Gloucester City Council

Meeting:	Cabinet Audit and Governance Committee	Date:	25 June 2014 26 June 2014
Subject:	Treasury Management Update – Quarter 4 Report 2013/14		
Report Of:	Corporate Director of Resources		
Wards Affected:	All		
Key Decision:	No Budget/Policy Framework: No		
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Appendices:	1. Prudential and Treasury Indicators 2. Treasury Management Investments 3. Economic Outlook 4. Detailed Economic Commentary 5. Interest rate forecasts		

FOR GENERAL RELEASE

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 4, 1st December 2013 to 31st March 2014.

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 4 ;

- **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 4.
- **Appendix 3** is an economic summary provided by the Councils treasury advisors.
- **Appendix 4** is a detailed commentary on the economic outlook
- **Appendix 5** is a detailed commentary on interest rate forecasts

1.4 The reports presented to Audit & Governance committee for the first 3 quarters of 2013-14 contained some errors in prudential indicator limits and also did not highlight that one limit had been exceeded in each quarter, including quarter 4. It

needs to be noted this did not present a significant risk to the Council as this indicator represents a risk when interest rates are high or rising.

1.5 The 2014-15 Treasury Management Strategy has revised these limits back to more realistic levels, in line with previous strategies and in accordance with general best practice.

2.0 Recommendations

2.1 **Cabinet** is asked to **RESOLVE** that the report be noted.

2.1. **Audit and Governance Committee** is asked to **RESOLVE**

(1) that the report be noted and note that no changes are required to the prudential indicators.

(2) to note that one prudential indicator has been exceeded during 2013-14.

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 Investment rates available in the market have been broadly stable during the quarter and have continued at historically low levels as a result of the Funding for Lending Scheme. The average level of funds available for investment purposes during the quarter was £5.4m. 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.

3.3 Investment performance for quarter ended 31st March 2014

Benchmark	Benchmark Return	Council Performance	Investment Interest Earned
7 day	0.34%	0.38	£5.360

As illustrated, the Council outperformed the benchmark by 0.2 bps. The Council's budgeted investment return for 2013/14 is £45,770 and performance for the year to date was £27,544 above budget.

