Treasury Management Strategy Statement

Annual Investment Strategy, Borrowing Strategy and Minimum Revenue Provision Policy Statement 2019/20

1 Introduction

Background

1.1 The Council is required to operate a balanced budget, which broadly means that cash raised during the year will meet cash expenditure. Part of the treasury management operation is to ensure that this cash flow is adequately planned, with cash being available when it is needed. Surplus monies are invested in line with the Treasury Management Policy, which includes the Council's risk appetite for treasury management investments.

1.2 The second main function of the treasury management service is the funding of the Council's capital plans, in line with the Council's Capital Investment Strategy. These capital plans provide a guide to the borrowing need of the Council, essentially the longer term cash flow planning to ensure that the Council can meet its capital investment obligations. This management of longer-term cash may involve arranging long or short-term loans, or using longer-term cash flow surpluses. On occasion any debt previously drawn may be restructured to meet council risk or cost objectives.

1.3. CIPFA defines treasury management as: "The management of the organisations borrowing, investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks."

1.4 The strategy for 2019/20 covers the following Capital and Treasury Management issues:

- the economic background and prospects for interest rates under which the Council's Treasury Management Strategy is set;
- the current treasury position;
- the capital plans and the prudential indicators;
- treasury indicators which limit the treasury risk and activities of the Council;
- the borrowing strategy;
- the policy of borrowing in advance of need;
- debt rescheduling;
- the investment policy and strategy, and credit worthiness policy;
- The Minimum Revenue Provision Policy (MRP);
- reporting requirements;
- training requirements; and
- the policy on use of external service providers.

1.5 The CIPFA Code of Practice for Treasury Management in Public Services (the TM Code), the CIPFA Prudential Code 2017, statutory Investment guidance 2018, and statutory MRP guidance 2018 and various associated guidance regulates the Council's treasury activities.

2 *External Context*

Economic Background

2.1 The UK’s progress negotiating its exit from the EU together with future trading arrangements will continue to be a major influence on the Council’s Treasury Management Strategy for 2019/20. The markets are assuming that a deal will be struck and some agreement will be reached on transition and future trading arrangements before the UK leaves the EU. There is however still the possibility of a ‘no deal’ Brexit hanging over economic activity. The risk to the interest rate forecast are considered to be to the downside.

2.2 A full economic outlook as provided by the Council’s treasury advisor is detailed at **Appendix P (1**), with the forecast for interest rates included at **Appendix P(2)** A recent Fitch creditworthiness outlook for 2019 is summarised as follows:

i) Global growth is expected to remain positive, however peak growth has clearly passed

ii) Main Global Risks:
- Global trade – persistent risks due to changing US trade policy
- Global financial tightening – higher interest rates and an end to Quantative Easing.
- Government debt levels – remain high in developed markets, growing fast in emerging markets.
- Geopolitics – populism, Italy, Brexit, elections in key emerging markets (Argentina, Nigeria, S.Africa), Korean peninsula, Middle East.

iii) 2018 stood out as a year where sovereign upgrades outnumbered downgrades, Fitch does not expect this to continue in 2019.

3. Treasury Position

The following table summarise the Council’s current Treasury position:

£'000	**31 March 2018 Actual**	**Dec 2018 Position**
Investment		
Managed In House		
Call Accounts - Money Market Funds	13,331	12,330
Notice Accounts	10,030	7,500
Temporary Fixed Deposits - Non Local Authorities	11,529	32,000
Temporary Fixed Deposits - Local Authorities	13,010	7,500
Long Term Investment	6	6
Total Investments	**47,906**	**59,336**
Borrowing		
Short Term Borrowing	5,500	5,500
Long Term Borrowing - PWLB	104,594	104,594
Long Term Borrowing - Market Loans	31,000	31,000
Total Borrowing	**141,094**	**141,094**
Net Investment/(Borrowing)	**-93,188**	**-81,758**

3.1 The table shows the position at the start of the financial year and the position as at 31 December 2018. Investment balances increased by £11.4m, primarily due to the reduction in the need to finance capital schemes; this has resulted in the net borrowing reducing by £11.4m since March 2018.

4 Capital Expenditure and Funding

4.1 In order to inform the Council's investment and borrowing strategy, consideration needs to be given to the Council's future capital investment plans. The table below highlights the current approved programme and new bids submitted as part of the capital programme budget included in the budget strategy for 2019/20. The table is split into General Fund and Housing Revenue Account (HRA) capital expenditure.

Capital Expenditure £'000	**2017/18 Actual**	**2018/19 Estimate**	**2019/20 Estimate**	**2020/21 Estimate**	**2021/22 Estimate**	**2022/23 Estimate**	**2023/24 Estimate**
General Fund	9,038	29,982	56,684	9,994	300	0	0
HRA	7,967	12,808	26,118	29,860	25,516	18,204	17,492
Total	**17,005**	**42,790**	**82,802**	**39,854**	**25,816**	**18,204**	**17,492**

Capital Expenditure £'000	**2017/18 Estimate**	**2018/19 Estimate**	**2019/20 Estimate**	**2020/21 Estimate**	**2021/22 Estimate**	**2022/23 Estimate**	**2023/24 Estimate**
Total Expenditure	**17,005**	**42,790**	**82,802**	**39,854**	**25,816**	**18,204**	**17,492**
Financed by:							
Capital receipts	2,768	9,405	11,053	4,028	250	0	0
Capital grants	2,928	3,667	14,291	1,106	300	0	0
Reserves	7,865	10,606	12,416	9,183	9,151	9,091	9,244
Revenue	1,923	5,570	2,449	2,288	3,463	3,648	3,549
Finance leases	230	0	0	0	0	0	0
Net financing need	**1,291**	**13,542**	**42,593**	**23,249**	**12,652**	**5,465**	**4,699**

4.2 The funding of the capital programme is in line with the Council's funding principles included in the proposed capital strategy, reported earlier in the agenda.

