

CYNGOR SIR YNYS MÔN

ADRODDIAD I	PWYLLGOR ARCHWILIO
DYDDIAD	22 GORFFENNAF 2014
PWNC	RHEOLI'R TRYSORLYS – CHWARTER CYNTAF 2014/15
SWYDDOG(ION) ARWEINIOL	RICHARD MICKLEWRIGHT
SWYDDOG CYSWLLT	BEN DAVIES (FFÔN: 2610)

Natur a rheswm dros adrodd

I gydymffurfio â rheoliadau a ryddhawyd o dan Ddeddf Llywodraeth Leol 2003 a gyda Chynllun Dirprwy Rheoli'r Trysorlys y Cyngor am 14/15 (Atodiad 8 y Datganiad Strategaeth Rheoli Trysorlys 2014/15). Mae'r Pwyllgor hwn yn gyfrifol am sgrwintneiddio materion rheoli'r trysorlys.

- Cyflwynir yr adroddiad hwn i sicrhau bod y Cyngor yn cydymffurfio â Chôd Ymarfer ar Reoli Trysorlys a gyhoeddwyd gan y Sefydliad Siartredig Cyllid Cyhoeddus a Chyfrifeg (CIPFA) yn ac sy'n argymhell diweddarau Aelodau ar weithgaredd rheoli trysorlys o leiaf ddwy waith y flwyddyn, a gorau oll yn chwarterol.
- Rhoes ymgynghorwyr trysorlys y Cyngor (Capita) grynodedb o'r cefndir economaidd a'r rhagolygon economaidd (Atodiadau 1 & 2) ac, yn ddiweddar, maent wedi darparu'r rhagolygon canlynol:-

	Med-14	Rhag-14	Maw-15	Meh-15	Med-15	Rhag-15	Maw-16	Meh-16	Med-16	Rhag-16	Maw-17	Meh-17
Graddfa Banc	0.50%	0.50%	0.75%	0.75%	1.00%	1.00%	1.25%	1.25%	1.50%	1.75%	2.00%	2.00%
Graddfa 5ml PWLB	2.70%	2.80%	2.90%	3.00%	3.00%	3.10%	3.20%	3.30%	3.30%	3.40%	3.50%	3.60%
Graddfa 10ml PWLB	3.70%	3.70%	3.80%	3.90%	4.00%	4.00%	4.10%	4.20%	4.20%	4.30%	4.40%	4.40%
Graddfa 25ml PWLB	4.40%	4.40%	4.50%	4.60%	4.70%	4.70%	4.80%	4.80%	4.90%	4.90%	4.90%	5.00%
Graddfa 50ml PWLB	4.40%	4.40%	4.50%	4.60%	4.70%	4.70%	4.80%	4.80%	4.90%	4.90%	4.90%	5.00%

2.1 Cynhaliodd Gwasanaethau Asedau Capita adolygiad o'i ragamcanion cyfradd llog ym Mai, yn dilyn adroddiad chwyddiant Banc Lloegr. Fodd bynnag, mae datblygiadau mwy diweddar i gyfarwyddyd blaen Banc Lloegr wedi golygu bod yn rhaid cael ail ddiweddariad yn y chwarter hwn ac fe wnaed hynny ar 30 Mehefin. Mae'r rhagamcan diweddaraf hwn yn awr yn cynnwys cynnydd cyntaf yn y gyfradd banc yn chwarter 1 2015 (yn flaenrol chwarter 4 2015).

