

ECONOMIC OUTLOOK FOR 2009/10

At the time of determining the Treasury Strategy Statement for 2009/10 in February 2009, the outlook for the economy and interest rates was as follows:

The UK, Eurozone and US economies were contracting, globally economies faced a prolonged recession or period of weakness following the financial market meltdown in the autumn of 2008. Availability of credit was restricted as banks undertook to repair their balance sheets. This exacerbated the slowdown as finance for small businesses effectively came to a standstill.

Asset values were falling and were forecast to drop further, particularly those which related to commodities and housing. The increase in food and energy inflation which had exerted a powerful squeeze on real incomes in 2008 was, however, expected to fade in 2009. Wage inflation was forecast to remain low and the labour market to remain weak; the threat of unemployment was likely to influence consumers to scale back spending and save instead.

The UK Bank Rate had been cut to 0.5% and in March 2010 the Bank of England announced its initial £75 billion of Quantitative Easing (QE). There remained a sizeable gap between short-dated LIBOR rates (i.e. the rates at which a banks are willing to borrow from other banks) and the Bank Rate; this gap was forecast to narrow. Gilts were expected to benefit from QE, resulting in lower yields.

THE ECONOMY AND EVENTS IN 2009/10

- After the particularly torrid economic recession and a severe downturn in growth that extended into early 2009, there were reports of nascent recovery. The Bank of England forecast UK growth to fall by 3.9% in 2009, whilst inflation was forecast to be heading lower and staying lower for longer. The depth of the recession was borne out by the 5.9% year-on-year fall in GDP recorded at the end of the second quarter of 2009. The service sector - the dominant element of UK economy - also stalled for much of early 2009 despite a number of optimistic surveys to the contrary. Green shoots of recovery were finally evident in the final quarter of 2009 with growth registering 0.4% for the quarter.
- In order to stimulate growth, the Bank of England maintained the Bank Rate at 0.5% throughout the year. The Bank also took extreme measures on an extraordinary scale to revive the economy through its Quantitative Easing (QE) programme. Financed by the issuance of central bank reserves QE was initially announced at £75 billion and then extended in stages to £200 billion.
- The Bank appears to have successfully staved off the very real risk of deflation. The increased supply of money in the system due to QE did not however translate into an increase in the movement of money in the system as banks are still unwilling to lend, and consumers are unwilling to borrow at pre-crisis levels.
- The housing market showed some signs of stability but increases in house prices were modest. Nationwide House prices registered a year on year growth of 9% at the end of March 2010.

- Consumer Price Inflation, having hit a high of 5.2% in September 2008, began the year at 2.9% (March data), fell to a low of 1.1% in September 2009 as the oil, commodity, utility and food prices (the main drivers of high inflation in 2008) fell out of the year-on-year statistical calculations. Thereafter, inflation pushed higher with rising oil and transport costs and VAT reverting to 17.5%. CPI at year end was 3.4% (March 2010 data).
- Companies and households on the whole reduced rather than increased their levels of debt. Credit remained scarce and at a premium, and certainly as compared to that available two years earlier. Businesses retrenched rather than hired workers and unemployment rose rapidly to just under 2.5 million. Against this background, wage growth was muted.
- The November 2009 Budget was primarily about public debt. The Chancellor's forecast for net public sector borrowing in 2009/10 was £175 billion or 12.4% of GDP. Gross gilt issuance was expected to hit a quite staggering £220 billion in 2009/10. Standard & Poor's responded to the debt that the UK government was building up and a lack of a credible plan to reduce the debt burden by changing the UK's rating outlook from stable to negative.
- The outlook for 2010 was therefore for a period of slow and patchy growth in the economy accompanied by stubbornly high unemployment. The UK fiscal deficit remained acute. Cuts in public spending and tax increases were becoming inevitable and a credible plan to reduce the deficit was urgently required after the May General Election, the absence of which increased the potential of a sovereign downgrade. The likelihood of a hung parliament had grown and had the potential of being disruptive to financial markets.

