

UK Economic Forecast Report

November 2009

BridgECourt & Company
29 Farm Street
London W1J 5RL

Telephone:
+44 (0)20 7347 7700

Fax:
+44 (0)20 7347 7701

Web:
www.bridgECourtandco.com

Author:
Robert Robinson
robert.robinson@bridgECourtandco.com

How much of the recovery is underpinned by sovereign risk?

Introduction

Looking forward over the next few years, most independent economists¹ are forecasting a move away from the sharply negative GDP figures recorded this year to very low levels of growth in 2010, and then annual increases of around 2% to 3% from 2011 to 2013. The UK economy is also expected to move away from the deflationary period experienced this year to low levels of inflation over the next few years. Similarly official bank rates are forecast to remain low, gradually rising to around 4% by 2013.

It is likely that the figures recorded for the UK economy would have been far worse if the UK Government had not implemented its policy of quantitative easing (QE) whereby the Bank of England has created money to buy mainly government bonds from UK banks.

The liquidity provided by the Bank of England has helped stabilise the UK banking sector, and over the past year inter bank lending rates have fallen and bank deposits and reserves increased. Despite the sharp reduction in household spending and fall in business investment, the extra money in circulation has helped support levels of demand and a far worse deflationary spiral has been avoided.

¹ Independent economists include a selection of academic, not for profit, and private sector forecasting organisations that are independent from the views and forecasts of HM Treasury. Their inclusion on a list of independent forecasters is subject to review and no significance should be attached to the inclusion or exclusion of any particular forecasting organisation.

So far some £175 billion has been pumped into the UK economy and an additional £25 billion has recently been announced, taking the total amount allocated under the QE policy to £200 billion. The fact that the market was expecting an even greater increase in the QE programme was reflected in the price of government bonds. This indicates the importance of the role of the Bank of England in the pricing of UK government bonds, and the absence of a “true” market price not manipulated by the levels of QE. The yield on UK government bonds is being kept artificially low by the QE programme, but there are some indications that in the wider market the risks associated with the UK economy are starting to be reflected in pricing. For example, the cost of credit default swaps (CDS), which insure against default by the UK government on its debt, has recently become more expensive.

At some stage the demand for borrowing will return and the money supplied from QE currently propping up bank balance sheets and reserve levels, may expect to be lent out to increase the profitability of the banks. Depending on the level of excess capacity in the economy, this could have inflationary implications. The timing of the ending of the QE programme will therefore be a key factor in minimising inflationary risk. As noted above, the market may be very sensitive to a sudden change in policy, which may have adverse effects on the price and liquidity of government bonds.

For the moment, most independent economists see high levels of inflation as a relatively remote risk because of the low levels of demand in the corporate and household sectors and because the level of the corresponding excess capacity in the economy remains relatively high. Furthermore monetary policy has so far helped the recapitalisation of the banks, rather than causing a surge of money supply into the wider economy.

How much risk is being transferred to sovereign debt?

In a largely illiquid market, government bonds are one of the few liquid asset classes. Banks have been encouraged to buy government bonds as part of their build up of deposits and reserves because they earn better returns than holding cash. Government bonds are deemed to be “risk free” because the Government can raise tax and print money and is therefore not expected to default on its obligation. However, if a Government becomes too indebted there may be a weakening of market confidence in the Government’s ability or willingness to meet its obligations, and this will be reflected lower prices for bonds. In the short term the likelihood of a sovereign default is extremely unlikely, but over the longer term if the fiscal deficit continues to grow, the probability of occurrence may not be so remote.

Government bonds can also be exposed to inflation risk, and if inflation outpaces the returns on the investment, then the value of the investment is eroded. If the market considers the risk of inflation to have increased, then again prices of government bonds are likely to fall, and yields are likely to rise.

The consequence of increasing probability of default and inflation risk is more expensive debt for Government. The Government already expects borrowing in the current fiscal year to reach £175 billion, and it is possible this figure will be revised upwards in the pre-budget report in December 2009. With the UK economy still in recession, this size of the deficit is continuing to grow, and in order to meet its public spending commitments the Government has increased its borrowing levels

and is likely to continue to do so into 2010. The trajectory of the size of the deficit and the borrowing levels over the next year or so is uncertain, but the build up of Government debt at its current rate is unsustainable if market confidence in Government bonds is to be maintained.

