

Gloucester City Council

Meeting:	Audit and Governance	:	17 March 2014
Subject:	Treasury Management Update – Quarter 3 Report 2013/14		
Report Of:	Corporate Director of Resources		
Wards Affected:	All		
Key Decision:	No	Budget/Policy Framework:	Yes
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Appendices:	1. Prudential and Treasury Indicators		
	2. Treasury Management Investments		
	3. Economic Outlook		
	4. Interest rate forecasts		

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 3, 1st October 2013 to 31st December 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 3 ;
- **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 3.
 - **Appendix 3** is an economic summary provided by the Councils treasury advisors.
 - **Appendix 4** is a detailed commentary on interest rate forecasts

2.0 Recommendations

- 2.1 Audit and Governance Committee is asked to **RESOLVE** that the report be noted and note that no changes are required 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 will 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 cashflow needs, but also to seek out value available 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.
- 3.2 Officers can confirm that the approved limits within the Annual Investment Strategy were not breached during the quarter ended 31st December 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 31st December 2013

Benchmark	Benchmark Return	Council Performance	Investment Interest Earned
7 day	0.35%	0.38%	£7.962

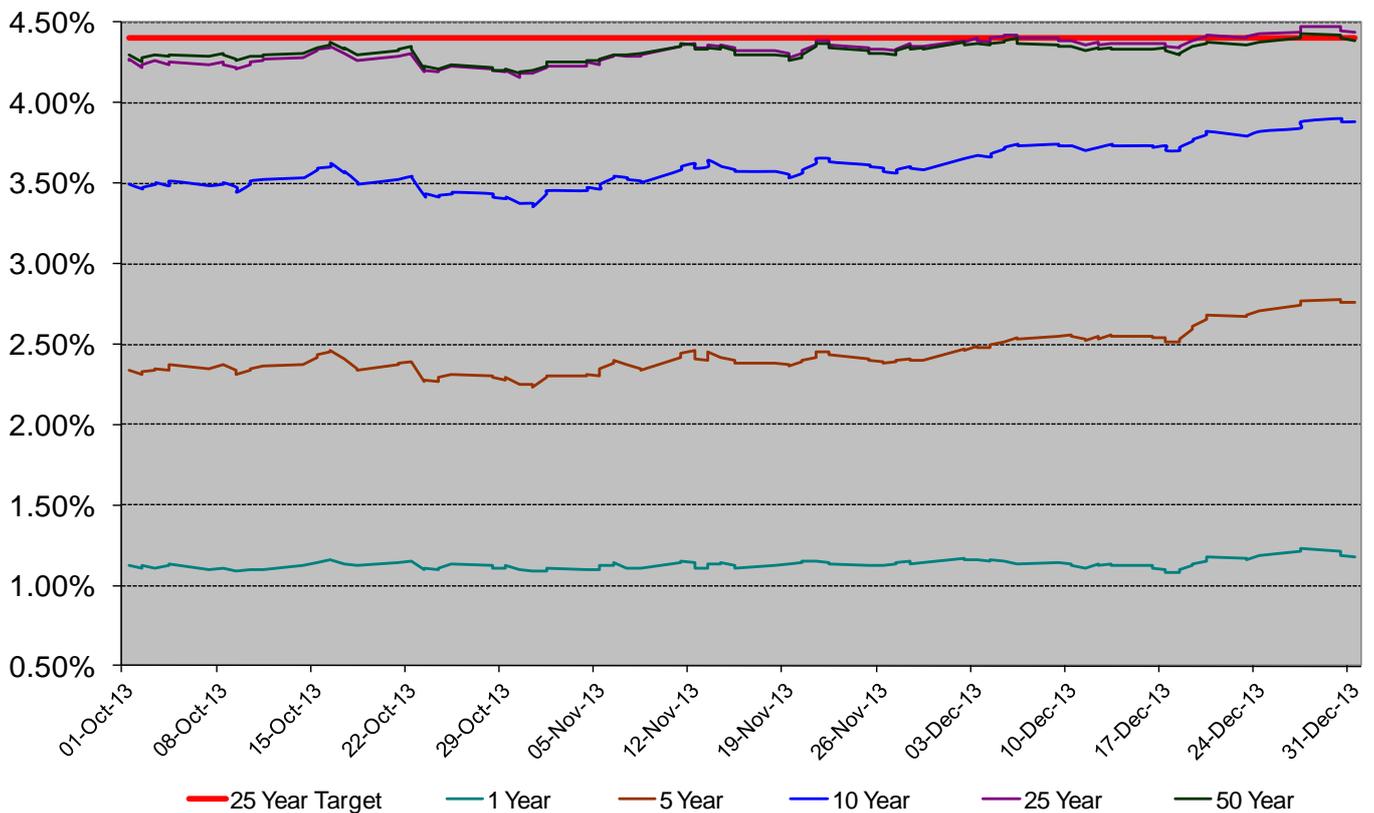
As illustrated, the Council outperformed the benchmark by 2.6 bps. The Council's budgeted investment return for 2013/14 is £45,770 and performance for the year to date is in line with the budget.

