Rother District Council

Report to	-	Audit and Standards Committee
Date	-	23 September 2019
Report of the	-	Executive Director
Subject	-	Treasury Management Report – July 2019

Recommendation: It be **RESOLVED:** That the report be noted.

Corporate Transformation Manager – Catherine Jobling
Assistant Director Resources – Robin Vennard

Introduction

1. Council approved the Council's 2019/20 Investment Strategy in February 2019 (minute CB18/66 refers). The investment strategy requires regular reports to be presented to this Committee on the Council's treasury management activities. Members are also reminded that investment activity is also reported through the Members' Bulletin. In managing its treasury management activities, the Council follows the Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management (revised 2017).

2. Treasury Management covers two main areas:-

   i. The management of day to day cash flows by way of short term investing and borrowing. Longer term investment opportunities may arise depending on cashflow requirements.
   ii. Management of the Council's long term debt portfolio which is used to finance capital expenditure that cannot be immediately funded by internal resources (e.g.by using Capital Receipts).

3. The CIPFA (Chartered Institute of Public Finance and Accountancy) Code of Practice for Treasury Management recommends that members be updated on treasury management activities regularly. This report, therefore, ensures this Council is implementing best practice in accordance with the Code.

<u>Economic Update</u>

4. Appendix A is our treasury advisors, Link Asset Services', view on the current economic environment and their outlook for the remainder of 2019/20. It details the impact this is likely to have on the Council's investment performance.

5. After the August 2018 increase in Bank Rate to 0.75%, the first above 0.5% since the financial crash in 2010, the MPC has put any further action on hold, probably until such time as there is some degree of certainty of what the UK will be heading into with Brexit. The above forecast, and other comments in this report, are based on a central assumption that there will be some form of agreement on a reasonable form of Brexit. Bank Rate forecasts will have to

change if this assumption does not materialise e.g. a no deal Brexit on 31 October may prompt the MPC to do an immediate cut of 0.5% in Bank Rate back to 0.25%. All other forecasts for investment and borrowing rates would also have to change.

The balance of risks to the UK

- The overall balance of risks to economic growth in the UK is probably to the downside due to the weight of all the uncertainties over Brexit.
- The balance of risks to increases in Bank Rate and shorter term PWLB rates are broadly similarly to the downside.

Financial Investments review

6. The Council currently makes most of its investments through the use of call and deposit accounts with the major financial UK institutions.

7. In addition to this the Council has invested £5 million in the Churches, Charities, Local Authorities' (CCLA) Property Investment Fund and £3 million in the HERMES Property Investment Fund.

8. As at 31 July 2019 the Council's total investments were £31,796,676. There was £12,045 million of borrowing at 31 July 2019 and the Capital Financing requirement was £16.217 million.

9. The Council's investment policy is governed by Ministry of Housing, Communities and Local Government investment guidance, which has been implemented in the annual investment strategy approved by the Council in February 2019. This policy sets out the approach for choosing investment counterparties, and is based on credit ratings provided by the three main credit rating agencies, supplemented by additional market data, (such as rating outlooks, credit default swaps, bank share prices etc.).

10. The investment activity during the year conformed to the approved strategy, and the Council had no liquidity difficulties.

11. The total income from investments is estimated at £164,819, slightly behind the profiled budget to July 2019 of £170,666, with an average rate of return on investments of 1.64%.

12. The investment portfolio as at 31 July 2019:

Deposit with	Type of account	Maturity Date	Amount £	Deposit	%
Lloyds (RFB)	Call Account		9,793,963	0.65%	30.80%
Bank of Scotland (RFB)	32 Days' notice		2,000,000	0.80%	6.29%
Bank of Scotland (RFB)	Call Account		6	0.65%	0.00%
Barclays (RFB)	Call Account		1,060	0.50%	0.00%
Santander	Call Account		1,649	0.55%	0.01%
Lloyds (RFB)	Deposit	17/01/2020	1,000,000	1.00%	3.14%
Lloyds (RFB)	Deposit	16/08/2019	1,000,000	1.05%	3.14%
Lloyds (RFB)	Deposit	24/04/2020	2,000,000	1.25%	6.29%
Lloyds (RFB)	Deposit	08/05/2020	1,000,000	1.25%	3.14%
Bank of Scotland (RFB)	Deposit	18/09/2019	3,000,000	1.05%	9.43%
Bank of Scotland (RFB)	Deposit	03/02/2020	1,500,000	1.05%	4.72%
Santander	Deposit	15/01/2020	2,500,000	1.00%	7.86%
HERMES Property Fund*	Long Term		2,999,998	2.88%	9.43%
CCLA Local Authority Property Fund*	Long Term		5,000,000	4.33%	15.72%
Total			**31,796,676**		100%

Total managed in-house	23,796,678
Total managed externally	7,999,998
Total Treasury Investments	**31,796,676**

* excludes capital return

13. Appendix B is our treasury advisors, Link Asset Services', view on investment returns. Appendix D is Link Asset Services' Country ratings update.

14. Appendix E contains an update to the Treasury Management Strategy Statement published in February 2019. The amendment is to include credit ratings of 20% of investments invested up to 1 year.

