Item: 7.2

Policy and Resources Committee: 26 November 2019.

Treasury Management – Mid-Year Update.

Report by Head of Finance.

1. Purpose of Report

To provide a mid-year update in respect of the Council's treasury management function for financial year 2019 to 2020.

2. Recommendations

The Committee is invited to scrutinise:

2.1.

The mid-year update for financial year 2019 to 2020, attached as Appendix 1 to this report, in respect of the following elements of treasury management, in order to obtain assurance that the Treasury Management Practices have operated effectively:

- Compliance with Treasury and Prudential Limits.
- Prudential and Treasury Indicators for financial 2019 to 2020 as at 30 September 2019.
- Treasury Portfolio as at 30 September 2019.
- Treasury Adviser's overview of the economy and interest rates for the first half of financial year 2019 to 2020.

3. Background

3.1.

Section 21 of the Financial Regulations confirms that the Council has adopted the key recommendations of Chartered Institute of Public Finance and Accountancy's Treasury Management in the Public Sector Code of Practice (the Code).

3.2.

The revised Chartered Institute of Public Finance and Accountancy's Code of Practice on Treasury Management in the Public Services (2011) further expands the definition of treasury management to include investment activities.

3.3.

The Council's investment priorities can be summarised as maintaining:

- The security of capital.
- The liquidity of its investments.

3.4.

The Council aims to achieve the optimum return on its investments commensurate with proper levels of security and liquidity. The risk appetite of the Council is low in order to give priority to security of its investments. This is in keeping with the nature of the Strategic Reserve Fund, which is to provide for the benefit of Orkney and its inhabitants, whilst having regard to the Fund's long term obligations in terms of the decline and decommissioning of the Flotta Oil Terminal in the future.

3.5.

The Financial Regulations refer to maintenance of the Treasury Management Policy Statement and Treasury Management Practices as the cornerstone for effective treasury management and the requirement to report annually on the Treasury Management function.

4. Treasury Management Performance

4.1.

A detailed analysis of the Treasury Management Performance for financial year 2019 to 2020, as at 30 September 2019, is attached as Appendix 1 to this report, and covers the following activities:

- Borrowing activity.
- Temporary loans.
- Strategic Reserve Fund.

4.2.

The conclusion of the analysis of performance is that existing treasury management practices have operated effectively over the first six months of financial year 2019 to 2020.

4.3.

Recurring slippage continues to be a feature within the approved capital programme. In financial year 2018 to 2019 works valued at £15,187,000 were re-profiled into 2019 to 2020 and beyond. Not only does this impact on the cost of delivering the capital programme works, it also delays the timescale over which the capital finance is required.

4.4.

The Council has established an authorised limit for external debt of £75,000,000 for the three-year period 2019 to 2022, together with an operational boundary of £60,000,000, as part of its Treasury Management Strategy for 2019 to 2020.

4.5.

The Council supports its capital financing requirement through a combination of borrowings and use of internal reserves. In determining this combination, the cost of raising additional finance or borrowing is compared against the opportunity cost of using internal reserves and balances, in that these funds could otherwise be generating an investment return for the Council. On the basis the capital financing requirement can be externalised through borrowings, and investment returns generated in excess of the cost of any borrowings to meet the requirements of the capital programme, the potential exists for a net saving to be realised by the treasury management function over the longer term.

4.6.

As at 30 September 2019, the Council's debt portfolio stood at £25,156,887, with loan maturities ranging over periods from one to 45 years. Overall this represents an average cost of borrowing of 3.92% per annum, with an average weighted duration of 34.6 years.

4.7.

The cost of this debt is managed as part of the loan charges associated with the capital programme and has been offset in the short term with surplus funds placed on deposit for periods of up to one year at an average rate of 1.01% for the first half of financial year 2019 to 2020.

4.8.

Although there remains much uncertainty over interest rates, with the long-term trend prediction for rates to rise, the Council should be well placed to benefit from savings on loan charges over the longer term.

4.9.

The prime objective for the managed funds remains to maintain or increase their real value over time, while at the same time generating an annual return which meets the targets set by the Council. These objectives normally require to be measured over a number of years while acknowledging that abnormal fluctuations in the short term do create a cause for concern.

4.10.

The Head of Finance developed an Action Plan, in consultation with Hymans Robertson, to commence the process of implementation of the changes to the investment strategy previously agreed by the Investments Sub-committee on 28 February 2019, including further diversification.

4.10.1.

Interviews with potential fund managers took place in August and October 2019 after which fund managers were appointed to three new mandates, as follows:

- Global Alpha.
- Global Private Loan Fund III.
- UK Strategic Alternative Income Fund.

4.11.

The process of onboarding the appointed Fund Managers to the new mandates has now commenced.

5. Corporate Governance

This report relates to the Council complying with its governance and financial processes and procedures and therefore does not directly support and contribute to improved outcomes for communities as outlined in the Council Plan and the Local Outcomes Improvement Plan.

6. Financial Implications

The financial implications are contained within the body of the report.

7. Legal Aspects

7.1.

Treasury Management arrangements help the Council meet its statutory obligation to secure best value.

7.2.

Section 40 of the Local Government in Scotland Act 2003 provides local authorities with the power to invest money. This power may be exercised in accordance with regulations made by Scottish Ministers under this section.

7.3.

Section 95 of the Local Government Act 1973 states that every local authority shall make arrangements for the proper administration of their financial affairs and shall secure that the proper officer has responsibility for the administration of those affairs.

8. Contact Officers

Gareth Waterson, Head of Finance, extension 2103, Email gareth.waterson@orkney.gov.uk

Colin Kemp, Corporate Finance Senior Manager, extension 2106, Email colin.kemp@orkney.gov.uk

9. Appendix

Appendix 1: Treasury Management Update – Mid year review 2019-20

Treasury Management Update

Mid-Year Ended 30 September 2019

Contents

Treasury Management Update

Mid-Year Ended 30 September 2019

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 (annual, mid-year or quarterly reports). This report, therefore, ensures this Council is implementing best practice in accordance with the Code.

