ISLE OF ANGLESEY COUNTY COUNCIL	
REPORT TO:	**EXECUTIVE COMMITTEE**
DATE:	**17 SEPTEMBER 2018**
SUBJECT:	**ANNUAL TREASURY MANAGEMENT REVIEW FOR 2017/18**
PORTFOLIO HOLDER(S):	**COUNCILLOR R WILLIAMS**
LEAD OFFICER(S):	**R MARC JONES**
CONTACT OFFICER(S):	**GARETH ROBERTS/CLAIRE KLIMASZEWSKI (EXT. 2675/1865)**

Nature and reason for reporting

To comply with regulations issued under the Local Government Act 2003 and with the Council's Treasury Management Scheme of Delegation for 2017/18 (Appendix 8 of the Treasury Management Strategy Statement 2017/18). In accordance with the Scheme of Delegation, this report was scrutinised by the Audit Committee on 24 July 2018 and forwarded to this Committee without comments. It will be presented to the full Council following this Committee.

Summary

The Council is required, by regulations issued under the Local Government Act 2003, to produce an annual treasury management review of activities and the actual prudential and treasury indicators for 2017/18. This report meets the requirements of both the CIPFA Code of Practice on Treasury Management (the Code) and the CIPFA Prudential Code for Capital Finance in Local Authorities (the Prudential Code).

During 2017/18, the minimum reporting requirements were that the full Council should receive the following reports:-

- an annual treasury strategy in advance of the year (received on 28 February 2017);
- a mid-year treasury update report (received on 28 February 2018);
- an annual review following the year describing the activity compared to the strategy (this report).

The regulatory environment places responsibility on Members for the review and scrutiny of treasury management policy and activities. This report is, therefore, important in that respect as it provides details of the outturn position for treasury activities and highlights compliance with the Council's policies previously approved by Members.

This Council confirms that it has complied with the requirement under the Code to give prior scrutiny to all of the above treasury management reports by the Audit Committee before they were reported to the full Council.

In order to support the scrutiny role of the members of the Audit Committee, Member training on treasury management issues was undertaken during June 2018.

During 2017/18, the Council complied with its legislative and regulatory requirements. The key data for actual prudential and treasury indicators detailing the impact of capital expenditure activities during the year, with comparators, are as follows:-

Data for Actual Prudential and Treasury Indicators	2016/17 Actual £000	2017/18 Original £000	2017/18 Actual £000
Capital expenditure			
• Non-HRA	28,033	39,799	20,064
• HRA	8,607	12,873	9,291
• Total	36,640	52,672	29,355
Total Capital Financing Requirement			
• Non-HRA	91,515	101,286	95,218
• HRA	42,499	41,648	41,648
• Total	134,014	142,934	136,866
Gross borrowing	117,110	125,018	117,029
External debt	117,110	125,018	117,029
Investments			
• Longer than 1 year			-
• Under 1 year	13,319	15,000	5,993
• Total	13,319	15,000	5,993

Other prudential and treasury indicators are to be found in the main body of this report. The Section 151 Officer also confirms that borrowing was only taken out for capital purposes and the statutory borrowing limit (the authorised limit) was not breached.

The financial year 2017/18 continued the challenging investment environment of previous years, namely low investment returns.

RECOMMENDATIONS

The Committee is recommended to:-

(i) Note that the outturn figures in this report will remain provisional until the audit of the 2017/18 Statement of Accounts is completed and signed off; any resulting significant adjustments to the figures included in this report will be reported as appropriate;
(ii) Note the provisional 2017/18 prudential and treasury indicators in this report;
(iii) Consider the annual treasury management report for 2017/18 and pass on to the next meeting of the full Council with any comments.

Appendices:

Appendix 1 - Summary Portfolio Valuation as at 31 March 2018
Appendix 2 - Credit ratings of investment counterparties and deposits held with each as at 31 March 2018
Appendix 3 - Credit ratings of investment counterparties and deposits held with each as at 3 July 2018
Appendix 4 - A Commentary by Capita Asset Services on the Economy, Investment and Borrowing Rates

Background Papers :

Treasury Management Strategy Statement 2017/18
Prudential and Treasury Indicators 2017/18
Treasury Management Mid-Year Review Report 2017/18
Capital Outturn Report 2017/18

1. INTRODUCTION

This report summarises the following functions / activities / outcomes in financial year 2017/18:-

- Capital activity;
- Impact of this activity on the Council's underlying indebtedness (the Capital Financing Requirement);
- The actual prudential and treasury indicators;
- Overall treasury position identifying how the Council has borrowed in relation to this indebtedness and the impact on investment balances;
- Interest rate movements in the year;
- Detailed debt activity; and
- Detailed investment activity.

2. THE COUNCIL'S CAPITAL EXPENDITURE AND FINANCING 2017/18

2.1 The Council undertakes capital expenditure on long-term assets. These activities may either be:-

- Financed immediately through the application of capital or revenue resources (capital receipts, capital grants, revenue contributions etc.) which has no resultant impact on the Council's borrowing need; or

- Financed from borrowing: this may be through planned borrowing or otherwise. If insufficient financing is available, or a decision is taken not to apply resources, the capital expenditure will give rise to a borrowing need.

