South Cambridgeshire District Council

REPORT TO:	Audit & Governance	19 December 2019
LEAD CABINET MEMBER:	Councillor John Williams, Lead Cabinet Member for Finance	
LEAD OFFICER:	Peter Maddock, Head of Finance	

MID YEAR 2019/2020 TREASURY MANAGEMENT REPORT

Executive Summary

1. This report outlines the mid-year treasury management report to 30 September 2019, including performance against the approved Prudential Indicators for Treasury Management.

Key Decision

2. This is not a key decision as there are no resource implications directly arising from the report at this stage.

Recommendations

3. **That Committee is invited to review the Treasury Management activity and performance for the period to 30 September 2019.**

Reason for Recommendation

4. To review the Treasury Management activity and performance for the period 1 April 2019 to 30 September 2019.

Details

Treasury Management Strategy

5. The Council's Treasury Management Strategy and prudential indicators for 2019/2020 was approved by Full Council on 21 February 2019.

6. As part of the Council's Mid-Year Review the Treasury Management Policy Statement and Treasury Management Strategy for 2019-2020 have been reviewed with regard to their compliance to the CIPFA Prudential Code and the CIPFA Treasury Management Code. They have also been reviewed to ensure their appropriateness in light of the Council's current investment and borrowing portfolios, and the ongoing delivery of the Council service objectives. After this review the Treasury Management Policy and Treasury Management Strategy Statement have been found appropriate and there are no changes required.

7. The Council, as a consequence of its activities, has borrowed and invested substantial sums of money and is, therefore, exposed to financial risks including the loss of invested funds and the revenue effect of changing interest rates. The

successful identification, monitoring and control of risk is therefore central to the Council's treasury management strategy This report covers the treasury management activity for the period 1 April 2019 to 30 September 2019 and the associated monitoring and risk management.

8. Following consultation in 2017, CIPFA published new versions of the Prudential Code for Capital Finance in Local Authorities (Prudential Code) and the Ministry for Housing, Communities & Local Government (MHCLG) published its revised investment Guidance which came into effect from April 2018.

9. The updated Prudential Code includes a new requirement for local authorities to provide a Capital Strategy, which is to be an overarching document approved by Full Council. The Council's Capital Strategy was considered by Full Council on 21 February 2019.

Investment Activity

10. As at 30 September 2019, the Council held £107.4 million of invested funds (nominal basis), representing income received in advance of expenditure plus balances and reserves held. The Council's investment balances during 2019/2020 have averaged £102.7million over the year.

11. The Guidance on Local Government Investments in England gives priority to security and liquidity and the Council's aim is to achieve a yield consistent with these principles.

12. The portfolio has been managed throughout 2019 on the basis of there would be an external borrowing requirement for capital expenditure. In the period to 30 September this has been covered by short term borrowing. This has allowed the Council to increase its allocation to higher yielding Ermine Street Housing loans. The remainder of the portfolio has been held in short term liquid money market funds and fixed deposits with other Local Authorities, Banks, Building Societies and a Housing Association.

13. The table below shows the opening balances of investments held at the beginning of the financial year and the movements on each fund up to 30 September 2019:

Investment Counterparty	01 April 2019	New	Matured	30 Sept 2019
Short Term:	**£000**	**£000**	**£000**	**£000**
Banks – Call/Liquidity Accounts	75	24,250	(23,935)	390
AAA Rated Money Market Fund	7,175	120,425	(121,025)	6,575
Clearing Banks	14,000	18,000	(12,000)	20,000
Other Banks	4,000		(4,000)	0
UK Local Authorities	4,500	9,200	(11,700)	2,000
Building Societies	3,000	9,000	(5,000)	7,000
Housing Associations	5,000	5,000	(5,000)	5,000
Total Short Term Investments	**37,750**	**185,875**	**(182,660)**	**40,965**

Investment Counterparty	01 April 2019	New	Matured	30 Sept 2019
Long Term:	**£000**	**£000**	**£000**	**£000**

South Cambs Ltd	58,653	5,355		64,008
Cambridge Leisure and Ice	1,255	1,145		2,400
Total Long Term Investments	**59,908**	**6,500**		**66,408**

Total Investments	**97,658**			**107,373**

14. The upward movement in value of £9.7 million is due to the reasons reflected in paragraph 10.

15. The most significant movements in the portfolio are an increase of £6 million placed with Clearing Banks and a further £5.4 million loaned to Ermine Street Housing. A more detailed analysis of the investment portfolio as at 30 September 2019 is shown at **Appendix A**.