5 Borrowing Strategy

5.1 The Council has a statutory requirement to self-manage its external borrowing, ensuring that in the long term borrowing is sustainable and affordable, this has become more important with the abolition of the HRA debt cap.

5.2 CFR is lower than the external debt, as cash supporting the Councils reserves, balances and cash flow has been used as a funding temporary measure. This strategy is prudent when there are low returns on investment and counterparty risk is still a material risk.

5.3 Under these circumstances, and the risks within the economic forecast; caution will be adopted for the 2019/20 treasury operations. The S151 Officer will monitor interest rates and adopt a pragmatic approach to changing circumstances:

- If it was felt that there was a significant risk of a sharp fall in long term and short term rates, then long term borrowing would be postponed, and potential rescheduling form fixed funding into short term funding will be considered.
- If it was felt that there was a significant risk of a sharp rise in interest rates in the long and short term, the portfolio position will be reappraised.
- Any decisions will be reported to Cabinet at the next available meeting.

5.4 Policy on borrowing in advance of need

The Council will not borrow more than or in advance of need, purely to profit from the investment of extra sums borrowed. Any decision to borrow in advance of need will be considered carefully to ensure that the associated risks can be managed, the proposal complies with the Council's Capital Strategy value for money can be obtained and the security of such funds can be maintained in the long term.

5.5 Debt Rescheduling

Where short term borrowing rates are considerably cheaper than long term fixed interest rates, there will be a potential opportunity to generate savings on interest costs by restructuring the Council's debt. Such savings will need to be considered in light of:

- the cost of repaying the debt early, and
- the potential for running down investment balances to repay debt, as interest income on investments are likely to be lower than the rates for current debt.

5.6 All rescheduling will be reported to Cabinet at the earliest opportunity.

6 Capital Financing Requirement (CFR)

6.1 The CFR represents what the Council has previously borrowed to finance capital expenditure and its ongoing need to borrow for capital purposes The CFR does not increase indefinitely, as the minimum revenue provision (MRP), a statutory annual revenue charge for borrowing over each assets life reduces the CFR. The CFR includes other long term liabilities such as finance leases. For financial management purposes the CFR is split between the General Fund and the HRA.

6.2 The composition of the CFR is detailed below for the 2017/18 Actual and forecast period to 2023/24:

£'000	2017/18 Actual	2018/19 Estimate	2019/20 Estimate	2020/21 Estimate	2021/22 Estimate	2022/23 Estimate	2023/24 Estimate
CFR – general fund	26,255	39,797	69,071	74,181	74,181	74,181	74,181
CFR - housing	127,933	127,933	141,252	155,179	167,831	173,296	177,995
Total CFR	**154,188**	**167,730**	**210,323**	**229,360**	**242,012**	**247,477**	**252,176**
Movement in CFR	(409)	13,542	42,593	19,037	12,652	5,465	4,699
Movement in CFR represented by:							
Net financing need	1,290	15,521	44,583	21,030	14,645	7,458	6,692
Assets acquired under finance leases	(445)	(234)	0	0	0	0	0
Less MRP	1,254	1,745	1,990	1,993	1,993	1,993	1,993
Movement in CFR	**(409)**	**13,542**	**42,593**	**19,037**	**12,652**	**5,465**	**4,699**

6.3 As detailed in the HRA budget report, the HRA will repay maturing debt of £17.6m in 2020/21; with an estimated £4.212m being funded from the debt repayment reserve; with the estimated balance of £13.388m being refinanced through new debt in 2020/21.

6.4 The table below compares the projections for the Council's outstanding debt to the CFR forecast for the planning horizon. For the majority of the reporting period the Council's will be sustaining an under borrowed position in delivering the current capital programme forecast.

£'000	2017/18 Actual	2018/19 Estimate	2019/20 Estimate	2020/21 Estimate	2021/22 Estimate	2022/23 Estimate	2023/24 Estimate
External debt at 1 Apr	136,094	142,500	158,194	202,994	224,241	239,103	246,778
New borrowing	5,000	15,521	44,583	21,030	14,645	7,458	6,692
Other long-term liabilities	1,406	173	217	217	217	217	217
Gross debt at 31 Mar	**142,500**	**158,194**	**202,994**	**224,241**	**239,103**	**246,778**	**253,687**
CFR	154,188	167,730	210,323	229,360	242,012	247,477	252,176
Under / (over) borrowing	**11,688**	**9,536**	**7,329**	**5,119**	**2,909**	**699**	**(1,511)**

6.5 The Council will be required to approve the CFR projections above.

7 Limits on Borrowing Activity

7.1 *Operational Boundary*

The Operational Boundary is the limit beyond which external debt is not expected to exceed. The limit may be higher or lower depending on the levels of actual debt and the ability to borrow from other cash resources.

Operational boundary £'000	2017/18 Estimate	2018/19 Estimate	2019/20 Estimate	2020/21 Estimate	2021/22 Estimate	2022/23 Estimate	2023/24 Estimate
Debt	148,494	161,788	206,415	227,445	242,090	249,548	256,240
Other long term liabilities	2,074	173	217	217	217	217	0
Total	**150,568**	**161,961**	**206,632**	**227,662**	**242,307**	**249,765**	**256,240**

7.2 *Authorised Limit for External Debt*

This is a key treasury management indictor and represents a control on the maximum level of borrowing. This is a legal limit, beyond which external debt cannot be breached. The limit needs to be set and revised by full Council. The limit is the level of debt which could be afforded in the short term; but not sustainable in the long term.