- Ar ddechrau'r flwyddyn newydd, roedd portffolio benthycar Cyngor i gyd o PWLB ac roedd £20.6m yn is na'r Angenrhaid Cyllido Cyfalaf (CFR) (h.y. rhan o'r benthycar wedi ei fewnoli). Mae Datganiad Strategaeth Rheoli Trysorlys 2014/15 (Adran 3.4.1) yn dweud y bydd agwedd hyblyg yn cael ei mabwysiadu yng nghyswllt y dewis rhwng benthycar mewnol ac allanol. Dyma fu'r achos, a bydd yn parhau felly, gydag ystyriaeth yn cael ei rhoi i'r holl ffactorau a restrir yn yr Adran honno. Mae'r penderfyniad i barhau i fewnoli wedi ei yrru yn bennaf oherwydd dau ffactor: (1) I gyfyngu cysylltiad yr Awdurdod i risg credyd (2) I gyfyngu'r gost o gario. Mae'r rhain wedi eu gosod ar y sail y bydd PWLB a chyfraddau buddsoddi yn parhau ar lefelau hanesyddol isel gyda dim ond cynnydd graddol yn cael ei ragamcanu i'r tymor canolog. Mae'r ymgynghorwyr a benodwyd i'r trysorlys (Capita Asset Services) hefyd wedi cefnogi'r penderfyniad i barhau i fewnoli benthycar ar hyn o bryd. Byddwn yn adrodd ar unrhyw newidiadau i'r ymagwedd gyfredol fel fydd yn briodol.

4. Mae'r tabl isod yn dangos y sefyllfa ar gychwyn ac ar ddiwedd y chwarter.

	30 Mehefin 2014		31 Mawrth 2014	
	£m	%	£m	%
Benthycia - (holl gyfraddau sefydlog)	89.6	5.72	89.6	5.72
Adneuon – Dim rhybudd	19.1	0.40	4.2	0.58
Adneuon – Cyfnod Sefydlog (< 1 blwyddyn)	0.0	n/a	5.0	0.80
Cyfanswm yr Adneuon	19.1	0.40	9.2	0.70
Yr Adneuon ar gyfartaledd yn y Chwarter	20.3	0.50	18.2	0.56

4.1 Mae manylion am y sefydliadau sydd ag adneuon ar gael yn Atodiad 3.

4.2 Yn ystod y cyfnod ni chymerwyd i fyny unrhyw fenthycia allanol, ni aeddfedodd unrhyw fenthyciadau ac ni aildrefnwyd unrhyw ddyledion.

4.3 Ar yr ochr buddsoddiadau, aeddfedodd adneuon tymor sefydlog gyda Banc Brenhinol yr Alban (RBS) (£5m, 80% 3 mis o hyd) ym Mai a chafodd hwn wedyn ei fuddsoddi ar sail dim rhybudd yn unig; roedd hyn er mwyn cynnal hyblygrwydd ac i leihau risg ac o ystyried y parhad o ran cyfraddau llog lefel isel.

Mae yna ddau bwynt sy'n werth eu nodi:-

- Bu'r rhestr o wrthbartion gyda chredyd da yn parhau yn hynod gyfyngedig gydag ychydig iawn o wrthbartion yn bodloni'r meini prawf credyd; a
- Mae'r graddfeydd buddsoddi sydd ar gael yn y farchnad wedi parhau ar lefelau hanesyddol isel.

4.4 O ran buddsoddiadau parhaol, fe adroddwyd yn flaenorol am faterion mesur credyd gyda Santander UK plc, ac roedd hyd y buddsoddiadau oedd yn cael eu hawgrymu wedi bod yn is na'r lefel dderbyniol i fuddsoddiadau ond bod sefyllfa'r banc wedi sefydlogi a gwella dros y flwyddyn. Nid yw'r hyd buddsoddi yn Santander a awgrymwyd gan Capita wedi bod yn is na 100 diwrnod ar unrhyw adeg yn ystod y chwarter ac ar adeg paratoi'r adroddiad hwn mae'n sefyll ar 6 mis a chyngor ein hymgyngorwyr trysorlys yw bod y banc yn ddigon diogel i ni allu buddsoddi ynddo ymhell y tu hwnt i'n hymrwymiad dim rhybudd. Roedd cyfraddau credyd ar yr hyd buddsoddi oedd yn cael ei awgrymu i Santander yn ein galluogi i fuddsoddi ynddo am hyd at 6 mis gyda chyfyngiad buddsoddiad o £7.5m ac fe lynwyd at hyn yn ystod y chwarter.

4.5 A chymryd yn ganiataol yr heriau parhaol a wynebwr gyda buddsoddi cronfeydd mewn sefydliadau diogel gyda chredyd da, sy'n cynnig graddfa resymol o ddychweliad am y risg, rydym yn edrych ar opsiynau i amrywio'r portffolio buddsoddi (o ran mathau a lleoliadau daearyddol y buddsoddiadau). Byddir yn adrodd yn ôl ar unrhyw ddatblygiadau i'r Pwyllgorau perthnasol fel y byddant yn briodol.

