

Treasury Management and Annual Investment Strategy 2017/18

1 Introduction

1.1 Treasury management is defined as:

‘The management of the local authority’s 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’.

1.2 The strategy covers:

- Statutory and regulatory requirements
- Balanced budget requirement
- Prudential and treasury Indicators
- Borrowing requirement
- Current treasury position
- Prospects for interest rates
- Investment policy
- Creditworthiness policy
- Country, counterparty and group exposure limits
- Cash flow and core fund investment
- Long term investment
- Year end investment report
- Policy on use of external service providers.

2 Statutory and regulatory requirements

2.1 The Local Government Act 2003 (the Act) and supporting regulations requires the Council to ‘have regard to’ the CIPFA Prudential Code and the CIPFA Treasury Management Code of Practice to set Prudential and Treasury Indicators for the next three years to ensure that the Council’s capital investment plans are affordable, prudent and sustainable.

2.2 The Act requires the Council to set out its Treasury Management Strategy for borrowing and to prepare an Annual Investment Strategy

which sets out the Council's policies for managing its investments and for giving priority to the **security** and **liquidity** of those investments.

- 2.3 The Department of Communities and Local Government has issued revised investment guidance which came into effect from 1 April 2010. There were no major changes required over and above the changes already required by the revised CIPFA Treasury Management Code of Practice 2009 (The Code of Practice).
- 2.4 The Code of Practice was adopted by this Council on 18 February 2010. In preparing this strategy due regard has also been given to the Code's subsequent revisions.
- 2.5 The primary requirements of the Code are as follows:
- Creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the Council's treasury management activities.
 - Creation and maintenance of Treasury Management Practices which set out the manner in which the Council will seek to achieve those policies and objectives.
 - Receipt by the full Council of an Annual Treasury Management Strategy, including the Annual Investment Strategy, for the year ahead; a mid-year Review Report; and an Annual Report (stewardship report) covering activities during the previous year.
 - Delegation by the Council of responsibilities for implementing and monitoring treasury management policies and practices and for the execution and administration of treasury management decisions.
 - Delegation by the Council of the role of scrutiny of the Treasury Management Strategy and policies to a specific named body. For this Council the delegated body is the Audit Committee.
- 2.6 The scheme of delegation and role of the Section 151 officer that give effect to these requirements are set out at **[Appendix 1]**.

3 Balanced budget requirement

- 3.1 It is a statutory requirement under Section 33 of the Local Government Finance Act 1992, for the Council to produce a balanced budget. In particular, Section 32 requires a local authority to calculate its budget requirement for each financial year to include the revenue costs that flow from capital financing decisions. This means that increases in

capital expenditure must be limited to a level whereby increases in charges to revenue from:

- increases in interest charges caused by increased borrowing to finance additional capital expenditure, and
- any increases in running costs from new capital projects are limited to a level which is affordable within the projected income of the Council for the foreseeable future.

4 Prudential and treasury indicators

- 4.1 It is a statutory duty under Section 3 of the Act and supporting regulations, for the Council to determine and keep under review how much it can afford to borrow. The amount so determined is termed the 'Affordable Borrowing Limit'. In England and Wales the Authorised Limit represents the legislative limit specified in the Act.
- 4.2 The Council must have regard to the Prudential Code when setting the 'Authorised Limit', which essentially requires it to ensure that total capital investment remains within sustainable limits and, in particular, that the impact upon its future council tax levels is 'acceptable'.
- 4.3 Whilst termed an 'Affordable Borrowing Limit', the capital plans to be considered for inclusion incorporate financing by both external borrowing and other forms of liability, such as credit arrangements. The 'Authorised Limit' is to be set, on a rolling basis, for the forthcoming financial year and two successive financial years.
- 4.4 The Council is also required to indicate if it has adopted the CIPFA Code of Practice on Treasury Management. The original 2001 Code was adopted on 30 September 2003 and the revised 2009 Code was adopted by the full Council on 18 February 2010. Subsequent Code amendments are also complied with.
- 4.5 Prudential and Treasury Indicators relevant to setting an integrated treasury management strategy are set out in **[Appendix 2]**.

5 Borrowing requirement

- 5.1 Other than for cash flow purposes and then within the limits set out at **[Appendix 2]** borrowing will not be necessary. All capital expenditure in 2017/18 will be funded from the Revenue Reserve for Capital Schemes, grants, developer contributions and capital receipts arising from the sale of assets.

- 5.2 The borrowing of monies purely to invest or on-lend and make a return is unlawful and this Council will not engage in such activity.

6 Current treasury position

- 6.1 The Council is debt free and as such the overall treasury position at 31 December 2016 comprised only investments which totaled £39m generating an average return of 0.61%.