Authorised limit £'000	2017/18 Estimate	2018/19 Estimate	2019/20 Estimate	2020/21 Estimate	2021/22 Estimate	2022/23 Estimate	2023/24 Estimate
Debt	168,660	176,788	221,415	242,445	257,090	264,548	271,240
Other long term liabilities	2,074	173	217	217	217	217	0
Total	**170,734**	**176,961**	**221,632**	**242,662**	**257,307**	**264,765**	**271,240**

7.3 *HRA Local Indicator – Interest Cover Ratio*

In line with Treasury Management Guidance, a local indicator has considered for the HRA as it is a statutory account. Registered Housing Providers use an interest cover ratio to identify the organisations ability to meet interest costs from the net operating surplus. The ratio for the HRA over the period to 2023/24 is between 1.50 to 1.66, as detailed below:

2017/18 Actual	2018/19 Estimate	2019/20 Estimate	2020/21 Estimate	2021/22 Estimate	2022/23 Estimate	2023/24 Estimate
1.54	1.66	1.5	1.51	1.64	1.62	1.59

8 *Maturity Structure of borrowing*

8.1 Theses gross limits are set to reduce the council's exposure to large fixed rate sums falling due for refinancing, and are required for upper and lower limits. The proposed limits for 2019/20 are unchanged from the 2018/19 strategy limits as follows:

Maturity Structure of fixed interest rate borrowing	Lower	Upper
Under 12 months	0%	15%
12 months to 2 years	0%	15%
2 years to 5 years	0%	15%
5 years to 10 years	0%	15%
10 years to 20 years	0%	30%
20 years to 30 years	0%	30%
30 years to 40 years	0%	40%
40 years to 50 years	0%	40%
Over 50 years	0%	10%

9 Minimum Revenue Provision – Policy Statement

9.1 The Council is required to pay off an element of the accumulated General Fund capital spend each year (the CFR) through a revenue charge (the Minimum Revenue Provision - MRP), although it is also allowed to undertake additional voluntary payments (VRP) if required.

9.2 Government regulations require the full Council to approve an MRP Statement in advance of each year. A variety of options are provided to councils, so long as there is a prudent provision. The Council is recommended to approve the following MRP Statement:

9.2 For capital expenditure incurred before 1 April 2008 or which in the future will be Supported Capital Expenditure, the MRP policy will allow for the borrowing need (CFR) to be repaid on an equal instalment basis over a period of 50 years with effect from the 2016/17 financial year. This has the benefits of reducing the amount payable for the first 17 years, introducing a consistent level of charge, and ensuring that this element of MRP is eventually completely repaid.

9.3 From 1 April 2008 for all unsupported borrowing (including finance leases) the MRP policy will be the Asset Life Method (option 3) – MRP will be based on the estimated life of the assets, in accordance with the regulations. This provides for a reduction in the borrowing need over approximately the asset's life. Repayments included in finance leases are applied as MRP.

9.4 There is no requirement on the HRA to make a minimum revenue provision but there is a requirement for a charge for depreciation to be made.

9.5 The Accountancy team will keep the Council's MRP Policy under review to ensure that it remains fit for purpose in relation to its borrowing requirements.

10 Investment Strategy

10.1 The Ministry of Housing, Communities and Local Government (MHCLG) and CIPFA, through the Treasury Management Code of Practice; have extended the meaning of 'investments 'to include non-treasury investments. The Treasury Management Strategy covers treasury investments only, non-treasury management investments are covered in the Capital Strategy**.**

10.2 The Council's Investment Strategy and supporting practices are required to be compliant with:

- Guidance for Central Government on Local Government Investments, and
- CIPFA Treasury Management in the Public Sector Code of Practice and Cross Sectoral Guidance notes 2017 (the TM code).

10.3 The Council's investment priorities will be security of investment first, portfolio liquidity second and then yield (investment returns).

10.4 This risk appetite will be delivered through the following key investment principles:

- All investments will be in Sterling;
- Minimum acceptable credit criteria are applied in order to generate a list of highly creditworthy counterparties. Risk is also managed through diversification of investment. Short term and long term ratings are used to monitor counterparties;
- Counterparties are also monitored through the use of other information, such as the opinion of the markets and information received through its treasury advisors, financial press, etc.;
- The Council applies the credit worthiness service provided by Link Asset Services, which is based on all three credit rating agencies(Fitch, Moody's and Standard & Poor's) and overlaid with credit watches and credit outlooks from credit agencies, CDS spreads and sovereign ratings; the result being that colour code bands are used by the council to determine the duration of the investment with organisations;

10.5 The types of investment instrument which the treasury management team are authorised to use are detailed at **Appendix P(3),** comprising 'specified' and 'non-specified investments;

  - *Specified Investments* are high level credit quality and subject to a maturity limit of less than 365 days.
  - *Non Specified Investments* are less highly credit quality, may be for periods in excess of 365 days and are more complex instruments, requiring greater consideration by officers and members. A limit of £10m or 25% of the investment portfolio will be set for such investments in 2019/20.

- A limit of £5m will be set for principal investments over 365 days;
- Each counterparty will be set a lending limit, through the use of a matrix table as detailed at **Appendix P(3),** these limits will apply to groups of companies;
- In addition, each type of investment will be set a transaction limit to support diversification;
- Investments will only be placed with counterparties from countries with a minimum sovereign rating of AA-(Fitch) based on the lowest available credit rating, this includes UK counterparties; **Appendix P (4)**
- No more than £15m will be placed with any non UK country at any time;
- Credit ratings will be monitored on a monthly basis, with extreme market movements resulting in the downgrade of the institution or removal from the Council's lending list;
- A bench mark return for 2019/20 of 1.00% is proposed for investments with a maturity of up to three months, this is based on a Bank Rate forecast of 1.25% as at March 2020.

