**Annex 5**

# Treasury Management and Annual Investment Strategy 2020/21

## 1 Introduction

1.1 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'.

1.2 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
- Medium and 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 Chartered Institute of Public Finance (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 Ministry for Housing, Communities and Local Government (MHCLG) issued revised Statutory Guidance on Local Government Investments (2018 Edition). CIPFA also amended the Prudential Code for Capital Finance in Local Authorities (2017 Edition) and the Treasury Management in the Public Services: Code of Practice and Cross Sectorial Guidance Notes (2017 Edition). The MHCLG and CIPFA Codes came into effect on 1st April 2018.

2.4 Historically the scope of the statutory guidance and CIPFA codes was limited to the investment of an authority's cash surpluses and the management of borrowing undertaken to support its capital expenditure plans. The updated statutory guidance and codes broaden that scope to include expenditure on loans and the acquisition of non-financial assets (property) intended to generate a profit. The Council has not engaged in any commercial investments and has no material non-treasury investments.

2.5 The Council formally adopted the revised CIPFA Treasury Management Code of Practice (2017 Edition) on 30 October 2018. 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 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 prior to 2026/27 is expected to be funded from the Revenue Reserve for Capital Schemes, grants, developer contributions and capital receipts arising from the sale of assets. This does not however,

preclude a decision to borrow in order to fund in full or in part a commercial investment opportunity that meets the Council's strategic priorities and objectives, achieves value for money and delivers a financial return. Each such opportunity to be considered on a case by case basis as appropriate.

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 2019 comprised only investments. On that date the Council's cash flow and core fund investments totaled £50m and was invested in a mix of money market funds, bank notice accounts and time deposits with banks and building societies. The average duration to maturity of the portfolio was 70 days with a weighted average rate of return 0.95%. Returns in future years are expected to improve as Bank Rate rises. Income from investments forms part of the Council's ten year medium term financial strategy (MTFS). An updated MTFS will be presented to Council in February 2020.

6.2 The Council also held £5m in externally managed property fund investments at 31 December 2019. The property funds are expected to generate income of 3.5% in 2019/20 rising to 4% in future years. Overtime, the rise in the value of each property funds' assets (capital appreciation) is expected to negate fund entry and exit costs.

6.2 At present the Council has no material non-treasury investments (e.g. directly owned commercial property, shares in subsidiaries or loans to third parties). The procedures, practices and governance arrangements to enable the Council to meet the requirements of the Chartered Institute of Public Finance & Accountancy's Treasury Management and Prudential Codes of Practice 2017 and the 2018 Statutory Guidance on Local Government Investments relating to non-treasury investments are referred to in the reports to Audit Committee 1 October 2018 and 20 January 2020.

## 7 Prospects for interest rates

7.1 The Council has appointed Link 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. Link's expectation for the Bank Rate for the financial year ends (March) is:

- 2019/ 2020 0.75%
- 2020/ 2021 1.00%
- 2021/ 2022 1.00%
- 2022/ 2023 1.25%

7.2 The above forecasts have been based on an assumption that there is an agreed deal on Brexit, including agreement on the terms of trade between the UK and EU, at some point in time. The result of the general election has removed much uncertainty around this major assumption. However, it does not remove uncertainty around whether agreement can be reached with the EU on a trade deal within the short time to December 2020, as the prime minister has pledged

7.3 It has been little surprise that the Monetary Policy Committee (MPC) has left Bank Rate unchanged at 0.75% so far in 2019 due to the ongoing uncertainty over Brexit and the outcome of the general election. In its meeting on 7 November, the MPC became more dovish due to increased concerns over the outlook for the domestic economy if Brexit uncertainties were to become more entrenched, and for weak global economic growth: if those uncertainties were to materialise, then the MPC may cut Bank Rate. However, if they were both to dissipate, then rates would need to rise at a 'gradual pace and to a limited extent'. Brexit uncertainty has had a dampening effect on UK GDP growth in 2019, especially around mid-year. There is still some residual risk that the MPC could cut Bank Rate as the UK economy is still likely to only grow weakly in 2020 due to continuing uncertainty over whether there could effectively be a no deal Brexit in December 2020 if agreement on a trade deal is not reached with the EU. Until that major uncertainty is removed, or the period for agreeing a deal is extended, the MPC is not expected to raise Bank Rate.

