INVESTMENT SUB-COMMITTEE – 24TH JANUARY 2020 – AGENDA ITEM 5 (2)

TREASURY MANAGEMENT STRATEGY STATEMENT 2020/21

1. Background

1.1 The Council is required to operate a balanced budget which broadly means that income raised during the year will meet planned expenditure. Part of the treasury management operation is to ensure that the cashflow for this is adequately planned, with cash being available when it is needed. Where surplus monies are available these are invested with counterparties or in instruments commensurate with the Council's low risk appetite, providing security and adequate liquidity initially before considering investment return.

1.2 The second main function of the treasury management service is the funding of the Council's capital plans. These plans provide a guide to borrowing need, essentially the longer term cash flow planning, to ensure that the Council can meet its capital spending obligations. This management of longer term cash may involve arranging long or short term loans, or using longer term cash flow surpluses. On occasion, when it is prudent and economic, any loan debt may be restructured to meet Council risk or cost objectives.

2. Treasury Management Strategy 2020/21

2.1 The proposed strategy for 2020/21 covers borrowing and investment issues. This includes the requirements of the Local Government Act 2003 and the CIPFA Treasury Management Code. The requirements of the CIPFA Prudential for Capital Finance Code 2017 are covered by the Capital Strategy.

3. Economic Background

3.1 Economic Outlook-The UK's progress negotiating its exit from the European Union, together with its future trading arrangements, will continue to be a major influence on the Authority's treasury management strategy for 2020/21.The stated position of the UK Government to leave the EU by the 31st December 2020 continues the uncertainty facing the UK economy. A more detailed economic and interest rate forecast provided is attached at **Appendix A** (page 12).

3.2 UK Consumer Price Inflation (CPI) for December was 1.5% year on year. The BoE forecasts inflation for 2020 as 1.5% and 2% for 2021. The most recent labour market data for October 2019 showed the unemployment rate edged up slightly to 3.8%. The average annual growth rate for pay excluding bonuses in October was 3.5% as and provide some pull on general inflation. Adjusted for inflation, real wages grew by 2.0%., a level likely to have little effect on consumer spending. Unemployment in October 2019 was 3.8%, 0.3% lower than October 2018.

3.3 Looking ahead, the BoE, in its November Monetary Policy Report, expects GDP growth to average around 1% for 2020, providing the UK's exit from the EU is relatively smooth.

3.4 Interest Rate Forecast- Following the Bank of England's decision to increase Bank Rate to 0.75% in August, no changes to monetary policy has been made since. The short term outlook for increases in interest rate increases is soft with the risks on the downside. The Monetary Policy Committee continues to reiterate that any further increases will be at a gradual pace and limited in extent. For the purpose of setting the budget, it has been assumed that new investments will be made at an average rate of 0.75%, and that new long-term loans will be borrowed at an average rate of 2.7%. A more detailed economic background and interest rate forecast provided is attached at **Appendix A.**

4. Current Treasury Portfolio

4.1 The Council's current treasury portfolio, as at 31 December 2019 is shown below at Table 1 and highlights the average interest rate return in 2019/20 compared to 2018/19 :-

Table 1	2019/20 Principal Amount £m	2019/20 Avg. Interest Rate %	2018/19 Avg. Interest Rate %
Notice Accounts & Cash Plus Funds	4.0	0.8	0.8
Money Market Funds	8.1	0.7	0.7
Short-term Deposits	0	0	0.7
CCLA Property Fund	4.0	4.3	5.0
Funding Circle	2.0	3.9	6.0
Schroders Bond Fund	3.0	4.6	4.4
UBS Multi-Asset Fund	3.0	3.9	4.0
CCLA Diversification Fund	2.0	3.2	3.0
Total Treasury Investments	**26.1**	**2.4**	**2.0**
Long-term PWLB loans (HRA)	61.2	2.7	2.7
Long-term PWLB loans (GF)	43.4	2.6	2.5
Total Borrowing	**104.6**	**2.7**	**2.7**
Net Borrowing	**78.5**		

5. Capital Strategy and Capital Investment Planning

5.1 The Council's Capital Strategy is shown as a separate document. This covers the following capital expenditure.

5.2 Physical capital assets owned by the Council and used in the delivery of services, and, where appropriate:

(i) Capital Loans to specific service providers e.g Loans to Gryllus Property Ltd and Freedom Leisure ; and

(ii) Loans and shareholdings in limited companies, joint ventures and other non-financial investments in property.

5.3 Such investments will be treated as capital expenditure for treasury management and prudential borrowing purposes even though they do not create physical assets in the Council's accounts. Appropriate budgets in respect of these activities are agreed as part of the Council's budget setting and ongoing monitoring processes and considered as part of the Investment Strategy.