Total net debt owed by the UK in September 2009 was around £683 billion. If cost of bank bail-outs is included, the figure is around £825 billion (close to 60% of GDP). Furthermore these figures do not include other liabilities underpinned by the UK Government, such as public sector pensions and off balance funding arrangements for PFIs and other government related entity borrowing. Taking these together, as well as further borrowing in fiscal year 2010/11, then it is quite possible that total net debt owed by the UK will exceed 100% of GDP in the not too distant future.

The confidence that has returned to the UK banking sector in recent months may be undermined if government bonds held in deposits and reserves start losing value. The banks already face the risk of refinancing large amounts of debt associated with investments made at the top of the asset bubble. It is not clear whether banks will need further bail-outs from the UK Government, and how this will impact the cost of borrowing for the UK Government.

Arguably the risks taken by the banking sector in recent years have largely been transferred to the UK government through bank "bail-outs" and part nationalisations. Policies such as QE and the belief in the "risk-free" nature of government debt, has meant that the pricing impact of this risk has not yet been fully realised by the markets. Further problems in the banking sector and a slower than expected recovery in the economy, may point to these risks eventually working their way to the surface. The consequence of this, higher cost of Government debt, will only prolong the period to full recovery.

Forecasts for key economic measures

Very modest levels of growth forecast by independent economists for 2010 and 2011 suggest there may well remain spare capacity in the economy and high levels of unemployment may persist throughout a recovery. The general consensus among independent economists appears to suggest a slow recovery, with growth only returning to its pre-recession levels after several years.

Different scenarios outside the consensus range are worth considering for business-planning purposes, including an extended deflationary period as well as a relatively quick recovery characterised by rapid growth in inflation. While the economy may appear to be moving out of recession, a combination of growing unemployment, increasing interest rates, tax rises and spending cuts may make the recovery far from straightforward. On the other hand, further stimulation by government may risk higher inflation if a full recovery is already underway.

The graphs shown below are taken from "Forecasts for the UK Economy - A Comparison of Independent Forecasters", published by HM Treasury in August 2009 and November 2009. The forecasts include medium term forecasts to 2013. The independent economists selected for the November forecasts are not necessarily all the same as those selected for the August forecast. The purpose of the comparison is to show broad trends across a range of forecasts and forecasters.

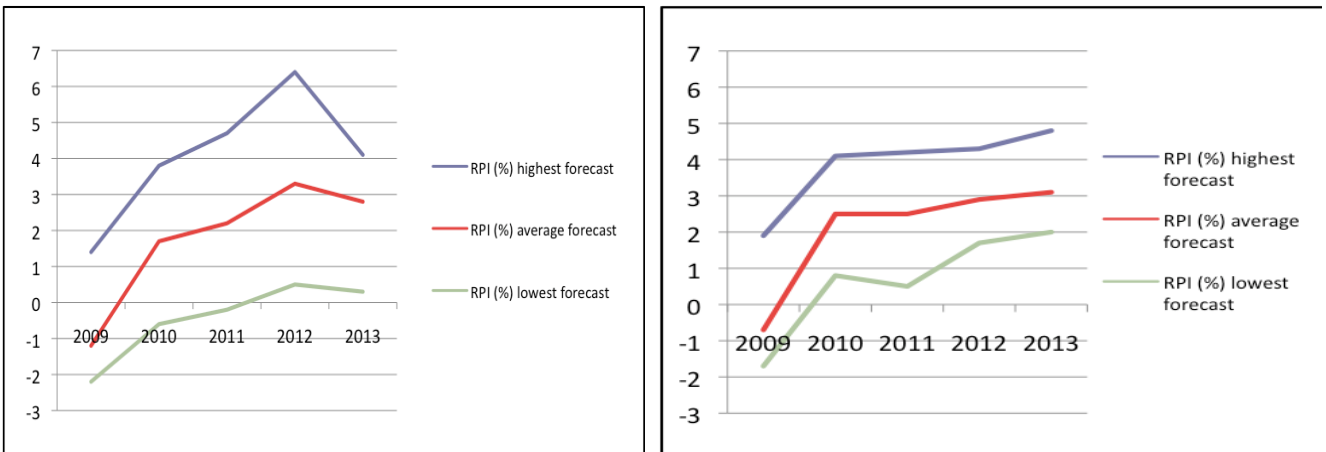
The graphs show the average forecast for key economic indicators across a group of independent forecasters, as well as the range between the most optimistic and most pessimistic individual

forecast. The graphs also track the broad changes to forecasts to key economic indicators between August 2009 and November 2009.