Prudential Indicators

15. During the period to 31 July 2019, the Council complied with its legislative and regulatory requirements. The key actual prudential and treasury indicators detailing the impact of capital expenditure activities to the period ended 31 July 2019, with comparators, are as follows:

Capital Expenditure in £ millions

	2019/20 Original Budget £ (000)	2019/20 Revised Budget £ (000)	2019/20 Estimated Outturn £ (000)
General Fund Services	8,967	11,537	11,537
Investments	12,238	12,488	12,488
Total	21,205	24,025	24,025

Capital financing requirement in £ millions

	2019/20 Budget £ (000)	2019/20 Revised Budget £ (000)	2019/20 Estimated Outturn £'000
CFR	3,650	16,217	16,217
Gross borrowing	2,512	12,046	12,046
Internal borrowing	1,138	4,171	4,171
Investments > 1year	5,000	7,935	7,935
Investments under 1 year	17,000	25,287	17,000
Total	22,000	33,222	24,935
Net Borrowing	(19,488)	(21,176)	(12,889)

16. Other prudential and treasury indicators are to be found in the main body of this report. The Assistant Director Resources (Chief Finance Officer) also confirms that borrowing was only undertaken for a capital purpose and the statutory borrowing limit, the authorised limit, was not breached.

17. The Council undertakes capital expenditure on long-term assets. These activities may either be:

    (a) Financed immediately through the application of capital or revenue resources (capital receipts, capital grants, revenue contributions etc.), which has no resultant impact on the Council's borrowing need; or

    (b) If insufficient financing is available, or a decision is taken not to apply resources, the capital expenditure will give rise to a borrowing need.

18. The actual capital expenditure forms one of the required prudential indicators. The table below shows the actual capital expenditure and how this was financed.

Capital Expenditure and Financing 2019/20

	2019/20 Budget £ (000)	2019/20 Revised Budget £ (000)	2019/20 Estimated Outturn £'000
Capital Expenditure	21,205	24,025	24,025
Financing			
Capital Receipts	1,930	3,198	3198
Grants and contributions	3,847	4,476	4,476
Borrowing	13,758	12,488	12,488
Capital Expenditure Charged to Revenue	1,670	3,863	3863
Total Funding	21,205	24,025	24,025

Borrowing

19. The Council's underlying need to borrow for capital expenditure is termed the Capital Financing Requirement (CFR). The figure is a gauge of the Council's indebtedness. The CFR results from the capital activity of the Council and resources used to pay for the capital spend. It represents the 2019/20 unfinanced capital expenditure (see above table), and prior years' net or

unfinanced capital expenditure which has not been paid for by revenue or other resources.

20. Part of the Council's treasury activities is to address the funding requirements for this borrowing need. Depending on the capital expenditure programme, the treasury service organises the Council's cash position to ensure that sufficient cash is available to meet the capital plans and cash flow requirements. This may be sourced through borrowing from external bodies, such as the Government, through the Public Works Loan Board (PWLB), or the money markets, or utilising temporary cash resources within the Council.

21. The Council's underlying borrowing need (CFR) is not allowed to rise indefinitely. Statutory controls are in place to ensure that capital assets are broadly charged to revenue over the life of the asset. The Council is required to make an annual revenue charge, called the Minimum Revenue Provision (MRP), to reduce the CFR. This is effectively a repayment of the borrowing need. External debt can also be borrowed or repaid at any time, but this does not change the CFR.

22. The total CFR can also be reduced by:

- The application of additional capital financing resources, (such as unapplied capital receipts);or
- Charging more than the statutory revenue charge (MRP) each year through Voluntary Revenue Provision (VRP).

23. The Council's 2019/20 MRP Policy, (as required by MHCLG Guidance), was approved as part of the Treasury Management Strategy Report for 2019/20 in February 2019.

24. The Council's CFR for the year is shown below:

CFR

	2019/20 Budget £ (000)	**2019/20 Revised Budget £ (000)**	**2019/20 Estimated Outturn £'000**
Opening balance	3,650	3,756	3,756
Add unfinanced capital expenditure	16,136	12,488	12,488
Less MRP/VRP	(156)	(27)	(27)
Closing balance	19,630	16,217	16,217

25. Borrowing activity is constrained by prudential indicators for gross borrowing and the CFR, and by the authorised limit.

26. The authorised limit is the "affordable borrowing limit" required by Section 3 of the Local Government Act 2003. Once this has been set, the Council does not have the power to borrow above this level. The table below demonstrates that during 2019/20 the Council plans to maintain gross borrowing within its authorised limit.

Treasury Indicators	Original 2019/20 Budget £'000	Revised ** Actual (Apr to Jul) £'000
Authorised limit for external debt	20,000	57,400
Operational boundary for external debt	10,000	52,000
Gross external debt	12,488	12,046
Investments		33,287
Net borrowing		(21,241)

**As amended by Council 8 July 2019 (Minute ref: C19/29)

27. The operational boundary is the expected borrowing position of the Council during the year. Periods where the actual position is either below or over the boundary are acceptable subject to the authorised limit not being breached.