5.4 Capital Financing Requirement (CFR) -The CFR measures the Council's underlying borrowing need for the capital strategy. Each year, the CFR will increase by the amounts of new capital expenditure not immediately financed and reduces by the resources set aside for financing capital expenditure incurred in earlier years. e.g MRP. The Capital Strategy sets out the Councils Capital Financing Requirement

5.5 Table 2 below shows that the CFR will increase over the medium term. Consequently, the capital financing charge to revenue will increase, reflecting the capital spending plans.

Capital Financing Requirement	Actual 2018/19	Estimate 2019/20	Estimate 2020/21	Estimate 2021/22	Estimate 2022/23
	£m	**£m**	**£m**	**£m**	**£m**
General Fund CFR	12.485	84.415	152.343	218.144	219.320
HRA CFR	61.308	71.686	85.731	98.326	102.762
Capital Financing Requirement	**73.793**	**156.101**	**238.074**	**316.470**	**322.082**
Movement in CFR		**82.308**	**81.973**	**78.396**	**5.612**

Table 3 below shows a forecast of borrowing requirement over the period

Forecast of Borrowing	Actual 2018/19	Estimate 2019/20	Estimate 2020/21	Estimate 2021/22	Estimate 2022/23
	£m	£m	£m	£m	£m
General Fund Borrowing	26.099	81.555	148.529	213.633	214.075
HRA Borrowing	61.189	61.189	64.803	69.953	69.953
Forecast Borrowing	**87.288**	**142.744**	**213.332**	**283.586**	**284.028**
CFR not funded by Borrowing	**0**	**13.357**	**24.742**	**32.884**	**38.054**

It should be noted that the estimated General Fund borrowing in Table 3 is based on the financing of the Council's planned Capital Programme, however if capital expenditure is does not occur in line with the profiled spend then borrowing will not be undertaken.

5.6 CIPFA's Prudential Code for Capital Finance in Local Authorities recommends that the Council's total debt should be lower than its highest forecast capital expenditure over the next three years. This is confirmed by comparing the total forecast capital expenditure per year in to the movement in CFR in Table 2 with projected Table 3. This allows some flexibility for limited early borrowing for future years,but ensures that borrowing is not undertaken for revenue purposes or that the Council is in an over-borrowed position for its capital strategy and programme.

6. Borrowing Strategy

6.1 The Council's main objective when borrowing money is to strike an appropriate balance between securing low interest costs and achieving cost certainty over the period for which funds are required. Given the significant cuts to public expenditure and in particular to local government funding, the Council's borrowing strategy continues to address the key issue of affordability without compromising the longer-term stability of the debt portfolio. The key factors influencing the 2020/21 borrowing strategy are:

(i) forecast the borrowing requirement of the Council;

(ii) the current economic and market environment; and

(iii) interest rate forecast awareness.

6.2 The Council's current strategy is to maintain borrowing and investments below their underlying full capital expenditure level. The Council is thus maintaining its an under-borrowed position, which means that capital expenditure has not been fully funded from loan debt as other funding streams (e.g. government grants, reserves or capital receipts) have also been used where available. This policy has served the Council well over the last few years while investment returns have been variable and counterparty risk has been relatively high.

6.3 However, the Council's borrowing position will still need to be kept under review to avoid incurring higher borrowing costs in future years when the Council may not be able to avoid new borrowing to finance capital expenditure and/or to refinance maturing debt.

6.4 As the overall financial climate still remains unsettled, the Treasury Management team will continue to monitor interest rates in financial markets and adopt a pragmatic approach to changing circumstances (within their approved remit). If it were considered that there was a significant risk of a sharp fall in long and short term rates (e.g. due to a marked increase of risks around relapse into recession or of risks of deflation), long term borrowings could be postponed, and potential rescheduling from fixed rate funding into short term borrowing could be considered. Further reports to the Investment Sub-Committee will be made as appropriate if a change in strategy is required.

7. Borrowing Limits

7.1 The Prudential Code requires the Council to set two limits on its total external debt, as set out in the table below. The limits have been adjusted as required for growth and slippage in the capital strategy. The limits are:

- Authorised Limit for External Debt (Prudential Indicator 7a). This is the limit prescribed by section 3(1) of the Local Government Act 2003 representing the maximum level of borrowing which the Council may incur. It reflects the level of external debt which, while not desired, could be afforded in the short term, but may not be sustainable in the longer term.

- Operational Boundary (Prudential Indicator 7b). This is the limit which external debt is not normally expected to exceed. The boundary is based on current debt plus anticipated net financing need for future years.