7.4 There has been much speculation during 2019 that the bond market has gone into a bubble, as evidenced by high bond prices and remarkably low yields. However, given the context that there have been heightened expectations that the US was heading for a recession in 2020, 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 substantive impact on consumer spending and inflation. 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 ultra-low interest rates on cash.

7.5 From time to time, gilt yields, and therefore PWLB rates, can be subject to exceptional levels of volatility due to geo-political, sovereign debt issues, emerging market developments and sharp changes in investor sentiment. Such volatility could occur at any time during the forecast period.

7.6 Economic and interest rate forecasting remains difficult with so many influences weighing on UK gilt yields and PWLB rates. 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.

7.7 Investment returns are likely to remain low during 2020/21 with little increase in the following two years. However, if substantive progress was made with an agreed trade deal averting a no deal Brexit, then there is upside potential for earnings.

7.8 Link's more detailed view of the current economic background is included at **[Appendix 4]**.

## 8 Investment policy

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

8.2 In accordance with the above guidance from the MHCLG 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 are not 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 also takes account of information that reflects the opinion of the markets. To this end the Council engages 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 includes 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 Link 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 Link'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/Pink | 5 years |
| Purple | 2 years |
| Blue | 1 year (UK nationalised 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 Link 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 Link 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 Link 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 the UK subject to a minimum sovereign credit rating of A- and from other countries subject to a minimum sovereign credit rating of AA-. The minimum will be the lowest rating determined

by 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.

| **Country, Counterparty and Group exposure** | **Maximum Proportion of Portfolio** |
|---|---|
| UK regulated financial institutions subject to UK Sovereign rating of A- or higher and the institution limits detailed below. | 100% |
| Non-UK regulated financial institutions as an amount per sovereign rated AA- or higher and subject to the institution limits detailed below. | 20% |
| Group of related financial institutions. | 20% |
| Each financial institution rated Fitch A-, F1 or higher (green excluding CDS using Link's credit methodology). | 20% |
| Each UK nationalised bank rated Fitch BBB, F2 or higher (green excluding CDS using Link's credit methodology). | 20% |
| Each AAA rated multilateral / supranational bank. | 20% |
| Each AAA rated CNAV, LVNAV or VNAV money market fund. | 20% |
| Each AAA rated enhanced cash fund / government liquidity fund / gilt fund subject to a maximum 20% exposure to all such funds. | 10% |
| Non-specified investments over 1 year duration. | 60% |
| Each non-rated property fund used for long term investment subject to a maximum £3m (20% of expected long term balances) per fund and across all such funds. No cash limit applies to new resources made available from, or in anticipation of, the sale of existing property assets or other windfalls. | N/A |
| Each non-rated diversified income (multi-asset) fund used for medium term investment subject to a maximum £3m (20% of expected long term balances) per fund and across all such funds. | N/A |

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 and other balances. Counterparty investments will be managed to ensure compliance with the limits at the start and end of each financial year when balances available for investment will be at a low point.

## 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 2020/21 is expected to be £12m 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 2020/21 a return on cash flow investments of 0.85% has been assumed.

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 2020/21 is expected to be £16m.

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 2020/21 a return on core fund investments of 1.20% has been assumed. 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 Medium and long term investment.

12.1 The strategy includes provision (paragraph 10.2 and detailed in Appendix 5) to undertake medium term investment in diversified income (cash, bonds, equity and property) through an externally managed collective investment scheme (fund). Investment in such schemes typically implies a 5 year commitment to recoup entry and exit fees and mitigate the potential for a fall in the value of assets under management.

12.2 A detailed evaluation of the funds asset quality, market risk, 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 separately identified.

