NOTTINGHAMSHIRE
Fire & Rescue Service
Creating Safer Communities

Nottinghamshire and City of Nottingham
Fire and Rescue Authority

TREASURY MANAGEMENT MID YEAR REVIEW 2019/20

Report of the Treasurer to the Fire Authority

Date: 20 December 2019

Purpose of Report:

To provide Members with an update on treasury management activity during the first half of the 2019/20 financial year.

Recommendations:

That Members note the contents of this report.

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1. BACKGROUND

1.1. The purpose of the treasury management function is to effectively manage the day to day cashflow of the organisation and to manage the borrowing required to finance the capital programme.

1.2 Accordingly, treasury management is defined as:

> "The management of the local authority's borrowing, investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks."

1.3 The CIPFA (Chartered Institute of Public Finance and Accountancy) Code of Practice on Treasury Management was adopted by the Fire Authority on 9 April 2010. The primary requirements of the Code are as follows:

1. The creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the Authority's treasury management activities.
2. The creation and maintenance of Treasury Management Practices which set out the manner in which the Authority will seek to achieve those policies and objectives.
3. Receipt by the Fire Authority of an annual Treasury Management Strategy Statement for the year ahead, a mid-year review report and an annual report covering activities during the previous year.
4. Delegation by the Authority of responsibilities for implementing and monitoring treasury management policies and practices and for the execution and administration of treasury management decisions.

1.4 The CIPFA Delegation by the Authority of the role of scrutiny of treasury management strategy and policies to a specific named body. For this Authority, the delegated body is the Finance and Resources Committee.

1.5 This mid-year report has been prepared in compliance with CIPFA's Code of Practice, and covers the following:

- An economic update for the first part of the 2019/20 financial year;
- The Authority's capital expenditure and prudential indicators;
- A review of the Treasury Management Strategy Statement;
- A review of the Authority's investment portfolio for 2019/20;
- A review of the Authority's borrowing strategy for 2019/20;
- A review of any debt rescheduling undertaken during 2019/20;
- A review of compliance with Treasury and Prudential Limits for 2019/20.

1.6 The Authority has appointed Link Asset Services as its external treasury management adviser.

1.7 In December 2017 CIPFA issued revised Prudential and Treasury Management Codes. From 2019/20, all fire authorities are required to prepare a Capital Strategy which is intended to provide the following:

- A high-level overview of how capital expenditure, capital financing and treasury management activity contribute to the provision of services.
- An overview of how the associated risk is managed.
- The implications for future financial sustainability.

1.8 A report setting out the Authority's Capital Strategy was approved by the Fire Authority on 14 December 2018.

2. REPORT

ECONOMIC UPDATE

2.1 2019 has been year of political upheaval, as Theresa May resigned as Prime Minister to be replaced by Boris Johnson on a platform of the UK leaving the EU on 31 October 2019. However, MPs blocked leaving on that date and the EU agreed an extension to 31 January 2020. In late October, MPs approved an outline of a Brexit deal to enable the UK to leave the EU on 31 January; however, even if a Conservative Government gains an overall majority in the general election on 12 December, there will still be much uncertainty as the detail of a trade deal will need to be negotiated by the current end of the transition period in December 2020.

2.2 The first half of 2019/20 has seen economic growth fall as Brexit uncertainty took its toll. In its inflation report of 1 August, the Bank of England was notably downbeat about the outlook for both the UK and major world economies. The MPC meeting of 19 September reemphasised their concern about the downturn in world growth and expressed concern that prolonged Brexit uncertainty would contribute to a build-up of spare capacity in the UK economy, especially in the context of a downturn in world growth. This mirrored investor concerns around the world which are now expecting a significant downturn or possibly even a recession in some major developed economies. The Monetary Policy Committee (MPC) has so far left Bank Rate unchanged at 0.75% throughout 2019 and is expected to hold off on changes until there is some clarity on what is going to happen over Brexit.