Overall Borrowing Limits	**Limit 2020/21**	**Limit 2020/22**	**Limit 2022/23**
Authorised Limit for External Borrowing	**£m**	**£m**	**£m**
Borrowing and Other Long Term Liabilities	215	285	285
Operational Boundary for External Debt			
Borrowing and Other Long Term Liabilities	210	280	280

7.2 Managing the profile of when debt matures is essential for ensuring that the Council is not exposed to large fixed rate sums falling due for re-financing within a short period, and thus potentially exposing the Council to additional cost. The table below sets out current upper limits for debt maturity.

Debt Maturity Profile Limits	Actual as at 31/12/19	Lower Limit 2020/21	Upper Limit 2020/21
	%		%
Under 1 year	3.9	5	15
1 to 2 years	6.3	5	15
2 to 5 years	9.1	10	25
5 years to 10 years	24.4	20	50
10 -20 years	11.2	20	50
Over 20 years	45.1	30	50
Total	**100%**		

7.3 In the event that there is a much sharper rise in long and short term rates than currently forecast, then the balance of the loan portfolio will be re-visited with a view to taking on longer term fixed rate borrowing in anticipation of future rate rises.

8. Debt Rescheduling

8.1 As short term borrowing rates will be considerably cheaper than longer term fixed interest rates, there may be opportunities to generate savings by switching from long term debt to short term debt. However, these savings will need to be considered in the light of the current treasury position and the cost of debt repayment (premiums can be incurred on premature redemption of PWLB debt).

9. Managing Cash Balances

9.1 The Council had accumulated reserves of £19.3m at the end of the financial 2018/19. This was supported by Short and Long Term Investments. The position is anticipated to be £18m at the end of the 2019/20 financial year. It is not anticipated that this position will alter significantly in 2020/21. In addition, the Council has significant inflows of cash and outflows each month, which require investment.

9.2 The Council’s policy is to set aside £4-5m to provide working capital to cover day to day contingencies. Therefore assuming a level of accumulated reserves of £18m plus a day to day working balance of £4-5m gives an average of £13-14m is available to be invested over the longer-term without impacting on the Council's need for liquidity.

9.3 As planned Capital Programme expenditure takes place in 2019/20, the Council will need to borrow to fund this investment in 2019/20 as cash balances will naturally reduce. The Council currently has £14m under long term investment., valued at £14.2m at the end of December 2019, which could be used to finance capital expenditure in the short term. However investment returns are currently higher than long term borrowing costs and it is not proposed therefore at this stage to use these investments.

10. Treasury Investment Strategy

10.1 The Council holds significant invested funds, representing income received in advance of expenditure, balances and reserves. During the first half of the current year, the Council's average investment balance has been around £25-30m and the cash flow projections shows this pattern is expected to continue in the forthcoming year. Investments are made with reference to the core balance, future cash flow requirements and the outlook for interest rates.

10.2 The Council's investment policy has regard to the CLG's Guidance on Local Government Investments ("the Investment Guidance") and the CIPFA Treasury Management in Public Services Code of Practice and Cross Sectoral Guidance Notes ("the CIPFA TM Code"). The Council's investment priorities will be security first, liquidity second, and then return.

10.3 In accordance with the above guidance and to minimise the risk to investments, the Council applies minimum acceptable credit criteria to generate a list of highly creditworthy counterparties which will provide security of investments, enable diversification and minimise risk. The key ratings used to monitor counterparties are the Short Term and Long Term ratings.

10.4 An investment time limit has to be set with regard to the Council's liquidity requirements and to reduce the need for early sale of an investment. For the year 2020/21, the proposed limit of investments for over 1 year is £14m.

10.5 The Council's officers recognise that ratings should not be the sole determinant of the quality of an institution and that it is important to assess continually and monitor the financial sector on both a micro and macro basis and in relation to the economic and political environments in which institutions operate. The assessment will also take account of information that reflects the opinion of the markets. To this end the Council will engage with its advisors and monitor changes in market variables and pricing with the credit ratings in order to generate optimal returns.

10.6 Other information sources used will include the financial press, share price and other such information pertaining to the banking sector to establish the most robust scrutiny process on the suitability of potential investment counterparties.

10.7 The primary principle governing the Council's treasury investment criteria is the security of its investments, closely followed by liquidity (i.e. repayment of money) and then finally the actual return on the investment. These factors in that order are a key consideration. After this main principle, the Council will ensure that:

(i) It maintains a policy covering both the categories of investment types it will invest in, criteria for choosing investment counterparties with adequate security and monitoring their security; and

(ii) It has sufficient liquidity in its investments. For this purpose it will set out procedures for determining the maximum periods for which funds may prudently be committed. These procedures also apply to the Council's prudential indicators covering the maximum principal sums invested.