1. Economic Background

UK. After only tepid annual **economic growth** of 1.4% in 2018, growth in quarter 1 was unexpectedly strong at 0.5%. However, this was boosted by stock building ahead of the original March Brexit deadline so quarter 2 was expected to be slightly negative and duly came in at -0.2% q/q, +1.3% y/y.

After the Monetary Policy Committee raised **Bank Rate** from 0.5% to 0.75% in August 2018, it is little surprise that they have abstained from any further increases since then. We are unlikely to see any further action from the MPC until the uncertainties over Brexit clear. If there were a no deal exit, it is likely that Bank Rate would be cut in order to support growth. Nevertheless, the MPC does have concerns over the trend in wage inflation which peaked at a new post financial crisis high of 3.9% in June before edging back to 3.8% in July, (excluding bonuses). Growth in employment fell to only 31,000 in the three months to July, well below the 2018 average, while the unemployment rate remained at 3.8 percent, its lowest rate since 1975.

As for **CPI inflation** itself, this fell to 1.7% in August and is likely to remain close to 2% over the next two years. If there was a no deal Brexit though, it could rise towards 4%, primarily as a result of imported inflation on the back of a weakening pound.

The rise in wage inflation and fall in CPI inflation is good news for **consumers** as their spending power is improving in this scenario as the difference between the two figures is now around 2.1%, i.e. a real terms increase. Given the UK economy is very much services sector driven, an increase in household spending power is likely to feed through into providing some support to the overall rate of economic growth in the coming months.

Brexit. A bill to delay Brexit until 31 January 2020 if there is no deal by 31 October 2019 has been passed. A general election is likely before the end of 2019; this could result in a potential loosening of monetary policy and therefore medium to longer dated gilt yields could rise on the expectation of a weak pound and concerns around inflation picking up. All eyes are now on whether a deal can be agreed by 31 October.

USA. President Trump's massive easing of fiscal policy in 2018 fuelled a (temporary) boost in consumption in 2018 which generated an upturn in the rate of growth to 2.9% for 2018, just below his target of 3%. Growth in quarter 1 of 2019 was a strong 3.1% but growth fell back to 2.0% in quarter 2. The strong growth in employment numbers during 2018 has reversed into a falling trend during 2019, indicating that the economy is cooling, while inflationary pressures are also weakening. After the Fed increased rates by 0.25% in December 2018 to between

2.25% and 2.50%, it has taken decisive action to reverse monetary policy by cutting rates by 0.25% in each of July and September in order to counter the downturn in the outlook for US and world growth. There are expectations that it could cut again in December.

EUROZONE. The annual rate of growth for 2018 was 1.8% but is expected to fall to possibly around half that rate in 2019. The European Central Bank (ECB) ended its programme of quantitative easing purchases of debt in December 2018, which meant that the central banks in the US, UK and EU had all ended the phase of post financial crisis expansion of liquidity supporting world financial markets by purchases of debt. However, the downturn in EZ growth in the second half of 2018 and into 2019, together with inflation falling well under the upper limit of its target range of 0 to 2%, (but it aims to keep it near to 2%), has prompted the ECB to take new measures to stimulate growth. At its March meeting it said that it expected to leave interest rates at their present levels "at least through the end of 2019", but that was of little help to boosting growth in the near term. Consequently, it announced a third round of TLTROs; this provides banks with cheap borrowing every three months from September 2019 until March 2021 which means that, although they will have only a two-year maturity, the Bank is making funds available until 2023, two years later than under its previous policy. As with the last round, the new TLTROs will include an incentive to encourage bank lending, and they will be capped at 30% of a bank's eligible loans. However, since then, the downturn in EZ and world growth has gathered momentum so at its meeting on 12 September, it cut its deposit rate further into negative territory, from -0.4% to -0.5% and announced a resumption of quantitative easing purchases of debt. It also increased the maturity of the third round of TLTROs from two to three years. However, it is doubtful whether this loosening of monetary policy will have much impact on growth and unsurprisingly, the ECB stated that governments will need to help stimulate growth by fiscal policy.

CHINA. Economic growth has been weakening over successive years, despite repeated rounds of central bank stimulus; medium term risks are increasing. The trade war with the US does not currently appear to be having a significant impact on growth. Major progress still needs to be made to eliminate excess industrial capacity and to switch investment from property construction and infrastructure to consumer goods production. It also needs to address the level of non-performing loans in the banking and credit systems.

JAPAN. has been struggling to stimulate consistent significant GDP growth and to get inflation up to its target of 2%, despite huge monetary and fiscal stimulus. It is also making little progress on fundamental reform of the economy.

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

2. Interest Rate Forecast

The Council's treasury advisor, Link Asset Services, has provided the following forecast:

Link Asset Services Interest Rate View	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22
Bank Rate View	0.75	0.75	0.75	0.75	0.75	1.00	1.00	1.00	1.00	1.00	1.25
3 Month LIBID	0.70	0.70	0.70	0.70	0.80	0.90	1.00	1.00	1.00	1.10	1.20
6 Month LIBID	0.80	0.80	0.80	0.80	0.90	1.00	1.10	1.10	1.20	1.30	1.40
12 Month LIBID	1.00	1.00	1.00	1.00	1.10	1.20	1.30	1.30	1.40	1.50	1.60
5yr PWLB Rate	2.20	2.30	2.50	2.60	2.70	2.70	2.80	2.90	3.00	3.00	3.10
10yr PWLB Rate	2.50	2.60	2.80	2.90	3.00	3.00	3.10	3.20	3.30	3.30	3.40
25yr PWLB Rate	3.10	3.30	3.40	3.50	3.60	3.70	3.70	3.80	3.90	4.00	4.00
50yr PWLB Rate	3.00	3.20	3.30	3.40	3.50	3.60	3.60	3.70	3.80	3.90	3.90

After the August 2018 increase in Bank Rate to 0.75%, the first above 0.5% since the financial crash, the MPC has put any further action on hold, probably until such time as the fog of Brexit might clear and there is some degree of certainty of what the UK will be heading into. ***The above forecast, and other comments in this report, are based on a central assumption that there will be some form of muddle through agreement on a reasonable form of Brexit.*** Bank Rate forecasts will have to change if this assumption does not materialise e.g. a no deal Brexit on 31 October could well prompt the MPC to do an immediate cut of 0.5% in Bank Rate back to 0.25%. All other forecasts for investment and borrowing rates would also have to change.

