BARNSLEY METROPOLITAN BOROUGH COUNCIL

This matter is not a Key Decision within the Council's definition and has not been included in the relevant Forward Plan

Report of the Executive Director of Core Services

TREASURY MANAGEMENT ACTIVITIES & INVESTMENT PERFORMANCE - QUARTER ENDED 30TH SEPTEMBER 2017

1. Purpose of the Report

1.1 The CIPFA (Chartered Institute of Public Finance and Accountancy) Code of Practice for Treasury Management recommends that members be updated on Treasury Management activities regularly (Treasury Management Strategy Statement (TMSS), annual and mid-year reports). This report, therefore, ensures that the Council is implementing best practice in accordance with the Code.

2. Recommendations

2.1 It is recommended that Members note:-

- **the Treasury Management activities undertaken during the quarter and compliance with the Prudential Indicators;**
- **the Authority's latest borrowing position (Section 5);**
- **the Authority's latest investment portfolio and performance for the quarter (Section 6); and**
- **the Authority's latest outturn position against the approved Treasury Management budget (Section 8).**

3. Economic Summary

3.1 Highlights and key messages:

- The UK economy struggled to pick up much pace;
- The labour market tightened further, but underlying wage pressures remained weak;
- Headline inflation picked up further;
- The Monetary Policy Committee (MPC) appeared to become more in favour of an interest rate rise;
- UK Public Finances performed better than expected; and
- Brexit negotiations lacked "significant progress".

3.2 A more detailed commentary from our advisors is provided in Appendix 3.

4. Interest Rate Forecast

4.1 The table below outlines the latest base rate projections from our advisors:

Base Rate	Dec 2017	Mar 2018	Jun 2018	Sep 2018	Dec 2018	Mar 2019	Jun 2019	Sep 2019	Dec 2019	Mar 2020
Capita Asset Services (Q1)	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.50%	0.50%	0.75%	0.75%
Capita Asset Services (Q2)	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.50%	0.50%	0.75%	0.75%
Capital Economics (Q1)	0.25%	0.25%	0.50%	0.50%	0.75%	0.75%	1.00%	1.00%	1.25%	-
Capital Economics (Q2)	0.50%	0.50%	0.75%	1.00%	1.25%	1.25%	1.50%	1.50%	1.75%	-

4.2 The UK base rate was cut in August 2016 (from 0.50% to 0.25%) following signs of a sharp slowdown in growth in the second half of the year, however this did not materialise. Inflation rose substantially in the first half of 2017, owing to a fall in the value of sterling since the referendum. As a result, the base rate has not been reduced further.

4.3 The forecast from our advisors (Capita Asset Services) remains unchanged from the previous quarter, which suggests a rate increase is unlikely to happen until 2019 after the Brexit negotiations have been concluded.

4.4 On the other hand, the majority of economists and investors within the market expect the Bank of England (BoE) to raise interest rates to 0.50% at their meeting next in November; the BoE itself has previously indicated that an increase is likely. Capital Economics, an independent financial advisory body concur with this outlook, as shown in the table above. It is vital therefore, that the Council maintains a prudent stance towards interest rate risk.

4.5 A detailed commentary from our advisors on the interest rate forecast is provided in Appendix 4.

5. The Authority's Borrowing Position

Borrowing Need (Capital Financing Requirement)

5.1 The Capital Financing Requirement (CFR) is essentially a measure of the Council's underlying borrowing need, based on historic and future capital investment. Capital investment which isn't financed from internal resources (i.e. Capital Receipts, Capital Grants and Contributions, Revenue or Reserves) will produce an increase in the CFR.

5.2 The CFR cannot increase indefinitely, as there is a statutory obligation for the Authority to set aside an annual revenue charge, the minimum revenue provision (MRP), which effectively restricts the proportion of the Council's budget that can be used to finance debt. This broadly reduces the borrowing need in line with each asset's life. In addition, the Authority is able to make voluntary contributions towards reducing its CFR as it sees fit.

5.3 Included in the CFR are other long term liabilities such as PFI schemes and finance leases. Whilst these increase the Council's overall CFR, the borrowing facility included means that we're not required to borrow separately. The borrowing CFR therefore excludes such amounts.

5.4 The table below outlines the Authority's projected borrowing need over the next 5 years, compared to the closing position from 2016/17. This covers the planned expenditure per the approved capital programme, plus anticipated capital investment yet to be approved (i.e. Better Barnsley phase 2):

	2016/17 Actual	2017/18 Estimate	2018/19 Estimate	2019/20 Estimate	2020/21 Estimate	2021/22 Estimate
Opening Capital Financing Requirement	**937,290**	**940,585**	**945,336**	**964,581**	**996,277**	**1,019,149**
Capital Investment	68,629	99,782	88,537	79,453	88,516	8,621
Resources Utilised	(53,822)	(83,824)	(59,747)	(38,148)	(55,086)	-
Increase in CFR from In Year Capital Investment	**14,807**	**15,958**	**28,790**	**41,305**	**33,430**	**8,621**
Amount Set Aside to Repay Debt	(11,512)	(11,207)	(9,545)	(9,609)	(10,558)	(10,768)
Closing Capital Financing Requirement	**940,585**	**945,336**	**964,581**	**996,277**	**1,019,149**	**1,017,002**
Borrowing CFR	699,558	705,756	726,491	759,350	783,845	783,076
PFI / Leasing CFR	241,027	239,580	238,090	236,927	235,304	233,926

5.5 The Authority's borrowing strategy makes reference to the temporary use of internal resources to finance its Capital Expenditure (referred to as internal borrowing). This approach allows the Authority to take advantage of the current low interest environment, however with it comes greater exposure to interest rate risk.