- The Council will consider the implications of investment instruments which could result in an adverse movement in the principal investment amount, which will result in a charge to the General Fund; and
- All credit limits will be continuously monitored for appropriateness.

10.6 The following changes have been made to the credit criteria for 2019/20 compared to 2018/19:

- the Non Specified limit has been reduced to a maximum of £10m and 25% of the investment portfolio, to reflect more fully the risk associated with such investments,
- in preparation for a disorderly Brexit and the possible reduced UK sovereignty rating, the minimum sovereignty rating has been applied to all counterparties, including those in the UK.

11 Reporting requirements

11.1 The Council is currently required to produce three main reports each year, which incorporate a variety of polices, estimates and actuals. These reports are all required to be scrutinised and reviewed. This role is undertaken by the Council's Scrutiny Panel and Governance and Audit Committee.

11.2 *Prudential and Treasury Indicators and Treasury Strategy* (This report) – The first, and most important report is recommended to Full Council following consideration by the Scrutiny Panel. It covers:

- the capital plans (including prudential indicators);
- a Minimum Revenue Provision (MRP) Policy (how residual capital expenditure is charged to revenue over time);
- the Treasury Management Strategy (how the investments and borrowings are to be organised) including treasury indicators; and
- an investment strategy (the parameters on how investments are to be managed).

The report includes the forecast for the impact of the capital programme on treasury management over the following five forecasting years.

11.3 *Mid-Year Treasury Management Report* – This will update members with the progress on the capital position, amending prudential indicators as necessary, and whether any policies require revision. The report in addition to reviewing progress in the current financial year, will include the impact on the following three years forecast.

11.4 *Annual Treasury Report* – This provides details of a selection of actual prudential and treasury indicators and actual treasury operations compared to the estimates within the strategy and the impact in future years.

11.5 Members will also be kept informed of any other significant matters that may occur as part of the quarterly Capital Monitoring reports to Scrutiny Panel and Governance and Audit Committee.

12 Treasury Management Consultants

12.1 The Council uses Link Asset Services, Treasury Solutions as its external treasury management advisors. The Council recognises that responsibility for treasury management decisions remains with the organisation at all times and will ensure that undue reliance is not placed upon our external service providers.

12.2 It also recognises that there is value in employing external providers of treasury management services in order to acquire access to specialist skills and resources. The Council will ensure that the terms of their appointment and the methods by which their value will be assessed are properly agreed and documented, and subjected to regular review.

13 Training

13.1 The CIPFA Code requires the responsible officer to ensure that Members with responsibility for treasury management or scrutiny receive adequate training in treasury management. This especially applies to members responsible for scrutiny. Training has previously been undertaken by members and further training will be arranged as required. The training needs of treasury management officers are periodically reviewed.

ECONOMIC BACKGROUND

- **GLOBAL OUTLOOK. World growth** has been doing reasonably well, aided by strong growth in the US. However, US growth is likely to fall back in 2019 and, together with weakening economic activity in China and the eurozone, overall world growth is likely to weaken.

Inflation has been weak during 2018 but, at long last, unemployment falling to remarkably low levels in the US and UK has led to a marked acceleration of wage inflation. The US Fed has therefore increased rates nine times and the Bank of England twice. However, the ECB is unlikely to start raising rates until late in 2019 at the earliest.

KEY RISKS - central bank monetary policy measures
Looking back on nearly ten years since the financial crash of 2008 when liquidity suddenly dried up in financial markets, it can be assessed that central banks' monetary policy measures to counter the sharp world recession were successful. The key monetary policy measures they used were a combination of lowering central interest rates and flooding financial markets with liquidity, particularly through unconventional means such as quantitative easing (QE), where central banks bought large amounts of central government debt and smaller sums of other debt.

The key issue now is that that period of stimulating economic recovery and warding off the threat of deflation, is coming towards its close. A new period is well advanced in the US, and started more recently in the UK, of reversing those measures i.e. by raising central rates and, (for the US), reducing central banks' holdings of government and other debt. These measures are now required in order to stop the trend of a reduction in spare capacity in the economy and of unemployment falling to such low levels, that the re-emergence of inflation is viewed as a major risk. It is, therefore, crucial that central banks get their timing right and do not cause shocks to market expectations that could destabilise financial markets. In particular, a key risk is that because QE-driven purchases of bonds drove up the price of government debt, and therefore caused a sharp drop in income yields, this also encouraged investors into a search for yield and into investing in riskier assets such as equities. Consequently, prices in both bond and equity markets rose to historically high valuation levels simultaneously. This meant that both asset categories were exposed to the risk of a sharp downward correction and we have indeed, seen a sharp fall in equity values in the last quarter of 2018. It is important, therefore, that central banks only gradually unwind their holdings of bonds in order to prevent destabilising the financial markets. It is also likely that the timeframe for central banks unwinding their holdings of QE debt purchases will be over several years. They need to balance their timing to neither squash economic recovery, by taking too rapid and too strong action, or, conversely, let inflation run away by taking action that was too slow and/or too weak. **The potential for central banks to get this timing and strength of action wrong are now key risks.** At the time of writing, (early January 2019), financial markets are very concerned that the Fed is being too aggressive with its policy for raising interest rates and was likely to cause a recession in the US economy.

The world economy also needs to adjust to a sharp change in **liquidity creation** over the last five years where the US has moved from boosting liquidity by QE purchases, to reducing its holdings of debt, (currently about $50bn per month). In addition, the European Central Bank ended its QE purchases in December 2018.

