Colchester

Governance and Audit Committee

Item 13

13 November 2018

Report of	**Assistant Director Policy and Corporate**	**Author**	**Margaret Donaldson** ☏ **282338**
Title	**Treasury Management Strategy - Mid Year Review Report 2018/19**		
Wards affected	Not applicable		

1. Executive Summary

1.1 In line with the Treasury Management governance arrangements detailed in the 2018/19 Treasury Management Strategy Statement(TMSS) and associated practices, as approved by Council on 21 February 2018; this report provides a mid-year review of the Council's treasury management arrangements for the period to 30 September 2018.

1.2 The report in order to comply with CIPFA's Code of Practice on Treasury Management covers the following:

- a brief economic update for the first part of the 2018/19 financial year,
- a review of the key elements of the TMSS and annual investment strategy,
- a review of the Council's treasury management prudential indicators,
- a review of the Council's borrowing strategy, and
- details of the areas to be taken into consideration in preparing the 2019/20 TMSS and related practices.

2. Recommended Decision

2.1 To note the report and recommend to Cabinet that no changes are made to the Council's Treasury management Strategy Statement for 2018/19 and associated practices as a result of the review. Further review will be undertaken as part of the preparation of the 2019/20 Treasury management Strategy Statement.

3. Reason for Recommended Decision

3.1 In line with Treasury Management governance arrangements Members are required to consider a mid-year Treasury Management report.

4. Alternative Options

4.1 Alternative options regarding treasury management activities are considered on an ongoing basis, in consultation with the Council's Treasury Advisors, Link Asset Services.

5. Introduction

5.1 The Council operates a balanced budget in line with statutory requirements. This broadly means that in year income meets the Council's spending requirements.

5.2 Treasury Management operations ensure:

- that cashflow is adequately planned, with surplus monies being invested in line with the Council's Treasury Management Policies and Practices and the Council's risk appetite for investments and borrowing
- that the Council's capital plans are fully funded, treasury management practices supporting the requirement for long term cashflow planning and supporting the Council's need to borrow.

5.3 Local Authorities are required under statute to self-regulate on the affordability, prudence and sustainability of its capital investment plans and borrowing through a process of setting estimates, indicators and the Council's overall risk appetite; and reporting on these on a regular basis.

5.4 Treasury Management is defined as ' the management of the Council's borrowing, investments and cash flows, its banking, money market and capital market transactions; the effective control of risks associated with these activities; and the pursuit of optimum performance consistent with those risks.'

5.5 The management of the Council's treasury management processes is supported by Treasury Management Practices and the Council employs Link Asset Services to provide specialist consultancy in respect of treasury management, especially with regards to investments and debt, as well as capital accounting arrangements and asset finance.

5.6 In line with statutory requirements the Council has adopted the Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management (revised 2017). This mid year position report complies with the Code.

6 Economic Update

6.1 The economic forecast remains difficult with numerous external influences impacting on the UK economy. A recent update provided by the Council's Treasury advisors, concludes the following over the next three years based on a level risk analysis:

- moderate levels of growth of 1.5% for 2018, increasing to 1.8% in 2019;
- inflation increased to 2.7% in August 2018, but is expected to fall back to the 2% national target over the next two years;
- unemployment continues at a 43 year low of 4%, with indications that employers are finding it difficult to recruit suitable staff; which could lead to wage inflation and a potential spur in increased household spending.
- the bank rate currently stands at 0.75%, with the Monetary Policy Committee (MPC) forecasting a gradual increase in the bank rate to 2.5% over the next ten years.
- a general election in the next 12 months could result in a loosening of monetary policy, expectations of a weak pound and an inflationary pick up; and
- the world economic outlook continues to dampen growth.

6.2 The forecast detailed in the previous paragraph is dependent on the UK's orderly withdrawal from the EU in March 2019.

6.3 Full details of the Council's Treasury Advisors economic analysis is included at **Appendix A** to this report, for further reference.

7 Treasury Management Strategy 2018/19

7.1 The Council's Treasury Management Strategy Statement 2018/19 as approved by Council on 21 February 2018, included the following key elements:

- the Council continues to maintain an under borrowed position. That is continuing to borrow internally, reducing the cost of carry as investment rates on offer currently are substantially below long term borrowing rates. This also has the advantage of reducing the Council's exposure to credit risk and improving the Council's scope to diversify high creditworthy counterparties, by reducing the level of investment balances available to invest and diversify.
- the Council's investment policy reflects a low appetite for risk; emphasising the priorities of security and liquidity over yield.
- the suggested budgeted return on investments placed for periods up to 100 days in the year is 0.6%.
- that the Council complies with the CIPFA Prudential and Treasury Management Codes (Revised 2017); in relation to setting of capital plans, setting and reporting on prudential indicators, evaluation of the General Fund MRP and other related governance guidance.