12.3 The strategy includes provision (paragraph 10.2 and detailed in Appendix 5) to undertake long term investment in property through an externally managed collective investment scheme (fund). Investment in such schemes typically implies a 10 year commitment 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. Sums invested will be reported at regular intervals with income received and changes in capital value separately identified.

## 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 Link Asset Services 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.

**Financial Services**
**January 2020**

## Appendices

1. Treasury management scheme of delegation
2. Prudential and treasury indicators
3. Interest rate forecasts
4. Economic background provided by Link Asset Services
5. Credit and counterparty risk management (TMP1)
6. Approved countries for investments

**Annex 5**

## Appendix 1 Treasury management scheme of delegation

### Full Council

- Budget approval.
- Approval of treasury management policy.
- Approval of the annual treasury management and investment strategy.
- Approval of amendments to the Council's adopted clauses, treasury management policy and annual treasury management and investment strategy.
- Approval of the treasury management outturn and mid-year reports.

### Cabinet

- Budget consideration.
- 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 and 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.
- Prepare and maintain effective treasury management practices (TMPs).
- Ensuring the adequacy of internal audit, and liaising with external audit.
- Recommending the appointment of external service providers.
- Preparation of a Capital Strategy and for ensuring the strategy is sustainable, affordable and prudent in the long term and that due diligence has been carried out to support each investment decision and those decisions are in accordance with the risk appetite of the authority.

## 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 2020/21 report that is to be submitted to Cabinet on 13 February 2020.

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

| TREASURY MANAGEMENT INDICATORS | 2018/19 | 2019/20 | 2020/21 | 2021/22 | 2022/23 |
|---|---|---|---|---|---|
| | Actual | Estimate | Estimate | Estimate | Estimate |
| | £'000 | £'000 | £'000 | £'000 | £'000 |
| Authorised Limit for external debt : | | | | | |
| borrowing | Nil | 5,000 | 7,000 | 7,000 | 7,000 |
| other long term liabilities | Nil | Nil | Nil | Nil | Nil |
| TOTAL | Nil | 5,000 | 7,000 | 7,000 | 7,000 |
| Operational Boundary for external debt:- | | | | | |
| borrowing | Nil | 2,000 | 4,000 | 4,000 | 4,000 |
| other long term liabilities | Nil | Nil | Nil | Nil | Nil |
| TOTAL | Nil | 2,000 | 4,000 | 4,000 | 4,000 |
| 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 | 15,411 (42.3%) | It is anticipated that exposure will range between 40% to 100% | | | |
| Upper limit for total principal sums invested for over 365 days at year end | 5,000 (13.7%) | 60% of funds | | | |

| Maturity structure of fixed rate borrowing during 2017/18 - 2021/22 | upper limit | lower limit |
|---|---|---|
| under 12 months | 100 % | 0 % |
| Over 12 months | 0 % | 0 % |

## Appendix 3 Interest rate forecasts – November 2019

| Bank Rate | NOW | 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 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Link Asset Services | **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% |
| Capital Economics | **0.75%** | 0.75% | 0.75% | 0.75% | 0.75% | - | - | - | 1.00% | - | - | - | - | - |

| 5yr PWLB Rate | NOW | 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 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Link Asset Services | **2.42%** | 2.40% | 2.40% | 2.50% | 2.50% | 2.60% | 2.70% | 2.80% | 2.90% | 2.90% | 3.00% | 3.10% | 3.20% | 3.20% |
| Capital Economics | **2.42%** | 2.40% | 2.50% | 2.50% | 2.60% | - | - | - | 2.80% | - | - | - | - | - |

| 10yr PWLB Rate | NOW | 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 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Link Asset Services | **2.66%** | 2.70% | 2.70% | 2.70% | 2.80% | 2.90% | 3.00% | 3.10% | 3.20% | 3.20% | 3.30% | 3.30% | 3.40% | 3.50% |
| Capital Economics | **2.66%** | 2.60% | 2.70% | 2.80% | 2.80% | - | - | - | 3.10% | - | - | - | - | - |