- **UK.** The flow of positive economic statistics since the end of the first quarter of 2018 has shown that pessimism was overdone about the poor growth in quarter 1 when adverse weather caused a temporary downward blip. Quarter 1 at 0.1% growth in GDP was followed by a return to 0.4% in quarter 2 and by a strong performance in quarter 3 of +0.6%. However, growth in quarter 4 is expected to weaken significantly.

- At their November quarterly Inflation Report meeting, the MPC repeated their well-worn phrase that future Bank Rate increases would be gradual and would rise to a much lower equilibrium rate, (where monetary policy is neither expansionary of contractionary), than before the crash; indeed they gave a figure for this of around 2.5% in ten years time, but declined to give a medium term forecast. However, with so much uncertainty around Brexit, they warned that the next move could be up or down, even if there was a disorderly Brexit. While it would be expected that Bank Rate could be cut if there was a significant fall in GDP growth as a result of a disorderly Brexit, so as to provide a stimulus to growth, they warned they could also *raise* Bank Rate in the same scenario if there was a boost to inflation from a devaluation of sterling, increases in import prices and more expensive goods produced in the UK replacing cheaper goods previously imported, and so on. In addition, the Chancellor could potentially provide fiscal stimulus to support economic growth, though at the cost of increasing the budget deficit above currently projected levels.
- It is unlikely that the MPC would increase Bank Rate in February 2019, ahead of the deadline in March for Brexit. Getting parliamentary approval for a Brexit agreement on both sides of the Channel will take well into spring 2019. However, in view of the hawkish stance of the MPC at their November meeting, the next increase in Bank Rate is now forecast to be in May 2019, (on the assumption that a Brexit deal is agreed by both the UK and the EU). The following increases are then forecast to be in February and November 2020 before ending up at 2.0% in February 2022.
- **Inflation.** The Consumer Price Index (CPI) measure of inflation has been falling from a peak of 3.1% in November 2017 to 2.3% in November. In the November Bank of England quarterly Inflation Report, inflation was forecast to still be marginally above its 2% inflation target two years ahead, (at about 2.1%), given a scenario of minimal increases in Bank Rate. This inflation forecast is likely to be amended upwards due to the Bank's report being produced prior to the Chancellor's announcement of a significant fiscal stimulus in the Budget; this is likely to add 0.3% to GDP growth at a time when there is little spare capacity left in the economy, particularly of labour.
- As for the **labour market** figures in October**,** unemployment at 4.1% was marginally above a 43 year low of 4% on the Independent Labour Organisation measure. A combination of job vacancies hitting an all-time high, together with negligible growth in total employment numbers, indicates that employers are now having major difficulties filling job vacancies with suitable staff. It was therefore unsurprising that wage inflation picked up to 3.3%, (3 month average regular pay, excluding bonuses). This meant that in real terms, (i.e. wage rates less CPI inflation), earnings are currently growing by about 1.0%, the highest level since 2009. This increase in household spending power is likely to feed through into providing some support to the overall rate of economic growth in the coming months. This tends to confirm that the MPC was right to start on a cautious increase in Bank Rate in August as it views wage inflation in excess of 3% as increasing inflationary pressures within the UK economy.
- In the **political arena**, there is a risk that the current Conservative minority government may be unable to muster a majority in the Commons over Brexit. However, our central position is that Prime Minister May's government will endure, despite various setbacks, along the route to reaching an orderly Brexit in March 2019. If, however, the UK faces a general election in the next 12 months, this could result in a potential loosening of monetary and fiscal policy and therefore medium to longer dated gilt yields could rise on the expectation of a weak pound and concerns around inflation picking up.
- **USA.** President Trump's massive easing of fiscal policy is fuelling a, (temporary), boost in consumption which has generated an upturn in the rate of strong growth which rose from 2.2%, (annualised rate), in quarter 1 to 4.2% in quarter 2 and 3.5%, (3.0% y/y), in quarter 3, but also an upturn in inflationary pressures. The strong growth in employment numbers and the reduction in the unemployment rate to 3.9%, near to a recent 49 year low, has fed through to an upturn in wage inflation which hit 3.2% in November, However, CPI inflation overall fell to 2.2% in November and looks to be on a falling trend to drop below the Fed's target of 2% during 2019. The Fed has continued on its series of increases in interest rates with another 0.25% increase in December to between 2.25% and 2.50%, this being the fifth increase in 2018 and the ninth in this cycle. However, they did also reduce their forecast for further increases from three to two. This latest increase compounded investor fears that the Fed is over doing the rate and level of increases in rates and that it is going to cause a US recession as a result. There is also much evidence in previous monetary policy cycles, of the Fed's series of increases doing exactly that. Consequently, we have seen stock markets around the world

plunging under the weight of fears around the Fed's actions, the trade war between the US and China, an expectation that world growth will slow, Brexit etc.

