

Gloucester City Council

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|-------------------------|--|---------------------------------|--------------------------------------|
| Meeting: | Audit and Governance Committee | : | 25TH November 2013 |
| | Cabinet Briefing | | 15th January 2014 |
| Subject: | Treasury Management Update – Quarter 2 Report 2013/14 | | |
| Report Of: | Corporate Director of Resources | | |
| Wards Affected: | All | | |
| Key Decision: | No | Budget/Policy Framework: | Yes |
| Contact Officer: | Jon Topping | | |
| | jon.topping@gloucester.gov.uk | | Tel: 396242 |
| Appendices: | 1. Treasury Management Investments | | |
| | 2. Prudential and Treasury Indicators | | |
| | 3. Economic Outlook | | |

1.0 Purpose of Report

- 1.1 One of the requirements of the revised Code of Practice for Treasury Management in November 2011 recommends that members should be updated on treasury management activities at least twice a year, but preferably quarterly. This report covers Quarter 2, 1st July 2013 to 30th September 2013.
- 1.2 This report will highlight issues specific to the Council and also highlight the overall economic outlook as provided by the Councils treasury advisors Capita Asset Services.
- 1.3 The body of the report provides an overview of the Councils performance in Quarter 2 ;
 - **Appendix 1** highlights the key performance indicators in line with the Councils Treasury Management Strategy.
 - **Appendix 2** is the investments held at the end of quarter 2.
 - **Appendix 3** is an economic summary provided by the Councils treasury advisors.

2.0 Recommendations

- 2.1 Audit and Governance Committee is asked to **RESOLVE** that the report be noted and to approve any changes it may require to the prudential indicators.

3.0 Annual Investment Strategy

The Treasury Management Strategy Statement (TMSS) for 2013/14, which includes the Annual Investment Strategy, was approved by the Council on 10th April 2013. It sets out the Council's investment priorities as being:

- Security of capital;
- Liquidity; and
- Yield

- 3.1 The Council also aim to achieve the optimum return (yield) on investments commensurate with proper levels of security and liquidity. In the current economic climate it is considered appropriate to keep investments short term to cover cash flow needs, but also to seek out value available in higher rates in periods up to 12 months, with highly credit rated financial institutions, using our suggested creditworthiness approach, including sovereign credit rating and Credit Default Swap (CDS) overlay information provided by Capita Asset Services.
- 3.2 Officers can confirm that the approved limits within the Annual Investment Strategy were not breached during the quarter ended 30th September 2013.
- 3.3 Investment rates available in the market have continued at historically low levels and have fallen further during the quarter as a result of the Funding for Lending Scheme. The average level of funds available for investment purposes during the quarter was £8.5m. These funds were available on a temporary basis, and the level of funds available was mainly dependent on the timing of precept payments, receipt of grants and progress on the Capital Programme.
- 3.4 Investment performance for quarter ended 30th September 2013

| Benchmark | Benchmark Return | Council Performance | Investment Interest Earned |
|--------------|------------------|---------------------|----------------------------|
| 7 day | 0.36% | 0.38% | £8,070 |

