REPORT TO	DATE OF MEETING
Governance Committee	1 February 2017

Report template revised July 2012

SUBJECT	PORTFOLIO	AUTHOR	ITEM
Treasury Management Activity 2016/17 – update to 31 December 2016	Finance	M L Jackson	9(a)

1. SUMMARY AND LINK TO CORPORATE PRIORITIES

To review the Treasury and Investment Strategies approved by the Council on 2 March 2016, and to report on performance in the first nine months of the year, and compliance with prudential and treasury indicators.

2. RECOMMENDATIONS

Governance Committee is asked to note and comment on the report.

3. DETAILS AND REASONING

The Code of Practice for Treasury Management specifies that Councils should review their Treasury Strategy and activity at least half yearly. A report was presented to Governance Committee on 21 September 2016 and Council on 5 October 2016. This report considers changes to economic conditions and interest rate forecasts in subsequent weeks.

4. INTEREST RATE FORECAST

The mid-year Treasury Management Activity Review for 2016/17 was presented to the Governance Committee meeting of 21 September 2016. The report recommended a number of changes to Prudential Indicators and Treasury Indicators, and presented commentary on interest rate forecasts. Interest rate forecasts indicated that Bank Rate and PWLB borrowing rates were expected to be lower than estimated at the time that the Treasury Strategy for 2016/17 had been prepared. Interest earned on cash invested was still expected to be as budgeted, because most term deposits had been placed before interest rates began to fall over the summer of 2016 and cash balances available to invest remained high. Reinvestment of sums at lower rates of interest would bring the average rate down, but budgeted interest on cash investments should still be achieved.

This report presents updated interest rate forecasts, and considers the impact on the interest receivable budget.

The latest interest rate forecast of the Council's Treasury Advisor, Capita Asset Services – Treasury Solutions is presented in Appendix C. A comparison of the forecast at the time the Treasury Strategy was prepared with the forecast presented in the mid-year report and the current forecast is presented as Appendix D.

Capita are no longer anticipating a further reduction in Base Rate to 0.10%. The current rate of 0.25% is expected to continue until the June quarter of 2019, when a return to 0.50% seems possible. An increase to 0.75% is indicated for the December quarter of 2019. When the strategy was prepared before the start of the financial year, it was estimated that this rate could be in place by March quarter of 2017.

Capita's suggested rate of return on cash invested is still much lower than estimated when the Treasury Strategy was prepared. The average earnings for three-month investments had been forecast to increase to 1.75% by 2018/19, and 3.00% by 2023/24. Taking account of the base rate cut and the likelihood that it will not increase above 0.25% for many years, the estimated rate achievable for 2018/19 for 3-month investments is now only 0.25%, and for 2023/24 only 1.75%. However, the suggested budgeted investment earnings rate for 2017/18, which had been reduced to 0.10% in the previous report, has now been increased to 0.25% for 3-month investments. While this council's investment counterparties continue to have suggested investment durations of 6 months or longer, it should be possible to exceed the suggested earnings rate by placing cash for longer periods at higher interest rates.

Public Works Loan Board (PWLB) interest rates are now expected to be a little higher than was indicated in the September mid-year report. However, the Council presently has no plans to incur external borrowing in the current financial year and the next two, so the increase in borrowing rates should have no immediate impact on the revenue budget. This plan will be re-assessed as part of the 2017/18 budget setting process.

5. REVIEW OF THE TREASURY STRATEGY

The Treasury Management and Investment Strategies for 2016/17 were approved by Council on 2 March 2016. They defined the Council's investment priorities as the security of capital sums invested, and the maintenance of liquidity. Consistent with these priorities, the optimum return (yield) on investments would be sought.

No changes to the Treasury Strategy or Treasury Indicators are required at this stage.

6. TREASURY ACTIVITY

Investment activity in the half year is summarised in the following table:

	Daily Investment £'000	Earnings to 31/12/2016 £	Average Rate %
Debt Management Office	0	0	0.00
Other fixed term deposits	20,989	104,752	0.66
Notice Accounts	4,000	31,315	1.04
Call accounts	2,615	4,215	0.21
Money Market Funds	7,009	18,772	0.36
Total	**34,613**	**159,054**	**0.61**

A full list of investments held at 31 December 2016 is shown at Appendix A. The total invested at that date was £39.841m, including term deposits, notice accounts, call accounts, and money market funds.

The list of investment counterparties and associated investment limits approved for 2016/17 are also presented in the same appendix.