4.0 New Borrowing

- 4.1 The 25 year PWLB target rate for new long term borrowing for the quarter remained at 4.40%.
- 4.2 No borrowing was undertaken during the quarter.

4.3 PWLB certainty rates, quarter ended 31st December 2013

	1 Year	5 Year	10 Year	25 Year	50 Year
Low	1.08%	2.23%	3.35%	4.16%	4.18%
Date	17/12/2013	31/10/2013	31/10/2013	30/10/2013	30/10/2013
High	1.23%	2.78%	3.90%	4.47%	4.43%
Date	27/12/2013	30/12/2013	30/12/2013	27/12/2013	27/12/2013
Average	1.13%	2.43%	3.59%	4.32%	4.31%



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 31st December 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 31st December 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 31st December 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.

APPENDIX 1

Prudential and Treasury Indicators as at 31st December 2013

Treasury Indicators	2013/14 Budget £'000	Quarter 3 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	£5.5M
Net borrowing	£84m	£62.1M
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 3 Actual £'000
Capital expenditure *		
• HRA	£5.066M	£2.207M
• GF	£7.208M	£2.794M
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	N/A
c) Increase in average housing rent per week (housing authorities only).	£0.63	£2.76

APPENDIX 2

Investment Portfolio

Investments held as at 31st December 2013 compared to our counterparty list:

Name	£'000	Date of Redemption	Counterparty Limits
Goldman Sachs	£1,000	Overnight	£5m
Natwest	<u>£4,500</u>	Overnight	£5m
	£5,500	Total Investments as at 31/12/13	

Detailed economic commentary on developments during quarter ended 31st Dec 2013

1.0 Economic Background

- 1.1 After strong UK growth of 0.7% in quarter 2 and 0.8% in quarter 3, it appears that UK Gross Domestic Product (GDP) is likely to have grown at an even faster pace in quarter 4 of 2013. Forward surveys are also very encouraging in terms of strong growth and there are positive indications that recovery is broadening away from reliance on consumer spending and the housing market into construction, manufacturing, business investment and exporting. This strong growth has resulted in unemployment falling much faster towards the threshold of 7%, set by the Monetary Policy Committee (MPC) before it said it would consider any increases in Bank Rate, than it expected last August when that threshold was initially set. Accordingly, markets are expecting a first increase in early 2015 though recent comments from MPC members have emphasised they would want to see strong growth well established, and an increase in real incomes, before they would consider raising Bank Rate.
- 1.1.1 Also encouraging has been a sharp fall in inflation Consumer Price Index (CPI) to 2.1% in November and forward indications are that inflation will continue to be subdued. The return to strong growth has also helped lower forecasts for the increase in Government debt by £73bn over the next five years, as announced in the Autumn Statement, and fostered optimism for achieving a balance in the cyclically adjusted budget within five years, a year earlier than previously forecast.
- 1.1.2 The big news in financial markets was that the Federal Reserve, in December, felt sufficiently confident that the premise for strong growth had been established in America that it could start to taper its asset purchases by reducing them by \$10bn per month from January 2014. These encouraging growth scenarios in the USA and UK led to a sharp jump up, in December, in short dated gilts; this, accordingly, impacted 5 and 10 year Public Works Loan Board (PWLB) rates.
- 1.1.3 The third quarter of 2013 saw:
- Signs that GDP growth may have accelerated;
 - Evidence pointed to a moderation of household spending growth;
 - Inflation fell to its lowest level since November 2009;
 - Unemployment approached the MPC's 7% forward guidance threshold;
 - The MPC maintained the stance of monetary policy;
 - 10-year gilt yields rose to 3% and the Financial Times Stock Exchange (FTSE) 100 reach 6749;
 - The Federal Reserve decided to reduce the size of its monthly asset purchases by \$10bn (from \$85bn to \$75bn).
- 1.1.4 After growing at a healthy quarterly rate of 0.8% in Q3, some of the early signs are that GDP growth was even stronger in the final quarter of last year. On the basis of

past form, the Chartered Institute of Purchasing and Supply (CIPS)/Markit business activity surveys point to quarterly GDP growth of around 1.5% in the final quarter. The official data available for the fourth quarter so far have also been encouraging. For example, if October's 0.4% monthly expansion in industrial output was matched in the final two months of the year, quarterly growth in Q4 would have been almost 1%.