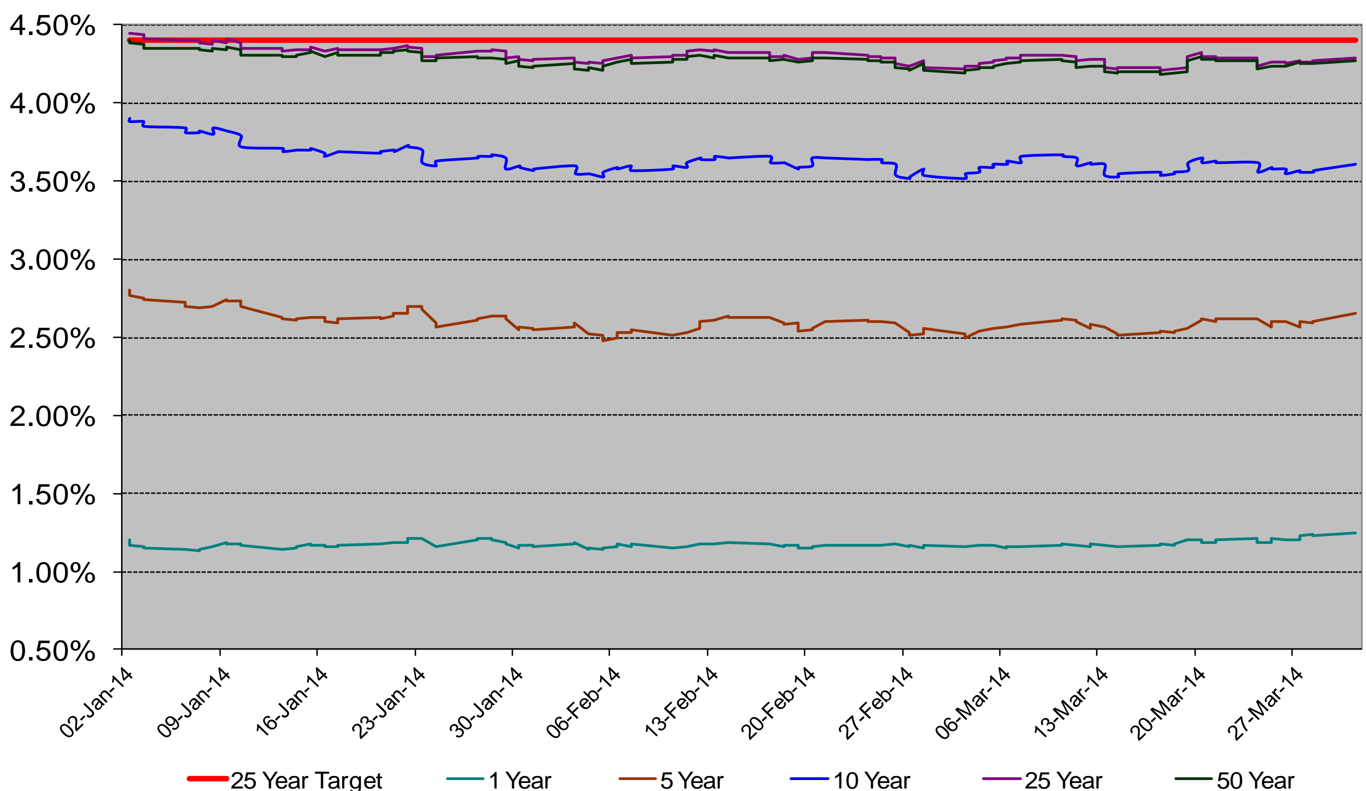
4.0 New Borrowing

4.1 The 25 year PWLB target (certainty) 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	1.13%	2.48%	3.52%	4.21%	4.18%
Date	07/01/2014	05/02/2014	27/02/2014	17/03/2014	17/03/2014
High	1.26%	2.80%	3.90%	4.45%	4.40%
Date	31/03/2014	02/01/2014	02/01/2014	02/01/2014	02/01/2014
Average	1.18%	2.60%	3.64%	4.31%	4.27%



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 March 2014 and has not borrowed in advance in all of 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 March 2014, 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 2013/14 the Council continued to maintain an under-borrowing position.

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 March 2014

Treasury Indicators	2013/14 Budget £'000	Quarter 4 Actual £'000
Authorised limit for external debt	£84M	£67.3M
Operational boundary for external debt	£83M	£67.3M
Gross external debt	£84M	£67.3M
Investments	Nil	Nil
Net borrowing	£84m	£67.3M
Maturity structure of fixed rate borrowing - upper and lower limits		
Under 12 months	**0% - 20%**	**31.9%**
12 months to 2 years	0% - 20%	0%
2 years to 5 years	0% - 50%	21.3%
5 years to 10 years	0% - 50%	6.6%
10 years to 20 years *1	0% - 90%	13.6%
20 years to 30 years *1	0% - 90%	26.6%
30 years to 40 years *1	0% - 90%	0%
40 years to 50 years *1	0% - 90%	0%
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	100%	44.4%
Upper limit for principal sums invested for over 364 days	£2m	Nil

The indicator highlighted in red above has been exceeded in all quarters of 2013-14. The indicators have been corrected in the 2014/15 Treasury Management Strategy

Prudential Indicators	2013/14 Budget £'000	Quarter 4 Actual £'000
Capital expenditure * • **HRA** • **GF**	£10.030M £7.209M	£6.049 £4.283
Capital Financing Requirement (CFR) * • **HRA** • **GF**	£62.750m £17.436m	£60.036 £16.402
Annual change in CFR *	£5.021	-£0.262
In year borrowing requirement	NIL	£4.251

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

There were no Investments held as at 31st March 2014

APPENDIX 3

1.0 Economic Background

1.1 After strong UK GDP growth of 0.7%, 0.8% and 0.7% in quarters 2, 3 and 4 respectively in 2013, it appears that strong growth will continue into 2014 as forward surveys are very encouraging. There are also positive indications that recovery is starting to broaden 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 MPC last August, before it said it would consider any increases in Bank Rate. In the February 2014 Inflation Report, the MPC therefore broadened its forward guidance by adopting five qualitative principles and looking at a much wider range of indicators. Accordingly, markets are expecting a first increase around the end of 2014, though recent comments from MPC members have emphasised they would want to see strong growth well established, and an increase in labour productivity / real incomes, before they would consider raising Bank Rate.

1.1.1 Also encouraging has been the sharp fall in inflation (CPI), reaching 1.7% in February: 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 by an additional £24bn, as announced in the March 2014 Budget - which also forecast a return to a significant budget surplus, (of £5bn), in 2018-19.

1.1.2 The Federal Reserve has continued with its monthly $10bn reductions in asset purchases which started in December; asset purchases have now fallen from $85bn to $55bn and are expected to stop by the end of 2014, providing strong economic growth continues this year.

