

Sector's Economic update

Economic performance to date

Economic sentiment, in respect of the prospects for the UK economy to recover swiftly from recession, suffered a major blow in August when the Bank of England substantially lowered its expectations for the speed of recovery and rate of growth over the coming months and materially amended its forecasts for 2012 and 2013. It was noted that the UK economy is heavily influenced by worldwide economic developments, particularly in the Eurozone, and that on-going negative sentiment in that area would inevitably permeate into the UK's economic performance.

With regard to the Eurozone, investor confidence remains weak because successive "rescue packages" have first raised, and then disappointed, market expectations. However, the uncertainty created by the continuing Eurozone debt crisis is having a major effect in undermining business and consumer confidence not only in Europe and the UK, but also in America and the Far East/China.

In the UK, consumer confidence remains very depressed with unemployment concerns, indebtedness and a squeeze on real incomes from high inflation and low pay rises, all taking a toll. Whilst inflation has fallen considerably (CPI @ 2.6% in July), UK GDP fell by 0.5% in the quarter to 30 June, the third quarterly fall in succession. This means that the UK's recovery from the initial 2008 recession has been the worst and slowest of any G7 country apart from Italy (G7 = US, Japan, Germany, France, Canada, Italy and UK). It is also the slowest recovery from a recession of any of the five UK recessions since 1930 and total GDP is still 4.5% below its peak in 2008.

This weak recovery has caused social security payments to remain elevated and tax receipts to be depressed. Consequently, the Chancellor's plan to eliminate the annual public sector borrowing deficit has been pushed back further into the future. The Monetary Policy Committee has kept Bank Rate at 0.5% throughout the period while quantitative easing was increased by £50bn to £375bn in July. In addition, in June, the Bank of England and the Government announced schemes to free up banking funds for business and consumers.

On a positive note, despite all the bad news on the economic front, the UK's sovereign debt remains one of the first ports of call for surplus cash to be invested in and gilt yields, prior to the ECB bond buying announcement in early September, were close to zero for periods out to five years and not that much higher out to ten years.

Outlook for the next six months of 2012/13

The risks in economic forecasts continue unabated from the previous treasury strategy. Concern has been escalating that the Chinese economy is heading for a hard landing, rather than a gentle slowdown, while America is hamstrung by political deadlock which prevents a positive approach to countering weak growth. Whether the presidential election in November will remedy this deadlock is debatable but urgent action will be required early in 2013 to address the US debt position. However, on 13 September the Fed announced an aggressive stimulus programme for the economy with a third round of quantitative easing focused on boosting the stubbornly weak growth in job creation, and this time with

no time limit. They also announced that it was unlikely that there would be any increase in interest rates until at least mid 2015.

Eurozone growth will remain weak as austerity programmes in various countries curtail economic recovery. A crunch situation is rapidly developing in Greece as it has failed yet again to achieve deficit reduction targets and so may require yet another (third) bail out. There is the distinct possibility that some of the northern European countries could push for the ejection of Greece from the Eurozone unless its financial prospects improve, which does not seem likely at this juncture. A financial crisis was also rapidly escalating over the situation in Spain.

However, in early September the ECB announced that it would purchase unlimited amounts of shorter term bonds of Eurozone countries which have formally agreed the terms for a bailout. Importantly, this support would be subject to conditions (which have yet to be set) and include supervision from the International Monetary Fund. This resulted in a surge in confidence that the Eurozone has at last put in place the framework for adequate defences to protect the Euro.

However, it remains to be seen whether the politicians in charge of Spain and Italy will accept such loss of sovereignty in the light of the verdicts that voters have delivered to the politicians in other peripheral countries which have accepted such supervision and austerity programmes. The Eurozone crisis is therefore far from being resolved as yet. The immediate aftermath of this announcement was a rise in bond yields in safe haven countries, including the UK. Nevertheless, this could prove to be as short lived as previous "solutions" to the Eurozone crisis.

The Bank of England Quarterly Inflation Report in August pushed back the timing of the return to trend growth and also lowered its inflation expectations. Nevertheless, concern remains that the Bank's forecasts of a weaker and delayed robust recovery may still prove to be over optimistic given the world headwinds the UK economy faces. Weak export markets will remain a drag on the economy and consumer expenditure will continue to be depressed due to a focus on paying down debt, negative economic sentiment and job fears. The Coalition Government, meanwhile, is likely to be hampered in promoting growth by the requirement of maintaining austerity measures to tackle the budget deficit.

The overall balance of risks is, therefore, weighted to the downside:

- We expect low growth in the UK to continue, with Bank Rate unlikely to rise in the next 24 months, coupled with a possible further extension of quantitative easing. This will keep investment returns depressed.
- The expected longer run trend for PWLB borrowing rates is for them to eventually rise, primarily due to the need for a high volume of gilt issuance in the UK and the high volume of debt issuance in other major western countries. However, the current safe haven status of the UK may continue for some time, tempering any increases in yield.
- This interest rate forecast is based on an assumption that growth starts to recover in the next three years to a near trend rate (2.5%). However, if the Eurozone debt crisis worsens as a result of one or more countries having to leave the Euro, or low growth in the UK continues longer, then Bank Rate is likely to be depressed for even longer than in this forecast.

Interest rate forecast

The Sector central forecast is for the first increase in Bank Rate to be in the first quarter of 2014 but there is downside risk to this projection. With growth predictions for the U.K continuing to be reduced on an almost monthly basis by both the Office for Budget Responsibility and economic commentators generally, and financial markets unconvinced that politicians have resolved the Euro-one sovereign debt crisis in the medium-term, with continued high levels of volatility continuing.

Table 5: PWLB Forecast

	Sep-12	Dec-12	Mar-13	Jun-13	Sep-13	Dec-13	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15
Bank rate	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.75%	1.00%	1.25%	1.25%	1.50%
5yr PWLB rate	2.10%	2.20%	2.20%	2.30%	2.40%	2.50%	2.60%	2.80%	3.00%	3.20%	3.40%
10yr PWLB rate	3.00%	3.20%	3.30%	3.40%	3.50%	3.60%	3.70%	3.80%	4.00%	4.20%	4.40%
25yr PWLB rate	4.20%	4.30%	4.30%	4.40%	4.50%	4.50%	4.60%	4.70%	4.80%	4.90%	5.00%
50yr PWLB rate	4.30%	4.40%	4.40%	4.50%	4.60%	4.60%	4.70%	4.80%	4.90%	5.00%	5.10%