2.2 The actual capital expenditure forms one of the required prudential indicators. The table below shows the actual capital expenditure and how this was financed.

	2016/17 Actual (£m)	2017/18 Estimate (£m)	2017/18 Actual (£m)
Non-HRA capital expenditure	28	40	20
HRA capital expenditure	9	13	9
Total capital expenditure	**37**	**53**	**29**
Non-HRA financed in year	28	40	20
HRA financed in year	9	13	9
Non-HRA capital expenditure financed by borrowing	**11**	**13**	**7**
HRA capital expenditure financed by borrowing	**0**	**0**	**0**

3. THE COUNCIL'S OVERALL BORROWING NEED

3.1 The Council's underlying need to borrow for capital expenditure is termed the Capital Financing Requirement (CFR). This figure is a gauge of the Council's debt position. The CFR results from the capital activity of the Council and what resources have been used to pay for the capital spend. It represents the 2017/18 capital expenditure financed by borrowing (see above table), and prior years' capital expenditure funded by borrowing which has not yet been paid for by revenue or other resources. The above table shows that £7m of Council fund capital expenditure is financed from borrowing. No actual Long Term external borrowing was taken out during the year, but was internally borrowed, with Council balances funding this in the short-term to reduce interest payments. However, the expectation is that, in the longer term, borrowing will need to be taken out to replenish Council balances.

3.2 Part of the Council's treasury activities is to address the funding requirements for this borrowing need. Depending on the capital expenditure programme, the treasury service organises the Council's cash position to ensure sufficient cash is available to meet the capital plans and cash flow requirements. This may be sourced through borrowing from external bodies (such as the Government, through the Public Works Loan Board (PWLB) or the money markets), or utilising temporary cash resources within the Council.

3.3 Reducing the CFR

3.3.1 The Council's underlying borrowing need (CFR) is not allowed to rise indefinitely. Statutory controls are in place to ensure that capital assets are broadly charged to revenue over the life of the asset. The Council is required to make an annual revenue charge called the Minimum Revenue Provision, MRP, to reduce the CFR. This is, effectively, a repayment of the borrowing need. This differs from the treasury management arrangements which ensure that cash is available to meet capital commitments. External debt can also be borrowed or repaid at any time, but this does not change the CFR.

3.3.2 The total CFR can also be reduced by:-

- the application of additional capital financing resources (such as unapplied capital receipts); or
- charging more than the statutory revenue charge (MRP) each year through a Voluntary Revenue Provision (VRP).

3.3.3 The Council's 2017/18 MRP Policy (as required by WG guidance) was approved as part of the Treasury Management Strategy Report for 2017/18 on 28 February 2017.

3.3.4 The Council's CFR for the year is shown below and represents a key prudential indicator. This would include any PFI and leasing schemes on the balance sheet which would increase the Council's borrowing need, the CFR. There were no such schemes during the year.

CFR: Council Fund	2016/17 Actual (£m)	2017/18 Budget (£m)	2017/18 Actual (£m)
Opening balance	84	92	92
Add capital expenditure financed by borrowing (as above)	11	13	7
Less MRP/VRP*	(3)	(4)	(4)
Closing balance	92	101	95

CFR: HRA	2016/17 Actual (£m)	2017/18 Budget (£m)	2017/18 Actual (£m)
Opening balance	43	42	42
Add unfinanced capital expenditure (as above)	0	0	0
Less MRP/VRP*	(1)	(1)	(1)
Closing balance	42	41	41

* Includes voluntary application of capital receipts

3.3.5 The borrowing activity is constrained by prudential indicators for gross borrowing and the CFR, and by the authorised limit.

3.4 Gross borrowing and the CFR

In order to ensure that borrowing levels are prudent over the medium term and only for a capital purpose, the Council should ensure that its gross external borrowing does not, except in the short term, exceed the total of the capital financing requirement in the preceding year plus the estimates of any additional capital financing requirement for the current and next two financial years. This, essentially, means that the Council is not borrowing to support revenue expenditure. This indicator allows the Council some flexibility to borrow in advance of its immediate capital needs in 2017/18. The table below highlights the Council's gross borrowing position against the CFR. The Council has complied with this prudential indicator.

	31 March 2017 Actual (£m)	31 March 2018 Budget (£m)	31 March 2018 Actual (£m)
Gross borrowing position	117.1	125.0	117.0
CFR	134.0	142.9	136.9

3.4.1 As part of the financing of capital expenditure for 2017/18, internal borrowing was used to finance the gap between available resources (capital receipts, capital grants, capital contributions and revenue contributions) and the capital expenditure. It was decided, in light of current and projected market interest rates and counterparty credit risks, to continue internalising borrowing, in the short-term at least. This means that instead of borrowing externally for all of the Council's borrowing requirement, the Council has instead used its own Council reserves to fund part of its capital programme.

3.4.2 The internal borrowing strategy has now been implemented over the last few years. The gross borrowing of £117.0m at 31 March 2018 is less than the forecast CFR for the following two years.

	Actual 2017/18 (£m)	Estimated 2018/19 (£m)	Estimated 2019/20 (£m)
Capital Financing Requirement	136.9	148.9	165.3

Source: Treasury Management Strategy 2017/18

3.5 The other debt related indicators are:-

3.5.1 The authorised limit - the authorised limit is the “affordable borrowing limit” required by Section 3 of the Local Government Act 2003. Once this has been set, the Council does not have the power to borrow above this level. The table below demonstrates that, during 2017/18, the Council maintained gross borrowing within its authorised limit.