- 1.1.5 Household spending growth, though, may have slowed. Numerous indicators of retail sales, including the official measure and those produced by the Confederation of British Industry (CBI) and British Retail consortium (BRC), suggest that consumer spending growth was weak in the first two months of Q4. This is not to say the consumer recovery has run its course. Indeed, the CBI survey showed a strong pick-up in sales in December. And the official measure of retail sales in the same month will be boosted by the inclusion of 'Black Friday' (despite this actually falling in the last week of November) which more timely data suggests saw a strong surge in sales. But it would take monthly growth of 1.6% in December for retail sales just to flat line in Q4 as a whole.
- 1.1.6 Nevertheless, growth in sales off the high street may not have done so badly. For instance, although growth in new car registrations slowed in Q4, it remained fairly strong, achieving 7% annual growth in December. So it still seems likely that overall household spending rose in the fourth quarter.
- 1.1.7 Although it is still high, the unemployment rate has been falling quickly towards the Monetary Policy Committee's (MPC) 7% threshold for re-assessing the stance of monetary policy. Employment rose by 250,000 in the three months to October, the largest quarterly gain since mid-2010. This brought the unemployment rate down to 7.4%, compared to a rate of 7.7% in the three months to July. What's more, the Office for National Statistics (ONS)' experimental single-month estimate of unemployment reached 7% in October.
- 1.1.8 The decline in unemployment, which has been faster than the MPC predicted in November, has prompted overnight index swap markets to price in a rate rise as soon as Q1 2015. But Committee members have increasingly emphasised that the 7% unemployment rate is a threshold for reconsidering policy, rather than a trigger for raising rates. Indeed, the Bank's Chief Economist Spencer Dale said that interest rates would remain low not just until unemployment had dropped, but also until the economy had "seen a prolonged period of strong growth...[and] real incomes are higher".
- 1.1.9 The recent fall in, and improvement in the outlook for, inflation, suggests that interest rates will probably remain on hold even if the unemployment rate falls quickly to the 7% threshold. Indeed, CPI inflation has fallen quite sharply, reaching 2.1% in November. This was the lowest rate in four years. A number of factors contributed to this. Falling commodity prices put downward pressure on food and petrol prices, while sterling's 7% appreciation on a trade-weighted basis since its low point in July may have helped core inflation to fall. Admittedly, CPI inflation might have ticked up again in December when energy companies raised their prices. But inflation should continue to fall after that, given that commodity prices have been flat over the past year or so and sterling's recent strength has reduced import prices, which should begin feed into prices on the high street.