16. Both the CIPFA Code and government guidance require the Authority to invest its funds prudently, and to have regard to the security and liquidity of its treasury investments before seeking the optimum rate of return, or yield. The Council's objective when investing money is to strike an appropriate balance between risk and return, minimising the risk of incurring losses from defaults and the risk of receiving low investment income.

17. In order to achieve these objectives, the Council's portfolio is diversified. The majority of the portfolio is invested in fixed deposits where Financial Institutions return 0.98% and Ermine Street Housing returns 3.72%. Liquidity assets typically return 0.73%. This has to 30 September 2019 generated the Council a blended return of 2.65%.

18. This has been achieved whilst maintaining a low level of credit risk. Counterparty credit quality is assessed and monitored with reference to credit ratings (the Council's minimum long-term counterparty rating is [A-] across all major agencies); credit default swap prices, financial statements, information on potential government support and reports in the quality financial press. This is shown below.

	Weighted Average Risk Number	Investment Portfolio	Bail-In Exposure		Average Balance	Rate of Return
		£000	£000	%		
30 September 2019	4.11	104,973	34,000	32.4	40,965	0.98%
31 March 2019	3.82	96,403	30,500	31.6	37,750	1.01%

19. The table also shows how the Council's exposure to Bail in Risk has not significantly changed.

Borrowing Strategy

20. As at 30 September 2019, the Council held £205.123 million of long term debt (principal borrowed, excluding lease liabilities), no change on 31 March 2019. The Council also held £5 million in short term debt that was paid in full on 1 October 2019.

21. Affordability and the "cost of carry" remained important influences on the Council's borrowing strategy alongside the consideration that, for any borrowing undertaken ahead of need, the proceeds would have to be invested in the money markets at

rates of interest significantly lower than the cost of borrowing. As short-term interest rates have remained low, and are likely to remain at these levels over the forthcoming two years, the Authority has determined it is more cost effective in the short-term to use internal resources instead of external borrowing.

22. The benefits of internal borrowing are monitored regularly against the potential for incurring additional costs by deferring borrowing into future years when long-term borrowing rates are forecast to rise. Link Asset Services (Treasury Management Advisers) assist the Council with this 'cost of carry' and breakeven analysis.

Borrowing Activity

23. At 31 March 2019 the Council had short term local authority borrowing of £3 million in addition to £205.123 million of PWLB loans for HRA self financing. The table below sets out the movement in the Council's borrowing over the year to date:

	01/04/2019	Maturing Debt	Interest Paid	Lease Payments	CFR Movement	30/09/2019
	£000	£000	%	£000		£000
Capital Financing Requirement	271,438				19,500	290,938
Short Term Borrowing (a)	13,000	8,000	0.80	0		5,000
Long Term Borrowing (b)	205,123	0	3.51	0		205,123
Total Borrowing (a+b)	**218,123**	**8,000**		**0**		**210,123**
Other Long Term Liabilities (c)	0	0	0	0		0
Total External Debt (a+b+c)	**218,123**	**8,000**	**0.80**	**0**		**210,123**

24. **PWLB Certainty Rate and Project Rate Update**: Authorities are required to notify MHCLG of any potential future borrowing in order to obtain 'Certainty Rate' (0.20% below the PWLB standard rate) the Council has submitted an application to borrow at this rate until November 2020. There is no penalty if the facility is not used.

25. **Debt Rescheduling**: The premium charge for early repayment of PWLB debt has become very expensive for the loans in the Council's portfolio and, therefore, unattractive for debt rescheduling activity. As a consequence, no rescheduling activity has been undertaken.