3.5.2 The operational boundary – the operational boundary is the expected borrowing position of the Council during the year. Periods where the actual position is either below or over the boundary are acceptable subject to the authorised limit not being breached.

3.5.3 Actual financing costs as a proportion of net revenue stream - this indicator identifies the trend in the cost of capital (borrowing and other long term obligation costs net of investment income) against the net revenue stream.

	2017/18
Authorised limit	£169.0m
Maximum gross borrowing position	£117.0m
Operational boundary	£164.0m
Financing costs as a proportion of net revenue stream – CF	6.25%
Financing costs as a proportion of net revenue stream – HRA	23.02%

4. TREASURY POSITION AS AT 31 MARCH 2018

4.1 The Council’s debt and investment position is organised by the treasury management service in order to ensure adequate liquidity for revenue and capital activities, security for investments and to manage risks within all treasury management activities. Procedures and controls to achieve these objectives are well established both through Member reporting, detailed in the summary, and through officer activity in accordance with the Treasury Management Strategy 2017/18. The borrowing and investment figures for the Council as at the end of the 2016/17 and 2017/18 financial years are as follows:-

	31 MARCH 2017			**31 MARCH 2018**		
	£’000	**Average Rate (%)**	**Average Maturity (yrs)**	**£’000**	**Average Rate (%)**	**Av erage Maturity (yrs)**
Debt	117.110	5.25	22.7	117.029	5.15	23.36
CFR	134,014			136.866		
Over / (under) borrowed	(16,904)			(19,837)		
Fixed term investments (all < 1 year, managed in house and fixed rate)	5,000	0.35				
No notice investments (all managed in house)	8,319	0.15		5.993	0.39	
Total Investments	13,319	0.22		5,993	0.39	

See a more detailed analysis in Appendix 1. The upper limits for fixed rate and variable rate exposures were not breached during the year.

4.2 Borrowing is further broken down by maturity as:-

	31 MARCH 2017		31 MARCH 2018	
	£m	% of total	£m	% of total
Total borrowing	117.1	100	117.0	100
Under 12 months	5.5	4.7	10.1	8.63
12 months and within 24 months	5.1	4.3	5.1	4.36
24 months and within 5 years	9.6	8.2	7.0	5.98
5 years and within 10 years	5.6	4.8	5.8	4.96
10 years and above	91.3	78.0	89.0	76.07

4.3 There was no debt rescheduling during the year as the average 1% differential between PWLB new borrowing rates and premature repayment rates made rescheduling unviable.

4.4 All of the Council's deposits were held in no notice deposit accounts which pay interest at rates near the prevailing base rate, £5.993m at 0.39% on 31 March 2018 (31 March 2017 £`8.3m at 0.15%). All investments were for under 1 year.

5. TREASURY STRATEGY FOR 2017/18

5.1 The expectation for interest rates within the treasury management strategy for 2017/18 anticipated that Bank Rate would not start rising from 0.25% until quarter 2 2019 and then only increase once more before 31 March 2020. There would also be gradual rises in medium and longer term fixed borrowing rates during 2017/18 and the two subsequent financial years. Variable or short-term rates were expected to be the cheaper form of borrowing over the period. Continued uncertainty in the aftermath of the 2008 financial crisis promoted a cautious approach, whereby investments would continue to be dominated by low counterparty risk considerations, resulting in relatively low returns compared to borrowing rates.

5.2 In this scenario, the treasury strategy was to postpone borrowing, where possible, to avoid the cost of holding higher levels of investments and to reduce counterparty risk.

5.3 During 2017/18, longer term PWLB rates were volatile but with little overall direction, whereas shorter term PWLB rates were on a rising trend during the second half of the year.

6. INVESTMENT OUTTURN FOR 2017/18

6.1 Investment Policy – the Council's investment policy is governed by Welsh Government investment guidance, which has been implemented in the annual Treasury Management Strategy Statement approved by the Council on February 28 2017. This policy sets out the approach for choosing investment counterparties and is based on credit ratings provided by the three main credit rating agencies, supplemented by additional market data (such as rating outlooks, credit default swaps, bank share prices etc.). The investment activity during the year conformed to the approved strategy and the Council had no liquidity difficulties.

6.2 The Bank Rate at the start of the financial year was 0.25%, however, this was increased to 0.5% on the 2nd November 2017. This meant that the counterparty organisations' interest rate on the typical call account ranged from 0.10% to 0.40%.

6.3 The expected investment strategy was to keep to shorter term deposits (up to 364 days), although the ability to invest out to longer periods was retained. Cash balances were expected to be up to £26m, ranging between £5m and £26m. The budget was set at 0.058% or £15k after adjusting for the higher rates on existing investments. As it turned out, average balances of £14.4m returned £31.2k (0.12%).

7. INVESTMENT SECURITY AND CREDIT QUALITY

7.1 No institutions in which we had made investments had any difficulty in repaying investments and interest on time and in full during the year.

7.2 During the year, we continued to use no notice accounts with major high street institutions (Santander, HSBC, RBS and Bank of Scotland) for day to day cash flow.