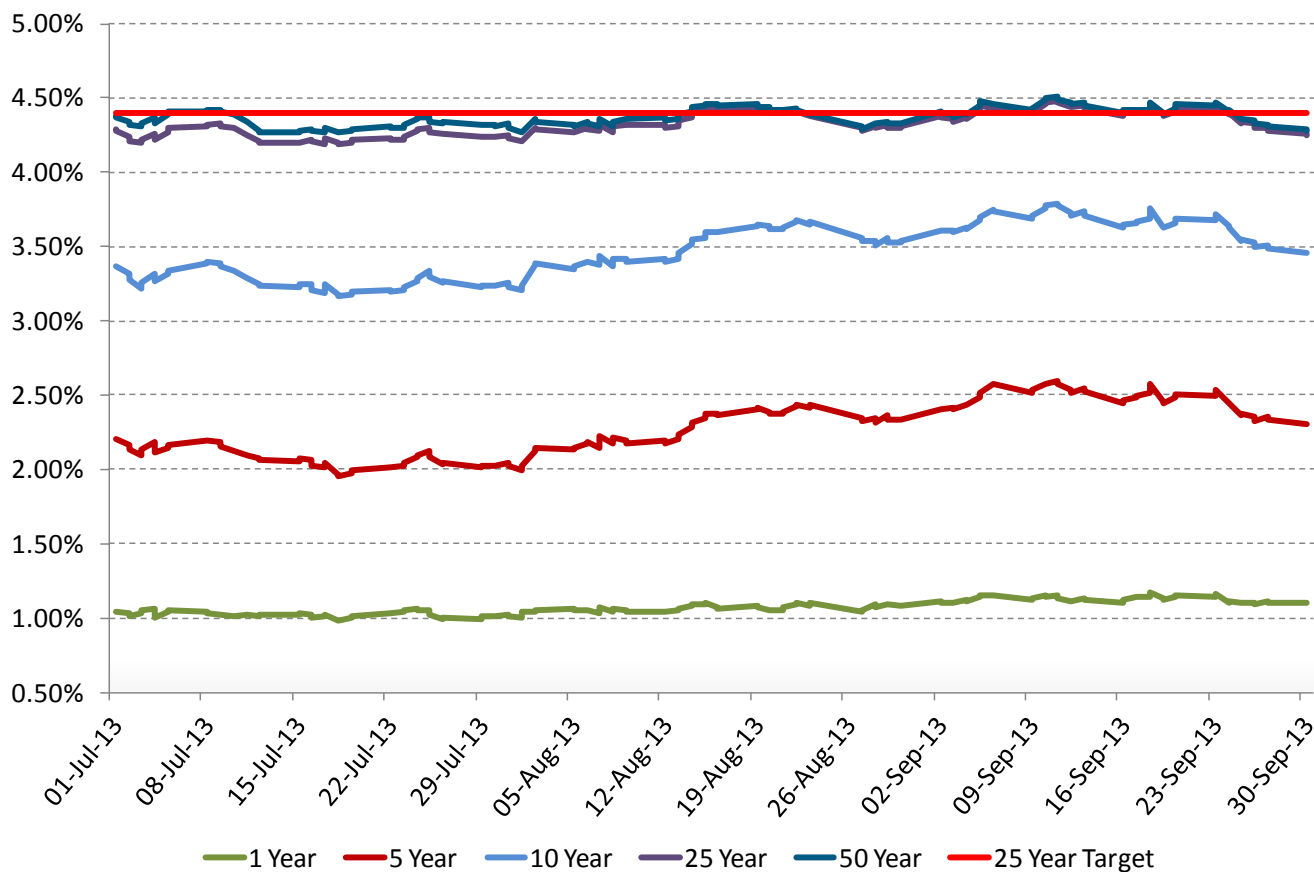
As illustrated, the Council outperformed the benchmark by 2 bps. The Council's budgeted investment return for 2013/14 is £45,770 and performance for the year to date is in line with the budget.

4.0 New Borrowing

- 4.1 The 25 year PWLB target rate for new long term borrowing for the quarter rose from 4.10% to 4.40%.
- 4.2 No borrowing was undertaken during the quarter.
- 4.3 PWLB certainty rates, quarter ended 30th September 2013

| | 1 Year | 5 Year | 10 Year | 25 Year | 50 Year |
|------------|--------|--------|---------|---------|---------|
| Low | 0.98% | 1.95% | 3.17% | 4.19% | 4.27% |

| | | | | | |
|---------|------------|------------|------------|------------|------------|
| Date | 18/07/2013 | 18/07/2013 | 18/07/2013 | 18/07/2013 | 18/07/2013 |
| High | 1.17% | 2.6% | 3.79% | 4.48% | 4.51% |
| Date | 18/09/2013 | 11/09/2013 | 11/09/2013 | 11/09/2013 | 11/09/2013 |
| Average | 1.07% | 2.27% | 3.47% | 4.32% | 4.37% |



4.4 To minimise investment risk, the Council has reduced external investments in lieu of new external borrowing. This was achieved by reducing the overall debt liability by repaying £5,000,000 of external debt. However, this policy will require ongoing monitoring in the event that upside risk to gilt yields prevails.

4.5 Borrowing in advance of need.

The Council has not borrowed in advance of need during the quarter ended 30th September 2013 and has no intention to borrow in advance in 2013/14.