7 Prospects for interest rates

- 7.1 The Council has appointed Capita Asset Services as treasury advisor to the Council and part of their service is to assist the Council to formulate a view on interest rates. **[Appendix 3]** draws together a number of current City forecasts for short term (Bank Rate) and longer fixed interest rates. Capita's expectation for the Bank Rate for the financial year ends (March) is:

- 2016/ 2017 0.25%
- 2017/ 2018 0.25%
- 2018/ 2019 0.25%
- 2019/ 2020 0.75%

- 7.2 The Monetary Policy Committee, (MPC), cut the Bank Rate from 0.50% to 0.25% on 4th August in order to counteract what it forecast was going to be a sharp slowdown in growth in the second half of 2016. It also gave a strong steer that it was likely to cut the Bank Rate again by the end of the year. However, economic data since August has indicated much stronger growth in the second half 2016 than that forecast; also, inflation forecasts have risen substantially as a result of a continuation of the sharp fall in the value of sterling since early July. Consequently, Bank Rate was not cut again in November or December and, on current trends, it now appears unlikely that there will be another cut, although that cannot be completely ruled out if economic growth dips significantly. During the two-year period 2017 – 2019, when the UK is negotiating the terms for withdrawal from the EU, it is likely that the MPC will do nothing to dampen growth prospects, (i.e. by raising Bank Rate), which will already be adversely impacted by the uncertainties of what form Brexit will eventually take. Capita conclude that a rise in Bank Rate to 0.50% is unlikely before quarter 2 2019, after those negotiations have been completed, (though the period for negotiations could be extended). However, if strong domestically generated inflation, (e.g. from wage increases within the UK), were to

emerge, then the pace and timing of increases in Bank Rate could be brought forward.

7.3 Economic and interest rate forecasting remains difficult with so many external influences weighing on the UK. The above forecasts, (and MPC decisions), will be liable to further amendment depending on how economic data and developments in financial markets transpire over the next year. Geopolitical developments, especially in the EU, could also have a major impact. Forecasts for average investment earnings beyond the three-year time horizon will be heavily dependent on economic and political developments.

7.4 The overall longer run trend is for gilt yields and PWLB rates to rise, albeit gently. It has long been expected that at some point, there would be a start to a switch back from bonds to equities after a historic long term trend over the last twenty five years of falling bond yields. The action of central banks since the financial crash of 2008, in implementing substantial quantitative easing purchases of bonds, added further impetus to this downward trend in bond yields and rising prices of bonds. The opposite side of this coin has been a rise in equity values as investors searched for higher returns and took on riskier assets. The sharp rise in bond yields since the US Presidential election, has called into question whether, or when, this trend has, or may, reverse, especially when America is likely to lead the way in reversing monetary policy. Until 2015, monetary policy was focused on providing stimulus to economic growth but has since started to refocus on countering the threat of rising inflationary pressures as strong economic growth becomes more firmly established. The expected substantial rise in the US rates over the next few years may make holding US bonds much less attractive and cause their prices to fall, and therefore bond yields to rise. Rising bond yields in the US would be likely to exert some upward pressure on bond yields in other developed countries but the degree of that upward pressure will be dampened by how strong, or weak, the prospects for economic growth and rising inflation are in each country, and on the degree of progress in the reversal of monetary policy away from quantitative easing and other credit stimulus measures.

7.5 PWLB rates and gilt yields have been experiencing exceptional levels of volatility that have been highly correlated to geo-political, sovereign debt crisis and emerging market developments. It is likely that these exceptional levels of volatility could continue to occur for the foreseeable future.

- 7.6 The overall balance of risks to economic recovery in the UK is to the downside, particularly in view of the current uncertainty over the final terms of Brexit and the timetable for its implementation.
- 7.7 Apart from the above uncertainties, downside risks to current forecasts for UK gilt yields and PWLB rates currently include:
- Monetary policy action by the central banks of major economies reaching its limit of effectiveness and failing to stimulate significant sustainable growth, combat the threat of deflation and reduce high levels of debt in some countries, combined with a lack of adequate action from national governments to promote growth through structural reforms, fiscal policy and investment expenditure.
 - Outcome of national polls (Dutch general election March 2017, French presidential election April/May 2017, French National Assembly election June 2017 and the German Federal election August/October 2017).
 - A resurgence of the Eurozone sovereign debt crisis and stresses arising from disagreement between EU countries on free movement of people, management of immigration and threats from terrorism.
 - Weak capitalisation of some European banks.
 - Geopolitical risks in Europe, the Middle East and Asia, causing a significant increase in safe haven flows.
 - UK economic growth and increases in inflation are weaker than currently anticipated.
 - Weak growth or recession in the UK's main trading partners - the EU and US.
- 7.8 The potential for upside risks to current forecasts for UK gilt yields and PWLB rates, especially for longer term PWLB rates, include:
- UK inflation rising to significantly higher levels than in the wider EU and in the US, causing an increase in the inflation premium in gilt yields.
 - A rise in US Treasury yields as a result of Fed. funds rate increases and rising inflation expectations in the USA, dragging UK gilt yields upwards.
 - 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.
 - A downward revision to the UK's sovereign credit rating undermining investor confidence in holding sovereign debt (gilts)

7.9 A more detailed view of the current economic background, provided by Capita, is contained in **[Appendix 4]**.

8 Investment policy

8.1 The Council's investment policy has regard to the CLG's Guidance on Local Government Investments (the Guidance) and the revised CIPFA Treasury Management in Public Services Code of Practice and Cross Sectoral Guidance Notes (the CIPFA TM Code). The Council's investment priorities will be security first, liquidity second, and then yield.