26. **Capital Financing Requirement:** The Council undertakes capital expenditure on long-term assets. These activities may either be:

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

- If insufficient financing is available for the investment, or a decision is taken not to apply other resources, the funding of capital expenditure will give rise to a borrowing need.

27. The underlying need to borrow for capital purposes is measured by the Capital Financing Requirement (CFR), while usable reserves and working capital are the underlying resources available for investment. The Authority's current strategy is to

maintain borrowing and investments below their underlying levels, sometimes known as internal borrowing.

2019/2020 Budget Monitoring

28. The Finance Team monitor and report on the Capital Financing budget on a regular basis. The latest position as at 30 September 2019 is shown in the table below:

	Current Budget	Forecast Outturn	Forecast Variance
	£000	£000	£000
Interest Payments	406	68.8	(337.2)
Minimum Revenue Provision	594	581	(13)
Total Expenditure	**1,000**	**649.8**	**(350.2)**
Investment Income	(2,004)	(2,689)	(685)
Commercial Property Rental Income	(0)	(842)	(842)
Total Income	**(2,004)**	**(3,531)**	**(1,527)**
Net Budget	**(1,004)**	**(2,881.2)**	**(1,877.2)**

29. Interest Payments are forecast to be lower than originally budgeted as the expectation of long term borrowing during the year will not be required, due to higher investment balances.

30. Minimum Revenue Provision shows a small saving of £13,000.

31. Investment Income shows increased income of £0.685 million that is due to the effect of higher balances than forecast, with a significant contribution from Ermine Street Housing.

External Economic Impact on Portfolio

32. The external economic context and market rate data is referenced in the Treasury Advisers report reproduced at **Appendix B.**

33. The Base Rate increase of 0.25% to 0.75% in August 2018 increased the yield available on liquid funds. This increased the return on the Council's Money Market Fund holdings and give an increased return on maturing deposits when reinvested.

Compliance with Performance Indicators

34. The Council has been compliant with the 2019/2020 Prudential Indicators approved by Full Council on 21 February 2019 except where indicated. All exceptions are due to the high levels of investments held in short term money market funds and overnight bank accounts.

35. The Council measures and manages its exposures to treasury management risks using the following indicators:

36. Performance against prudential indicators in 2019/2020 is as follows:

(1) Interest Rate Exposure: This indicator is set to control the Council's exposure to interest rate risk. The upper limits on fixed and variable interest rate exposures are set out in the table below:

Maturity structure of borrowing	Under 12 months	More than 12 months	Under 12 months - Actual	More than 12 months - Actual
Upper limit for fixed interest rate exposure	100%	100%	2.37%	97.62%
Upper limit for variable rate exposure	100%	0%	0%	0%

(2) Maturity Structure of Borrowing: The structure of the Council's borrowing is set out below.

Fixed Rate Borrowing		
Lender	Repayable within	Amount £,000
Local Authorities	<12 Months	5,000
PWLB	15 – 20 years	15,000
PWLB	20 – 25 years	50,000
PWLB	25 – 30 years	50,000
PWLB	30 – 35 years	50,000
PWLB	35 – 40 years	50,000

(3) Principal Sums Invested for Periods Longer than 364 Days: The purpose of this indicator is to control the Council's exposure to the risk of incurring losses by seeking early repayment of its investments. The Council takes in consideration the advice of its Treasury Advisers when determining the duration of investments with financial institutions (excluding Ermine Street Housing and Cambridge Leisure and Ice Centre) The suggested duration for our counterparties are:

Counterparty	Suggested maximum duration	Actual duration	Total investments £000
Local Authorities	5 years	89 days	2,000
Lloyds	12 months	364 days	10,000
Santander[1]	6 months	364 days	10,000
Coventry BS	6 months	6 months	4,000
Yorkshire BS[1]	100 days	364 days	3,000

[1] The longer duration fixed term deposits with these Counterparties were placed prior to the appointment of our Treasury Advisers.

(4) Liquidity: The Council has adopted a voluntary measure of its exposure to liquidity risk by maintaining a minimum £20 million working cash balance (total investment balance less loans to Ermine Street Housing and Cambridge Leisure and Ice). This liquidity is available to meet unexpected payments without additional borrowing.