The balance of risks to the UK

- The overall balance of risks to economic growth in the UK is probably to the downside due to the weight of all the uncertainties over Brexit, as well as a softening global economic picture.
- The balance of risks to increases in Bank Rate and shorter term PWLB rates are broadly similarly to the downside.

BOND YIELDS / PWLB RATES. There has been much speculation recently that we are currently in a bond market bubble. However, given the context that there are heightened expectations that the US could be heading for a recession, and a general background of a downturn in world economic growth, together with inflation generally at low levels in most countries and expected to remain subdued, conditions are ripe for low bond yields. While inflation targeting by the major central banks has been successful over the last thirty years in lowering inflation expectations, the real equilibrium rate for central rates has fallen considerably due to the high level of borrowing by consumers: this means that central banks do not need to raise rates as much now to have a major impact on consumer spending, inflation, etc. This has pulled down the overall level of interest rates and bond yields in financial markets over the last thirty years. We have therefore seen over the last year, many bond yields up to ten years in the Eurozone actually turn negative. In addition, there has, at times, been an inversion of bond yields in the US whereby ten year yields have fallen below shorter term yields. In the past, this has been a precursor of a recession. The other side of this coin is that bond prices are elevated as investors would be expected to be moving out of riskier assets i.e. shares, in anticipation of a downturn in corporate earnings and so selling out of equities. However, stock markets are also currently at high levels as some investors have focused on chasing returns in the context of dismal ultra-low interest rates on cash deposits.

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

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

Another danger is that unconventional monetary policy post 2008, (ultra-low interest rates plus quantitative easing), may end up doing more harm than good through prolonged use. Low interest rates have encouraged a debt fuelled boom which now makes it harder for economies to raise interest rates. Negative interest rates could damage the profitability of commercial banks and so impair their ability to lend and / or push them into riskier lending. Banks could also end up holding large amounts of their government's bonds and so create a potential doom loop, (see appendix 4 Eurozone downside risk). In addition, the financial viability of pension funds could be damaged by low yields on holdings of bonds.

3. Annual Investment Strategy

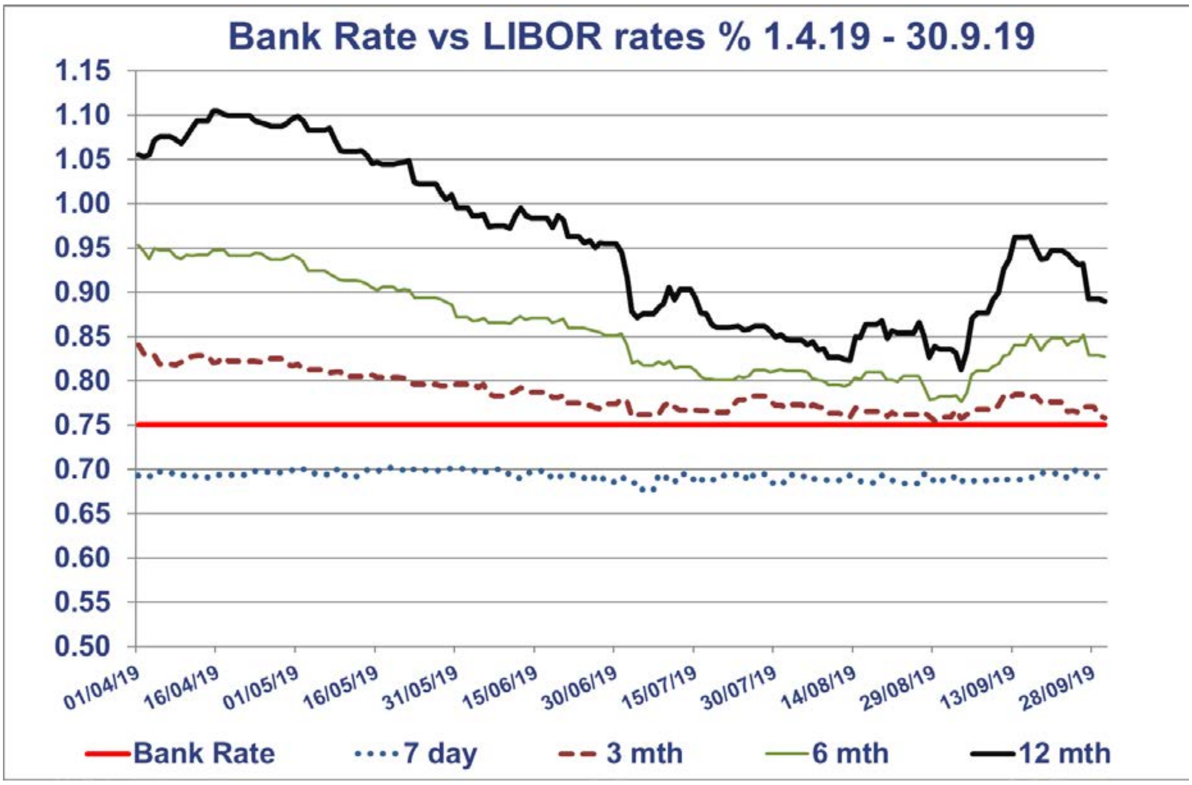
The Treasury Management Strategy Statement (TMSS) for 2019/20, which includes the Annual Investment Strategy, was approved by the Council on 19 February 2019. It sets out the Council's investment priorities as being:

- Security of capital;
- Liquidity; and
- Yield.