8.2 In accordance with the above guidance from the CLG and CIPFA, and in order to minimise the risk to investments, the Council applies minimum acceptable credit criteria in order to generate a list of highly creditworthy counterparties. The key ratings used to monitor counterparties are the Short Term and Long Term ratings.

8.3 Ratings will not be the sole determinant of the quality of an institution; it is important to continually assess and monitor the financial sector on both a micro and macro basis and in relation to the economic and political environments in which institutions operate. The assessment will also take account of information that reflects the opinion of the markets. To this end the Council will engage with its advisors to maintain a monitor on market pricing such as 'credit default swaps' and overlay that information on top of the credit ratings.

8.4 Other information sources used will include the financial press, share price and other information relating to the banking sector in order to establish a robust scrutiny process on the suitability of potential investment counterparties.

8.5 Investment instruments identified for use are listed in **[Appendix 5]** under 'specified' and 'non-specified' investment categories. Counterparty limits are detailed in section 10 below.

9 Creditworthiness policy

9.1 The creditworthiness service provided by Capita has been progressively enhanced over the last few years and now uses a sophisticated modelling approach with credit ratings from all three rating agencies - Fitch, Moody's and Standard and Poor's. The credit ratings are supplemented using the following overlays:

- Credit watches and credit outlooks from credit rating agencies;

- Credit Default Swap (CDS) spreads to give early warning of likely changes in credit ratings; and
- Sovereign ratings to select counterparties from only the most creditworthy countries.

9..2 This modelling approach combines credit ratings, credit watches and credit outlooks in a weighted scoring system which is then combined with an overlay of CDS spreads for which the end product is a series of colour code bands which indicate the relative creditworthiness of counterparties. These colour codes are also used by the Council to inform the duration of an investment and are therefore referred to as durational bands. The Council is satisfied that this service now gives a much improved level of security for its investments.

9.3 The selection of counterparties with a high level of creditworthiness is achieved by selecting institutions down to a minimum durational band within Capita’s weekly credit list of potential counterparties (worldwide). Subject to an appropriate sovereign and counterparty rating the Council uses counterparties within the following durational bands:

Yellow	5 years
Purple	2 years
Blue	1 year (nationalised or part nationalised UK Banks)
Orange	1 year
Red	6 months
Green	100 Days

9.4 The Council does not use the approach suggested by CIPFA of using the lowest rating from all three rating agencies to determine creditworthy counterparties. Moody’s tends to be more aggressive in giving low ratings than the other two agencies and adopting the CIPFA approach may leave the Council with too few banks on its approved lending list. The Capita creditworthiness service uses a wider array of information than just primary ratings and in combination with a risk weighted scoring system undue preponderance is not given to any one agency’s ratings.

9.5 All credit ratings are reviewed weekly and monitored on a daily basis. The Council is alerted to changes to ratings of all three agencies through its use of the Capita creditworthiness service.

- If a downgrade results in the counterparty no longer meeting the Council’s minimum criteria its use for new investment is withdrawn immediately.

- In addition to the use of credit ratings the Council is advised of movements in Credit Default Swap data against the iTraxx benchmark and other market data on a daily basis. Extreme market movements may result in a scaling back of the duration assessment or removal from the Councils lending list altogether.

9.6 Sole reliance is not placed on the use of the Capita service. In addition the Council uses market information including information on any external support for banks to assist the decision making process.

10 Country, counterparty and group exposure limits

10.1 The Council has determined that it will only use approved counterparties from countries with a minimum sovereign credit rating of AA- as determined by all three rating agencies - Fitch, Moody's and Standard and Poor's. The list of countries that qualify using this credit criteria as at the date of this report are shown in **[Appendix 6]**. The list will be amended in accordance with this policy should ratings change.

10.2 Avoidance of a concentration of investments in too few counterparties or countries is a key to effective diversification and in this regard the limits set out below are thought to achieve a prudent balance between risk and practicality and are applicable to cash flow and core fund investment.