Counterparty Type	Amount £000	% of Portfolio at 30 September
Long term (>1yr)		
Ermine St Housing	64,008	60
CLIC	2,400	2
Total Long term	**66,408**	**62**
Short term (<365 days)		
Banks	20,390	19
Building Societies	7,000	7
Housing Assoc.	5,000	5
Local Authorities	2,000	2
Money Market Funds	6,575	5
Short Term (Working Cash Balance)	**40,965**	**38**

Outlook for Quarter 4 2019/2020

37. The Council will continue to make acquisitions under the Investment Strategy and make further loans to Ermine Street Housing. The Council will receive minimal receipts from Council Tax and National Non Domestic Rates during February and March and it is forecast that £15 million in short term loans will be required to manage cash flow needs.

38. The view is that the UK economy still faces a challenging outlook as the successor Government, following the General Election, continues to negotiate the country's exit from the European Union. Central bank actions and geopolitical risks, such as prospective trade wars, have and will continue to produce significant volatility in financial markets, including bond markets.

Implications

39. In the writing of this report, taking into account the financial, legal, staffing, risk management, equality and diversity, climate change, community safety and any other key issues, the following implications have been considered:

Legal

40. It is a statutory duty, under Section 3 of the Local Government Act 2003 and supporting regulations, for the Council to approve a range of prudential indicators as part of its approval of the General Fund Revenue Budget and Capital Programme.

41. The Chartered Institute of Public Finance and Accountancy's Treasury Management Code (CIPFA's TM Code) requires that authorities report on the performance of the treasury management function at least twice yearly (mid-year and at year end).

Policy

42. There are no specific policy implications associated with the recommendations contained in this report. The Chartered Institute of Public Finance & Accountancy (CIPFA) Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes (the CIPFA Code) and the CIPFA Prudential Code for Capital Finance in Local Authorities 2017 (as amended) have been used in the preparation of this report.

Finance

43. There are no new resource implications associated with the recommendations contained in this report.

Risks

44. There are no specific risk implications associated with the recommendations contained in this report.

Environmental

45. There are no specific environmental implications associated with the recommendations contained in this report.

Equality and Diversity

46. In preparing this report, due consideration has been given to the District Council's statutory Equality Duty to eliminate unlawful discrimination, advance equality of opportunity and foster good relations, as set out in Section 149(1) of the Equality Act 2010. A relevance test for equality has determined that the activity has no relevance to South Cambridgeshire District Council's statutory equality duty to eliminate unlawful discrimination, advance equality of opportunity and foster good relation. An equality impact assessment is not needed.

Effect on Council Priority Areas

47. Timely and robust consideration of the Council's treasury management activities is vital to ensure that financial performance is in line with expectations.

Background Papers

Where the Local Authorities (Executive Arrangements) (Meetings and Access to Information) (England) Regulations 2012 require documents to be open to inspection by members of the public, they must be available for inspection:

(a) at all reasonable hours at the offices of South Cambridgeshire District Council;
(b) on the Council's website; and
(c) in the case of documents to be available for inspection pursuant to regulation 15, on payment of a reasonable fee required by the Council by the person seeking to inspect the documents at the offices of South Cambridgeshire District Council.

The following documents are relevant to this report:

- General Fund Medium Term Financial Strategy – Report to Cabinet: 7 November 2018

- Budget Report – Report to Cabinet: 6 February 2019

- Business Plan 2019 - 2024 – Report to Council: 21 February 2019

- Medium Term Financial Strategy and General Fund Budget – Report to Council: 21 February 2019

Appendices

A Schedule of Investments as at 30 September 2019

B Treasury Management Adviser – External Economic Context and Market Rate Data

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Appendix A – Schedule of Investments as at 30 September 2019