8. BORROWING OUTTURN 2017/18

8.1 Borrowing – the only borrowing that was made during the year was a £5m borrowing from the Tyne & Wear Pension Fund. This was made on the 20th October 2017 at an interest rate of 0.33% for a period of 3 months. Upon maturity on the 19th January 2018, the borrowing was rolled over for a further 3 months at an interest rate of 0.50%.

8.2 Rescheduling - no rescheduling was done during the year as the average 1% differential between PWLB new borrowing rates and premature repayment rates made rescheduling unviable.

8.3 Repayments – two PWLB loans matured during the year. The first loan matured on the 6th June 2017 and was for £2.5m. The loan was originally taken in 2009 at an interest rate of 3.25%. The seond loan matured on 17th July 2017 for £3.5m, and was taken out in 1992 at an interest rate of 10.375%. These loans were repaid using the Councils cash balances, no new loans were taken to re-finance the loans.

9. ACTIVITY SINCE 2017/18

9.1 On April 19th 2018, a £5m borrowing from the Tyne & Wear Pension Fund was repaid by the Isle of Anglesey County Council.

9.2 During the early months of 2018/19, the Isle of Anglesey County Council has continued to invest in instant access call accounts, where funds are readily available when called upon.

9.3 No new borrowing has been undertaken to date in 2018/19.

9.4 There haven’t been any PWLB loan repayments to date in 2018/19.

10. CHANGES DURING 2017/18

10.1 Revised CIPFA Codes - in December 2017, the Chartered Institute of Public Finance and Accountancy (CIPFA) issued a revised Treasury Management Code and Cross Sectoral Guidance Notes and a revised Prudential Code. A particular focus of these revised codes was how to deal with local authority investments which are not treasury type investments e.g. by investing in purchasing property in order to generate income for the Authority at a much higher level than can be attained by treasury investments. One recommendation was that local authorities should produce a new report to Members to give a high level summary of the overall capital strategy and to enable Members to see how the cash resources of the Authority have been apportioned between treasury and non-treasury investments. Officers will report to Members when the implications of these new codes have been assessed as to the likely impact on this Authority.

10.2 Markets in Financial Instruments Directive II (MiFID II) - the EU set the date of 3 January 2018 for the introduction of regulations under MiFID II. These regulations govern the relationship that financial institutions conducting lending and borrowing transactions will have with local authorities from that date. This has had little effect on this Authority apart from having to fill in forms sent by each institution dealing with this Authority and for each type of investment instrument we use, apart from for cash deposits with banks and building societies.

11. CONCLUSION

11.1 A review of the Treasury Management performance for 2017/18 is provided above. The year was fairly stable, with the most significant activity being a loan from Tyne & Wear Pension Fund amounting to £5.0m for 3 months, that was rolled over for a further 3 months upon maturity. Two PWLB Loans for £5.5m were repaid during the year. Investment returns reduced to an all time low due to the low bank base rate and the Council held appropriate cash balances at all times, though the low interest rate meant that the returns were low. However, this is consistent with the Treasury Management Strategy 2017/18, where the key objectives were low risk and ensuring there is sufficient cash to pay the Council's creditors, etc. The financial position of the Council's financial instruments as at 31 March 2018 is shown in Appendix 1.

R MARC JONES
HEAD OF FUNCTION (RESOURCES) & SECTION 151 OFFICER **7 AUGUST 2018**

APPENDIX 1

Summary Portfolio Valuation
As at 31 March 2018

	Nominal / Principal (£)	Fair Value (£)
FINANCIAL ASSETS		
Cash (interest bearing accounts) (1)	5,993,375	6,007,584
FINANCIAL LIABILITIES		
PWLB loan – Fixed	**111,184,478**	166,042,050
PWLB loan – Annuity	241,122	372,142
WG Loan	131,400	131,400
Salix	471,881	471,881
Tyne & Wear Pension Fund	5,000,000	5,000,000

Counterparties

(1) Cash (interest bearing accounts)		
Santander	2,074,120	
Bank of Scotland	3,684,119	
Nat West Cash Manager A/c	233,447	
RBS	1,690	
	5,993,376	

APPENDIX 2

Cyfraddau Credyd Gwrthbartïon buddsoddi a'r adneuon a ddelir gyda phob un ar 31 Marwth 2018 *
Credit ratings of investment counterparties and deposits held with each as at 31 March 2018*

