
REPORT FOR: CABINET

Date of Meeting:	9 January 2020
Subject:	Treasury Management Strategy Statement and Annual Investment Strategy: Mid-year Review 2019/20
Key Decision:	No
Responsible Officer:	Dawn Calvert, Director of Finance
Portfolio Holder:	Councillor Adam Swersky, Portfolio Holder for Finance and Resources
Exempt:	No
Decision subject to Call-in:	No
Wards affected:	All
Enclosures:	Appendix 1: Economic update for 2019/20

Section 1 – Summary and Recommendations

This report sets out the mid-year review of Treasury Management activities for 2019/20.

Recommendation

Cabinet is requested to note the Treasury Management Mid-Year review for 2019/20.

Reasons

- (a) To promote effective financial management and comply with the Local Authorities (Capital Finance and Accounting) Regulations 2003, other relevant guidance and the Council's Financial Regulations.
- (b) To keep Members informed of Treasury Management activities and performance.

Section 2 – Report

1. Background

- 1.1 The purpose of this report is to present the Council's Annual Treasury Management Mid-Year Report for 2019/20 in accordance with the Council's treasury management practices and in compliance with the Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management. The Council has complied with all elements of the Treasury Management Strategy Statement (TMSS) as the treasury management function has operated within the Treasury Limits and Prudential Indicators as set out in the TMSS and set out in this report.
- 1.2 Treasury management comprises:
 - Managing the Council's borrowing to ensure funding of the Council's current and future Capital Programme is at optimal cost;
 - Investing surplus cash balances arising from the day-to-day operations of the Council to obtain an optimal return while ensuring security of capital and liquidity.
- 1.3 The annual revenue budget includes the revenue costs that flow from capital financing decisions. Under the Treasury Management Code, increases in capital expenditure should be limited to levels whereby increases in interest charges and running costs are affordable within the Council's revenue account.
- 1.4 The Council regards the successful identification, monitoring and control of risk to be the prime criteria by which the effectiveness of its treasury management activities will be measured. Accordingly, the analysis and reporting of treasury management activities will focus on their risk implications for the organisation to ensure the security and liquidity of the Council's treasury investments.
- 1.5 The Council recognises that effective treasury management will provide support towards the achievement of its business and service objectives. It is therefore committed to the principles of achieving value for money in treasury management, and to employing suitable comprehensive performance measurement techniques, within the context of the Treasury Management Code.

2. Reporting Requirements

- 2.1 The Council and/or Cabinet are required to receive and approve, as a minimum, three main reports each year, which incorporate a variety of policies, estimates and actuals.

Treasury Management Strategy Statement report - The first, and most important report is presented to the Council in February and covers:

- The Treasury Management Strategy Statement (TMSS), which details how the investments and borrowings for capital expenditure are to be organised, including Treasury Limits and Prudential Indicators.
- The Annual Investment Strategy which forms part of the TMSS, (the parameters on how investments are to be managed).
- the MRP Policy (how capital expenditure is charged to revenue over time).

Mid-year Review report (this report) – This is presented to Cabinet in December and updates Members on the progress of the Capital Programme, reporting on Prudential Indicators to give assurance that treasury management function is operating within the Treasury Limits and Prudential Indicators set out in the TMSS.

Treasury Management Outturn report – This is presented to Cabinet in June and provides details of a selection of actual prudential and treasury indicators and actual treasury operations compared to the estimates within the TMSS.

Scrutiny - The above reports are required to be adequately scrutinised, normally before being recommended to Cabinet / Council, with the role being undertaken by the Governance, Audit, Risk Management and Standards Committee (GARMS). The Council has complied with the Code to the extent that all Treasury Management reports have been scrutinised though the efficient conduct of the Council's business may require consideration by GARMS subsequent to consideration by Cabinet/Council.

- 2.2 The Council has delegated responsibility for the implementation and regular monitoring of its treasury management policies and practices to the Section 151 Officer. The Section 151 Officer chairs the Treasury Management Group (TMG), which monitors the treasury management activity and market conditions monthly.