- 1.1.10 The housing market continued to recover in Q4, supported by the earlier implementation of the mortgage guarantee element of the Government's Help to Buy Scheme. Prices rose at an annual rate of 8.4% and 6.4% in November according to the Halifax and Nationwide measures, respectively. And would-be buyers continue to enter the market more quickly than sellers, with the Royal Institute of Chartered Surveyors (RICS) survey pointing to further price rises. The cost of new mortgages remains low, too, with the quoted interest rate on a 5-year fixed mortgage at a 75% loan-to-value ratio at 3.36% in November, 2 basis points lower than the average in Q3 and 81 basis points lower than when the Funding for Lending Scheme (FLS) was introduced in July 2012. But talk of a housing bubble on the national level still seems to be wide of the mark, with prices well below their pre-crisis peak in real terms. Moreover, the FLS was adjusted so that it no longer provides cheap finance for mortgages.
- 1.1.11 Meanwhile, there were few surprises in the Autumn Statement. The Chancellor announced a fiscally neutral package of policies, with measures to ease the cost of households' utility bills offset by further spending cuts. More bullish forecasts from the OBR left expected public borrowing over the next five years £73 billion lower than projected in the March Budget. All this left Mr Osborne expected to meet his primary fiscal mandate to balance the cyclically adjusted current budget in five years a year early, though he still misses the supplementary target for the debt to GDP ratio to be falling in 2015/16.
- 1.1.12 Internationally, the biggest news was the Federal Reserve's decision at its December meeting to begin tapering its asset purchases. Although the announcement that the Fed's monthly purchases would be reduced by \$10bn was not the consensus view, which saw tapering beginning in the early part of 2014, it was not a big surprise. The decision reflected the relative strength of the US labour market, which on average added over 200,000 jobs per month in the four months up to November.
- 1.1.13 Markets took the Fed's move in their stride, with equities and bond yields up slightly on the day. Over the quarter, equities performed well domestically and overseas as economic prospects improved. The FTSE 100 was up by 4.4% to 6749, while the S&P 500 rose by almost 10%. Gilt yields also rose, with the ten-year rate ending Q4 28 basis points higher at 3%, having closely tracked US Treasury yields. Sterling rose by 2.3% against the dollar to finish the year at 1.66, while it rose by 0.5% against the euro to 1.20.
- 1.1.14 Activity indicators in the Eurozone point towards continued weak, albeit positive, economic growth in the fourth quarter of 2013 after a mere 0.1% quarterly expansion in Q3. And disinflationary pressures are intense. Although CPI inflation rose from 0.7% to 0.9% in November, it remains well below the European Central Bank (ECB)'s target of below but close to 2%. This is despite the ECB cutting its main refinancing rate by 25 basis points to 0.25% in November.

2.1 Interest Rate Forecast

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

	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17
Bank rate	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.75%	1.00%	1.00%	1.25%
5yr PWLB rate	2.50%	2.60%	2.70%	2.70%	2.80%	2.80%	2.90%	3.00%	3.10%	3.20%	3.30%	3.40%	3.40%
10yr PWLB rate	3.60%	3.70%	3.80%	3.80%	3.90%	3.90%	4.00%	4.10%	4.20%	4.30%	4.30%	4.40%	4.50%
25yr PWLB rate	4.40%	4.50%	4.50%	4.60%	4.60%	4.70%	4.80%	4.90%	5.00%	5.10%	5.10%	5.10%	5.10%
50yr PWLB rate	4.40%	4.50%	4.50%	4.60%	4.70%	4.80%	4.90%	5.00%	5.10%	5.20%	5.20%	5.20%	5.20%

Capita Asset Services undertook a review of its interest rate forecasts in late November, after the Bank of England's latest quarterly Inflation Report. This latest forecast now includes a first increase in Bank Rate in quarter 2 of 2016 (previously quarter 3) and reflects greater caution as to the speed with which the MPC will start increasing Bank Rate than the current expectations of financial markets.

3.1 Summary Outlook

Until 2013, the economic recovery in the UK since 2008 had been the worst and slowest recovery in recent history. However, growth has rebounded during 2013 to surpass all expectations, propelled by recovery in consumer spending and the housing market. Forward surveys are currently very positive in indicating that growth prospects are also strong for 2014, not only in the UK economy as a whole, but in all three main sectors, services, manufacturing and construction. This is very encouraging as there does need to be a significant rebalancing of the economy away from consumer spending to construction, manufacturing, business investment and exporting in order for this start to recovery to become more firmly established. One drag on the economy is that wage inflation continues to remain significantly below CPI inflation so disposable income and living standards are under pressure, although income tax cuts have ameliorated this to some extent. Labour productivity must improve significantly before increases in pay rates are warranted. With regard to the US, the main world economy, it faces similar debt problems to those of the UK, but thanks to reasonable growth, cuts in government expenditure and tax rises, the annual government deficit has been halved from its peak without appearing to do too much damage to growth, although labour force participation rates remain lower than ideal.

As for 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 dynamically address fundamental issues of low growth, international uncompetitiveness and the need for overdue reforms of the economy (as Ireland has done). It is, therefore, possible over the next few years that levels of government debt to 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.

