

REPORT TO	ON
Governance Committee	31 January 2018

Jan 2017



TITLE	REPORT OF	Agenda item No.
Treasury Management Activity 2017/18 – update to 31 December 2017	Deputy s151 Officer	

Is this report confidential?	No
------------------------------	----

1. PURPOSE OF THE REPORT

- 1.1 To report on Treasury Management performance to the end of December 2017.
- 1.2 To provide updates on other issues relevant to Treasury Management activity.

2. RECOMMENDATIONS

- 2.1 Governance Committee is asked to note the report.

3. EXECUTIVE SUMMARY

- 3.1 Prudential and Treasury Indicators for 2017/18 will be revised when the Treasury Strategy for 2018/19 to 2020/21 is presented to Council in February 2018. The Council has operated within the approved indicators in the year to 31 December 2017.
- 3.2 The average daily investment total for the period to 31 December 2017 was £35.181m at an average rate of 0.48%. This exceeded the target of 0.16%, and the earnings rate of 0.25% for 2017/18 suggested by the Council's Treasury advisors.
- 3.3 Appendix A presents an analysis of investments as at 31 December 2017 and a list of approved investment counterparties for 2017/18.
- 3.4 Appendix B presents an update on economic matters; and Appendix C is a commentary on interest rate forecasts. Appendix D compares interest rate estimates as at March, August and December 2017.
- 3.5 The Markets in Financial Instruments Directive (MiFID) II has been implemented from 3 January 2018. The Council has opted-up to being a Professional Client with several financial institutions to continue using approved investment counterparties such as Money Market Funds.
- 3.6 CIPFA have released the revised Treasury Management Code and Prudential Code. Any changes relevant to this Council will be reflected in the Treasury Strategy 2018/19 to 2020/21.

4. CORPORATE PRIORITIES

The report relates to the following corporate priorities

Clean, green and safe		Strong and healthy communities	
Strong South Ribble in the heart of prosperous Lancashire		Efficient, effective and exceptional council	✓

5.0 BACKGROUND TO THE REPORT

- 5.1 The mid-year review of the Treasury Strategy and Treasury Management activity required by the Code of Practice for Treasury Management was presented to the Governance Committee's meeting of 13 September 2017. This report provides updated information in respect of Treasury Management activity, and issues relevant to Treasury Management.

6. PRUDENTIAL INDICATORS

- 6.1 During the first three quarters of financial year 2017/18, the Council has operated within the Treasury and Prudential Indicators set out in the Treasury Strategy 2017/18 to 2019/20 and in compliance with the Council's Treasury Management Practices. The Prudential and Treasury Indicators in respect of 2017/18 will be revised in the Treasury Strategy 2018/19 to 2020/21.

7. TREASURY ACTIVITY

- 7.1 Investment activity in the year to 31 December is summarised in the following table:

Investment Activity	Earnings to		
	Average Daily Investment £000	31 December 2017 £	Average Rate %
Debt Management Office	0	0	0.00
Fixed Term Deposits	22,273	91,426	0.54
Notice Accounts	4,415	21,258	1.02
Call Accounts	1,779	3,155	0.24
Money Market Funds	6,714	11,038	0.22
Total	35,181	126,877	0.48

- 7.2 In the equivalent period in 2016/17, the average daily investment was £34.613 million and interest earned was £0.159m. A full list of investments held at 31 December 2017 is shown at Appendix A. The total invested was £36.245m, including term deposits, notice accounts, call accounts, and money market funds. The equivalent figure in December 2016 was £39.841m.
- 7.3 The list of investment counterparties and associated investment limits approved for 2017/18 are also presented in the same appendix.
- 7.4 The interest earning benchmark is the average LIBID 7-day rate plus 15%. This was 0.16% for the most recent period available, compared to the rate achieved of 0.48%. In addition, the rate achieved exceeded Capita's suggested earnings rate of 0.25% for 2017/18, which was based on term deposits of only three months. This Council's term deposits have been mainly for six or twelve months, as shown in Appendix A, and these attract higher interest rates.
- 7.5 At this stage in 2016/17, the average rate achieved was 0.61%. All counterparties are offering lower rates of interest than they were a year ago. However, there was a sharp

increase in the 7-day LIBID rate in November 2017, and this may be reflected in increases in interest rates available when deposits mature and are reinvested.

- 7.6 The following table compares the budgets for interest receivable against the latest projection.

