APPENDIX C (i)

TREASURY MANAGEMENT STRATEGY STATEMENT AND ANNUAL INVESTMENT STRATEGY 2014/15

Economic Background

Global economy

The Eurozone – The sovereign debt crisis has eased during 2013 which has been a year of comparative calm after the hiatus of the Cyprus bailout in the spring. The Eurozone finally escaped from seven quarters of recession in quarter 2 of 2013 but the growth is likely to remain weak and so will dampen UK growth. The European Central Bank's (ECB) pledge to buy unlimited amounts of bonds of countries which ask for a bail out has provided heavily indebted countries with a strong defense against market forces. This has bought them time to make progress with their economies to return to growth or to reduce the degree of recession. However, debt to Gross Domestic Product (GDP) ratios (2012 figures) of 176% Greece, Italy 131%, Portugal 124%, Ireland 123% and Cyprus 110%, remain a cause of concern, especially as many of these countries are experiencing continuing rates of increase in debt in excess of their rate of economic growth i.e. these debt ratios are continuing to deteriorate.

Any sharp downturn in economic growth would make these countries particularly vulnerable to a new bout of sovereign debt crisis. It should also be noted that Italy has the third biggest debt mountain in the world behind Japan and the US. Greece remains particularly vulnerable and continues to struggle to meet Eurozone targets for fiscal correction. Many commentators still view a Greek exit from the Euro as inevitable and there are concerns that austerity measures in Cyprus could also end up forcing an exit. The question remains as to how much damage an exit by one country would do and whether contagion would spread to other countries. However, the longer a Greek exit is delayed, the less are likely to be the repercussions beyond Greece on other countries and on European Union (EU) banks.

Sentiment in financial markets has improved considerably during 2013 as a result of firm Eurozone commitment to support struggling countries and to keep the Eurozone intact. However, the foundations of this current "solution" to the Eurozone debt crisis are still weak and events could easily conspire to put this into reverse.

US – The economy has managed to return to reasonable growth in Quarter 2 2013 of 2.5% year on year in spite of the fiscal cliff induced sharp cuts in federal expenditure that came into force on 1 March 2013, and increases in taxation. The Federal Reserve has continued to provide stimulus to the economy through its $85bn per month asset purchase programme of quantitative easing (QE). However, it is expected that this level of support will start to be tapered down by the end of 2013. Consumer, investor and business confidence levels have improved markedly in 2013. The housing market has turned a corner with house sales increases and house prices returning to healthy levels. Many home owners have therefore been helped to escape from negative equity and banks have also largely repaired their damaged balance sheets so that they can resume healthy levels of lending. All this portends well for a reasonable growth rate looking forward.

China - Concerns that Chinese growth could be heading downwards have been allayed by recent stronger statistics. There are still concerns around an unbalanced economy which is heavily dependant on new investment expenditure, and for a potential bubble in the property sector to burst, as it did in Japan in the 1990's, with its consequent impact on the financial health of the banking sector.

Japan – Japan has seen strong growth of 4% in the first two quarters of 2013 which portends well for the hope that Japan can escape from stagnation and help support world growth. The fiscal challenges though are huge; the gross debt to GDP ratio is about 245% in 2013 while the government is currently running an annual fiscal deficit of around 50% of total government expenditure.

UK economy

Economic Growth – Until 2013, the economic recovery in the UK since 2008 had been the worst and slowest recovery in recent history. However, growth rebounded in quarter 1 (+0.3%) and quarter 2 (+0.7%) of 2013 to surpass all expectations as all three main sectors, services, manufacturing and construction contributed to this strong upturn. The August 2013 Bank of England Inflation Report consequently upgraded growth forecasts for 2013 from 1.2% to 1.4% and for 2014 from 1.7% to 2.5%. Wage inflation continues to remain significantly below Consumer Price Inflation (CPI) inflation so disposable income and living standards are under pressure, although income tax cuts have ameliorated this to some extent. A rebalancing of the economy towards exports has started but as 40% of UK exports go to the Eurozone, the difficulties in this area are likely to continue to dampen UK growth.