Over the three-month period between August 2009 and November 2009, forecasts for the main economic indicators have remained relatively stable. 2009 has been characterised by successive quarters of negative economic growth. Forecasters expect improvements in economic performance in 2010 and beyond, although the speed of recovery has been reduced from previous forecasts given the unexpected severity of the recession this year. Most forecasters expect the UK to be out of recession by 2010, and the trends do not appear to show the UK falling back into recession once the recovery has started.

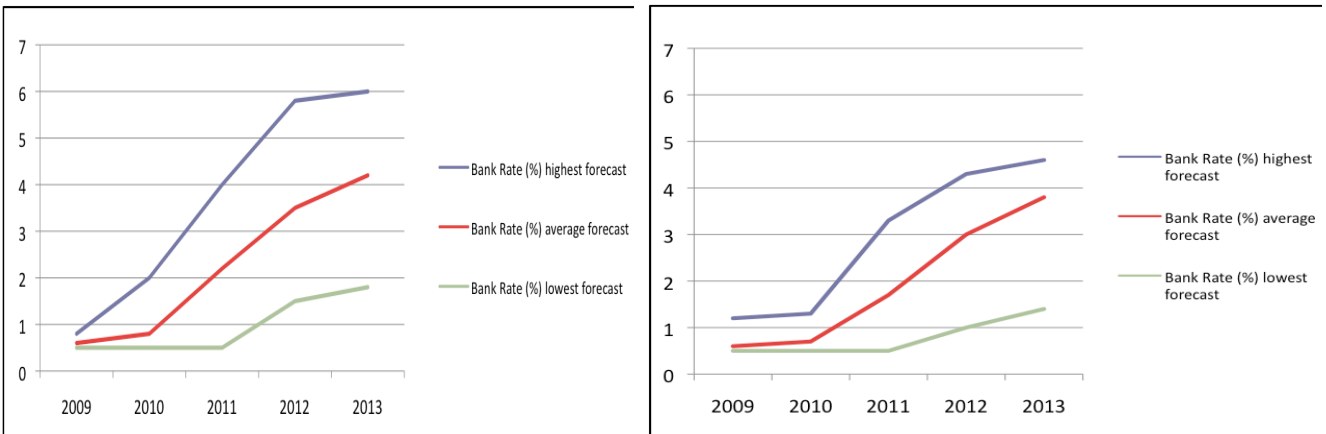
There has been a slight change relating to the average independent forecasts for RPI, with RPI expected to increase to about 3% by the end of the forecasting period at a more gradual rate than before. This reflects the continued levels of excess capacity that is expected to persist as the economy recovers at a slower pace. According to most independent economists, high inflation remains a relatively remote risk at this stage. Nevertheless, in the same way that forecasts for 2009 have been adjusted downwards, forecasters are likely to revise their forecasts in response to unexpected economic data. The reliability of the forecasts over a five-year period cannot be certain, and businesses planners would be wise to consider other scenarios outside the forecast range.

Independent Economists' Forecast Annual average % RPI - August 2009 & November 2009



