APPENDIX D (i)

TREASURY MANAGEMENT STRATEGY STATEMENT AND ANNUAL INVESTMENT STRATEGY 2014/15

Economic Background

Global economy

The Eurozone - Concerns have subsided considerably in 2013. However, sovereign debt difficulties have not gone away and major concerns could return in respect of any countries that do not address fundamental issues of low growth, international uncompetitive and the need for overdue reforms of the economy. It is, therefore, possible over the next few years that levels of government debt to Gross Domestic Product (GDP) ratios could continue to rise to levels that could result in a loss of investor confidence in the financial viability of such countries. This could mean that sovereign debt concerns have not disappeared but, rather, have only been postponed.

US - 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

Forward Guidance – The Bank of England issued forward guidance with 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 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 2 of 2016.

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Inflation – Inflation has fallen from a peak of 3.1% in June 2013 to 2.1% in November 2013.

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;
- 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:-

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- 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.