The interest earning benchmark is the average LIBID 7 day rate. This was 0.35% for the period reported, compared to the rate achieved of 0.61%. Capita's suggested budgeted earnings rate for 2016/17, based on 3-month investments, is 0.25%.

The following table compares the budget for interest receivable against the latest projection. Though interest rates are now lower than expected in the Treasury Strategy, cash balances available to invest have remained high. In addition, much of the balance invested was placed before the cut in BoE base rate. Much of the total for term deposits (£10m) will mature during the remainder of the financial year, and will be reinvested at lower rates of interest than being paid at present. Capita's suggested rate of 0.25% has been assumed, though the aim will be to do better. The updated forecast for the year is presented in the table below.

	Budget for year £'000	Actual to 31/12/2016 £'000	Forecast for year £'000
Interest earned	165	159	188
Heritable repayment	0	0	0
Total	**165**	**159**	**188**

Investment Options

Banks and building societies currently approved for use as investment counterparties, together with Capita's recommended investment durations, are as follows:

Suggested Investment Durations as at 21 January 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	6 mths	£4m per group
	Lloyds Bank Plc	6 mths	
	Barclays Bank Plc	6 mths	£4m
	Coventry Building Society	6 mths	£4m
	Goldman Sachs International Bank	6 mths	£4m
	HSBC Plc	12 mths	£4m
	Leeds Building Society	6 mths	£4m
	Nationwide Building Society	6 mths	£4m
	Santander UK Plc	6 mths	£4m
Germany	Landesbank Hessen-Thuringen Girozentrale (Helaba)	12 mths	£3m

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.

The banks and building societies that have accepted investments from the council as at 31 December 2016 are as listed in Appendix A. Major UK institutions with Capita ratings which have not been used by the council include Abbey National Treasury Services PLC (same group as Santander UK), Close Brothers Ltd, HSBC Bank PLC, Standard Chartered Bank (suggested duration only 100 days), Sumitomo Mitsui Banking Corporation Europe Ltd (could be used via a pooled deposits arrangement), UBS Ltd, and Yorkshire Building Society (suggested duration only 100 days).

Icelandic Investment Claim

So far in 2016/17 there have been no repayments in respect of the Heritable investment claim, and none have been assumed in the forecast for interest receivable. 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.

7. BORROWING

The Treasury Strategy indicated that no external borrowing was necessary in the current financial year and the next two years. This remains the case and no borrowing is planned at present.

Use of the Council's own cash balances instead of external borrowing is a form of temporary internal borrowing at a variable rate. The cost of such internal borrowing is in effect the rate of interest that could have been earned had the cash been invested rather than being used to finance capital expenditure. However, if the Council had more cash to invest (as a result of taking loans from the PWLB to finance capital expenditure), the average rate achieved would have fallen below the 0.61% earned to date because the likelihood is that part of the balance would have been placed in the DMO at a low rate of interest. Depending on the period of the loans, the cost of PWLB borrowing to generate the additional cash would be between 1.35% and 2.45% at present. This budgetary plan will be re-assessed as part of the 2017/18 Budget Setting process.

8. PRUDENTIAL INDICATORS AND TREASURY INDICATORS

Council of 2 March 2016 approved Prudential Indicators and Treasury Indicators for 2016/17. A number of amended Prudential and Treasury indicators were approved by Council of 5 October 2016.

No changes to indicators are recommended in this report, though revised indicators for 2016/17 are presented in the report Treasury Strategy 2017/18 to 2019/20.

9. TREASURY CONSULTANTS' ADVICE

Appendix B presents the advice of Capita Asset Services' economic research consultants Capital Economics in respect of economic matters as at 31 December 2016. In addition, a detailed commentary on interest rate forecasts by Capita is presented as Appendix C. A comparison of interest rate forecasts is presented as Appendix D.

10. WIDER IMPLICATIONS

In the preparation of this report, consideration has been given to the impact of its proposals in all the areas listed below, and the table shows any implications in respect of each of these. The risk assessment which has been carried out forms part of the background papers to the report.

