APPENDIX 2

Sector's Treasury Management Update

Quarter Ended 30th June 2013

The CIPFA (Chartered Institute of Public Finance and Accountancy) Code of Practice for Treasury Management recommends that members be updated on treasury management activities regularly (TMSS, annual and midyear reports). This report therefore ensures this council is implementing best practice in accordance with the Code.

1. Economic Background

- During the quarter ended 30th June: -
  - Indicators suggested that the economy accelerated;
  - Stronger household spending, both on and off the high street;
  - Inflation remained stubbornly above the MPC's 2% target;
  - The MPC remained in a state of limbo ahead of Mark Carney's arrival;
  - 10-year gilt yields rose above 2.5% and the FTSE 100 fell below 6,100;
  - The Federal Reserve discussed tapering the pace of asset purchases under Quantitative Easing 3 (QE3).
- After avoiding recession in the first quarter with a 0.3% quarterly expansion, it looks likely that the economy grew even more strongly in Q2. On the basis of past form, the CIPS/Markit business surveys for April and May point to 0.5% quarterly growth in the second quarter of 2013. Official output data echoed the message from the business surveys. The 3m/3m change in industrial production reached 0.9% in April, the strongest pace since July 2010. Similarly, the service sector expanded by 0.8% on the same basis. And while output in the volatile construction sector in April was 1% lower than a year ago, it was the smallest annual fall since the end of 2011, raising the prospect that the sector supported the recovery in Q2.
- There have been signs of renewed vigour in household spending in the second quarter. May's 2.1% monthly rise in retail sales overturned April's 1.1% fall. This tallied with information from the Bank of England agents, who reported a further pick-up in retail sales values in May. Non-high street spending looks to have been robust too, with new car registrations up by 20% in the year to May.
- The pick-up in economic growth appears to have supported the labour market, with employment rising by 24,000 in the three months to April. Admittedly, this was a lot slower than the 113,000 quarterly gain in employment seen on average over the past twelve months. But the rise in employment was still strong enough to reduce the level of unemployment further. The ILO measure fell by 5,000 in the three months to April while the timelier claimant count measure reported an

8,600 fall in May. Meanwhile, pay growth rebounded strongly in April, though this was mostly driven by high earners delaying bonuses until after April's cut in the additional rate of income tax. Excluding bonuses, earnings rose by just 1.3% y/y, well below the rate of inflation at 2.7% in May.

- Meanwhile, the Bank of England extended its Funding for Lending Scheme (FLS) into 2015 and sharpened the incentives for banks to extend more business funding. To date, the mortgage market still appears to have been the biggest beneficiary from the scheme, with the quoted interest rate on a 2-year fixed rate mortgage at a 90% loan-to-value ratio now 4.6%, around 130 basis-points lower in May than when the FLS was introduced in August 2012.
- Alongside the Government's Help to Buy scheme, which provides equity loans to credit-constrained borrowers, this is helping to boost demand in the housing market. Mortgage approvals by high street banks, as measured by the BBA, rose from 33,000 to 36,100 in May. Excluding a stamp-duty holiday related spike in January 2012, this was the highest level for over three years. The rise in demand has helped to push up house prices, with both the Halifax and Nationwide measures reporting a 0.4% monthly gain in May. On an annual basis, measured prices were up by 3.7% and 1.1% respectively.
- Turning to the fiscal situation, the public borrowing figures continued to be distorted by a number of one-off factors. On an underlying basis, borrowing in Q2 looked to be broadly in line with last year's figures, highlighting the government's difficulty in reducing borrowing while economic growth is relatively lacklustre.
- Meanwhile, the 2013 Spending Review, covering only 2015/16, made no changes to the headline Government spending plan. Total expenditure was still forecast to be broadly flat in real terms in 2015/16 and the £50bn planned capital expenditure announced for that fiscal year was identical to the amount already outlined in March's Budget.
- On the monetary policy front, June's MPC meeting, the last chaired by the outgoing Governor Mervyn King, showed that the Committee remained in limbo ahead of the arrival of his replacement, Mark Carney. The Committee voted 6-3 to keep the level of asset purchases unchanged at £375bn, with the majority judging that the current stimulus and Funding for Lending Scheme would be sufficient to support growth in the context of price stability.
- Having fallen from 2.8% to 2.4% in April, CPI inflation rose to 2.7% in May. May's rise mostly reflected price changes due to the earlier timing of Easter, which depressed inflation in April. Even so, inflation is still likely to have risen further in June due to base effects, with last year's fuel price falls providing an unfavourable annual comparison. That said, underlying price pressures do seem to be easing, with wages and producer prices both growing at subdued rates. Indeed, if anything, the inflation outlook brightened over the second quarter, with the price of oil falling from $108pb to $103pb while sterling appreciated by around 1.5% on a trade-weighted basis.

