The Actuarial Profession
making financial sense of the future

Ross Walker, UK Economist, RBS

UK Economy Outlook

21 November

Public finances

So far, so good . . . But rising risks of an overshoot in borrowing

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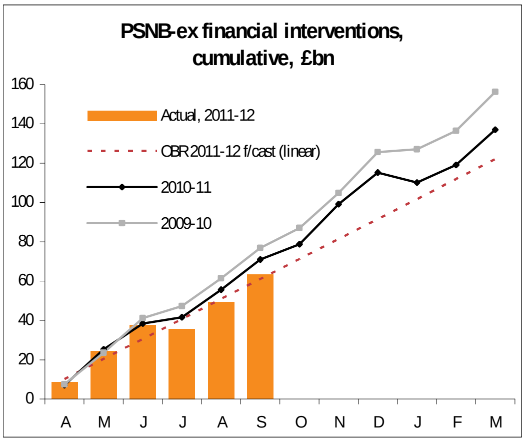
2011-12 FY: Half-time report

Half-way through the 2011-12 FY, the UK public sector deficit reduction has been broadly in line with official (OBR) forecasts to fall to £122bn, 7.9% of GDP.

Deteriorating growth outlook means the risks remain skewed towards a modest overshoot (RBS f/cast: £126bn, 8.2% of GDP) – not enough to unnerve the markets. Bigger overshoot risks in 2012-13 (RBS: £108bn, 6.7% of GDP, vs £101bn/6.2%).

Public spending control: cumulative spending growth in 2011-12 = 2.9% y/y vs OBR f/cast of 3.6%. This is important as future deficit reductions hinge mainly on spending restraint.

Tax inflows marginally weaker than expected. Once adjusting for the Bank Payroll Tax and the Bank Levy, cumulative growth in receipts = 6.0% y/y vs OBR f/cast of 6.9%.



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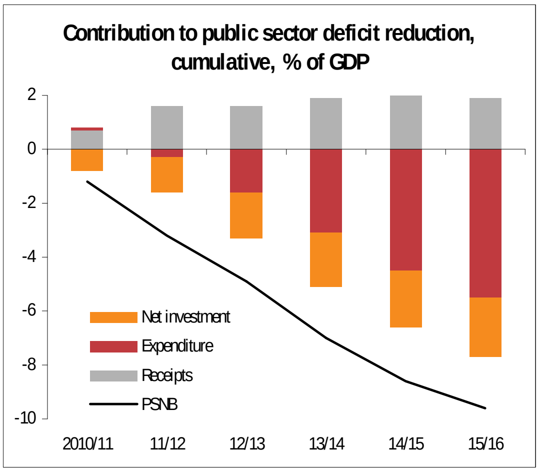
UK medium-term fiscal strategy

Over the six year period to 2015-16, some 80% of the UK deficit reduction is planned to come from public expenditure restraint.

The tax rises (VAT, 50p income tax rate, NICs) have been largely implemented.

On the expenditure side, the cuts have been concentrated on investment spending.

Current expenditure has continued to rise in nominal terms – the 'cuts' have been to spending *growth*. Initial current expenditure cuts should be easy to identify given high levels of public spending, but will be politically difficult.



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Growth prospects

Near-term volatility and medium-term downside risks for trend rates

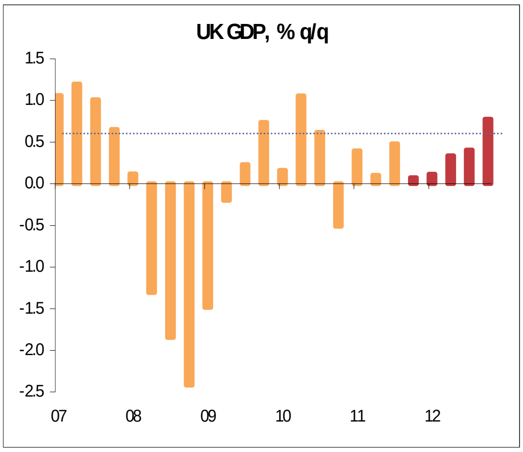
Short-term growth: Double-dip risks

A sluggish recovery: Peak-to-trough decline in GDP of 7.1%. The level of output has since recovered by just 3.4% (from its low in Q2 2009).

