw some improvements as equity markets made gains and bond yields eased modestly. However, in the UK this trend in bond yields reversed somewhat as an uncertain economic outlook together with concerns around the government’s fiscal position and autumn Budget saw ‘term premia’ rise as investors demanded a higher return for holding gilts.

The Budget itself was more muted than had been expected. Despite a weak economic outlook, this helped UK markets perform better with gilt yields trending downwards, inflation easing, and expectations for cuts in Bank of England (BoE) Bank Rate increasing.

The end of February 2026 saw the start of the war between US/Israel and Iran. The conflict caused oil and other commodity prices to rise sharply as the shipping lanes in the region became effectively closed, restricting global oil supply. At the end of the period, the economic outlook remained highly uncertain in terms of its impact on inflation as well as countries’ fiscal and monetary policy conditions around the globe.

Prior to the start of the war, headline UK consumer price inflation (CPI) inflation had generally been trending downwards, albeit the 3% in February 2026 was unchanged from January. Core CPI also stayed put at 3.1%. Inflation was expected to fall further over the coming months to the BoE’s 2% target, but the war changed this. Inflation is now expected to rise again, but how quickly and by how much depends on the duration of the war and how long commodity prices are elevated.

The Office for National Statistics (ONS) reported the UK economy expanded by 0.1% in Q4 2025. This followed previous modest gains of 0.2% in Q2 and by 0.1% in Q3. Of the subsequent monthly figures, the ONS estimated that GDP showed no growth in January 2026. As this is from before the war started the impact on growth will not be seen formally in the data for a couple more months.

While the most recent labour market figures were slightly better than expected, the general trend has been one of persistent weakness. In the three months to January 2026, the unemployment rate rose to 5.2% (from 5.1%), while the employment rate held at 75.1%. Despite inflation being expected to rise in the coming months, labour market conditions remain loose and so any upward pressure on wages from general inflation is likely to be tempered by the weaker labour market environment.

After cutting Bank Rate to 3.75% in December 2025, the BoE’s Monetary Policy Committee (MPC) voted 5-4 to hold rates in February 2026 and then unanimously to do so again in March. Until the war started, financial markets were expecting Bank Rate to be cut to 3.5% at the March meeting. However, the conflict in the Middle East quickly changed this. The MPC noted the risks to both inflation and growth and indicated they could move

rates either up or down depending on the conditions. Financial markets quickly responded to this by pricing in rate hikes.

Following the March MPC meeting, Arlingclose, the Council's treasury adviser, revised its central interest rate view and now predicts Bank Rate will be held at 3.75%. However, the conflict makes the outlook for rates highly uncertain. In the short-term the risks are to the upside with the chance of higher Bank Rate should the MPC decide it wishes to quickly quash potential second-round effects from higher inflation. Further out, if Bank Rate is hiked quickly, the pace and magnitude of subsequent cuts could take it far lower than was previously anticipated as policymakers add significant stimulus to a much weaker economic growth outlook.

The US Federal Reserve had been cutting rates over the period, reducing Fed Funds Rate target range by 0.25% at its December meeting to 3.50%-3.75%. At the three subsequent meetings, the rate was held at the same range. Policymakers noted that while inflation was elevated, economic activity had been expanding but the war with Iran made the path of monetary policy highly uncertain. Despite this, the Fed still suggested that further rate cuts were likely in 2026 and 2027.

The European Central Bank (ECB) has kept its key interest rates on hold since June 2025, maintaining the deposit rate at 2.0% and main refinancing rate at 2.15%. At its March 2026 meeting, the ECB noted the war in the Middle East had significantly increased uncertainty, creating upside risks for inflation and downside risks for growth, leading it to revise up its forecasts accordingly.

Financial markets: After declining sharply early in the financial year following the announcement of US tariffs, sentiment in financial markets had improved but equity and bond markets remained volatile throughout. However, the latter part of the period was dominated by the US/Israel war with Iran, which saw equity markets fall sharply, and bond yields rise as concerns over the inflationary impact from sharply higher oil and other commodity prices outweighed the flight-to-quality into government bonds often seen in conflicts.

Equity markets had been registering gains after the declines during the April sell-off, but the war reversed this, and markets saw another sharp drawdown. Both the FTSE 100 and 250 fell by around 10% over the month from the start of the conflict to the end of the financial year.

The period saw significant volatility in gilt yields. The 10-year UK benchmark gilt yield started the year at 4.65% and ended at 4.86%. However, over this time the 10-year yield hit a low of 4.23% and a high of 4.95% in the space of a month. It was a similar picture for the 20-year gilt which started at 5.18% and ended at 5.45% with a low and high of 4.92% and 5.55% respectively. The Sterling Overnight Rate (SONIA) averaged 4.01% over the 12 months to 31st March.

Credit review: Arlingclose maintained its recommended maximum unsecured duration limit on most of the banks on its counterparty list at 6 months. The other banks remain on 100 days.

After spiking in April 2025 following the US trade tariff announcements, UK credit default swap (CDS) prices had trended down before picking up modestly in October and November. After declining again in December and into the new calendar year, they rose sharply once again when the war in the Middle East started. They were still elevated at the end of the period, but prices for all banks on Arlingclose's counterparty list remained within limits deemed satisfactory for maintaining credit advice at current durations.

Financial market volatility is expected to remain, and CDS levels will be monitored for signs of ongoing credit stress. As ever, the institutions and durations on the Council's counterparty list recommended by Arlingclose remain under constant review.

Arlingclose Ltd
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