Country, Counterparty and Group exposure	Maximum Proportion of Investment Portfolio
UK Sovereign (subject to a minimum rating of AA-)	100%
Each non-UK Sovereign rated AA- or better	20%
Group limit excluding UK nationalised / part nationalised banks	20%
Each counterparty rated Fitch A-, F1 (green excluding CDS using Capita's credit methodology) or better	20%
Each UK nationalised or part nationalised bank / group	25%
Each AAA multilateral / supranational bank	20%
Each AAA rated enhanced cash fund / government liquidity fund / gilt fund subject to maximum 20% exposure to all such funds	10%

Each money market fund rated Moody's AAAMf or Fitch AAAMmf, or Standard & Poor's AAAM	20%
Non-specified investments over 1 year duration	60%
Each non-rated property fund used for long term investment subject to a maximum 40% exposure to all such funds (exposure calculated at the time of deposit)	20%

10.3 Cash flow balances vary depending on the timing of receipts and payments during the month and from month to month. The investment limits identified in paragraph 10.2 will be based on an estimate of the expected average daily cash flow balance at the start of the financial year augmented by core cash balances.

11 Cash flow and core fund investment

11.1 Funds available for investment are split between cash flow and core cash. Cash flow funds are generated from the collection of council tax, business rates and other income streams. They are consumed during the financial year to meet payments to precepting authorities and government (NNDR contributions) and to meet service delivery costs (benefit payments, staff salaries and suppliers in general). The consumption of cash flow funds during the course of a financial year places a natural limit on the maximum duration of investments (up to one year). Core funds comprise monies set aside in the Council's revenue and capital reserves and are generally available to invest for durations in excess of one year.

11.2 **Cash flow investments.** The average daily cash flow balance throughout 2017/18 is expected to be £15m with a proportion available for longer than three months. Cash flow investments will be made with reference to cash flow requirements (liquidity) and the outlook for short-term interest rates i.e. rates for investments up to 12 months. Liquidity will be maintained by using bank deposit accounts and money markets funds. Where duration can be tolerated, additional yield will be generated by utilising term deposits with banks and building societies and enhanced cash funds. Cash balances available for more than 3 months may be transferred to the core fund portfolio if a better overall return for the Council can be achieved by doing so.

11.3 In compiling the Council's estimates for 2017/18 a return on cash flow investments of 0.35% has been assumed. This return is consistent

with that achieved on overnight deposits since the August 2016 cut in Bank Rate.

- 11.4 **Core fund investments.** Historically the Council's core funds have been managed by an external fund manager. All core funds were returned to the Council for in-house management during 2014/15. The core fund balance is diminishing as a proportion is consumed each year (approximately £2m per annum) to support the Council's revenue budget and capital expenditure plans. The average core fund balance during 2017/18 is expected to be £14m.
- 11.5 The Council will avoid locking into longer term deals while investment rates continue their current low levels unless attractive rates are available with counterparties of particularly high creditworthiness which make longer term deals worthwhile and are within the risk parameters set by the Council.
- 11.6 In compiling the Council's estimates for 2017/18 a return on core fund investments of 0.55% has been assumed. As above, this reflects the marked downshift in returns offered by banks and other institutions since August 2016. Subject to the credit quality and exposure limits outlined in paragraph 10.2, liquidity and yield will be achieved by a mix of investments using predominantly fixed term deposits and certificates of deposit. Notice accounts and enhanced cash funds will also be used if these offer favourable returns relative to term deposits.

12 Long term investment.

- 12.1 The strategy includes provision (paragraph 10.2 and detailed in Appendix 5) to undertake long term investment in property through a collective investment scheme (fund). Investment in such schemes typically involves a minimum commitment of 5 years to recoup entry and exit fees. To mitigate the risk that capital values may fall due to changes in economic activity, investment duration cannot be determined with certainty at the time the investment commences. As a consequence any cash balances applied to such an investment must be available for the long term and there must be flexibility over the timing of redemption(s) in the future.
- 12.2 A detailed evaluation of the funds asset quality, market risk, leverage, redemption constraints, management and governance arrangements will be undertaken in advance of any investment taking place. Any sums invested will be reported at regular intervals with income received and changes in capital value identified separately.

13 Year end investment report

13.1 At the end of the financial year, the Council will report on its investment activity as part of its Annual Treasury Report.

14 Policy on the use of external service providers

14.1 The Council uses Capita as its external treasury management advisors.

14.2 The Council recognises that responsibility for treasury management decisions remains with the Council at all times and will ensure that undue reliance is not placed upon our external service providers.

14.3 It also recognises that there is value in employing external providers of treasury management services in order to acquire access to specialist skills and resources. The Council will ensure that the terms of their appointment and the methods by which their value will be assessed are properly agreed and documented, and subjected to regular review.