5.6 The table below outlines the anticipated levels of internal borrowing over the next 5 years, assuming like-for-like replacement of existing loans as they mature (for illustrative purposes only). This shows that, based on the Authority's anticipated expenditure plans, its exposure to interest rate risk will increase significantly from 2019/20:

	2017/18 Opening	2017/18 Current	2018/19 Estimate	2019/20 Estimate	2020/21 Estimate	2021/22 Estimate
Borrowing CFR	699,558	705,756	726,491	759,350	783,845	783,076
Total Borrowing	551,479	559,424	555,026	550,593	546,122	542,859
Internal Borrowing	**148,079**	**146,332**	**171,465**	**208,757**	**237,723**	**240,217**
% of Borrowing CFR	21%	21%	24%	27%	30%	31%

5.7 The table below outlines the movement on the Authority's borrowing position during the quarter:

	Balance on 01/07/2017 £m	New Borrowing £m	Debt Repaid £m	Balance on 30/09/2017 £m	Net Increase/ (Decrease) £m
Temporary Borrowing	89.283	51.900	(39.280)	101.903	12.620
PWLB Borrowing	394.061	-	(1.262)	392.799	(1.262)
Other Long Term Loans	63.000	-	-	63.000	-
Long Term Local Authority	3.897	-	-	3.897	-
TOTAL BORROWING	**550.241**	**51.900**	**(40.542)**	**561.599**	**11.358**
Other Long Term Liabilities	227.901	-	-	227.901	-
TOTAL DEBT	**778.142**	**51.900**	**(40.542)**	**789.500**	**11.358**

5.8 The Authority's overall debt position increased by £11.4M during the quarter, predominantly arising from the medium-term borrowing undertaken to cover the PWLB loans maturing in 2019/20. This helps to spread the refinancing risk whilst addressing the Council's future borrowing need.

5.9 A Debt Options analysis has been carried out to assess the Council's portfolio and its requirements over the next 5 years. It is important to ascertain the right approach in a difficult climate. An analysis has been completed to project the impact of taking various decisions and how this feeds through to the Capital Financing Budget. Several options were outlined in the 2017/18 TMSS to address the Authority's borrowing position, as set out in section 8.

New Borrowing

5.10 No new long-term borrowing was undertaken during the quarter, but the borrowing requirements of the Authority, together with the borrowing rates available are being closely monitored by Officers. The latest PWLB certainty rate forecasts are shown within Appendix 4.

Borrowing in Advance of Need

5.11 The Council has not borrowed in advance of need during the quarter ended 30th September 2017.

Debt Rescheduling

5.12 Debt rescheduling opportunities have been very limited in the current economic climate given the consequent structure of interest rates, and following the increase in the margin added to gilt yields which has impacted PWLB new borrowing rates since October 2010. No debt rescheduling has therefore been undertaken to date in the current financial year and none is expected over the remainder of the financial year.

5.13 As mentioned above, various borrowing opportunities are currently being explored with an ongoing review of the Council's Treasury Management position.

6. The Authority's Investment Portfolio

6.1 The table below outlines the movement on the Authority's investment portfolio during the quarter:

	Balance on 01/07/2017 £m	**Investments Made £m**	**Investments Repaid £m**	**Balance on 30/09/2017 £m**	**Net Increase/ (Decrease) £m**
Long-Term Investments *	7.000	-	-	7.000	-
Short-Term Investments	15.000	15.000	(5.000)	25.000	10.000
Money Market Funds / Instant Access	24.600	73.300	(73.600)	24.300	(0.300)
TOTAL INVESTMENTS	**46.600**	**88.300**	**(78.600)**	**56.300**	**9.700**

* The 'long-term investments' referred to above are long-term in that they're invested for an indefinite period, however they can be recalled within 3 days.

6.2 The Authority's overall investment portfolio increased by £9.7M during the quarter predominantly arising from timing differences between the receipt of cash income and liabilities falling due in the period.

6.3 All of our investments are in-line with the investment priorities and approved limits set out in the TMSS for 2017/18 (further details below):

1. Security of capital;
2. Liquidity; and
3. Yield.

Officers can confirm that the approved limits within the Annual Investment Strategy were not breached during the quarter.

Counterparty	Rating	Principal (£m)	Status
Lloyds	A	5.00	Fixed deposit to 09.10.17
Goldman Sachs International Bank	A	5.00	Fixed deposit to 04.12.17
Plymouth City Council	AA	5.00	Fixed deposit to 12.10.17
Wirral Council	AA	5.00	Fixed deposit to 25.10.17
Leeds City Council	AA	5.00	Fixed deposit to 05.02.18
Svenska Handelsbanken	AA-	9.40	Instant Access
Money Market Funds	AAAmmf	14.90	Instant Access
Enhanced Money Market Funds	AAAmmf	7.00	Accessible within 3 days
TOTAL INVESTMENTS		**56.30**	

6.4 Following the base rate cut in August 2016, the Authority has seen interest rate reductions across its instant access accounts and money market funds. Officers are continuing to assess daily cash flows and liquidity requirements to ensure that the Authority's investments are the most suitable within the current environment.

6.5 The 7 day London Interbank Bid Rate (LIBID) is used as a performance indicator for measuring the return on investments. The average rate of return on the Authority's investments for the quarter was 0.29%, exceeding the 7 day LIBID benchmark of 0.11%.