Interest Receivable Budget	Budget for 2017/18 £000	Actual to 31 December 2017 £000	Forecast for year £000
Interest earned	159	127	159
Total	159	127	159

Investment Options

- 7.7 Banks and building societies currently approved for use as investment counterparties, together with Link Asset Services' recommended investment durations, are as follows:

Suggested Investment Durations as at 31 December 2017			
Country	Counterparty	Suggested Duration	Limit per institution
United Kingdom	Royal Bank of Scotland Plc	12 mths	£5m per group
	National Westminster Bank Plc	12 mths	
	Bank of Scotland Plc	12 mths	£5m per group
	Lloyds Bank Plc	12 mths	
	Barclays Bank Plc	6 mths	£5m
	Coventry Building Society	6 mths	£5m
	Goldman Sachs International Bank	6 mths	£5m
	HSBC Plc	12 mths	£5m
	Leeds Building Society	100 days	£5m
	Nationwide Building Society	6 mths	£5m
	Santander UK Plc	6 mths	£5m
	Skipton Building Society	100 days	£5m
	Yorkshire Building Society	100 days	£5m
Germany	Landesbank Hessen-Thuringen Girozentrale (Helaba)	12 mths	£4m

- 7.8 In practice, several of these institutions cannot be used by this council. Some of the banks do not require investments from local authorities; some only accept minimum deposits

greater than our strategy allows; and some accept deposits for minimum periods greater than we can invest for, such as two or three years. Finally interest rates offered by some banks are so low that there is little or no advantage in using them instead of the DMO's DMADF. The banks and building societies that have accepted investments from the council are as listed in Appendix A.

Icelandic Investment Claim

- 7.9 So far in 2017/18 there have been no repayments in respect of the Heritable investment claim. The balance of the claim remaining to be recovered is still £40,000. In total, £1.974m of the original £2m investment has been recovered. Recovery to date is around 98% of the claim value, which has exceeded expectations.

8. TREASURY CONSULTANTS' ADVICE

- 8.1 During the year the Capita Group sold Capita Treasury Solutions Limited (operating as Capita Asset Services) to the Link Group. The company has been renamed Link Treasury Services Limited and operates as Link Asset Services. Appendix B presents the advice of Link Asset Services in respect of economic matters in the first three quarters of 2017/18. In addition, a detailed commentary on interest rate forecasts is presented as Appendix C. Bank rate and PWLB borrowing rate forecasts are given from March quarter 2017 through to March quarter 2021. Appendix D compares estimated interest rates when the Treasury Strategy was reported (March 2017) with the mid-year estimate (August 2017) and the current estimate (December 2017).
- 8.2 Following the increase in Bank Rate to 0.50%, the next increase to 0.75% is expected in the December quarter of this year. When the Treasury Strategy was prepared the first increase in bank Rate was expected in the June quarter of 2019, and it was expected to reach 0.75% only in the December quarter of 2019.

9. MARKETS IN FINANCIAL INSTRUMENTS DIRECTIVE (MiFID) II

- 9.1 The EU set the date of 3 January 2018 for the introduction of regulations under MiFID II. These regulations govern the relationship that financial institutions conducting lending and borrowing transactions will have with local authorities from that date. This has had little effect on this Council apart from having to complete forms sent by each institution in order to continue using the counterparties and investment types previously approved by Council. To date this Council has been successful in electing to opt up to professional client status with all financial institutions which have required it to do so. This means that access to all previous counterparties including money market funds has been maintained to date.

10. CIPFA TREASURY MANAGEMENT CODE AND PRUDENTIAL CODE

- 10.1 In December 2017, CIPFA issued a revised Treasury Management Code and Cross-Sectoral Guidance Notes, and a Revised Prudential Code. The Treasury Strategy for 2018/19 onwards will take account of any changes introduced by the 2017 Codes.
- 10.2 A particular focus of these revised Codes was how to deal with local authority investments which are not treasury type investments, for example investment in purchasing property in order to generate income for the Council at a much higher level than can be achieved by treasury investments. It is recommended that local authorities should produce a new report to members to give a high level summary of the overall capital strategy, and to enable members to see how the cash resources of the authority have been apportioned between treasury and non-treasury investments. CIPFA has acknowledged that the 2018/19 budget cycle is already at an advanced stage, so that compliance with the revised Codes may take

place at the next available opportunity. Any requirements of the revised Codes not implemented immediately will be explained in the Treasury Strategy report.