10.8 The Interim Chief Finance Officer (S151 Officer) will use the services of the Council's Treasury management adviser currently, Link Asset Services, to provide advice on an up to date counterparty list in compliance with the following criteria and will revise the criteria and submit them to Council for approval as necessary.

10.9 The Council takes into account the following relevant matters when proposing counterparties:

(i) the financial position and jurisdiction of the institution;

(ii) the market pricing of credit default swaps for the institution;

(iii) any implicit or explicit Government support for the institution;

(iv) the use of two of the major credit rating agencies external short and long term credit ratings to assess creditworthiness;

(v) Sovereign ratings to select counterparties from only the most creditworthy countries; and

(vi) core Tier 1 capital ratios.

NB- Definition of Credit Default Swap – CDS are a financial instrument for swapping the risk of debt default. Credit default swaps may be used for emerging market bonds, mortgage-backed securities, corporate bonds and local government bond. The buyer of a credit default swap pays a premium for effectively insuring against a debt default.

10.10 The MHCLG Guidance on Local Government Investments made under section 15(1) of the Local Government Act 2003, places restrictions on Local authorities in relation to investments. Investments fall in to one of the three categories; Specified Investments , Loans and Non Specified Investments

10.11 A specified investment is defined as an investment which satisfies all of the conditions below:

(i) the investment is denominated in sterling and any payments or repayments in respect of the investment are payable only in sterling;

(ii) the investment is not a long term investment. This means that the local authority has a contractual right to repayment within 12 months, either because that is the expiry term of the investment or through a non conditional option;

(iii) the making of the investment is not defined as capital expenditure under Regulation 25 of the Capital Finance regulations (2013); and

(iv) the investment is made with a body or in an investment scheme of high credit quality; or with the UK Government, a UK Local Authority or parish/community council.

10.12 Loans- Authorities may provide loans to local enterprises, local charities, wholly owned companies and joint ventures as part of a wider strategy for delivering economic growth and delivering services for the Council. This is covered within the Council's Capital Strategy in more detail.

10.13 A non-specified investment is any investment that is not a loan and does not meet the criteria to be treated as a specified investment. These principally relates to non–financial investments which an Authority holds primarily or partially to generate a profit. This is covered within the Council's Capital Strategy.

Credit Rating of Treasury Management Investments

10.14 The criteria for providing a pool of high quality short, medium and long-term, cash-based investment counterparties along with the time and monetary limits for institutions on the Council's counterparty list are in the table below. The Council defines the following as being of "high credit quality" for making specified investments, subject to the monetary and time limits shown.

High Credit Quality	Individual Monetary limit[1]	Aggregate Monetary Limit	Fitch Credit rating[3]
UK Central Government	No Limit	No Limit	Not applicable
UK Local Authorities including PCC's	£2m each	LT: £8m	Not applicable
Banks[(1)] operating in the UK[(2)]	£2m each	LT: £8m ST: None	LT:AA- ST: F1
Overseas Banks (subject to Sovereign Rating AAA or AA+)	£2m each	£8m	LT:AA- ST: F1
UK building societies with an asset base > £1bn	£2m each		LT: A ST:F1
UK building societies with an asset base < £1bn	£1m each		LT: A ST:F1
Money Market Funds	£4m each		ST: AAA
Pooled Funds*			
Bond Funds without credit ratings	£4m each	£8m	Not applicable
Property Funds without credit ratings	£4m each	£4m	Not applicable
Multi Asset Funds	£4m each	£8m	Not applicable
Long Term Loans to small business ranked no lower than average risk by independent credit analysis	£100,000	£6m	Not applicable
Company shares to participate in the UK Municipal Bonds Agency	£10,000	£10,000	Not applicable

[1] banks within the same group ownership are treated as one bank for limit purposes
[2] where the bank is used as a reserve account the criteria will exclude consideration of the long term credit rating
[3] Minimum Credit rating required, is expressed as a Fitch rating or the equivalent S&P or Moodys ratings etc
[4] The Council has placed an overall limit on pooled funds of £16m

10.15 The majority of the Council's investments will be made for relatively short periods and in highly credit rated investments, giving priority to security and liquidity ahead of yield. In order that the Council is not at risk of a large single default, the maximum that will be lent to any one organisation (other than the UK Government) will be £2 million or £4 million per pooled fund. A group of banks under the same ownership will be treated as a single organisation for limit purposes.

11. Money market Funds and Pooled Funds

11.1 Money market funds are pooled investment vehicles consisting of instruments similar to those used by the Council. They have the advantage of providing wide diversification of investment risks, coupled with the services of a professional fund manager. Fees of between 0.10% and 0.20% per annum are deducted from the interest paid to the Council.