5.0 Debt Rescheduling

5.1 Debt rescheduling opportunities have been limited in the current economic climate and following the increase in the margin added to gilt yields which has impacted PWLB new borrowing rates since October 2010. During the quarter ended 30th September 2013, no debt rescheduling was undertaken.

6.0 Compliance with Treasury and Prudential Limits

- 6.1 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 TMSS.
- 6.2 During the financial year to date the Council has operated within the treasury and prudential indicators set out in the Council's Treasury Management Strategy Statement and in compliance with the Council's Treasury Management Practices. The prudential and treasury Indicators are shown in appendix 1.

7.0 Other

- 7.1 During the first half of 2013/14 the Council continued to maintain an under-borrowing position. As at 30th September 2013 the position is almost level with a small under borrowing of £0.1m.
- 7.2 This under-borrowing reflects that the Council resources such as reserves and provisions will have reduced debt rather than be externally invested. This strategy is sensible, at this point in time, for two reasons. Firstly, there is no differential between the marginal borrowing rate and investment rate so there is nothing to be gained by investing Council resources externally. Secondly, by using the resources to reduce debt the Council will reduce exposure to investment counterparty risk.

Prudential and Treasury Indicators as at 30th September 2013

| Treasury Indicators | 2013/14 Budget £'000 | Quarter 2 Actual £'000 |
|--|-------------------------|---------------------------|
| Authorised limit for external debt | £84M | £67.6M |
| Operational boundary for external debt | £83M | £67.6M |
| Gross external debt | £84M | £67.6M |
| Investments | Nil | £7M |
| Net borrowing | £84m | £60.6M |
| Maturity structure of fixed rate borrowing - upper and lower limits | | |
| Under 12 months | 0% - 85% | 31.9% |
| 12 months to 2 years | 0% - 85% | 0% |
| 2 years to 5 years | 0% - 85% | 21.3% |
| 5 years to 10 years | 0% - 90% | 6.6% |
| 10 years to 20 years *1 | 5% - 95% | 13.6% |
| 20 years to 30 years *1 | 5% - 95% | 26.6% |
| 30 years to 40 years *1 | 5% - 95% | 0% |
| 40 years to 50 years *1 | 5% - 95% | 0% |
| Upper limit of fixed interest rates based on net debt *2 | | |
| Upper limit of fixed interest rates based on net debt *2 | 100% | 55.6% |
| Upper limit of variable interest rates based on net debt *2 | | |
| Upper limit of variable interest rates based on net debt *2 | 100% | 44.4% |
| Upper limit for principal sums invested for over 364 days | | |
| Upper limit for principal sums invested for over 364 days | £2m | Nil |

| Prudential Indicators | 2013/14 Budget £'000 | Quarter 2 Actual £'000 |
|---|-------------------------|---------------------------|
| Capital expenditure * | | |
| • HRA | £5.066M | £1.592M |
| • GF | £7.208M | £1.149M |
| Capital Financing Requirement (CFR) * | | |
| • HRA | £62.750m | N/A |
| • GF | £17.436m | N/A |
| Annual change in CFR * | £5.021 | N/A |
| In year borrowing requirement | NIL | NIL |
| Ratio of financing costs to net revenue stream * | | |
| • HRA | 12.7% | N/A |
| • GF | 9.4% | N/A |

| | | |
|---|-------|-------|
| Incremental impact of capital investment decisions:- | | |
| a) Increase in council tax (band change) per annum. | £2.41 | N/A |
| b) Increase in precept for police, fire or other precepting authorities. | £0.00 | £2.22 |
| c) Increase in average housing rent per week (housing authorities only). | £0.63 | £2.76 |

Notes

* Housing authorities should split these lines into HRA and non HRA

* 1 paragraph 229 2013 Code: requires debt to be split into 10 year bands if most debt is over 10 years.

* 2 page 62 of the Code: alternative option based on net interest

The CIPFA Treasury Management Code of Practice 2011, page 36 on TMP6 Reporting Requirements, stipulates that midyear and / or quarterly update reports on treasury management must include updates on the prudential indicators. However, this is a minimum requirement which means that each local authority needs to decide if updates of the prudential indicators should also be included e.g. if a major capital project is cancelled or incurs major slippage, then the borrowing requirement and CFR prudential indicators may require significant updating, and therefore inclusion in this report, so that members can gain a proper understanding of the consequent impact on, and the changes required, to the treasury indicators. It would then also be appropriate if the above table was expanded to include a separate column for revised prudential and treasury indicators besides the column for the original indicators.