5. Yn ystod y chwarter fe barhaodd y Cyngor o fewn ei Gyfyngiadau Pwylllog a Thrysorlys. Bydd yr Adroddiad Adolygiad Canol-blwyddyn yn rhoi diweddariad a dadansoddiad o berfformiad yn erbyn y trysorlys a dangosyddion pwylllog gydag unrhyw newidiadau i'r ffigurau fel fydd yn briodol.

6. Ni fu unrhyw weithgaredd ers diwedd y chwarter sydd angen ei nodi.

7. Y cynlluniau ar gyfer gweddill y flwyddyn yw:

- Parhau i fuddsoddi balansau sy'n weddill mewn modd sy'n sicrhau diogelwch ynghyd â hylifedd a chynnyrch;
- Parhau i fewnoli benthyca tra'n monitro'r farchnad yn rheolaidd;
- Monitro'r farchnad fel y gellir aildrefnu ar adeg briodol os daw cyfleon ar gael;
- Ymateb i gynlluniau posib ar gyfer defnyddio benthyca digefnogaeth neu gymorth benthyca unwaith ac am byth.

8. **ARGYMHELLIAD**

Ystyried cynnwys yr adroddiad.

Cefndir Economaidd / Economic Background

- During the quarter ended 30 June 2014:
 - Indicators suggested that the economic recovery accelerated;
 - Household spending rose again;
 - Inflation fell to its lowest level since September 2009;
 - The ILO measure of unemployment fell further to 6.6%;
 - The MPC suggested that the economy might warrant higher interest rates before the end of the year;
 - Low tax receipts put the fiscal tightening slightly off track; and
 - The European Central Bank (ECB) made announcements designed to boost bank lending and counter the risk of deflation.

- After a healthy quarterly expansion in UK GDP of 0.8% in Q1, some of the early indicators point to growth accelerating in the second quarter. On the basis of past form, the CIPS/Markit business activity surveys point to quarterly GDP growth of around 1.5% in Q2. Admittedly, the composite PMI has tended to overstate the pace of the recovery over the past year. However, survey data was also encouraging on the strength of the recovery in Q2. All of the headline figures in April's industrial production release were encouraging. Indeed, even if production only manages to hold steady in the remaining two months of the quarter, it would still be 0.7% higher in Q2 overall than in Q1. That said, the £2.5bn trade deficit in April, compared to £1.7bn last year, highlights that the recovery is still struggling to rebalance towards exports.

- Meanwhile, household spending looks to have supported further GDP growth in Q2. While retail sales volumes fell by 0.5% on the previous month in May, following strong growth in April, the underlying trend remains strong as a combination of rapid jobs growth and falling prices continues to fuel a recovery in consumer spending. In addition, the more forward-looking survey balances of expected sales also point to solid growth in consumer spending in the near-term. Furthermore, non-high street spending remained robust too. Annual growth in new car registrations averaged around 5% in April and May and the Bank of England's Agents' Survey recorded the measure of consumer services turnover at its joint highest level in May since 1998. So it still seems likely that overall household spending strengthened in the second quarter.

- The labour market has continued its strong recovery. Employment rose by a huge 345,000 in the three months to April, by far the biggest increase since records began in 1971. Despite an increase in the workforce, employment growth was enough to bring the headline (three-month average) unemployment rate down to 6.6% in April. In addition, the timelier claimant count measure of unemployment fell by 27,400 in May, potentially pointing to further falls in the broader ILO measure of unemployment. Nonetheless, pay growth has remained subdued, with headline annual growth (three month average) in average earnings (including bonuses) falling to 0.7% in April, well below inflation of 1.8%. Since real earnings have yet to rise, some consumers may be overstretching their finances in order to spend more.

- Meanwhile, after sending dovish messages through the May Inflation Report, the MPC's communications have now gone full circle, from trying to prevent interest rate expectations from rising too quickly via the introduction of forward guidance last summer, to trying to *raise* them now. A number of Committee members, including Governor Mark Carney, have warned of not-too-distant policy tightening.