7. Compliance with Treasury and Prudential Limits

7.1 It is a statutory duty for the Council to determine and keep under review the affordable borrowing limits. The Council's approved Prudential and Treasury Indicators (affordability limits) are included in the approved TMSS.

7.2 During the quarter the Council operated within the treasury and prudential indicators set out in the Council's TMSS and in compliance with the Council's Treasury Management Practices. The Prudential and Treasury Indicators are shown in Appendix 1.

8. Budget

8.1 The Council has a specific Capital Financing Budget to cover the cost of borrowing and other long term liabilities. These costs are offset to some extent by the income generated from the Council's investments.

8.2 The Capital Financing Budget is projected to underspend in 2017/18 by £2m reflecting the savings generated from the change in the Council's MRP policy (Corporate Financial Performance Report - Quarter Ended September 2017 refers). The permanent saving has been built into the Council's Medium Term Financial Strategy (MTFS) from 2018/19; therefore the underspend is a one-off for 2017/18.

8.3 We may also see some one-off savings from the temporary and variable rate borrowing undertaken in recent times (taking advantage of the current low interest rate environment).

These savings will be absorbed in future years as the Council seeks to reduce its exposure to interest rate / refinancing risk. Future reports will update on this position.

9. The Future Outlook for Treasury Management Activities

9.1 The Finance Business Unit continues to closely monitor the Council's borrowing position together with projected interest rate forecasts for the next two years.

9.2 Affordability and the 'cost of carry' (the difference between long-term borrowing rates and short-term investment rates) remain important influences on the borrowing strategy and the Authority determines it cost effective in the short-term to use internal resources. However, the Council will not be able to sustain a temporary / internally borrowed position indefinitely and will eventually need to fix out more borrowing in the near future to fund the Glass Works scheme and other previously approved commitments. In addition to this, the Council has a number of loans that will mature over the next 2-3 years at relatively high rates. The Finance Business Unit will again seek to replace these loans at lower rates as part of the process to optimise the Council's longer term borrowing position.

9.3 Several borrowing recommendations were outlined in the 2017/18 TMSS including:

1) Borrowing from the newly formed Municipal Bond Agency (MBA). The Agency has been established to provide an alternative source of funding for Local Authorities from the PWLB. The Agency is a new initiative and has not yet made its first bond issue. Should the bond issue fail to materialise within our required timescales, the Authority will look into alternative borrowing options. A further cabinet report will be released for approval in due course.

2) Fixing out a proportion of the debt portfolio, to move towards fixing out temporary variable loans as a policy objective. Repaying the variable rate debt will reduce interest rate risk (without incurring a penalty), but clearly will introduce additional costs to refinance.

3) Reviewing the feasibility of taking out deferred loans to cover off a large variable loan due to mature in 2019/20. Options are available to fix the rate now for a period of up to 4 years in advance. This would allow the Authority to maintain a short term, cheap position, with the comfort of fixed rate loans being delivered in the future. The risks are, once committed the funds must be taken and the market rates could potentially be cheaper in future although this is unlikely with current interest rates so low. The Finance Business Unit is currently looking at options with our advisers and in active discussions with several lending institutions to implement one or more forward loans. A cabinet report on the forward borrowing options will be released for approval in the near future.

9.4 In addition to the above, ongoing work is being undertaken to review other areas in the Council's debt portfolio to create further savings. A specific example is the review of the Building Schools for the Future PFI programme. This has already been completed for phase 2 in conjunction with the Local Education Partnership and it is proposed to complete phase 1 and 3 during 2017/18 and 2018/19.

9.5 Opportunities to repay the Authority's LOBO loans have been investigated, but at this time further progress has not been made. This is primarily due to the German lenders, FMS, who do not appear to want to engage in discussions to re-negotiate the deal despite initially encouraging dialogue. As a result this option has been discounted for the time being but will be re-established if further opportunities present themselves in future.

9.6 The Authority is aware of two upcoming reforms that may impact on its investment activities in the near future:

1) Markets in Financial Institutions Directive (MiFiD II). MiFiD II is a wide-ranging Directive which aims to strengthen the investment services market. It introduces a number of key changes to client categorisation, meaning Local Authorities will have to opt- up to professional client status in order to access certain products. To do so they will have to meet a number of qualitative and quantitative tests. These changes are set to take effect from January 2018. Officers are in contact with the relevant parties, and in some cases have begun the opt-up process, however due to a lack of standardisation the process could be fairly lengthy, therefore regular updates will be provided via the Treasury Management Panel.

2) Money Market Fund Reform. The Money Market Fund Reform introduces a new structural fund - the Low Volatility Net Asset Value (LVNAV) Fund – and some changes to the existing Money Market Funds. These regulations will apply to new funds from July 2018 and existing funds from January 2019. Officers will continue to monitor the situation and provide a further update in quarter 3.