Q3 saw some rebound in GDP (0.5% q/q) following near-stagnation in Q2. Forward-looking indicators point to a relapse.

Our central forecast is for the UK to narrowly avoid recession: growth of 0.1% q/q in Q4 and Q1, but the latest survey data suggest downside risks.

We forecast GDP growth of 1.0% in 2011 and 2012.



Medium-term growth: Slower for longer?

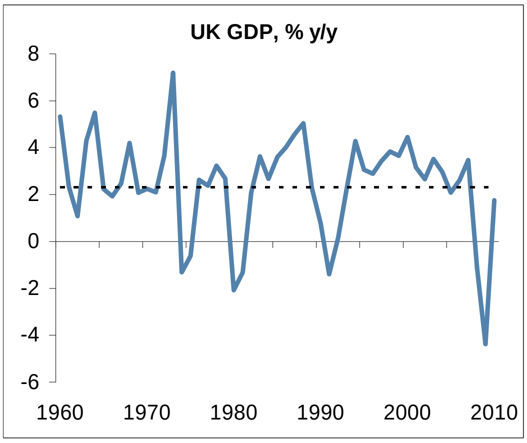
Long-run average UK GDP growth is around 2¼-2½%.

These trends underpin the OBR's medium-term GDP projections: 2.9% real, 5.7% nominal.

OBR assumes real trend rate of 2.1% from 2013 onwards:

Output per hour worked:	+2.0%
Average hours worked:	-0.2%
Employment rate:	-0.2%
Population:	+0.5%

Long-run trend rates are determined by factors such as technological progress – hard to incorporate this into an economic forecast. But balance sheet constraints and deleveraging will provide a persistent headwind.



Inflation outlook

Peak within sight

Medium-term growth: Slower for longer?

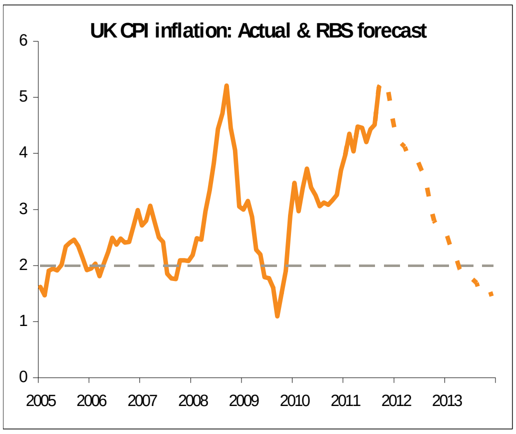
CPI inflation is close to its peak. We expect inflation to be back at its 2% target by early 2013.

What brings inflation down?

- **Temporary upside distortions drop out (VAT hike, global energy shock).**
- **Persistence of economic spare capacity.**
- **Continuation of muted wage inflation against backdrop of rising unemployment.**

Main upside inflation risk: sterling. Essential the UK government retains credibility in global financial markets.

At this stage, there is no particular reason to believe there will be any tendency for UK inflation to overshoot its target in the medium-term.



Conclusions

Some of the near-term pessimism surrounding the **public finances** looks exaggerated. Modest upward revisions to borrowing in 2011-12 are likely, but not to the extent that markets will balk. Bigger risks in 2012-13 FY (£7bn overshoot).

Event risk: OBR may unveil more radical revisions to its **medium-term growth and borrowing forecasts**, but we do not expect any such changes before the spring 2012 Budget (the November 29th update is more likely to involve 'scenario analysis').

UK deficit reduction rests on **spending restraint, not further tax rises** – political will is more important than the economic cycle. Forecast revisions will amount to a change of gear, not a change of direction.

GDP growth will average closer to 1½% over the next decade than the 2½% long-run average.

Inflation has been more elevated and stickier than expected, but significant declines are likely in the coming months: petrol price base effects, VAT hike dropping out, utility price rises largely in the data, persistent spare capacity, weak household income growth.