- Indeed, the main factor that could dissuade the MPC from starting on an earlier path for increasing Bank Rate is inflation. CPI inflation fell to 1.5% in May, the lowest rate since late 2009. Recent developments, including sterling's further appreciation, falls in producer price inflation and very weak wages growth, suggest that CPI inflation could fall to as low as 1% later this year.

- Meanwhile, May's public borrowing figures contained tentative signs that the coalition is struggling to bring down the deficit in line with fiscal plans this year. The underlying measure of borrowing (PSNB ex. excluding APF and Royal Mail pension fund transfers) was £13.3bn in May, exceeding the consensus forecast of £12.2bn. The increase was largely driven by a drop in tax receipts, rather than strong increases in spending. Spending in April and May is around 9% higher than it was in the same period last year. However, it is still too early in the fiscal year to draw conclusions from these figures.
- One risk which continues to linger is an overheating housing market. Fears that a nationwide bubble is building will not have been assuaged by the Financial Policy Committee's (FPC) relatively timid action announced alongside June's Financial Stability Report. Indeed, the 15% limit on the proportion of the volume of new mortgages that can be advanced at a multiple of 4.5 times income or more is unlikely to prevent a further rise in high loan-to-income ratio lending, given that the limit is a fair way above the actual current proportion of 10%. Furthermore, the tweaks to the existing stress tests used to assess mortgage applicants seem unlikely to make a material difference either. Admittedly, the housing market has already shown some signs of slowing of its own accord. Indeed, approvals for new mortgages fell to an eleven-month low in May, and the new buyer enquiries balance of the RICS Housing Market Survey has continued to moderate. However, with supply remaining tight, further strong increases in house prices in the near-term look likely. Although the FPC could announce further measures at a later date, the timidity of its actions so far may have slightly increased the chances that the MPC could raise Bank Rate in the not too distant future.
- Internationally, the robust 217,000 increase in US non-farm payrolls in May is another encouraging sign that the economy is getting back on the right track after the weather-related weakness during the winter. The 0.6% m/m rise in US industrial production in May also suggests that activity is bouncing back. Meanwhile, the US Federal Reserve continued tapering its asset purchases by a further \$10bn in June's policy meeting and highlighted that the benign outlook for inflation means monetary policy will remain loose for some time. The Fed lowered its forecasts for GDP growth and unemployment, but the FOMC's policy statement made no reference to the recent build up of price pressures.
- Activity indicators for the Eurozone suggest that the recovery only gained a little momentum in Q2. Moreover, the spectre of deflation continues to hang over the region. HICP inflation fell from 0.7% to 0.5% in May, the joint weakest rate since 2009 and far beneath the ECB's 2% price stability ceiling. Furthermore, unit labour costs have risen by just 0.1% in the past year. As developments in wages tend to affect wider measures of inflation after a short lag, the latest data suggests that consumer price inflation could fall even further. Accordingly, the ECB made a number of announcements in June designed to boost bank lending and counter deflationary risks, including rate cuts and potential asset purchases. However, the policies involved are not as bold as they might seem. The interest rate cuts were very small and the decision not to sterilise bond purchases made under the Securities Markets Programme amounts to just 1.7% of GDP.
- In the UK, equities continued to underperform, despite improving expectations for the strength and sustainability of the UK's recovery. Indeed, they have continued to underperform US equities, even though the consensus expects the UK to grow faster than the US in 2014. Meanwhile, gilt yields edged up – particularly at the short-end of the curve – following the MPC's communications in June, which were more hawkish than May's Inflation Report. In contrast, forward rates at the long end of the curve fell further, although it is not clear whether this is a result of pessimism about the UK's growth prospects in the long run, or a decline in the term premium which reflects uncertainty about the future path of interest rates.