3. Matters covered in report

- 3.1 This report covers the following:
- Treasury Management Strategy Statement and Annual Investment Strategy Review
 - Treasury Position as at 30 September 2019
 - Review of the Council's Investment Portfolio for 2019/20

- Review of the Council's Borrowing Portfolio for 2019/20
- Compliance with Treasury Limits and Prudential Indicators
- Economic update for 2019/20 (Appendix 1)

4. Options considered

4.1 The report is in accordance with the reporting requirements of the CIPFA Treasury Management Code.

5. Treasury Management Strategy Statement and Annual Investment Strategy Review

5.1 The Treasury Management Strategy Statement, (TMSS), for 2019/20 was approved by Council on 28 February 2019. It stated that for the next three years the Capital Programme would continue to be funded from grants and revenue resources but that substantial borrowing would also be required.

5.2 The approved TMSS has been updated to reflect the approval for additional £100m Capital Programme borrowing to finance long term commercial investments. This was approved by Council in July 2019 as part of the 2 Year Budget Strategy 2021/22 to 2021/22.

5.3 The TMSS approved borrowing strategy requires revision following an unexpected 1% increase in the cost of new PWLB borrowing. This decision was made by HM Treasury with immediate effect from 9th October 2019. The Council is now seeking other sources of affordable funding to be able to deliver the Capital Programme within current budget provision. Cabinet will be updated as this area evolves.

6. Treasury Position as at 30 September 2019

6.1 The Council's borrowings and investments (cash balances) position as at 30 September 2019 is detailed below:

Table 1: Investments and Borrowings

	As at 31 March 2019			As at 30 September 2019		
	Principal £'000	Rate %	Life	Principal £'000	Rate %	Life
Total Investments	26,328	0.40	2 days	57,904	0.54	6 Days
Total Borrowing						
Public Works Loan Board	248,461	4.01	33.2 Years	348,461	3.46	37.5 Years
Market Loans	65,800	4.27	39.7 Years	53,800	3.93	48.0 Years
Temporary Borrowing	32,000	0.97	0.6 Years	0	0.00	0.0 Years
Total	346,261	4.08	34.6 Years	402,261	3.53	39.0 Years

- The increase in cash held, reflects the net increase in new borrowing after repaying temporary debt.
- £100m new PWLB long term borrowing taken to finance the Capital Programme and to refinance maturing debt.

- Temporary borrowing taken in Q4 2018/19 repaid by Q2 2019/20.
- The reduced average cost of borrowing reflects the repayment of a higher coupon £12m market loan on maturity and new PWLB borrowing of £100m taken at lower rates.

Review of the Council's Investment Portfolio for 2019/20

6.2 The Council is a prudent investor placing security and liquidity considerations ahead of income generation. The Council has reduced cash balances and a cash management strategy focused on minimising the net cost of borrowing. Therefore it has not been appropriate to commit investments to periods beyond one month with a consequent effect on investment return.

6.3 The table below sets out the counterparty position as at 30 September 2019:

Table 2 - Investment Balances

	2018/19		2019/20	
	Mar-19		Sep-19	
	£'000	%	£'000	%
Specified Investments				
Banks & Building Societies	0	0.00	0	0.00
Money Market Funds	1,604	6.09	1,610	2.78
Local Authorities	0	0.00	10,000	17.27
Non –Specified Investments				
Banks & Building Societies	24,724	93.91	46,294	79.95
Enhanced Money Market Funds	0	0.00	0	0.00
Total	26,328	100.00	57,904	100.00

6.4 The Council held £57.904m of investments as at 30 September 2019 compared with £26.328m at 31 March 2019. The investment portfolio yield for the first six months of the year is 0.54% The Council's investment income budget is £1.4m and the forecast outturn is £1.44m. This includes the loan income from the £15m loan to the West London Waste Authority which the Council approved in July 2013 to finance the cost of a new energy from waste plant. The term of the loan is 25 years at an interest rate of 7.604% on a reducing balance. The loan balance at the 31 March 2019 was £16.17m which includes interest accrued to date. For the financial year 2019/20, the outturn forecast on the interest accrued is £1.26m which is included as part of the investment income budget.

6.5 During the period cash investments have been held with Lloyds, Royal Bank of Scotland PLC, Svenska Handelsbanken and with other local authorities .Counterparty use has been with consistent with previous years and in accordance with the credit criteria set out in the TMSS.

Review of the Council's Borrowing Portfolio for 2019/20

- 6.6 At 30 September 2019 the Council held £402.261m of external borrowing after taking £100m new borrowing from the PWLB. It is forecast that up to £42.3m new borrowing will be required to finance capital expenditure before the end of the financial year.
- 6.7 Table 3 below analyses the maturity profile of borrowing as at 30 September 2019.

