APPENDIX 3

Sector's Economic background – June quarter

1. The June quarter saw:
   - The economic recovery struggle to regain momentum;
   - Conditions on the high street deteriorate;
   - Mixed signals on the strength of the labour market recovery;
   - Public sector borrowing come out disappointingly high;
   - The near-term outlook for CPI inflation deteriorate further;
   - The Monetary Policy Committee move away from raising interest rates;
   - UK equities stay broadly flat and gilt yields fall;
2. The economic recovery has been struggling to regain momentum after underlying activity more or less stagnated between October and March. The additional bank holiday for the Royal Wedding pulled down both industrial and services output in April, but the CIPS/Markit business surveys have failed to pick up by much since. An average of the surveys over the last three months points to quarterly GDP growth in Q2 of just 0.3% - less than half its trend rate.
3. The industrial recovery appears to have lost momentum quite quickly. The CIPS/Markit manufacturing survey has fallen to a level consistent with falls in manufacturing output. The output expectations balance of the CBI industrial trends survey has fallen more modestly, but has nonetheless dropped for the past three months in a row.
4. Meanwhile, the consumer outlook has darkened. The pick-up in the consumer sector seen during the spring appears to have been only temporary, reflecting the good weather and extra bank holiday. Retail sales volumes fell in May, more than reversing April's increase. The CBI's distributive trades survey fell in June and a number of well-known retailers have recently fallen into administration. Consumers appear to be reacting to the squeeze on their real incomes. Household real disposable incomes fell by 0.8% in Q1 and inflation is outpacing average earnings by about 2.5%. Consumer confidence also fell back in June and remains consistent with further falls in consumer spending.
5. Meanwhile, the news on the labour market has been mixed. The Workforce Jobs measure of employment rose strongly in Q1. But the more timely Labour Force Survey measure flattened off in April and May and the number of job vacancies continued to fall throughout the quarter. The claimant count measure of unemployment also continued to rise over the last three months. This only partly reflected a rise in the number of lone parents claiming Jobseeker's Allowance due to recent benefit changes.
6. The housing market has continued to tread water. The number of mortgage approvals for new house purchase was broadly unchanged over the quarter at a very low level of around 46,000. House prices have also remained broadly flat. The Nationwide index ended the second quarter at about the same level as it ended the first.
7. Meanwhile, net trade looks unlikely to provide as big a contribution to GDP growth in Q2 as it did in Q1. Net trade boosted quarterly GDP growth by some 1.4% in Q1. However, the trade deficit was unchanged in April compared to March.
8. The weakness of the economy appears to be having some adverse effect on the public finances. Borrowing in the first two months of the fiscal year totalled £27.4bn, compared to last year's £25.9bn. It is early days but, at this rate, borrowing will overshoot the OBR's Budget full-year forecast of £122bn.
9. Oil prices rose but then fell back during the quarter and ended Q2 at $113 per barrel, close to the level seen at the end of Q1. Agricultural prices fell sharply over the past quarter.

10. The near-term outlook for inflation has deteriorated further. Although CPI inflation held steady at 4.5% in May, it now looks likely to rise to 5.5% or even higher within the next few months. Food price inflation is likely to rise further and Scottish Power announced in June a 19% rise in gas prices and 10% rise in electricity prices to take effect in August. Other utility suppliers are likely to follow suit. Households' inflation expectations rose sharply in June. But so far, there are no signs of any pick-up in pay growth. The median pay settlement was unchanged at 2.5% in May.

11. Most Monetary Policy Committee members still think that the rise in inflation will be only temporary and that inflation will fall back sharply next year. So, despite the worsening of the near-term inflation outlook, the weakness of the activity data has pushed most members further away from an interest rate rise. Some members have even started to discuss the prospect of giving the economy more support. Admittedly, the hurdle for more quantitative easing will be quite high, but it is certainly possible if the economy remains as weak as we expect.

12. In financial markets, the FTSE 100 finished the quarter at around 5,950 – about the same level as at the end of the first quarter. This was broadly in line with international stock markets – the S&P500 was also little changed over the period. Ten year gilt yields fell from 3.69% to 3.38% on the back of a drop in interest rate expectations. At the end of March, markets were expecting interest rates to have risen by this July, but now they expect rates to stay on hold until July next year. Meanwhile, sterling was broadly unchanged against the dollar at about $1.60, and fell only a touch against the euro.

13. In the US, the recovery also appears to have lost a significant amount of momentum. The ISM manufacturing index fell sharply in May and reversed only a fraction of this drop in June. Payrolls employment rose by a disappointing 54,000 in May. Meanwhile, the euro-zone economy expanded at a healthy pace in Q1, but recent falls in most leading indicators suggest that growth is slowing there too. Germany has continued to outperform the rest of the region. The risk of an imminent Greek disaster eased temporarily after an initial draft agreement on a second Greek bailout package but European policymakers' inability to deal with the crisis quickly and effectively created further uncertainty and volatility.