FINANCIAL	The financial implications are outlined within the report.
LEGAL	The report is written to demonstrate compliance with various Regulations and statutory Codes of Practice.
RISK	The Council's treasury management strategy and policies are designed to ensure the effective control and management of the risks associated with such activities.
THE IMPACT ON EQUALITY	There are no adverse impacts on equality issues.
OTHER (see below)	

Asset Management	*Corporate Plans and Policies*	*Crime and Disorder*	*Efficiency Savings/Value for Money*
Equality, Diversity and Community Cohesion	*Freedom of Information/ Data Protection*	*Health and Safety*	*Health Inequalities*
Human Rights Act 1998	*Implementing Electronic Government*	*Staffing, Training and Development*	*Sustainability*

BACKGROUND DOCUMENTS

Treasury Management in the Public Services: Code of Practice
CIPFA Prudential Code for Capital Finance in Local Authorities
DCLG Guidance on Local Government Investments

Appendix A

Investments as at 31st December 2016

Counterparty	Type	Amount £'000	Rate %	Date of investment	Date of Maturity
Bank of Scotland	Term	1,000	0.50	13/10/2016	13/01/2017
Nationwide Building Society	Term	1,000	0.36	03/10/2016	03/03/2017
Coventry Building Society	Term	1,000	0.34	04/10/2016	06/03/2017
Goldman Sachs International Banl	Term	3,000	0.60	14/09/2016	14/03/2017
Nationwide Building Society	Term	2,000	0.36	29/09/2016	29/03/2017
Bank of Scotland	Term	2,000	0.65	30/09/2016	30/03/2017
Coventry Building Society	Term	1,000	0.37	03/11/2016	03/05/2017
Goldman Sachs International Banl	Term	1,000	0.65	03/11/2016	03/05/2017
Coventry Building Society	Term	1,000	0.37	16/11/2016	16/05/2017
Lancashire County Council	Term	3,000	0.63	24/05/2016	24/05/2017
Coventry Building Society	Term	1,000	0.37	17/10/2016	18/04/2017
Bank of Scotland	Term	1,000	0.60	14/12/2016	14/06/2017
Helaba	Term	1,000	0.85	16/06/2016	16/06/2017
Nationwide Building Society	Term	1,000	0.42	16/12/2016	16/06/2017
Lancashire County Council	Term	1,000	0.63	29/06/2016	28/06/2017
Helaba	Term	2,000	0.55	14/12/2016	14/12/2017
Fixed Term Deposits sub total		**23,000**	**Listed in order of maturity**		
Santander UK - 95 Day	Notice	0			
Santander UK - 180 Day	Notice	4,000	0.90		
Notice Accounts sub total		**4,000**			
Bank of Scotland	Call	0	0.15		
Barclays (deposit account)	Call	2,200	0.20 (1)		
Barclays (current account)	Call	474			
Call Accounts sub total		**2,674**			
Federated MMF	MMF	3,782	0.36 (2)		
Standard Life (Ignis) Liquidity MMF	MMF	3,382	0.37 (2)		
BlackRock MMF	MMF	3,003	0.33		
Money Market Funds sub total		**10,167**			
Total		**39,841**			

Notes:

(1) Includes 0.20% annual bonus.

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

Investment Counterparties 2016/17

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 1 year	Unlimited £4m 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	£4m per group (or independent institution)
Non-UK Banks	Non-UK banks of high credit quality	Orange Red Green	1 year 6 months 3 months	£3m per group (or independent institution); £6m in total for this category
Money Market Funds				
Money Market Funds (CNAV)	MMFs of high credit quality - AAA rated		Instant access	£4m 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
Property Funds				
Property Funds	Specific Funds to be selected based on CAS guidance & undertaking due diligence checks			£2m in total for this category

Appendix B

Detailed economic commentary on developments during quarter ended 31 December 2016
This section has been provided by Capital Economics and therefore includes their views and opinions of future trends and events.

- During the quarter ended 31 December 2016:
  - The economy maintained its momentum, despite Brexit;
  - Households continued to drive overall economic growth;
  - The labour market showed some signs of weakening;
  - CPI inflation rose above 1% for the first time in two years;
  - The Chancellor eased the planned fiscal squeeze, but the MPC kept policy unchanged;
  - Monetary policy in the US and the Euro-zone diverged.

- Economic growth appears to have barely lost pace, despite the vote for Brexit. Indeed, quarterly GDP growth in Q3 of 2016 is now estimated to have been 0.6%, up from the initial estimate of 0.5%: Q2's growth rate was also nudged down from 0.7% to 0.6%. Moreover, the average level of the Markit/CIPS all-sector PMI in October and November was 54.8, compared to an average of 51.4 in Q3. On the basis of past form, this is consistent with quarterly GDP growth of about 0.5%. And the sharp rise in the manufacturing PMI in December suggests the sector ended the year solidly.