Gilts and Money Market Rates

- LIBOR and LIBID rates (i.e. the rates at which a banks are willing to borrow from and lend to other banks) which had been stubbornly high in early 2009, slowly moved lower towards the Bank Rate of 0.5%.
- UK Government Gilts were the main beneficiary of the economic downturn (it is an asset class that responds positively to poor economic news); they also formed the significant bulk of the QE purchases and are thought to have pushed gilt yields, and consequently the cost of borrowing, lower by 0.5%.

Economic and Money Market Data, PWLB Rates

The average, low and high rates correspond to the daily rates during the financial year and rather than those summarised in the tables below

Bank Rate, Money Market Rates

Date	Bank Rate	O/N LIBID	7-day LIBID	1-month LIBID	3-month LIBID	6-month LIBID	12-month LIBID	2-yr SWAP Bid	3-yr SWAP Bid	5-yr SWAP Bid
01/04/2009	0.50	0.400	0.500	0.800	1.400	1.800	1.820	1.973	2.361	2.954
30/04/2009	0.50	0.350	0.350	0.600	1.200	1.600	1.700	2.010	2.440	2.998
31/05/2009	0.50	0.400	0.350	0.450	1.050	1.250	1.600	1.890	2.498	3.243
30/06/2009	0.50	0.300	0.400	0.600	0.950	1.200	1.600	2.277	2.959	3.650
31/07/2009	0.50	0.400	0.400	0.500	0.900	1.200	1.300	2.133	2.873	3.603
31/08/2009	0.50	0.350	0.350	0.400	0.450	0.700	1.000	1.915	2.595	3.310
30/09/2009	0.50	0.480	0.460	0.350	0.520	0.500	0.850	1.805	2.485	3.210
31/10/2009	0.50	0.500	0.460	0.370	0.550	0.840	1.000	1.878	2.520	3.208
30/11/2009	0.50	0.350	0.350	0.370	0.450	0.650	1.050	1.727	2.315	3.009
31/12/2009	0.50	0.300	0.350	0.370	0.450	0.650	1.200	1.986	2.630	3.363
31/01/2010	0.50	0.350	0.350	0.370	0.450	0.700	1.100	1.693	2.298	3.063
28/02/2010	0.50	0.350	0.350	0.420	0.500	0.800	1.240	1.525	2.078	2.878
31/03/2010	0.50	0.250	0.250	0.420	0.510	0.810	1.260	1.520	2.050	2.808
Minimum	0.50	0.200	0.250	0.250	0.350	0.490	0.830	1.517	2.050	2.808
Average	0.50	0.368	0.390	0.470	0.695	0.928	1.283	1.914	2.540	3.254
Maximum	0.50	0.750	0.520	1.050	1.500	1.800	2.150	2.447	3.117	3.770
Spread		0.550	0.270	0.800	1.150	1.310	1.320	0.930	1.068	0.963

PWLB Borrowing Rates – Fixed Rate, Maturity Loans

Change Date	Notice No	1 year	4½-5 yrs	10-10½ yrs	19½-20 yrs	29½-30 yrs	39½-40 yrs	49½-50 yrs
01-Apr-09	073/09	0.83	2.54	3.36	4.15	4.38	4.41	4.53
30-Apr-09	092/09	0.84	2.63	3.61	4.40	4.47	4.50	4.51
29-May-09	113/09	0.88	2.79	3.87	4.59	4.72	4.75	4.79
30-Jun-09	137/09	1.05	2.92	3.68	4.39	4.48	4.51	4.50
31-Jul-09	161/09	1.11	3.26	4.12	4.72	4.74	4.77	4.73
28-Aug-09	183/09	0.85	2.74	3.71	4.14	4.25	4.28	4.31
30-Sep-09	205/09	0.86	2.79	3.80	4.15	4.22	4.25	4.27
30-Oct-09	228/09	0.91	2.89	3.87	4.29	4.30	4.32	4.32
30-Nov-09	249/09	0.80	2.76	3.79	4.25	4.25	4.27	4.25
31-Dec-09	271/09	0.93	3.11	4.29	4.65	4.59	4.61	4.57
29-Jan-10	020/10	0.95	3.06	4.20	4.57	4.54	4.56	4.53
26-Feb-10	040/10	0.81	2.85	4.20	4.70	4.69	4.72	4.69
31-Mar-10	063/10	0.83	2.89	4.19	4.65	4.67	4.70	4.69
	Low	0.68	2.47	3.30	4.01	4.10	4.13	4.17
	Average	0.90	2.89	3.93	4.45	4.50	4.52	4.52
	High	1.23	3.29	4.42	4.84	4.80	4.83	4.84