11.2 Funds that offer same-day liquidity and a constant net asset value will be used as an alternative to instant access call accounts, while funds whose value changes with market prices and/or have a notice period will be used for longer investment periods.

12. Risk assessment and credit ratings

12.1 The Council uses long-term credit ratings from at least two of the main credit rating agencies to assess the risk of investment default. The lowest available credit rating will be used to determine credit quality.

12.2 Long-term ratings are expressed on a scale from AAA (the highest quality) through to D (indicating default). Ratings of BBB- and above are described as investment grade, while ratings of BB+ and below are described as speculative grade. The Council's credit rating criteria are set to ensure that it is unlikely that the Council will hold speculative grade investments directly, despite the risk of repeated downgrades. The Council may invest in bond funds that hold speculative grade bonds themselves, giving the Council an indirect exposure, but the risk is mitigated by the high level of diversification and the expert fund management.

12.3 Credit ratings are obtained and monitored by the Council's treasury advisers, who will notify changes in ratings as they occur. Where an entity has its credit rating downgraded so that it fails to meet the approved investment criteria then:

- no new investments will be made;
- any existing investments that can be recalled or sold at no cost will be; and
- full consideration will be given to the recall or sale of all other existing investments with the affected counterparty.

13 Other information on the security of investments

13.1 The Council understands that credit ratings are good, but not perfect, predictors of investment default. Full regard will therefore be given to other available information on the credit quality of the organisations in which it invests, including credit default swap prices, financial statements and reports in the quality financial press. No investments will be made with an organisation if there are substantive doubts about its credit quality, even though it may meet the above criteria.

13.2 If these restrictions mean that insufficient commercial organisations of "high credit quality" are available to invest the Council's cash balances, then the surplus will be deposited with Money Market Funds, the UK Government, via the Debt Management Office for example, or with other local authorities. This will cause a reduction in the level of investment income earned, but will protect the principal sum invested.

14. Foreign countries

14.1 Investments in foreign countries will be limited to those that hold an AAA or AA+ sovereign credit rating from two of the three major credit rating agencies, and to a maximum of £2 million per foreign country. Investments in countries whose lowest sovereign rating is not AAA will be limited to one year's duration. No country limit will apply to investments in the UK, irrespective of the sovereign credit rating.

14.2 Overseas subsidiaries of foreign banking groups will normally be assessed according to the country of domicile of the parent organisation. However, Santander UK plc (a subsidiary of Spain's Banco Santander) will be classed as a UK bank due to its substantial UK franchises and the arms-length nature of the parent-subsidiary relationships.

14.3 Sovereign credit rating criteria and foreign country limits will not apply to investments in multilateral development banks (e.g. the European Investment Bank and the World Bank) or other supranational organisations (e.g. the European Union).

15 Liquidity management

15.1 The Council uses financial systems to determine the maximum period for which funds may prudently be committed. The forecast is compiled on a pessimistic basis, with receipts under-estimated and payments over-estimated to minimise the risk of the Council being forced to borrow on unfavourable terms to meet its financial commitments. Decisions on long-term investments are set by reference to the Council's medium term financial plan and cash flow forecast.

16. Interest rate exposures

16.1 This indicator is set to control the Council's exposure to interest rate risk. The upper limits on fixed and variable rate interest rate exposures, expressed as net principal borrowed will be:

	2020/21 £m	2021/22 £m	2022/23 £m
Upper limit on fixed interest rate exposures	215	285	285
Upper limit on variable interest rate exposures	50	60	60

16.2 Fixed rate investments and borrowings are those where the rate of interest is fixed for the whole financial year. Instruments that mature during the financial year are classed as variable rate.

17 Risk Implications - principal sums invested for periods longer than 364 days

17.1 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 recommendation for the upper limit of principal sums maturing beyond the year end is £16m, as shown below:

	2020/21	2021/22	2022/23
Limit on principal invested beyond year end	£16m	£16m	£16m

18 Investment training

18.1 The needs of the Council's treasury management staff for training in investment management are assessed annually as part of the staff appraisal process, and additionally when the responsibilities of individual members of staff change.

18.2 Staff regularly attend training courses, seminars and conferences provided by treasury management advisors and CIPFA. Relevant staff are also encouraged to study professional qualifications from CIPFA, the Association of Corporate Treasurers and other appropriate organisations. A regular programme for the training of Members responsible for Treasury Management is being provided.

19 Other Financial Policies

19.1 Charging interest to the Housing Revenue Account- Following the reform of housing finance, the Council is free to adopt its own policy on sharing interest costs and income between the General Fund and Housing Revenue Account (HRA). The CIPFA Code recommends that Authorities state their policy on this matter each year in their treasury management strategy.