2.3 The consumer price index (CPI) rate of inflation has been hovering around the Bank of England's target of 2% during 2019, but fell to 1.7% in August. It is likely to remain close to 2% over the next two years and so does not pose any immediate concern to the MPC at this time. However, if there were to be a no deal Brexit, inflation could rise towards 4%, primarily as a result of imported inflation due to a weakened pound.

2.4 It was against this backdrop uncertainty that the Bank of England produced its quarterly inflation report (now renamed the Monetary Policy Report) on 7 November. The Bank made a change in their Brexit assumptions to now include a deal being eventually passed. Possibly the biggest message that is

worth taking note of from the Monetary Policy Report, was an increase in concerns among Monetary Policy Committee (MPC) members around weak global economic growth and the potential for Brexit uncertainties to become entrenched and so delay UK economic recovery. Consequently, the MPC voted 7-2 to maintain Bank Rate at 0.75% but two members were sufficiently concerned to vote for an immediate Bank Rate cut to 0.5%. The MPC warned that if global growth does not pick up or Brexit uncertainties intensify, then a rate cut was now more likely. Conversely, if risks do recede, then a more rapid recovery of growth will require gradual and limited rate rises. The speed of recovery will depend on the extent to which uncertainty dissipates over the final terms for trade between the UK and EU and by how much global growth rates pick up. The Bank revised its inflation forecasts downwards to 1.25% in 2019, 1.5% in 2020, and 2.0% in 2021; hence the MPC views inflation as causing little concern in the near future.

2.5 A more detailed economic update can be found in Appendix A, and interest rate forecasts can be found in Appendix B.

REVIEW OF THE TREASURY MANAGEMENT STRATEGY

2.6 The Treasury Management Strategy approved by the Authority sets out the policies for managing investments and for giving priority to the security and liquidity of those investments. The risk appetite of this Authority is low in order to give priority to security of its investments. Accordingly, the following types of low risk investments may be made:

- Deposits with the Debt Management Office (Government);
- Term deposits with Banks and Building Societies;
- Call deposits with Banks and Building Societies;
- Term Deposits with uncapped English and Welsh local authority bodies;
- Triple-A rated Money Market Funds (CNAV, LVNAV and VNAV);
- UK Treasury Bills;
- Certificates of Deposit.

2.7 The Treasury Management Strategy includes a limit of £4m to be invested with any single counterparty, although this limit is only used in exceptional circumstances and a maximum of £2m is normally adhered to. No term deposits will be made for more than 1 year without the prior approval of the Treasurer and the Chair of Finance and Resources Committee. The selection of counterparties with a high level of creditworthiness will be achieved by selection of institutions down to a minimum durational band within Link's weekly credit list of potential counterparties. The Authority will therefore use counterparties within the following durational bands:

- Blue 1 year (only applies to nationalised or semi nationalised UK Banks);
- Orange 1 year;
- Red 6 months;
- Green 100 days.

2.8 The Authority will avoid locking into longer term deals whilst investment rates are down at such low levels unless exceptionally attractive rates are available which make longer term deals worthwhile.

2.9 In terms of cash resources, the strategy is to maintain a bank overdraft facility of £200,000, to continue to use cash flow forecasting to predict cash surpluses and shortfalls so that these can be managed and to invest small bank account balances in the Business Premium Account on a daily basis if the interest rate is favourable.

2.10 In the first half of the year, the current account was overdrawn on 4 occasions. As a result, the Authority incurred interest charges of £209.

REVIEW OF THE INVESTMENT PORTFOLIO

2.11 The Authority's priority is to ensure security of capital and liquidity, and to obtain an appropriate level of return which is consistent with its risk appetite. As shown by interest rate forecasts in Appendix A, investment returns are currently low when compared with rates commonly seen in previous decades. The current economic environment prompts a low risk and short term investment strategy.