Appendix 1

Prudential and Treasury Indicators as at 30th September 2017

Prudential Indicators	Limit for 2017/18 (£'000)	Quarter 2 Actual (£'000)	Compliance with Indicator?
Maximum Debt Compared to Authorised Limit	990.591	799.726	Yes
Average Debt Compared to Operational Boundary	960.591	790.855	Yes

Maturity structure of fixed rate borrowing	Upper Limit (%)	Lower Limit (%)	Quarter 2 Actual (£'000)	Quarter 2 Actual (%)	Compliance with Indicator?
Under 12 months	0	50	136.584	29	Yes
12 months to 2 years	0	25	24.416	5	Yes
2 years to 5 years	0	25	36.680	8	Yes
5 years to 10 years	0	25	48.726	10	Yes
10 years to 20 years	0	75	21.426	4	Yes
20 years to 30 years	0	75	55.539	12	Yes
30 years to 40 years	0	75	67.400	14	Yes
40 years to 50 years	0	75	86.030	18	Yes

Treasury Indicators	Limit for 2017/18 (%)	Quarter 2 Actual (%)	Compliance with Indicator?
Upper limit of fixed interest rates based on net debt	90	85	Yes
Upper limit of variable interest rates based on net debt	25	15	Yes

Treasury Indicators	Limit for 2017/18 £'000	Quarter 2 Actual (£'000)	Compliance with Indicator?
Upper limit for principal sums invested over 364 days*	20.000	-	Yes

** The 'long-term investments' referred to in section 6.1 are long-term in the sense that they're invested for an indefinite period, however they can be recalled within 3 days we have excluded them from the indicator above.*

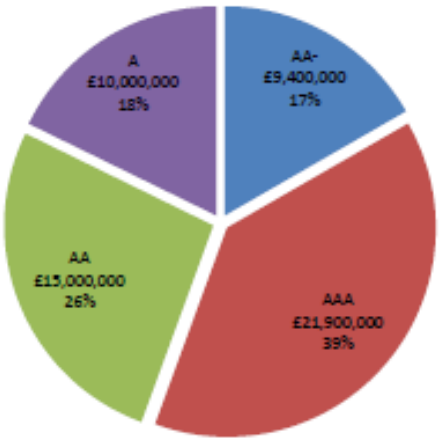
Appendix 2

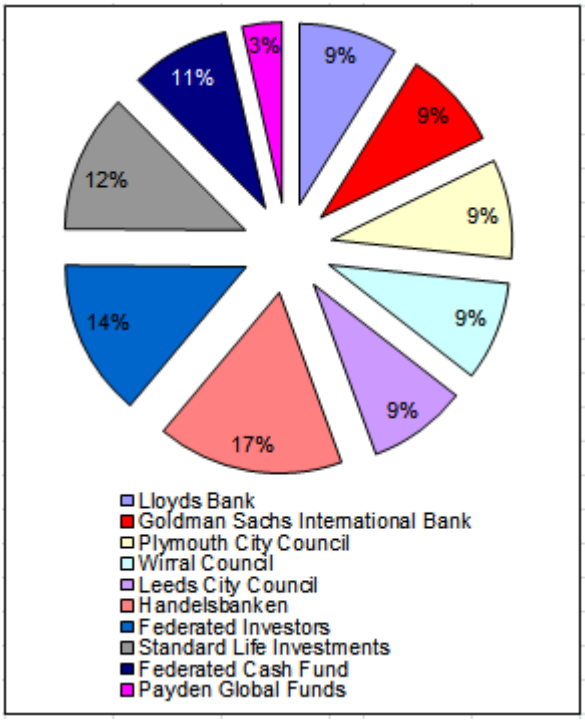
Analysis of Investment Portfolio as at 30th September 2017

Current Investment List

Borrower	Principal (£)	Interest Rate	Start Date	Maturity Date	Lowest Long Term Rating	Historic Risk of Default
MMF Federated Investors (UK)	7,900,000	0.21%		MMF	AAA	0.000%
MMF Standard Life	7,000,000	0.20%		MMF	AAA	0.000%
Svenska Handelsbanken AB	9,400,000	0.30%		Call	AA-	0.000%
USDBF Federated Sterling Cash Plus Fund	5,000,000	0.03%		USDBF	AAA	0.000%
USDBF Payden Sterling Reserve Fund	2,000,000	0.14%		USDBF	AAA	0.000%
Lloyds Bank Plc	5,000,000	0.55%	07/04/2017	09/10/2017	A	0.001%
Plymouth City Council	5,000,000	0.25%	12/07/2017	12/10/2017	AA	0.001%
Wirral Metropolitan Borough Council	5,000,000	0.25%	25/09/2017	25/10/2017	AA	0.002%
Goldman Sachs International Bank	5,000,000	0.64%	02/06/2017	04/12/2017	A	0.010%
Leeds City Council	5,000,000	0.32%	27/09/2017	05/02/2018	AA	0.008%
Total Investments	**£56,300,000**	**0.29%**				0.002%

Rating Exposure





Investments by Counterparty	£	Type
Lloyds Bank	5,000,000	UK Bank
Goldman Sachs International Bank	5,000,000	UK Bank
Plymouth City Council	5,000,000	Local Authority
Wirral Council	5,000,000	Local Authority
Leeds City Council	5,000,000	Local Authority
Handelsbanken	9,400,000	Non-UK Bank
Federated Investors	7,900,000	MMF
Standard Life Investments	7,000,000	MMF
Federated Cash Fund	5,000,000	Short Duration
Payden Global Funds	2,000,000	Short Duration
TOTAL	**56,300,000**	

Detailed Commentary on Developments during the Quarter (Capita Asset Services)

- During the quarter ended 30th September 2017:
  - The economy struggled to pick up much pace;
  - The labour market tightened further, but underlying wage pressures remained weak;
  - Headline inflation picked up further;
  - The MPC took a much more hawkish turn;
  - The public finances performed better than expected;
  - Brexit negotiations lacked "significant progress".

- Following a fairly meagre expansion of 0.3% in Q2, the economy struggled to gather much momentum in Q3 of 2017. The economy-wide Markit/CIPS all-sector PMI is consistent, on the basis of past form, with quarterly GDP growth of only 0.4% or so. Admittedly, some of the early hard data hasn't been especially encouraging. For example, services output contracted by 0.2% in July.