Rhagolygon Economaidd / Economic Outlook

1. THE UK

1a. May Bank of England Quarterly Inflation Report

Over the last four quarters, we have had a continuing run of strong economic news which has consolidated confidence that the UK economy is recovering strongly. However, please note that the Governor said the economy “has only just begun to head back towards normal” after the slowest ever recovery from a recession. Widespread disbelief that unemployment would take nearly three years to fall to 7%, as the Bank forecast at the time of the August Inflation Report, has indeed proved to be well founded as the rate fell to 6.8% in Q1 2014 and then to 6.6% in quarter 2. Accordingly, this latest Inflation Report has seen the Bank provide a view of the economy as moving from a recovery supported by household spending to a more broadly based expansion sustained by:-

- Growth in business investment;
- A change from falling to rising real wages (average wage increases started to exceed the rate of CPI inflation over the last quarter but more recently, this situation has reversed back again);
- Increasing employment;
- Productivity growth to support those real wage increases and improve export competitiveness – expected to reach 2.5% by the end of 2014.

Key economic statistics in the Inflation Report were as follows: -

1. GDP has grown at an annual rate of 3.1% over the last four quarters;
2. Bank of England GDP forecasts: 2014 unchanged at 3.4%, 2015 upped from 2.7% to 2.9%, and for 2016 unchanged at 2.8%;
3. Inflation to be well behaved over the next two years: rising to 2.0% in two years' time from 1.7% in Q2 2015;
4. Growth of productivity has only started to marginally improve, although it is expected to gradually rise back to its average historical rate.

We have reservations that the Bank's current forecasts for GDP growth may be over optimistic and that strong economic growth could weaken as the main impetus has come from consumer spending and an uplift in borrowing to buy property. Whilst the release of this burst of pent up demand to buy property is having a very welcome effect on the economy, this surge is likely to fade in time and will then leave a question mark over where growth is going to come from. Basically, there are four main areas of demand in the UK economy: -

1. Consumers – but most consumers are maxed out on borrowing and trying to pay down debt. In addition, although average wage inflation is now higher than CPI inflation, many consumers are still experiencing declining disposable income as their wage increases are continuing to be less than inflation. This will not reverse until productivity and business investment improve, so as to warrant paying higher wages than are being paid currently. It is mainly higher wages that could provide a solid stimulus to an increase in consumer expenditure which would then underpin strong growth. There are also concerns that a significant number of mortgage holders are going to find it very difficult to manage increases in Bank Rate, and so in mortgage rates, when they do start.
2. Government – again, maxed out on borrowing and committed to austerity programmes to reduce its expenditure. Further austerity measures are still to come.

3. Foreigners buying our exports – but the EU, our major export market, is likely to experience tepid growth, at best, for the next few years. Also the rise in the value of Sterling means that imports are becoming cheaper which will cause UK consumers to increase purchases of cheaper imported goods in preference to UK produced competing products, so depressing UK GDP growth.
4. Business investment in fixed capital formation; but this has fallen from 13.5% to 10.4% of GDP over 2008 - 2013. However, there are encouraging signs that businesses are catching the upturn in optimism and are beginning to increase investment and exports into new markets in emerging countries. However, it will take a significant length of time for this start to make a material impact on total UK GDP growth rates and to take over the baton from consumers.

1b. The evolution of forward guidance

If you have been following the comments flying around through late June and early July, you may have ended up with the impression that Carney and other MPC members have been giving rather confused signals as to what the MPC's thoughts are when making "forward guidance" comments on what is going to happen to Bank Rate and when. Here is a quick recap of how forward guidance has evolved: -