11. WIDER IMPLICATIONS AND BACKGROUND DOCUMENTATION

11.1 Comments of the Statutory Finance Officer

The report meets the requirement of the Treasury Management Code of Practice that the Treasury Strategy and activity should be reviewed half-yearly.

11.2 Comments of the Monitoring Officer

The purpose of the Report is to comply with various guidance including the Code of Practice for Treasury Management. There are no concerns from a legal perspective with the contents of this report.

Other implications: <ul style="list-style-type: none">• Risk• Equality• HR	The Council's treasury management strategy and policies are designed to ensure the effective control and management of the risks associated with such activities.
---	---

12. BACKGROUND DOCUMENTS (or there are no background papers to this report)

Treasury Management in the Public Services: Code of Practice (2011)
CIPFA Prudential Code for Capital Finance in Local Authorities (2011)
CIPFA Treasury Risk Management Toolkit for Local Authorities (2012)
DCLG Guidance on Local Government Investments (2010)

SMT Member's Name: Jane Blundell

Job Title: Principal Management Accountant/Deputy s151

Report Author:	Telephone:	Date:
Michael Jackson Principal Financial Accountant	01257 515490	12/01/2018

Investments as at 31 December 2017

Counterparty	Type	Amount £000	Rate %	Date of investment	Date of Maturity
Bank of Scotland	Term	1,000	0.36%	13/07/2017	15/01/2018
Coventry BS	Term	2,000	0.32%	10/08/2017	12/02/2018
Goldman Sachs International Bank	Term	2,000	0.59%	14/09/2017	14/03/2018
Goldman Sachs International Bank	Term	2,000	0.59%	29/09/2017	29/03/2018
Lancashire County Council	Term	1,000	0.53%	16/05/2017	16/05/2018
Goldman Sachs International Bank	Term	1,000	0.66%	22/11/2017	22/05/2018
Lancashire County Council	Term	3,000	0.53%	06/06/2017	05/06/2018
Lancashire County Council	Term	1,000	0.55%	28/06/2017	27/06/2018
Thurrock Borough Council	Term	2,000	0.50%	29/09/2017	29/06/2018
Helaba	Term	2,000	0.64%	06/12/2017	06/12/2018
Helaba	Term	2,000	0.60%	14/12/2017	14/12/2018
Fixed Term Deposits sub total		19,000	Listed in order of maturity		
Santander UK PLC	180 Day Notice	4,000	0.55%	15/03/2016	n/a
Bank of Scotland	175 Day Notice	4,000	0.75%	30/11/2017	n/a
Notice Accounts sub total		8,000			
Barclays (deposit account)	Call	4,445	0.25%		On Call
Call Accounts sub total		4,445			
Federated MMF	MMF	2,400	0.24% (1)		On Call
Standard Life MMF	MMF	0	0.20% (1)		On Call
BlackRock MMF	MMF	2,400	0.22% (1)		On Call
Money Market Funds sub total		4,800			
Total		36,245			

Notes:

(1) MMF rates are variable. This is the calculated average for the year to December

Summary of Term Deposits by Counterparty	Type	Amount £000	Limit £000
Bank of Scotland	Term	1,000	5,000
Coventry BS	Term	2,000	5,000
Goldman Sachs International Bank	Term	5,000	5,000
Helaba	Term	4,000	4,000
Lancashire County Council	Term	5,000	5,000
Thurrock Borough Council	Term	2,000	5,000
Fixed Term Deposits sub total		<u>19,000</u>	

Investment Counterparties 2017/18

Category	Institutions	CAS Colour Code	Maximum Period	Limit per Institution
Banks & Building Societies: Call Accounts /Term Deposits / Certificates of Deposit (CDs)				
Government related/guaranteed	DMADF (DMO) UK Local Authority	Yellow Yellow	6 months 2 years	Unlimited £5m per LA
UK part-nationalised institutions	Royal Bank of Scotland group	Blue	1 year	£5m per group
UK-incorporated Institutions	UK banks and building societies of high credit quality	Orange Red Green	1 year 6 months 3 months	£5m per group (or independent institution)
Non-UK Banks	Non-UK banks of high credit quality	Orange Red Green	1 year 6 months 3 months	£4m per group (or independent institution); £8m in total for this category
Money Market Funds				
Money Market Funds (CNAV) **	MMFs of high credit quality - AAA rated		Instant access	£5m per fund
Enhanced Money Market Funds (VNAV)	EMMFs of high credit quality - AAA rated		T+2 or T+3	£3m per fund; £6m in total for this category