Table 3: Borrowing Maturity Profile

Maturity structure of borrowing	upper limit %	lower limit %	LOBO interest reset date	
			£'000	%
under 12 months	30	0	20,800	5
12 months and within 24 mths	20	0	0	0
24 months and within 5 years	30	0	5,000	1
5 years and within 10 years	40	0	20,000	5
10 years and above	90	30	356,461	89
Total			402,261	100

- 6.8 The forecast outturn on borrowing costs is £8.3m, a favourable variance of £1.8m on the budget of £10.1m, reflecting slippage on the Capital Programme. The repayment of £12m higher coupon debt and £100m new borrowing taken at a lower than budgeted rate of 2.31% further reduced the cost of borrowing.
- 6.9 Debt rescheduling opportunities have been very limited in the current economic climate given the structure of interest rates and the high cost of restructuring, further limited by the unexpected 1% increase in the cost of new borrowing from PWLB. This decision was made by HM Treasury with immediate effect from 9th October 2019. The Council will need to consider other sources of affordable funding to be able to deliver the capital programme within current budget constraints. Cabinet will be updated as this area evolves.

7. Economic and Interest Rates Updates

- 7.1 An economic update for the first part of the 2019/20 financial year along with the interest rate forecast and commentary provided by Link Treasury Services as at 30th September 2019 is included as Appendix 1.

8. Compliance with Prudential Indicators

Capital Expenditure and Funding

- 8.1 The Council's Capital Programme is the key driver of Treasury Management activity. The output of the Capital Programme is reflected in the statutory prudential indicators, which are designed to assist Members' overview and confirm the capital expenditure programme.

The table below summarises the capital expenditure and funding for the current financial year.

Table 4 Capital Expenditure

	2018/19	2019/20	2019/20
	Actual	Estimate	Forecast
	£'000	£'000	£'000
Capital Expenditure			
Non - HRA	47,690	97,674	117,800
HRA	7,091	26,586	21,471
TOTAL	54,781	124,260	139,271
Funding:-			
Grants	9,011	20,845	18,399
Capital receipts	4,820	1,277	4,783
Revenue financing	6,386	6,135	11,988
Section 106 / Section 20	337	200	5,825
TOTAL	20,554	28,457	40,995
Net financing need for the year	34,227	95,803	98,276

- 8.2 In July 2019 Council approved an addition of £100m in borrowing approval to the Capital Programme to finance long term commercial investments.
- 8.3 The 2019/20 forecast borrowing requirement (the net financing need) reflects brought forward slippage and underspending in year on the capital programme.

Capital Financing Requirement (CFR)

- 8.4 The CFR as set out in Table 5, is the total historic outstanding capital expenditure which has not yet been paid for from either revenue or capital resources. It is essentially a measure of the Council's underlying borrowing need. Any new capital expenditure, which has not immediately been paid for, will increase the CFR.

Table 5: Capital Financing Requirement

	2018/19	2019/20	2019/20
	Actual	Estimate	Forecast
	£'000	£'000	£'000
CFR as at 31 March			
Non – HRA	367,486	504,688	432,211
HRA	150,046	162,622	161,218
TOTAL	517,532	667,310	593,429
Movement in CFR	23,309	149,778	75,897

- 8.5 Debt outstanding, including that arising from PFI and leasing schemes, should not normally exceed the CFR. As the Council has historically funded a substantial amount of capital expenditure from revenue

resources, as shown in Table 6 below, current forecast gross debt of £459.3m is below the forecast CFR of £593.4m.

Table 6: Changes to Gross Debt

	2018/19	2019/20	2019/20
	Actual	Estimate	Forecast
	£'000	£'000	£'000
External Debt			
Debt at 1 April	324,261	439,745	346,261
Expected change in Debt	22,000	95,803	98,277
Other long-term liabilities (OLTL) 1st April	16,175	14,704	15,501
Actual/ Forecast gross debt at 31 March	362,436	550,252	460,039
Capital financing requirement	517,532	667,310	593,429
Under / (Over) borrowing	155,096	117,058	133,390

Operational Boundary and Authorised Limit

- 8.6 Operational Boundary – This limit is based on the Council's programme for capital expenditure, capital financing requirement and cash flow requirements for the year.
- 8.7 Authorised Limit – This represents a limit beyond which external debt is prohibited. The Council's policy is to set this rate at the Capital Financing Requirement. The Government retains an option to control either the total of all councils' programmes, or those of a specific council, although this power has not yet been exercised.