- The tariff war between the US and China has been generating a lot of heat during 2018, but it is not expected that the current level of actual action would have much in the way of a significant effect on US or world growth. However, there is a risk of escalation if an agreement is not reached soon between the US and China.
- **Eurozone.** Growth was 0.4% in quarters 1 and 2 but fell back to 0.2% in quarter 3, though this was probably just a temporary dip. In particular, data from Germany has been mixed and it could be negatively impacted by US tariffs on a significant part of manufacturing exports e.g. cars. For that reason, although growth is still expected to be in the region of nearly 2% for 2018, the horizon is less clear than it seemed just a short while ago. Having halved its quantitative easing purchases of debt in October 2018 to €15bn per month, the European Central Bank ended all further purchases in December 2018. The ECB is forecasting inflation to be a little below its 2% top limit through the next three years so it may find it difficult to warrant a start on raising rates by the end of 2019 if the growth rate of the EU economy is on a weakening trend.
- **China.** Economic growth has been weakening over successive years, despite repeated rounds of central bank stimulus; medium term risks are increasing. Major progress still needs to be made to eliminate excess industrial capacity and the stock of unsold property, and to address the level of non-performing loans in the banking and credit systems. Progress has been made in reducing the rate of credit creation, particularly from the shadow banking sector, which is feeding through into lower economic growth. There are concerns that official economic statistics are inflating the published rate of growth.
- **Japan** - has been struggling to stimulate consistent significant GDP growth and to get inflation up to its target of 2%, despite huge monetary and fiscal stimulus. It is also making little progress on fundamental reform of the economy. It is likely that loose monetary policy will endure for some years yet to try to stimulate growth and modest inflation.
- **Emerging countries.** Argentina and Turkey are currently experiencing major headwinds
- and are facing challenges in external financing requirements well in excess of their reserves of foreign exchange. However, these countries are small in terms of the overall world economy, (around 1% each), so the fallout from the expected recessions in these countries will be minimal.
- **INTEREST RATE FORECASTS**
- The interest rate forecasts provided by Link Asset Services in paragraph 3.2 are predicated on an assumption of an agreement being reached on Brexit between the UK and the EU. In the event of an orderly non-agreement exit, it is likely that the Bank of England would take action to cut Bank Rate from 0.75% in order to help economic growth deal with the adverse effects of this situation. This is also likely to cause short to medium term gilt yields to fall. If there was a disorderly Brexit, then any cut in Bank Rate would be likely to last for a longer period and also depress short and medium gilt yields correspondingly. It is also possible that the government could act to protect economic growth by implementing fiscal stimulus.
- **The balance of risks to the UK**
  - The overall balance of risks to economic growth in the UK is probably neutral.
  - The balance of risks to increases in Bank Rate and shorter term PWLB rates, are probably also even and are broadly dependent on how strong GDP growth turns out, how slowly inflation pressures subside, and how quickly the Brexit negotiations move forward positively.
- One risk that is both an upside and downside risk, is that all central banks are now working in very different economic conditions than before the 2008 financial crash as there has been a major increase in consumer and other debt due to the exceptionally low levels of borrowing rates that have prevailed for ten years since 2008. This means that the neutral rate of interest in an economy, (i.e. the rate that is neither expansionary nor deflationary), is difficult to determine definitively in this new environment, although central banks have made statements that they expect it to be much lower than before 2008. Central banks could therefore either over or under do increases in central interest rates.

- **Downside risks to current forecasts for UK gilt yields and PWLB rates currently include:**
  - **Brexit –** if it were to cause significant economic disruption and a major downturn in the rate of growth.
  - **Bank of England monetary policy** takes action too quickly, or too far, over the next three years to raise Bank Rate and causes UK economic growth, and increases in inflation, to be weaker than we currently anticipate.
  - A resurgence of the **eurozone sovereign debt crisis**, possibly in **Italy**, due to its high level of government debt, low rate of economic growth and vulnerable banking system, and due to the election in March of a government which has made a lot of anti-austerity noise. The EU rejected the initial proposed Italian budget and demanded cuts in government spending which the Italian government initially refused. However, a fudge was subsequently agreed, but only by *delaying* the planned increases in expenditure to a later year. This can has therefore only been kicked down the road to a later time. The rating agencies have started on downgrading Italian debt to one notch above junk level. If Italian debt were to fall below investment grade, many investors would be unable to hold it. Unsurprisingly, investors are becoming increasingly concerned by the words and actions of the Italian government and consequently, Italian bond yields have risen – at a time when the government faces having to refinance large amounts of debt maturing in 2019.
  - Weak capitalisation of some **European banks**. Italian banks are particularly vulnerable; one factor is that they hold a high level of Italian government debt - debt which is falling in value. This is therefore undermining their capital ratios and raises the question of whether they will need to raise fresh capital to plug the gap.
  - **German minority government.** In the German general election of September 2017, Angela Merkel's CDU party was left in a vulnerable minority position dependent on the fractious support of the SPD party, as a result of the rise in popularity of the anti-immigration AfD party. Then in October 2018, the results of the Bavarian and Hesse state elections radically undermined the SPD party and showed a sharp fall in support for the CDU. As a result, the SPD is reviewing whether it can continue to support a coalition that is so damaging to its electoral popularity. After the result of the Hesse state election, Angela Merkel announced that she would not stand for re-election as CDU party leader at her party's convention in December 2018, (a new party leader has now been elected). However, this makes little practical difference as she is still expected to aim to continue for now as the Chancellor. However, there are five more state elections coming up in 2019 and EU parliamentary elections in May/June; these could result in a further loss of electoral support for both the CDU and SPD which could also undermine her leadership.
  - **Other minority eurozone governments.** Spain, Portugal, Ireland, the Netherlands and Belgium all have vulnerable minority governments dependent on coalitions which could prove fragile. Sweden is also struggling to form a government due to the anti-immigration party holding the balance of power, and which no other party is willing to form a coalition with. The Belgian coalition collapsed in December 2018 but a minority caretaker government has been appointed until the May EU wide general elections.
  - **Austria, the Czech Republic and Hungary** now form a strongly anti-immigration bloc within the EU while **Italy,** in 2018, also elected a strongly anti-immigration government. Elections to the EU parliament are due in May/June 2019.
  - Further increases in interest rates in the US could spark a **sudden flight of investment funds** from more risky assets e.g. shares, into bonds yielding a much improved yield. Throughout the last quarter of 2018, we saw sharp falls in equity markets interspersed with occasional partial rallies. Emerging countries which have borrowed heavily in dollar denominated debt, could be particularly exposed to this risk of an investor flight to safe havens e.g. UK gilts.
  - There are concerns around the level of **US corporate debt** which has swollen massively during the period of low borrowing rates in order to finance mergers and acquisitions. This has resulted in the debt of many large corporations being downgraded to a BBB credit rating, close to junk status. Indeed, 48% of total investment grade corporate debt is now

rated at BBB. If such corporations fail to generate profits and cash flow to reduce their debt levels as expected, this could tip their debt into junk ratings which will increase their cost of financing and further negatively impact profits and cash flow.