Economic Background

UK. After the UK economy surprised on the upside with strong growth in 2016, growth in 2017 was disappointingly weak in the first half of the year; quarter 1 came in at only +0.3% (+1.7% y/y) and quarter 2 was +0.3% (+1.5% y/y), which meant that growth in the first half of 2017 was the slowest for the first half of any year since 2012. The main reason for this has been the sharp increase in inflation, caused by the devaluation of sterling after the referendum, feeding increases in the cost of imports into the economy. This has caused, in turn, a reduction in consumer disposable income and spending power and so the services sector of the economy, accounting for around 75% of GDP, has seen weak growth as consumers cut back on their expenditure.

However, growth picked up in quarter 3 to 0.4% and in quarter 4 there have been encouraging statistics from the manufacturing sector which is seeing strong growth, particularly as a result of increased demand for exports. It has helped that growth in the EU, our main trading partner, has improved significantly over the last year. However, this sector only accounts for around 11% of GDP so expansion in this sector will have a much more muted effect on the average total GDP growth figure for the UK economy as a whole. Growth in quarter 4 is expected to be around 0.4% again which would see annual growth in 2017 coming in at around 1.7 – 1.8%, almost as strong as the recently upwardly revised figure for 2016 of 1.8%, (which meant that the UK was equal to Germany as having the strongest GDP growth figure for the G7 countries in 2016).

The Monetary Policy Committee (MPC) meeting of 14 September 2017 surprised markets and forecasters by suddenly switching to a much more aggressive tone in its words warning that Bank Rate will need to rise. Recent Bank of England Inflation Reports have flagged up that they expected CPI inflation to peak at just over 3% in late 2017, before falling back to near to its target rate of 2% in two years' time. Inflation actually came in at 3.1% in November. The reason why the MPC became so aggressive with its wording in September and November around increasing Bank Rate was due to 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 they now needed to take action. In addition, the MPC took 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, the Bank 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.

It was therefore no surprise that the MPC increased Bank Rate by 0.25% to 0.5% in November. However, their forward guidance of two more increases of 0.25% by 2020 was viewed as being more dovish than markets had expected. However, some forecasters are flagging up that they expect growth to improve significantly in 2018, as the fall in inflation will bring to an end the negative impact on consumer spending power while a strong export performance will compensate for weaker services sector growth. If this scenario were to materialise, then the MPC would have added reason to embark on more than one increase in Bank Rate during 2018. While there is so much uncertainty around the Brexit negotiations, consumer confidence, and business confidence to spend on investing, it is far too early to be confident about how the next two years will pan out.

EU. Economic growth in the EU, (the UK's biggest trading partner), had 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 this stimulus. GDP growth was 0.6% in quarter 1 (2.1% y/y), 0.7% in quarter 2 (2.4% y/y) and 0.6% in quarter 3 (2.6% y/y). However, despite providing massive monetary stimulus, the European Central Bank is still struggling to get inflation up to its 2% target and in November inflation was only 1.2%. It is therefore unlikely to start on an upswing in rates until possibly towards the end of 2019.

USA. Growth in the American economy has been volatile in 2015 and 2016. 2017 followed that path again with quarter 1 coming in at only 1.2% but quarter 2 rebounding to 3.1% and quarter 3 coming in at 3.2%, the first time since 2014 that two successive quarters have been over 3%. Unemployment in the US has also fallen to the lowest level for many years, reaching 4.1% in November, while wage inflation pressures, and inflationary pressures in general, have been building. The Fed has started on an upswing in rates with four increases since December 2016 to lift the central rate to 1.25 – 1.50%. There could then be another four more increases in 2018. In October, the Fed became the first major western central bank to make a start on unwinding quantitative easing by phasing in a start to a gradual reduction of reinvesting maturing debt.

Chinese economic growth has been weakening over successive years, despite repeated rounds of central bank stimulus and 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. GDP growth has been gradually improving during 2017 to reach an annual figure of 2.1% in quarter 3. However, it is still struggling to get inflation anywhere near to its target of 2%, despite huge monetary and fiscal stimulus. It is also making little progress on fundamental reform of the economy.