28. The actual financing costs as a proportion of net revenue stream identifies the trend in the cost of capital, (borrowing and other long term obligation costs net of investment income), against the net revenue stream.

Prudential indicators	2019/20 Budget £'000	2019/20 Estimated Outturn £'000
Capital expenditure charged to the general fund	1,670	3,863
Capital Financing Requirement (CFR)	19,630	16,217
Annual change in CFR	15,980	12,461
In year borrowing requirements	12,488	12,046
Ratio of financing costs to net revenue stream %	2.50%	2.59%

29. During 2019/20, the Council maintained an under-borrowed position. This meant that the capital borrowing need, (the Capital Financing Requirement), was not fully funded with loan debt, as cash supporting the Council's reserves, balances and cash flow was used as an interim measure. This strategy was prudent as investment returns were low and minimising counterparty risk on placing investments also needed to be considered.

30. The Council's treasury management debt and investment position is organised by the treasury management service in order to ensure adequate liquidity for revenue and capital activities, security for investments and to manage risks within all treasury management activities. Procedures and controls to achieve these objectives are well established both through Member reporting detailed

in the summary, and through officer activity detailed in the Council's Treasury Management Practices. At the 31 July 2019 the Council's treasury borrowing position was as follows:

Borrowing position as at 31 July 2019					
PWLB Ref:	**Amount o/s**	**Interest rate**	**Term**	**Type**	**Repayments**
507499	447,776.00	2.59%	50	Annuity	16102.16
507503	447,770.00	2.58%	50	Annuity	16070.34
509130	1,650,000.00	2.39%	50	Annuity	56729.24
509131	1,000,000.00	2.24%	50	Maturity	22,400.00
509165	8,500,000.00	2.48%	50	Annuity	297571.66
Total Borrowing	12,045,546.00	2.46%			408,873.40

31. The maturity structure of the debt portfolio was as follows:

Maturity structure of fixed rate borrowing		**(Apr - July) Actual £'000**
Under 12 months		66
12 months to 2 years		234
2 years to 5 years		373
5 years to 10 years		686
10 years to 20 years *1		1,653
20 years to 30 years *1		2,114
30 years to 40 years *1		2,704
40 years to 50 years *1		4,215
Upper limit of fixed interest rates based on net debt		100%
Upper limit of variable interest rates based on net debt		50%
Upper limit for principal sums invested over 364 days	10,000	10,000

32. Appendix C is our treasury advisors, Link Asset Services', view on borrowing.

Non-Treasury Investments

33. The Council has recently invested in the economic regeneration of Rother through its Property Investment Strategy and the expected income from these non-Treasury Investments is estimated as follows.

	2019/20 Estimated Property Investment Income		
Property	**Income Property Investment Strategy**	**MRP & interest**	**Net Income**
14 Terminus Road*	106,000	(32,091)	73,909
18-40 Beeching Road*	87,684	(48,435)	39,249
16 Beeching Road*	97,000	(48,435)	48,565
Glovers House	389,583	(190,133)	199,450
Total	680,267	(319,094)	361,173

* Ground rent included in rental income

34. The budget for rental income from all investment properties is £1,939,000. This is made up of £970,000 for the existing assets and £969,000 for the properties purchased through the property investment strategy. The estimated outturn for 2019/20 is £1,650,267 a shortfall of £288,918. This equates to a 6.6% gross return on the value of all properties including those purchased under the Property Investment Strategy (PIS). PIS Properties after allowing for borrowing costs are generating an expected return of 2.92%. The Property Investment Panel met on the 31 July 2019 and considered the purchase of a commercial property in Eastbourne. This proposal was not supported by the Panel.

35. The performance of the non-Treasury investments can be summarised in the table below:-

Property	2019/20 Budget £ (000)	2019/20 Estimated Outturn £'000	Variation
14 Terminus Road*	74	74	-
18-40 Beeching Road*	39	39	-
16 Beeching Road*	49	49	-
Glovers House	199	199	-
Future properties	232	0	(232)
Total	593	361	(232)

Conclusion

36. The investment activity during the year conformed to the approved strategy, and the Council had no liquidity difficulties. The investment environment for treasury activities remains very difficult with absolute returns continuing to be very low. The diversification into Property Funds has increased the net overall return but does come with a greater degree of capital risk than other investments and is less liquid. The Council's Property Investment Strategy has regeneration at its heart and is planned to generate returns in excess of 2% (net of borrowing costs), which is greater than predicted for treasury investments. Again this comes with greater risk due to the commitment to repaying borrowing and the direct operational risks of managing property.

Malcolm Johnston
Executive Director

Risk Assessment Statement
The risks arising from the Councils treasury investments and its non-Treasury investments are outlined in this report. Failure to follow the Council's investment strategy could increase the risk of financial loss

During the quarter ended 30 June 2019 *(quarter 2 of 2019):*

- Brexit was delayed until 31st October 2019;
- GDP rose by a solid 0.5% q/q in Q1, but contracted at the start of Q2;
- the fundamentals that determine consumer spending remained healthy;
- inflation bobbed around the Bank of England's 2% target;
- there was a widespread fall in investors' global interest rate expectations; and
- the MPC kept Bank Rate on hold at 0.75%, but struck a more dovish tone.