2.12 The Authority held £12m of investments at 31 October 2019, up from £9.05m at 31 March 2019. The weighted average rate of return at 31 October 2019 was 0.92%. The weighted average rate of return has consistently been above the benchmark 3 month LIBID rate throughout the year. Details of the Authority's investments can be found in Appendix C.

2.13 The approved limits within the Authority's Annual Investment Strategy have not been breached during the period from 1 April 2019 to 31 October 2019.

2.14 The Authority's budget for investment interest for 2019/20 is £66k. £41k has been received during the period to 31 October 2019. The forecast outturn for the 2019/20 financial year is £101k.

REVIEW OF THE BORROWING STRATEGY

2.15 The strategy for 2019/20 is to use a combination of capital receipts, borrowing and internal funds to finance capital expenditure.

2.16 In the Treasury Management Strategy, it was predicted that the Authority would need to borrow up to £9m during the 3-year period from 2019/20 to finance the capital programme and replace £1.5m of maturing loans. The Authority took a £4m short term loan for cash flow purposes at the end of the 2018/19 financial year. This loan was repaid in July 2019. No long-term maturity loans are due to be repaid during 2019/20.

2.17 On 9 October 2019, the Treasury and Public Works Loans Board (PWLB) announced an increase in the margin over gilt yields of 100 basis points on top of the current margin of 80 basis points which this authority has paid prior to this date for new borrowing from the PWLB. There was no prior warning

that this would happen and it now means that every local authority must reassess how to finance their external borrowing needs, and assess the extent to which the financial viability of their capital programmes has been affected due to this unexpected increase in the cost of borrowing. Whereas the Authority has previously relied on the PWLB as its main source of funding, alternative cheaper sources of borrowing may now be considered. It is likely that various financial institutions will enter the market or make products available to local authorities in response to the sudden increase in PWLB rates. Officers will work with treasury advisors to carefully consider all funding options before undertaking any further long term borrowing. The Authority's current Treasury Management Strategy permits fixed rate market borrowing when rates are lower than PWLB rates. The Authority is also permitted to take loans from the Municipal Bond Agency should any be offered in the future.

2.18 Prior to the decision to increase PWLB rates on 9 October, rates had been on a falling trend during the period from 1 April 2019. Longer term rates almost halved during the first 6 months of the financial year to reach historic lows. Current forecasts provided by the Authority's treasury advisor show that PWLB rates are expected to rise slowly but steadily over the next few years, with the 25-year rate forecast to reach 4.00% by March 2022, up from 3.06% at 31 October 2019. Further detail about the interest rate forecasts can be found in Appendix B.

2.19 The Authority's capital financing requirement (CFR) as at 31 March 2019 was £25.74m. The CFR denotes the Authority's underlying need to borrow for capital purposes. Current borrowing stands at £25.56m. As borrowing rates are currently higher than investment rates the Authority can avoid carrying costs by not borrowing too far in advance of expenditure, however a balance needs to be struck between avoiding unnecessary carrying costs and managing the interest rate risk which arises from delaying borrowing while interest rates are at relatively low levels.

2.20 Current cash flow forecasts show that the Authority may require some short term borrowing for cash flow purposes towards the end of the financial year. Further long term borrowing is not anticipated.

2.21 No rescheduling of debt has taken place to date, as the interest rate climate has not resulted in an advantageous environment for rescheduling.

2.22 All aspects of the borrowing strategy remain in place at this mid-point in the year.

REVIEW OF COMPLIANCE WITH TREASURY AND PRUDENTIAL LIMITS

2.23 The following indicators were approved by Members for the 2019/20 financial year. As at 31 October, the actual performance was as shown in the final column of the table below.

