

**TREASURY MANAGEMENT STRATEGY STATEMENT AND
ANNUAL INVESTMENT STRATEGY 2013-14**

Interest Rate and Economic Outlook Forecasts

(Sector – Jan 2013)

	Jan 2013 (%)	Mar 2013 (%)	Jun 2013 (%)	Sep 2013 (%)	Dec 2013 (%)	Mar 2014 (%)	Jun 2014 (%)	Sep 2014 (%)	Dec 2014 (%)	Mar 2015 (%)
Bank Rate	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.75
5 yr PWLB*	1.99	1.50	1.50	1.60	1.60	1.70	1.70	1.80	2.00	2.20
10yr PWLB	2.96	2.50	2.50	2.60	2.60	2.70	2.70	2.80	3.00	3.20
25yr PWLB	4.15	3.80	3.80	3.80	3.80	3.90	3.90	4.00	4.10	4.30
50yr PWLB	4.32	3.90	3.90	4.00	4.00	4.10	4.10	4.20	4.30	4.50

*Public Works Loan Board

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Economic Background

Global economy – The Eurozone debt crisis has continued to cast a cloud over world economy and has depressed growth in most countries. This has impacted the UK economy which is unlikely to grow significantly in 2012 and is creating a major headwind for recovery in 2013. Quarter 2 of 2012 was the third quarter of contraction in the economy; this recession is now the worst and slowest recovery of any of the five recessions since 1930.

The **Eurozone sovereign debt crisis** has abated somewhat following the European Central Bank's (ECB) pledge to buy unlimited amounts of bonds of countries which ask for a bailout. The immediate target for this statement is Spain which continues to prevaricate on making such a request and so surrendering its national sovereignty to Independent Monetary Fund (IMF) supervision. However, the situation in Greece is heading towards a crunch point as the Eurozone imminently faces up to having to relax the time frame for Greece reducing its total debt level below 120% of GDP and providing yet more financial support to enable it to do that. Many commentators still view a Greek exit from the Euro as inevitable as total debt now looks likely to reach 190% of GDP i.e. unsustainably high. The question remains as to how much damage a Greek exit would do and whether contagion would spread to cause Portugal and Ireland to also leave the Euro, though the longer a Greek exit is delayed, the less likely are repercussions beyond Greece on other countries and on EU banks

Sentiment in financial markets has improved considerable following the ECB action, the German courts agreeing that the bailout mechanisms are legal, and the Dutch general election voting for pro Eurozone policies. However, the foundations to this "solution" to the Eurozone debt crisis are flimsy and events could easily conspire to put this into reverse.

The US economy has only been able to manage disappointingly weak growth in 2012 despite huge efforts by the Federal Reserve to stimulate the economy by liberal amounts of quantitative easing (QE) combined with a commitment to a continuation of ultra low interest rates into 2015. Unemployment levels have been slowly reducing but against a background of a fall in the numbers of those available for work. The fiscal cliff facing the new President at the start of 2013 was a major dampener discouraging business from spending on investment and increasing employment more significantly in case there is a sharp contraction in the economy in the pipeline. However, the housing market does look as if it has reached the bottom and house prices are now on the up.

Hopes for a broad based recovery have, therefore, focused on the emerging markets. However, there are increasing concerns over warning signs in

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various parts of the Chinese economy that indicate it may be heading for a hard landing rather than a gradual slow down.

UK economy

The Government's austerity measures, aimed at getting the public sector deficit into order over the next four years, now look as if they will fail to achieve their objectives in the original planned timeframe. Achieving this target is dependant on the UK economy growing at a reasonable pace but recession in the Eurozone, our biggest trading partner, has depressed growth whilst tax receipts have not kept pace with additional welfare benefit payments. It will be important for the Government to retain investor confidence in UK gilts so there is little room for it to change course other than to move back the timeframe.