	Amount	Interest	Total	Term	Rate	Maturity Date
	£000	£000	£000	Days	%	
Counterparty						
Barclays Call Account	390		390	Overnight	0.50	01/10/2019
Aberdeen Std Life MMF	6,575		6,575	Overnight	0.73	01/10/2019
Yorkshire Building Society	1,000	10.471	1,010	364	1.05	31/10/2019
Santander	1,000	12.466	1,012	364	1.25	31/10/2019
Santander	1,000	12.363	1,012	361	1.25	29/11/2019
Lloyds	1,000	9.727	1,010	317	1.12	28/02/2019
Santander	1,500	7.562	1,508	184	1.00	31/10/2019
Lloyds	1,000	12.500	1,013	364	1.25	30/04/2019
Santander	3,000	13.479	3,013	164	1.00	21/10/2019
Places for People	1,000	13.961	1,014	364	1.40	27/05/2020
Lloyds	2,000	24.110	2,024	352	1.25	20/05/2020
Places for People	2,500	36.151	2,536	364	1.45	30/06/2020
Santander	2,000	4.882	2,005	99	0.90	10/10/2019
Places for People	1,500	21.690	1,522	364	1.45	06/07/2020
Santander	1,500	3.440	1,503	93	0.90	10/10/2019
LB of Barking & Dagenham	2,000	3.609	2,004	89	0.74	21/10/2019
Lloyds	1,000	10.970	1,011	364	1.10	31/07/2020
Lloyds	2,000	5.403	2,005	116	0.85	02/12/2019
Coventry Building Society	2,000	5.757	2,006	133	0.79	20/12/2019
Coventry Building Society	1,000	4.212	1,004	183	0.84	19/02/2020
Coventry Building Society	1,000	4.327	1,004	188	0.84	27/02/2020
Lloyds	1,000	10.327	1,010	359	1.05	28/08/2020
Lloyds	1,000	3.889	1,004	169	0.84	27/02/2020
Yorkshire Building Society	2,000	3.800	2,004	95	0.73	20/12/2019
Lloyds	1,000	3.353	1,003	144	0.85	14/02/2020
Ermine Street Housing	61,056				3.85	Various
Ermine Street Housing	2,952				1.00	Various
Cambridge Leisure & Ice	2,400			25 Years	4.31	31/03/2043
Total	107,373					

Appendix B – Treasury Management Adviser – External Economic Context and Market Rate Data

Economics update

UK. This first half year has been a time of upheaval on the political front as Theresa May resigned as Prime Minister to be replaced by Boris Johnson on a platform of the UK leaving the EU on or 31 October, with or without a deal. However, in September, his proroguing of Parliament was overturned by the Supreme Court and Parliament carried a bill to delay Brexit until 31 January 2020 if there is no deal by 31 October. MPs also voted down holding a general election before 31 October, though one is likely before the end of 2019. So far, there has been no majority of MPs for any one option to move forward on enabling Brexit to be implemented. At the time of writing the whole Brexit situation is highly fluid and could change radically by the day. Given these circumstances and the likelihood of an imminent general election, any interest rate forecasts are subject to material change as the situation evolves. If the UK does soon achieve a deal on Brexit agreed with the EU then it is possible that growth could recover relatively quickly. The MPC could then need to address the issue of whether to raise Bank Rate at some point in the coming year when there is little slack left in the labour market; this could cause wage inflation to accelerate which would then feed through into general inflation. On the other hand, if there was a no deal Brexit and there was a significant level of disruption to the economy, then growth could weaken even further than currently and the MPC would be likely to cut Bank Rate in order to support growth. However, with Bank Rate still only at 0.75%, it has relatively little room to make a big impact and the MPC would probably suggest that it would be up to the Chancellor to provide help to support growth by way of a fiscal boost by e.g. tax cuts, increases in the annual expenditure budgets of government departments and services and expenditure on infrastructure projects, to boost the economy.

The first half of 2019/20 has seen UK **economic growth** fall as Brexit uncertainty took a toll. In its Inflation Report of 1 August, the Bank of England was notably downbeat about the outlook for both the UK and major world economies. The MPC meeting of 19 September reemphasised their concern about the downturn in world growth and also expressed concern that prolonged Brexit uncertainty would contribute to a build-up of spare capacity in the UK economy, especially in the context of a downturn in world growth. This mirrored investor concerns around the world which are now expecting a significant downturn or possibly even a recession in some major developed economies. It was therefore no surprise that the Monetary Policy Committee (MPC) left Bank Rate unchanged at 0.75% throughout 2019, so far, and is expected to hold off on changes until there is some clarity on what is going to happen over Brexit. However, it is also worth noting that the new Prime Minister is making some significant promises on various spending commitments and a relaxation in the austerity programme. This will provide some support to the economy and, conversely, take some pressure off the MPC to cut Bank Rate to support growth.