Treasury or Prudential Indicator or Limit	Approved for 2019/20	Actual as at 31/10/19
Estimate of Ratio of Financing Costs to Net Revenue Stream	5.5%	Not available until year end
Estimate of Total Capital Expenditure to be Incurred	£5,448,000	£1,285,000
Estimate of Capital Financing Requirement	£30,098,000	Actual not available until year end. Estimate not exceeded.
Operational Boundary	£30,600,000	Not exceeded
Authorised Limit	£33,660,000	Not exceeded
Upper limit for fixed rate interest exposures	100%	100%
Upper limit for variable rate interest exposures	30%	0%
Loan Maturity:	Limits:	
Under 12 months	Upper 20% Lower 0%	11.9%
12 months to 5 years	Upper 30% Lower 0%	14.3%
5 years to 10 years	Upper 75% Lower 0%	9.3%
10 years to 20 years	Upper 100% Lower 0%	9.3%
Over 20 years	Upper 100% Lower 30%	55.2%
Upper Limit for Principal Sums Invested for Periods Longer than 364 Days	£2,000,000	Not applicable

3. FINANCIAL IMPLICATIONS

The financial implications of this report are set out in full within the body of the report.

4. HUMAN RESOURCES AND LEARNING AND DEVELOPMENT IMPLICATIONS

There are no human resources or learning and development implications arising from this report.

5. EQUALITIES IMPLICATIONS

An equality impact assessment has not been undertaken because this report gives a review of activities rather than introducing a new policy.

6. CRIME AND DISORDER IMPLICATIONS

There are no crime and disorder implications arising directly from this report.

7. LEGAL IMPLICATIONS

There are no legal implications arising directly from this report, other than the requirement to act within the Authority's powers when undertaking treasury management borrowings and investments.

8. RISK MANAGEMENT IMPLICATIONS

The investment of local authority funds cannot be achieved without some element of risk. Careful choice of borrowers using creditworthiness indices will minimise this risk. This prudent approach will undoubtedly result in some interest rate loss but the principles of security and liquidity are paramount.

9. COLLABORATION IMPLICATIONS

There are no collaboration implications arising from this report.

10. RECOMMENDATIONS

That Members note the contents of this report.

11. BACKGROUND PAPERS FOR INSPECTION (OTHER THAN PUBLISHED DOCUMENTS)

None.

Charlotte Radford
TREASURER TO THE FIRE AUTHORITY

APPENDIX A

ECONOMICS UPDATE

Source: Link Asset Services

UK

This first half year has been a time of upheaval on the political front as Theresa May resigned as Prime Minister to be replaced by Boris Johnson on a platform of the UK leaving the EU on or 31 October, with or without a deal. However, MPs blocked leaving on that date and the EU agreed an extension to 31 January 2020. In late October, MPs approved an outline of a Brexit deal to enable the UK to leave the EU on 31 January. However, even if a Conservative Government gains an overall majority in the general election on 12 December, there will still be much uncertainty as the detail of a trade deal will need to be negotiated by the current end of the transition period in December 2020. If the UK is able to agree a deal with the EU by the end of transition period then it is possible that growth could recover relatively quickly. The Monetary Policy Committee (MPC) could then need to address the issue of whether to raise Bank Rate at some point in the coming year when there is little slack left in the labour market; this could cause wage inflation to accelerate which would then feed through into general inflation. On the other hand, if there was a no deal Brexit and there was a significant level of disruption to the economy, then growth could weaken even further than currently and the MPC would be likely to cut Bank Rate in order to support growth.

The first half of 2019/20 has seen UK **economic growth** fall as Brexit uncertainty took a toll. In its Inflation Report of 1 August, the Bank of England was notably downbeat about the outlook for both the UK and major world economies. The MPC meeting of 19 September reemphasised their concern about the downturn in world growth and also expressed concern that prolonged Brexit uncertainty would contribute to a build-up of spare capacity in the UK economy, especially in the context of a downturn in world growth. This mirrored investor concerns around the world which are now expecting a significant downturn or possibly even a recession in some major developed economies. It is therefore no surprise that the Monetary Policy Committee (MPC) has left Bank Rate unchanged at 0.75% so far during 2019, and is expected to hold off on changes until there is some clarity on what is going to happen over Brexit.