Receding inflation + ongoing fiscal consolidation = **looser for longer monetary policy**. We expect another £50bn of QE in February 2012. Financial markets do not expect a BoE Bank Rate rise until 2014.

UK has a plan and will continue to implement it. Some fiscal slippage is likely but will probably be manageable. There is a sense of economic and financial realism/acceptance in the UK, hence, **the UK remains a 'safe haven'** (everything is relative).

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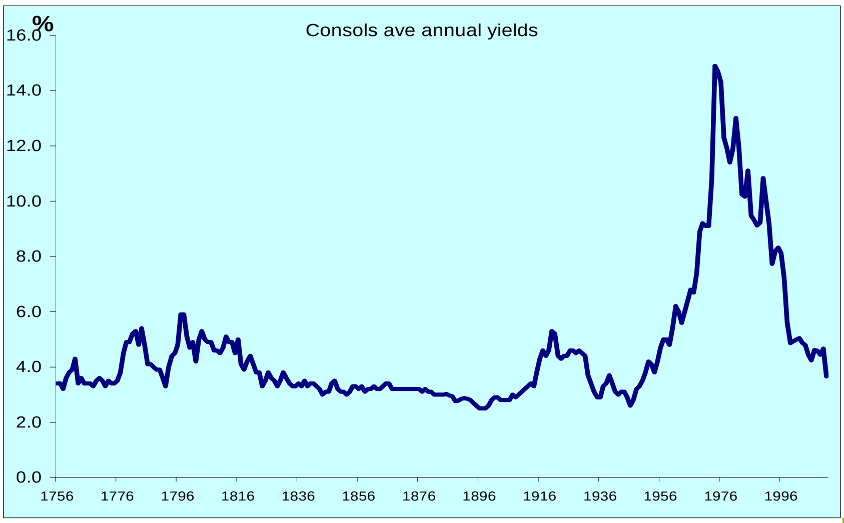
Andrew Roberts, Head of European Rates Strategy, RBS

UK Gilts: the best looking pig in the slaughterhouse

So, are Gilts rich or cheap at lowest yield since 1950?



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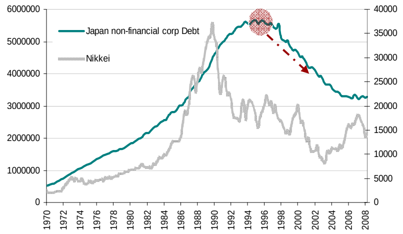
Themes

- Deleveraging = investors have had enough propping up debt fuelled growth => lower trend GDP
- Fiscal tightening necessary to avoid capital flight.
- Problem! happening in a slowdown. Slowdown becomes dramatic = recession.
- You need monetary ease. Problem! ECB hard money hawks in the way (three cheers for the Bank of England)
- Sovereign collapse in EMU = problem for banks that lent them the money = problem for the sovereigns who sponsor those banks
- Winners are those countries with flexible central banks. Eg USA, UK. Also, Canada, Australia, Sweden, Norway, Denmark, Singapore
- UK has been my top 'safe haven' play in the world for 18 months (went long in April 2010). Reappraisal of BoE, willingness by govt to enact fiscal tightening, relative merits as EMU countries ran into trouble. One risk: Big UK bank balance sheets

Deleveraging is a slow and painful process

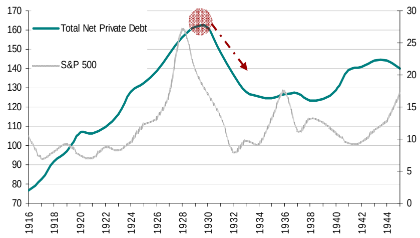
- **Both Japan during the 1990s and US during the 1930s took years to delever**
- **There is a lag between a market crash and deleveraging**
- **The financial crisis is global this time (more so than the Great Depression era)**