The economy posted a **stronger-than-expected expansion in Q1 of 0.5% q/q,** but that was probably a temporary high as activity was brought forward ahead of the original 29th March Brexit deadline. As a result, we doubt Q2 will be as good. Indeed, stock building added 0.9 ppts to the quarterly rate of GDP growth in Q1 as firms built up their stocks ahead of a possible no deal Brexit. Admittedly, a large chunk of these stocks were imported, so the net boost was smaller than this – perhaps around 0.3 ppts. Nonetheless, stock building will exert a similar *drag* on GDP growth in Q2.

In fact, the chances of the economy escaping a **quarterly contraction in Q2** seem to be receding in light of the latest survey and official data. GDP fell by 0.4% m/m in April, the largest monthly fall in three years. This partly reflected the decision by car manufacturers to bring forward their annual car plant shutdowns from August to April in case of a no deal. As a result, vehicle production dropped by 24% m/m knocking 0.2 ppts off overall GDP in April. Granted, the Society of Motor Manufacturers & Traders (SMMT) car production data suggest that these losses were recouped in May. After all, production rose by 60% m/m, which probably provided a 0.3 ppts boost to GDP in May.

Even so, GDP may still struggle to expand in Q2 as a whole – we have pencilled in a contraction of 0.1% q/q. Indeed, June's manufacturing PMI suggests the sector is still suffering from a Brexit-related hangover and a weak global economy and probably shrank in Q2.

What's more, household spending will probably fall short of the impressive 0.6% q/q rise in Q1. Retail sales volumes were flat in April and fell by 0.5% m/m in May. But a major slump in consumer spending in Q2 or further ahead seems unlikely.

Indeed, looking through the Brexit volatility, while consumer confidence has been relatively weak, the fundamentals that determine consumer spending have remained healthy. Admittedly, **employment** only rose by 32,000 in the three months to April, well below the 98,000 average monthly rise in 2018. But with the unemployment rate still at its 45-year low of 3.8%, the tightness in the labour market has pushed up wage growth. Indeed, the headline measure excluding bonuses nudged up from 3.3% in March to 3.4% in April – just below the decade high of 3.5%. And with inflation bobbing around the Bank of England's 2% target**, real wage growth has reached its highest rate since late 2016.**

CPI inflation dropped from 2.1% in April to 2.0% in May as the previous upward pressure on airfares due to the later timing of Easter unwound. Underlying price pressures look subdued too. Core services inflation fell from

3.1% to 2.9% in May and input price inflation dropped from 4.5% to just 1.3%, its lowest rate since June 2016. At the same time, output price inflation nudged down from 2.1% in May to 1.8%.

Nonetheless, there are still some reasons to think that CPI inflation will edge up at the end of the year as rising agricultural prices push up food inflation and core inflation starts to pick up now that the lagged effects of a fall in import price inflation have come to an end. What's more, the recent pick-up in wage costs is consistent with a **rise in core services inflation to just shy of 4% in early-2020.**

Bank Rate. Meanwhile, investors have reassessed the outlook for UK monetary policy and have gone from expecting rate hikes in early May to now expecting *cuts*. This is partly because of the weakening global outlook and rising expectations of rate cuts in the US and euro-zone. But growing concerns over a no deal Brexit have also weighed on expectations. Indeed, at the Treasury Committee in June, the Governor of the Bank of England, Mark Carney, gave the strongest hint yet that in a no deal Brexit, the Monetary Policy Committee (MPC) would cut rates. In that scenario, we think that rates would be cut fairly quickly from 0.75% to 0.25%.

Meanwhile, it wasn't surprising that the **MPC** kept Bank Rate on hold at 0.75% at June's meeting given the drop in GDP in April and inflation falling back to target in May. What was perhaps more surprising after its hawkish comments in May, was the Committee's new-found dovish tone. The MPC noted that "the near term data have been broadly in line with the May Inflation Report, but that **downside risks to growth have increased."** It also sounded more concerned about the possibility of a no deal Brexit. Instead of chastising the market for underestimating how much interest rates might rise as it did in May, the MPC pointed out that "the ongoing tension between the MPC's forecast…of a smooth Brexit and the assumptions about alternative Brexit scenarios that were priced into financial market variables".

Turning to fiscal policy, regardless of the Brexit situation, all roads appear to lead to **looser fiscal policy.** There was good news for the Chancellor at the end of 2018/19. Public sector net borrowing (PSNB ex.) came in only just above the OBR's February forecast of £23.4bn in 2018/19 – a far cry from the £37.1bn the OBR predicted in March 2018. Admittedly, PSNB ex. will probably rise slightly this year due to a number of promises made by the current Chancellor Phillip Hammond in the 2018 Budget, including spending on the NHS. But the OBR's projections still suggest that there is around £27bn headroom against the current fiscal rule.

Indeed, both **Johnson and Hunt** are promising wider ranging and bigger tax cuts and spending rises with the policies announced so far adding up to £20bn and £40bn a year respectively. Of course, using up the headroom is not free money. It simply means that there is room to increase borrowing without breaking the current fiscal rule that the cyclically-adjusted budget deficit has to be below 2% of GDP in 2020/21.