- Having continued to rally over April and May, financial markets sold off in June following a Federal Reserve statement that suggested the central bank may 'taper' its asset purchases earlier than anticipated. The resulting rise in US Treasury yields was replicated in the UK, with 10 year gilt yields rising to 2.5% from 1.8% at the start of the quarter. Equities were hit too, with the FTSE 100 falling from 6,411 at the start of the quarter to below 6,100 before ending the quarter a bit higher at 6,240.
- In the US, the statement from the Fed took the limelight. The Fed's comments sparked a sharp sell-off in the Treasury market, with 10-year Treasury yields hitting 2.54%. The Fed move was a response to the improving economic outlook in the US. Indeed, payroll figures showed that the US added 175,000 new jobs in May, helping to pull the unemployment rate down to 7.6%, from 8.2% a year ago. In the housing market, house prices rose by 12% in the year to April, which helped to bring more households out of negative equity.
- Meanwhile, tensions in the Eurozone eased over the second quarter, but there remained a number of triggers for a potential flare-up. For example, the Democratic Left party left the Greek governing coalition in June, causing 10 year Greek government bond yields to surge to 11.5% from around 8% a month ago. And while the economic survey data improved consistently over the first half of the year, the composite Eurozone PMI is still pointing to a further contraction in output in Q2. If this materialises, it would be the seventh quarter of Eurozone recession, the longest on record.

2. Interest Rate Forecast

The Council's treasury advisor, Sector, has provided the following forecast:

	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%
5yr PWLB rate	1.80%	1.80%	1.90%	2.00%	2.10%	2.20%	2.40%
10yr PWLB rate	2.90%	2.90%	3.00%	3.10%	3.20%	3.30%	3.50%
25yr PWLB rate	4.10%	4.10%	4.20%	4.20%	4.30%	4.40%	4.60%
50yr PWLB rate	4.20%	4.20%	4.40%	4.40%	4.50%	4.60%	4.70%

Sector undertook a review of its interest rate forecasts following the issue of the latest Bank of England Inflation Report in May 2013. Sector has left unchanged its forecast for the first increase in Bank Rate to be in March 2015. However, forecasts for PWLB rates have been increased as a result of the marked recovery in

confidence in equity markets, anticipating stronger economic recovery in America, supported by growth in the Far East. The rise in equity prices was dented towards the end of the quarter by comments from Ben Bernanke, chairman of the Federal Reserve, that QE3 would be tapered off in the not too distant future. This seemed to catch financial markets by surprise and generated a bit of a stampede out of bonds and equities. This sharp selloff in bonds caused ten year bond yields to jump up nearly 90 bps between the low and high for the quarter.

SUMMARY OUTLOOK

UK Economy

In Mervyn King's last Inflation Report as Governor of the Bank of England, there was a distinct shift towards optimism in terms of a marginal upgrading of growth forecasts so that the wording changed for the recovery from "remain weak by historical standards" to "modest and sustained recovery over the next three years". In addition, there was a lowering of the inflation forecast to now hit the 2% target within two years. However, this is still a long way away from strong recovery though the chances of there being more quantitative easing (QE) have receded due to business surveys indicating that the economy is on the up. QE has not increased from a total of £375bn since October 2012 and other measures have been implemented in preference to further QE. Thus the Funding for Lending Scheme (FLS), (started in August 2012), was expanded in April to provide further incentive to banks to expand lending to small and medium size enterprises. The FLS certainly seems to be having a positive effect in terms of stimulating house purchases (though levels are still far below the pre crisis level), and a marginal increase in house prices. However, concerns are increasing that QE and FLS are also in danger of causing asset price bubbles. Investors may seek higher returns by switching investment of cash from deposit accounts (yielding very low rates) and from government and corporate bonds - ahead of the eventual end of QE - to equities, whilst FLS may have the side effect of inflating house prices, creating the potential for prices in each of these markets to be pushed at some point in time to potentially unsustainable levels.

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

UK

- Mark Carney starts on 1st July as the new Governor of the Bank of England. His appointment could lead to some changes to the way the MPC operates and makes decisions and announcements. It is possible there could be forward guidance e.g. that Bank Rate will not go up until some target rate, e.g. unemployment, had fallen to a specified level. Some commentators are guessing that this could effectively close the door to any increase in Bank Rate until sometime in 2016.
- Growth in Q1 of 2013 was confirmed at +0.3%. Q2 looks likely to be even higher at around +0.5%. 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. But this is still a long way away from the UK getting back to strong growth.

- A fair proportion of UK GDP is dependent on overseas trade; the high correlation of UK growth to US and EU GDP growth means that the UK economy is likely to register growth rates below the long term average in 2013 and 2014, though this should be on an improving trend.
- Consumers are likely to remain focused on paying down debt and 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.
- 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.
- There is little potential for more QE in 2013 in the UK and so gilt yields are vulnerable to pressures to rise, especially as gilt yields are powerfully influenced by American treasury yields and American investors have been spooked by Bernanke's comments on tapering QE in America.
- In February 2013 Moody's downgraded the UK's AAA credit rating one notch to AA+ and Fitch followed suit in April. There was little reaction in financial markets, as this had been widely anticipated.