Japan in 1990: Leveraging and the Equity Market



Source: ABN Amro structuring team

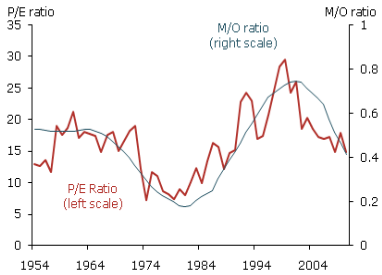
US during the Great Depression

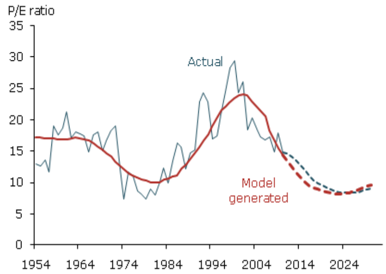


Source: ABN Amro structuring team

Why the quote on demographics? Lower trend GDPs – US example

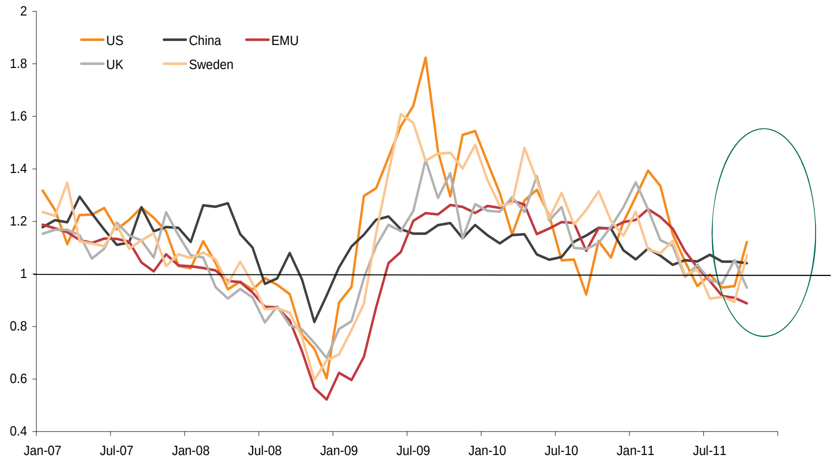
- ***Boomer Retirement: Headwinds for U.S. Equity Markets? By Zheng Liu and Mark M. Spiegel, August 2011***



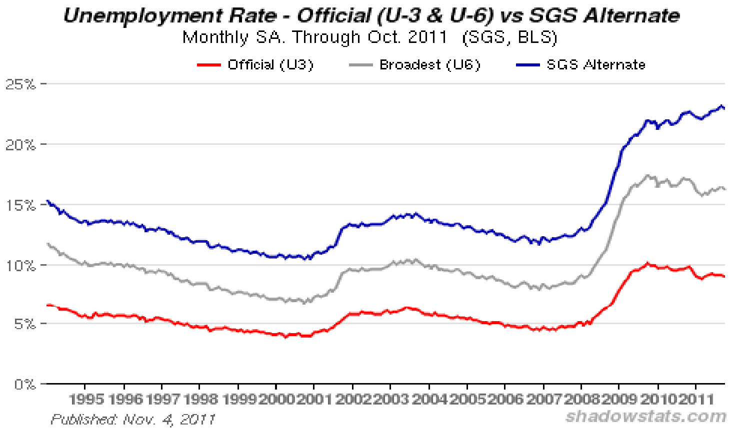


'Given the projected path for P/E* and the estimated convergence process, we find that the actual P/E ratio should decline from about 15 in 2010 to about 8.3 in 2025 before recovering to about 9 in 2030. '

New orders to inventories ratio shows the turn. Turn in EMU most severe. Next worst is UK