Grŵp Bancio/ Banking Group	Sefydliad/ Institution	Adneuon / Deposit £'000	Hyd (Galw tymor sefydlog **) / Duration (Call / Fixed Term) **	Cyfnod (O-I)/ Period (From - To)	Cyfradd Dychweliad/ Rate of Return %	Cyfradd Tymor Hir Fitch Long Term Rating	Cyfradd Tymor Byr Fitch Short Term Rating	Cyfradd Tymor Hir Moody's Long Term Rating	Cyfradd Tymor Byr Moody's Short Term Rating	Cyfradd Tymor Hir Standard & Poor's (S&P) Long Term Rating	Cyfradd Tymor Byr Standard & Poor's (S&P) Short Term Rating	Lliw Sector/Hyd Awgrymiedig/ Sector Colour / Suggested Duration
Lloyds Banking Group plc	Royal Bank of Scotland plc	**3,684**	**Galw/ Call**	**n/a**	**0.40**	**A+**	**F1**	**Aa3**	**P-1**	**A**	**A-1**	**Coch – 6 mis/ Red - 6 months**
Santander Group plc	Santander UK plc	**2,074**	**Galw/ Call**	**n/a**	**0.25**	**A**	**F1**	**Aa3**	**P-1**	**A**	**A-1**	**Coch - 6 mis / Red – 6 months**
Royal Bank of Scotland group plc	The Royal Bank of Scotland plc	**2**	**Galw/ Call**	**n/a**	**0.10**	**BBB+**	**F2**	**A2**	**P-1**	**BBB+**	**A-2**	**Glas – 12 mis/ Blue – 12 months**
Royal Bank of Scotland group plc	National Westminster Bank plc	**233**	**Galw/ Call**	**n/a**	**0.05**	**BBB+**	**F2**	**A2**	**P-1**	**BBB+**	**A-2**	**Glas – 12 mis/ Blue – 12 months**

* Ceir y Rhestr Meini Prawf Gwrthbartïon yn Atodiad 6 o'r Datganiad Strategaeth Rheoli Trysorlys 2017/18 / The Counterparty Criteria can be found at Appendix 6 of the 2017/18 Treasury Management Strategy Statement.

** Sef tymor ar pwynt y buddsoddi/Being term at the point of investment.

ATODIAD / APPENDIX 3

Cyfraddau Credyd Gwrthbartïon buddsoddi a'r adneuon a ddelir gyda phob un ar 29 Mehefin 2018 *
Credit ratings of investment counterparties and deposits held with each as at 29 June 2018*

Grŵp Bancio/ Banking Group	Sefydliad/ Institution	Adneuon / Deposit £'000	Hyd (Galw / tymor sefydlog) / Duration (Call / Fixed Term) **	Cyfnod (O-I)/ Period (From - To)	Cyfradd Dychweliad/ Rate of Return %	Cyfradd Tymor Hir Fitch Long Term Rating	Cyfradd Tymor Byr Fitch Short Term Rating	Cyfradd Tymor Hir Moody's Long Term Rating	Cyfradd Tymor Byr Moody's Short Term Rating	Cyfradd Tymor Hir Standard & Poor's (S&P) Long Term Rating	Cyfradd Tymor Byr Standard & Poor's (S&P) Short Term Rating	Lliw Sector/Hyd Awgrymiedig/ Sector Colour / Suggested Duration
Lloyds Banking Group plc	Bank of Scotland plc	**7,487**	**Galw/ Call**	**n/a**	**0.40**	**A+**	**F1**	**Aa3**	**P-1**	**A+**	**A-1**	**Oren –12 mis/ Orange - 12 months**
Santander Group plc	Santander UK plc	**1,207**	**Galw/ Call**	**n/a**	**0.25**	**A**	**F1**	**Aa3**	**P-1**	**A**	**A-1**	**Coch - 6 mis / Red – 6 months**
Royal Bank of Scotland group plc	The Royal Bank of Scotland plc	**2**	**Galw/ Call**	**n/a**	**0.10**	**A-**	**F2**	**A1**	**P-1**	**A-**	**A-2**	**Glas – 12 mis / Blue – 12 months**
Royal Bank of Scotland group plc	National Westminster Bank plc	**Dim/Nil**	**Galw/ Call**	**n/a**	**0.05**	**A-**	**F2**	**A1**	**P-1**	**A-**	**A-2**	**Glas – 12 mis / Blue – 12 months**

* Ceir y Rhestr Meini Prawf Gwrthbartïon yn Atodiad 6 o'r Datganiad Strategaeth Rheoli Trysorlys 2018/19 / The Counterparty Criteria can be found at Appendix 6 of the 2018/19 Treasury Management Strategy Statement.

** Sef tymor ar pwynt y buddsoddi/Being term at the point of investment.

1. The Economy and Interest Rates

UK. The outcome of the EU referendum in June 2016 resulted in a gloomy outlook and economic forecasts from the Bank of England based around an expectation of a major slowdown in UK GDP growth, particularly during the second half of 2016, which was expected to push back the first increase in Bank Rate for at least three years. Consequently, the Bank responded in August 2016 by cutting Bank Rate by 0.25% to 0.25% and making available over £100bn of cheap financing to the banking sector up to February 2018. Both measures were intended to stimulate growth in the economy. This gloom was overdone as the UK economy turned in a G7 leading growth rate of **1.8% in 2016**, (actually joint equal with Germany), and followed it up with another **1.8% in 2017**, (although this was a comparatively weak result compared to the US and EZ).

During the calendar year of 2017, there was a major shift in expectations in financial markets in terms of how soon Bank Rate would start on a rising trend. After the UK economy surprised on the upside with strong growth in the second half of 2016, growth in 2017 was disappointingly weak in the first half of the year; quarter 1 came in at +0.3% (+1.7% y/y) and quarter 2 was +0.3% (+1.5% y/y), which meant that growth in the first half of 2017 was the slowest for the first half of any year since 2012. The main reason for this was the sharp increase in inflation caused by the devaluation of sterling after the EU referendum, feeding increases into the cost of imports into the economy. This caused a reduction in consumer disposable income and spending power as inflation exceeded average wage increases. Consequently, the services sector of the economy, accounting for around 75% of GDP, saw weak growth as consumers responded by cutting back on their expenditure. However, growth did pick up in quarter 3 to 0.5% before dipping slightly to 0.4% in quarter 4.