- That said, some monthly pull-back in services output always seemed likely following two consecutive strong monthly gains. Part of July's weakness merely reflects an unwinding of the boost from strong motion picture production in June. Moreover, our seasonally-adjusted measure of SMMT new car registrations suggests that car sales have picked up over the course of Q3. Note too that retail sales volumes rose by a monthly 1% in August and the manufacturing sector looks to have done better.

- What's more, Q2's Quarterly National Accounts painted households' balance sheets in a better light, suggesting that spending growth rests on more solid foundations. Due to an improvement in the data source for dividend income, the household saving ratio has been revised up, on average, by 0.9pp since 1997. The rise in self-employment and the importance of dividend income over more recent years, has seen a bigger upward revision to the latest data. Q1's ratio was revised up from 1.7% to 3.8% and the saving ratio increased further, to 5.4%, in Q2. This suggests that households have more scope to reduce savings in order to smooth their spending while real incomes are being squeezed.

- Admittedly, there are still concerns about rapid growth in consumer credit which averaged just under 10% y/y in Q3. However, the expansion in credit only explains about 1.4% of the increase in spending in Q2, so consumers are not "reliant" on unsecured borrowing.

- Moreover, the Bank of England's Financial Policy Committee appears to be concerned about the low level of risk that banks are attaching to consumer credit, as it deemed the risk to the economy to be small. As a result, all else being equal, (pending the results of the full stress tests in November), UK banks will need to hold around £10bn more capital to protect against losses on unsecured consumer borrowing.

- In any case, overall household spending growth should continue to be supported by the robust labour market as total employment rose by 181,000 in the three months to July. This pushed the unemployment rate down to 4.3%, its lowest rate since 1975. This still hasn't translated into a pick-up in wage growth though. Although the weakness in annual growth in average weekly earnings in July was largely a reflection of a large annual fall in bonus payments, regular pay growth, (i.e. excluding bonuses), was barely 2%, and so was well below the rate of inflation.

- Indeed, CPI inflation has risen from 2.6% at the end of Q3, to 2.9% in August, and looks set to nudge up to over 3% before the end of the year. The majority of the rise in the consumer price level over the past year is a result of higher imported goods prices, on account of the drop in the exchange rate related to the EU referendum. However, that impact should start to fade from around the turn of the year. In fact, price pressures at the start of the production pipeline, have already begun to ease; input price inflation has eased from just under 20% in

January, to 7.6% in August. Meanwhile, output price inflation never rose as far as was suggested by its previous relationship with input prices; however, it, too, has eased back recently.

- Elsewhere, other measures of domestically-generated inflation have remained fairly subdued, and below the rates that have previously been consistent with hitting the inflation target. The average of the measures of domestically generated inflation (i.e. stripping out the impact of the drop in the pound), which we track, has held broadly steady over the past few quarters.

- Despite this, the Bank of England's Monetary Policy Committee (MPC) has taken a more hawkish shift in Q3, with September's meeting signalling that an imminent rate hike is now firmly on the table. While Bank Rate remains at 0.25%, and the stock of asset purchases at £435bn, there are a number of reasons why a hike at November's MPC meeting now looks very likely: -

- The key points from the latest Inflation Report are as follows: -
  - First, the MPC stopped only just shy of saying as much, in that "some withdrawal of monetary stimulus was likely to be appropriate over the coming months".
  - Second, changes in policy have tended to come in the MPC meeting alongside the quarterly Inflation Report.
  - Third, the language was a lot more specific than on previous occasions where guidance has been given. This was also language that the whole Committee signed off on and not just in a speech by the Governor, as has been the case in the past.
  - Fourth, markets are now expecting it, with the market-implied probability of a rate hike in November having risen from less than 50% at the end of August, to 86% at the start of October.
  - Finally, the MPC has set itself a low hurdle for raising rates. All that needs to happen is for the economy to "follow a path consistent with the prospect of a continued erosion of slack and a gradual rise in underlying inflationary pressure". So it may not need to see actual evidence of domestically-generated inflation building in order to hike rates before the end of the year.

- Turning to fiscal policy, borrowing has come in below the OBR's forecasts. Cumulative borrowing in the first five months of this fiscal year was 0.7% lower than the previous year, in contrast to the 13% rise that the OBR expects for the full fiscal year. This was largely because receipts have been stronger than anticipated. Admittedly, the OBR's forecasts envisage the deterioration coming later on in the fiscal year, as the boost related to the shift in self-assessment income as individuals sought to avoid the rise in the dividend tax rate is unwound in January and February 2018. Nonetheless, even taking that into account, borrowing is still likely to come in below forecast this fiscal year, assuming the recent trend continues.

- This might give the Chancellor more scope to ease back on austerity at the upcoming Autumn Budget on 22nd November. A relaxation of the public sector pay cap has already been announced, as has a £10bn increase in funding for the Help to Buy Scheme.

- Elsewhere, Brexit negotiations made some headway in Q3, with the UK making some concessions to the EU. Admittedly, there are still some sticking points, including the role of the European Court of Justice in enforcing citizens' rights post-Brexit, the size and scope of the financial settlement (or so-called "exit bill"), and workable solutions to avoiding a hard border on the island of Ireland. As a result, it looks unlikely that the European Council will be able to judge at its October meeting that "sufficient progress" has been made in order to advance the talks to the next phase of the negotiations.