As for **inflation** itself, CPI has been hovering around the Bank of England's target of 2% during 2019, but fell to 1.7% in August. It is likely to remain close to 2% over the next two years and so it does not pose any immediate concern to the MPC at the current time. However, if there was a no deal Brexit, inflation could rise towards 4%, primarily as a result of imported inflation on the back of a weakening pound.

With regard to the **labour market,** despite the contraction in quarterly GDP growth of -0.2% q/q, (+1.3% y/y), in quarter 2, employment continued to rise, but at only a muted rate of 31,000 in the three months to July after having risen by no less than 115,000 in quarter 2 itself: the latter figure, in particular, suggests that firms are preparing to expand output and suggests there could be a return to positive growth in quarter 3. Unemployment continued at a 44 year low of 3.8% on the Independent Labour Organisation measure in July and the participation rate of 76.1% achieved a new all-time high. Job vacancies fell for a seventh consecutive month after having previously hit record levels. However, with unemployment continuing to fall, this month by 11,000, employers will still be having difficulty filling job vacancies with suitable staff. It was therefore unsurprising that wage inflation picked up to a high point of 3.9% in June before easing back slightly to 3.8% in July, (3 month average regular pay, excluding bonuses). This meant that in real terms, (i.e. wage rates higher than CPI inflation), earnings grew by about 2.1%. As 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. The latest GDP statistics also included a revision of the savings ratio from 4.1% to 6.4% which provides reassurance that consumers' balance sheets are not

over stretched and so will be able to support growth going forward. This would then mean that the MPC will need to consider carefully at what point to take action to raise Bank Rate if there is an agreed Brexit deal, as the recent pick-up in wage costs is consistent with a rise in core services inflation to more than 4% in 2020.
In the **political arena**, if there is a general election soon, 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 although, conversely, a weak international backdrop could provide further support for low yielding government bonds and gilts.

USA. President Trump's massive easing of fiscal policy in 2018 fuelled a temporary boost in consumption in that year which generated an upturn in the rate of strong growth to 2.9% y/y. Growth in 2019 has been falling back after a strong start in quarter 1 at 3.1%, (annualised rate), to 2.0% in quarter 2. Quarter 3 is expected to fall further. The strong growth in employment numbers during 2018 has reversed into a falling trend during 2019, indicating that the economy is cooling, while inflationary pressures are also weakening The Fed finished its series of increases in rates to 2.25 – 2.50% in December 2018. In July 2019, it cut rates by 0.25% as a 'midterm adjustment' but flagged up that this was not to be seen as the start of a series of cuts to ward off a downturn in growth. It also ended its programme of quantitative tightening in August, (reducing its holdings of treasuries etc). It then cut rates again in September to 1.75% - 2.00% and is thought likely to cut another 25 bps in December. Investor confidence has been badly rattled by the progressive ramping up of increases in tariffs President Trump has made on Chinese imports and China has responded with increases in tariffs on American imports. This trade war is seen as depressing US, Chinese and world growth. In the EU, it is also particularly impacting Germany as exports of goods and services are equivalent to 46% of total GDP. It will also impact developing countries dependent on exporting commodities to China.