APPENDIX 2**Investment Portfolio
Investments held as at 30th September 2013 compared to our
counterparty list:**

| Name | £'000 | Date of Redemption | Counterparty Limits |
|---|---------------|-------------------------------|--------------------------------|
| Goldman Sachs | £4,000 | Overnight | £5m |
| Natwest | <u>£3,000</u> | Overnight | £5m |
| Total Investments as at 30/09/13 | £7,000 | | |

1.0 Economic Background

1.1 During the quarter ended 30 September 2013:-

- Indicators suggested that the economic recovery accelerated;
- Household spending growth remained robust;
- Inflation fell back towards the 2% target;
- The Bank of England introduced state-contingent forward guidance;
- 10-year gilt yields rose to 3% at their peak and the Financial Times Stock Exchange (FTSE) 100 fell slightly to 6460;
- The Federal Reserve decided to maintain the monthly rate of its asset purchases.

1.1.1 After strong growth of 0.7% in Q2, it appears that UK Gross Domestic Product (GDP) is likely to have grown at an even faster pace in Q3. On the basis of past form, the Chartered Institute of Purchasing and Supply (CIPS)/Markit business surveys for July and August point to quarterly growth of potentially over 1.0% in the third quarter of 2013. Similarly, the official data have continued to improve. Admittedly, industrial production was flat in July. But even if it held steady in the rest of the quarter, it would still be 0.9% higher in Q3 than in Q2. In addition, the service sector expanded by 0.2% m/m and the construction sector grew by 2.2% m/m in July after growth of 1.8% q/q in Q2.

1.1.2 Consumer spending also continued to rise and may beat the increase seen in Q2. While the 1.1% monthly rise in retail sales in July was almost entirely offset by a 0.9% fall in August, the unusually warm weather in August is likely to have had a part to play in this. The retail surveys also painted a positive picture for household spending growth, with the Bank of England's Agents' Scores, BRC and CBI retail sales indicators showing stronger growth in Q3. And while growth in non-high street spending may have slowed, it probably remained robust. For example, although annual growth in new car registrations eased from the 24% rate seen in Q2, it was still a strong 15% in August.

1.1.3 The run of good news on the labour market continued, with the International Labour Organisation (ILO) unemployment rate falling to 7.7% in July from 7.8% in June. Employment rose by 80,000 in the three months to July, supported by an even bigger rise in full-time employment. This meant that the ratio of full-time to part-time workers continued to rise after it troughed last summer. The timelier claimant count measure of the unemployment rate also fell. Indeed, the cumulative fall in unemployment of 68,900 in July and August – the biggest two month fall since May and June 1997 – brought the claimant count unemployment rate down from 4.4% at the end of Q2 to 4.2% in August. Despite this, the headline (3 month average of the annual) rate of pay growth fell from 2.2% in June to just 1.1% in July. Excluding bonuses, earnings growth ticked up slightly to 1.1% y/y, but this remained well below the rate of Consumer Price Index (CPI) inflation at 2.7% in August, meaning real wages continued to fall.