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%	0.75%	0.75%	1.00%	1.25%	1.50%	1.75%
5yr PWLB rate	2.60%	2.60%	2.70%	2.80%	2.90%	2.90%	3.00%	3.10%	3.20%	3.20%	3.30%	3.40%	3.50%
10yr PWLB rate	3.70%	3.70%	3.80%	3.80%	3.90%	3.90%	4.00%	4.10%	4.20%	4.30%	4.40%	4.50%	4.50%
25yr PWLB rate	4.40%	4.40%	4.50%	4.60%	4.70%	4.70%	4.80%	4.90%	5.00%	5.00%	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%	5.10%	5.10%	5.20%	5.20%

Capita Asset Services undertook a review of its interest rate forecasts in February, after the Bank of England's latest quarterly Inflation Report. This latest forecast now includes a first increase in Bank Rate in quarter 4 of 2015 (previously quarter 2 of 2016), 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 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 was that wage inflation had been significantly below CPI inflation, so disposable income and living standards were being eroded, (although income tax cuts had ameliorated this to some extent). However, the recent fall in inflation has narrowed the gap between wage increases and inflation and this gap could narrow even more during this year, especially if there is also a recovery in growth in labour productivity (leading to significant increases in pay rates). 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 subsided considerably during 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.

APPENDIX 4

Detailed economic Commentary on developments during quarter ended 31st March 2014

During the first quarter of 2014:

- Indicators suggested that the economic recovery had retained its vigour;
- Household spending rose again;
- Inflation fell to its lowest level in over 4 years;
- Unemployment edged closer to the MPC's 7% forward guidance 'phase one' threshold;
- The MPC's revamped guidance appeared to keep market rates anchored;
- The Budget indicated that the fiscal shackles remained firmly in place;
- The US Federal Reserve continued with its monthly stimulus taper.

- After another strong quarterly expansion in UK GDP of 0.7% in Q4, some of the early indicators suggested that the economic recovery had retained its vigour into the first quarter. Admittedly, some of the survey data has come in a touch softer, but on the basis of past form, the CIPS/Markit business activity surveys still point to robust quarterly GDP growth in Q1. That being said, the survey data have overdone the strength of the recovery over recent months. January's industrial production figures suggested that the recovery in manufacturing output did not gather much pace from Q4's 0.5% q/q outturn. The 2.4% monthly fall in the volume of exports in January highlights that the recovery is still struggling to broaden out to the external sector.
- Meanwhile, household spending may have made a decent contribution to GDP growth in Q1. Although it fell in January, the official measure of retail sales volumes rebounded by 1.7% in February. Despite the slightly weaker tone of March's CBI Distributive Trades Survey, over Q1 as a whole, it looks as if retailers enjoyed decent sales growth. On the basis of past form, the average reading of the reported sales balance is consistent with annual growth in the official measure of retail sales volumes of around 3%. The more forward-looking survey balances of expected sales also point towards a further pick-up in consumer spending in the near-term.
- What's more, growth in sales off the high street has also been strong. For example, annual growth in new car registrations averaged around 17% in January and February, up from 12% in Q4. This all suggests that overall household spending may have strengthened.
- Household spending growth has been supported by further improvement in the labour market. However, the jobs recovery has lost a little pace over recent months. Indeed, the 105,000 increase in employment between the three months to October and the three months to January was the smallest rise since July. Although the headline (three-month average) unemployment rate fell from 7.4% in October to 7.2% in January, this remained above November's recent low of 7.1%. As a result, the unemployment rate is still just above the 7% threshold as set out in 'phase one' of the Monetary Policy Committee's forward guidance.

- However, the MPC decided to tweak its forward guidance at the time of the February Inflation Report. Forward guidance ‘phase two’ contains no less than five elements: –

- The MPC sets policy to achieve the 2% inflation target, and, subject to that, to support the Government’s economic policies, including those for growth and employment.
- Despite the sharp fall in unemployment, there remains scope to absorb spare capacity further before raising Bank Rate
- When Bank Rate does begin to rise, the appropriate path so as to eliminate slack over the next two to three years and keep inflation close to the target is expected to be gradual (i.e. probably 25bp)
- Even when the economy has returned to normal levels of capacity utilisation and inflation is close to the target, the appropriate level of Bank Rate is likely to be materially below the 5% level set on average by the Committee prior to the financial crisis.
- The MPC will not sell any of the holding of £375bn of gilts before the first rise in Bank Rate

