

Economic Update provided by Sector

1. Global economy

The Euro zone sovereign debt crisis continued with Spain, and particularly Italy, being the focus of renewed market concerns that they may soon join with Greece, Ireland and Portugal in needing assistance. This uncertainty and the lack of a co-ordinated or credible Euro zone response, left commentators concerned over the potential impact of sovereign default and resulting effect on the Euro zone banking sector. The approval by various countries of the €440bn bail out fund in September has brought temporary relief to financial markets but this does not provide a credible remedy to the scale of the Greek debt problem or the sheer magnitude of the potential needs of other countries for support.

This, coupled with political difficulties in the US over their plans to address the budget deficit, the size and control over the US sovereign debt, and the subsequent loss of the AAA credit rating from Standard and Poor's, has led to a much more difficult and uncertain outlook for the world economy.

Growth prospects in the US, UK and the euro zone have been lower than expected, with future prospects similarly cut. Whilst not a central view, concerns of a double dip recession in some Western countries have increased. World stock markets fell in the second quarter of 2011-12 as a consequence.

2. UK economy

Following zero growth in the final half of 2010-11 the UK economy grew by a weaker than expected 0.1% in the first quarter of 2011-12, providing a knock on effect to future growth prospects. Growth prospects will be governed by UK consumer sentiment, which is currently subdued due to falling disposable income. Higher VAT, overhanging debt, high inflation and concerns over employment are likely to weigh heavily on consumers into the future.

The announcement by the MPC on 6 October of a second round of quantitative easing of £75bn emphasised how seriously the MPC now views recession as being a much bigger concern than inflation. Although inflation remains stubbornly high, the MPC's expectation of future falls resulting in an undershoot of its 2% target opened the way for this new round of QE.

International investors continue to view UK government gilts as being a safe haven from the EU sovereign debt crisis. The consequent increase in demand for gilts has helped to add downward pressure on gilt yields and sent PwLB borrowing rates to low levels.

3. Outlook for the next six months of 2011-12

There remain huge uncertainties in economic forecasts due to the following major difficulties:

- the increase in risk that the UK, US and EU could fall into recession
- the likely political gridlock in the US preventing significant government fiscal action to boost growth ahead of the Presidential elections in November 2012
- the potential for a major EU sovereign debt crisis which could have a significant impact on financial markets and the global and UK economies
- the degree to which government austerity programmes will dampen economic growth;
- the potential for further quantitative easing, and the timing of this in both the UK and US

- the speed of recovery of banks' profitability and balance sheet imbalances and the risk of substantial losses being incurred on EU sovereign debt

The overall balance of risks is weighted to the downside:

- We expect low growth in the UK to continue, with a low Bank Rate to continue for at least 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 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, postponing any increases until 2012.

Sector's interest rate forecast

	NOW	Dec-11	Mar-12	Jun-12	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	0.50	0.50	0.75	1.00	1.25	1.50	2.00	2.25	2.50
3 month LIBID	0.75	0.70	0.70	0.70	0.70	0.70	0.75	0.80	0.90	1.20	1.40	1.60	2.10	2.40	2.60
6 month LIBID	1.00	1.00	1.00	1.00	1.00	1.00	1.10	1.20	1.40	1.60	1.80	2.00	2.50	2.70	2.90
12 month LIBID	1.50	1.50	1.50	1.50	1.50	1.60	1.70	1.80	1.90	2.20	2.40	2.60	3.10	3.20	3.30
5 yr PWLB	2.30	2.30	2.30	2.30	2.30	2.40	2.50	2.60	2.70	2.80	2.90	3.10	3.30	3.50	3.70
10 yr PWLB	3.30	3.30	3.30	3.30	3.40	3.40	3.50	3.60	3.70	3.80	4.00	4.20	4.40	4.60	4.80
25 yr PWLB	4.20	4.20	4.20	4.20	4.30	4.30	4.40	4.50	4.60	4.70	4.80	4.90	5.00	5.10	5.20
50 yr PWLB	4.30	4.30	4.30	4.30	4.40	4.40	4.50	4.60	4.70	4.80	4.90	5.00	5.10	5.20	5.30