19.2 The Council is required to notionally split each of its existing long-term loans into General Fund and HRA pools. For TDC, the only borrowing relates to the £70.2m that was borrowed on 28th March 2012 which was assigned to the HRA pool. In the future, any new long-term loans borrowed will be assigned in their entirety to one pool or the other. Interest payable and other costs/income arising from long-term loans (e.g. premiums and discounts on early redemption) will be charged/credited to the respective revenue account. Transfers between the General Fund and HRA will be made at the Authority's average short term interest rate on investments, adjusted for credit risk.

19.3 Financial Derivatives- In the absence of any explicit legal power to do so, the Authority will not use standalone financial derivatives (such as swaps, forwards, futures and options). Derivatives embedded into loans and investments, including pooled funds and forward starting transactions, may be used, and the risks that they present will be managed in line with the overall treasury risk management strategy.

19.4 Markets in Financial Instruments Directive- The Authority has registered as a professional client with its providers of financial services, including advisers, banks, brokers and fund managers, allowing it access to a greater range of services but without the greater regulatory protections afforded to individuals and small companies. Given the size and range of the Authority's treasury management activities, the [Chief Financial Officer (Section 151 Officer) believes this to be the most appropriate status.

19.5 Business models- Under the new IFRS 9 standard, the accounting for certain investments depends on the Authority's "business model" for managing them. The Authority aims to achieve value from its internally managed treasury investments by a business model of collecting the contractual cash flows and therefore, where other criteria are also met, these investments will continue to be accounted for at amortised cost.

ECONOMIC BACKGROUND

UK. Brexit. 2019 has been a year 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 31 October 2019, with or without a deal. However, MPs blocked leaving on that date and the EU agreed an extension to 31 January 2020. In late October, MPs approved an outline of a Brexit deal to enable the UK to leave the EU on 31 January. Now that the Conservative Government has gained a large overall majority in the **general election** on 12 December, this outline deal will be passed by Parliament by that date. However, there will still be much uncertainty as the detail of a trade deal will need to be negotiated by the current end of the transition period in December 2020, which the Prime Minister has pledged he will not extend. This could prove to be an unrealistically short timetable for such major negotiations that leaves open two possibilities; one, the need for an extension of negotiations, probably two years, or, a no deal Brexit in December 2020.

GDP growth has taken a hit from Brexit uncertainty during 2019; quarter three 2019 surprised on the upside by coming in at +0.4% q/q, +1.1% y/y. However, the peak of Brexit uncertainty during the final quarter appears to have suppressed quarterly growth to probably around zero. The economy is likely to tread water in 2020, with tepid growth around about 1% until there is more certainty after the trade deal deadline is passed.

While the Bank of England went through the routine of producing another **quarterly Inflation Report,** (now renamed the Monetary Policy Report), on 7 November, it is very questionable how much all the writing and numbers were worth when faced with the uncertainties of where the UK will be after the general election. The Bank made a change in their Brexit assumptions to now include a deal being eventually passed. Possibly the biggest message that was worth taking note of from the Monetary Policy Report, was an increase in concerns among MPC members around weak global economic growth and the potential for Brexit uncertainties to become entrenched and so delay UK economic recovery. Consequently, the MPC voted 7-2 to maintain Bank Rate at 0.75% but two members were sufficiently concerned to vote for an immediate Bank Rate cut to 0.5%. The MPC warned that if global growth does not pick up or Brexit uncertainties intensify, then a rate cut was now more likely. Conversely, if risks do recede, then a more rapid recovery of growth will require gradual and limited rate rises. The speed of recovery will depend on the extent to which uncertainty dissipates over the final terms for trade between the UK and EU and by how much global growth rates pick up. The Bank revised its inflation forecasts down – to 1.25% in 2019, 1.5% in 2020, and 2.0% in 2021; hence, the MPC views inflation as causing little concern in the near future.

The **MPC meeting of 19 December** repeated the previous month's vote of 7-2 to keep Bank Rate on hold. Their key view was that there was currently 'no evidence about the extent to which policy uncertainties among companies and households had declined' i.e. they were going to sit on their hands and see how the economy goes in the next few months. The two members who voted for a cut were concerned that the labour market was faltering. On the other hand, there was a clear warning in the minutes that the MPC were concerned that "domestic unit labour costs have continued to grow at rates above those consistent with meeting the inflation target in the medium term".

If economic growth were to weaken considerably, the MPC has relatively little room to make a big impact with Bank Rate still only at 0.75%. It would therefore, 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 Government has already made moves in this direction and it made significant promises in its election manifesto to increase government spending by up to £20bn p.a., (this would add about 1% to GDP growth rates), by investing primarily in infrastructure. This is likely to be announced in the next Budget, probably in February 2020. The Chancellor has also amended the fiscal rules in November to allow for an increase in government expenditure.