Table 7: Boundaries

	2018/19	2019/20	2019/20
	Actual	Estimate	Forecast
	£'000	£'000	£'000
Authorised Limit for external debt (CFR)			
Borrowing and finance leases	517,532	667,310	667,310
Operational Boundary for external debt			
Borrowing	346,261	630,000	630,000
Other long term liabilities	16,175	16,000	15,501
Total	362,436	646,000	645,501
Upper limit for fixed interest rate exposure			
Net principal re fixed rate borrowing	346,261	630,000	630,000
Upper limit for variable rate exposure			
Net principal re variable rate borrowing	0	0	0
Upper limit for principal sums invested over 364 days	60,000	60,000	60,000

9. IMPLICATIONS OF THE RECOMMENDATIONS

- 9.1 The recommendations are asking the Cabinet to note the position on treasury management activities. They do not affect the Council's staffing / workforce and have no equalities, procurement, data protection or community safety impact.

10. PROCUREMENT IMPLICATIONS

- 10.1 There are no procurement implications arising from this report.

11. LEGAL IMPLICATIONS

- 11.1 The Local Government Act 2003 requires the Council to 'have regard to' the Prudential Code and to set Prudential Indicators for the next three years to ensure that the Council's capital investment plans are affordable, prudent and sustainable. These are contained within this report. The Act requires the Council to set out its treasury strategy for borrowing and to prepare an Annual Investment Strategy. This sets out the Council's policies for managing its investments and for giving priority to the security and liquidity of those investments. This report assists the Council in fulfilling its statutory obligation under the Local Government Act 2003 to monitor its borrowing and investment activities.

12. FINANCIAL IMPLICATIONS

- 12.1 In addition to supporting the Council's revenue and capital programmes the Treasury Management interest budget is an important part of the revenue budget. Any savings achieved, or overspends incurred, have a direct impact on the financial performance of the budget. There is no direct financial impact of paying the London living Wage (LLW) arising from treasury management activity.

13. PERFORMANCE ISSUES

- 13.1 The Council meets the requirements of the CIPFA Code of Practice for Treasury Management and therefore is able to demonstrate best practices for the Treasury Management function.
- 13.2 As part of the Code the Council must agree a series of prudential indicators and measure its performance against them. These indicators and performance are detailed in the report and reported to Council

14. ENVIRONMENTAL IMPACT

- 14.1 There are no direct environmental impacts.

15. RISK MANAGEMENT IMPLICATIONS

- 15.1 Risk included on Directorate risk register? Yes. Risk 9: Loss of an investment/deposit
- 15.2 The identification, monitoring and control of risk are central to the achievement of the treasury objectives. Potential risks are identified, mitigated and monitored in accordance with treasury practice notes approved by the Treasury Management Group.

16. EQUALITIES IMPLICATIONS/PUBLIC SECTOR EQUALITY DUTY

- 16.1 There is no direct equalities impact.

17. CORPORATE PRIORITIES

- 17.1 This report deals with the Treasury Management Strategy which plays a significant part in supporting the delivery of all the Council's corporate priorities.

Section 3 - Statutory Officer Clearance

Name: Dawn Calvert Chief Financial Officer

Date 19 December 2019

Name: David Hodge on behalf of the *
Monitoring Officer

Date: 25 November 2019

Name: Nimesh Mehta Head of Procurement

Date: 28 November 2019

Name: Charlie Stewart Corporate Director

Date: 19 December 2019

Ward Councillors notified:	No
EqIA carried out:	No
EqIA cleared by:	N/A

Section 4 - Contact Details and Background Papers

Contact: Iain Millar (Treasury and Pensions Manager)
 Tel: 020-8424-1432/ Email: iain.millar@harrow.gov.uk

Background Papers: N/A

Call-In Waived by the Chair of Overview and Scrutiny Committee	NO
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Economic update for 2019-20