Consequently, market expectations during the autumn rose significantly that the MPC would be heading in the direction of imminently raising Bank Rate. The **MPC meeting of 14 September** provided a shock to the markets with a sharp increase in tone in the minutes where the MPC considerably hardened their wording in terms of needing to raise Bank Rate very soon. The **2 November MPC quarterly Inflation Report meeting** duly delivered on this warning by withdrawing the 0.25% emergency rate cut which had been implemented in August 2016. Market debate then moved on as to whether this would be a one and done move for maybe a year or more by the MPC, or the first of a series of increases in Bank Rate over the next 2-3 years. The MPC minutes from that meeting were viewed as being dovish, i.e. there was now little pressure to raise rates by much over that time period. In particular, the GDP growth forecasts were pessimistically weak while there was little evidence of building pressure on wage increases despite remarkably low unemployment. The MPC forecast that CPI would peak at about 3.1% and chose to look through that breaching of its 2% target as this was a one off result of the devaluation of sterling caused by the result of the EU referendum. The inflation forecast showed that the MPC expected inflation to come down to near the 2% target over the two to three year time horizon. So this all seemed to add up to cooling expectations of much further action to raise Bank Rate over the next two years.

However, GDP growth in the second half of 2017 came in stronger than expected, while in the new year there was evidence that wage increases had started to rise.

The **8 February MPC meeting** minutes therefore revealed another sharp hardening in MPC warnings focusing on a reduction in spare capacity in the economy, weak increases in productivity, higher GDP growth forecasts and a shift of their time horizon to focus on the 18 – 24 month period for seeing inflation come down to 2%. (CPI inflation ended the year at 2.7% but was forecast to still be just over 2% within two years.) This resulted in a marked increase in expectations that there would be another Bank Rate increase in May 2018 and a bringing forward of the timing of subsequent increases in Bank Rate. This shift in market expectations resulted in **investment rates** from 3 – 12 months increasing sharply during the spring quarter.

PWLB borrowing rates increased correspondingly to the above developments with the shorter term rates increasing more sharply than longer term rates. In addition, UK gilts have moved in a relatively narrow band this year, (within 25 bps for much of the year), compared to **US treasuries**. During the second half of the year, there was a noticeable trend in treasury yields being on a rising trend with the Fed raising rates by 0.25% in June, December and March, making six increases in all from the floor. The effect of these three increases was greater in shorter terms around 5 year, rather than longer term yields.

As for **equity markets**, the FTSE 100 hit a new peak near to 7,800 in early January before there was a sharp selloff in a number of stages during the spring, replicating similar developments in US equity markets.

The major UK landmark event of the year was the inconclusive result of the **general election** on 8 June. However, this had relatively little impact on financial markets. However, **sterling** did suffer a sharp devaluation against most other currencies, although it has recovered about half of that fall since then. Brexit negotiations have been a focus of much attention and concern during the year but so far, there has been little significant hold up to making progress.

The **manufacturing sector** has been the bright spot in the economy, seeing stronger growth, particularly as a result of increased demand for exports. It has helped that growth in the EU, our main trading partner, has improved significantly over the last year. However, the manufacturing sector only accounts for around 11% of GDP so expansion in this sector has a much more muted effect on the average total GDP growth figure for the UK economy as a whole.

EU. Economic growth in the EU, (the UK's biggest trading partner), was lack lustre for several years after the financial crisis despite the ECB eventually cutting its main rate to -0.4% and embarking on a massive programme of quantitative easing to stimulate growth. However, growth eventually picked up in 2016 and subsequently gathered further momentum to produce an overall GDP figure for 2017 of 2.3%. Nevertheless, despite providing this massive monetary stimulus, the ECB is still struggling to get inflation up to its 2% target and in March, inflation was still only 1.4%. It is, therefore, unlikely to start an upswing in rates until possibly towards the end of 2019.