Currently, the UK is enjoying a major financial benefit from some of the lowest sovereign borrowing costs in the world as the UK is seen as a safe haven from Eurozone debt. There is little evidence of consumer confidence levels recovering or that the manufacturing sector is picking up. On the positive side, growth in the services sector has rebounded in Q3 2012 and banks have made huge progress since 2008 in shrinking their balance sheets to more manageable levels and also in reducing their dependency on wholesale funding. However, availability of credit remains tight in the economy and the Funding for Lenders scheme, which started in August 2012, has not yet had the time to make a significant impact. Finally, the housing market remains tepid and the outlook is for house prices to be little change for a prolonged period.

Economic Growth – Economic growth has basically flat lined since the election of 2010 and the economic forecasts for 2012 and beyond were revised substantially lower in the Bank of England Inflation Quarterly Report for August 2012 and were then further lowered in the November 2012 Report. Quantitative easing was increased again by £50bn in July 2012 to a total of £375bn. Many forecasters are expecting a further round of QE to stimulate economic activity regardless of any near-term optimism. The announcement in November 2012 that £35bn will be transferred from the Bank of England's Asset Purchase Facility to the Treasury is also effectively a further addition of QE.

Unemployment – The Government's austerity strategy has resulted in a substantial reduction in employment in the public sector. Despite this, total employment has increased to the highest level for four years as over one million jobs have been created in the private sector in the last two years.

Inflation and Bank Rate - Inflation has fallen sharply during 2012 from a peak of 5.2% in September 2011 to 2.2% in September 2012. However,

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inflation increased back to 2.7% in October 2012 though it is expected to fall further to the 2% target level within the two year horizon.

AAA rating – The UK continues to enjoy an AAA sovereign rating. However, the credit rating agencies will be carefully monitoring the rate of growth in the economy as a disappointing performance in that area could lead to a major derailment of the plans to contain the growth in the total amount of Government debt over the next few years.

Sector's forward view

Economic forecasting remains difficult with so many external influences weighing on the UK. There does, however, appear to be consensus among analysts that the economy remains relatively fragile and whilst there is still a broad range of views as to the potential performance, they have all been downgraded throughout 2012. Key areas of uncertainty include:

- The potential for the Eurozone to withdraw support for Greece at some point if the costs of such support escalate were to become prohibitive, so causing a worsening of the Eurozone debt crisis and heightened risk of the breakdown of the bloc or even of the currency itself;
- Inter government agreement on how to deal with the Eurozone debt crisis could fragment; the impact of the Eurozone crisis on financial markets and the banking sector;
- The impact of the Government's austerity plan on confidence and growth and the need to rebalance the economy from services to exporting manufactured goods;
- The under-performance of the UK economy which could undermine the Government's policies that have been based upon levels of growth that are unlikely to be achieved;
- The risk of the UK's main trading partners, in particular the European Union (EU) and United States (US), falling into recession;
- Stimulus packages failing to stimulate growth;
- Election due in Germany in 2013;
- Potential for protectionism i.e. an escalation of the currency war / trade dispute between the US and China;
- The potential for action to curtail the Iranian nuclear programme;

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- The situation in Syria deteriorating and impacting other countries in the Middle East.

The focus of so many consumers, corporates and banks on reducing their borrowing, rather than spending, will continue to act as a major headwind to a return to robust growth in western economies.

Given the weak outlook for economic growth, Sector sees the prospects for any interest rate changes in Bank Rate before 2015 as very limited. There is potential for the start of Bank Rate increases to be even further delayed if growth disappoints.

Sector believes that the longer run trend is for gilt yields and PWLB rates to rise due to high volumes of gilt issuance in the UK, and the high volume of debt issuance in other major western countries. The interest rate forecast in this report represents a balance of downside and upside risks. The downside risks have already been commented on. However, there are specific identifiable upside risks as follows to PWLB rates and gilt yields, and especially to longer term rates and yields: -

- UK inflation being significantly higher than the wider EU and US causing an increase in the inflation premium in gilt yields;
- Reversal of QE; this could initially be allowing gilts held by the Bank to mature without reinvesting in new purchases, followed later by outright sale of gilts currently held;
- Reversal of Sterling's safe haven status on an improvement in financial stresses in the Eurozone;
- The possibility of a UK credit rating downgrade (Moody's has stated that it will review the UK's Aaa rating at the start of 2013).