Eurozone

- Most Eurozone countries are now battling against recession, although Germany is experiencing a resurgence of business confidence and surveys are pointing towards a resumption of growth. Growth prospects for many Eurozone countries are poor due to the need to adopt austerity programmes to bring government deficits under control.
- The ECB cut its central rate from 0.75% to 0.5% in this quarter but this is unlikely to lead to much in the way of improvement in the prospects for GDP growth.
- Although market anxiety about Greece has subsided after the agreement to a further major financial support package amounting to

nearly €50bn in December. In addition, business surveys are indicating some improvement in the economy, concerns are building that yet another haircut to reduce total debt to a more manageable level will eventually be required, together with more bail out funds. Whether all parties to such a deal would be prepared to pour more money into Greece remains an open question. The eventual end game could therefore still be that Greece is eventually forced to exit (dubbed "Grexit") the Eurozone and to return to the drachma.

- There is also increasing concern that the contraction in Spain's economy and the very high level of unemployment of 27%, similar to the level in Greece and Portugal, could mean that all three countries could get into a downward deflationary spiral, which makes achieving fiscal correction increasingly difficult and possibly unachievable. The 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 immediate future. However, the poor economic fundamentals and outlook for these economies could well mean that a storm in financial markets has only been delayed, not cancelled. Spain has resisted asking for an official national bailout, although it has received financial support to recapitalise its four largest banks.
- The general election in Italy has created a highly unstable political situation where the two dominant parties have 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. Whether such a coalition could effectively implement an agreed policy of austerity is very much open to question – which will make Italy vulnerable to swings in investor confidence.
- There could therefore be volatility in Spanish and Italian bond yields over the next year, depending on political and economic developments.
- A general election is due in Germany in the autumn of 2013. It currently looks likely that this will lead to little change in current policy on the Euro and support for peripheral countries. However, polls are indicating that 25% of the electorate now favour Germany leaving the Euro and stopping the flow of money from Germany to profligate southern countries. Any further disasters in the Eurozone could see this sentiment increase significantly.
- A bailout for Cyprus was eventually agreed in the last week of March. Slovenia, however, looks increasingly likely to be the next in line for a bailout, so their bond yields have risen. However, huge damage will be done to the Cypriot economy by the fallout from this bailout and

many commentators consider it is only a matter of time before another bailout will be needed – or exit from the Euro.

- There are also concerns about the way austerity programmes are affecting economic growth in Ireland and Portugal. The Eurozone remains particularly vulnerable to investor fears of contagion if one country gets into major difficulty. Chancellor Merkel will be hoping that no major blow up occurs before the German general election which requires Germany to pour yet more money into a floundering country.

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 7.6%, but still a long way from the target rate of 6.5% for an increase in the Fed. rate.
- The housing market has turned a corner, both in rising price rises and the volume of house sales. Many householders are now not in negative equity.
- US equities reached all time highs, and so added to the feel good factor, until Ben Bernanke's words on tapering QE3 spooked investors.
- There has been a strong resurgence of confidence in US financial markets due to the "fiscal cliff" being largely averted or postponed. However, tax increases and cuts in Government expenditure leading to cuts in jobs, are damping the potential for recovery in growth rates.
- GDP in Q1 was disappointingly downgraded from +2.4% to a sub par +1.8%.
- 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 rehoming 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

- GDP growth has been disappointing in 2013. 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 during the Government promoted expansion of credit, aimed at protecting the overall rate of growth in the economy since the Lehmans crisis.
- Since the change of national leadership, the new leaders have taken action to test the robustness of the banking system which has caused a rise in fear that there could be a credit crunch looming up in China.

Japan

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

Sector's forward view

Economic forecasting remains difficult with so many external influences weighing on the UK. Major volatility in bond yields is likely during 2013/14 as investor fears and confidence ebb and flow between favouring more risky assets i.e., equities, and safer bonds. Key areas of uncertainty include:

- 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 could also generate safe haven flows into UK gilts.
- Monetary policy action failing to stimulate growth in western economies, especially the Eurozone and Japan.
- The potential for weak growth or recession in the UK's main trading partners - the EU and US.
- The impact of the UK Government's austerity plan in dampening confidence and growth.
- Geopolitical risks e.g. Syria, Iran, North Korea

However, there is particular potential for upside risks to UK gilt yields and PWLB rates, especially for longer term PWLB rates, as follows: -

- UK inflation being significantly higher than in the wider EU and US, causing an increase in the inflation premium inherent to gilt yields.
- A renewed increase in investor confidence that robust world economic growth is firmly expected, together with a reduction or end of QE operations in the US, causing a flow of funds out of bonds into equities.
- A reversal of Sterling's safe-haven status on an improvement in financial stresses in the Eurozone.
- In the longer term - a reversal of QE; 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.
- 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 recovery of economic growth.

The overall balance of risks to economic recovery in the UK is now evenly weighted. Sector believes that 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. Near-term, the prospect of further QE has diminished but measures other than QE may be more favoured by Governor Carney if additional support is viewed as being required.

Given the generally weak outlook for economic growth, Sector sees the prospects for any increase in Bank Rate before 2015 as limited. Indeed, the first increase could be even further delayed if the tentative signs of growth failed to be maintained.