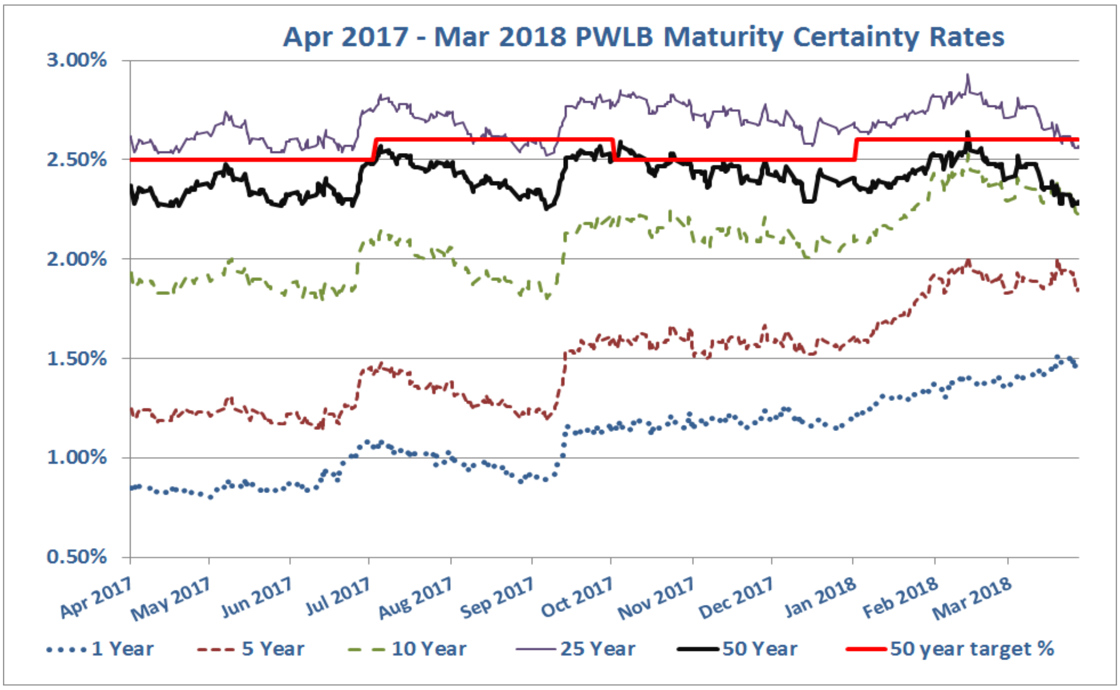
USA. Growth in the American economy was volatile in 2015 and 2016. 2017 followed that path again with quarter 1 at 1.2%, quarter 2 3.1%, quarter 3 3.2% and quarter 4 2.9%. The annual rate of GDP growth for 2017 was 2.3%, up from 1.6% in 2016. Unemployment in the US also fell to the lowest level for 17 years, reaching 4.1% in October to February, while wage inflation pressures, and inflationary pressures in general, have been building. The Fed has been the first major western central bank to start on an upswing in rates with six increases since the first one in December 2015 to lift the central rate to 1.50 – 1.75% in March 2018. There could be a further two or three increases in 2018 as the Fed faces a challenging situation with GDP growth trending upwards at a time when the recent Trump fiscal stimulus is likely to increase growth further, consequently increasing inflationary pressures in an economy which is already operating at near full capacity. In October 2017, the Fed also became the first major western central bank to make a start on unwinding quantitative easing by phasing in a gradual reduction in reinvesting maturing debt.

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

Japan. GDP growth has been improving to reach an annual figure of 2.1% in quarter 4 of 2017. However, it is still struggling to get inflation up to its target rate of 2% despite huge monetary and fiscal stimulus, although inflation has risen in 2018 to reach 1.5% in February. It is also making little progress on fundamental reform of the economy.

