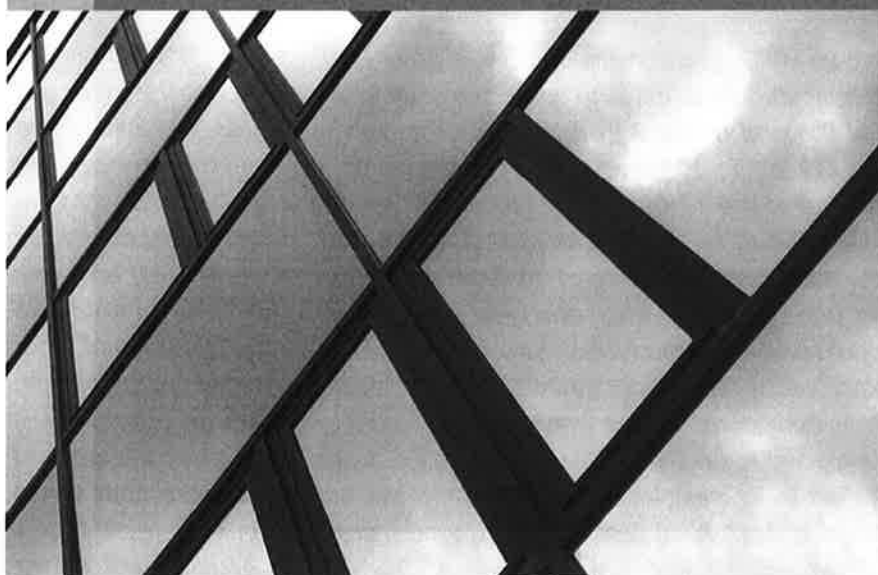


Treasury solutions

Updated Interest Rate Forecast
20 January 2016



Capita Asset Services Updated Interest Rate Forecast

Not a very happy new year!

- *We have undertaken an early revision of our interest rate forecasts before our previously scheduled revision after the February Inflation Report as a result of the downbeat UK and world economic news in recent weeks and the extreme volatility we have seen in financial markets, with a few doom and gloom commentators unable to see any silver linings at all.*
- *Our revised forecast has pushed back the timing of the start of increases in Bank Rate from quarter 2 2016 to quarter 4. The pace of increases has remained slow and gradual. Our PWLB forecasts similarly now reflect a slower pace of increase.*
- *Our forecasts reflect the differences in the strength and pace of recovery between the US and UK which has resulted in the Fed. making a start on increasing rates in December 2015 while the slower and weaker pace of recovery in the UK, and continuing measures to reduce Government budget deficits in the UK, mean that the UK's MPC will take a slower and more gradual path in increasing rates than in the US.*
- *However, the key to MPC decision making will always be inflation. The November Inflation Report indicated that inflation was currently expected to struggle to get barely over 2% at the end of the 2 to 3 year time horizon assuming that Bank Rate did not go up until Q2 2017. However, once the falls in oil, gas and food prices over recent months fall out of the 12 month calculation of CPI, there will be a tick up from the current rate little above zero, and was expected to get to around 1 percent by the end of 2016. However, with the price of oil having recently fallen further, and with sanctions having been lifted on Iran, enabling it to sell oil freely into international markets, there could well be some further falls still to come in 2016. The price of other commodities exported by emerging countries could also have downside risk and several have seen their currencies already fall by 20-30%, (or more), over the last year. These developments could well lead the Bank of England to lower the pace of increases in inflation in its next Inflation Report. On the other hand, the start of the national living wage in April 2016 (and further staged increases until 2020), will raise wage inflation; however, it could also result in a decrease in employment so the overall inflationary impact may be muted.*
- *Yesterday, Bank of England Governor Carney definitively ruled out an increase in Bank Rate in the very near future. He has previously laid out three criteria that need to be met before he would look to make a start on increasing Bank Rate. These criteria are patently not being met at the current time:*
 1. *Quarter-on-quarter GDP growth is above 0.6% i.e. using up spare capacity. This condition was met in Q2 2015, but Q3 came up short and Q4 looks likely to also fall short.*

2. *Core inflation (stripping out most of the effect of decreases in oil prices), registers a concerted increase towards the MPC's 2% target. This measure was on a steadily decreasing trend since mid-2014 until November 2015 @ 1.2%. December 2015 saw a slight increase to 1.4%.*
 3. *Unit wage costs are on a significant increasing trend. This would imply that spare capacity for increases in employment and productivity gains are being exhausted, and that further economic growth will fuel inflationary pressures.*
- *Confidence is another big issue to factor into forecasting. Recent volatility in financial markets could dampen investment decision making as corporates take a more cautious view of prospects in the coming years due to international risks. This could also impact in a slowdown in increases in employment. However, consumers will be enjoying the increase in disposable incomes as a result of falling prices of fuel, food and other imports from emerging countries, so this could well feed through into an increase in consumer expenditure and demand in the UK economy, (a silver lining!). Another silver lining is that the UK will not be affected as much as some other western countries by a slowdown in demand from emerging countries, as the EU and US are our major trading partners.*

CAPITA ASSET SERVICES' FORWARD VIEW

Economic forecasting remains difficult with so many external influences weighing on the UK. Our Bank Rate forecasts, (and also MPC decisions), will be liable to further amendment depending on how economic data and developments in financial markets transpire over the next year. Forecasts for average earnings beyond the three year time horizon will be heavily dependent on economic and political developments. Major volatility in bond yields is likely to endure as investor fears and confidence ebb and flow between favouring more risky assets i.e. equities, or the safe haven of bonds.