Of course, how much borrowing rises depends on **the outcome of Brexit.**

- If a deal is reached, faster GDP growth would reduce public spending, raise tax revenues and cut the deficit, perhaps allowing fiscal policy to be loosened without borrowing rising at all.
- However, in a no deal, the weaker economy would push up the deficit. As a result, the new Chancellor would have to choose between keeping the fiscal rules intact or loosening fiscal policy to give the

economy a boost. We think that he/she would opt for the latter, arguing that exceptional circumstances allowed for his/her fiscal rules to be suspended.

The fact that both Johnson and Hunt seem willing to leave the EU without a deal means **the chances of a general election** and a Labour government have also risen, as Parliament may vote to bring down the government. Looser fiscal policy seems to be on the cards under a Labour Government too. Admittedly, Labour only plans to raise borrowing by a small amount, in part because it plans to pay for higher day-to-day spending with tax increases. But there is a big question mark over whether Labour would manage to raise as much money from its planned tax rises as it claims. Indeed, the Institute for Fiscal Studies thinks that, at best, Labour will raise £41bn rather than £49bn, leaving a "manifesto black hole" of nearly £10bn.

Turning to the **financial markets**, concerns over global growth and subsequent falls in interest rate expectations have caused **developed market bond yields to slump** – the 10-year gilt yield fell from 1.05% at the start of the quarter to 0.81%. However, lower interest rate expectations have supported increases in equities. The FTSE 100 finished the quarter around 2.5% higher although it underperformed compared to the S&P 500 perhaps since the FTSE 100 has a high concentration of energy firms, so the fall in oil prices over the quarter has probably weighed on its overall performance.

Meanwhile, despite the narrowing in the gap between 2-year government bond yields in the US and the UK to around 100bps, which would normally put upward pressure on sterling in relation to the dollar, **sterling** has fallen to $1.26 this quarter. This is mainly because investors have become more concerned about a no deal Brexit with betting markets now pricing in about a 30% chance of a no deal compared with just 15% at the start of May.

Elsewhere, in the **US**, the markets are convinced the **Fed will start to cut rates in July.** But we think that a temporary truce in the trade war means it is slightly more likely that a cut will be delayed until September. However, a sharp slowdown in GDP growth in the second half of 2019 should still prompt the Fed to cut interest rates by a cumulative 75bps.

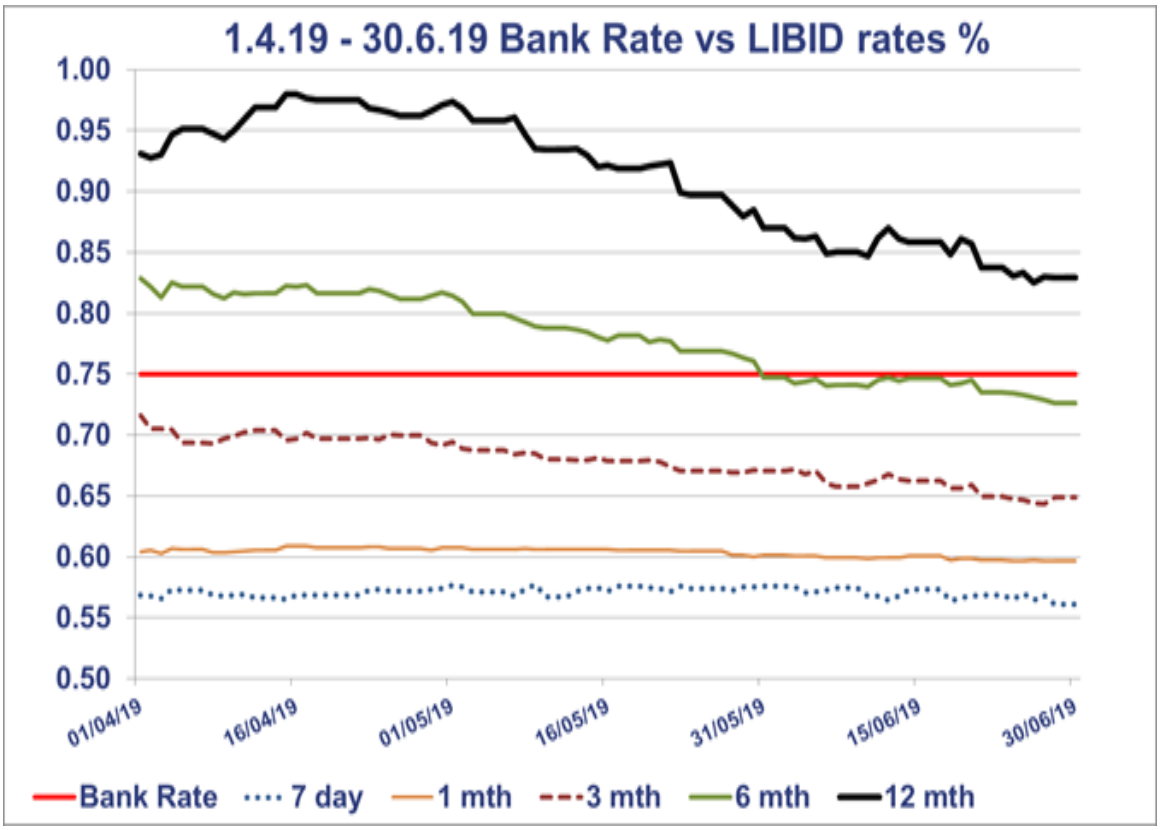
Meanwhile GDP growth in the **euro-zone** will probably only manage 0.2% q/q in Q2. Our expectations for interest rates in the euro-zone are roughly in line with market expectations – we have pencilled in a 10bps cut in September from -0.4% currently to -0.5%. What's more, we expect the ECB to re-launch QE in October.