EUROZONE. Growth has been slowing from +1.8 % during 2018 to around half of that in 2019. Growth was +0.4% q/q (+1.2% y/y) in quarter 1 and then fell to +0.2% q/q (+1.0% y/y) in quarter 2; there appears to be little upside potential to the growth rate in the rest of 2019. German GDP growth fell to -0.1% in quarter 2; industrial production was down 4% y/y in June with car production down 10% y/y. Germany would be particularly vulnerable to a no deal Brexit depressing exports further and if President Trump imposes tariffs on EU produced cars. The European Central Bank (ECB) ended its programme of quantitative easing purchases of debt in December 2018, which meant that the central banks in the US, UK and EU had all ended the phase of post financial crisis expansion of liquidity supporting world financial markets by purchases of debt. However, the downturn in EZ growth in the second half of 2018 and into 2019, together with inflation falling well under the upper limit of its target range of 0 to 2%, (but it aims to keep it near to 2%), has prompted the ECB to take new measures to stimulate growth. At its March meeting it said that it expected to leave interest rates at their present levels "at least through the end of 2019", but that was of little help to boosting growth in the near term. Consequently, it announced a third round of TLTROs; this provides banks with cheap borrowing every three months from September 2019 until March 2021 which means that, although they will have only a two-year maturity, the Bank is making funds available until 2023, two years later than under its previous policy. As with the last round, the new TLTROs will include an incentive to encourage bank lending, and they will be capped at 30% of a bank's eligible loans. However, since then, the downturn in EZ and world growth has gathered momentum so at its meeting on 12 September, it cut its deposit rate further into negative territory, from -0.4% to -0.5%, and announced a resumption of quantitative easing purchases of debt. It also increased the maturity of the third round of TLTROs from two to three years. However, it is doubtful whether this loosening of monetary policy will have much impact on growth and unsurprisingly, the ECB stated that governments will need to help stimulate growth by fiscal policy. On the political front, Austria, Spain and Italy are in the throes of forming coalition governments with some unlikely combinations of parties i.e. this raises questions around their likely endurance. The recent results of two German state elections will put further pressure on the frail German CDU/SDP coalition government.

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 also still needs to be made to eliminate excess industrial capacity and to switch investment from property construction and infrastructure to consumer goods production. The trade war with the US does not appear currently to have had a

significant effect on GDP growth as some of the impact of tariffs has been offset by falls in the exchange rate and by transhipping exports through other countries, rather than directly to the US.

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.

WORLD GROWTH. The trade war between the US and China is a major concern to financial markets and is depressing worldwide growth, as any downturn in China will spill over into impacting countries supplying raw materials to China. Concerns are focused on the synchronised general weakening of growth in the major economies of the world compounded by fears that there could even be a recession looming up in the US, though this is probably overblown. These concerns have resulted in government bond yields in the developed world falling significantly during 2019. If there were a major worldwide downturn in growth, central banks in most of the major economies will have limited ammunition available, in terms of monetary policy measures, when rates are already very low in most countries, (apart from the US), and there are concerns about how much distortion of financial markets has already occurred with the current levels of quantitative easing purchases of debt by central banks. The latest PMI survey statistics of economic health for the US, UK, EU and China have all been sub 50 which gives a forward indication of a downturn in growth; this confirms investor sentiment that the outlook for growth during the rest of this financial year is weak.

Interest rate forecasts

The Council's treasury advisor, Link Asset Services, has provided the following forecast.
This forecast includes the increase in margin over gilt yields of 100bps introduced on 9.10.19.

Link Asset Services Interest Rate View										
	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	1.00	1.00	1.00	1.25
3 Month LIBID	0.70	0.70	0.70	0.80	0.90	1.00	1.00	1.00	1.10	1.20
6 Month LIBID	0.80	0.80	0.80	0.90	1.00	1.10	1.10	1.20	1.30	1.40
12 Month LIBID	1.00	1.00	1.00	1.10	1.20	1.30	1.30	1.40	1.50	1.60
5yr PWLB Rate	2.30	2.50	2.60	2.70	2.70	2.80	2.90	3.00	3.00	3.10
10yr PWLB Rate	2.60	2.80	2.90	3.00	3.00	3.10	3.20	3.30	3.30	3.40
25yr PWLB Rate	3.30	3.40	3.50	3.60	3.70	3.70	3.80	3.90	4.00	4.00
50yr PWLB Rate	3.20	3.30	3.40	3.50	3.60	3.60	3.70	3.80	3.90	3.90