7.2 It is proposed that no changes are made to the Treasury Management Strategy as part of this mid-year review.

8 The Council's Capital Position and Prudential Indicators

8.1 This part of the report is structured to provide an update on the following, in line with the requirements of the relevant codes of practice:

- The Council's capital expenditure plans;
- How these plans are being financed;
- The impact of changes to the Council's capital plans on prudential Indicators and the underlying need to borrow; and
- Compliance with the limits on borrowing activity.

8.2 *Prudential Indicator for Capital Expenditure*
The table below identifies the revised 2018/19 capital programme forecast since the original capital budget was approved by Council in February 2018. A review of the capital programme is due to be reported to Scrutiny Panel at the end of November and as such the figures reported here may change:

Capital Expenditure 2018/19	Original Estimate £'000	Spend to End of September 2018 £'000	Revised Estimate £'000
General Fund capital expenditure	29,416	3,852	41,712
HRA capital expenditure	9,188	3,872	12,808
Total capital expenditure	38,604	7,724	54,520

8.3 The material changes between the Original capital expenditure forecast and the Revised estimate are as follows:

- The inclusion of the Mercury Theatre Redevelopment Phase 2
- Disabled Facilities and Private Sector Renewal grants budget were increased to reflect Central Governments grant allocation of £1.2m;
- The Northern Gateway Heat Network scheme has been profiled and an estimated budget of £3.0m has been included for 2018/19;
- The Housing Revenue Account (HRA) capital budget, includes an additional budget of £1.5m for the buyback of Right to Buy properties, as approved by Cabinet in July 2018; and
- The Revised estimate includes scheme slippage from 2017/18 and the inclusion of schemes which are fully funded from external sources (for example S106 receipts and Grants).

8.4 *Changes to the Financing of the Capital Programme*

The expected funding arrangements in relation to the proposed capital programme for 2018/19 are detailed below. The borrowing element of the table will increase the underlying indebtedness of the Council (the Capital Financing Requirement – CFR), although this will be reduced in part by revenue charges for the repayment of debt (Minimum Revenue Provision - MRP) and may also be supplemented by maturing debt and other treasury requirements.

Capital Expenditure 2018/19	**Original Estimate £'000**	**Spend to End of September 2018 £'000**	**Revised Estimate £'000**
General Fund capital expenditure	29,416	3,852	41,712
HRA capital expenditure	9,188	3,872	12,808
Total capital expenditure	38,604	7,724	54,520
Resourced by:			
· Capital receipts	15,818	1,010	6,557
· Capital grants	3,436	873	12,078
· Capital reserves	3,634	0	0
· Finance Leases	0	0	0
· Revenue	5,454	5,177	14,177
New borrowing requirement	10,262	665	21,708

8.5 *Capital Financing Requirement*
The following table shows the CFR, the Council's underlying need to borrow for capital purposes

CFR 2018/19	Original Estimate £'000	Current Position £'000	Revised Estimate £'000
Opening balance	155,435	154,597	154,597
Add unfinanced capital expenditure (as above)	10,262	665	21,708
Add on-balance sheet leasing schemes	0	0	0
Write-off of finance lease creditor	0	0	0
Less MRP/VRP	1,745	1,745	1,745
Closing balance	**163,952**	**153,517**	**174,560**

It is forecast that the CFR will increase to £175m as a result of the estimated temporary borrowing requirements for the following schemes in 2018/19

- Colchester northern Gateway North – Sports Hub – 2018/19 borrowing requirement £9.380m as reported to Cabinet in October 2018,
- Northern Gateway Heat Network - 2018/19 borrowing requirement £1.314m, and
- Town Centre Regeneration – £0.95m

These requirements reflect temporary medium term borrowing for upfront costs prior to the generation of capital receipts.

8.6 *Limits to Borrowing Activity*
Councils' have responsibility to ensure that over the medium term net borrowing (borrowing less investments) will only be for capital purposes. Gross external debt should not, except in the short term, exceed the CFR in the preceding year plus any additional CFR for 2018/19 and the next two financial years. This allows early flexibility for limited early borrowing for future years. The Council has approved a policy for borrowing in advance of need which will be adhered to if this proves prudent.