Detailed economic commentary on developments during quarter ended 31 December 2017

- During the quarter ended 31 December 2017:
 - The economy maintained a mediocre pace;
 - Employment fell, but there were some signs of a pick-up in wage growth;
 - Headline inflation reached its highest since March 2012;
 - The MPC hiked Bank Rate for the first time in a decade;
 - The Chancellor provided a bigger-than-expected Budget giveaway;
 - The European Commission gave the green light to progress to the second phase of Brexit negotiations.
- The economy looks to have broadly maintained its fairly mediocre pace in the fourth quarter. Indeed, the Markit/CIPS all-sector PMI points to growth of between 0.4% and 0.5%. The CBI's monthly growth indicator rose sharply in December, but the quarter average is consistent with a similar pace of growth.
- With the latest Quarterly National Accounts confirming that the economy grew by 0.4% in Q3 of 2017, full-year growth is likely to come in at about 1.8%. What's more, the breakdown revealed a more balanced growth picture for Q3, with business investment growth revised up to 0.5% q/q and net trade's contribution nudged up from an initial estimate of a 0.5% drag on GDP growth, to a neutral 0.0%. However, consumer spending growth of 0.5% q/q still outpaced the 0.2% increase in households' real disposable incomes on the quarter so the household saving ratio fell from 5.6% in Q2 to 4.5%.
- The early evidence suggests that the breakdown of Q4 growth will reveal that consumer spending growth remained relatively robust again. After all, retail sales values rose by 1.1% in November alone. However, with Black Friday and Cyber Monday distorting the figures somewhat, (the ONS do not currently seasonally adjust for these discounting periods), it is hard to get a clear reading. Note also that new car registrations fell in the three months to November and this will drag on overall consumer spending.
- The official output figures for October paint a fairly encouraging picture. Admittedly, the services sector appears to have been the key driver of growth, with the construction sector mired in recession. But the manufacturing sector looks set to have put in another good performance over Q4 as a whole.
- Meanwhile, the jobs market showed some signs of weakening in Q4. While the unemployment rate held steady at 4.3% in the three months to October, this was largely a

result of a shrinking workforce. Indeed, employment fell by 56,000 over the same period. This decline was predominantly driven by a drop in the number of self-employed workers.

- The survey evidence suggests that this weakening should prove to be a temporary blip. Indeed, all of the surveys that we track point to growth in employment accelerating significantly from the current 1% rate. What's more, the, (admittedly experimental), ONS single-month estimates suggest that much of the recent fall in employment was due to an unusually weak sample in the first month of each quarter.
- More encouragingly, there has been some evidence of a strengthening in wage growth. Headline underlying annual wage growth, (three-month average excluding bonuses - the measure which the MPC focuses on), rose to 2.3% in October. In addition, the single-month estimate picked up to 2.4%, the strongest figure since December 2016. Given signs of recruitment difficulties, and a rise in some survey measures of private-sector pay settlements, some acceleration in nominal pay growth looks probable over the coming quarters.
- However, wage growth is still being outpaced by inflation. CPI inflation rose to 3.1% in November, forcing Bank of England Governor Mark Carney to write to the Chancellor to explain why inflation has deviated by more than 1% from the 2% target for the first time since October 2016, (when inflation was just 0.9%). The largest upward contribution came from airfares, which fell by less than they did last year.
- Nonetheless, there are some tentative signs that inflation has now peaked. For a start, despite an up-tick in November, producer input price inflation has fallen back markedly from the 20% or so rates seen in early 2017. What's more, the peak impact of the pound's depreciation on imported goods inflation now also looks to have passed. In addition, a weighted average of global agricultural commodity prices and domestic food producer prices suggests that food price inflation could ease a bit over the coming months.
- However, the rise in oil prices from \$58 per barrel at the end of Q3, to over \$66pb at the end of Q4, will put some renewed upward pressure on firms' costs. Rising wholesale energy prices, if passed onto consumers, will also result in the contribution to overall inflation picking up from retail gas and electricity prices. Nonetheless, we think that these factors are only likely to prevent a quicker fall-back in CPI inflation, rather than push it higher in the near term.
- The MPC pressed ahead with its first increase in Bank Rate for ten years in November. This did not come as a surprise, though, given that it had been strongly signalled in advance at the September MPC meeting, and had been over 90% priced into markets. The relatively dovish tone of the Inflation Report suggested that any further rate rises would be extremely limited, and might not come for some time. Indeed, the Governor appeared to broadly endorse the market curve underpinning the Inflation Report forecasts, which is for two further hikes over the next three years (2017-19). This is in contrast to the consensus of economists, which expects one or two hikes in 2018 alone.
- December's MPC minutes did not provide any hints of when the next hike will come. The decision to leave rates on hold was unanimous, and while it was too early to fully judge the impact of the previous month's hike, the initial reaction had been broadly in line with previous experience.
- Nonetheless, the MPC sounded a bit more optimistic about Brexit in December, noting that recent progress in negotiations had reduced the "likelihood of a disorderly exit" from the EU. Indeed, the European Council gave the green light to move to the second phase of the negotiations, which will focus on a transitional deal and future arrangement. A transition is likely to consist of around two-years of continued single market and customs union membership, albeit without UK participation in the decision making governing institutions.

