

SECTOR

Treasury Management Update

Quarter Ended 30th June 2012

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ECONOMIC BACKGROUND

- The economic outlook has generally weakened;
- Demand on the high street was volatile, as a result of temporary distortions;
- Employment rose and unemployment fell, but earnings growth remained weak;
- Inflation continued to fall;
- The Bank and the HM Treasury announced measures to help the UK banking sector;
- The MPC indicated another tranche of quantitative easing (QE);
- Gilt yields fell on the back of deteriorating economic data and safe-haven flows from the euro-zone;
- Sentiment towards the Eurozone alternately rose on the announcement of measures to address the crisis, but then fell back as measures disappointed.

The weakening business surveys since the start of Q1 suggests that the economy will be lucky to escape a third successive quarterly contraction (output shrunk by 0.4% in Q3 FY 11/12 and 0.3% in Q4 FY 11/12). Admittedly, the weighted output balance of the CIPS/Markit surveys in April and May was at a level consistent with quarterly expansion, albeit of only 0.2%. However it is not clear that the CIPS surveys have improved on the detrimental impact on output of the extra bank holiday for the Queen's Jubilee at the start of June.

The CIPS surveys does exclude the retail sector and high street spending, which performed strongly in May on the official measure, following a weak, poor-weather driven performance in April. Evidence for early June from the CBI's Distributive Trades Survey suggests that the Jubilee holiday may have boosted spending. Nevertheless, consumer confidence showed no signs of breaking out of its long-depressed state.

The labour market continued to perform relatively better. The Labour Force Survey measure of employment rose by 166,000 in the three months to April, whilst unemployment fell by 51,000 in the period February-April. The scale of the decline was more modest than the rise in employment, with the number of people looking for work outpacing jobs growth. The narrower claimant count measure of unemployment did rise by 8,000 in May, the largest increase since September 2011.

Pay growth remained weak. Annual growth of overall average earnings rose from 0.8% to 1.9% in April as the poor bonus season ended. Excluding bonuses, growth was only 1.8%. Given the rate of inflation over this period, real pay continued to fall on an annual basis, an underlying drag on the consumer and therefore growth.

House prices trended downwards. The Nationwide measure fell in two of the three months from April to June, with the annual rate of house price inflation declining from -0.7% in May to -1.5% in June. The less timely Halifax measure also saw an overall decline in prices over April and May.

Banks' funding costs eased over the quarter, reflecting actions by the Bank of England and Treasury to boost liquidity. Two initiatives were announced in June - a 'funding for lending' scheme which would allow banks to temporarily "swap" their assets with the Bank of England

in return for money they could lend to customers, and an emergency scheme that offered six-month low-cost liquidity to banks in tranches of £5bn a month.

Costs, however, remained elevated and banks began to pass higher costs onto borrowers. Borrowing rates on most types of new mortgages picked up in April and May.

Trade data showed a sharp deterioration in April. The UK posted its second largest monthly trade deficit on record, driven in large part by a widening of the gap between exports and imports with countries outside the EU. Exports to the Eurozone also fell, with weakness extending from the peripheral countries to what had previously been perceived as strong economies like Germany.

The latest public finance figures also disappointed. While April's budget surplus was the largest on record, this was flattered to the tune of £28bn by the transfer of a share of the assets of the Royal Mail's pension fund to the public sector. Once allowance was made for this, net borrowing for the first two months of the financial year was almost £4bn higher than the equivalent period in 2011/12.

Inflation fell further in the second quarter. CPI inflation fell from 3.5% in March to 2.8% in May, driven by declines in fuel and food prices. Core inflation fell from 2.5% to 2.2%.

The most striking development in inflationary pressures was in the price of oil, which fell from \$125 at the beginning of April to around \$96 at the end of June, its lowest level since early 2011.

Consistent with the decline in inflation, medium-term indicators of inflation suggested that underlying price pressures remained weak. Household respondents to June's YouGov/Citigroup inflation expectations survey predicted the annual rate of inflation in a year's time would be 2.4%, the lowest year-ahead expectation since April 2010.