Limits to Borrowing activity 2018/19	**Original Estimate £'000**	**Current Position £'000**	**Revised Estimate £'000**
Gross Debt 1 April	143,627	144,282	144,282
Borrowing in Year	10,262	665	10,262
Other Long Term Liabilities	1,383	1,383	1,383
Gross Debt 31 March	**155,272**	**146,330**	**155,927**
CFR	**163,952**	**153,517**	**174,560**
Under/(Over) Borrowing Position	**8,680**	**7,187**	**18,633**

The Council is expected to be in an under borrowed position compared to its CFR at the end of 2018/19, in line with the Treasury Management Strategy and can demonstrate that borrowing is for capital investment purposes.

8.7 Following on from the estimated gross debt calculation for 2018/19, the Operational Boundary is the limit against which external debt is not normally expected to exceed.

	Original	**Current**	**Revised**
	Estimate	**Position**	**Estimate**
Limits to Borrowing Activity 2018/19	**£'000**	**£'000**	**£'000**
Operational Boundary	159,613	146,330	159,613

In line the requirement for increased borrowing in year as detailed at paragraph 8.5, it is recommended that the Councils' Operational Boundary for 2018/19 remains in line with the original limit.

8.8 A further prudential indicator evaluates the overall level of borrowing, the Authorised Limit, a statutory limit determined under section3 (1) of the Local Government Act 2003. The indicator represents the limit beyond which borrowing is prohibited, it reflects the level of borrowing although not desired could be afforded in the short term; but is not sustainable in the long term. It is the expected maximum borrowing limit with some headroom for unexpected movements. The indicator is calculated and revised annually as part of the Treasury Management Strategy update, to reflect business strategy changes impacting on the Council's capital investment programme and therefore cash flow in the medium term.

8.9 The Treasury Management Strategy set the Council's Authorised limit at £180.252m for 2018/19, based on the revised forecast spend and borrowing needs for 2018/19; the limit will not be breached in 2018/19.

9 Investment Portfolio 2018/19

9.1 In accordance with the Prudential Code, the Council is required to ensure that the security and liquidity of its investments take priority over the level of return. As detailed at paragraph 5, it is a very difficult investment market in terms of earning the returns commonly experienced decades ago. Investments rates are low and in line with the current bank rate. There is also potential for the re-emergence of a Eurozone sovereign debt crisis and its impact on banks prompts a low risk and short term strategy for investment. Investment returns are likely to remain low in the medium term.

9.2 The Council held £59.2m of investments as at 30th September 2018(£45.236m as at 31 March 2017).

9.3 A full list of investments is listed at Appendix B (confidential section of the Agenda).

9.4 In comparison to the Council's investment structure as at 31st March 2018, investments with Local Authorities represents 23% of the portfolio compared to 27% as at 31st March 2018. Local Authorities are offering competitive returns for high credit standing organisations. Despite the ongoing financial pressures on Local Authorities to reduce budgets and transform services in the long term; the credit standing of Local Authorities remains high due to statutory requirements (Balanced budget requirement, Treasury Management and Prudential Codes, Statutory Investment guidance and Local Authorities can only be created or discontinued by statutory prescription). In addition despite the financial challenges faced by many Local Authorities

CIPFA/LASAAC concluded that Local Authority accounts should be prepared on a ‘going concern’ basis. However, consideration will also be given to the diversity of the Council’s investment portfolio when considering investment options with other Local Authorities.

9.5 As at 30 September 2018, the Council’s investment portfolio closely mirrored the profile recommended for the Council by its Treasury Advisors.

9.6 The Director of Finance confirms that the approved limits within the Annual Investment Strategy were not breached during the first six months of the year.

9.7 The Council’s budgeted investment return for 2018/19 is £0.264m and investment returns are on target to achieve, both the annual budget and the benchmark rate of return.

9.8 The current investment counterparty criteria selection approved in the Treasury Management Strategy is meeting the requirement of the treasury management function.

10 Borrowing

10.1 The Council is forecast to have borrowings of £155,927m at the end of the financial year, with the expectation of utilising £18,633m of cash flow funds in lieu of borrowing to fund the capital programme. This is prudent and cost effective approach in the current economic climate.

9.2 As detailed at paragraph 8.5 and 8.6 further borrowing of c£10m is anticipated during this financial year. This level of borrowing is dependent on timing of a number of capital projects, such as the lending to the housing company in respect of the agreed housing development plans. As such, it remains possible that the Council may borrow less than this in this financial year.

9.3 The Council once again applied to HM Treasury for the PWLB certainty rate for the period 1 November 2018 to 31 October 2019. This enables the Council to borrow at 2 base points below the PWLB rate during the relevant period.