Investment Rates

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

Link Asset Services Interest Rate View	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	0.75	0.75	0.75	1.00	1.00	1.25	1.25	1.50	1.50	1.50
3 Month LIBID	0.70	0.70	0.70	0.80	0.90	1.00	1.20	1.30	1.40	1.40	1.40
6 Month LIBID	0.80	0.90	0.80	0.90	1.00	1.20	1.40	1.50	1.60	1.60	1.60
12 Month LIBID	1.00	1.00	1.10	1.20	1.30	1.40	1.50	1.60	1.70	1.80	1.80
5yr PWLB Rate	1.50	1.60	1.70	1.80	1.90	2.00	2.10	2.10	2.20	2.30	2.40
10yr PWLB Rate	1.80	1.90	2.00	2.10	2.20	2.30	2.40	2.50	2.60	2.60	2.70
25yr PWLB Rate	2.40	2.50	2.60	2.70	2.80	2.90	3.00	3.00	3.10	3.20	3.30
50yr PWLB Rate	2.30	2.40	2.50	2.60	2.70	2.80	2.90	2.90	3.00	3.10	3.20

Longer term investment rates were on a falling trend during most of this quarter.



Our treasury management advisers, Link Asset Services provided us on 1 July with the following update to their interest rate forecasts. *(Note – some updating has been done.)*

Comparison of forecasts for Bank Rate today v. previous forecast											
	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22
1.7.19	0.75	0.75	0.75	0.75	1.00	1.00	1.25	1.25	1.50	1.50	1.50
7.5.19	0.75	0.75	1.00	1.00	1.25	1.25	1.25	1.50	1.50	1.50	1.75
change	0.00	0.00	-0.25	-0.25	-0.25	-0.25	0.00	-0.25	0.00	0.00	-0.25

- ***We normally update our interest rate forecasts after the Bank of England releases its quarterly interest rate forecast. However, these are far from being normal times! What we have seen since our previous forecasts on 7 May, is a sharp deterioration of economic growth news, and expectations for growth, in the major economies of the world – the US, EU and China. This has led to a sharp downturn in government bond yields, lower than we previously anticipated. We, therefore, felt that we could not wait until the next quarterly Inflation Report on 1 August to take account of this sharp movement in financial markets.***
- ***As for the UK itself and forecasts for Bank Rate, we have moved back our forecast for the first increase from quarter 1 2020 to quarter 3 2020. Our central assumption is that there will be a reasonable form of muddle through Brexit. But it is clear to all that there are very many uncertainties around this central assumption.***
- ***In addition, we now also have a greater number of uncertainties around our Bank Rate and PWLB rate forecasts e.g.: -***
  - ***when / whether Brexit will occur***
  - ***hard Brexit / deal Brexit***
  - ***will there be an extension of the Brexit deadline / would the EU agree to an extension?***
- ***There are also a great number of uncertainties around the political situation and the Tory leadership contest e.g.:-***
  - ***the fiscal policy changes proposed by both candidates to counter the effects of a hard Brexit through tax cuts etc.***
  - ***how MPs will vote on Brexit and these fiscal proposals***
  - ***how would the Bank of England respond to a major fiscal loosening***
  - ***could MPs vote to revoke article 50 (withdrawal from EU)***
  - ***whether there could be a general election if the Commons ends up in stalemate***
  - ***the chances of a no deal Brexit increasing, as negotiating a deal before 31 October looks challenging***
- ***In order to make any forecast we have, as previously mentioned, had to make one central assumption – a reasonable muddle through outcome for Brexit. If the facts change, our forecasts will also change. As events unfold it is possible we may see 50bps movement in rates and yields at any time e.g. a hard Brexit could result in an immediate 50 bps cut in Bank Rate. But that is not our central assumption.***
- ***Our key advice to clients in the midst of such large-scale uncertainties is to focus on managing risk, rather than making a bet on one outcome or the other.***
- ***A key issue facing all central banks, except the US Fed, is that they have very little ammunition, in terms of normal monetary policy measures, to take action to counter the next economic downturn. The Bank of England and the MPC will have an agenda to restock their ammunition***

by raising Bank Rate as soon as is feasible, and, at a later time, possibly unwinding quantitative easing.