Detailed Commentary on Interest rate forecasts

THE 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 strongly rebounded in 2013 - quarter 1 (+0.3%), 2 (+0.7%) and 3 (+0.8%), to surpass all expectations as all three main sectors, services, manufacturing and construction contributed to this strong upturn. The Bank of England has, therefore, upgraded growth forecasts in the August and November quarterly Inflation Reports for 2013 from 1.2% to 1.6% and for 2014 from 1.7% to 2.8%, (2015 unchanged at 2.3%). The November Report stated that: -

In the United Kingdom, recovery has finally taken hold. The economy is growing robustly as lifting uncertainty and thawing credit conditions start to unlock pent-up demand. But significant headwinds — both at home and abroad — remain, and there is a long way to go before the aftermath of the financial crisis has cleared and economic conditions normalise. That underpins the MPC's intention to maintain the exceptionally stimulative stance of monetary policy until there has been a substantial reduction in the degree of economic slack. The pace at which that slack is eroded, and the durability of the recovery, will depend on the extent to which productivity picks up alongside demand. Productivity growth has risen in recent quarters, although unemployment has fallen by slightly more than expected on the back of strong output growth.

Forward surveys are currently very positive in indicating that growth prospects are also strong for 2014, not only in the UK economy as a whole, but in all three main sectors, services, manufacturing and construction. This is very encouraging as there does need to be a significant rebalancing of the economy away from consumer spending to construction, manufacturing, business investment and exporting in order for this start to recovery to become more firmly established. One drag on the economy is that wage inflation continues to remain significantly below CPI inflation so disposable income and living standards are under pressure, although income tax cuts have ameliorated this to some extent. This therefore means that labour productivity must improve significantly for this situation to be corrected by the warranting of increases in pay rates.

Forward guidance. The Bank of England issued forward guidance in August which said that the Bank will not start to consider raising interest rates until the jobless rate (Labour Force Survey / 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 in August, but revised to possibly quarter 4 2014 in November. The UK unemployment rate has already fallen to 7.4% on the three month rate to October 2013 (although the rate in October alone was actually 7.0%). 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 recession since 2007 was notable for how unemployment did NOT rise to the levels that would normally be expected in a major recession and the August Inflation Report noted that productivity had sunk to 2005 levels. There has, therefore, been a significant level of retention of labour, which will mean that there is potential for a significant amount of GDP growth to be accommodated without a major reduction in

unemployment. However, it has been particularly encouraging that the strong economic growth in 2013 has also been accompanied by a rapid increase in employment and forward hiring indicators are also currently very positive. It is therefore increasingly likely that early in 2014, the MPC will need to amend its forward guidance by reducing its 7.0% threshold rate and/or by adding further wording similar to the Fed's move in December (see above).

Credit conditions. While Bank Rate has remained unchanged at 0.5% and quantitative easing has remained unchanged at £375bn in 2013, the Funding for Lending Scheme (FLS) was extended to encourage banks to expand lending to small and medium size enterprises. The second phase of Help to Buy aimed at supporting the purchase of second hand properties, will also start in earnest in January 2014. These measures have been so successful in boosting the supply of credit for mortgages, and so of increasing house purchases, (though levels are still far below the pre-crisis level), that the Bank of England announced at the end of November that the FLS for mortgages would end in February 2014. While there have been concerns that these schemes are creating a bubble in the housing market, house price increases outside of London and the south-east have been 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 2.1% in November. It is expected to remain near to the 2% target level over the MPC's two year time horizon.

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

THE GLOBAL ECONOMY

The Eurozone (EZ). The sovereign debt crisis has eased considerably during 2013 which has been a year of comparative calm after the hiatus of the Cyprus bailout in the spring. In December, Ireland escaped from its three year EZ bailout programme as it had dynamically addressed the need to substantially cut the growth in government debt, reduce internal price and wage levels and promote economic growth. The EZ finally escaped from seven quarters of recession in quarter 2 of 2013 but growth is likely to remain weak and so will dampen UK growth. The ECB's pledge to buy unlimited amounts of bonds of countries which ask for a bail out, has provided heavily indebted countries with a strong defence 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 GDP ratios (2012 figures) of Greece 176%, 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 EZ targets for fiscal correction. Whilst a Greek exit from the Euro is now improbable in the short term, as Greece has made considerable progress in reducing its annual government deficit and a return towards some economic growth, some commentators still view an eventual exit as being likely. There are also concerns that austerity measures in Cyprus could also end up in 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 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 to this current “solution” to the Eurozone debt crisis are still weak and events could easily conspire to put this into reverse. There are particular concerns as to whether democratically elected governments will lose the support of electorates suffering under EZ imposed austerity programmes, especially in countries like Greece and Spain which have unemployment rates of over 26% and unemployment among younger people of over 50%. The Italian political situation is also fraught with difficulties in maintaining a viable coalition which will implement an EZ imposed austerity programme and undertake overdue reforms to government and the economy. There are also concerns over the lack of political will in France to address issues of poor international competitiveness,