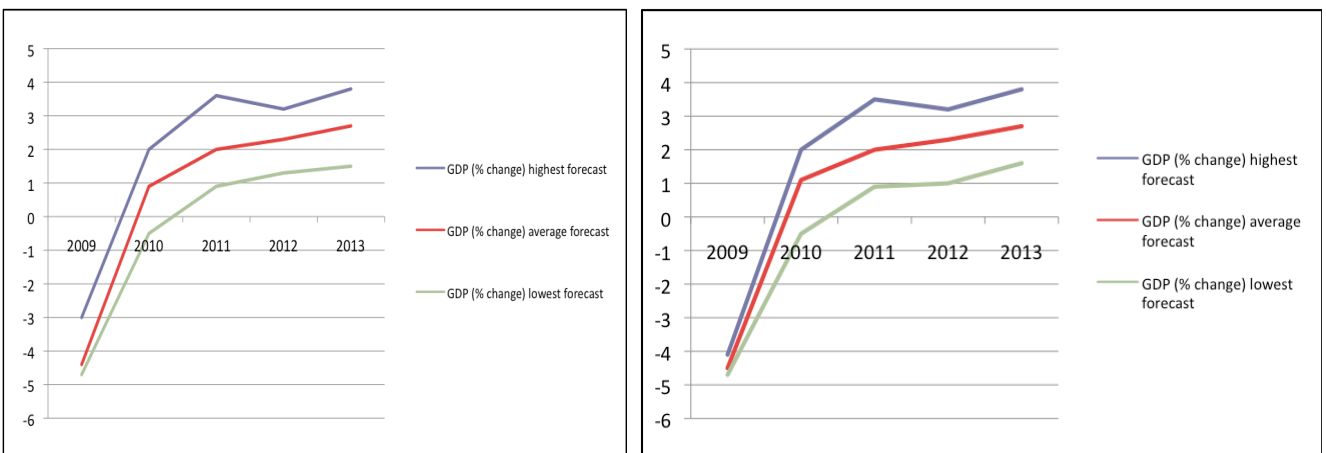
Source: HM Treasury

Independent Economists' Forecast Change in Bank Rate - August 2009 & November 2009



Source: HM Treasury

Independent Economists' Forecast Change in GDP - August 2009 & November 2009



Source: HM Treasury

Risks Relating to Government Supported Entity Debt

As well as the risks associated with holding sovereign debt, there is also a significant amount of debt associated with government-supported entities (GREs) that is either directly or indirectly supported by their respective sovereign governments. The risks associated with this debt may be somewhat more opaque than risks associated with straightforward sovereign debt. This is because the cost of GRE debt relies on an interpretation of the importance and closeness of a particular entity to its sovereign government, and an interpretation of the strength of the type of support provided by that government.

This subjectivity can be exacerbated by different perceptions of support in different countries, and local judgments regarding the relative importance of certain industries to a particular government. Furthermore, the decision regarding the importance of an entity and the willingness and ability of a government to support it is affected by political and economic considerations at particular points in the economic and political cycles.

If there is a tendency to perceive that most GREs (regardless of the sector) are important to a government, then attempts to demonstrate differences between the relative risks of different GREs may be difficult. The consequence of this is that the value of the GRE investment may remain high until the government is deemed to be acting in a non-supportive way in a particular sector, which contradicts the investment assumptions. At which point investments in that GRE sector (and potentially in other government-supported sectors) may be subject to a rapid decline in value.

The “stand-alone” value of a GRE is an important consideration in an assessment of how far the overall value could fall if a sovereign government failed to provide its assumed level of support, and transparency around how the “stand-alone” value is calculated is key.

Investment decisions in GRE assets that give greater emphasis to sovereign government creditworthiness and to the likelihood of that government providing support, may be at risk of greater volatility in the event of changing economic and political circumstances.

Sovereign governments are exposed to economic cycles as much as any other entity. In challenging periods it is possible that priorities will change, and governments may be less willing and able to provide support to GREs in a way that was previously expected.

Disclaimer

This report has been issued by Bridgecourt & Company Limited and has been provided to you solely for your information and should not be considered as an offer, or solicitation of an offer, to sell, buy or subscribe to any securities or any financial instruments.

This report is intended for use by professional and business investors and issuers only. Any information and opinion contained in this report has been based on sources believed to be reliable, but, neither Bridgecourt & Company, nor any of its directors, employees, or affiliates accepts liability from any loss arising from the use this information and opinion.

Any opinions, forecasts or estimates in this report are judgments made at a point in time, and there can be no assurance that future results or events will be consistent with any such opinions, forecasts or estimates. Past performance should not be taken as an indication or guarantee of future performance, and no representation or warranty, express or implied, is made regarding future performance.

Information in this report is subject to change without notice, its accuracy is not guaranteed, it may be incomplete, and it may not contain all material information concerning a particular organisation, security or financial instrument. Bridgecourt & Company is not agreeing to, nor is it required to, update the information, opinions, forecasts or estimates contained in this report.

The value of any securities or financial instruments mentioned in this report can fall as well as rise. Investors should seek financial advice regarding the appropriateness of investing in any securities, financial instrument or investment strategies mentioned in this report.

This report may not be reproduced in whole or in part, copies circulated, or disclosed to another party, without the prior written consent of Bridgecourt & Company.