UK. 2019 has been a year of upheaval on the political front as Theresa May resigned as Prime Minister to be replaced by Boris Johnson on a platform of the UK leaving the EU on 31 October, with or without a deal. However, MPs blocked leaving on that date and the EU has agreed an extension to 31 January 2020. In addition, a general election has been called for December. At the time of writing (30 October), the whole Brexit situation could still change at any time. Given these circumstances and the uncertainty about the result of the general election, any interest rate forecasts are subject to material change as the situation evolves. If Parliament fully approves the Withdrawal Bill, then it is possible that growth could recover relatively quickly. The MPC could then need to address the issue of whether to raise Bank Rate at some point in the coming year when there is little slack left in the labour market that could cause wage inflation to accelerate; this would then feed through into general inflation. On the other hand, if there was a no deal Brexit and there was a significant level of disruption to the economy, then growth could weaken even further than currently: the MPC would then be likely to cut Bank Rate in order to support growth. However, with Bank Rate still only at 0.75%, the MPC has relatively little room to make a big impact and it would probably suggest that it would be up to the Chancellor to provide help to support growth by way of a fiscal boost by e.g. tax cuts, increases in the annual expenditure budgets of government departments and services and expenditure on infrastructure projects, to boost the economy. The Government has already made moves in this direction.

The first half of 2019 saw UK **economic growth** falling to -0.2% in quarter 2 as Brexit uncertainty took a toll. In its Inflation Report of 1 August, the Bank of England was notably downbeat about the outlook for both the UK and major world economies. The **MPC** meeting of 19 September reemphasised their concern about the downturn in world growth and also expressed concern that prolonged Brexit uncertainty would contribute to a build-up of spare capacity in the UK economy, especially in the context of a downturn in world growth. This mirrored investor concerns around the world which are now expecting a significant downturn or possibly even a recession in some major developed economies. It was therefore no surprise that the Monetary Policy Committee (MPC) left Bank Rate unchanged at 0.75% throughout 2019, so far, and is expected to hold off on changes until there is some clarity on what is going to happen over Brexit. However, it is also worth noting that since Boris Johnson became Prime Minister, the government has made significant statements on various spending commitments and a relaxation in the austerity programme. This will provide some support to the economy and, conversely, take some pressure off the MPC to cut Bank Rate to support growth.

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

With regard to the **labour market**, despite the contraction in quarterly GDP growth of -0.2% q/q, (+1.3% y/y), in quarter 2, employment continued to rise, but at only a muted rate of 31,000 in the three months to July after having risen by no less than 115,000 in quarter 2 itself. However, in the three months to August, employment swung into negative with a fall of 56,000, the first fall for two years. Unemployment duly rose from a 44 year low of 3.8% on the Independent Labour Organisation

measure in July to 3.9%. Wage inflation also edged down slightly from a high point of 3.9% to 3.8% in August, (3 month average regular pay, excluding bonuses). This meant that in real terms, (i.e. wage rates higher than CPI inflation), earnings grew by about 2.1%. As the UK economy is very much services sector driven, an increase in household spending power is likely to feed through into providing some support to the overall rate of economic growth in the coming months. The quarter 2 GDP statistics also included a revision of the savings ratio from 4.1% to 6.4% which provides reassurance that consumers' balance sheets are not over stretched and so will be able to support growth going forward. This would then mean that the MPC will need to consider carefully at what point to take action to raise Bank Rate if there is an agreed Brexit deal, as the recent pick-up in wage costs is consistent with a rise in core services inflation to more than 4% in 2020.

In the **political arena**, a general election could result in a potential loosening of monetary policy and therefore medium to longer dated gilt yields could rise on the expectation of a weak pound and concerns around inflation picking up although, conversely, a weak international backdrop could provide further support for low yielding government bonds and gilts.

USA. President Trump's massive easing of fiscal policy in 2018 fuelled a temporary boost in consumption in that year which generated an upturn in the rate of growth to a robust 2.9% y/y. **Growth** in 2019 has been falling back after a strong start in quarter 1 at 3.1%, (annualised rate), to 2.0% in quarter 2. Quarter 3 is expected to fall further. The strong growth in employment numbers during 2018 reversed into a falling trend during 2019, indicating that the economy is cooling, while inflationary pressures are also weakening.

The 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 etc). It then cut rates again in September to 1.75% - 2.00% and is thought likely to cut another 25 bps in December. 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).

Investor confidence has been badly rattled by the progressive ramping up of increases in tariffs President Trump has made on Chinese imports and China has responded with increases in tariffs on American imports. This **trade war** is seen as depressing US, Chinese and world growth. In the EU, it is also particularly impacting Germany as exports of goods and services are equivalent to 46% of total GDP. It will also impact developing countries dependent on exporting commodities to China.