The above forecasts have been based on an assumption that there is some sort of muddle through to an agreed deal on Brexit at some point in time. Given the current level of uncertainties, this is a huge assumption and so forecasts may need to be materially reassessed in the light of events over the next few weeks or months.
It has been little surprise that the Monetary Policy Committee (MPC) has left Bank Rate unchanged at 0.75% so far in 2019 due to the ongoing uncertainty over Brexit. In its meeting on 1 August, the MPC became more dovish as it was more concerned about the outlook for both the global and domestic economies. That's shown in the policy statement, based on an assumption that there is an agreed deal on Brexit, where the suggestion that rates would need to rise at a "gradual pace and to a limited extent" is now also conditional on "some recovery in global growth". Brexit uncertainty has had a dampening effect on UK GDP growth in 2019, especially around mid-year. If there were a no deal Brexit, then it is likely that there will be a cut or cuts in Bank Rate to help support economic growth. The September MPC meeting sounded even more concern about world growth and the effect that prolonged Brexit uncertainty is likely to have on growth.
Bond yields / PWLB rates. There has been much speculation recently that we are currently in a bond market bubble. However, given the context that there are heightened expectations that the US could be heading for a recession, and a general background of a downturn in world economic growth, together with inflation generally at low levels in most countries and expected to remain subdued, conditions are ripe for low bond yields. While inflation targeting by the major central banks has been successful over the last thirty years in lowering inflation expectations, the real equilibrium rate for central rates has fallen considerably due to the high level of borrowing by consumers: this means that

central banks do not need to raise rates as much now to have a major impact on consumer spending, inflation, etc. This has pulled down the overall level of interest rates and bond yields in financial markets over the last thirty years. We have therefore seen over the last year, many bond yields up to ten years in the Eurozone actually turn negative. In addition, there has, at times, been an inversion of bond yields in the US whereby ten year yields have fallen below shorter term yields. In the past, this has been a precursor of a recession. The other side of this coin is that bond prices are elevated as investors would be expected to be moving out of riskier assets i.e. shares, in anticipation of a downturn in corporate earnings and so selling out of equities. However, stock markets are also currently at high levels as some investors have focused on chasing returns in the context of dismal ultra-low interest rates on cash deposits.

What we saw during the last half year up to 30 September is a near halving of longer term PWLB rates to completely unprecedented historic low levels. *(See paragraph 7 for comments on the increase in margin over gilt yields of 100bps introduced on 9.10.19.)* There is though, an expectation that financial markets have gone too far in their fears about the degree of the downturn in US and world growth. If, as expected, the US only suffers a mild downturn in growth, bond markets in the US are likely to sell off and that would be expected to put upward pressure on bond yields, not only in the US, but due to a correlation between US treasuries and UK gilts, which at various times has been strong but at other times weaker, in the UK. However, forecasting the timing of this and how strong the correlation is likely to be, is very difficult to forecast with any degree of confidence.

One potential danger that may be lurking in investor minds is that Japan has become mired in a twenty year bog of failing to get economic growth and inflation up off the floor, despite a combination of massive monetary and fiscal stimulus by both the central bank and government. Investors could be fretting that this condition might become contagious.

Another danger is that unconventional monetary policy post 2008, (ultra-low interest rates plus quantitative easing), may end up doing more harm than good through prolonged use. Low interest rates have encouraged a debt fuelled boom which now makes it harder for economies to raise interest rates. Negative interest rates could damage the profitability of commercial banks and so impair their ability to lend and / or push them into riskier lending. Banks could also end up holding large amounts of their government's bonds and so create a potential doom loop. (A doom loop would occur where the credit rating of the debt of a nation was downgraded which would cause bond prices to fall, causing losses on debt portfolios held by banks and insurers, so reducing their capital and forcing them to sell bonds – which, in turn, would cause further falls in their prices etc.). In addition, the financial viability of pension funds could be damaged by low yields on holdings of bonds.

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, as well as a softening global economic picture.
- 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. 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.** In 2018, Italy was a major concern due to having a populist coalition government which made a lot of anti-austerity and anti-EU noise. However, in September 2019 there was a major change in the coalition governing Italy which has brought to power a much more EU friendly government; this has eased the pressure on

Italian bonds. Only time will tell whether this new unlikely alliance of two very different parties will endure.

- 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.** Austria, 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.
- 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 **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.