- 1.1.4 Meanwhile, the cost of new credit has continued to fall, perhaps in response to the extension of the Bank of England's Funding for Lending Scheme (FLS) earlier this year. The quoted interest rate on a 5-year fixed mortgage at a 75% loan-to-value ratio was 3.34% in August, 7 basis points lower than in June and 77 basis points lower than when the FLS was introduced in July 2012.
- 1.1.5 Demand in the housing market continued to grow at a fast pace, supported by the FLS and the Government's Help to Buy scheme, which provide equity loans to credit-constrained borrowers. The Royal Institution of Chartered Surveyors (RICS) housing market survey reported that new buyer enquiries hit their highest level on record in August. Mortgage approvals for new house purchase rose to their highest level since February 2008 in August. Consequently, house prices continued to rise, with the Halifax and Nationwide measures recording 6.2% and 3.5% y/y rises in August, respectively. Office for National Statistics (ONS) data, though, shows that in real terms only London experienced year-on-year price rises in July. All other regions saw modest falls.
- 1.1.6 The economic recovery may finally be feeding through to the public finances. Although the government registered a surprise deficit in July (a month that normally delivers a surplus), in August net borrowing was 'just' £13.2bn, compared to £14.4bn in August 2012.
- 1.1.7 The new Governor of the Bank of England, Mark Carney, took office in July. Alongside the August Quarterly Inflation Report, the Bank introduced its new policy of forward guidance in which the Monetary Policy Committee (MPC) pledged not to raise official interest rates, or reduce the size of the asset purchase facility, until the ILO unemployment rate falls to 7%. At this point, the MPC would discuss whether or not to alter official policy. This guidance was subject to three 'knockouts' which, if breached, would invalidate the guidance. These are that the MPC forecasts inflation at or above 2.5% in 18-24 months' time, inflation expectations are no longer sufficiently well anchored or financial stability is threatened by the stance of monetary policy. On the MPC's current forecasts, the unemployment rate is most likely to reach 7% in late 2016.
- 1.1.8 However, financial markets continued to price in increases in Bank Rate by mid-2015, with overnight index swap rates and gilt yields rising after the announcement of forward guidance. Members of the MPC subsequently appeared at the Treasury Select Committee and three gave further speeches to clarify the guidance, but there was little market impact. However, the Bank of England's surveys suggest the message may have got through to the public as the balance of people expecting interest rates to rise over the next 12 months fell from 29% in May to 24% in August.
- 1.1.9 Meanwhile, CPI inflation fell from a 2013 peak of 2.9% in June to 2.7% in August. The fall was primarily the result of a drop in the contribution from petrol prices and a reduction in core inflation from 2.3% in June to 2% in August. CPI inflation looks likely to have edged down again in September, perhaps to about 2.5%, reflecting a further fading of both energy prices and core inflation.
- 1.1.10 The big news in financial markets was that the Federal Reserve unexpectedly decided not to taper its asset purchases in September. In announcing its decision to maintain monthly purchases at \$85bn, the Fed explained that it wanted to "await more evidence that [the economic recovery] will be sustained before adjusting the

pace of its purchases.” This came despite previous hints of tapering from the Fed and the fall in the unemployment rate in both July and August. It currently stands at

1.1.11 Across the quarter as a whole, advanced economy bond markets sold off, suggesting the rise in UK gilt yields was not solely down to markets’ scepticism about domestic forward guidance. Gilt yields tracked US Treasury yields up, with ten-year gilts rising by around 60 basis points to reach 3% in early September for the first time since mid-2011. After the Fed’s decision not to taper, gilt yields fell back, although not enough to offset the previous rise. Ten-year gilts finished the quarter at 2.7%. Equity markets stayed relatively flat over the quarter. While the Financial Times Stock Exchange (FTSE) 100 rose from 6470 to 6620 over the first few weeks of June, the index closed the quarter at 6462.

1.1.12 Meanwhile, Eurozone business surveys suggested that the economy continued to expand in Q3, albeit at a moderate pace. There was also a general election in Germany in which the incumbent Chancellor, Angela Merkel, performed better than expected by winning 41.5% of the vote. She is now likely to form a coalition, but it remains to be seen what form this will take.

2.1 Interest Rate Forecast

The Council’s treasury advisor, Capita Asset Services, has provided the following forecast:

| | Dec-13 | Mar-14 | Jun-14 | Sep-14 | Dec-14 | Mar-15 | Jun-15 |
|----------------|--------|--------|--------|--------|--------|--------|--------|
| Bank rate | 0.50% | 0.50% | 0.50% | 0.50% | 0.50% | 0.50% | 0.50% |
| 5yr PWLB rate | 2.50% | 2.50% | 2.60% | 2.70% | 2.70% | 2.80% | 2.80% |
| 10yr PWLB rate | 3.70% | 3.70% | 3.70% | 3.80% | 3.80% | 3.90% | 4.00% |
| 25yr PWLB rate | 4.40% | 4.40% | 4.40% | 4.50% | 4.50% | 4.60% | 4.70% |
| 50yr PWLB rate | 4.40% | 4.40% | 4.40% | 4.50% | 4.60% | 4.70% | 4.80% |

Capita Asset Services undertook a review of its interest rate forecasts in late September as a result of an increase in confidence in economic recovery, chiefly in the US, but more recently, also in the UK and Eurozone. The latest forecast now includes a first increase in Bank Rate in quarter 3 of 2016 (previously quarter 4).