- Consumer spending continued to be the key driver of growth in Q4. Admittedly, retail sales only rose by a monthly 0.2% in November. But this followed a whopping 1.8% monthly increase in October. As a result, even if sales volumes were flat in December, they would have risen by 2.1% over Q4 as a whole, the largest increase since Q2 2014 and up from Q3's 1.9% rise.

- This does not look sustainable though. Q3's National Accounts revealed a fall in households' real disposable incomes, and as a result the 0.7% rise in overall household spending was funded entirely through a fall in the household saving ratio. With inflation having picked up and employment growth having slowed in Q4, it looks likely that the saving ratio may have fallen further.

- The labour market's recent strength seems to be waning. Employment actually fell in the three months to October, the first fall since Q2 2015. Annual growth in employment remained positive, albeit weak, at 1.1%. Granted, the unemployment rate held steady at its post-crisis low of 4.8%. But note that this was due to people moving into inactivity rather than employment.

- Note that some slowdown in employment growth was inevitable, regardless of the outcome of the referendum, as labour market slack has diminished. Indeed the unemployment rate is now around the level often thought to be its "natural" rate. Looking ahead, we doubt that any job losses will be particularly severe or sustained. Survey measures of firms' employment intentions are consistent with annual growth in private sector employment of about 1% over the coming months.

- Meanwhile, perhaps in response to past tightening in the labour market, there have been some more optimistic signs on the wages front, with annual growth in average weekly earnings (including bonuses) holding broadly stable at 2.5% in the three months to October, following a 2.4% rise in Q3.

- At the current time, this is enough to outpace inflation. CPI inflation picked up from 0.7% in Q3 to average 1.1% in October and November. The 1.2% level reached in November was the highest since October 2014, although this still remains low by historical standards. However, inflation is on a steep upward trajectory. Components of inflation that typically respond quite quickly to exchange rate movements, such as petrol and food prices, have had big upward influences on the headline rate recently, and will continue to do so as the drop in the pound makes its way through the inflation pipeline.

- Price pressures at the beginning of the pipeline are already building rapidly. Producer input price inflation rose from 6.5% in Q3 to an average of 12.6% in October and November. There is typically quite a long lag between producer prices and CPI inflation, but we should start to see this feed through to higher prices on the high street over the course of 2017. Indeed, CPI inflation is still on track to breach the 2% inflation target in spring 2017, and should peak at around 3% by spring 2018.

- For now at least, the MPC doesn't appear to be too fazed by this overshoot of the 2% inflation target: it left interest rates unchanged at 0.25% during Q4. Given the uncertainty about the economic outlook, and especially the impact from the two year window for Brexit negotiations from March 2017, interest rates look set to remain on hold for a long while yet.

- By contrast, the US Fed pressed ahead and raised interest rates by 25bp in December, as expected, taking the Fed funds target range to between 0.50% and 0.75%. At the same time, the ECB announced that it would slow the pace of its asset purchases from April 2017, but committed to extending the purchases by another nine months (to December 2017). This highlights the unusual divergence in western monetary policy set to occur over the next year or so.

- Meanwhile, the latest data suggests that the public finances are broadly on track to meet the recently revised OBR's near-term forecasts. Borrowing on the PSNB ex measure in the first eight months of the fiscal year so far was about 11% lower than last year. This compares to the OBR's expectations of a 10% fall for the fiscal year as a whole.

- But hopes of a complete "reset" of fiscal policy were dashed in November's Autumn Statement. Chancellor Philip Hammond did lessen the fiscal squeeze a bit, but the UK still faces another bout of austerity over the coming years. Of course, the new fiscal rules – which include achieving a cyclically-adjusted budget deficit of below 2% by 2020/21 – do offer the Chancellor a bit of room for manoeuvre if the economy were to turn out much weaker. On the basis of the OBR's new forecasts, the deficit will be about 0.8% on this measure by that point, leaving him about 1.2% of GDP to play with.

- Ongoing deficit reduction in the UK is in contrast to the US, where we expect a major fiscal stimulus on the back of Trump's victory. Indeed, we have revised up our US GDP growth forecast for 2017 from 2% to 2.7%.

- Meanwhile, in financial markets, the FTSE 100 rose by 2.4% between Q3 and Q4 of 2016, taking it to a record high. This partly reflected the 3.5% drop in the trade-weighted value of sterling, (which boosts the sterling value of UK firms' overseas profits), but also the generally positive market reaction to Trump's victory in the US election. That said, Brexit worries are still lingering, with the FTSE UK Local Index, which only includes firms of which more than 70% of their sales are generated in the UK, falling by 5.4%. Meanwhile, reflecting a combination of rising US Treasury yields on the back of Trump's victory, as well as fears about the sterling-driven rise in inflation over the next few years in the UK, 10-year UK government bond yields rose by close to 50bp during Q4.