While the Bank of England went through the routine of producing another quarterly Inflation Report, (now renamed the Monetary Policy Report), on 7 November, it is very questionable how much all the writing and numbers are worth when faced with the uncertainties of where the UK will be after the general election. The Bank made a change in their Brexit assumptions to now include a deal being eventually passed. Possibly the biggest message that is worth taking note of from the Monetary Policy Report, was an increase in concerns among MPC members around weak global economic growth and the potential for Brexit uncertainties to become entrenched and so delay UK economic recovery. Consequently, the MPC voted 7-2 to maintain Bank Rate at 0.75% but two members were sufficiently concerned to vote for an immediate Bank Rate cut to 0.5%. The MPC warned that if global growth does not pick up or Brexit uncertainties intensify, then a rate cut was now more likely.

Conversely, if risks do recede, then a more rapid recovery of growth will require gradual and limited rate rises. The speed of recovery will depend on the extent to which uncertainty dissipates over the final terms for trade between the UK and EU and by how much global growth rates pick up. The Bank revised its inflation forecasts down to 1.25% in 2019, 1.5% in 2020, and 2.0% in 2021; hence the MPC views inflation as causing little concern in the near future.

If economic growth were to weaken considerably, the MPC has relatively little room to make a big impact with Bank Rate still only at 0.75%. It would therefore, probably suggest that it would be up to the Chancellor to provide help to support growth by way of a fiscal boost by e.g. tax cuts, increases in the annual expenditure budgets of government departments and services and expenditure on infrastructure projects, to boost the economy. The Government has already made moves in this direction and both of the largest parties have made significant promises in their election manifestos to increase government spending. The Chancellor has also amended the fiscal rules in November to allow for an increase in government expenditure. In addition, it has to be borne in mind that even if the post-election Parliament agrees the deal on 31 January 2020, the current transition period for negotiating the details of the terms of a trade deal with the EU only runs until 31 December 2020. This could prove to be an unrealistically short timetable for such major negotiations which leaves open two possibilities; one the need for an extension of negotiations, probably two years, or a no deal Brexit in December 2020.

As for **inflation** itself, CPI has been hovering around the Bank of England's target of 2% during 2019, but fell to 1.7% in August. It is likely to remain close to 2% over the next two years and so it does not pose any immediate concern to the MPC at the current time. However, if there was a no deal Brexit, inflation could rise towards 4%, primarily as a result of imported inflation on the back of a weakening pound.

With regard to the **labour market,** despite the contraction in quarterly GDP growth of -0.2% q/q, (+1.3% y/y), in quarter 2, employment continued to rise, but at only a muted rate of 31,000 in the three months to July after having risen by no less than 115,000 in quarter 2 itself: the latter figure, in particular, suggests that firms are preparing to expand output and suggests there could be a return to positive growth in quarter 3. Unemployment continued at a 44-year low of 3.8% on the Independent Labour Organisation measure in July and the participation rate of 76.1% achieved a new all-time high. Job vacancies fell for a seventh consecutive month after having previously hit record levels. However, with unemployment continuing to fall, this month by 11,000, employers will still be having difficulty filling job vacancies with suitable staff. It was therefore unsurprising that wage inflation picked up to a high point of 3.9% in June before easing back slightly to 3.8% in July, (3-month average regular pay, excluding bonuses). This meant that in real terms, (i.e. wage rates higher than CPI inflation), earnings grew by about 2.1%. As the UK economy is very much services sector driven, an increase in household spending power is likely to feed through into providing some support to the overall rate of economic growth in the coming months. The latest GDP statistics also included a revision of the savings ratio from 4.1% to 6.4% which provides reassurance that consumers' balance sheets are not over stretched and so will be able to support growth going forward. This would then mean that the MPC will need to consider carefully at what point to take action to raise Bank Rate if there is an agreed Brexit deal, as the recent pick-up

in wage costs is consistent with a rise in core services inflation to more than 4% in 2020.