EUROZONE. **Growth** has been slowing from +1.8 % during 2018 to around half of that in 2019. Growth was +0.4% q/q (+1.2% y/y) in quarter 1 and then fell to +0.2% q/q (+1.0% y/y) in quarter 2; there appears to be little upside potential to the growth rate in the rest of 2019. German GDP 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 depressing exports further and if President Trump imposes tariffs on EU produced cars.

The European Central Bank (ECB) ended its programme of quantitative easing purchases of debt in December 2018, which 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 by quantitative easing purchases of debt. However, the downturn in EZ growth in the second half of 2018 and into 2019, together with inflation falling well under the upper limit of its target range of 0 to 2%, (but it aims to keep it near to 2%), has prompted the ECB to take new measures to stimulate growth. At its March meeting it said that it expected to leave interest rates at their present levels “at least through the end of 2019”, but that was of little help to boosting growth in the near term. Consequently, it announced a **third round of TLTROs**; this provides banks with cheap borrowing every three months from September 2019 until March 2021 which means that, although they will have only a two-year maturity, the Bank was making funds available until 2023, two years later than under its previous policy. As with the last round, the new TLTROs will include an incentive to encourage bank lending, and they will be capped at 30% of a bank's eligible loans. However, since then, the downturn in EZ and world growth has gathered momentum; at its meeting on 12 September, it cut its deposit rate further into negative territory, from -0.4% to -0.5%, and announced a **resumption of quantitative easing purchases of debt**; (at its October meeting it said this would start in November at €20bn per month - a relatively small amount compared to the previous buying programme). It also increased the maturity of the third round of TLTROs from two to three years. However, it is doubtful whether this loosening of monetary policy will have much impact on growth and, unsurprisingly, the ECB stated that governments will need to help stimulate growth by ‘growth friendly’ fiscal policy.

On the political front, Austria, Spain and Italy have been in the throes of **forming coalition governments** with some unlikely combinations of parties i.e. this raises questions around their likely endurance. The latest results of two German state elections will put further pressure on the frail German CDU/SDP coalition government.

CHINA. Economic growth has been weakening over successive years, despite repeated rounds of central bank stimulus; medium term risks are increasing. Major progress still needs to be made to eliminate excess industrial capacity and the stock of unsold property, and to address the level of non-performing loans in the banking and 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.

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

WORLD GROWTH. Until recent years, world growth has been boosted by increasing globalisation i.e. countries specialising in producing goods and commodities in which they have an economic advantage and which they then trade with the rest of the world. This has boosted worldwide productivity and growth, and, by lowering costs, has also depressed inflation. However, the rise of China as an economic superpower over the last thirty years, which now accounts for nearly 20% of total world GDP, has unbalanced the world economy. The Chinese government has targeted achieving major world positions in specific key sectors and products, especially high tech areas and production of rare earth minerals used in high tech products. It is achieving this by massive financial support (i.e. subsidies) to state owned firms, government directions to other firms, technology theft, restrictions on market access by foreign firms and informal targets for the domestic market share of Chinese producers in the selected sectors. This is regarded as being unfair competition that is putting western firms at an unfair disadvantage or even putting some out of business. It is also regarded with suspicion on the political front as China

is an authoritarian country that is not averse to using economic and military power for political advantage. The current trade war between the US and China therefore needs to be seen against that backdrop. It is, therefore, likely that we are heading into a period where there will be a **reversal of world globalisation and a decoupling of western countries** from dependence on China to supply products. This is likely to produce a backdrop in the coming years of weak global growth and so weak inflation. Central banks are, therefore, likely to come under more pressure to support growth by looser monetary policy measures and this will militate against central banks increasing interest rates.

The trade war between the US and China is a major concern to **financial markets** due to the synchronised general weakening of growth in the major economies of the world, compounded by fears that there could even be a recession looming up in the US, though this is probably overblown. These concerns resulted in **government bond yields** in the developed world falling significantly during 2019. If there were a major worldwide downturn in growth, central banks in most of the major economies will have limited ammunition available, in terms of monetary policy measures, when rates are already very low in most countries, (apart from the US). 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. The latest PMI survey statistics of economic health for the US, UK, EU and China have all been predicting a downturn in growth; this confirms investor sentiment that the outlook for growth during the year ahead is weak.