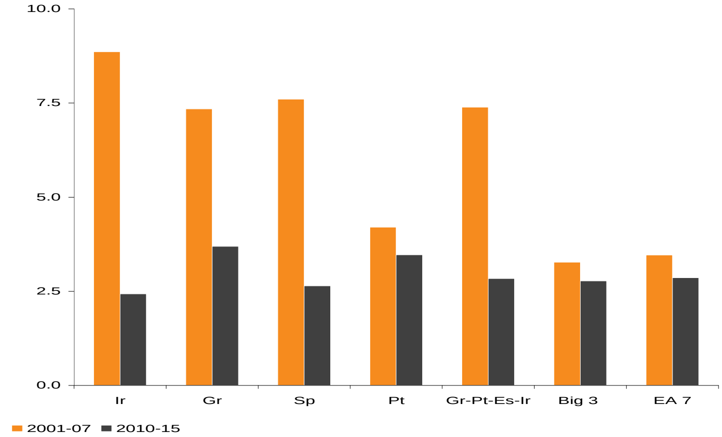
US unemployment is 23%



Source: Courtesy of ShadowStats.com

The augmented U-6 rate includes long-term discouraged workers (defined out of existence in 1994). U-6 only includes short-term discouraged workers

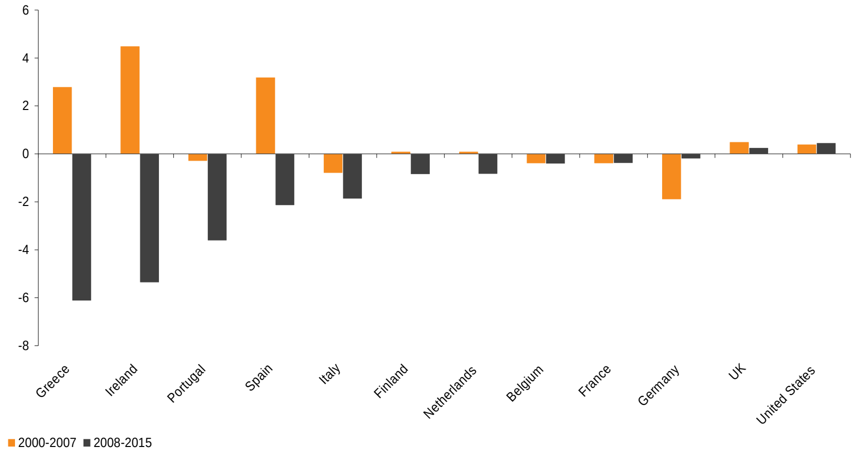
That weak growth theme is seen worst in the (previous) EMU ‘tigers’



And nominal GDP in non-core EMU will be far lower than during credit supercycle

Source: RBS European economics

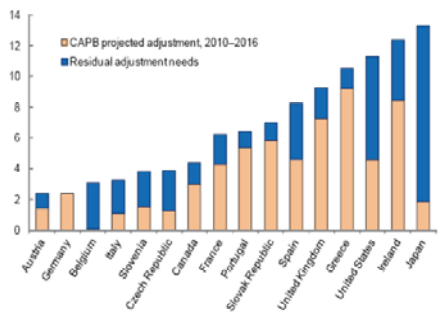
Which means they have a funding problem, with nominal growth < long-term interest rates . . .



Which countries need to enact more fiscal tightening? UK has tough task, but is on board

Figure 1.13. Selected Advanced Economies: Illustrative Adjustment Needs and Projected Fiscal Adjustment

(Percent of GDP)

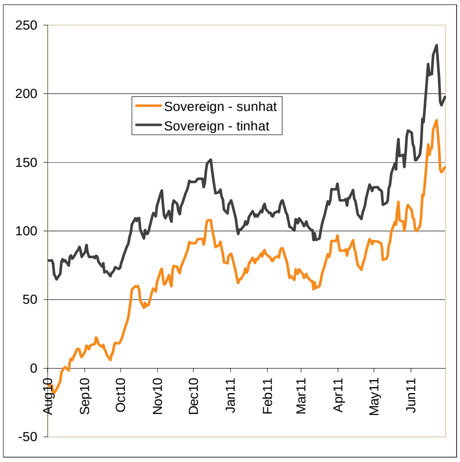


Source: IMF staff estimates and projections.
Note: The figure compares the estimated adjustment needs between 2010 and 2020 to achieve debt targets in 2030 (see note in Table 1.5a) and the projected change in the cyclically adjusted primary balance between 2010 and 2016 for the countries with positive residual adjustment needs beyond 2010. The 2010–16 projected adjustment exceeds illustrative needs in Australia, Denmark, Hong Kong SAR, Iceland, Israel, Korea, the Netherlands, New Zealand, Sweden, and Switzerland.