- ***On the international scene, after the Fed raised central rates to 2.25% – 2.50% on 19 December, it now appears that the chance of any further increases has probably ended and markets are now forecasting cumulative cuts of 1% to 1.25% over the next year or so.***
- ***The ECB has had to change tack to committing to put more monetary stimulus into the economy in order to stimulate lack lustre economic growth. Core inflation is likely to stay well below its target rate. It is becoming increasingly likely that there could be some marginal change downwards in the current negative central rates and a resumption of quantitative easing in order to stimulate economic growth and so encourage a rise in inflation towards its target of near to, but under, 2%.***
- ***Economic growth prospects in China have also cooled despite various monetary policy measures to stimulate economic growth.***

The balance of risks to the UK

- The overall balance of risks to economic growth in the UK is probably to the downside due to the weight of all the uncertainties over Brexit.
- The balance of risks to increases in Bank Rate and shorter term PWLB rates are broadly similarly to the downside.

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 eleven 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 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** 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 **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 2018 of a government which has made a lot of anti-austerity noise. The EU is again in the midst of a sharp disagreement with Italy over setting a budget within the limits of EU rules. The rating agencies have already downgraded Italian debt to one notch above junk level. If Italian debt were to fall below investment grade, many investors would be unable to hold Italian debt. Unsurprisingly, investors are becoming increasingly concerned by the actions of the Italian government and consequently, Italian bond yields have risen – at a time when the government faces having to refinance over €200bn of debt maturing in 2019. However, the biggest concern is the major holdings of Italian government debt held by Italian banks and insurers. Any downgrading of such debt would cause Italian bond prices

to fall, causing losses on their portfolios, so reducing their capital and forcing them to sell bonds – which, in turn, would cause further falls in their prices etc. This is the so called **'doom loop'**. Due to the Italian government's already high level of debt, it would not be able to afford to bail out the banking system. **Portugal** faces the same problem as its debt is also only one notch above junk level.

- Weak capitalisation of some **European banks**, particularly Italian banks.
- **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 had a major internal debate as to whether it could 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. However, this makes little practical difference as she has continued as Chancellor, though more recently concerns have arisen over her health.
- **Other minority EU governments.** Sweden, Spain, Portugal, Netherlands and Belgium all have vulnerable minority governments dependent on coalitions which could prove fragile.
- **Italy, Austria, the Czech Republic and Hungary** now form a strongly anti-immigration bloc within the EU. There has also been rising anti-immigration sentiment in Germany and France.
- The increases in interest rates in the US during 2018, combined with an on-off potential trade war between the USA and China, sparked major volatility in equity markets during the final quarter of 2018 and into 2019. Some **emerging market countries** which have borrowed heavily in dollar denominated debt could be particularly exposed to investor flight from equities to safe havens, typically US treasuries, German bunds and 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 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,** for example in 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 agreement was reached all round that removed all threats of economic and political disruption between the EU and the UK.
- **The Fed causing a sudden shock in financial markets** through misjudging the timing, direction and pace for the next movements in the Fed Funds Rate and in changes in levels 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 inflationary 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.

LINK ASSET SERVICES' FORECASTS

We do not currently think that the MPC would increase Bank Rate before any clearing of the fog on Brexit. We have pushed back our first increase in Bank Rate from February 2020 to August 2020. Our forecast for the end of the three year forecast period has been lowered from 1.75% to 1.50%.

Financial markets, (short sterling rates), are now expecting a first increase in Bank Rate towards the end of 2023.

Forecasts for average investment earnings beyond the three year time horizon will be heavily dependent on economic and political developments.