- Unless specific solutions to overcoming the hard border between Northern Ireland and the Republic of Ireland can be found, then the Government's pledge to maintain full regulatory alignment between Northern Ireland and the Republic of Ireland points to a softer form of Brexit. In addition, the fact that Parliament will have a binding vote on the Withdrawal Bill suggests that the prospect of a no-deal Brexit has diminished. Nonetheless, given the Government's ambiguity, the future relationship still remains uncertain. The next key milestone will be March's European Council meeting, where progress towards agreeing a transition deal will be assessed.
- Meanwhile, the MPC estimated that the impact of the policy decisions taken at the Chancellor's Autumn Budget would add around 0.3% to GDP over the next three years, and boost CPI inflation by 0.1pp. Granted, this is not especially large, but all else equal, it might point to slightly more monetary tightening than otherwise. It was somewhat surprising that the Chancellor was able to provide such a giveaway, amounting to some £10bn in 2019-20, while still adhering to his fiscal rules, (albeit with a smaller margin of around £15bn against his fiscal target, compared to £26bn in March.)
- The swingeing downgrades to the OBR's economic forecasts made the medium-term fiscal picture much worse. However, the Chancellor was able to use some accounting tricks to pay for almost all of the giveaway due to the re-classification of housing associations from the public to the private sector. Key components of the package included extra spending on the NHS, the abolition of stamp duty for most first time buyers, the freezing of most excise duties, extra spending on homebuilding and changes to the universal credit system.
- Meanwhile, in financial markets, sterling depreciated by 0.3% on a trade-weighted basis over Q4. While it appreciated by 0.2% against the US dollar, this was offset by a fall against the euro. Equities put in a good performance, with the FTSE 100 rising by 4.3% on the quarter. Note too that this was not just currency effects, as the FTSE UK local index, which only includes firms that generate more than 70% of their sales domestically, rose by the same amount. Despite Bank Rate rising for the first time in over a decade, 10-year government bond yields actually fell in Q4, from 1.4% to just shy of 1.3%.
- Internationally, the US Federal Reserve hiked interest rates by 25bp in December, as had been widely expected. This took the fed funds target range to 1.25%-1.5%. Despite factoring in the imminent fiscal stimulus as a result of President Trump's tax-plan, into the growth projections, the Fed still only expects there to be three more hikes in 2018. On the activity front, the economy looks set to have expanded at close to 3% annualised in the fourth quarter, similar to the rates of expansion seen in Q2 and Q3.
- The Eurozone economy continues to perform strongly, with surveys pointing to an acceleration in quarterly growth from 0.6% in Q3 to about 0.8% in Q4. However, the ECB does not appear to be in any rush to end asset purchases. With the inflation outlook still reliant on policy support, we expect the ECB to continue to buy assets for the whole of 2018, with no interest rate rise before September 2019.

Detailed commentary on interest rate forecasts

Link Asset Services forecasts

The MPC made some obvious comments around the fact that the UK is going through a period of heightened uncertainty due, particularly, to the unknowns around how the Brexit negotiations will proceed and the likely effect on households and companies. They will adjust their responses according to how these turn out and in the light of how the economy progresses over the next two to three years. We would agree with these qualifications. Obviously, if the negotiations are very difficult and end up being disappointing, this could put in jeopardy even two Bank Rate increases over the next three years.