INTEREST RATE FORECASTS

The interest rate forecasts provided by Link Asset Services in paragraph 3.3 are **predicated on an assumption of an agreement being reached on Brexit between the UK and the EU**. On this basis, while GDP growth is likely to be subdued in 2019 due to all the uncertainties around Brexit depressing consumer and business confidence, an agreement is likely to lead to a boost to the rate of growth in subsequent years which could, in turn, increase inflationary pressures in the economy and so cause the Bank of England to resume a series of gentle increases in Bank Rate. Just how fast, and how far, those increases will occur and rise to, will be data dependent. The forecasts in this report assume a modest recovery in the rate and timing of stronger growth and in the corresponding response by the Bank in raising rates.

- In the event of an **orderly non-agreement exit**, it is likely that the Bank of England would take action to cut Bank Rate from 0.75% in order to help economic growth deal with the adverse effects of this situation. This is also likely to cause short to medium term gilt yields to fall.
- If there was a **disorderly Brexit**, then any cut in Bank Rate would be likely to last for a longer period and also depress short and medium gilt yields correspondingly. Quantitative easing could also be restarted by the Bank of England. It is also possible that the government could act to protect economic growth by implementing fiscal stimulus.

However, there would appear to be a majority consensus in the Commons against any form of non-agreement exit so the chance of this occurring has diminished.

The balance of risks to the UK

- The overall balance of risks to economic growth in the UK is probably to the downside due to the weight of all the uncertainties over Brexit, as well as a softening global economic picture.
- The balance of risks to increases in Bank Rate and shorter term PwLB rates are broadly similarly to the downside.
- In the event that a Brexit deal was agreed with the EU and approved by Parliament, the balance of risks to economic growth and to increases in Bank Rate is likely to change to the upside.

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

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

- **Brexit** – if it were to cause significant economic disruption and a major downturn in the rate of growth.
- **Bank of England** takes action too quickly, or too far, over the next three years to raise Bank Rate and causes UK economic growth, and increases in inflation, to be weaker than we currently anticipate.
- A resurgence of the **Eurozone sovereign debt crisis**. In 2018, Italy was a major concern due to having a populist coalition government which made a lot of anti-austerity and anti-EU noise. However, in September 2019 there was a major change in the coalition governing Italy which has brought to power a much more EU friendly government; this has eased the pressure on Italian bonds. Only time will tell whether this new coalition based on an unlikely alliance of two very different parties will endure.
- Weak capitalisation of some **European banks**, particularly Italian banks.
- **German minority government**. In the German general election of September 2017, Angela Merkel's CDU party was left in a vulnerable minority position dependent on the fractious support of the SPD party, as a result of the rise in popularity of the anti-immigration AfD party. The SPD has done particularly badly in state elections since then which has raised a major question mark over continuing to support the CDU. Angela Merkel has stepped down from being the CDU party leader but she intends to remain as Chancellor until 2021.
- **Other minority EU governments**. Austria, Sweden, Spain, Portugal, Netherlands and Belgium also have vulnerable minority governments dependent on coalitions which could prove fragile.
- **Austria, the Czech Republic, Poland and Hungary** now form a strongly anti-immigration bloc within the EU. There has also been rising anti-immigration sentiment in Germany and France.
- In October 2019, the IMF issued a report on the World Economic Outlook which flagged up a synchronised slowdown in world growth. However, it also flagged up that there was **potential for a rerun of the 2008 financial crisis**, but this time centred on the huge debt binge accumulated by corporations during the decade of low interest rates. This now means that there are corporates who would be unable to cover basic interest costs on **some \$19trn of corporate debt in major western economies**, if world growth was to dip further than just a minor cooling. This debt is mainly held by the shadow banking sector i.e. pension funds, insurers, hedge funds, asset managers etc., who, when there is \$15trn of corporate and government debt now yielding negative interest rates, have been searching for higher returns in riskier assets. Much of this debt is only marginally above investment grade so any rating downgrade could force some holders into a fire sale, which would then depress prices further and so set off a spiral down. The IMF's answer is to suggest imposing higher capital charges on lending to corporates and for central banks to regulate the investment operations of the shadow banking sector. In October 2019, the deputy Governor of the Bank of England also flagged up the dangers of banks and the shadow banking sector lending to

corporates, especially highly leveraged corporates, which had risen back up to near pre-2008 levels.

- **Geopolitical risks**, for example in North Korea, but also in Europe and the Middle East, which could lead to increasing safe haven flows.

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

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