As for **inflation** itself, CPI has been hovering around the Bank of England's target of 2% during 2019, but fell again in both October and November to a three-year low of 1.5%. It is likely to remain close to or under 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 hard or no deal Brexit, inflation could rise towards 4%, primarily because of imported inflation on the back of a weakening pound.

With regard to the **labour market,** growth in numbers employed has been quite resilient through 2019 until the three months to September where it fell by 58,000. However, there was an encouraging pick up again in the three months to October to growth of 24,000, which showed that the labour market was not about to head into a major downturn. The unemployment rate held steady at a 44-year low of 3.8% on the Independent Labour Organisation measure in October. Wage inflation has been steadily falling from a high point of 3.9% in July to 3.5% in October (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 2.0%. 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 other message from the fall in wage growth is that employers are beginning to find it easier to hire suitable staff, indicating that supply pressure in the labour market is easing.

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 growth to a robust 2.9% y/y. **Growth** in 2019 has been falling after a strong start in quarter 1 at 3.1%, (annualised rate), to 2.0% in quarter 2 and then 2.1% in quarter 3. The economy looks likely to have maintained a growth rate similar to quarter 3 into quarter 4; fears of a recession have largely dissipated. The strong growth in employment numbers during 2018 has weakened during 2019, indicating that the economy had been cooling, while inflationary pressures were also weakening. However, CPI inflation rose from 1.8% to 2.1% in November, a one year high, but this was singularly caused by a rise in gasoline prices.

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 intended 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 by 0.25% again in September and by another 0.25% in its October meeting to 1.50 – 1.75%.. At its September meeting it also said it was going to **start buying Treasuries again**, although this was not to be seen as a resumption of quantitative easing but rather an exercise to relieve liquidity pressures in the repo market. Despite those protestations, this still means that the Fed is again expanding its balance sheet holdings of government debt. In the first month, it will buy $60bn, whereas it had been reducing its balance sheet by $50bn per month during 2019. As it will be buying only short-term (under 12 months) Treasury bills, it is technically correct that this is not quantitative easing (which is purchase of long term debt). The Fed left rates unchanged in December. However, the accompanying statement was more optimistic about the future course of the economy so this would indicate that further cuts are unlikely.

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. However, in November / December, progress has been made on agreeing a phase one deal between the US and China to roll back some of the tariffs; this gives some hope of resolving this dispute.

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, +0.2% q/q (+1.2% y/y) in quarter 2 and then +0.2% q/q, +1.1% in quarter 3; there appears to be little upside potential in the near future. German GDP growth has been struggling to stay in positive territory in 2019 and fell by -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 then 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 quantitative easing 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 that means that, although they will have only a two-year maturity, the Bank was 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; 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 for an unlimited period.** At its October meeting it said these purchases would start in November at €20bn per month - a relatively small amount compared to the previous buying programme. 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 would need to help stimulate growth by 'growth friendly' fiscal policy.

There were no policy changes in the December meeting, which was chaired for the first time by the new President of the ECB, Christine Lagarde. However, the outlook continued to be down beat about the economy; this makes it likely there will be further monetary policy stimulus to come in 2020. She did also announce a thorough review of how the ECB conducts monetary policy, including the price stability target. This review is likely to take all of 2020.

On the political front, Austria, Spain and Italy have been in the throes of **forming coalition governments** with some unlikely combinations of parties i.e. this raises questions around their likely endurance. The latest results of German state elections has put further pressure on the frail German CDU/SDP coalition government and on the current leadership of the CDU. The results of the Spanish general election in November have not helped the prospects of forming a stable coalition.

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 shadow banking systems. In addition, there still needs to be a greater switch from investment in industrial capacity, property construction and infrastructure to consumer goods production.

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. Until recent years, world growth has been boosted by increasing **globalisation** i.e. countries specialising in producing goods and commodities in which they have an economic advantage and which they then trade with the rest of the world. This has boosted worldwide productivity and growth, and, by lowering costs, has also depressed inflation. However, the rise of China as an economic superpower over the last thirty years, which now accounts for nearly 20% of total world GDP, has unbalanced the world economy. The Chinese government has targeted achieving major world positions in specific key sectors and products, especially high tech areas and production of rare earth minerals used in high tech products. It is achieving this by massive financial support, (i.e. subsidies), to state owned firms, government directions to other firms, technology theft, restrictions on market access by foreign firms and informal targets for the domestic market share of Chinese producers in the selected sectors. This is regarded as being unfair competition that is putting western firms at an unfair disadvantage or even putting some out of business. It is also regarded with suspicion on the political front as China is an authoritarian country that is not averse to using economic and military power for political advantage. The current trade war between the US and China therefore needs to be seen against that backdrop. It is, therefore, likely that we are heading into a period where there will be a **reversal of world globalisation and a decoupling of western countries** from dependence on China to supply products. This is likely to produce a backdrop in the coming years of weak global growth and so weak inflation. **Central banks are, therefore, likely to come under more pressure to support growth by looser monetary policy measures and this will militate against central banks increasing interest rates**.