The Council will aim to achieve the optimum return (yield) on its investments commensurate with proper levels of security and liquidity. In the current economic climate it is considered appropriate to keep investments short term to cover cash flow needs, but also to seek out value available in periods up to 12 months with highly credit rated financial institutions, using our suggested creditworthiness approach, including a minimum sovereign credit rating and Credit Default Swap (CDS) overlay information.

(a) The average level of funds available for investment purposes during the 6 months ending 30 September 2019 was £28,729,602. These funds were available on a temporary basis, and the level of funds available was mainly dependent on the timing of precept payments, receipt of grants and progress on the Capital Programme. The temporary loans portfolio has operated within policy during financial year 2019 to 2020 so far and has realised a return of £144,262.85 at a rate of 1.01%, as at 30 September 2019. This is ahead of average 3 months LIBOR (London Inter-Bank Offered Rate) performance benchmark (0.76%) and is therefore considered to be an acceptable return.

Half year ended 30 September 2019

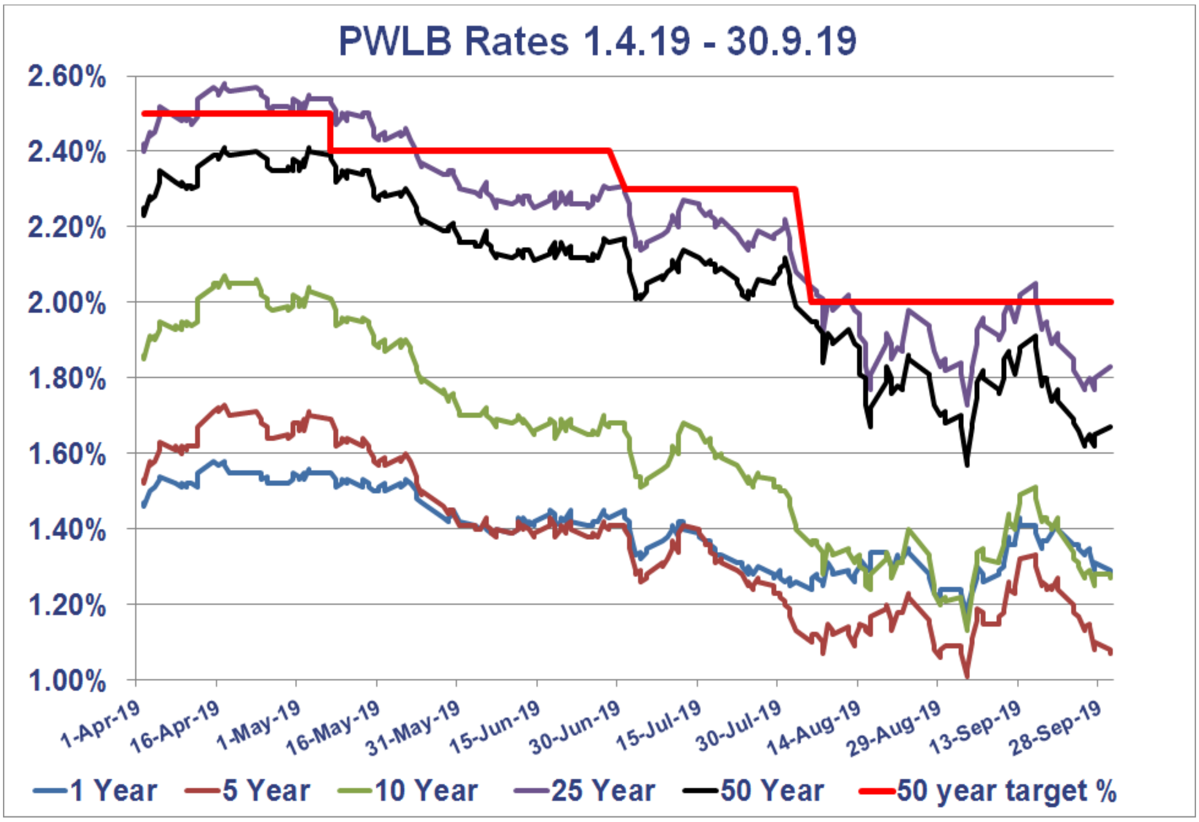


	Bank Rate	7 day	1 mth	3 mth	6 mth	12 mth
High	0.75	0.58	0.61	0.72	0.83	0.98
High Date	01/04/2019	09/05/2019	15/04/2019	01/04/2019	01/04/2019	15/04/2019
Low	0.75	0.55	0.58	0.63	0.65	0.69
Low Date	01/04/2019	05/07/2019	08/08/2019	29/08/2019	04/09/2019	04/09/2019
Average	0.75	0.57	0.60	0.66	0.73	0.83
Spread	0.00	0.03	0.03	0.09	0.18	0.29

4. New Borrowing

Due to the overall financial position no new borrowing was undertaken during the half year ended 30 September 2019. It is anticipated that no borrowing will be undertaken during this financial year, however, this policy will require ongoing monitoring in the event that upside risk to gilt yields and PWLB rates prevail

PWLB rates have been on a falling trend during this period and longer rates have almost halved to reach historic lows. The 50 year PWLB target (certainty) rate for new long term borrowing fell from 2.50% to 2.00% during this period.



	1 Year	5 Year	10 Year	25 Year	50 Year
Low	1.17%	1.01%	1.13%	1.73%	1.57%
Date	03/09/2019	03/09/2019	03/09/2019	03/09/2019	03/09/2019
High	1.58%	1.73%	2.07%	2.58%	2.41%
Date	15/04/2019	17/04/2019	17/04/2019	17/04/2019	17/04/2019
Average	1.40%	1.37%	1.62%	2.20%	2.07%

5. Debt Rescheduling

No debt rescheduling was undertaken during the half year ended 30 September 2019.