- As a result, it may not be until the next meeting in December, that the door opens to discussing the UK's future relationship with the EU, including any transitional arrangement. The Government does appear to have broadly sketched out what this may entail though –

an approximately 2-year period with continuing freedom of movement and trade “on current terms”, suggesting membership of the single market and customs union beyond the March 29th 2019 date when the UK is scheduled to officially leave the EU.

- Finally, in financial markets, sterling appreciated by around 1% over the course of Q3 on a trade-weighted basis. However, it is around 5% higher than its low over the quarter, following a significant appreciation on the back of the hawkish shift of the MPC. Despite the rise in the exchange rate, the FTSE 100 climbed by 0.8% over the quarter. That said, the more domestically-focussed FTSE UK Local index, which only includes firms that make 70% or more of their sales in the UK, only rose by 0.3%. Meanwhile the sharp shift upwards in expectations of Bank Rate increases has caused 10-year government bond yields to rise by 40bp since their Q3 low, although at less than 1.40%, they remain low by historical standards.

- Internationally, the US Federal Reserve has set out its strategy for unwinding quantitative easing and signalled that one more hike in interest rates before the end of the year looks likely. Survey indicators suggest that the euro-zone economy has continued to perform strongly. The European Central Bank is expected in October to lay out its own plans to taper its asset purchases in 2018.

Detailed Commentary on Interest Rate Forecasts and Forward View (Capita Asset Services)

August Quarterly Inflation Report Review

Our Treasury Management advisers, Capita Asset Services have provided us with the following update to their interest rate forecasts. This was provided on 9 August i.e. before the MPC meeting of 14 September which sharply increased expectations of how soon Bank Rate was likely to start going up.

	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20
Bank rate	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.50%	0.50%	0.75%	0.75%
5yr PWLB rate	1.50%	1.60%	1.70%	1.70%	1.80%	1.80%	1.90%	1.90%	2.00%	2.00%
10yr PWLB rate	2.20%	2.30%	2.30%	2.40%	2.40%	2.50%	2.50%	2.60%	2.60%	2.70%
25yr PWLB rate	2.90%	2.90%	3.00%	3.00%	3.10%	3.10%	3.20%	3.20%	3.30%	3.30%
50yr PWLB rate	2.70%	2.70%	2.80%	2.80%	2.90%	2.90%	3.00%	3.00%	3.10%	3.10%

- Following the latest Bank of England quarterly Inflation Report on 3 August, we have reviewed the forecasts we made on 17 May after the previous quarterly Inflation Report for May 2017. Today's forecasts are unchanged from our May forecasts as there is very little in the way of any material change of any significance over the last three months to warrant making any changes.

- The key points from the latest Inflation Report are as follows: -
  - Forecast for GDP growth for 2017 was shaved from 1.9% to 1.7%; this was probably inevitable following weak growth in quarter 1 of only +0.2% and +0.3% in quarter 2. The forecast for 2018 was also shaved from 1.7% to 1.6%; this is merely minor tinkering.
  - Little change in inflation forecasts; inflation to peak around 3% in October, (currently 2.6%), then to fall back to about 2.2% at the end of the three year time horizon.
  - The MPC confirmed that its "overall assessment of the outlook for inflation and activity..... is broadly similar to that in May."
  - Some MPC members were clearly more concerned about the degree to which they could look through increases in inflation caused by the effective devaluation of the pound since the referendum, and the consequent feed through into the CPI measure of inflation. The vote was therefore 6-2 for no change whereas it was 5-3 in the previous meeting, the change from 3 to 2 votes being accounted for by the departure of Kirstin Forbes. The new Deputy Governor for Markets and Banking, Dave Ramsden, will join the MPC in September, which will then be back to having nine members.
  - The MPC announced that the Term Funding Scheme, providing cheap finance to banks, would end in February 2018, although, due to strong demand from banks, the size of the facility was being increased from £100bn to £115bn to encourage the banks to make cheap funding available to borrowers.

- It also needs to be borne in mind that the Financial Policy Committee (FPC) of the Bank of England is concerned about the sustained strong rise in unsecured consumer credit, (especially car loans), and, in early July, increased the counter cyclical capital buffer requirement on the banking sector from 0% to 0.5%. This requires the major banks to increase capital set aside by £11.4bn over the next 18 months. This will have little immediate impact on bank lending as most banks have existing capital in excess of the minimum required, and also due to the phasing in time period. This is also a blanket approach which does not specifically address the issues around unsecured consumer credit.

The FPC also intends to raise the capital buffer requirement to 1.0% in November 2017. It also said it would bring forward to July, stress tests on the banks related to consumer credit. It was then going look specifically at consumer credit in September, after the result of those stress tests, with a view to making specific recommendations on credit quality requirements.

- Carney's speech 29 June – the Governor repeated in this speech his previous comments that rates might need to rise more quickly IF various tests were met e.g.
  - IF business investment and a rise in exports started to outweigh the slowdown in consumer expenditure
  - IF unemployment stays low
  - IF wage inflation remains subdued
  - how the economy reacts to the prospect of tighter financial conditions
  - how the Brexit negotiations turn out.

- The MPC's forecasts are based on an assumption that there is a smooth transition to the UK's new relationship with the EU. However, the wording around this assumption was subtly amended this time, suggesting somewhat less confidence about that.