1. **August 2013.** The MPC would not consider raising Bank Rate until the unemployment rate falls to 7%; this was deemed unlikely to occur until late 2016.
2. **February 2014 Quarterly Inflation Report.** Forward guidance mark 1 was abolished as the unemployment rate fell rapidly (the 7% threshold was breached in April 2014). Mark 2 'fuzzy guidance' was to be based on a range of about eighteen indicators but was still to be driven, ultimately, by the fundamental concept of how quickly the amount of slack in the economy after the recession, was used up. However, there were a wide range of views in the MPC as to how much slack there was and also around how quickly it would be used up, as there is no definitive and objective way of measuring this concept of slack. However, the Bank, and Carney, both commented that market views of likely increases in Bank Rate were in the right ball park (i.e. late 2014 / early 2015).
3. **14 May: 2014 Quarterly Inflation Report.** By this time, we had hard data that the UK economic recovery was going full steam ahead in 2014, i.e. this pointed to it being more likely that Bank Rate would have to go up sooner than had been expected previously. Instead of which, Carney went out on a limb and made comments to the effect that the possibility of any Bank Rate increase in 2014 and, arguably, even as soon as Q1 2015 was minimal. No other MPC member contradicted these comments, so the logical inference was that his comments must also have been a reflection of the view of the MPC.
4. **12 June: Carney Mansion House speech.** Carney expressed surprise that financial markets had not factored in a higher probability that Bank Rate could go up in 2014. To say that the financial markets were flabbergasted by this dramatic change of tack since a month ago was a bit of an understatement!
5. **18 June: MPC minutes.** The MPC said, (for a second time), that the decision on rates was becoming more balanced. It also said that the low probability (15%) attached in the markets to a rise in 2014 was "somewhat surprising". So Carney's comments at the Mansion House were not a Suarez moment of madness but rather comments that the whole MPC agreed with. So the financial markets now had to go back to where they started from; that they WERE right that a Bank Rate increase was likely in 2014, probably towards the end of the year (November 2014 would be the quarterly Inflation Report month when the MPC would be most likely to take action in

Q4). However, to be fair to Carney and the MPC, saying that 15% was too low leaves wide open just how too low this was, i.e. should it have been a 30% risk; or 70%? Do those comments really mean the financial markets are now right to pencil in a first increase in Q4 2014?

6. **24 June: Select Committee Carney comments.** An MP accused Carney of being an 'unreliable boyfriend' i.e. blowing hot one day and cold the next day. Overall, MPs felt that Carney's attempts at communicating forward guidance had been muddled and left the financial markets, and others, confused in as much as the various attempts at forward guidance had pointed in different directions. Carney attempted to dig himself out of this onslaught by emphasising that the timing for the FIRST increase in Bank Rate would be data driven i.e. no one could say for certain when that would occur. However, what he placed the most emphasis on was the medium term, i.e. the timing of the first increase was of a lesser degree of importance. So, in the medium term, increases would be "**limited and gradual**". Also, rates would not get back to around 5% as before the financial crisis. He also criticised the financial markets for not responding to the strength of recent economic data and commented that the MPC would change its views according to how data evolved. This evoked a response from one MP to say that in that case, forward guidance was redundant and we had returned to the days of "old fashioned smoke and mirrors"!

1c. **So where are we now?**

Let's make an attempt at trying to blow away the smoke of battle to see clearly where we are now: -

- a. Since our previous interest rate forecast on 19 May, short Sterling rates (a good indicator for when financial markets expect the first increase in Bank Rate), have shifted significantly from indicating an early 2015 first increase to Q4 2014.
- b. The one piece of guidance which appears to have emerged from the fray of battle unscathed is that in the medium term increases in Bank Rate will be "**LIMITED AND GRADUAL**". Also, rates would not get back to around 5% as before the financial crisis.
- c. The MPC have also indicated their concerns that an earlier increase in Bank Rate could help them later with implementing a slower pace of increases in Bank Rate and keeping Bank Rate lower, than if there was a later timing for the first increase. It, therefore, becomes a matter of debate as to how rigidly they will be driven by actual data and what their 2 to 3 year forecasts for inflation (and on the other side of the same coin - slack), indicate, and instead how much weight they will put on their judgement to decide on the optimum time to vote for the first increase given their medium term concerns. Another way of putting this is 'should forecasters now be placing more weight on what they think the MPC will do, rather than what they think inflation, and other data, would warrant on their own in terms of the timing of the first increase in Bank Rate?'
- ch. Many forecasters have, therefore, brought forward their forecast for the first increase in Bank Rate to take account of the various comments that have been made by the MPC and Carney and the fact that economic recovery in 2014 is likely to be very robust. (27.6.14 June Q1 GDP figure came in at an annual rate of 3.0%. Surveys and other economic data are now pointing to Q2 building further momentum to around an annual rate of 3.4%.) We agree with this movement and have moved forward our first increase in Bank Rate from Q4 2015 to Q1 2015.

