Economic and Interest Outlook

Financial markets remain reasonably volatile as the structural changes necessary within economies and the banking system evolve. This volatility provides opportunities for active treasury management. The economic interest rate outlook provided by the Council's treasury advisor, Arlingclose Ltd, for November 2009 is detailed below.

	Dec-09	Mar-10	Jun-10	Sep-10	Dec-10	Mar-11	Jun-11	Sep-11	Dec-11	Mar-12
Official Bank Rate										
Upside risk				+0.25	+0.25	+0.50	+0.50	+0.50	+0.50	+0.50
Central case	**0.50**	**0.50**	**0.50**	**0.50**	**1.00**	**1.50**	**2.25**	**3.00**	**4.00**	**4.00**
Downside risk					-0.50	-0.50	-0.50	-0.25	-0.25	**-0.25**
1-yr LIBID										
Upside risk				+0.25	+0.50	+0.50	+0.50	+0.50	+0.50	+0.50
Central case	**1.25**	**1.25**	**1.25**	**1.50**	**2.00**	**2.75**	**3.50**	**4.00**	**4.25**	**4.25**
Downside risk					-0.25	-0.25	-0.25	-0.25	-0.25	-0.25
5-yr gilt										
Upside risk		+0.25	+0.25	+0.25	+0.50	+0.50	+0.50	+0.50	+0.50	+0.50
Central case	**2.60**	**2.70**	**2.80**	**2.90**	**3.00**	**3.25**	**3.50**	**3.75**	**4.00**	**4.25**
Downside risk		-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25
10-yr gilt										
Upside risk			+0.25	+0.25	+0.25	+0.25	+0.25	+0.25	+0.25	+0.25
Central case	**3.60**	**3.75**	**3.75**	**4.00**	**4.00**	**4.25**	**4.25**	**4.50**	**4.50**	**4.75**
Downside risk			-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25
20-yr gilt										
Upside risk		+0.25	+0.25	+0.25	+0.25	+0.25	+0.25	+0.25	+0.25	+0.25
Central case	**4.10**	**4.25**	**4.50**	**4.75**	**4.75**	**5.00**	**5.00**	**5.00**	**5.00**	**5.00**
Downside risk		-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25
50-yr gilt										
Upside risk	+0.25	+0.25	+0.25	+0.50	+0.50	+0.50	+0.50	+0.50	+0.50	+0.50
Central case	**4.00**	**4.25**	**4.50**	**4.50**	**4.50**	**4.75**	**4.75**	**4.75**	**4.75**	**4.75**
Downside risk			-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25

- The recovery in growth is likely to be slow and uneven, more "W" than "V" shaped. The Bank of England will stick to its lower-for-longer stance on policy rates.

- Gilt yields will remain volatile; yields have been compressed by Quantitative Easing and will rise once QE tapers off and if government debt remains at record high levels.

- Central banks will eventually wind down and exit their emergency liquidity provisions and shrink their balance sheets, but official interest rates in the UK, Eurozone and US will stay low for some while.

- There are significant threats to the forecast from potential downgrades to sovereign ratings and/or political instability.

The underlying assumptions being:

- The Bank of England has increased Quantitative Easing (QE) to £200bn to insure against the downside risks to growth and stimulate the economy.

- The Bank forecasts GDP to grow by 4% in 2011 but concedes growth could be impeded by corporate and consumer balance sheet adjustments, restrictions in bank credit and consumers' cautious spending behaviour. This is an optimistic forecast in our view; evidence of recovery is scant with weak real economic data and rising unemployment.

- Looming bank regulation and liquidity and capital requirements will curb banking lending activity. The Bank retains the option to reduce the rate on commercial banks' deposits to encourage them to lend.

- The employment outlook remains uncertain. Pay freezes and job cuts will continue into 2010.

- Inflation is not an immediate worry. The Bank's forecast is for CPI to rise in the next few months from higher commodity prices and VAT reverting to 17.5%, but is forecast to remain below 2% in the short term, only surpassing the target in 2012. There is a risk that inflation overshoots in 2010 prompting a letter from the Bank's Governor to the Chancellor.

- The UK fiscal deficit remains acute. Cuts in public spending and tax increases are now inevitable and more likely to be pushed through in 2010 by a new government with a clear majority.

- The net supply of gilts will rise to unprecedented levels in 2010. Failure to articulate and deliver on an urgent and credible plan to lower government borrowing to sustainable levels over the medium term will be negative for gilts.

- The Federal Reserve Chairman Bernanke's diagnosis of a weak U.S. economy and labour market signal that the Fed's "extended period" of low rates may get even longer. The outlook the Eurozone is more optimistic but the European Central Bank will only increase rates after a durable upturn in growth.