The overall longer run trend is for gilt yields and PWLB rates to rise, due to the high volume of gilt issuance in the UK, and of bond issuance in other major western countries. An eventual world economic recovery will also see investors switching from the safe haven of bonds to equities.

We have pointed out consistently that the Fed. rate is likely to go up both sooner and more strongly than Bank Rate in the UK. These increases will have corresponding effects in pushing up US Treasury and UK gilt yields. While there is normally a high degree of correlation between the two yields, we would expect to see a decoupling of yields between the two i.e. we would expect US yields to go up faster than UK yields. We will need to monitor this area closely and the resulting effect on PWLB rates.

The overall balance of risks to economic recovery in the UK is currently to the downside. Only time will tell just how long this current period of reasonably strong economic growth will last; it also remains exposed to vulnerabilities in a number of key areas.

We would, however, remind clients of the view that we have expressed in our previous interest rate revision newsflashes of just how unpredictable PWLB rates and bond yields are

at present. We are experiencing exceptional levels of volatility which are highly correlated to emerging market, geo-political and sovereign debt crisis developments. Our revised forecasts are based on the Certainty Rate (minus 20 bps) which has been accessible to most authorities since 1st November 2012.

Downside risks to current forecasts for UK gilt yields and PWLB rates currently include:

- Emerging country economies, currencies and corporates destabilised by falling commodity prices and / or Fed. rate increases, causing a flight to safe havens (bonds).
- Geopolitical risks in Eastern Europe, the Middle East and Asia, increasing safe haven flows.
- UK economic growth and increases in inflation are weaker than we currently anticipate.
- Weak growth or recession in the UK's main trading partners - the EU and US.
- A resurgence of the Eurozone sovereign debt crisis.
- Recapitalisation of European banks requiring more government financial support.
- Monetary policy action failing to stimulate sustainable growth and combat the threat of deflation in western economies, especially the Eurozone and Japan.

The potential for upside risks to current forecasts for UK gilt yields and PWLB rates, especially for longer term PWLB rates include: -

- Uncertainty around the risk of a UK exit from the EU.
- The pace and timing of increases in the Fed. funds rate causing a fundamental reassessment by investors of the relative risks of holding bonds as opposed to equities and leading to a major flight from bonds to equities.
- UK inflation returning to significantly higher levels than in the wider EU and US, causing an increase in the inflation premium inherent to gilt yields.

	NOW	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19
BANK RATE	0.50	0.50	0.50	0.50	0.75	0.75	1.00	1.00	1.25	1.25	1.50	1.50	1.75	1.75
3 month LIBID	0.52	0.50	0.50	0.60	0.80	0.90	1.00	1.10	1.30	1.40	1.50	1.60	1.80	1.90
6 month LIBID	0.66	0.70	0.70	0.80	0.90	1.00	1.20	1.30	1.50	1.60	1.70	1.80	2.00	2.20
12 month LIBID	0.98	1.00	1.00	1.10	1.20	1.30	1.50	1.60	1.80	1.90	2.00	2.10	2.30	2.40
5 yr PWLB	1.92	2.00	2.10	2.20	2.30	2.40	2.50	2.60	2.70	2.80	2.90	3.00	3.10	3.20
10 yr PWLB	2.58	2.60	2.70	2.80	2.90	3.00	3.10	3.20	3.30	3.40	3.50	3.60	3.60	3.70
25 yr PWLB	3.36	3.40	3.40	3.50	3.60	3.70	3.70	3.80	3.90	4.00	4.00	4.10	4.10	4.10
50 yr PWLB	3.18	3.20	3.20	3.30	3.40	3.50	3.60	3.70	3.80	3.90	3.90	4.00	4.00	4.00

BANK RATE	now	previously
Q1 2016	0.50%	0.50%
Q1 2017	0.75%	1.00%
Q1 2018	1.25%	1.75%
Q1 2019	1.75%	2.00%

Our target borrowing rates and the current PWLB (certainty) borrowing rates are set out below.

PWLB debt	Current borrowing rate as at 19.1.16	Target borrowing rate now (Q1 2016)	Target borrowing rate previous (Q1 2016)
5 year	1.92%	2.00%	2.40%
10 year	2.58%	2.60%	3.00%
25 year	3.36%	3.40%	3.70%
50 year	3.18%	3.20%	3.60%

Our suggested budgeted investment earnings rates for investments up to about three months duration in each financial year for the next seven years are as follows: -

Average earnings in each year	Now	Previously
2015/16	0.50%	0.50%
2016/17	0.60%	0.90%
2017/18	1.25%	1.50%
2018/19	1.75%	2.00%
2019/20	2.25%	2.25%
2020/21	2.50%	2.50%
2021/22	2.75%	3.00%
2022/23	2.75%	3.00%
2023/24	3.00%	3.00%
Later years	3.00%	3.00%

As there are significant potential risks from the Eurozone and from financial flows from emerging markets in particular, caution must be exercised in respect of all interest rate forecasts at the current time. The general expectation for an eventual trend of gently rising gilt yields and PWLB rates is expected to remain unchanged, as market fundamentals will focus on the sheer volume of UK gilt issuance, (and also US Treasury issuance), and the price of those new debt issues. Negative, (or positive), developments in the EZ sovereign debt crisis and some emerging market countries could significantly impact safe-haven flows of investor money into UK, US and German bonds and produce shorter term movements away from our central forecasts.

Our interest rate forecast for Bank Rate is in steps of 25 bps whereas PWLB forecasts have been rounded to the nearest 10 bps and are central forecasts within bands of + / - 25 bps.

Naturally, we continue to monitor events and will update our forecasts as and when appropriate.

Interest Rate Strategy Group

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