6. Compliance with Treasury and Prudential Limits

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

During the half year ended 30 September 2019, the Council has operated within the treasury and prudential indicators set out in the Council's Treasury Management Strategy Statement and in compliance with the Council's Treasury Management Practices. The prudential and treasury Indicators are shown in Appendix 1 of this document.

7. Other

1. Changes in risk appetite
The 2018 CIPFA Codes and guidance notes have placed enhanced importance on risk management. Where an authority changes its risk appetite e.g. for moving surplus cash into or out of certain types of investment funds or other types of investment instruments, this change in risk appetite and policy should be brought to members' attention in treasury management update reports.

No changes have taken place during financial year 2019/20 however it should be noted that the Head of Finance developed an Action Plan, in consultation with Hymans Robertson, to commence the process of implementation of the changes to the investment strategy previously agreed by the Sub-committee on 25 February 2019, including further diversification. Interviews with potential fund managers took place in August and October 2019 after which fund managers were appointed to three new mandates, as follows:

Global Alpha.
Global Private Loan Fund III.
UK Strategic Alternative Income Fund.

The process of onboarding the appointed Fund Managers to the new mandates has now commenced.

APPENDIX 1: Prudential and Treasury Indicators for 2019-20 as at 30 September 2019

The Council's capital expenditure plans are the key driver of treasury management activity. The output of the capital expenditure plans is reflected in the prudential indicator, which are designed to assist members' overview and confirm capital expenditure plans.

Treasury Indicators	2019/20 Budget £'000	30/9/19 Actual £'000
Authorised limit for external debt	75,000	
Operational boundary for external debt	60,000	
Gross external debt		25,157
Investments – in-house only (excl. SRF)		28,707
Net borrowing		(3,550)

Maturity structure of fixed rate borrowing - upper and lower limits		
2 years to 5 years		5,101
5 years to 10 years		56
40 years to 50 years		20,000

Prudential Indicators	2019/20 Budget £'000	30/9/19 Actual £'000
Capital expenditure	33,288	8,755
Capital Financing Requirement (CFR)	15,362	3,127
Annual change in CFR	13,609	1,769
In year borrowing requirement	15,362	3,127

APPENDIX 2: Treasury Portfolio

Investments held as at 30 September 2019:

Treasury Investments – Managed in house	Principal (£)	Interest Rate	Maturity Date
Aberdeen Standard Investments Money Market Fund	6,700,000	0.74%	MMF
Insight Money Market Fund	1,800,000	0.71%	MMF
The Royal Bank of Scotland Plc	207,470	0.20%	Call
North Tyneside Metropolitan Borough Council	2,000,000	1.05%	02/10/2019
Toronto Dominion Bank	2,000,000	1.08%	25/10/2019
Bank of Scotland	1,000,000	0.95%	28/10/2019
Santander UK Plc	1,000,000	1.00%	22/11/2019
Santander UK Plc	2,000,000	1.00%	13/12/2019
Thurrock Borough Council	3,000,000	1.10%	17/01/2020
Lloyds Bank Plc	2,000,000	1.23%	28/01/2020
Santander UK Plc	3,000,000	1.10%	11/03/2020
Bank of Scotland Plc	2,000,000	1.25%	22/06/2020
Bank of Scotland Plc	2,000,000	1.25%	17/07/2020
Treasury Investments – Managed in house	**28,707,470**		

Non-Treasury Strategic Reserve Fund Local Investments - Managed in house	Actual (£)
Fishing Quota	2,688,000
Private Companies	3,421,000
Other	13,000
Strategic Reserve Fund Investments – Managed in house	**6,122,000**

Treasury Strategic Reserve Fund – Managed externally	Actual (£)	Performance quarter ending 30/09/19	Benchmark
Equity funds	97,717,694	3.2%	3.7%
Bond funds	53,071,111	3.4%	2.8%
Property funds	22,548,002	0.6%	0.5%
Diversified Growth Fund	39,199,753	1.0%	0.2%
Credit Strategies Fund	20,940,746	0.9%	0.2%
Strategic Reserve Fund Investments – Managed externally	**233,477,306**		

APPENDIX 3: Detailed economic commentary on developments during quarter ended 30 September 2019

- **During the quarter ended 30 September 2019 *(quarter 3 of 2019):***
  - Boris Johnson replaced Theresa May as Prime Minister;
  - GDP fell by 0.2% q/q in Q2, but rose at the start of Q3;
  - The fundamentals that determine consumer spending remained healthy;
  - Inflation fell below the Bank of England's 2% target;
  - There was a widespread fall in investors' global interest rate expectations;
  - The MPC kept Bank Rate on hold at 0.75%, but struck a more dovish tone.

The economy posted a weaker-than-expected contraction in activity in **Q2 of 2019 of 0.2% q/q**, but that was probably temporary as activity had been shifted from Q2 into Q1 ahead of the original 29th March Brexit deadline. For example, some car manufacturers brought forward their annual car plant shutdowns from August to April in case of a no deal.

What's more, stock building added 0.5 percentage points (ppts) to GDP growth in Q1 before knocking 0.4ppts off growth in Q2. But a good deal of those stocks were imported, so that overstates the impact. Taking into account the effect on imports and exports, we estimate that net stock building added 0.2ppts to growth in Q1 before knocking 0.2ppts off growth in Q2.

The fall in GDP in Q2 has raised concerns that the UK economy could already be in a recession even before Brexit. However, there are at least two reasons to think that growth will probably rebound in Q3, ensuring that the UK avoids a recession. First, GDP grew by 0.3% m/m in July, the largest rise since January. That means that it would take GDP growth in both August and September of an unlikely -0.4% m/m to prevent growth from being positive in Q3 as a whole.