Forward Guidance – The Bank of England also issued forward guidance with the Inflation Report which said that the Bank will not start to consider raising interest rates until the jobless rate has fallen to 7% or below. This would require the creation of about 750,000 jobs and was forecast to take three years. The UK unemployment rate currently stands at 2.5 million i.e. 7.7%. The Bank's guidance is subject to three provisos, mainly around inflation; breaching any of them would sever the link between interest rates and unemployment levels. This actually makes forecasting Bank Rate much more complex given the lack of available reliable forecasts by economists over a three year plus horizon. The forecast in this report for Bank Rate not to start increasing until quarter 3 of 2016 is based on a slow reduction of unemployment, in line with the Bank of England's forecast, and contrary to the prevalent market view where rates are indicating that Bank Rate is expected to start going up in early 2015.

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Credit Conditions – While Bank Rate has remained unchanged at 0.50% and QE has remained unchanged at £375bn in 2013, the Funding for Lending Scheme (FLS), aimed at encouraging banks to expand lending to small and medium size enterprises, has been extended. The FLS certainly seems to be having a positive effect in terms of encouraging house purchases, FLS is also due to be bolstered by the second phase of Help to Buy aimed to support purchasing of second hand properties, which started in October 2013. While there have been concerns that these schemes are creating a bubble in the housing market, the housing market remains weak outside of London and the south-east with a significant increase in house prices either being entirely absent or minimal. However, bank lending to small and medium enterprises continues to remain weak and inhibited by banks still repairing their balance sheets and anticipating tightening of regulatory requirements.

Inflation – Inflation has fallen from a peak of 3.1% in June 2013 to 2.7% in September 2013. It is expected to fall back to reach the 2% target level within the two year horizon.

AAA Rating – The UK has lost its AAA rating from Fitch and Moody's rating agencies but that caused little market reaction.

Capita Asset Services forward view

Economic forecasting remains difficult with so many external influences weighing on the UK. Major volatility in bond yields is likely during the remainder of 2013/14 as investor fears and confidence ebb and flow between favoring more risky assets i.e. equities, and safer bonds.

The longer run trend is for gilt yields and PWLB rates to rise, due to the high volume of gilt issuance in the UK, and of bond issuance in other major western countries. Increasing investor confidence in economic recovery is also likely to compound this effect as a continuation of recovery will further encourage investors to switch back from bonds to equities.

The overall balance of risks to economic recovery in the UK is currently weighted to the upside after five months of robust good news on the economy. However, only time will tell just how long this period of strong economic growth will last; it also remains exposed to vulnerabilities in a number of key areas.

Downside risks currently include:

- The conflict in the UK between market expectations of how quickly unemployment will fall as opposed to the Bank of England's forecasts;

- A return to weak economic growth in the US, UK and China causing major disappointment to investor and market expectations;

- The potential for a significant increase in negative reactions of populaces in Eurozone countries against austerity programmes, especially in countries with very high unemployment rates e.g. Greece and Spain, which face huge challenges in engineering economic growth to correct their budget deficits on a sustainable basis;

- Problems in other Eurozone heavily indebted countries e.g. Cyprus and Portugal which could also generate safe haven flows into UK gilts;
- Monetary policy action failing to stimulate sustainable growth in western economies, especially the Eurozone and Japan;
- Weak growth or recession in the UK's main trading partners – the EU and US, depressing economic recovery in the UK;
- Geographical risks e.g. Syria, Iran, and North Korea, which could trigger safe haven flows back into bonds.

The potential for upside risks to UK gilt yields and PWLB rates, especially for longer term PWLB rates include:-

- A sharp upturn in investor confidence that sustainable robust world economic growth is firmly expected, causing a surge in the flow of funds out of bonds into equities;
- A reversal of Sterling's safe haven status on a sustainable improvement in financial stresses in the Eurozone;
- Further downgrading by credit rating agencies of the creditworthiness and credit rating of UK Government debt, consequent upon repeated failure to achieve fiscal correction targets and sustained recovery of economic growth which could result in the ratio of total government debt to GDP to rise to levels that undermine investors confidence in the UK and UK debt;
- UK inflation being significantly higher than in the wider EU and US, causing an increase in the inflation premium inherent to gilt yields; and
- In the longer term – an earlier than currently expected reversal of QE in the UK; this could initially be implemented by allowing gilts held by the Bank to mature without reinvesting in new purchases, following later by outright sale of gilts currently held.