Source: IMF, April 2011

We like high quality corporate risk versus sovereign risk

Protecting yourself against sovereign failure is more expensive than protecting yourself from corporate failure



Tin hat companies

Vodafone, BAT, Danone, Nestle, Tesco, Imperial Tobacco, EON, Sanofi, GDF Suez, KPN

Sun hat companies

WPP, Anglo American, Xstrata, Daimler, BP, Vinci, PPR, Sainsbury, Casino, St Gobain

And too much debt to service. Everyone fears multi trn writedowns

Total sovereign debt writedowns to 'sustainable' debt to GDP levels

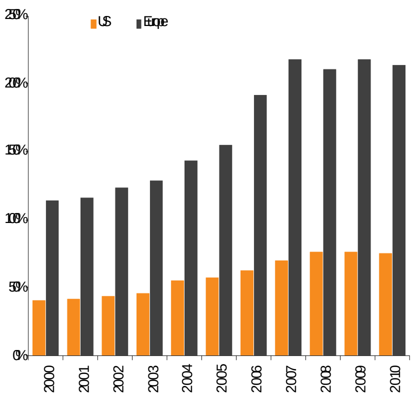
	Total sovereign debt	Sovereign debt/GDP	Haircut required to reach 'sustainable' 50% debt/GDP level	€bn debt to write down
Portugal	161	83%	**40%**	**64**
Ireland	148	96%	**48%**	**71**
Greece	329	142%	**65%**	**213**
Spain	639	60%	**17%**	**107**
Italy	1,843	119%	**58%**	**1,069**
Belgium	341	97%	**48%**	**165**
Stressed sovereigns	**3,461**	**98%**	**49%**	**1,688**
Euro zone	7,858	85%	**41%**	**3,257**
EU	9,849	80%	**38%**	**3,709**

Source: European Commission, IMF, RBS calculations

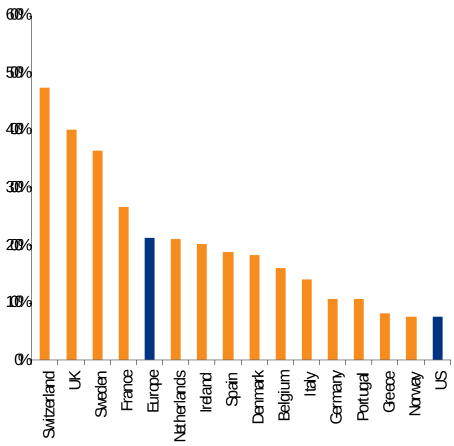
European bank exposure – beware interlinkages