In the **political arena**, the outcome of the general election is likely to result in a 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 although, conversely, a weak international backdrop could provide further support for low yielding government bonds and gilts.

USA

President Trump's massive easing of fiscal policy in 2018 fuelled a temporary boost in consumption in that year which generated an upturn in the rate of strong growth to 2.9% y/y. Growth in 2019 has been falling back after a strong start in quarter 1 at 3.1%, (annualised rate), to 2.0% in quarter 2. Quarter 3 is expected to fall further. 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. The Federal Reserve finished its series of increases in rates to 2.25 – 2.50% in December 2018. In July 2019, it cut rates by 0.25% as a 'midterm adjustment' but flagged up that this was not to be seen as the start of a series of cuts to ward off a downturn in growth. It then cut rates again in September to 1.75% - 2.00% and is thought likely to cut another 25 bps in December. Investor confidence has been badly rattled by the progressive ramping up of increases in tariffs President Trump has made on Chinese imports and China has responded with increases in tariffs on American imports. This trade war is seen as depressing US, Chinese and world growth. In the EU, it is also particularly impacting Germany as exports of goods and services are equivalent to 46% of total GDP. It will also impact developing countries dependent on exporting commodities to China.

EUROZONE

Growth has been slowing from +1.8 % during 2018 to around half of that in 2019. Growth was +0.4% q/q (+1.2% y/y) in quarter 1 and then fell to +0.2% q/q (+1.0% y/y) in quarter 2; there appears to be little upside potential to the growth rate in the rest of 2019. German GDP growth fell to -0.1% in quarter 2; industrial production was down 4% y/y in June with car production down 10% y/y. Germany would be particularly vulnerable to a no deal Brexit depressing exports further and if President Trump imposes tariffs on EU produced cars. The European Central Bank (ECB) ended its programme of quantitative easing purchases of debt in December 2018, which 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 Eurozone (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 Targeted Longer-Term Refinancing Operations (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. 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. On the political front, Austria, Spain and Italy are in the throes of forming coalition governments with some unlikely combinations of parties i.e. this raises questions around their likely endurance. The recent results of two German state elections will put further pressure on the frail German CDU/SDP coalition government.

CHINA

Economic growth has been weakening over successive years, despite repeated rounds of central bank stimulus; medium term risks are increasing. Major progress still needs to be made to eliminate excess industrial capacity and the stock of unsold property, and to address the level of non-performing loans in the banking and credit systems. Progress also still needs to be made to eliminate excess industrial capacity and to switch investment from property construction and infrastructure to consumer goods production. The trade war with the US does not appear currently to have had a significant effect on GDP growth as some of the impact of tariffs has been offset by falls in the exchange rate and by transhipping exports through other countries, rather than directly to the US.

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 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.

APPENDIX B

INTEREST RATE FORECASTS

Source: Link Asset Services

This forecast includes the increase in margin over gilt yields of 100bps introduced on 9.10.19.

Link Asset Services Interest Rate View	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	1.00	1.00	1.00	1.00	1.00	1.25
3 Month LIBID	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	0.90	1.00	1.10	1.10	1.20	1.30	1.40
12 Month LIBID	1.00	1.00	1.00	1.10	1.20	1.30	1.30	1.40	1.50	1.60
5yr PWLB Rate	2.30	2.50	2.60	2.70	2.70	2.80	2.90	3.00	3.00	3.10
10yr PWLB Rate	2.60	2.80	2.90	3.00	3.00	3.10	3.20	3.30	3.30	3.40
25yr PWLB Rate	3.30	3.40	3.50	3.60	3.70	3.70	3.80	3.90	4.00	4.00
50yr PWLB Rate	3.20	3.30	3.40	3.50	3.60	3.60	3.70	3.80	3.90	3.90

The above forecasts have been based on an assumption that a Brexit deal will be agreed at some point in time. Given the current level of uncertainties, this is a huge assumption and so forecasts may need to be materially reassessed in the light of events over the next few weeks or months.