APPENDIX 4

Sector's Summary Outlook – September 2011

1. The key question is how quickly, and strongly, will the UK economy respond to the positive stimulus from low Bank Rate, quantitative easing and the devaluation of sterling? Negative growth of -0.5% in Q4 2010 was a huge shock; +0.5% (quarter on quarter) in Q1 2011 meant that growth had been flat for six months. A marginal upgrading of Q1 growth figures will have only a marginal effect on the big picture for the UK but there is considerable uncertainty as to how the UK economy will evolve in the coming months. US Q1 growth of only 1.8% (on an annualised basis) was also a disappointment despite non-farm payroll data showing improvement.
2. China and India have embarked on a major thrust to cool their over-heating economies and so may depress the rate of world economic growth. An anaemic economic recovery is probably the most likely outcome in the UK and US, after the initial rebound in 2010, for the next three to four years; recovery is likely to be slower and more protracted than normal business cycle recoveries as this is a financial crisis recovery where lack of credit is still stifling growth. The Bank of England is likely to determine that further increases in CPI in 2011, towards 5%, as being due to one off factors that will drop out of the index within 12 months, so underpinning the view that inflation will be back to near target within a two to three year time horizon.
3. This does assume that raised inflation expectations do not feed through into a significant increase in the general level of wage settlements. There has been a significant erosion of the confidence of financial markets in the EU handling of the peripheral debt crisis. There is now a major and escalating risk that the Greek, Irish, Portuguese debt crisis may not be contained and could lead to debt restructurings that could do significant damage to banks which already have weakened balance sheets. It is worth noting that many western governments have already exhausted their capacity to increase government debt to again bail out banks further damaged by any such future events and to counter the dampening of economic growth that would follow.

APPENDIX 5

Sector's Interest rate outlook and forecast – September 2011

1. The Council's treasury adviser, Sector, provides the following interest rate forecast and outlook:

Sector's Interest Rate View													
	Mar-11	Sep-11	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12	Mar-13	Jun-13	Sep-13	Dec-13	Mar-14	Jun-14
Base Rate	0.50	0.50%	0.50%	0.50%	0.50%	0.50%	0.75%	1.00%	1.25%	1.50%	1.75%	2.25%	2.50%
3 mth LIBID	0.70	0.70%	0.70%	0.70%	0.70%	0.70%	0.90%	1.10%	1.30%	1.60%	1.90%	2.40%	2.70%
6 mth LIBID	1.00	1.00%	1.00%	1.00%	1.20%	1.30%	1.50%	1.70%	1.90%	2.10%	2.40%	2.70%	3.00%
12 mth LIBID	1.50	1.50%	1.50%	1.50%	1.60%	1.80%	2.00%	2.25%	2.50%	2.75%	3.00%	3.40%	3.70%

2. Although inflation pressures have remained a significant problem for the UK, the bias towards an accommodative monetary policy stance is likely to persist for some time to come. In theory, inflation remains the main driving force behind the MPC's decision processes. In practice, it is clear from its willingness to leave rates on hold throughout the year that growth prospects are a (if not the) key influence on policy.

3. Domestic growth has been virtually flat for the last nine months and there are no real signs that a return to a more buoyant profile is in prospect. The encouraging recovery in manufacturing output appears to have run out of steam and the slack is not yet being taken up by services and construction.

4. With the fiscal squeeze entering its more intense phase, the risks of a slide towards a double-dip recession remain present. The international activity backdrop has not helped in this respect. Indeed, the Bank of England has highlighted the problems in the euro-zone as one of the greatest risks to the UK recovery, although it does not quantify the potential impact.

5. US activity appears to have faltered over the summer months and has not been helped by the blow to confidence from a persistently weak housing market and the wrangling over the Federal debt ceiling. Eurozone growth remains heavily dependent on the German recovery, which appears to have faltered in the second quarter. Deteriorating confidence across the zone suggests the pace of activity could slacken further.

6. Weak activity in the western industrialised nations may help to modify upward pressure on global raw material prices, although a slide to the lower levels enjoyed in the early part of the past decade is very unlikely. Supply shortages and strong demand from China in particular rule out a more benign profile.

7. To date, the vast bulk of UK inflation pressures have been externally generated, principally rising food and commodity prices on the back of a combination of sterling weakness and strong global demand. Domestic pressures have remained subdued.

8. The main risk that the MPC has identified in the past is a marked deterioration in domestic inflation expectations and the dangers that this might trigger a bout of spiralling domestic costs. However, for this train of events to materialise we need to see an escalation in wage growth. Neither the labour market nor the willingness of the corporate sector to acquiesce to demands for higher pay are strong enough to pose much of a threat for the foreseeable future.

9. UK inflation is expected to ease sharply in 2012 as the factors that have driven prices higher in the last year – sterling weakness, the rise in commodity and energy prices and the hike in VAT – fall out of the indices. Prior to that, the Bank of England suggests the annual increase might hit 5%.

10. Projections of a more benign profile will support the MPC's policy of leaving rates on hold while the recovery in the economy remains threatened by low private sector confidence and the ongoing fiscal squeeze. If inflation does fall as anticipated and growth remains in the doldrums, the chances of a fresh phase of Quantitative Easing as the only means of boosting activity will increase.

11. Long-term interest rates remain extremely difficult to predict in these highly uncertain times. While the current level of yield is not justified by the recent performance of inflation, turmoil in the Eurozone and the problems associated with the US debt ceiling and ratings downgrade, have generated exceptional demand for safe-haven investments. Investors are willing to hold top quality government debt despite negative real rates of return.
12. Debt default and struggling economic recoveries will remain key drivers for the market for some time to come. Yields will remain under downward pressure while the threat of sovereign defaults and economic stagnation persist.
13. Nevertheless, with one or two exceptions, the health of the global economy is considerably better than during the depths of the 2008/09 credit crunch. Once the eurozone crisis passes its peak and demand for safe haven instruments slackens, the markets should see a rebalancing of yields and a rise in longer term rates towards levels more in keeping with a positive inflation environment.