- All members voted in favour of this new guidance. That being said, divisions within the MPC regarding the amount of slack in the economy have opened up, with several members revealing their own personal ‘best estimate’ of the output gap in recent speeches, to spurious degrees of accuracy. The Bank’s own estimate of the output gap is a range of between 1% to 1.5%.
- CPI inflation fell to 1.7% in February, the lowest rate since October 2009. Further increases in the value of sterling over the first quarter will exert downward pressure on import prices, which, combined with past falls in commodity prices, should mean that inflation continues to trend downwards. This all emphasises the fact that interest rates will be on hold for a long while yet.
- Meanwhile, fiscal policy is not set to ease any time soon. Indeed, the package of measures announced in the Budget in March were, broadly speaking, fiscally neutral. Admittedly, there were a few measures to help businesses and consumers, notably another increase in the annual investment allowance for businesses and in the personal income tax allowance, but these amount to small beer relative to the size of the overall fiscal tightening yet to come. The OBR’s forecasts for borrowing were not materially revised from those in the Autumn Statement, indicating that the Chancellor is still expected to meet his primary fiscal mandate – to return the cyclically-adjusted current budget to balance over a rolling five-year period – a year early.
- Mr Osborne also refrained from bowing to pressure to take the heat out of the housing market. In fact, he added further support to the flagship Help to Buy Scheme by extending the first phase, (the equity loan part), until 2020, though the more controversial mortgage-guarantee part of the scheme was left untouched. The latest housing market data will have done little to alleviate fears of a bubble. Prices rose at an annual rate of 10.2% and 9.2% in February according to the Halifax and Nationwide measures, respectively. Admittedly, the fall in the new buyer enquiries balance of February’s RICS survey suggests that demand may be beginning to wane. But the new sales instructions balance fell further into negative territory. On

the basis of past form, the difference between these two balances points to house prices continuing to rise strongly in the near-term.

- Internationally, the US Fed made tweaks to its own forward guidance in March, when it dropped its explicit unemployment rate threshold in favour of a more qualitative form of forward guidance. Although economic activity was weakened by adverse weather, the Federal Open Market Committee (FOMC), decided to continue with its monthly reduction in stimulus taper; reducing asset purchases by a further $10bn to $55bn per month, (originally $85bn). Markets also brought forward their expectations for the timing of the first rise in interest rates from around the end of 2015, to mid-2015 as a result of upward revisions to the Fed's interest rate projections. In the Fed Chair Janet Yellen's comments in the post-FOMC meeting press conference, she suggested that the "considerable period" language used for forward guidance, (for rates remaining low), could be interpreted as meaning that rates might begin to rise six months or so after the Fed ends its monthly asset purchases: this caused a sell-off in US equity markets.
- Activity indicators for the Eurozone continue to suggest that the currency bloc is recovering, albeit very slowly. The economy expanded by 0.3% in Q4, following a mere 0.1% quarterly expansion in Q3. Survey data, such as the PMIs, suggest that the recovery may not have gathered much pace in Q1. Moreover, the spectre of deflation continues to hang over the region. Average Eurozone HICP inflation was 0.8% in February, well below the ECB's target of below, but close to, 2%. However, this average meant that some individual countries were experiencing deflation which is particularly unhelpful for heavily indebted countries, and especially for those also struggling with low or negative growth. The large amount of spare capacity in the Eurozone economy, combined with further increases in value of the euro, suggest that disinflationary pressures are unlikely to go away soon. Accordingly, the ECB may be forced to act soon to prevent the crisis from reigniting.
- Meanwhile, domestic equities performed poorly over the quarter as a whole, with the FTSE falling by 2% to around 6615, compared to a rise of 0.5% in the S&P 500. Emerging markets were undermined by the tapering of Fed purchases which has led to a marked flow of funds back out of emerging markets to western economies due to the better prospects for growth in the latter. Financial markets were also rattled by concerns about the fallout from political troubles surrounding Ukraine and by renewed worries about credit conditions and a slowdown in economic growth in China. The MSCI Emerging Market Local Currency Index has fallen by 1.1% since the turn of the year. These fears have led to a return of volatility and some renewal of safe haven flows from equities to bonds; developed country bond markets have, therefore, rallied, with gilt yields and treasury yields both falling by over 30bp since the start of 2014.

APPENDIX 5

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 - quarters 1, 2, 3 and 4 being respectively +0.3%, +0.7%, +0.8% and +0.7%, to surpass all expectations as all three main sectors, services, manufacturing and construction contributed to this strong upturn. The Bank of England, therefore, upgraded growth forecasts in the August and November quarterly Inflation Reports for 2013 from 1.2% to 1.6% and it actually ended up at 1.9%. For 2014, its forecasts were upgraded respectively from 1.7% to 2.8%, and then in the February report to 3.4% (2015 2.7%, 2016 2.8%).