- Finally, the UK government still plans to trigger Article 50 and begin Brexit negotiations by the end of March, and has promised to lay out its plans before it does so. A soft(ish) form of Brexit still looks in prospect. Granted, controlling immigration and ending the influence of the European Court of Justice appear to be key priorities, but the government has stated it wants to retain a very close trading relationship, and that a transitional deal may be considered in order to smooth the process.

About Capital Economics

Capital Economics is one of the leading independent economic research companies in the world. Our large team of more than 60 experienced economists provides award-winning macroeconomic, financial market and sectoral analysis, forecasts and consultancy, from offices in London, New York, Toronto, Sydney and Singapore.

Founded in 1999, we have gained an enviable reputation for original and insightful analysis, and have built up a diverse and distinguished client base. The majority are in the financial sector, including some of the world's largest investment banks and wealth managers, as well as smaller and more specialist firms. But we also have a growing number of corporate clients from a wide range of sectors and industries, and many relationships with governments and central banks, both in advanced and emerging economies.

Our publications are packaged into a wide range of services from which subscribers can choose according to their needs (and budgets). These include overview services covering the global economy and financial markets, as well as country and regional services producing detailed research for the US, Canada, Latin America, the UK, Western Europe, the Nordic countries and Switzerland, Emerging Europe, the Middle East, Africa, Emerging Asia, China, India, Japan, Australia and New Zealand.

Appendix C

Detailed commentary on interest rate forecasts

Our treasury management advisers, Capita Asset Services have provided us with the following update to their interest rate forecasts.

November quarterly inflation report and post US Presidential election review

- We updated our forecasts to take into account the Bank of England quarterly Inflation Report for November 2016, the decision of the MPC meeting of 3 November, and the US Presidential election of 8 November. We also felt that we should allow financial markets to settle down for a few days after the result of that election, which provided a surprise outcome. We therefore undertook a review of our forecasts on 14 November.

- Despite many ominous warnings that there could be significant turbulence in financial markets if Donald Trump won the election, markets have surprised by their lack of such a reaction. In fact, stock markets in America hit a new record high in the first few days after the election and have reached further highs since then. However, Treasury yields have risen sharply in expectation of a significant rise in inflation, as an economy which is already working near to full capacity could be in line for a significant boost to economic growth if Trump's expansion of infrastructure expenditure plans become a reality.

- His plans to cut taxes, at the same time as boosting expenditure, could also lead to a sharp rise in total debt issuance from the current level of around 72% of GDP towards 100% during his term in office. However, although the Republicans now have a monopoly of power for the first time since the 1920s, in having a President and a majority in both Congress and the Senate, there is by no means any certainty that the politicians and advisers he has been appointing to his team, and both houses, will implement the more extreme policies that Trump outlined during his election campaign. Indeed, Trump may even rein back on some of those policies himself.

- The MPC meeting of 3 November left Bank Rate unchanged at 0.25% and other monetary policy measures also remained unaltered. This was in line with market expectations, but a major change from the previous quarterly Inflation Report MPC meeting of 4 August, which had given a strong steer in its forward guidance that it was likely to cut Bank Rate again, probably by the end of the year if economic data turned out as forecast by the Bank.

- The November MPC decision included a forward view that Bank Rate could go either up or down depending on how economic data evolve in the coming months. Our central view remains that Bank Rate will remain unchanged at 0.25% until the first increase to 0.50% in June 2019, (unchanged from our previous forecast). However, we would not, as yet, discount the risk of a cut in Bank Rate if economic growth were to take a significant dip downwards, though we think this is unlikely, especially given the run of strong economic data since then. We would also point out that forecasting as far ahead as mid 2019 is highly fraught as there are many potential economic headwinds which could blow the UK economy one way or the other as well as political developments in the UK, (especially over the terms of Brexit), EU, US and beyond, which could have a major impact on our forecasts.

- The pace of Bank Rate increases in our forecasts has been slightly increased beyond the three year time horizon to reflect higher inflation expectations.