11 Other

*10.*1 *UK Banks - ring fencing*
With effect from 1 January 2019, the largest UK banks are required by law to separate core retail banking services from their investment and international banking activities; this is to improve the resilience and resolvability of banks. This will not change the fundamentals of credit assessment which the Council relies on to evaluate investments.

10.2 *Accounting standard changes to Financial Instruments*
A revised accounting standard came into effect on 1 April 2018 in relation to the Accounting for Financial Instruments (Investment and borrowing).The change has been implemented to ensure any market value changes will impact on the Income and Expenditure statement rather being held on the balance sheet. An initial assessment has been made of the required accounting changes and the impact for the Council’s revenue account is immaterial. The assessment will be considered by the Council’s external auditors in December 2018.

10.3 *Changes to risk appetite*
Guidance on investment from the Ministry for Housing, Communities and Local Government and CIPFA’s Codes of Practice on Treasury Management and Prudential Indicators have enhanced the importance of risk management both in terms of treasury investments and non-treasury investments(investment properties, lending to third

parties, etc.) The Treasury Management and Capital Strategy for 2019/20 onwards will be required to identify the Council's risk appetite for both treasury activities and non-treasury investments.

10.4 *HRA Debt Repayment*

As a result of the Governments "Re-invigorating the Right To Buy" policy in 2012, Councils are selling more properties than Government assumed as part of the original HRA Reform debt settlement in April 2012. The Government therefore introduced a system which shares capital receipts. Part of this sharing enables Councils to re-invest capital receipts in the replacement of these additional sales (namely 1-4-1 RTB receipts). It also allows Councils to retain a proportion of capital receipts to reduce HRA debt, which are held in a separate reserve. The logic being that each property in the HRA supports the overall level of HRA debt through its net rental income (excess of rental income over running costs). Therefore, if debt wasn't reduced, it would mean the HRA Business Plan would have debt but without the necessary number of dwellings to service that debt as a result of their sale. Therefore by reducing debt, the interest costs payable would be reduced and the Council is able to maintain existing levels of services to tenants and leaseholders. Put another way, if the Council did not reduce our debt, an increasing proportion of tenants' rental income would be spent on interest costs, with a decreasing proportion being spent on existing services.

The next opportunity to repay debt is in May 2020, when a £17.6million loan matures. It's prudently assumed that there will be £5million in the debt repayment reserve at that point in time. The Council's Treasury Management Strategy for 2019/20 will take into consideration the Council's options in relation to the repayment of HRA debt.

10.5. It should also be noted that the recent decision to remove the HRA borrowing cap will allow the Council to consider borrowing to support new council house building.

11. Standard References

11.1 There are no particular references to the Strategic Plan; consultation; or publicity consideration; community safety; health and safety implications.

12. Financial implications

12.1 As set out in the body of this report.

13. Risk Management Implications

13.1 The Council's Treasury Management Strategy supported by the Treasury Management Practices, reflects the council's low risk appetite for treasury management investments; in line with the current economic outlook. The mid-year review provides the opportunity to report and review on the practices for the first six months of the financial year against the Council's strategy and take remedial action as required.

Appendices

Appendix A – Economic Update from Link Asset Services
Appendix B – Confidential paper

Background Papers

Appendix A

Economics and interest rates - Link Asset Services Advice

Economics update

UK. The first half of 2018/19 has seen UK **economic growth** post a modest performance, but sufficiently robust for the Monetary Policy Committee, (MPC), to unanimously (9-0) vote to increase **Bank Rate** on 2nd August from 0.5% to 0.75%. Although growth looks as if it will only be modest at around 1.5% in 2018, the Bank of England's August Quarterly Inflation Report forecast that growth will pick up to 1.8% in 2019, albeit there were several caveats – mainly related to whether or not the UK achieves an orderly withdrawal from the European Union in March 2019.

Some MPC members have expressed concerns about a build-up of **inflationary pressures**, particularly with the pound falling in value again against both the US dollar and the Euro. The Consumer Price Index (CPI) measure of inflation rose unexpectedly from 2.4% in June to 2.7% in August due to increases in volatile components, but is expected to fall back to the 2% inflation target over the next two years given a scenario of minimal increases in Bank Rate. The MPC has indicated Bank Rate would need to be in the region of 1.5% by March 2021 for inflation to stay on track. Financial markets are currently pricing in the next increase in Bank Rate for the second half of 2019.

As for the **labour market,** unemployment has continued at a 43 year low of 4% on the Independent Labour Organisation measure. A combination of job vacancies hitting an all-time high in July, 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 2.9%, (3 month average regular pay, excluding bonuses) and to a one month figure in July of 3.1%. This meant that in real terms, (i.e. wage rates higher than CPI inflation), earnings grew by about 0.4%, near to the joint high of 0.5% since 2009. (The previous high point was in July 2015.) Given the UK economy is very much services sector driven, an 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 were 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. However, the MPC will need to tread cautiously before increasing Bank Rate again, especially given all the uncertainties around Brexit.