- Carney's speech 18 September – the Governor laid out a detailed explanation for a sharp reappraisal of the inflationary pressures facing the UK. The focus was on an emerging view that with unemployment falling to only 4.3%, the lowest level since 1975, and improvements in productivity being so weak, that the amount of spare capacity in the economy was significantly diminishing towards a point at which the Bank now needed to be ready to take action to raise Bank Rate in the near term. In addition, there was a more tolerant view of low wage inflation as this now looks like a common factor in nearly all western economies as a result of increasing globalisation. This effectively means that the UK labour faces competition from overseas labour e.g. in outsourcing work to third world countries, and this therefore depresses the negotiating power of UK labour. However, he was also concerned that the withdrawal of the UK from the EU would effectively lead to a decrease in such globalisation pressures in the UK, and so would be inflationary over the next few years. The MPC clearly took this detailed analysis on board in writing the minutes for the meeting.

- The August MPC minutes did warn again that markets were too pessimistic in thinking Bank Rate would not start rising until quarter three of 2018 as the Bank expects wage growth to accelerate due to continuing falls in unemployment and rising vacancy levels, although it did lower its forecasts for wage inflation at this time. We do feel some caution on this area as wage growth has been remarkably benign despite continuing falls in unemployment; this may reflect hidden levels of unemployment e.g. people wanting to move from part time to full time employment. It may also be that employers in the UK are particularly cautious of the effects of Brexit so are resisting wage increases. We also feel that the MPC will focus on inflation risks, ahead of protecting growth, if inflation looks like rising to levels significantly above current forecasts. However, it is very difficult to be at all certain about risks around this, especially when currency movements in the pound, dollar and euro will be very hard to predict and are subject to major unknowns. It is notable that sterling has now recovered from around $1.20 to the pound after the referendum to around $1.32. This will help to lower inflation caused by increases in costs of imports. However, the Fed is expected to embark on quarterly increases in interest rates in 2018 and this should cause the dollar to strengthen, i.e. the value of sterling against the dollar is likely to fall back again over the next couple of years. Overall though, we know that the spike in inflation caused by sterling's sharp devaluation after the referendum will be working its way out of the CPI figures after 2017. There is therefore room for different views on how seriously inflation pressures are building up. There is also room for different views on how strong economic growth will be in the next eighteen months once the fall back in inflation below the level of wage inflation results in an increase in consumer spending power, which is likely to also be supported by continuing increases in total employment. In addition, exports look likely to do well during the second half of 2017 and onwards.

- Our forecasts assume that there is no cancellation of the emergency cut in Bank Rate in August 2016 from 0.50% to 0.25% and a stop to the quantitative easing (QE) programme in the shorter-term. After the MPC meeting of 14 September, there has been a big increase in this risk that the MPC could simply reverse both. The question would then be whether the MPC pauses for a further period before reaching a time when there is a progression to a sustained trend of gentle increases in Bank Rate, or emabrks on a series of gradual increases throughout 2018. Our forecasts for both Bank Rate and PWLB rates would then need revision if either option were to occur. (We will be updating our forecasts after the Inflation Report and MPC meeting on 2 November.)

- Capital Economics' forecasts for UK economic growth are as follows: 2017 +1.7%; 2018 +2.2%; 2019 +2.0%. They feel that pessimism about the underlying strength of the UK economy is still being overdone by the Bank and that Brexit will not have as big an effect as initially feared by some commentators. They are forecasting that the first increase of 0.25% in Bank Rate will occur in November 2017 and three increases of 0.25% in 2018.

- One major uncertainty is the degree to which there will be a major financial stimulus programme in the US - depending on the degree of agreement, or otherwise, between President Trump and Congress. It now looks more likely that any fiscal stimulus will be delayed to 2018 and to be more moderate than Trump was promising – if it occurs! The risk of a trade war between America and China appears to have evaporated as China has become a sought after partner to the US in curbing North Korea's nuclear ambitions. However, the continuing series of North Korean missile tests has increased tension and concerns as to the potential for American response.

- Rising EU and geopolitical risks e.g.

  - UK general election 8 June. The loss of the Conservative's Parliamentary majority was a shock and has raised concerns around the potential for repercussions over the lifetime of this Parliament.
  - The Dutch general and French presidential elections earlier this year passed off without creating any adverse waves for the EU. Indeed, President Macron of France is strongly committed to turning the EU into a fully federal institution so as to enable it to tackle the major challenges facing the EU in terms of needed reform to make it viable. However, such reforms could also potentially arouse electoral antipathy to the EU.
  - French National Assembly election June 2017. President Macron gained a stunning working majority in this election to give him a very strong platform from which to carry out his promises of radical reform. However, the unions and farmers will, no doubt, not take those threats of reform lying down, (or maybe that will be one of their literal actual tactics)!
  - Greece has been a source of constant major stress in the EU due to its tardiness and reluctance in implementing key reforms required by the EU to make the country more efficient and to make significant progress towards the country being able to pay its way. However, another fudge has been concocted recently so as to avoid a crisis ahead of major Greek repayments pf debt and ahead of the imminent German general election; consequently, this potential trauma has been side-stepped – for now, though the total size of the Greek debt still remains unsustainable, (according to the IMF), at 179% of GDP, and there is no way that Germany will agree to writing off debt. The current bailout ends in 2018. In July, after the new bailout agreement, Greece managed to return to the bond markets in July and to issue €3bn of 5 year bonds at 4.625%, with demand being double the amount made available. This was also a lower rate than its previous issue in 2014.
  - Spain has had two general elections in 2015 and 2016, both of which failed to produce a workable government with a majority of the 350 seats. At the eleventh hour on 31 October 2016, before it would have become compulsory to call a third general election, the party with the biggest bloc of seats (137), was given a majority confidence vote to form a government. This is potentially a highly unstable situation, particularly given the need to deal with an EU demand for implementation of a