Second, the flipside of car manufacturers closing in April is that some of them remained open in August, when they would normally close. As a result, seasonally adjusted vehicle production rose by about 8.5% m/m in August, which should add about 0.1ppts to quarterly GDP growth. To be fair, this may be the highlight of the manufacturing sector. Even though the manufacturing PMI rose a little in September, it is still pointing to manufacturing output contracting by about 1.0% q/q in Q3. That said, the services sector is typically unfazed by contractions in manufacturing. So the weakness of manufacturing shouldn't spill over into weaker consumer demand. As such, we have pencilled in **a rise of 0.3% q/q in GDP in Q3.**

Indeed, **household spending growth**, which is the biggest component of demand, will probably remain pretty strong. Looking through the Brexit volatility, while consumer confidence has been relatively weak, the fundamentals that determine consumer spending have remained healthy. Admittedly, employment grew by just 31,000 in the three months to July. But this came on the back of a jump of 62,000 in the three months to June. And with the unemployment rate still at its 45-year low of 3.8%, the tightness in the labour market has pushed up wage growth. Wage growth on the measure including bonuses nudged up from 3.8% in June to 4.0% in July, the fastest rate since 2008. And with inflation having fallen to 1.7% in August, below the Bank of England's 2% target, real wage growth has reached its highest rate since 2016.

The fall in **CPI inflation** from 2.1% in July to 1.7% in August was mainly due to lower inflation in the recreation and cultural services categories. Lower clothing inflation also helped to supress the headline measure. While you can pick out these more volatile components as the cause of the fall in inflation, the big picture is that there is little upward pressure on underlying inflation at the moment. Core inflation fell from 1.9% to 1.5%, its lowest rate in almost three years.

Nonetheless, there are still some reasons to think that CPI inflation will edge up at the end of the year as rising agricultural prices push up food inflation and core inflation starts to pick up now that the lagged effects of a fall in import price inflation have come to an end. What's more, the recent pick-up in wage costs is consistent with a rise in core services inflation to more than 4% in 2020.

Meanwhile, investors have become much more downbeat on the outlook for UK monetary policy. At the start of July investors were pricing in less than one 25bps rate cut from 0.75% within a year and then for interest rates to rise back to 0.75% again. Now, however, they are pricing in almost two rate cuts over the next two years and then for interest rates to remain low. This is partly because of the weakening global outlook and the rate cuts in the US and euro-zone. And it's partly because the **Monetary Policy Committee (MPC)** seems to have become more downbeat. Indeed, at its latest meeting in September the MPC noted that "underlying growth has slowed, but remains slightly positive, and that a degree of excess supply appears to have opened up". As a result, it wasn't surprising that the MPC kept Bank Rate on hold.

The Bank also gave us some indication of what it might do in **three familiar Brexit scenarios;** a deal, delay and no deal Brexit! If there were a Brexit deal at the end of October or in January, with inflation currently below the 2% target, the MPC is unlikely to feel under much pressure to rush ahead with rate hikes. But the Committee does think that interest rates would rise "at a gradual pace and to a limited extent".

However, it also pointed out that a further delay to Brexit would weigh on GDP growth and "domestically generated inflationary pressures would be reduced". The implication is that more delays to Brexit delay rate hikes and could even open the door to rate cuts. Indeed, Michael Saunders gave the strongest hint yet in a recent speech that he at least thinks that rate cuts might be required. And if there is a no deal then the MPC is still saying that "the monetary policy response would not be automatic and could be in either direction", although some MPC members have indicated that they would be more inclined to cut rates.

The extent by which borrowing rises depends on the outcome of Brexit. If a deal is reached, faster GDP growth would reduce public spending, raise tax revenues and cut the deficit, perhaps allowing fiscal policy to be loosened without borrowing rising by too much. However, in a no deal, the weaker economy, combined with a substantial fiscal loosening to support the economy, would push up the deficit sharply.

The passing of legislation by **Parliament** to prevent a no deal Brexit on 31 October means that we think the most likely outcome is another delay to Brexit until 31 January 2020. If there is a delay, then the general election that would surely follow in November or December would probably determine what happens to Brexit and the economy.

Turning to the financial markets, concerns over global growth and subsequent falls in interest rate expectations have caused developed market bond yields to drop – the **10-year gilt yield** fell from 0.81% at the start of the quarter to 0.47% at the end.

Meanwhile, despite the recent drop in the chances of a no deal Brexit on 31st October, **sterling** has fallen by about 3% from $1.27 to $1.23 this quarter. Given that the differential between 10-year gilts and 10-year US Treasuries has remained around 120 basis points, the fall in sterling is probably due to strength in the US dollar as demand for safe haven assets has increased.

The drop in sterling failed to give the **FTSE 100** a boost. The two markets usually have an inverse relationship as a rise in the pound lowers the sterling value of UK firms' overseas profits. But the FTSE 100 finished the quarter around 1.0% lower, slightly underperforming the S&P 500.

Elsewhere, in the **US** the markets think the Fed will cut interest rates twice more over the next two years. We agree that interest rates will fall once more this year, however, we don't expect the Fed to continue cutting interest rates next year. Meanwhile, we have lowered our forecast for GDP growth in the **euro-zone** next year from 0.8% to just 0.5%. And even if the ECB is reluctant to loosen policy further before Christine Lagarde takes over as President in November, we suspect that the Bank will cut its deposit rate by a further 30bps next year and step up its assets purchases.

APPENDIX 4: Detailed commentary on interest rate forecasts

Our treasury management advisers, Link Asset Services provided us on 11 November with the following update to their interest rate forecasts.