January 2017

Appendices

1. Treasury management scheme of delegation
2. Prudential and Treasury indicators
3. Interest rate forecasts
4. Economic background provided by Capita Asset Services
5. Specified and Non-specified Investments
6. Approved countries for investments

Appendix 1 Treasury management scheme of delegation**Full Council**

- Budget approval.
- Approval of treasury management policy.
- Approval of the Annual Treasury Management Strategy and Annual Investment Strategy.
- Approval of amendments to the Council's adopted clauses, Treasury Management Policy and the Annual Treasury Management Strategy and Annual Investment Strategy.
- Approval of the treasury management outturn report.

Cabinet

- Budget consideration.
- Approval of Treasury Management Practices.
- Approval of the division of responsibilities.
- Approval of the selection of external service providers and agreeing terms of appointment.
- Acting on recommendations in connection with monitoring reports.

Audit Committee

- Reviewing the Annual Treasury Management Strategy and Annual Investment Strategy and making recommendations to Cabinet and Council.
- Receive reports on treasury activity at regular intervals during the year and making recommendations to Cabinet.
- Reviewing treasury management policy, practices and procedures and making recommendations to Cabinet and Council.

Finance, Innovation and Property Advisory Board

- Receiving budgetary control reports at regular intervals that include treasury management performance.

The S151 (responsible) officer

- Recommending clauses, treasury management policy/practices for approval, reviewing the same regularly, and monitoring compliance.
- Submitting regular treasury management policy reports.
- Submitting budgets and budget variations.
- Receiving and reviewing management information reports.
- Reviewing the performance of the treasury management function.
- Ensuring the adequacy of treasury management resources and skills, and the effective division of responsibilities within the treasury management function.
- Ensuring the adequacy of internal audit, and liaising with external audit.
- Recommending the appointment of external service providers.

Appendix 2 Prudential and Treasury Indicators

The prudential indicators relating to capital expenditure cannot be set until the capital programme is finally determined and will as a consequence be reported as part of the Setting the Budget for 2017/18 report that is to be submitted to Cabinet on 9 February 2017.

The treasury management indicators are as set out in the table below:

TREASURY MANAGEMENT INDICATORS	2015/16	2016/17	2017/18	2018/19	2019/20
	Actual	Estimate	Estimate	Estimate	Estimate
	£'000	£'000	£'000	£'000	£'000
Authorised Limit for external debt :					
borrowing	Nil	5,000	5,000	5,000	5,000
other long term liabilities	Nil	Nil	Nil	Nil	Nil
TOTAL	Nil	5,000	5,000	5,000	5,000
Operational Boundary for external debt:-					
borrowing	Nil	2,000	2,000	2,000	2,000
other long term liabilities	Nil	Nil	Nil	Nil	Nil
TOTAL	Nil	2,000	2,000	2,000	2,000
Actual external debt	Nil	Nil	Nil	Nil	Nil
Upper limit for fixed interest rate exposure > 1 year at year end	Nil	It is anticipated that exposure will range between 0% to 60%			
Upper limit for variable rate exposure < 1 year at year end	13,468 (55.6%)	It is anticipated that exposure will range between 40% to 100%			
Upper limit for total principal sums invested for over 364 days at year end	Nil (0%)	60% of core funds			

Maturity structure of fixed rate borrowing during 2016/17 - 2019/20	upper limit	lower limit
under 12 months	100 %	0 %
Over 12 months	0 %	0 %

Appendix 3 Interest Rate Forecasts - January 2017

Capita Asset Services Interest Rate View													
	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 View	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%
3 Month LIBID	0.30%	0.30%	0.30%	0.30%	0.30%	0.30%	0.30%	0.40%	0.50%	0.60%	0.70%	0.80%	0.90%
6 Month LIBID	0.40%	0.40%	0.40%	0.40%	0.40%	0.40%	0.40%	0.50%	0.60%	0.70%	0.80%	0.90%	1.00%
12 Month LIBID	0.70%	0.70%	0.70%	0.70%	0.70%	0.80%	0.80%	0.90%	1.00%	1.10%	1.20%	1.30%	1.40%
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													
Capita Asset Services	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%
Capital Economics	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.50%	0.50%	0.50%
5yr PWLB Rate													
Capita Asset Services	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%
Capital Economics	1.60%	1.70%	1.90%	2.00%	2.10%	2.20%	2.30%	2.40%	2.50%	2.70%	2.80%	2.90%	3.00%
10yr PWLB Rate													
Capita Asset Services	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%
Capital Economics	2.40%	2.40%	2.50%	2.60%	2.60%	2.70%	2.70%	2.80%	2.90%	3.10%	3.20%	3.30%	3.40%
25yr PWLB Rate													
Capita Asset Services	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%
Capital Economics	2.95%	3.05%	3.05%	3.15%	3.25%	3.25%	3.35%	3.45%	3.55%	3.65%	3.75%	3.95%	4.05%
50yr PWLB Rate													
Capita Asset Services	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%
Capital Economics	2.80%	2.90%	3.00%	3.10%	3.10%	3.20%	3.20%	3.30%	3.40%	3.60%	3.70%	3.80%	3.90%