- **Geopolitical risks,** especially North Korea, but also in Europe and the Middle East, which could lead to increasing safe haven flows.

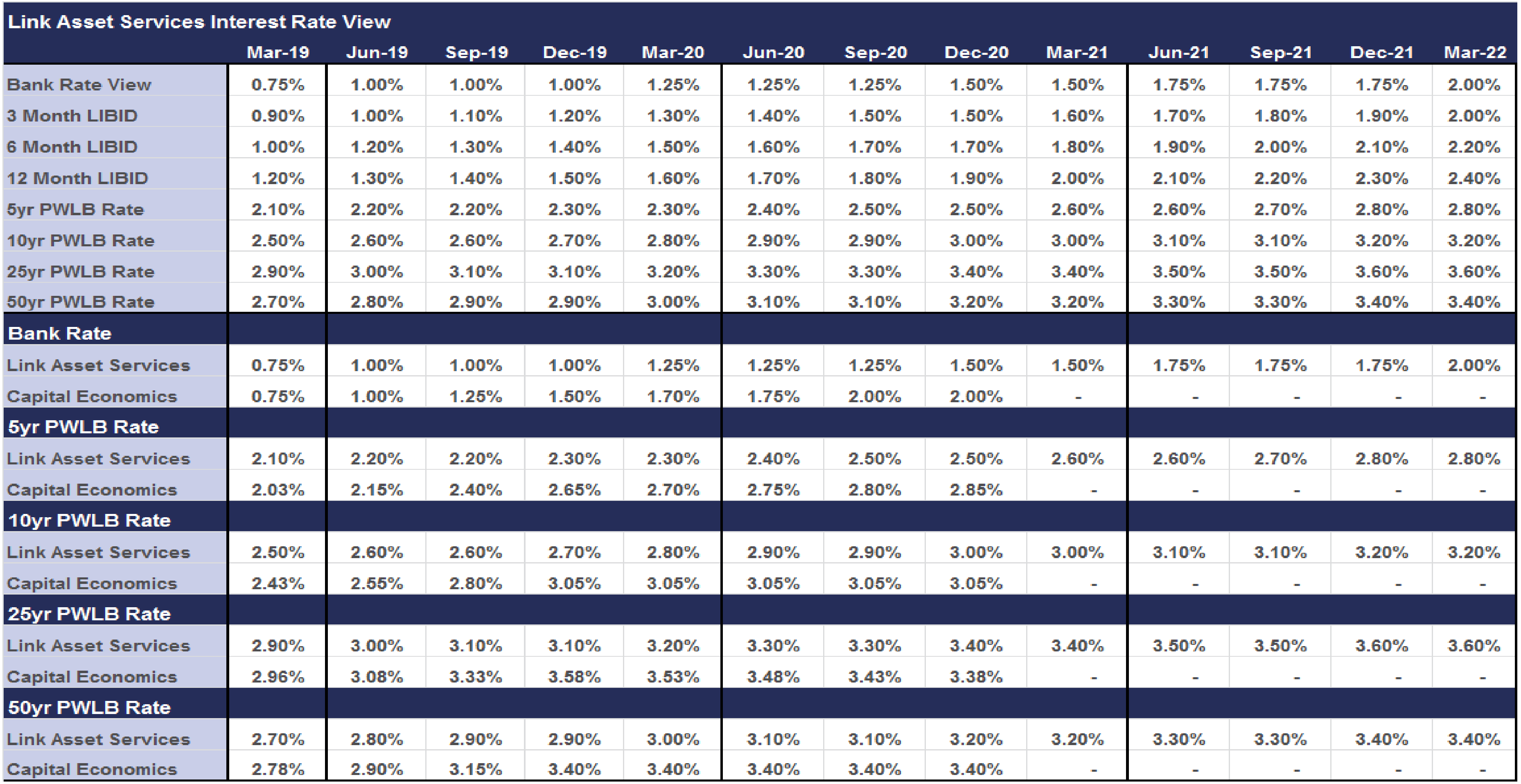
- **Upside risks to current forecasts for UK gilt yields and PWLB rates**
  - **Brexit –** if both sides were to agree a compromise that removed all threats of economic and political disruption.
  - **The Fed causing a sudden shock in financial markets** through misjudging the pace and strength of increases in its Fed Funds Rate and in the pace and strength of reversal of QE, which then leads to a fundamental reassessment by investors of the relative risks of holding bonds, as opposed to equities. This could lead to a major flight from bonds to equities and a sharp increase in bond yields in the US, which could then spill over into impacting bond yields around the world.
  - The **Bank of England is too slow** in its pace and strength of increases in Bank Rate and, therefore, allows inflation pressures to build up too strongly within the UK economy, which then necessitates a later rapid series of increases in Bank Rate faster than we currently expect.
  - **UK inflation,** whether domestically generated or imported, returning to sustained significantly higher levels causing an increase in the inflation premium inherent to gilt yields.

Interest Rate Forecasts

Appendix P (2)

Interest Rate Forecasts 2019 – 2022

PWLB rates and forecast shown below have taken into account the 20 basis point certainty rate reduction effective as of the 1st November 2012.