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 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 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, but also an upturn in inflationary pressures. With inflation moving towards 3%, the Fed increased rates another 0.25% in September to between 2.00% and 2.25%, this being four increases in 2018, and indicated they expected to increase rates four more times by the end of 2019. The dilemma, however, is what to do when the temporary boost to consumption wanes, particularly as the recent imposition of tariffs on a number of countries' exports to the US, (China in particular), could see a switch to US production of some of those goods, but at higher prices. Such a scenario would invariably make any easing of monetary policy harder for the Fed in the second half of 2019.

EUROZONE. Growth was unchanged at 0.4% in quarter 2, but has undershot early forecasts for a stronger economic performance in 2018. 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 2% for 2018, the horizon is less clear than it seemed just a short while ago.

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.

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.

Interest rate forecasts

The Council's treasury advisor, Link Asset Services, has provided the following forecast:

Link Asset Services Interest Rate View											
	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21
Bank Rate View	0.75%	0.75%	0.75%	0.75%	1.00%	1.00%	1.00%	1.25%	1.25%	1.50%	1.50%
3 Month LIBID	0.75%	0.80%	0.80%	0.90%	1.10%	1.10%	1.20%	1.40%	1.50%	1.60%	1.60%
6 Month LIBID	0.85%	0.90%	0.90%	1.00%	1.20%	1.20%	1.30%	1.50%	1.60%	1.70%	1.70%
12 Month LIBID	1.00%	1.00%	1.00%	1.10%	1.30%	1.30%	1.40%	1.60%	1.70%	1.80%	1.80%
5yr PWLB Rate	2.00%	2.00%	2.10%	2.20%	2.20%	2.30%	2.30%	2.40%	2.50%	2.50%	2.60%
10yr PWLB Rate	2.40%	2.50%	2.50%	2.60%	2.70%	2.70%	2.80%	2.90%	2.90%	3.00%	3.10%
25yr PWLB Rate	2.80%	2.90%	3.00%	3.10%	3.10%	3.20%	3.30%	3.30%	3.40%	3.50%	3.50%
50yr PWLB Rate	2.60%	2.70%	2.80%	2.90%	2.90%	3.00%	3.10%	3.10%	3.20%	3.30%	3.30%

The flow of generally positive economic statistics after the end of the quarter ended 30 June meant that it came as no surprise that the MPC came to a decision on 2 August to make the first increase in Bank Rate above 0.5% since the financial crash, to 0.75%. However, the MPC emphasised again, 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 they declined to give a medium term forecast. We do not think that the MPC will increase Bank Rate in February 2019, ahead of the deadline in March for Brexit. We also feel that the MPC is more likely to wait until August 2019, than May 2019, before the next increase, to be followed by further increases of 0.25% in May and November 2020 to reach 1.5%. However, the cautious pace of even these limited increases is dependent on a reasonably orderly Brexit.

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.

Downside risks to current forecasts for UK gilt yields and PWLB rates currently include:

- Bank of England monetary policy takes action too quickly 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 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. This is likely to lead to friction with the EU when setting the target for the fiscal deficit in the national budget. Unsurprisingly, investors have taken a dim view of this and so Italian bond yields have been rising.
- Austria, the Czech Republic and Hungary now form a strongly anti-immigration bloc within the EU while Italy, this year, has also elected a strongly anti-immigration government. In the German general election of September 2017, Angela Merkel's CDU party was left in a vulnerable minority position as a result of the rise of the anti-immigration AfD party. To compound this, the result of the Swedish general election in September 2018 has left an anti-immigration party potentially holding the balance of power in forming a coalition government. The challenges from these political developments could put considerable pressure on the cohesion of the EU and could spill over into impacting the euro, EU financial policy and financial markets.
- The imposition of trade tariffs by President Trump could negatively impact world growth. President Trump's specific actions against Turkey pose a particular risk to its economy which could, in turn, negatively impact Spanish and French banks which have significant exposures to loans to Turkey.
- Weak capitalisation of some European banks.

- Rising interest rates in the US could negatively impact emerging countries which have borrowed heavily in dollar denominated debt, so causing an investor flight to safe havens e.g. UK gilts.

- 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

- President Trump's fiscal plans to stimulate economic expansion causing a significant increase in inflation in the US and causing further sell offs of government bonds in major western countries.
- 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.