Appendix 4 Economic Background Provided by Capita Asset Services

UK. GDP growth rates in 2013, 2014 and 2015 of 2.2%, 2.9% and 1.8% were some of the strongest rates among the G7 countries. Growth is expected to have strengthened in 2016 with the first three quarters coming in respectively at +0.4%, +0.7% and +0.5%. The latest Bank of England forecast for growth in 2016 as a whole is +2.2%. The figure for quarter 3 was a pleasant surprise which confounded the downbeat forecast by the Bank of England in August of only +0.1%, (subsequently revised up in September, but only to +0.2%). During most of 2015 and the first half of 2016, the economy had faced headwinds for exporters from the appreciation of sterling against the Euro, and weak growth in the EU, China and emerging markets, and from the dampening effect of the Government's continuing austerity programme.

The **referendum** vote for Brexit in June 2016 delivered an immediate fall in confidence indicators and business surveys at the beginning of August, which were interpreted by the Bank of England in its August Inflation Report as pointing to an impending sharp slowdown in the economy. However, the following monthly surveys in September showed an equally sharp recovery in confidence and business surveys so that it is generally expected that the economy will post reasonably strong growth numbers through the second half of 2016 and also in 2017, albeit at a slower pace than in the first half of 2016.

The **Monetary Policy Committee**, (MPC), meeting of 4th **August** was therefore dominated by countering this expected sharp slowdown and resulted in a package of measures that included a cut in Bank Rate from 0.50% to 0.25%, a renewal of quantitative easing, with £70bn made available for purchases of gilts and corporate bonds, and a £100bn tranche of cheap borrowing being made available for banks to use to lend to businesses and individuals.

The **MPC** meeting of 3 **November** left Bank Rate unchanged at 0.25% and other monetary policy measures also remained unchanged. 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 MPC meeting of 15 December also left Bank Rate and other measures unchanged.

The latest MPC decision included a forward view that **Bank Rate** could go either up or down depending on how economic data evolves 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 quarter 2 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. 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 i.e. a sharp slowdown in growth from +0.7% in quarter 2, in reaction to the June referendum result. 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 and were again strong in November. In addition, the GfK consumer confidence index recovered quite strongly to -3 in October after an initial sharp plunge in July to -12 in reaction to the referendum result. However, in November it fell to -8 indicating a return to pessimism about future prospects among consumers, probably based mainly around concerns about rising inflation eroding purchasing power.

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' GDP forecasts 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 **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. This will mean that the PSBR deficit elimination timetable will need to slip further into the future as promoting growth, and ultimately boosting tax revenues in the longer term, will be a more urgent priority. The Governor of the Bank of England had warned that a vote for Brexit would be likely to cause a slowing in growth, particularly from a reduction in business investment, due to the uncertainty of whether the

UK would have continuing full access, (i.e. without tariffs), to the EU single market. He also warned that the Bank could not do all the heavy lifting to boost economic growth and suggested that the Government would need to help growth e.g. by increasing investment expenditure and by using fiscal policy tools. The newly appointed Chancellor, Phillip Hammond, announced, in the aftermath of the referendum result and the formation of a new Conservative cabinet, that the target of achieving a budget surplus in 2020 would be eased in the Autumn Statement on 23 November. This was duly confirmed in the Statement which also included some increases in infrastructure spending.

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 just under 3% in 2018. This increase was largely due to the effect of the sharp fall in the value of sterling since the referendum, although during November, sterling has recovered some of this fall to end up 15% down against the dollar, and 8% down against the euro (as at the date of the December 2016 MPC meeting). This depreciation 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 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.

What is clear is that **consumer disposable income** will come under pressure, as the latest employers' survey is forecasting median pay rises for the year ahead of only 1.1% at a time when inflation will be rising significantly higher than this. The CPI figure has been on an upward trend in 2016 and reached 1.2% in November. However, prices paid by factories for inputs rose to 13.2% though producer output prices were still lagging behind at 2.3% and core inflation was 1.4%, confirming the likely future upward path.

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 hit a new peak on the way up again of 1.55% on 15 November. 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 quarter 3 at +0.5% q/q,

confounded the pessimism. Inflation expectations also rose sharply as a result of the continuing fall in the value of sterling.

Employment had been growing steadily during 2016 but encountered a first fall in over a year, of 6,000, over the three months to October. The latest employment data in December, (for November), was distinctly weak with an increase in unemployment benefits claimants of 2,400 in November and of 13,300 in October. House prices have been rising during 2016 at a modest pace but the pace of increase has slowed since the referendum; a downturn in prices could dampen consumer confidence and expenditure.