3.1 SUMMARY OUTLOOK

UK economy

After the previous Inflation Report included a somewhat encouraging shift towards optimism in terms of a marginal upgrading of growth forecasts, the August Inflation Report occurred in the midst of a welter of economic statistics which have left economists and forecasters speechless in terms of finding suitable words to describe a major simultaneous shift up in gear of the economy in all of the three sectors of services, manufacturing / industrial AND construction! It is therefore not surprising that the Report upgraded growth forecasts for 2013 from 1.2% to 1.4% and for 2014 from 1.7% to 2.5%. However, Bank Governor Mark Carney put this into perspective by describing this welcome increase as not yet being “escape velocity” to ensure we return to strong AND sustainable growth, after what has been the weakest recovery on record after a recession. So very encouraging – yes, but, still a long way to go! As for inflation, it was forecast to be little changed from the previous Report – falling back to 2% within two years and staying there during year three.

In addition to the stimulus provided by Quantitative Easing (QE), the Funding for Lending Scheme (FLS), is aimed at encouraging banks to expand lending to small and medium size enterprises. The FLS certainly seems to be having a positive effect in terms of encouraging house purchases (though levels are still far below the pre-crisis level), and causing a significant increase in house prices – but only in London and the south east. FLS is also due to be bolstered by the second phase of Help to Buy aimed to support purchasing of second hand properties, which is now due to start in October.

Forward guidance caveats

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 (Labour Force Survey /International Labour Organisation (ILO) i.e. not the claimant count measure) 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 % on the Labour Force Survey (LFS) / ILO measure. 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 Capita Asset Services view is that the recession since 2007 was notable for how unemployment did NOT rise to the levels that would normally be expected in a major recession. The latest Inflation Report noted that productivity has sunk to 2005 levels. We are, therefore, concerned that there has been a significant level of retention of labour, which will mean that a significant amount of GDP growth can be accommodated without a major reduction in unemployment.

In summary, our current views are centred around the following: -

UK

- Growth has been on an upward trend – 0.3% in Q1; 0.7% in Q2 and likely to be much stronger in Q3. The so called double dip recession at the beginning of 2012 was erased by the latest revision of statistics.
- Business surveys, consumer confidence, consumer borrowing and house prices are all on the up and may help to create a wide spread feel good factor. However, this is still a long way away from the UK getting back to sustainable strong growth.
- A fair proportion of UK GDP is dependent on overseas trade; the high correlation of UK growth to US and EU Gross Domestic Product (GDP) growth means that the UK economy is still vulnerable to what happens in overseas markets.
- Consumer expenditure is likely to remain suppressed by inflation being higher than increases in average earnings i.e. disposable income will continue to be eroded.
- The coalition government is hampered in promoting growth by the need to tackle the budget deficit. However, the March Budget did contain measures to boost house building and the supply of mortgages, and brought forward, by one year to April 2014, the start of a £10,000 tax free allowance for incomes.
- There is little sign of a co-ordinated strategy for the private sector to finance a major expansion of infrastructure investment to boost UK growth.
- Government inspired measures to increase the supply of credit to small and medium enterprises (which are key to achieving stronger growth) by banks are not succeeding.
- Gilt yields remain vulnerable to pressures to rise, especially as they are powerfully influenced by US treasury yields and American investors have been spooked by Chairman Bernanke's comments on tapering QE. The Fed's reluctance to start tapering in September has, potentially, only delayed a trend for gilt yields to rise.

Eurozone

- Most Eurozone countries are now starting to see a return to growth after a prolonged recession. The prospects for growth, at least in the short term, have also improved. However, for some countries, austerity programmes could prove to be a self defeating spiral of falling demand, tax receipts, and GDP, leading to a rise, not fall, in debt to GDP ratios. Debt ratios in excess of 90% will cause market concern as beyond this level, the costs of servicing such debt becomes oppressive and growth inhibiting. This could, therefore, lead to an inevitable end game in the over the next few years of withdrawal from the Eurozone bloc in order to regain national control of a currency, government debt, monetary policy and, therefore, of setting national interest rates. The European Central Bank (ECB's) pledge to provide unlimited bond buying support for countries that request an official bailout means that market anxiety about these countries is likely to be subdued in the near term. However, the poor economic

fundamentals and outlook for some economies could well mean that an eventual storm in financial markets has only been delayed, not cancelled.