PWLB Repayment Rates - Fixed Rate, Maturity Loans

Change Date	Notice No.	1 year	4½-5 yrs	10-10½ yrs	19½-20 yrs	29½-30 yrs	39½-40 yrs	49½-50 yrs
01-Apr-09	073/09	0.58	2.16	3.11	3.88	4.12	4.16	4.11
30-Apr-09	092/09	0.59	2.23	3.36	4.14	4.22	4.13	4.07
29-May-09	113/09	0.63	2.37	3.62	4.33	4.47	4.41	4.34
30-Jun-09	137/09	0.80	2.54	3.43	4.13	4.23	4.12	4.03
31-Jul-09	161/09	0.86	2.85	3.87	4.46	4.49	4.35	4.25
28-Aug-09	183/09	0.60	2.33	3.46	3.88	4.00	3.93	3.82
30-Sep-09	205/09	0.61	2.37	3.55	3.89	3.97	3.89	3.80
30-Oct-09	228/09	0.66	2.46	3.62	4.03	4.04	3.95	3.88
30-Nov-09	249/09	0.55	2.33	3.54	4.00	3.99	3.87	3.80
31-Dec-09	271/09	0.68	2.66	4.04	4.40	4.33	4.19	4.11
29-Jan-10	020/10	0.70	2.61	3.95	4.32	4.28	4.15	4.06
26-Feb-10	040/10	0.56	2.39	3.95	4.45	4.44	4.32	4.24
31-Mar-10	063/10	0.58	2.42	3.94	4.40	4.42	4.32	4.25
	Low	0.43	1.83	2.93	3.74	3.84	3.79	3.73
	Average	0.65	2.47	3.68	4.19	4.24	4.15	4.07
	High	0.98	2.88	4.17	4.59	4.55	4.47	4.40

PWLB Variable Rates

	1-M Rate	3-M Rate	6-M Rate
01-Apr-2009	0.8000	0.8000	0.8500
30-Apr-2009	0.6500	0.7500	0.8000
29-May-2009	0.6500	0.7000	0.7500
30-Jun-2009	0.6500	0.7000	0.7500
31-Jul-2009	0.5500	0.6000	0.6000
28-Aug-2009	0.5500	0.5500	0.5500
30-Sep-2009	0.6000	0.5500	0.6000
30-Oct-2009	0.6000	0.6000	0.6000
30-Nov-2009	0.6000	0.6000	0.6000
31-Dec-2009	0.6000	0.6500	0.6500
29-Jan-2010	0.6500	0.6500	0.6500
26-Feb-2010	0.6500	0.6500	0.7000
01-Mar-2010	0.6500	0.6500	0.7000
31-Mar-2010	0.6500	0.6500	0.7000
Minimum	0.5500	0.5500	0.5500
Average	0.6303	0.6414	0.6697
Maximum	0.8000	0.8500	0.9000

Economic Data

<u>Inflation</u>	CPI	RPI
Feb-09	3.2	0.0
Mar-09	2.9	-0.4
Apr-09	2.3	-1.2
May-09	2.2	-1.1
Jun-09	1.8	-1.6
Jul-09	1.8	-1.4
Aug-09	1.6	-1.3
Sep-09	1.1	-1.4
Oct-09	1.5	-0.8
Nov-09	1.9	0.3
Dec-09	2.9	2.4
Jan-10	3.5	3.7
Feb-10	3.0	3.7
Mar-10	3.4	4.4
<u>Growth</u>	Q-o-Q	Y-o-Y
Q1 2009	-2.6	-5.4
Q2 2009	-0.6	-5.9
Q3 2009	-0.3	-5.3
Q4 2009	0.4	-3.1