Economic Background

Global Economy

The sovereign debt crisis peaked in May 2010 prompted, in the first place, by major concerns over the size of the Greek government's total debt and annual deficit. However, any default or write down of Greek debt would have substantial impact on other countries, in particular, Portugal, Spain and Ireland. This crisis culminated in the EU and IMF putting together a €750bn support package in mid May.

The unexpectedly high rate of growth in quarter 2 of 2010 in the UK and the Euro zone was a one-off particularly driven by strong growth in the construction sector catching up from inclement weather earlier in the year; general expectations are for anaemic (but not negative) growth next year in the western world.

UK Economy

Following the general election in May 2010, the coalition government has put in place an austerity plan to carry out correction of the public sector deficit over the next five years. The inevitable result of fiscal contraction will be major job losses during this period, in particular in public sector services. This will have a knock on effect on consumer and business confidence and appears to have also hit the housing market as house prices have started on a negative trend during the summer of 2010. Mortgage approvals are also at very weak levels and declining, all of which indicates that the housing market is likely to be very weak next year.

Economic Growth – GDP growth is likely to have peaked in the current period of recovery at 1.2% in quarter 2 of 2010. The outlook is for anaemic growth in 2011/12 although the Bank of England and the Office for Budget responsibility are forecasting much stronger growth than most forecasters are currently expecting.

Unemployment – the trend of falling unemployment (on the benefit claimant count) has now been replaced since July 2010 with small increases that are likely to be the start of a new trend for some years ahead of rising unemployment.

Inflation and Bank Rate – CPI has remained high during 2010. It peaked at 3.7% in April and has gradually declined to 3.1% in September (RPI 4.6%). Although inflation has remained stubbornly above the Monetary Policy Committee's (MPC) 2% target, the MPC is confident that inflation will fall back under the target over the next two years.

The Bank of England finished its programme of quantitative easing (QE) with a total of £200bn in November 2009. However, there is currently major expectation that there could be a second round of quantitative easing in late 2010 or early 2011 to help support economic growth.

Sector's view is that there is unlikely to be any increase in Bank Rate until the middle of 2011.

AAA rating – prior to the general election, credit rating agencies had been issuing repeated warnings that, unless there was a major fiscal contraction, the AAA sovereign rating was at significant risk of being downgraded. Sterling was also under major pressure during the first half of the year. However, after the Chancellor's budget on 22 June, Sterling has strengthened against the US dollar and confidence has returned that the UK will retain its AAA rating. In addition, international investors now view UK government gilts as being a safe haven from EU government debt. The consequent increase in demand for gilts has helped to add downward pressure on gilt yields and PWLB rates. If there is a second round of QE, this is likely to put further downward pressure on gilt yields and so on PWLB rates, or at the least, prolong the period they stay at these low levels.

Sector's Forward View

It is currently difficult to have confidence as to exactly how strong the UK economic recovery is likely to be, and there is a range of views in the market. Sector has adopted a moderate view. There are huge uncertainties in all forecasts due to the major difficulties of forecasting the following areas:

- The speed of economic recovery in the US and EU
- The degree to which government austerity programmes will dampen economic growth
- The speed of rebalancing of the UK economy towards exporting and substituting imports
- Changes in the consumer savings ratio
- The potential for more quantitative easing, and the timing of this in both the UK and US
- The speed of recovery of banks' profitability and balance sheet imbalances
- The potential for a major EU sovereign debt crisis which could have a significant impact on financial markets and the global and UK economy

The overall balance of risks is weighted to the downside and there is some risk of a double dip recession and deleveraging, creating a downward spiral of falling demand, falling jobs and falling prices, although this is currently viewed as being a small risk.

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 the high volume of debt issuance in other major western countries.