Comparison of forecasts for Bank Rate today v. previous forecast														
	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22	Mar-23
11.11.19	0.75	0.75	0.75	0.75	0.75	1.00	1.00	1.00	1.00	1.00	1.25	1.25	1.25	1.25
5. 8 .19	0.75	0.75	0.75	0.75	1.00	1.00	1.00	1.00	1.00	1.25	n/a	n/a	n/a	n/a
change	0.00	0.00	0.00	0.00	-0.25	0.00	0.00	0.00	0.00	-0.25	n/a	n/a	n/a	n/a

- While the Bank of England went through the routine of producing another quarterly Inflation Report at the start of August, it was very questionable how much all the writing and numbers were worth when faced with the huge uncertainties of where the UK will be on 1 November 2019. If there was a reasonable chance that negotiations were going positively and looked like heading towards agreement, it surely cannot be ruled out that there could be a further delay to the 31 October deadline, as both sides have great concerns about the economic damage that would be done to their economies if there was a no deal. However, there is also the issue of what the House of Commons may, or may not do, especially now that the Supreme Court has overturned the proroguing of Parliament and has also passed a bill to delay Brexit until 31 January 2020 if there is no deal before 31 October. All one can say for certain is that there is currently a great deal of uncertainty over Brexit.

- Possibly the biggest message that is worth taking note of from the Inflation Report, is the downbeat comments in terms of the outlook for the major world economies. In terms of the UK, it was notably downbeat about expectations for how strong a recovery in growth would be - even if there was a Brexit deal; investment levels look unlikely to suddenly rebound strongly. This was reflected in a downgrading of the Bank's growth forecasts.

- The MPC meeting of 19 September was notably dovish in emphasising increasing concerns about the impact that prolonged uncertainty was likely to have on UK growth, but also noted more concern about the environment of weaker global growth.

- While the USA is not heading towards a recession, the Fed has taken action to counter the slowdown in growth with two cuts of 25 bps each in July and September to reach 1.75 – 2.00%; it may cut again before the year end.

- The ECB is increasingly concerned by the headwinds facing the EZ economy as a whole, but especially the German and Italian economies. Germany is particularly exposed to a downturn in the world economy due to exports being a very important part of its economy. Italy just looks stuck in weak growth and successive governments have done little to face up to major issues that need dealing with. The ECB has therefore emphasised that while it can tinker at the edges with cuts in rates, and boosting liquidity in financial markets, the heavy lifting will have to be done by fiscal policy measures through national government action. Such siren noises have generally fallen on deaf ears in years gone by and Italy is perilously close already to exceeding the 3% budget deficit limit.

- The US tariff war with China looks to be coming more entrenched. This is not good news for China which is already facing a slowdown in its rate of economic growth. It will also impact on the US economy and especially on developing economies dependent on exporting commodities to China.

- Japan is, as always for the last two decades, mired in a battle with trying to get inflation consistently up from near zero, and with weak economic growth. Despite massive monetary policy measures, quantitative easing, and fiscal measures by the government, it is achieving little despite having its foot flat on the floor of the accelerator pedal of measures to stimulate growth.
- As for our forecasts for UK Bank Rate, we have moved back our forecast for the first increase from quarter 3 2020 to quarter 4 2020 and the second increase from quarter 1 2021 to quarter 1 2022. In order to make any forecast we have had to make one central assumption – a reasonable muddle through outcome for Brexit, possibly including a further delay to the deadline. If the facts change, our forecasts will also change. As events unfold it is possible we could see 25 – 50 bps movements in rates and yields at any time e.g. a hard Brexit could result in an immediate cut in Bank Rate. However, that is not our central assumption.
- We would point out to all clients that we have downgraded our forecasts for the speed of recovery in interest earnings on cash investments through to 2023/24.
- As for PWLB rates, we have seen a further sharp fall in most PWLB rates since our previous forecast.
- Our key advice to clients in the midst of such large-scale uncertainties is to focus on managing risk, rather than making a bet on one outcome or the other.
- A key issue facing most central banks of major world economies, except the US Fed, is that they have very little ammunition, in terms of normal monetary policy measures, to take action to counter the next economic downturn. Central banks will therefore have an agenda to restock their ammunition as soon as possible by raising central rates, but only when that becomes feasible, and, at a later time, possibly unwinding quantitative easing. Until they are able to raise rates back to more normal levels, central banks will be emphasising that responsibility for stimulating economic growth in the event of a significant economic downturn, will have to fall to governments to adopt fiscal measures of increasing expenditure and/or cutting taxes.

The balance of risks to the UK

- The overall balance of risks to economic growth in the UK is probably to the downside due to the weight of all the uncertainties over Brexit, as well as a softening global economic picture.
- The balance of risks to increases in Bank Rate and shorter term PWLB rates are broadly similarly to the downside.

One risk that is both an upside and downside risk is that all central banks are now working in very different economic conditions than before the 2008 financial crash. There has been a major increase in consumer and other debt due to the exceptionally low levels of borrowing rates that have prevailed for eleven years since 2008. This means that the neutral rate of interest in an economy, (i.e. the rate that is neither expansionary nor deflationary), is difficult to determine definitively in this new environment, although central banks have made statements that they expect it to be much lower than before 2008. Central banks could, therefore, over or under-do increases in central interest rates.

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

- **Brexit** – if it were to cause significant economic disruption and a major downturn in the rate of growth.
- **Bank of England** takes action too quickly, or too far, over the next three years to raise Bank Rate and causes UK economic growth, and increases in inflation, to be weaker than we currently anticipate.