- d. But...and this little word BUT can have such a powerful effect! What would happen in the medium term if economic data were to take a nasty turn? Suppose the MPC over estimate the amount of slack in the economy and under estimate the speed with which it is used up? Or, to put it another way, suppose they get their forecasts for inflation over the next 2-3 years too low and inflation builds up quickly and threatens to become a significant risk. Could the commitment to “limited and gradual” increases in Bank Rate melt and disappear like snow on a balmy spring day? One wonders.

Accordingly, in our revised interest rate forecast, this earlier start to the timing of the first increase in Bank Rate has resulted in slight increases in Bank Rate in the two subsequent years compared to our previous forecast. However, we have slowed down the pace at which increases occur in line with the ‘slow and gradual’ forward guidance which has been emphasised recently.

2. THE GLOBAL ECONOMY

We can only repeat our previous warnings that we are in times when events can precipitate major volatility in markets. During this year we have seen a flight to safe havens resulting from investment flows out of emerging countries back to western economies as the prospects for higher growth in these economies has improved. This has been triggered by the Fed’s start to tapering and successive months of reducing QE purchases by \$10bn per month.

As for the EZ, while Ireland and Portugal have made very good progress and have been able to exit from their bail out programmes, there remains the prospect that Greece could require a third bailout package, though not one on the same scale as the first two.

A further concern over the EZ is the potential “Japanification” of the economy as some countries are now experiencing, or are very near to, deflation. Deflation causes a real increase in the value of debt. This is dangerous in itself for already heavily indebted countries but even more so where countries are still running up annual deficits of 3% or more. We are, therefore, concerned that some EZ countries experiencing low growth, will, over the next few years, see a significant increase in total government debt to GDP ratios. There is a potential danger for these ratios to rise to the point where markets lose confidence in the financial viability of one, or more, countries. However, it is impossible to forecast whether any individual country will lose such confidence, or when, and so precipitate a resurgence of the EZ debt crisis. While the ECB has adequate resources to manage a debt crisis in a small EZ country, if one, or more, of the larger countries were to experience a major crisis of market confidence, this would present a serious challenge to the ECB and to EZ politicians. All eyes are currently on the ECB in terms of whether they will provide further policy support, having resorted to negative interest rates in June in an effort to encourage financial institutions to lend into the “real economy”.

3. CAPITA ASSET SERVICES FORWARD VIEW

We would remind clients of the view that we expressed in our previous interest rate revision newsflashes of just how unpredictable PWLB rates and bond yields are as we are experiencing volatility which is highly correlated to geo-political developments.

As there remain the threat of potential risks from a number of sources 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 predicted to remain unchanged, as market fundamentals will focus on the improved UK economic performance as well as issues such as the sheer volume of UK gilt issuance (and also US Treasury issuance) and the price of those new debt issues. Negative (or positive) developments on the geo-political front as well as any fresh issues regarding an EZ-related sovereign debt crisis 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 is based on an initial assumption that we will not be heading into a major resurgence of the EZ debt crisis, or a break-up of the EZ, but rather that there will be a managed, albeit painful and tortuous, resolution of the debt crisis where EZ institutions and governments eventually do what is necessary - but only when all else has been tried and failed. Under this assumed scenario, growth within the EZ will be tepid for the next couple of years and, therefore, has the potential to dampen UK growth, as the EU is our biggest export market.

Our PWLB forecasts are based around a balance of risks. However, we would flag up the potential for upside risks, especially for longer term PWLB rates, as follows:-

- A further surge in investor confidence that robust world economic growth is firmly expected, causing a greater flow of funds out of bonds and into equities.
- UK inflation being significantly higher than in the wider EU and US, causing an increase in the inflation premium inherent to gilt yields.