The February Report stated that: -

> *The UK recovery has gained momentum and inflation has returned to the 2% target. Reduced uncertainty, easier credit conditions and the stimulative stance of monetary policy should support continued solid economic growth, with the expansion in demand becoming more entrenched and more broadly based. Robust growth has not so far been accompanied by a material pickup in productivity. Instead, employment gains have been exceptionally strong and unemployment has fallen much more rapidly than expected. The LFS headline unemployment rate is likely to reach the MPC's 7% threshold by the spring of this year. Even so, the Committee judges that there remains spare capacity, concentrated in the labour market.*
>
> *Inflation is likely to remain close to the target over the forecast period. Given this, and with spare capacity remaining, the MPC judges that there remains scope to absorb slack further before raising Bank Rate. Moreover, the continuation of significant headwinds — both at home and from abroad — mean that Bank Rate may need to remain at low levels for some time to come.*

Forward surveys are currently 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 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 during 2013 was that wage inflation was running significantly below CPI inflation so disposable income and living standards were being eroded, although income tax cuts did ameliorate this to some extent. However, with the recent fall in inflation and slight improvement in wage inflation, the gap between the two has narrowed significantly and looks likely to narrow further during 2014 as slack in the labour market declines. However, the Bank is concerned to see labour productivity improve as it is this which will warrant paying higher wages and promote sustainable economic growth. One factor that could delay the start of Bank Rate increases is if the significant appreciation in the value of sterling that has occurred, (about 10% since early 2013), were to continue through 2014 and beyond; this would be likely to inhibit UK GDP growth through a fall in UK exports, (as they become more expensive), and an increase in imports, which become cheaper and so suppress UK consumer purchases of UK made goods and services.

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. Due to the rebound in economic growth, this unemployment rate has fallen much faster than expected and so in the February Inflation Report, forward guidance was amended (see appendix 3).

Credit conditions. While Bank Rate has remained unchanged at 0.5% and quantitative easing has remained unchanged at £375bn in 2013/14, 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, started 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 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 more subdued. 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 1.7% in February. 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 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. Portugal is currently hoping to also leave the EZ bailout programme in the near future. However, Greece is still embroiled in arguments with the EU and IMF over further austerity measures to return its public finances to balance within a reasonable time period.

As for economic growth, the EZ finally escaped from seven quarters of recession in quarter 2 of 2013 (+0.1%) but growth remained weak in quarter 3 (+0.1%) and quarter 4 (+0.3%) and 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 (Q3 2013 figures) of Greece 172%, Italy 133%, Portugal 129%, Ireland 125% 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 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 a rigorous 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 grew by 1.9% in 2013 (2012 2.8%), which was a reasonable result in spite of the fiscal cliff induced sharp cuts in federal expenditure that kicked in on 1 March, and increases in taxation. Quarterly (annualised) growth rates for 1, 2, 3 and 4 in 2013 were respectively +1.1%, +2.5%, +4.1% and 2.6%. The second-half growth pace was a stellar 3.3 percent and a jump from 1.8 percent in the first six months of the year. The Fed therefore decided in December to start reducing its $85bn per month asset purchases programme of quantitative easing by $10bn and these monthly decreases continued during quarter 1 2014. This is likely to mean that all monthly asset purchases will cease by the end of 2014. In December, the Fed 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'. The head of the Fed, Janet Yellen, in late March, said that the first increase in interest rates was likely to occur about six months after the end of asset purchases. Consumer, investor and business confidence levels 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 the issues of 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 saw a return to reasonable growth and positive inflation during the first half of 2013 which augured well for the hopes that Japan could escape from the bog of stagnation and deflation and so help to support world growth. However, quarterly growth slowed to only +0.3% in quarter 4 of 2013 and an increase in sales tax from 5% to 8% due in April 2014 could dampen growth further. Overall, growth improved from +1.4% in 2012 to +1.6% in 2013. The fiscal challenges though are huge; the gross debt to GDP ratio was 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 react to further tapering of asset purchases by the Fed. and the impending start of a new economic cycle of gradually rising interest rates. During quarter 1 2014, fears rose over emerging market countries, especially Argentina due to the chronic mismanagement of the economy. There were also fears over Turkey and Brazil. A further bout of fear was unleashed through the developing political situation in Ukraine, especially over Russian intervention in the Crimea. These fears stimulated safe haven flows from equities into bonds and so the quarter saw a fall in bond yields. Political events could therefore have a potentially powerful effect looking forward.

The overall 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, therefore, also 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 needs to increase above CPI inflation, so that disposable income can start to increase and so support a sustainable increase in consumer spending.
- 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.
- 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 challenging; there is an urgent need for a political consensus that can implement a programme of austerity measures and long overdue reforms. Italy has the third highest government debt mountain in the world.
- Problems in other Eurozone heavily indebted countries 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 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.