USA. The American economy had a patchy 2015 with sharp swings in the quarterly growth rate leaving the overall growth for the year at 2.4%. Quarter 1 of 2016 at +0.8%, (on an annualised basis), and quarter 2 at 1.4% left average growth for the first half at a weak 1.1%. However, quarter 3 at 3.2% signalled a rebound to strong growth. The Federal Reserve embarked on its long anticipated first increase in rates at its December 2015 meeting. At that point, confidence was high that there would then be four more increases to come in 2016. Since then, more downbeat news on the international scene, and then the Brexit vote, have caused a delay in the timing of the second increase of 0.25% which came, as expected, in December 2016 to a range of 0.50% to 0.75%. Overall, despite some data setbacks, the US is still, probably, the best positioned of the major world economies to make solid progress towards a combination of strong growth, full employment and rising inflation: this is going to require the central bank to take action to raise rates so as to make progress towards normalisation of monetary policy, albeit at lower central rates than prevailed before the 2008 crisis. The Federal Reserve also indicated that it expected three further increases of 0.25% in 2017 to deal with rising inflationary pressures.

The result of the presidential election in November is expected to lead to a strengthening of US growth if pre-election promises of a major increase in expenditure on infrastructure are implemented. This policy is also likely to strengthen inflation pressures as the economy is already working at near full capacity. In addition, the unemployment rate is at a low point verging on what is normally classified as being full employment. However, the US does have a substantial amount of hidden unemployment in terms of an unusually large, (for a developed economy), percentage of the working population not actively seeking employment.

In the first week since the US election, there was a 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 could 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, (and conversely bond yields pushed down), by the artificial and temporary power of quantitative easing.

Eurozone (EZ). In the Eurozone, the ECB commenced, in March 2015, a €1.1 trillion programme of quantitative easing to buy high credit quality government and other debt of selected EZ countries at a rate of €60bn per month. This was intended to run initially to September 2016 but was extended to March 2017 at its December 2015 meeting. At its December and March 2016 meetings it progressively cut its deposit facility rate to reach -0.4% and its main refinancing rate from 0.05% to zero. At its March meeting, it also increased its monthly asset purchases to €80bn. These measures have struggled to make a significant impact in boosting economic growth and in helping inflation to rise significantly from low levels towards the target of 2%. Consequently, at its December meeting it extended its asset purchases programme by continuing purchases at the current monthly pace of €80 billion until the end of March 2017, but then continuing at a pace of €60 billion until the end of December 2017, or beyond, if necessary, and in any case until the Governing Council sees a sustained adjustment in the path of inflation consistent with its inflation aim. It also stated that if, in the meantime, the outlook were to become less favourable or if financial conditions became inconsistent with further progress towards a sustained adjustment of the path of inflation, the Governing Council intended to increase the programme in terms of size and/or duration.

EZ GDP growth in the first three quarters of 2016 has been 0.5%, +0.3% and +0.3%, (+1.7% y/y). Forward indications are that economic growth in the EU is likely to continue at moderate levels.

Asia. Economic growth in China has been slowing down and this, in turn, has impacted economic growth in emerging market countries dependent on exporting raw materials to China. Medium term risks have been increasing in China e.g. a build-up in the level of credit compared to the size of GDP, plus there is a need to address over supply of housing and surplus industrial capacity, which both need to be eliminated. This needs to be combined with a rebalancing of the economy from investment expenditure to consumer spending. However, the central bank has a track record of supporting growth through various monetary policy measures, though these further stimulate the growth of credit risks and so increase the existing major imbalances within the economy.

Economic growth in Japan has proven difficult to sustain despite successive rounds of monetary stimulus and fiscal action to promote consumer spending.

The government is also making limited progress on fundamental economic reform.

Emerging countries. There have been concerns around the vulnerability of some emerging countries exposed to the downturn in demand for commodities from China or to competition from the increase in supply of American shale oil and gas reaching world markets. The ending of sanctions on Iran has also brought a further increase in oil supplies into the world markets. While these concerns have subsided during 2016, if interest rates in the USA do rise substantially over the next few years, (and this could also be accompanied by a rise in the value of the dollar in exchange markets), this could impact on emerging countries with large amounts of debt denominated in dollars. The Bank of International Settlements has recently released a report that \$340bn of emerging market corporate debt will fall due for repayment in the final two months of 2016 and in 2017 – a 40% increase on the figure for the last three years.

Financial markets could also be vulnerable to risks from those emerging countries with major sovereign wealth funds, that are highly exposed to the falls in commodity prices from the levels prevailing before 2015, especially oil, and which, therefore, may have to liquidate substantial amounts of investments in order to cover national budget deficits over the next few years if the price of oil does not return to pre-2015 levels.