- The August quarterly Inflation Report was based on a pessimistic forecast of near to zero GDP growth in quarter 3 of 2016 i.e. a sharp slowdown in growth from +0.6% in quarter 2, in reaction to the shock of the result of the referendum in June. However, consumers have very much stayed in a 'business as usual' mode and there has been no sharp downturn in spending; it is consumer expenditure that underpins the services sector which comprises about 75% of UK GDP. After a fairly flat three months leading up to October, retail sales in October surged at the strongest rate since September 2015 before levelling off in November. In addition, the GfK consumer confidence index has recovered moderately to -7 in December after an initial sharp plunge in July to -12 in reaction to the referendum result. GDP growth in quarter 3 of 2016 has therefore come in at a robust +0.6% q/q, +2.2% y/y while business surveys are indicating reasonable continuing strength into quarter 4 and into the start of 2017.

- Bank of England GDP forecasts in the November quarterly Inflation Report were as follows, (August forecasts in brackets) - 2016 +2.2%, (+2.0%); 2017 1.4%, (+0.8%); 2018 +1.5%, (+1.8%). There has, therefore, been a sharp increase in the forecast for 2017, a marginal increase in 2016 and a small decline in growth, now being delayed until 2018, as a result of the impact of Brexit.

- Capital Economics' forecasts for economic growth are as follows: 2016 +2.0%; 2017 +1.5%; 2018 +2.5%. They feel that pessimism is still being overdone by the Bank and Brexit will not have as big an effect as initially feared by some commentators.

- The other key factor in forecasts for Bank Rate is inflation where the MPC aims for a target for CPI of 2.0%. The November Inflation Report included an increase in the peak forecast for inflation from 2.3% to 2.7% during 2017; (Capital Economics are forecasting a peak of 3.2% in 2018). This increase was largely due to the effect of the sharp fall in the value of sterling since the referendum, though the December MPC meeting reported a 6% recovery on a trade weighted basis since its 3 November meeting to leave sterling 15%, (was 16%), down against the US dollar and 8%, (was 11%), down against the euro; this will feed through into a sharp increase in the cost of imports and materials used in production in the UK. However, the MPC is expected to look through the acceleration in inflation caused by external, (outside of the UK), influences, although it has given a clear warning that if wage inflation were to rise significantly as a result of these cost pressures on consumers, then they would take action to raise Bank Rate. The MPC also commented that the partial recovery in the value of sterling, if maintained, would cause a small reduction in their November forecast rise in CPI inflation above the 2% target rate.

- What is clear is that consumer disposable income will come under pressure if CPI rises to exceed wage inflation. The CPI figure for November of 1.2% was the highest for over two years, but is expected to rise rapidly above 2% in Q1 of 2017. On the other hand, wage inflation excluding bonuses came in at 2.6% in October. However, growth in real disposable income in Q3 was negative so the robust increase in retail sales was only achieved by consumers running down their savings and increasing borrowing; this looks unsustainable in the longer term and makes consumer expenditure increasingly vulnerable to rises in interest rates on borrowing when they do occur.

- Gilt yields, and consequently PWLB rates, have risen sharply since hitting a low point in mid-August. There has also been huge volatility during 2016 as a whole. The year started with 10 year gilt yields at 1.88%, fell to a low point of 0.53% on 12 August, and finished at the end of December at 1.49% after some peaks higher during that month. The rebound since August reflects the initial combination of the yield-depressing effect of the MPC's new round of quantitative easing on 4 August, together with expectations of a sharp downturn in expectations for growth and inflation as per the pessimistic Bank of England Inflation Report forecast, followed by a sharp rise in growth expectations since August when subsequent business surveys, and GDP growth in quarters 2 and 3 at +0.6% q/q, confounded the pessimism. Inflation expectations also rose sharply as a result of the continuing fall in the value of sterling.

- The Chancellor has said he will do 'whatever is needed' i.e. to promote growth; there are two main options he can follow – fiscal policy e.g. cut taxes, increase investment allowances for businesses and/or increase government expenditure on infrastructure, housing etc. While the Autumn Statement contained only moderate measures, the PSBR deficit elimination timetable did slip further into the future, as expected, so as to place the priority on promoting economic growth, (and ultimately boosting tax revenues / reducing the budget deficit in the longer term).

- Employment had been continuing to grow weakly during 2016 but in the three months to October, there was the first small fall. House prices are also continuing to rise at a modest pace; but any downturn in prices could dampen consumer confidence and expenditure.