We can only forecast given the current situation and have to flag up that there is a wide spread of potential outcomes during this forecast period. There is, therefore, a likelihood of heightened volatility as events actually unfold. We would, however, refer clients back to our previous newsflash on 18 September which explained how the strong causal link in western economies between falling unemployment and rising inflation, appears to be broken. This has led some commentators to raise the question as to whether we are now moving into a new paradigm of low unemployment at the same time as low inflation, where central bank policy targets of focusing primarily on inflation are beginning to be called into fundamental question. The example of Japan, which has struggled for some two decades to get inflation up to 2% despite massive repeated rounds of QE, is just one example. What will actually happen to wage inflation, therefore, remains a key issue. If wage inflation continues to remain very subdued over the next two to three years, this will act as a significant headwind to the MPC justifying further increases in Bank Rate due to inflationary threats building up. However, it has in the past 'looked through' e.g. one off increases in inflation which it saw as a temporary occurrence; the MPC could, therefore, be flexible in implementing its mandate of focusing primarily on inflation. Alternatively, they could justify increases in Bank Rate as being primarily due to the need to simply remove monetary policy stimulus as this has caused massive distortions in the economy with asset prices e.g. share prices and house prices have been the main beneficiaries, while savers have been the major losers through low interest rates.

Our own forecasts are cautious and in line with this subdued path for increases in Bank Rate; we do not currently see inflation posing a significant threat over the next three years. We have 0.25% increases in November 2018 to 0.75%, 1.0% in November 2019 and 1.25% in August 2020. This is much in line with market expectations. Our central assumption is that the UK will make progress with concluding a satisfactory outcome over the Brexit negotiations with the EU by March 2019, although the UK finance sector is likely to be an area of particular concern and difficulty.

LINK 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. Volatility in bond yields is likely to endure as investor fears and confidence ebb and flow between favouring relatively more "risky" assets i.e. equities, or the "safe haven" of government bonds.

The overall longer run trend is for gilt yields and PWLB rates to rise, albeit gently. 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 yields of gilts and treasuries in the UK and US respectively, we would expect to see a growing decoupling of yields between the two i.e. we would expect US bond yields to go up faster than UK yields. We will need to monitor this area closely and any resulting effect on PWLB rates.

The overall balance of risks to economic recovery in the UK is probably to the downside, particularly with the current level of uncertainty over the final terms of Brexit.

The balance of risks to increases in Bank Rate and shorter term PWLB rates are probably to the upside, and are dependent on how strong GDP growth turns out, how quickly inflation pressures rise, and how quickly the Brexit negotiations move forward positively.

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 ruptures 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. 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:

- Bank of England takes action too quickly over the next three years to raise Bank Rate and causes UK economic growth, and increases in inflation, to be weaker than we currently anticipate.
- Geopolitical risks, especially North Korea, but also in Europe and the Middle East, which could lead to increasing safe haven flows.
- A resurgence of the Eurozone sovereign debt crisis, possibly Italy, due to its high level of government debt, low rate of economic growth and vulnerable banking system.
- Weak capitalisation of some European banks.
- Germany is still without an effective government after the inconclusive result of the general election in October. In addition, Italy is to hold a general election on 4 March and the anti EU populist Five Star party is currently in the lead in the polls, although it is unlikely to get a working majority on its own. Both situations could pose major challenges to the overall leadership and direction of the EU as a whole and of the individual respective countries.
- The result of the October 2017 Austrian general election has resulted in a strongly anti-immigrant coalition government. In addition, the Czech ANO party became the largest party in the October 2017 general election on a platform of being strongly against EU migrant quotas and refugee policies. Both developments could provide major impetus to other, particularly former Communist bloc countries, to coalesce to create a major obstacle to progress on EU integration and centralisation of EU policy. This, in turn, could spill over into impacting the euro, EU financial policy and financial markets.
- Rising protectionism under President Trump
- A sharp Chinese downturn and its impact on emerging market countries

The potential for upside risks to current forecasts for UK gilt yields and PWLB rates, especially for longer term PWLB rates include: -

- The Bank of England is too slow in its pace and strength of increases in Bank Rate and, therefore, allows inflation pressures to build up too strongly within the UK economy, which then necessitates a later rapid series of increases in Bank Rate faster than we currently expect.
- UK inflation returning to sustained significantly higher levels causing an increase in the inflation premium inherent to gilt yields.
- The Fed causing a sudden shock in financial markets through misjudging the pace and strength of increases in its Fed. Funds Rate and in the pace and strength of reversal of quantitative easing, which then leads to a fundamental reassessment by investors of the relative risks of holding bonds, as opposed to equities. This could lead to a major flight from bonds to equities and a sharp increase in bond yields in the US, which could then spill over into impacting bond yields around the world.