Brexit timetable and process:

- March 2017: UK Government notifies the European Council of its intention to leave under the Treaty on European Union Article 50.
- March 2019: two-year negotiation period on the terms of exit. This period can be extended with the agreement of all members i.e. not that likely.
- UK continues as an EU member during this two-year period with access to the single market and tariff free trade between the EU and UK.
- The UK and EU would attempt to negotiate, among other agreements, a bi-lateral trade agreement over that period.
- The UK would aim for a negotiated agreed withdrawal from the EU, although the UK may also exit without any such agreements.
- If the UK exits without an agreed deal with the EU, World Trade Organisation rules and tariffs could apply to trade between the UK and EU but this is not certain.
- On exit from the EU: the UK parliament would repeal the 1972 European Communities Act. The UK will then no longer participate in matters reserved for EU members, such as changes to the EU's budget, voting allocations and policies.
- It is possible that some sort of agreement could be reached for a transitional time period for actually implementing Brexit after March 2019 so as to help exporters to adjust in both the EU and in the UK.

Appendix 5 Specified and Non-specified Investments

All specified and non-specified Investments will be:

Subject to the sovereign, counterparty and group exposure limits identified in the Annual Investment Strategy.

Subject to the duration limit suggested by Capita **(+6 months for UK Financial Institutions)** at the time each investment is placed.

Subject to a maximum of 60% of core funds, in aggregate, being held in non-specified investments at any one time.

Sterling denominated.

Specified Investments (maturities up to 1 year):

investment	Minimum Credit Criteria
UK Debt Management Agency Deposit Facility	UK Sovereign AA-
Term deposits - UK local authorities	UK Sovereign AA-
Term deposits - UK nationalised and part nationalised banks	UK Sovereign AA-
Term deposits - banks and building societies	UK / Non-UK Sovereign AA-. Counterparty A-, F1 or Green excluding CDS
Certificates of deposit - UK nationalised and part nationalised banks	UK Sovereign AA-
Certificates of deposit - banks and building societies	UK / Non-UK Sovereign AA-. Counterparty A-, F1, or Green excluding CDS
UK Treasury Bills	UK Sovereign AA-
UK Government Gilts	UK Sovereign AA-
Bonds issued by multi-lateral development banks	AAA
Sovereign bond issues (other than the UK govt)	AAA
Money Market Funds	At least one of : AAAmf, AAAmmf or AAAM
Enhanced Cash and Government Liquidity Funds	AAA

Non-specified Investments (maturities in excess of 1 year and any maturity if not included above):

Investment	Minimum Credit Criteria	Max duration to maturity
Fixed term deposits with variable rate and variable maturities (structured deposits) - UK nationalised and part nationalised banks	UK Sovereign AA-	2 years
Fixed term deposits with variable rate and variable maturities (structured deposits) - banks and building societies	UK / Non-UK Sovereign AA-. Counterparty A-, F1 (Green)	2 years
Term deposits - local authorities	UK Sovereign AA-	2 years
Term deposits - UK nationalised and part nationalised banks	UK Sovereign AA-	2 years
Term deposits - banks and building societies	UK / Non-UK Sovereign AA-. Counterparty A-, F1(Green)	2 years
Certificates of deposit - UK nationalised and part nationalised banks	UK Sovereign AA-	2 years
Certificates of deposit - banks and building societies	UK / Non-UK Sovereign AA-. Counterparty A-, F1 (Green)	2 years
Commercial paper - UK nationalised and part nationalised banks	UK Sovereign AA-	2 years
Commercial paper - banks and building societies	UK / Non-UK Sovereign AA-. Counterparty A-, F1 (Green)	2 years
Floating rate notes issued by multilateral development banks	AAA	5 years
Bonds issued by multilateral development banks	AAA	5 years
Sovereign bond issues (other than the UK Government)	AAA	5 years
UK Government Gilts	UK Sovereign AA-	25% 5 years
UK Government Gilts	UK Sovereign AA-	25% 10 years
Property Funds	N/A	N/A

Accounting treatment of investments. The accounting treatment may differ from the underlying cash transactions arising from investment decisions made. To ensure that the Council is protected from any adverse revenue impact, which may arise from these differences, we will review the accounting implications of new transactions before they are undertaken.

Appendix 6 Approved countries for investments

All counterparties in addition to meeting the minimum credit criteria specified in the Annual Investment Strategy must be regulated by a sovereign rated as a minimum AA- by each of the three rating agencies - Fitch, Moody's and Standard and Poor's.

This list will be reviewed and amended if appropriate on a weekly basis by the Director of Finance and Transformation.

As of 31 December 2016 sovereigns meeting the above requirement which also have banks operating in sterling markets with credit ratings of green or above on the Capita Asset Services' Credit Worthiness List were:

AAA	Australia Canada Denmark Germany Luxembourg Netherlands Norway Singapore Sweden Switzerland
AA+	Finland Hong Kong USA
AA	Abu Dhabi (UAE) France Qatar UK
AA-	Belgium