| 25yr PWLB Rate | NOW | 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 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Link Asset Services | **3.20%** | 3.30% | 3.40% | 3.40% | 3.50% | 3.60% | 3.70% | 3.70% | 3.80% | 3.90% | 4.00% | 4.00% | 4.10% | 4.10% |
| Capital Economics | **3.20%** | 3.00% | 3.10% | 3.20% | 3.20% | - | - | - | 3.40% | - | - | - | - | - |

| 50yr PWLB Rate | NOW | 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 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Link Asset Services | **3.04%** | 3.20% | 3.30% | 3.30% | 3.40% | 3.50% | 3.60% | 3.60% | 3.70% | 3.80% | 3.90% | 3.90% | 4.00% | 4.00% |
| Capital Economics | **3.04%** | 3.00% | 3.10% | 3.20% | 3.20% | - | - | - | 3.50% | - | - | - | - | - |

| Link Asset Services Interest Rate View | Now | 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 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Bank Rate | 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% |
| 3 Month LIBID | 0.67% | 0.70% | 0.70% | 0.80% | 0.90% | 1.00% | 1.00% | 1.00% | 1.10% | 1.20% | 1.30% | 1.30% | 1.30% | 1.30% |
| 6 Month LIBID | 0.75% | 0.80% | 0.80% | 0.90% | 1.00% | 1.10% | 1.10% | 1.20% | 1.30% | 1.40% | 1.50% | 1.50% | 1.50% | 1.50% |
| 12 Month LIBID | 0.86% | 1.00% | 1.00% | 1.10% | 1.20% | 1.30% | 1.30% | 1.40% | 1.50% | 1.60% | 1.70% | 1.70% | 1.70% | 1.70% |

## Appendix 4 Economic background based on text provided by Link Asset Services

1 **UK GDP growth** has taken a toll from the Brexit uncertainty throughout 2019. Quarter 1 was unexpectedly strong at 0.5% q/q, quarter 2 dire at -0.2% q/q and quarter 3 surprised on the upside at +0.4% q/q (+1.1% y/y). However, the peak of Brexit uncertainty during the final quarter appears to have suppressed quarterly growth to near zero. The economy is expected to tread water in 2020, with tepid growth of around 1% until there is more certainty once the Brexit trade deal deadline of December 2020 passes.

3 While the Bank of England went through the routine of producing another **quarterly Inflation Report** (now renamed the Monetary Policy Report) in November 2019, it is questionable how much all the writing and numbers were worth when faced with the uncertainties of where the UK will be after the general election in December. The Bank made a change in their Brexit assumptions to now include a withdrawal agreement being passed. Possibly the biggest message of note 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.

4 The **MPC meeting in December** repeated the previous month's vote of 7-2 to keep Bank Rate on hold. Their key view was that there was currently 'no evidence about the extent to which policy uncertainties among companies and households had declined' prompting no immediate action. The two members who voted for a cut were concerned that the labour market was faltering. On the other hand, there was a clear warning in the minutes that the MPC were concerned that 'domestic unit labour costs have continued to grow at rates above those consistent with meeting the inflation target in the medium term'.

5 If economic growth were to weaken considerably, the MPC has little room to make a significant impact with Bank Rate still only at 0.75%. The MPC may suggest Government support growth by way of a **fiscal boost** e.g. tax cuts, increases in the annual expenditure budgets of government departments and services and expenditure on infrastructure projects. Some movement has already been made in this direction with the Chancellor amending the fiscal rules in November to allow for an increase in government expenditure. The

Government's election manifesto also promised to increase government spending by up to £20bn per annum (expected to add some 1% to GDP growth rates) by investing primarily in infrastructure.

6 CPI **inflation** has been hovering around the Bank of England's target of 2% during 2019, but fell again in both October and November to a three-year low of 1.5%. It is likely to remain close to or under 2% over the next two years and should not pose any immediate concern to the MPC at the current time. However, a no deal Brexit could see inflation rise towards 4% primarily because of imported inflation on the back of a weakening pound.