The trade war between the US and China is a major concern to **financial markets** due to 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 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). There are also concerns about how much distortion of financial markets has already occurred with the current levels of quantitative easing purchases of debt by central banks and the use of negative central bank rates in some countries. The latest PMI survey statistics of economic health for the US, UK, EU and China have all been predicting a downturn in growth; this confirms investor sentiment that the outlook for growth during the year ahead is weak.

INTEREST RATE FORECASTS

The interest rate forecast are **predicated on an assumption of an agreement being reached on Brexit between the UK and the EU.** On this basis, while GDP growth is likely to be subdued in 2019 and 2020 due to all the uncertainties around Brexit depressing consumer and business confidence, an agreement on the detailed terms of a trade deal is likely to lead to a boost to the rate of growth in subsequent years. This could, in turn, increase inflationary pressures in the economy and so cause the Bank of England to resume a series of gentle increases in Bank Rate. Just how fast, and how far, those increases will occur and rise to, will be data dependent. The forecasts in this report assume a modest recovery in the rate and timing of stronger growth and in the corresponding response by the Bank in raising rates.

- In the event of an **orderly non-agreement exit in December 2020**, it is likely that the Bank of England would take action to cut Bank Rate from 0.75% in order to help economic growth deal with the adverse effects of this situation. This is also likely to cause short to medium term gilt yields to fall.
- If there were a **disorderly Brexit**, then any cut in Bank Rate would be likely to last for a longer period and also depress short and medium gilt yields correspondingly. Quantitative easing could also be restarted by the Bank of England. It is also possible that the government could act to protect economic growth by implementing fiscal stimulus.

The balance of risks to the UK

- The overall balance of risks to economic growth in the UK is probably even, but dependent on a successful outcome of negotiations on a trade deal.
- The balance of risks to increases in Bank Rate and shorter term PWLB rates are broadly similarly to the downside.
- In the event that a Brexit deal was agreed with the EU and approved by Parliament, the balance of risks to economic growth and to increases in Bank Rate is likely to change to the upside.

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 since 2008. This means that the neutral rate of interest in an economy, (i.e. the rate that is neither expansionary nor deflationary), is difficult to determine definitively in this new environment, although central banks have made statements that they expect it to be much lower than before 2008. Central banks could therefore either over or under do increases in central interest rates.

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

- **Brexit** – if it were to cause significant economic disruption and a major downturn in the rate of growth.
- **Bank of England** 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 coalition based on an 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. The CDU has done badly in recent state elections but the SPD has done particularly badly and this has raised a major question mark over continuing to support the CDU. Angela Merkel has stepped down from being the CDU party leader but she intends to remain as Chancellor until 2021.
- **Other minority EU governments.** Austria, Finland, Sweden, Spain, Portugal, Netherlands and Belgium also have vulnerable minority governments dependent on coalitions which could prove fragile.
- **Austria, the Czech Republic, Poland and Hungary** now form a strongly anti-immigration bloc within the EU. There has also been rising anti-immigration sentiment in Germany and France.

- In October 2019, the IMF issued a report on the World Economic Outlook which flagged up a synchronised slowdown in world growth. However, it also flagged up that there was **potential for a rerun of the 2008 financial crisis**, but his time centred on the huge debt binge accumulated by corporations during the decade of low interest rates. This now means that there are corporates who would be unable to cover basic interest costs on **some $19trn of corporate debt in major western economies,** if world growth was to dip further than just a minor cooling. This debt is mainly held by the shadow banking sector i.e. pension funds, insurers, hedge funds, asset managers etc., who, when there is $15trn of corporate and government debt now yielding negative interest rates, have been searching for higher returns in riskier assets. Much of this debt is only marginally above investment grade so any rating downgrade could force some holders into a fire sale, which would then depress prices further and so set off a spiral down. The IMF's answer is to suggest imposing higher capital charges on lending to corporates and for central banks to regulate the investment operations of the shadow banking sector. In October 2019, the deputy Governor of the Bank of England also flagged up the dangers of banks and the shadow banking sector lending to corporates, especially highly leveraged corporates, which had risen back up to near pre-2008 levels.
- **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.