Source: Stratfor

Europe, including the UK, is highly leveraged



Bank assets as % of GDP

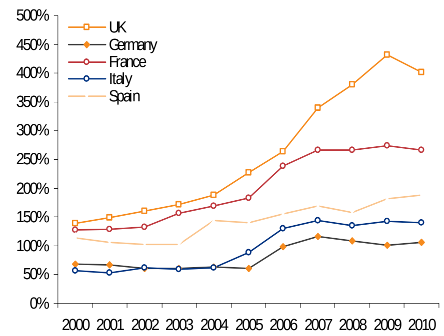


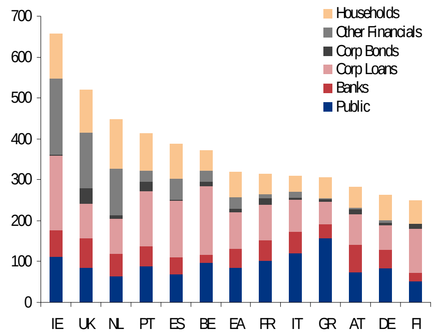
Bank assets as % of GDP

Source: Albert Gallo, RBS credit strategy

The UK looks vulnerable with its large banking sector & total debt

Aggregate bank assets, % GDP

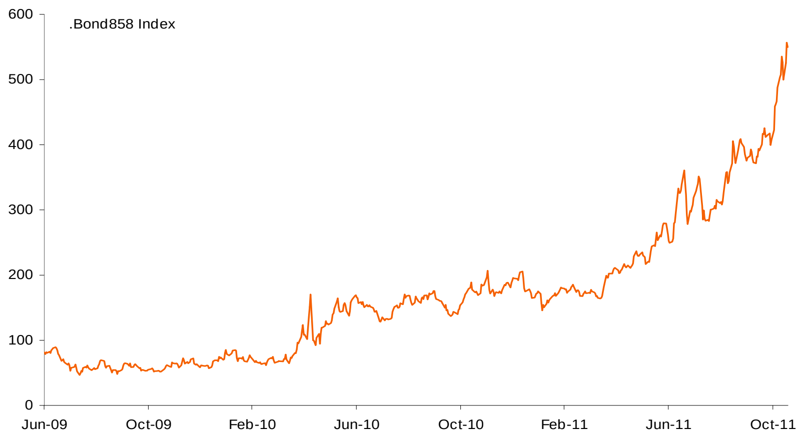




Total debt, public & private

Source: Bloomberg

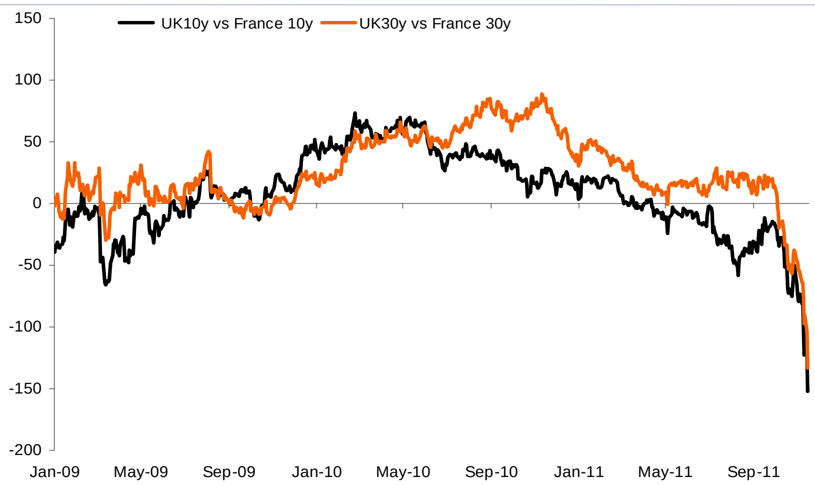
Bond spreads in EMU continue to show rising & extreme stress. More



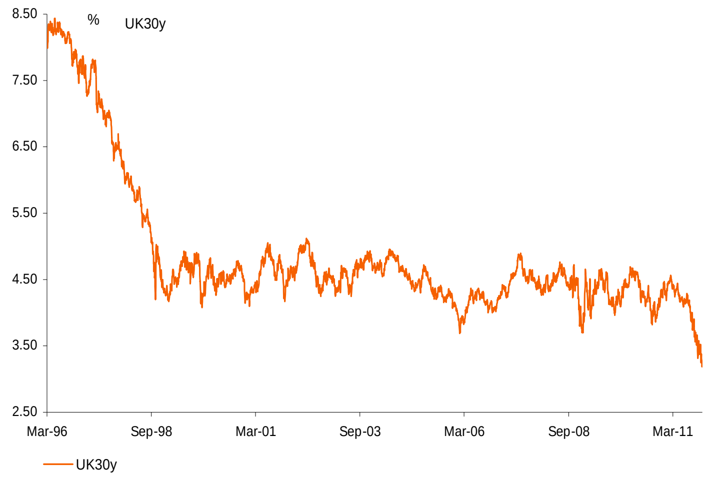
RBS market –weighted spread of all 10-yr EMU govts to Germany

The UK is a better credit than Germany. Cost of insuring Germany is > than the UK

UK vs France, your best illustration of safe-haven-UK



OK Gilts are expensive, but all part of the safe haven trade



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