package of austerity cuts which will be highly unpopular. The national government's actions over the Catalan independence referendum will not help to maintain this fragile political situation.
  - The under capitalisation of Italian banks poses a major risk with state aid firmly ruled out by the EU as a potential way out.
  - Italian general election; the latest possible date for a general election in Italy is 20 May 2018. The constitutional referendum last December, on reforming the Senate and reducing its powers, became a confidence vote on Prime Minister Renzi who duly resigned when he lost the vote. The rejection of these proposals stopped progress to fundamental political and economic reform which is urgently needed to deal with Italy's core problems, especially low growth. They were also intended to give Italy more stable government as no western European country has had such a multiplicity of governments since the Second World War, due to the equal split of power between the two chambers of the Parliament which are both voted in by the Italian electorate but by using different voting systems. This means there is now major uncertainty about the road ahead for Italy and its ability to tackle the needed major reform. Italy has the third biggest government debt mountain in the world.
  - German Federal election 24 September 2017. Chancellor Merkel has retained her party in power as the biggest party but suffered a significant loss in support from voters. This now makes it very fraught forming a working coalition and this is expected to take some months of negotiation.
  - The core EU, (note, not just the Eurozone currency area), principle of free movement of people within the EU is a growing issue leading to major stress and tension between EU states, especially with the Visegrad bloc of former communist states.

- Economic growth in the EU, (the UK's biggest trading partner), has been lack lustre for several years after the financial crisis despite the ECB eventually cutting its main rate to -0.4% and embarking on a massive programme of QE. However, growth picked up in 2016 and now looks to have gathered ongoing substantial strength and momentum thanks to all this stimulus.

- US. Growth in the American economy has been volatile in 2015 and 2016. 2017 is following that path again with quarter 1 coming in at only 1.2% but quarter 2 rebounding to 3.1%, resulting in an overall annualised figure of 2.1% for the first half year. Unemployment in the US has also fallen to the lowest level for many years, reaching 4.4%, while wage inflation pressures, and inflationary pressures in general, have been building. The Fed has started on a gradual upswing in rates with three increases since December 2016; and there could be one more rate rise in 2017 which would then lift the central rate to 1.25 – 1.50%. There could then be another four more increases in 2018. At its June meeting, the Fed strongly hinted that it would soon begin to unwind its $4.5 trillion balance sheet holdings of bonds and mortgage backed securities by reducing its reinvestment of maturing holdings.

- Chinese economic growth has been weakening over successive years, despite repeated rounds of central bank stimulus; medium term risks are increasing. Major progress still needs to be made to eliminate excess industrial capacity and the stock of unsold property, and to address the level of non-performing loans in the banking and credit systems.

- Japan is struggling to stimulate consistent significant growth 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.

Capita Asset Services' Forward View

- Economic forecasting remains difficult with so many external influences weighing on the UK. Our Bank Rate forecasts, (and also MPC decisions), will be liable to further amendment depending on how economic data and developments in financial markets transpire over the next year. Forecasts for average earnings beyond the three year time horizon will be heavily dependent on economic and political developments. Major volatility in bond yields is likely to

endure as investor fears and confidence ebb and flow between favouring more risky assets i.e. equities, or the safe haven of bonds.

- The overall longer run trend is for gilt yields and PWLB rates to rise, albeit gently. A world economic recovery will likely see investors switching from the safe haven of bonds to equities.

- We have pointed out consistently that the Fed. Rate is likely to go up more quickly and more strongly than Bank Rate in the UK. While there is normally a high degree of correlation between the two yields, we would expect to see a growing decoupling of yields between the two i.e. we would expect US yields to go up faster than UK yields. We will need to monitor this area closely and the resulting effect on PWLB rates.
- The overall balance of risks to economic recovery in the UK remains to the downside, particularly with the current uncertainty over the final terms of Brexit.

- The balance of risks to increases in Bank Rate and shorter term PWLB rates are to the upside and are dependent on how quickly inflation pressures rise and how high the peak will be.

- Our forecasts are predicated on an assumption that there is no break-up of the Eurozone or EU, (apart from the departure of the UK), within our forecasting time period, despite the major challenges that are looming up, and that there are no major ructions in international relations, especially between the US and China / North Korea, which have a major impact on international trade and world GDP growth.

- We would, as always, remind clients of the view that we have expressed in our previous interest rate revision newsflashes of just how unpredictable PWLB rates and bond yields are at present. We are experiencing exceptional levels of volatility which are highly correlated to geo-political and sovereign debt crisis developments. Our revised forecasts are based on the Certainty Rate (minus 20 bps) which has been accessible to most authorities since 1st November 2012.

- Downside risks to current forecasts for UK gilt yields and PWLB rates currently include:
  - Geopolitical risks in Europe, the Middle East and Asia, which could lead to increasing safe haven flows.
  - UK economic growth and increases in inflation are weaker than we currently anticipate.
  - Weak growth or recession in the UK's main trading partners - the EU and US.
  - A resurgence of the Eurozone sovereign debt crisis.
  - Weak capitalisation of some European banks.
  - Monetary policy action failing to stimulate sustainable growth and to get inflation up consistently to around monetary policy target levels.

- The potential for upside risks to current forecasts for UK gilt yields and PWLB rates, especially for longer term PWLB rates include:
  - The pace and timing of increases in the Fed. Funds rate causing a fundamental reassessment by investors of the relative risks of holding bonds as opposed to equities and leading to a major flight from bonds to equities.
  - UK inflation returning to significantly higher levels causing an increase in the inflation premium inherent to gilt yields.