7 With regard to the **labour market,** growth in numbers employed has been quite resilient through 2019 until the three months to September where it fell by 58,000. However, there was an encouraging pick up again in the three months to October with growth of 24,000. The unemployment rate held steady at a 44-year low of 3.8% on the Independent Labour Organisation measure in October. Wage inflation has been steadily falling from a high point of 3.9% in July to 3.5% in October (3-month average regular pay, excluding bonuses). This meant that in real terms (wage rates higher than CPI inflation) earnings grew by about 2%. 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 other message from the fall in wage growth is that employers are beginning to find it easier to hire suitable staff, indicating that supply pressure in the labour market is easing.

8 **USA.** President Trump's easing of fiscal policy in 2018 fuelled a temporary boost in consumption in that year which generated an upturn in the rate of growth to a robust 2.9% y/y. **Growth** in 2019 has been falling after a strong start in quarter 1 at 3.1%, (annualised rate), to 2.0% in quarter 2 and then 2.1% in quarter 3. The economy looks likely to have maintained a growth rate similar to quarter 3 into quarter 4. Fears of a recession have largely dissipated. The strong growth in employment numbers during 2018 has weakened during 2019, indicating that the economy had been cooling, while inflationary pressures were also weakening. However, CPI inflation rose from 1.8% to 2.1% in November, a one year high, caused by a rise in gasoline prices.

9 The US **Federal Reserve** (Fed) 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 intended to be seen as the start of a series of cuts to ward off a downturn in growth. It also ended its programme of quantitative tightening in August, (reducing its holdings of treasuries). It then cut rates by 0.25% again in September and by another 0.25% in its October meeting to 1.50 – 1.75%. At its September meeting it also said it was going to **start buying Treasuries again**, although this was

not to be seen as a resumption of quantitative easing but rather an exercise to relieve liquidity pressures in the repo market. Despite those protestations, this still means that the Fed is again expanding its balance sheet holdings of government debt. In the first month, it will buy $60bn, whereas it had been reducing its balance sheet by $50bn per month during 2019. As it will be buying only short-term (under 12 months) Treasury bills, it is technically correct that this is not quantitative easing (which is purchase of long term debt). The Fed left rates unchanged in December. However, the accompanying statement was more optimistic about the future course of the economy which would indicate that further cuts are unlikely.

10 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. However, in November / December, progress has been made on agreeing a phase one deal between the US and China to roll back some of the tariffs; this gives some hope of resolving this dispute.

11 **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, +0.2% q/q (+1.2% y/y) in quarter 2 and then +0.2% q/q (+1.1%y/y) in quarter 3; there appears to be little upside potential in the near future. German GDP growth has been struggling to stay in positive territory in 2019 and fell by -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 and the potential for US imposed tariffs on EU produced cars.

12 **The European Central Bank (ECB)** ended its programme of quantitative easing (purchases of debt) in December 2018, which then 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 through quantitative easing. 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% (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’ and announced a **third round of TLTROs** (targeted longer term refinancing operations) providing banks with cheap borrowing. As with the last round, the new TLTROs include an incentive to encourage bank lending. Since then, the downturn in EZ and world growth has gathered momentum. At its September meeting the ECB cut its deposit rate further into negative territory, from -0.4% to -0.5%, and announced a **resumption of**

**quantitative easing** for an unlimited period. At its October meeting, doubtful whether this loosening of monetary policy will have much impact, the ECB stated that governments would need to help stimulate growth by 'growth friendly' fiscal policy.

14 **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 shadow banking systems. In addition, there still needs to be a greater switch from investment in industrial capacity, property construction and infrastructure to consumer goods production.