- **Rising EU and geopolitical risks e.g.**

  - **Greece** continues to cause 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 – and before the EU is prepared to agree to release further bail out funds.
  - **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, 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 under capitalisation of **Italian banks** poses a major risk with state aid firmly ruled out by the EU as a potential way out. The longer that this issue remains unresolved, the greater the likelihood that exposed banks will suffer an outflow of liquidity and so the bigger the cost will become to remedy the situation.
  - **4 December Italian constitutional referendum** on reforming the Senate and reducing its powers; this became a confidence vote on Prime Minister Renzi who duly resigned when the 'no' vote won. The rejection of these proposals will be an impediment 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 as Italy, 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. Paolo Gentiloni has subsequently been appointed as Prime Minister but it is notable how little market reaction there has been to these events – for the time being!
  - **Dutch general election 15.3.17**; a far right party is currently polling neck and neck with the incumbent ruling party. However, the proportional voting system means that there is a multiplicity of parties so each general election results in an exercise in gathering a viable coalition after the results are in. In addition, anti-big business and anti-EU activists have already collected two thirds of the 300,000 signatures required to force a referendum to be taken on approving the EU – Canada free trade pact. This could delay the pact until a referendum in 2018 which would require unanimous approval by all EU governments before it can be finalised. In April 2016, Dutch voters rejected by 61.1% an EU – Ukraine cooperation pact under the same referendum law. Dutch activists are concerned by the lack of democracy in the institutions of the EU.
  - **French presidential election**; first round 23 April; second round 7 May 2017.
  - **French National Assembly election** 11 and 18 June 2017.
  - **German Federal election August** – 22 October 2017. This could be affected by significant shifts in voter intentions as a result of terrorist attacks, dealing with a huge influx of immigrants and a rise in anti EU sentiment.

- 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.
- Given the number and type of challenges the EU faces in the next eighteen months, there is an identifiable risk for the EU project to be called into fundamental question. The risk of an electoral revolt against the EU establishment has gained traction after the shock results of the UK referendum and the US Presidential election. But it remains to be seen whether any shift in sentiment will gain sufficient traction to produce any further shocks. The risks are increasing that voter dissatisfaction with the EU could lead to another country lining up after the UK, to leave the EU, unless the EU positively addresses the major challenges it faces over the next few years.

- **Economic growth in the EU**, (the UK's biggest trading partner), has been lack lustre at +1.7% y/y in 2016 despite the ECB cutting its main rate to -0.4% and embarking on a massive programme of quantitative easing during 2016. The latest economic statistics give some grounds for optimism that as a result of this aggressive quantitative easing programme, growth could at last be accelerating going into 2017. However, growth could be negatively impacted by adverse political developments - which could then also impact on UK exports and growth.

- The **US economy** grew strongly in quarter three of 2016 at 3.5%, (on an annualised basis), after an anaemic 1.4% in quarter 2. The election result is likely to have given the Fed added impetus to go ahead with the rate rise of 0.25%, as expected in December, due to the expansionary plans Trump has been outlining. There could well be three or four further increases in 2017 and 2018 in order to contain inflationary pressures which are expected to increase as a result of Trump's policies.

- In the first week since the US election, there was a **major shift in investor sentiment away from bonds to equities**, especially in the US. However, gilt yields in the UK and bond yields in the EU have also been dragged higher. Some commentators are saying that this rise has been an overreaction to the US election result which is likely to be reversed. Other commentators take the view that this could well be the start of the long expected eventual unwinding of bond prices propelled upwards to unrealistically high levels by the artificial and temporary power of quantitative easing.

- **Japan** has been struggling to gain consistent significant growth but has achieved an annualised rate in quarter 3 of +2.7%, (Q2 +2.6%). It has also been struggling to put deflation firmly behind it and to get inflation up to reasonable levels, despite huge monetary and fiscal stimulus. It has been making little progress on fundamental reform of the economy.

- **Chinese economic growth** has been weakening despite successive 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.

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. An eventual world economic recovery may also 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 treasury and gilt yields, we would expect to see a growing decoupling 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, and impact, of Brexit.
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 combat the threat of deflation in western economies, especially the Eurozone and Japan.

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 than in the wider EU and US, causing an increase in the inflation premium inherent to gilt yields.