Link Asset Services Interest Rate View	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22
Bank Rate View	0.75%	1.00%	1.00%	1.00%	1.25%	1.25%	1.25%	1.50%	1.50%	1.75%	1.75%	1.75%	2.00%
3 Month LIBID	0.90%	1.00%	1.10%	1.20%	1.30%	1.40%	1.50%	1.50%	1.60%	1.70%	1.80%	1.90%	2.00%
6 Month LIBID	1.00%	1.20%	1.30%	1.40%	1.50%	1.60%	1.70%	1.70%	1.80%	1.90%	2.00%	2.10%	2.20%
12 Month LIBID	1.20%	1.30%	1.40%	1.50%	1.60%	1.70%	1.80%	1.90%	2.00%	2.10%	2.20%	2.30%	2.40%
5yr PWLB Rate	2.10%	2.20%	2.20%	2.30%	2.30%	2.40%	2.50%	2.50%	2.60%	2.60%	2.70%	2.80%	2.80%
10yr PWLB Rate	2.50%	2.60%	2.60%	2.70%	2.80%	2.90%	2.90%	3.00%	3.00%	3.10%	3.10%	3.20%	3.20%
25yr PWLB Rate	2.90%	3.00%	3.10%	3.10%	3.20%	3.30%	3.30%	3.40%	3.40%	3.50%	3.50%	3.60%	3.60%
50yr PWLB Rate	2.70%	2.80%	2.90%	2.90%	3.00%	3.10%	3.10%	3.20%	3.20%	3.30%	3.30%	3.40%	3.40%
Bank Rate													
Link Asset Services	0.75%	1.00%	1.00%	1.00%	1.25%	1.25%	1.25%	1.50%	1.50%	1.75%	1.75%	1.75%	2.00%
Capital Economics	0.75%	1.00%	1.25%	1.50%	1.70%	1.75%	2.00%	2.00%	-	-	-	-	-
5yr PWLB Rate													
Link Asset Services	2.10%	2.20%	2.20%	2.30%	2.30%	2.40%	2.50%	2.50%	2.60%	2.60%	2.70%	2.80%	2.80%
Capital Economics	2.03%	2.15%	2.40%	2.65%	2.70%	2.75%	2.80%	2.85%	-	-	-	-	-
10yr PWLB Rate													
Link Asset Services	2.50%	2.60%	2.60%	2.70%	2.80%	2.90%	2.90%	3.00%	3.00%	3.10%	3.10%	3.20%	3.20%
Capital Economics	2.43%	2.55%	2.80%	3.05%	3.05%	3.05%	3.05%	3.05%	-	-	-	-	-
25yr PWLB Rate													
Link Asset Services	2.90%	3.00%	3.10%	3.10%	3.20%	3.30%	3.30%	3.40%	3.40%	3.50%	3.50%	3.60%	3.60%
Capital Economics	2.96%	3.08%	3.33%	3.58%	3.53%	3.48%	3.43%	3.38%	-	-	-	-	-
50yr PWLB Rate													
Link Asset Services	2.70%	2.80%	2.90%	2.90%	3.00%	3.10%	3.10%	3.20%	3.20%	3.30%	3.30%	3.40%	3.40%
Capital Economics	2.78%	2.90%	3.15%	3.40%	3.40%	3.40%	3.40%	3.40%	-	-	-	-	-

Investment Risk Matrix **APPENDIX P (3)**

Specified Investments – All such investments will be sterling denominated, with **maturities up to a maximum of 1 year**, meeting the minimum 'high' quality criteria where applicable.

Non-Specified Investments – These are investments that do not meet the specified investment criteria. A limit of the lesser of £20m or 50% of the portfolio will be held in aggregate in non-specified investments.

A variety of investment instruments may be used that will fall into one of the above categories, subject to the credit quality of the institution. The criteria, time limits and monetary limits applying to institutions or investment vehicles are:

Organisation	**Min. Credit Criteria**	**Money Limit**	**Maturity Limit**
Banks and Building Societies (including term deposits, CDs or corporate bonds)	Yellow	£10m	5 years
	Purple	£10m	2 years
	Orange	£10m	1 year
	Blue	£10m	1 year
	Red	£7.5m	6 months
	Green	£5.0m	100 days
	No colour	Not to be used	
UK Government Gilts	UK sovereign rating	£10m	1 year
UK Government Treasury Bills	UK sovereign rating	£10m	1 year
UK Local & Police Authorities	N/A	Unlimited	1 year
Debt Management Agency Deposit Facility	AAA	Unlimited	6 months
Money Market Funds	AAA	£10m	Liquid
Ultra-Short Dated Bond Funds	Dark Pink / Light Pink / AAA	£10m	Liquid
Bonds issued by Multilateral Development Banks	AAA	£3m	6 months
Property Funds	AAA	£5m	

Notes:

- Non U.K. country limit of £15m
- Limit in all Building Societies of £10m

The use of property funds can be deemed capital expenditure, and as such will be an application of capital resources. The Council will seek guidance on the status of any fund it may consider using. Appropriate due diligence will also be undertaken before investment of this type is undertaken.

The criteria in this appendix are intended to be the operational criteria in normal times. At times of heightened volatility, risk and concern in financial markets, this strategy may be amended by temporary operational criteria further limiting investments to counterparties of a higher creditworthiness and / or restricted time limits.

Sovereign Credit Rating Appendix P (4)

This list is based on those countries that have sovereign rating of AA- or higher and also have banks operating in sterling markets, which have high credit ratings of green or above in the Link Asset Services credit worthiness service.

- ***Based on lowest available rating***
    - AAA
        - Australia
        - Canada
        - Denmark
        - Germany
        - Luxembourg
        - Netherlands
        - Norway
        - Singapore
        - Sweden
        - Switzerland
    - AA+
        - Finland
        - U.S.A.
    - AA
        - Abu Dhabi (UAE)
        - France
        - Hong Kong
        - U.K.
    - AA-
        - Belgium
        - Qatar

Updated as at 9.1.2019