17 **WORLD GROWTH**. The trade war between the US and China has coincided with a general weakening of growth in the major economies of the world raising concern in the financial markets. These concerns have resulted in **government bond yields** in the developed world falling significantly during 2019. If there were a worldwide downturn in growth, central banks in most of the major economies now have limited scope in terms of monetary policy measures (rates are already very low). There are also concerns about how much distortion of financial markets has already occurred with the current levels of quantitative easing purchases of debt by central banks and the use of negative central bank rates in some countries. The latest PMI survey statistics of economic health for the US, UK, EU and China have all been predicting a downturn in growth confirming investor sentiment that the outlook for global growth during the year ahead is weak.

December 2019

## Appendix 5 Credit and counterparty risk management (TMP1)

All specified and non-specified Investments will be:

Subject to the sovereign, counterparty and group exposure limits identified in the Annual Investment Strategy (Section 10).

Subject to the duration limit suggested by Link (+6 months for UK financial institutions) at the time each investment is placed.

Subject to a maximum of 60% of funds 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 A- |
| Term deposits - UK local authorities | UK Sovereign A- |
| Term deposits - UK nationalised banks | UK Sovereign A- Counterparty BBB, F2 or Green excluding CDS |
| Term deposits – all other banks and building societies | UK Sovereign A- / Non-UK Sovereign AA- Counterparty A-, F1 or Green excluding CDS |
| Certificates of deposit - UK nationalised banks | UK Sovereign A- Counterparty BBB, F2 or Green excluding CDS |
| Certificates of deposit – all other banks and building societies | UK Sovereign A- / Non-UK Sovereign AA-. Counterparty A-, F1,or Green excluding CDS |
| UK Treasury Bills | UK Sovereign A- |
| UK Government Gilts | UK Sovereign A- |
| Bonds issued by multi-lateral development banks | AAA |
| Sovereign bond issues (other than the UK govt) | AAA |
| Money Market Funds (CNAV, LVNAV or VNAV) | AAA |
| Enhanced Cash and Government Liquidity Funds | AAA |

**Annex 5**

**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 banks | UK Sovereign A- Counterparty BBB,F2 (Green) | 2 years |
| Fixed term deposits with variable rate and variable maturities (structured deposits) - banks and building societies | UK sovereign A- / Non-UK Sovereign AA-. Counterparty A-, F1 (Green) | 2 years |
| Term deposits - local authorities | UK Sovereign A- | ***3 years*** |
| Term deposits - UK nationalised banks | UK Sovereign A- Counterparty BBB,F2 (Green) | 2 years |
| Term deposits - banks, building societies | UK Sovereign A- / Non-UK Sovereign AA-. Counterparty A-, F1 (Green) | 2 years |
| Certificates of deposit - UK nationalised banks | UK Sovereign A- Counterparty BBB,F2 (Green) | 2 years |
| Certificates of deposit - banks and building societies | UK Sovereign A- / Non-UK Sovereign AA-. Counterparty A-, F1 (Green) | 2 years |
| Commercial paper - UK nationalised banks | UK Sovereign A- Counterparty BBB,F2 (Green) | 2 years |
| Commercial paper - banks and building societies | UK Sovereign A- / Non-UK Sovereign AA-. Counterparty A-, F1 (Green) | 2 years |
| Floating rate notes issued by multilateral development banks | AAA | 2 years |
| Bonds issued by multilateral development banks | AAA | 2 years |
| Sovereign bonds (other than the UK Government) | AAA | 2 years |
| UK Government Gilts | UK Sovereign A- | 5 years |
| Property Funds | N/A | N/A |
| Diversified Income 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

Each financial institution must meet the minimum credit criteria specified in the Annual Investment Strategy (Section 10). For non-UK regulated institutions the institutions sovereign must be rated AA- or higher 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 2019 sovereigns meeting the above requirement which also (except for Hong Kong, Norway and Luxembourg) have banks operating in sterling markets with credit ratings of green or above on the Link Asset Services' Credit Worthiness List were:

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

At 31st December 2019 the UK received a credit rating of AA from each of Fitch, Moody's and Standard and Poor's.