- The ECB maintained its central policy rate at 0.5% in this quarter.
- Greece: after the agreement to a further major financial support package amounting to nearly €50bn in December 2012, it now looks almost certain that the country will need another, smaller, bailout package as progress has not been quick enough in rectifying the national finances.
- Spain: there is also increasing concern over the Spanish economy; the social cost and pain of a very high level of unemployment of 27%, similar to the level in Greece, could mean that both countries are approaching the limit of operating austerity programmes within democratic systems. Spain has, to date, resisted asking for an official national bailout, although it has received financial support to recapitalise its four largest banks.
- Italy: the general election created a highly unstable political situation where the two dominant parties initially formed an unlikely coalition due to the blocking power of the new upstart Five Star anti-austerity party which has 25% of seats and has refused to enter a coalition agreement with ANY party. There could therefore be volatility in Spanish and Italian bond yields over the next year, depending on political and economic developments.
- Germany: the general election in September returned Angela Merkel's party to power, but not with an overall majority. It will have to form a coalition, but with a new makeup, as the previous junior party was wiped out.
- Cyprus: the fallout from the bail out in March 2013 has done huge damage to the Cypriot economy and many commentators consider it is only a matter of time before another bailout will be needed – or exit from the Euro.
- The Eurozone remains particularly vulnerable to investor fears of contagion if one country gets into major difficulty.

US

- There has been a marked improvement in consumer, investor and business confidence this year.
- Unemployment has continued on a steady, but unspectacular decline to 7.3%, but is still a long way from the target rate of 6.5% for an increase in the Fed policy rate.
- The housing market has turned a corner, both in terms of rising prices and in increases in the volume of house sales. More householders are, therefore, escaping from negative equity.
- US equities have reached all time highs.
- The package of tax increases and cuts in Government expenditure starting in 2013 does not appear to be having a major impact on depressing growth.
- GDP in Q1 was disappointingly downgraded from +2.4% to a sub par +1.8% before rising to 2.5% in Q2.
- The shale gas revolution is providing some solid underpinning to the US economy by enhancing its international competitiveness through cheap costs of fuel.

- There has been a start to the repatriation of manufacturing production from China to the USA as Chinese labour costs have continued their inexorable rise and new forms of high tech production have made home based production more viable and flexible.

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 dependent on new investment expenditure, and for a potential bubble in the property sector to burst, as it did in Japan in the 1990s, with its consequent impact on the financial health of the banking sector.
- There are also increasing concerns around the potential size, and dubious creditworthiness, of some bank lending to local government organisations and major corporates. This primarily occurred during the government promoted expansion of credit, which was aimed at protecting the overall rate of growth in the economy after the Lehmans crisis.

Japan

- The initial euphoria generated by “Abenomics”, the huge QE operation instituted by the Japanese government to buy Japanese debt, has tempered as the follow through of measures to reform the financial system and introduce other economic reforms, appears to have stalled.

3.2 Our 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 favouring more risky assets i.e. equities, and safer bonds.

Near-term, there is some residual risk of further QE - if there is a dip in strong growth or if the MPC takes action to do more QE in order to reverse the rapid increase in market rates, especially in gilt yields and interest rates up to 10 years. This could cause shorter-dated gilt yields and Public Works loan Board (PWLB) rates over the next year or two to significantly undershoot the forecasts in the table below. The failure in the US, (at the time of writing), over passing a Federal budget for the new financial year starting on 1 October, and the expected tension over raising the debt ceiling in mid-October, could also see bond yields temporarily dip until any binding agreement is reached between the opposing Republican and Democrat sides. Conversely, the eventual start of tapering by the Fed could cause bond yields to rise.

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
- Prolonged political disagreement over the US Federal Budget and raising the debt ceiling
- 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.
- The Italian political situation is frail and unstable.
- 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.
- Geopolitical risks e.g. Syria, Iran, 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 investor 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.

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, followed later by outright sale of gilts.