	Mar-17	Jun-17	Sep-17	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%	0.25%	0.25%	0.25%	0.50%	0.50%	0.75%	0.75%
5yr PWLB rate	1.60%	1.60%	1.60%	1.60%	1.70%	1.70%	1.70%	1.80%	1.80%	1.90%	1.90%	2.00%	2.00%
10yr PWLB rate	2.30%	2.30%	2.30%	2.30%	2.30%	2.40%	2.40%	2.40%	2.50%	2.50%	2.60%	2.60%	2.70%
25yr PWLB rate	2.90%	2.90%	2.90%	3.00%	3.00%	3.00%	3.10%	3.10%	3.20%	3.20%	3.30%	3.30%	3.40%
50yr PWLB rate	2.70%	2.70%	2.70%	2.80%	2.80%	2.80%	2.90%	2.90%	3.00%	3.00%	3.10%	3.10%	3.20%

BANK RATE	now	previously
Q1 2017	0.25%	0.10%
Q1 2018	0.25%	0.10%
Q1 2019	0.25%	0.25%
Q1 2020	0.75%	-

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

PWLB debt	Current borrowing rate as at 4.1.17	Target borrowing rate now (Q1 2017)	Target borrowing rate previous (Q4 2016)
5 year	1.43%	1.60%	1.00%
10 year	2.16%	2.30%	1.50%
25 year	2.80%	2.90%	2.30%
50 year	2.57%	2.70%	2.10%

Borrowing advice

Although yields have risen from their low points, yields are still at 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 not rise from 0.25% until June 2019 and then will only rise slowly.

Proposed new PWLB Local Infrastructure Rate

At the Autumn Statement 2016, the government announced that it would consult on lending local authorities up to £1 billion at a new Local Infrastructure Rate of gilts + 60 basis points to support infrastructure projects that are high value for money. Loans at the new rate would be available for a period of three years, with a maximum term of 50 years.

The government would like further input from stakeholders before proceeding with this policy and so clients may wish to respond to this consultation exercise. Clients may also wish to consider what the potential impact could be on their capital programmes and the financing of the same.

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	Now	Previously
2016/17	0.25%	0.25%
2017/18	0.25%	0.10%
2018/19	0.25%	0.25%
2019/20	0.50%	0.50%
2020/21	0.75%	0.75%
2021/22	1.00%	1.00%
2022/23	1.50%	1.25%
2023/24	1.75%	1.50%
Later years	2.75%	2.50%

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 certainty rate adjustment)											
				5 year			10 year			25 year			50 year		
	Dec 16	Aug 16	Feb 16	Dec 16	Aug 16	Feb 16	Dec 16	Aug 16	Feb 16	Dec 16	Aug 16	Feb 16	Dec 16	Aug 16	Feb 16
Sep-16	0.25	0.25	0.50	1.05	1.00	2.00	1.56	1.50	2.50	2.31	2.30	3.30	2.14	2.10	3.10
Dec-16	0.25	0.10	0.50	1.35	1.00	2.10	2.07	1.50	2.60	2.70	2.30	3.30	2.45	2.10	3.10
Mar-17	0.25	0.10	0.75	1.60	1.00	2.20	2.30	1.50	2.70	2.90	2.30	3.50	2.70	2.10	3.30
Jun-17	0.25	0.10	0.75	1.60	1.10	2.30	2.30	1.60	2.80	2.90	2.40	3.50	2.70	2.20	3.30
Sep-17	0.25	0.10	1.00	1.60	1.10	2.40	2.30	1.60	2.90	2.90	2.40	3.60	2.70	2.20	3.40
Dec-17	0.25	0.10	1.00	1.60	1.10	2.60	2.30	1.60	3.00	3.00	2.40	3.60	2.80	2.20	3.40
Mar-18	0.25	0.10	1.25	1.70	1.10	2.70	2.30	1.60	3.10	3.00	2.40	3.70	2.80	2.20	3.50
Jun-18	0.25	0.25	1.25	1.70	1.20	2.80	2.40	1.70	3.30	3.00	2.50	3.70	2.80	2.30	3.60
Sep-18	0.25	0.25	1.50	1.70	1.20	2.90	2.40	1.70	3.40	3.10	2.50	3.70	2.90	2.30	3.60
Dec-18	0.25	0.25	1.50	1.80	1.20	3.00	2.40	1.70	3.50	3.10	2.50	3.80	2.90	2.30	3.70
Mar-19	0.25	0.25	1.75	1.80	1.20	3.10	2.50	1.70	3.60	3.20	2.50	3.80	3.00	2.30	3.70
Jun-19	0.50	0.50		1.90	1.30		2.50	1.80		3.20	2.60		3.00	2.40	
Sep-19	0.50			1.90			2.60			3.30			3.10		
Dec-19	0.75			2.00			2.60			3.30			3.10		
Mar-20	0.75			2.00			2.70			3.40			3.20		