BANK RATE	Current forecast	Previous forecast
Q4 2017	0.50%	0.25%
Q1 2018	0.50%	0.25%
Q1 2019	0.75%	0.25%
Q1 2020	1.00%	0.75%
Q1 2021	1.25%	N/A

Borrowing advice: although yields have risen from their low points, yields are still around historic lows and borrowing should be considered if appropriate to your strategy. We still see value in the 40yr to 50yr range at present but that view would be negated if Bank Rate does not climb to at least 2.5% over the coming years. Accordingly, clients will need to review and assess their risk appetite in terms of any underlying borrowing requirement they may have, and also project forward their position in respect of cash backed resources.

Any new borrowing should also take into account the continuing cost of carry, the difference between investment earnings and borrowing rates, especially as our forecasts indicate that Bank Rate may rise to only 1.25% by March 2021.

Our target borrowing rates and the current PWLB (certainty) borrowing rates are set out below.

PWLB debt	Current borrowing rate as at 2.1.18	Target borrowing rate @ 31.12.17
5 year	1.60%	1.50%
10 year	2.11%	2.10%
25 year	2.68%	2.80%
50 year	2.41%	2.50%

Our suggested budgeted investment earnings rates for investments up to about three months' duration in each financial year for the next seven years are as follows:

Average earnings in each year	Current forecast	Previous forecast
2017/18	0.40%	0.25%
2018/19	0.60%	0.25%
2019/20	0.90%	0.50%
2020/21	1.25%	0.75%
2021/22	1.50%	1.00%
2022/23	1.75%	1.50%
2023/24	2.00%	1.75%
Later years	2.75%	2.75%

As there are so many variables at this time, caution must be exercised in respect of all interest rate forecasts. The general expectation for an eventual trend of gently rising gilt yields and PWLB rates is expected to remain unchanged. Negative, (or positive), developments could significantly impact safe-haven flows of investor money into UK, US and German bonds and produce shorter term movements away from our central forecasts.

Our interest rate forecast for Bank Rate is in steps of 25 bps whereas PWLB forecasts have been rounded to the nearest 10 bps and are central forecasts within bands of + / - 25 bps.

Naturally, we continue to monitor events and will update our forecasts as and when appropriate.

Appendix D

	Bank Rate %			PWLB Borrowing Rates % (including 0.20% certainty rate adjustment)											
				5 year			10 year			25 year			50 year		
	Dec 17	Aug 17	Mar 17	Dec 17	Aug 17	Mar 17	Dec 17	Aug 17	Mar 17	Dec 17	Aug 17	Mar 17	Dec 17	Aug 17	Mar 17
Mar-18	0.50	0.25	0.25	1.60	1.60	1.70	2.20	2.30	2.30	2.90	2.90	3.00	2.60	2.70	2.80
Jun-18	0.50	0.25	0.25	1.60	1.70	1.70	2.30	2.30	2.40	3.00	3.00	3.00	2.70	2.80	2.80
Sep-18	0.50	0.25	0.25	1.70	1.70	1.70	2.40	2.40	2.40	3.00	3.00	3.10	2.80	2.90	2.90
Dec-18	0.75	0.25	0.25	1.80	1.80	1.80	2.40	2.40	2.40	3.10	3.10	3.10	2.90	2.90	2.90
Mar-19	0.75	0.25	0.25	1.80	1.80	1.80	2.50	2.50	2.50	3.10	3.10	3.20	2.90	2.90	3.00
Jun-19	0.75	0.50	0.50	1.90	1.90	1.90	2.60	2.50	2.50	3.20	3.20	3.20	3.00	3.00	3.00
Sep-19	0.75	0.50	0.50	1.90	1.90	1.90	2.60	2.60	2.60	3.20	3.30	3.30	3.00	3.00	3.10
Dec-19	1.00	0.75	0.75	2.00	2.00	2.00	2.70	2.60	2.60	3.30	3.30	3.30	3.10	3.10	3.10
Mar-20	1.00	0.75	0.75	2.10	2.00	2.00	2.70	2.70	2.70	3.40	3.30	3.40	3.20	3.10	3.20
Jun-20	1.00			2.10			2.80			3.50			3.30		
Sep-20	1.25			2.20			2.90			3.50			3.30		
Dec-20	1.25			2.30			2.90			3.60			3.40		
Mar-21	1.25			2.30			3.00			3.60			3.40		