- A resurgence of the **Eurozone sovereign debt crisis.** In 2018, Italy was a major concern due to having a populist coalition government which made a lot of anti-austerity and anti-EU noise. However, in September 2019 there was a major change in the coalition governing Italy which has brought to power a much more EU friendly government; this has eased the pressure on Italian bonds. Only time will tell whether this new unlikely alliance of two very different parties will endure.
- Weak capitalisation of some **European banks**, particularly Italian banks.
- **German minority government.** In the German general election of September 2017, Angela Merkel's CDU party was left in a vulnerable minority position dependent on the fractious support of the SPD party, as a result of the rise in popularity of the anti-immigration AfD party. Then in October 2018, the results of the Bavarian and Hesse state elections radically undermined the SPD party and showed a sharp fall in support for the CDU. As a result, the SPD had a major internal debate as to whether it could continue to support a coalition that is so damaging to its electoral popularity. After the result of the Hesse state election, Angela Merkel announced that she would not stand for re-election as CDU party leader at her party's convention in December 2018. However, this makes little practical difference as she has continued as Chancellor, though more recently concerns have arisen over her health.
- **Other minority EU governments.** Austria, Sweden, Spain, Portugal, Netherlands and Belgium all have vulnerable minority governments dependent on coalitions which could prove fragile.
- **Italy, Austria, the Czech Republic and Hungary** now form a strongly anti-immigration bloc within the EU. There has also been rising anti-immigration sentiment in Germany and France.
- There are concerns around the level of **US corporate debt** which has swollen massively during the period of low borrowing rates in order to finance mergers and acquisitions. This has resulted in the debt of many large corporations being downgraded to a BBB credit rating, close to junk status. Indeed, 48% of total investment grade corporate debt is rated at BBB. If such corporations fail to generate profits and cash flow to reduce their debt levels as expected, this could tip their debt into junk ratings which will increase their cost of financing and further negatively impact profits and cash flow.
- **Geopolitical risks,** for example in North Korea, but also in Europe and the Middle East, which could lead to increasing safe haven flows.

Upside risks to current forecasts for UK gilt yields and PWLB rates

- **Brexit** – if agreement was reached all round that removed all threats of economic and political disruption between the EU and the UK.
- The **Bank of England is too slow** in its pace and strength of increases in Bank Rate and, therefore, allows inflationary pressures to build up too strongly within the UK economy, which then necessitates a later rapid series of increases in Bank Rate faster than we currently expect.
- **UK inflation,** whether domestically generated or imported, returning to sustained significantly higher levels causing an increase in the inflation premium inherent to gilt yields.

1. LINK ASSET SERVICES' FORECASTS

We do not currently think that the MPC would increase Bank Rate before any clearing of the fog on Brexit. We have moved back our forecast for the first increase from quarter 3 2020 to quarter 4 2020 and the second increase from quarter 1 2021 to quarter 1 2022.

Forecasts for average investment earnings beyond the three-year time horizon will be heavily dependent on economic and political developments.

Gilt yields and PWLB rates

The general situation is for volatility in bond yields 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, although there are likely to also be periods of sharp volatility from time to time.

Our forecasts are also 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 and Iran, which have a major impact on international trade and world GDP growth. However, the current round of increases in tariff rates sparked by President Trump, both actual and threatened, are causing on-going concern around the potential impact on world growth and also on inflationary pressures.

We would, as always, remind clients of the view that we have expressed in our previous interest rate revision newsflashes of just how volatile 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.

Link Asset Services Interest Rate View											
	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22
Bank Rate View	0.75	0.75	0.75	0.75	0.75	1.00	1.00	1.00	1.00	1.00	1.25
3 Month LIBID	0.70	0.70	0.70	0.70	0.80	0.90	1.00	1.00	1.00	1.10	1.20
6 Month LIBID	0.80	0.80	0.80	0.80	0.90	1.00	1.10	1.10	1.20	1.30	1.40
12 Month LIBID	1.00	1.00	1.00	1.00	1.10	1.20	1.30	1.30	1.40	1.50	1.60
5yr PWLB Rate	1.20	1.30	1.50	1.60	1.70	1.70	1.80	1.90	2.00	2.00	2.10
10yr PWLB Rate	1.50	1.60	1.80	1.90	2.00	2.00	2.10	2.20	2.30	2.30	2.40
25yr PWLB Rate	2.10	2.30	2.40	2.50	2.60	2.70	2.70	2.80	2.90	3.00	3.00
50yr PWLB Rate	2.00	2.20	2.30	2.40	2.50	2.60	2.60	2.70	2.80	2.90	2.90

BANK RATE	now	previously
Q1 2020	0.75%	0.75%
Q1 2021	1.00%	1.25%
Q1 2022	1.25%	1.50%

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

PWLB debt	Current borrowing rate as at 5.8.19	Target borrowing rate now (end of Q3 2019)	Target borrowing rate previous (end of Q3 2019)
5 year	1.12%	1.20%	1.50%
10 year	1.37%	1.50%	1.80%
25 year	2.04%	2.10%	2.40%
50 year	1.95%	2.00%	2.30%

Borrowing advice: since November 2018, PWLB rates have fallen significantly. As our long term forecast for Bank Rate is 2.25%, and all PWLB rates are very near to or below 2.25%, and well below 2.25% in periods up to 10 years, there is added value in most borrowing periods. Value, however, in the longer term rates could be negated or minimal, if Bank Rate does not climb to at least 2.25% over the medium term. 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 2022.*** Please speak to your CRM to discuss opportunities available.

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

Average earnings in each year	Now	Previously
2019/20	0.75%	0.75%
2020/21	1.00%	1.00%
2021/22	1.00%	1.50%
2022/23	1.50%	1.75%
2023/24	1.50%	2.00%
2024/25	1.75%	2.00%
Later years	2.25%	2.25%

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 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.

APPENDIX 5: Approved countries for investments as at 30 September 2019

Clients may wish to inform members of changes to their approved list of countries for investments.

Based on lowest available rating

AAA

- Australia
- Canada
- Denmark
- Germany
- Luxembourg
- Netherlands
- Norway
- Singapore
- Sweden
- Switzerland

AA+

- Finland
- U.S.A.

AA

- Abu Dhabi (UAE)
- Hong Kong
- France
- U.K.

AA-

- Belgium
- Qatar