BOND YIELDS/PWLB RATES

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 saw during the last half year up to 30 September 2019 is a near halving of longer term PWLB rates to completely unprecedented historic low levels. The Treasury has since taken action to increase PWLB rates (see paragraph 2.17 of the main report for details). 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 also in the UK. However, the timing of this and how strong the correlation is likely to be between the movement in the US and UK bond markets is very difficult to forecast with any degree of confidence.

There is a danger 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. (A doom loop would occur where the credit rating of the debt of a nation was downgraded which would cause bond prices to fall, causing losses on debt portfolios held by banks and insurers, so reducing their capital and forcing them to sell bonds – which, in turn, would cause further falls in their prices etc.). In addition, the financial viability of pension funds could be damaged by low yields on holdings of bonds.

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 alliance of two very different parties will endure.

- Weak capitalisation of some **European banks**, particularly Italian banks.

- **Minority EU governments.** Germany, Austria, Sweden, Spain, Portugal, Netherlands and Belgium all have 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.

INVESTMENT DETAILS **APPENDIX C**

	April		May		June		July		August		September		October	
Investment	**£000k**	**Interest rate %**	**£000k**	**Interest rate %**	**£000k**	**Interest rate %**	**£000k**	**Interest rate %**	**£000k**	**Interest rate %**	**£000k**	**Interest rate %**	**£000k**	**Interest rate %**
Bank of Scotland 32 day	1,050	0.80%	1,050	0.80%	2,000	0.95%	3,000	0.95%	3,000	0.95%	1,000	0.95%	1,000	0.95%
Barclays 95 day	1,500	0.95%	1,500	0.95%	1,500	0.95%	2,500	0.95%	1,500	0.95%	1,500	0.95%	1,500	0.95%
Barclays fixed term deposit									1,000	0.75%	1,000	0.75%	1,000	0.75%
Goldman Sachs 185 day	2,000	0.87%	2,000	0.87%	2,000	0.87%	2,000	0.87%	2,000	0.87%	2,000	0.87%	2,000	0.87%
Lloyds 32 day	1,000	0.80%	1,000	0.80%	2,000	0.95%	2,000	0.95%	2,000	0.95%	2,000	0.95%	2,000	0.95%
Lloyds 95 day	1,000	1.10%	1,000	1.10%			1,000	1.10%	1,000	1.10%	1,000	1.10%	1,000	1.10%
Nationwide 1 day	600	0.40%	600	0.40%	600	0.40%	600	0.40%	600	0.40%	600	0.40%	600	0.40%
Nationwide 125 day									1,000	1.20%	1,000	1.20%	1,000	1.20%
Nationwide 95 day	1,400	0.90%	1,400	0.90%	1,400	0.90%	1,400	0.90%	1,400	0.90%	400	0.90%	400	0.90%
Santander 95 day	500	0.85%	500	0.85%	500	0.85%	1,500	0.90%	1,500	0.90%	1,500	0.90%	1,500	0.90%
Total invested £000k	**9,050**		**9,050**		**10,000**		**14,000**		**15,000**		**12,000**		**12,000**	
Weighted average rate of return	**0.87%**		**0.87%**		**0.89%**		**0.92%**		**0.92%**		**0.92%**		**0.92%**	
3 Month LIBID rate (for benchmarking)	**0.70%**		**0.68%**		**0.66%**		**0.65%**		**0.64%**		**0.65%**		**0.66%**	
Weighted average life	**94 days**		**94 days**		**82 days**		**81 days**		**84 days**		**92 days**		**92 days**	