The MPC voted narrowly against pursuing more quantitative easing (QE) at its June meeting. The consensus view was that the MPC would decide on further purchases in July. The Governor of the Bank of England said in June that, as a consequence of the Eurozone crisis, he was already more pessimistic than suggested by the forecasts published in the Bank's Inflation Report only six weeks earlier.

As a result of, safe-haven flows from the Eurozone and the impact of QE, government bond yields fell during the quarter, with ten year yields at one point dropping below 1.5%, their lowest level ever.

After signs of acceleration in Q4 FY 11/12, the US economy's recovery lost momentum. Total non-farm payroll employment was up only 69,000 in May, following a similarly weak rise in April of 77,000. US retail sales values fell in April and May.

Market sentiment towards the Eurozone remained volatile as successive 'rescue packages' first raised, and then disappointed, expectations. The economic news suggested that the Eurozone economy contracted sharply in the second quarter, while Eurozone unemployment rose to 11.1% in May, the highest rate since the creation of the euro in 1999.

SUMMARY OUTLOOK

The outlook for the global economy remains clouded with uncertainty. The UK economy has struggled to generate a sustained recovery so this offers little hope for a strong recovery in 2012, and possibly even into 2013. Consumer and business confidence levels are generally low and it is not easy to see potential for a significant increase in the growth rate in the short term.

Eurozone

- Regular Eurozone summits have yet to put in place the building blocks for a long-term recovery;
- The outcome of the French and Greek elections have emphasised the desire of the southern nations states and France to see more of a growth agenda than has been prevalent of late and also a potential move towards fiscal union;
- Cash outflows from banks have generally been from the southern nation states to Germany, Holland, Denmark and Finland.
- The Germans remain reticent about fiscal union of any sort;
- In the first week of July, the ECB cut the base lending rate to 0.75% from 1% whilst the deposit rate was reduced to zero.

US

- Economic prospects have disappointed in recent weeks with the key non-farm payroll monthly figures tending to dip below 100,000 new jobs. For a proper, robust recovery, something in the order of 200,000 new jobs needs to be created each month.
- Operation Twist remains in place, ensuring that long term funding costs are forced down as well as the loose monetary policy at the short end of the curve;
- However, in a typically fraught election year, the US still has to address reducing the huge total of public debt and annual deficits but that will have to wait until 2013 at the earliest;
- Presidential elections are due in November 2012.

China

- Falling inflation has opened the way for relaxing credit restrictions to boost growth, which has been flagging;
- Current expectations are that it will maintain a reasonable rate of growth, though less than in previous years.

UK

- Austerity measures, aimed at getting the public sector deficit into order over the next four years, may start losing support unless the economy starts to revive soon;
- Some £80bn is going to be made available by the Government to the banks to parcel through to business but it is not clear that all of this will be taken up;
- The housing market, a gauge of consumer confidence, remains subdued although house prices are being supported by the weak £ relative to some of the other main currencies;
- Economic forecasts for 2012 and beyond have been revised lower on a near quarterly basis;
- The Bank of England embarked on a £50bn third round of Quantitative Easing (QE) at the start of July to stimulate economic activity. It is unlikely to be the last tranche of QE and the total now stands at £375bn;
- Inflation has eased from its peak of 5.2% (CPI) in September 2011, now standing at 2.8% with the outlook brighter given commodity and oil prices seem to be in decline, at least for the moment
- "Safe haven" status has underpinned demand for gilts and kept yields at historic lows. Unlikely to see material change in near term.

SECTOR'S FORWARD VIEW

Economic forecasting remains difficult with so many external influences weighing on the UK. Key areas of uncertainty include:

- The impact of the Eurozone crisis on financial markets and the banking sector;
- The impact of the UK Government's austerity plan on confidence and growth;
- Monetary policy action failing to stimulate growth in western economies;
- The potential for weak growth or recession in the UK's main trading partners - the EU and US;

The overall balance of risks remains weighted to the downside. 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. However, near-term, QE is likely to depress yields and further QE thereafter may lead to a reassessment of Sector's central forecast

Given the weak outlook for economic growth, Sector sees the prospects for any interest rate changes before early 2014 as very limited indeed. There is potential for the start of Bank Rate increases to be even further delayed if growth disappoints.