Downside risks currently include:-

- The situation over Ukraine poses a major threat to EZ and world growth if it was to deteriorate into “economic warfare” between the West and Russia, where Russia resorted to using its control over gas supplies to Europe. Heightened political risks in the Middle East and East Asia could also trigger safe haven flows back into bonds.
- A failure to rebalance UK growth towards exporting and business investment causing a weakening of overall economic growth beyond 2014.
- A resurgence of the EZ sovereign debt crisis caused by ongoing deterioration in government debt to GDP ratios.
- Recapitalising of European banks requiring more government financial support.
- Lack of support by populaces in Eurozone countries for austerity programmes, especially in countries with very high unemployment rates e.g. Greece and Spain, which still face huge challenges in engineering economic growth to correct their budget deficits on a sustainable basis.
- Monetary policy action failing to stimulate sustainable growth in western economies, especially the Eurozone and Japan.
- There are also increasing concerns that the reluctance of western economies to raise interest rates significantly for some years. This plus the huge QE measures which remain in place (and may be added to by the ECB in the near future), has created potentially unstable flows of liquidity searching for yield and therefore heightened the potential for an increase in risks in order to get higher returns. This is a return of the same environment which led to the 2008 financial crisis.

Graddfeydd Credyd Gwrthbartion buddsoddi a'r adneuron a ddelir gyda phob un ar Mehefin 2014 *
Credit ratings of investment counterparties and deposits held with each as at 30 June 2014*

Grŵp Bancio/ Banking Group	Sefydliad/ Institution	Adneuron / Deposit £'000	Hyd (Galw tymor sefydlog) / Duration (Call / Fixed Term**)	Cyfnod (O/I)/ Period (From - To)	Graddfa Dychweliad/ Rate of Return %	Graddfa Tymor Hir Fitch Long Term Rating ****	Graddfa Tymor Byr Fitch Short Term Rating ****	Graddfa Tymor Hir Moody's Long Term Rating ****	Graddfa Tymor Byr Moody's Short Term Rating ****	Graddfa Tymor Hir Standard & Poor's (S&P) Long Term Rating ****	Graddfa Tymor Byr Standard & Poor's (S&P) Short Term Rating ****	Lliw Sector/Hyd Awgrymiedig/ Sector Colour / Suggested Duration
Lloyds Banking Group plc	Bank of Scotland plc	8,513	Galw/ Call	n/a	0.40	A	F1	A1	P-1	A	A-1	Glas - 12 mis/ Blue - 12 months
HSBC Holdings plc	HSBC Bank plc	501	Galw/ Call	n/a	0.25	AA-	F1+	Aa3	P-1	AA-	A-1+	Oren - 12 mis / Orange - 12 months
Santander Group plc	Santander UK plc	49	Galw/ Call	n/a	0.40	A	F1	A2	P-1	A	A-1	Coch - 6 mis/ Red - 6 months
The Royal Bank of Scotland Group plc	The Royal Bank of Scotland plc	10,000	Galw/ Call	n/a	0.40	A	F1	Baa1	P-2	A-	A-2	Glas - 12 mis / Blue - 12 months

* Ceir y Rhestr Benthycy Cymeradwyedig yn Atodiad 5 o'r Datganiad Strategaeth Rheoli Trysorlys 2014/15 Strategaeth Buddsoddi Blynyddol / The Counterparty Criteria can be found at Appendix 6 of the 2014/15 Treasury Management Strategy Statement / Annual Investment Strategy

** Sef tymor ar pwynt y buddsoddi/Being term at the point of investment.

*** During the quarter the Moody's Long Term rating for the Bank of Scotland plc was upgraded to A1 from A2. The bank is part nationalised and so this did not have a bearing on the investment criteria during the quarter.

**** Yn Atodiad 4 ceir y graddfeydd credyd cyfatebol ar gyfer y 3 asiantaeth graddio y cyfeirir atynt uchod./The equivalent credit ratings for the 3 rating agencies referred to above can be found at Appendix 4.

**Graddfeydd Credyd Cyfartebol/
Equivalent Credit Ratings (Fitch, Moodys, S&P)**

Tymor Hir Fitch Long Term	Tymor Hir Moodys Long Term	Tymor Hir S&P Long Term
AAA	Aaa	AAA
AA+	Aa1	AA+
AA	Aa2	AA
AA-	Aa3	AA-
A+	A1	A+
A	A2	A
A-	A3	A-
BBB+	Baa1	BBB+
BBB	Baa2	BBB
BBB-	Baa3	BBB-
Tymor Byr Fitch Short Term	Tymor Byr Moodys Short Term	Tymor Byr S&P Short Term
F1+	n/a	A-1+
F1	P-1	A-1
F2	P-2	A-2
F3	P-3	A-3