USA. The economy has managed to return to robust growth in Q2 2013 of 2.5% y/y and 4.1% y/y in Q3, in spite of the fiscal cliff induced sharp cuts in federal expenditure that kicked in on 1 March, and increases in taxation. The Federal Reserve therefore decided in December to reduce its \$85bn per month asset purchases programme of quantitative easing by \$10bn. It also amended its forward guidance on its pledge not to increase the central rate until unemployment falls to 6.5% by adding that there would be no increases in the central rate until ‘well past the time that the unemployment rate declines below 6.5%, especially if projected inflation continues to run below the 2% longer run goal’. Consumer, investor and business confidence levels have all improved markedly in 2013. The housing market has turned a corner and house sales and increases in house prices have returned to healthy levels. Many house 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. There are concerns that Chinese growth could be on an overall marginal downward annual trend. There are also concerns that the new Chinese leadership have only started to address 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 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 the introduction of other economic reforms, appears to have stalled. However, at long last, Japan has seen a return to reasonable growth and positive inflation during 2013 which augurs well for the hopes that Japan can escape from the bog of stagnation and deflation and so help to 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. Within two years, the central bank will end up purchasing about

Y190 trillion (£1,200 billion) of government debt. In addition, the population is ageing due to a low birth rate and, on current trends, will fall from 128m to 100m by 2050.

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 to endure as investor fears and confidence ebb and flow between favouring more risky assets i.e. equities, and safer bonds.

There could well be volatility in gilt yields over the next year as financial markets anticipate further tapering of asset purchases by the Fed. The timing and degree of tapering could have a significant effect on both Treasury and gilt yields. Equally, while the political deadlock and infighting between Democrats and Republicans over the budget has almost been resolved the raising of the debt limit, has only been kicked down the road. A final resolution of these issues could have a significant effect on gilt yields during 2014.

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 evenly weighted. 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.

The interest rate forecasts in this report are based on an initial assumption that there will not be a major resurgence of the EZ debt crisis, or a break-up of the EZ, but rather that there will be a managed, albeit painful and tortuous, resolution of the debt crisis where EZ institutions and governments eventually do what is necessary - but only when all else has been tried and failed. Under this assumed scenario, growth within the EZ will be tepid for the next couple of years and some EZ countries experiencing low or negative growth, will, over that time period, see a significant increase in total government debt to GDP ratios. There is a significant danger that these ratios could rise to the point where markets lose confidence in the financial viability of one, or more, countries. However, it is impossible to forecast whether any individual country will lose such confidence, or when, and so precipitate a resurgence of the EZ debt crisis. While the ECB has adequate resources to manage a debt crisis in a small EZ country, if one, or more, of the large countries were to experience a major crisis of market confidence, this would present a serious challenge to the ECB and to EZ politicians.

Downside risks currently include:

- UK strong economic growth is currently very dependent on consumer spending and recovery in the housing market. This is unlikely to endure much beyond 2014 as most consumers are maxed out on borrowing and wage inflation is less than CPI inflation, so disposable income is being eroded.
- A weak rebalancing of UK growth to exporting and business investment causing a major weakening of overall economic growth beyond 2014
- Weak growth or recession in the UK's main trading partners - the EU and US, depressing economic recovery in the UK.
- Prolonged political disagreement over the raising of the US debt ceiling.

- A return to weak economic growth in the US, UK and China causing major disappointment in investor and market expectations.
- A resurgence of the Eurozone sovereign debt crisis caused by ongoing deterioration in government debt to GDP ratios to the point where financial markets lose confidence in the financial viability of one or more countries and in the ability of the ECB and Eurozone governments to deal with the potential size of the crisis.
- 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; this will cause major difficulties in implementing austerity measures and a programme of overdue reforms. Italy has the third highest government debt mountain in the world.
- Problems in other Eurozone heavily indebted countries (e.g. Cyprus and Portugal) which could also generate safe haven flows into UK gilts, especially if it looks likely that one, or more countries, will need to leave the Eurozone.
- A lack of political will in France, (the second largest economy in the EZ), to dynamically address fundamental issues of low growth, poor international uncompetitiveness and the need for overdue reforms of the economy.
- Monetary policy action failing to stimulate sustainable growth in western economies, especially the Eurozone and Japan.
- 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.
- 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 Quantitative Easing (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 currently held.