Gilt yields and PWLB rates

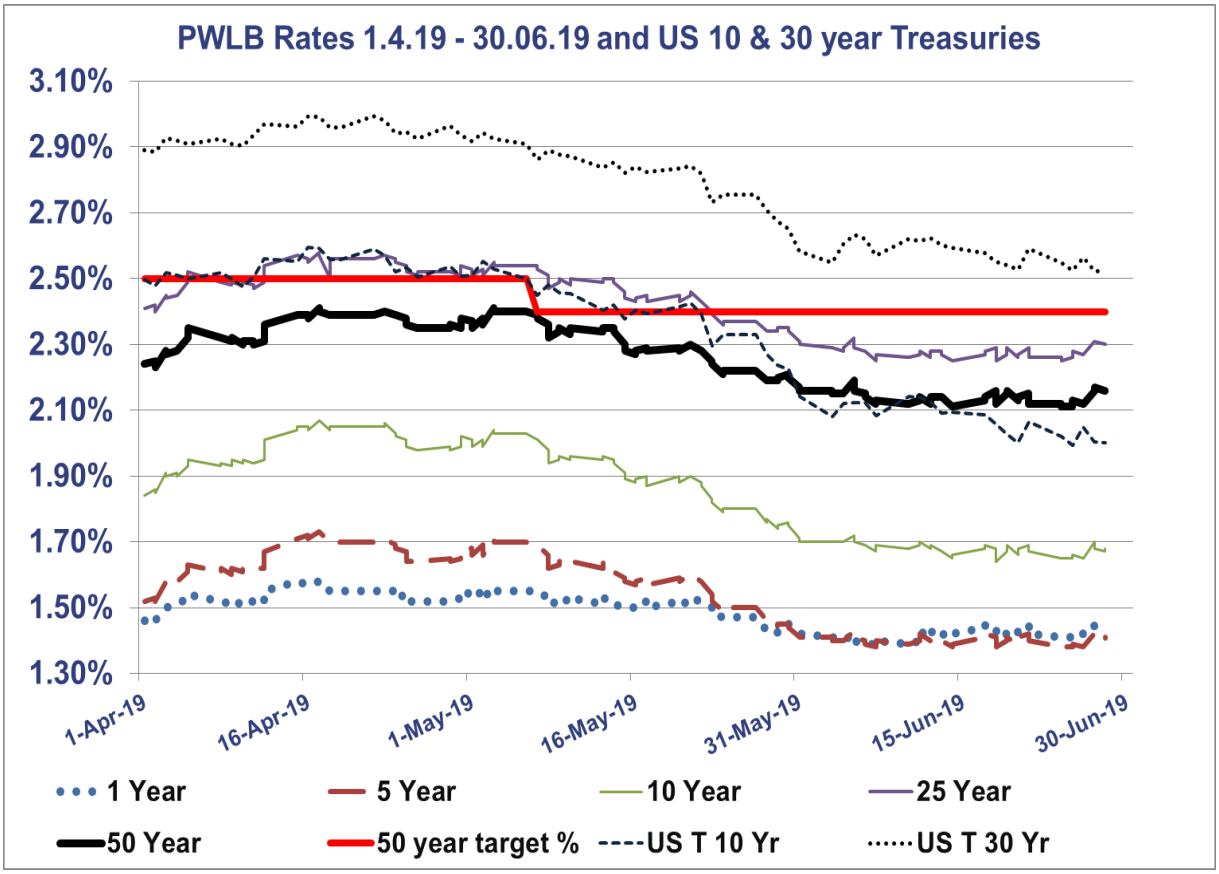
The general situation is for volatility in bond yields to endure as investor fears and confidence ebb and flow between favouring relatively more "risky" assets i.e. equities, or the "safe haven" of government bonds. The overall longer run trend is for gilt yields and PWLB rates to rise, albeit gently, although there are likely to also be periods of sharp volatility from time to time.

We have pointed out consistently that the Fed. Rate was likely to go up more quickly and more strongly than Bank Rate in the UK, but now it is likely to fall before the second stage of any UK monetary policy tightening.

Our forecasts are also predicated on an assumption that there is no break-up of the Eurozone or EU, (apart from the departure of the UK), within our forecasting time period, despite the major challenges that are looming up, and that there are no major ructions in international relations, especially between the US and China / North Korea and Iran, which have a major impact on international trade and world GDP growth. However, the current round of increases in tariff rates sparked by President Trump, both actual and threatened, are causing on-going concern around the potential impact on world growth and also on inflationary pressures.

Borrowing

PWLB rates have been on a general falling trend during most of this quarter to reach lows during June. This fall has been largely caused by a fall in US Treasury yields as investors have become increasingly concerned that the US economy is heading towards a sharp fall in GDP growth. The 50 year PWLB target (certainty) rate for new long term borrowing started at 2.50% and fell to 2.40%.



	1 Year	5 Year	10 Year	25 Year	50 Year
01/04/2019	1.46%	1.52%	1.84%	2.41%	2.24%
30/06/2019	1.43%	1.41%	1.68%	2.30%	2.16%
Low	1.39%	1.38%	1.64%	2.25%	2.11%
Date	06/06/2019	07/06/2019	18/06/2019	07/06/2019	14/06/2019
High	1.58%	1.73%	2.07%	2.58%	2.41%
Date	15/04/2019	17/04/2019	17/04/2019	17/04/2019	17/04/2019
Average	1.49%	1.55%	1.86%	2.42%	2.26%

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

Appendix E

Creditworthiness Policy

1. This Council applies the creditworthiness service provided by Link Asset Services. This service employs a sophisticated modelling approach utlilising credit ratings from the three main credit rating agencies – Fitch, Moodys and Standard and Poors. The credit ratings of counterparties are supplemented with the following overlays:

   - credit watches and credit outlooks from credit rating agencies;
   - CDS spreads to give early warning of likely changes in credit ratings; and
   - sovereign ratings to select counterparties from only the most creditworthy countries.

2. This modelling approach combines credit ratings, credit watches and credit outlooks in a weighted scoring system which is then combined with an overlay of CDS spreads for which the end product is a series of colour coded bands which indicate the relative creditworthiness of counterparties. These colour codes are used by the Council to determine the duration for investments. The Council will therefore use counterparties within the following durational bands:

   Blue 1 year (only applies to nationalised or semi nationalised UK Banks)
   Orange 1 year
   Red 6 months
   Green 100 days
   No colour not to be used

3. The credit ratings have been updated since February 2019 to include the orange credit rating

4.

	Colour	£limit or % of Fund Limit	Time Limit
Banks and Building Societies – part nationalised	Blue	30%	1 yr
Banks and Building Societies	Red	50%	6 months
Banks and Building Societies	Green	50%	100 days
Banks and Building Societies	Orange	20%	1yr
Banks and Building Societies	No colour	Not to be used	N/A
Council's banker	Not applicable	Unlimited/ 100%	1 day