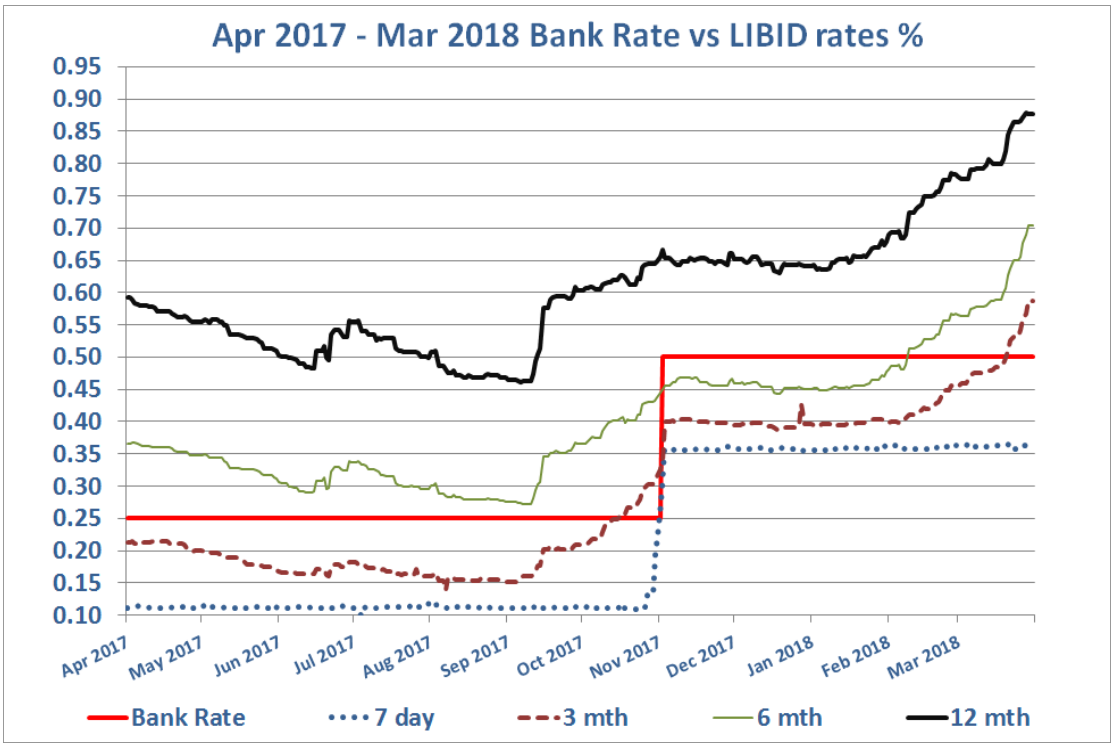
2. Borrowing Rates in 2017/18

PWLB certainty maturity borrowing rates As depicted in the graph and tables below and in appendix 3, PWLB 25 and 50 year rates have been volatile during the year with little consistent trend. However, shorter rates were on a rising trend during the second half of the year and reached peaks in February / March. During the year, the 50 year PWLB target (certainty) rate for new long term borrowing was 2.50% in quarters 1 and 3 and 2.60% in quarters 2 and 4. The graphs and tables for PWLB rates show, for a selection of maturity periods, the average borrowing rates, the high and low points in rates, spreads and individual rates at the start and the end of the financial year.



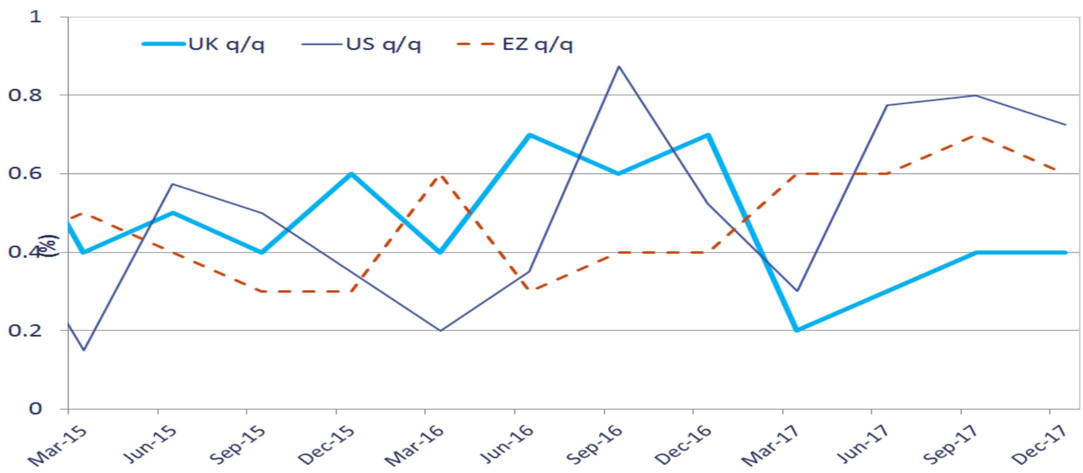
3. Investment Rates in 2017/18

Investment rates for 3 months and longer have been on a rising trend during the second half of the year in the expectation of Bank Rate increasing from its floor of 0.25%, and reached a peak at the end of March. Bank Rate was duly raised from 0.25% to 0.50% on 2.11.17 and remained at that level for the rest of the year. However, further increases are expected over the next few years. Deposit rates continued into the start of 2017/18 at previous depressed levels due, in part, to a large tranche of cheap financing being made available under the Term Funding Scheme to the banking sector by the Bank of England; this facility ended on 28.2.18.

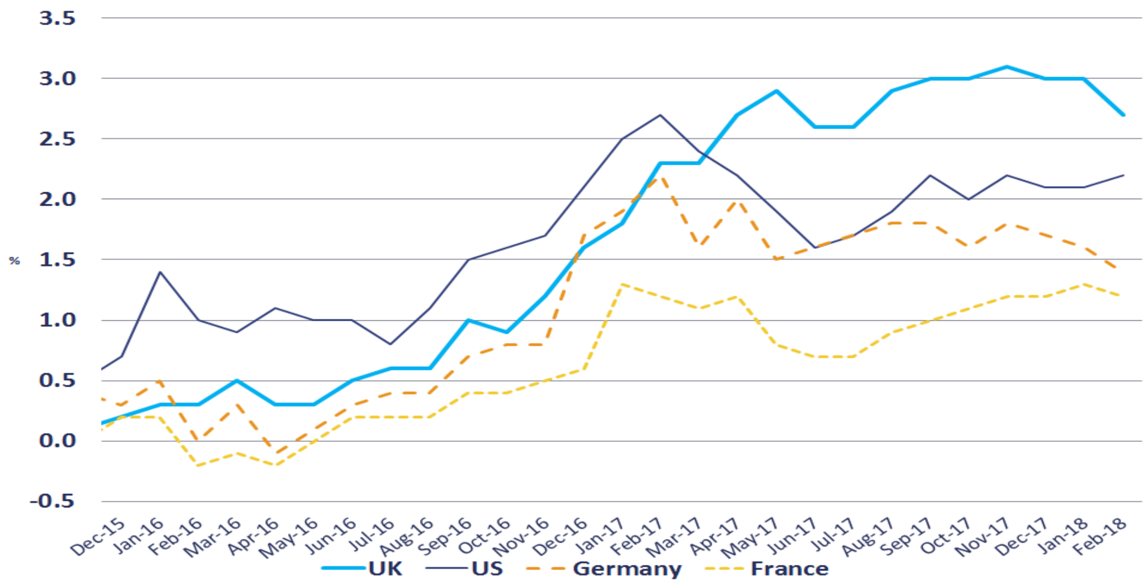


4. Other Graphs

UK, US and EZ GDP growth

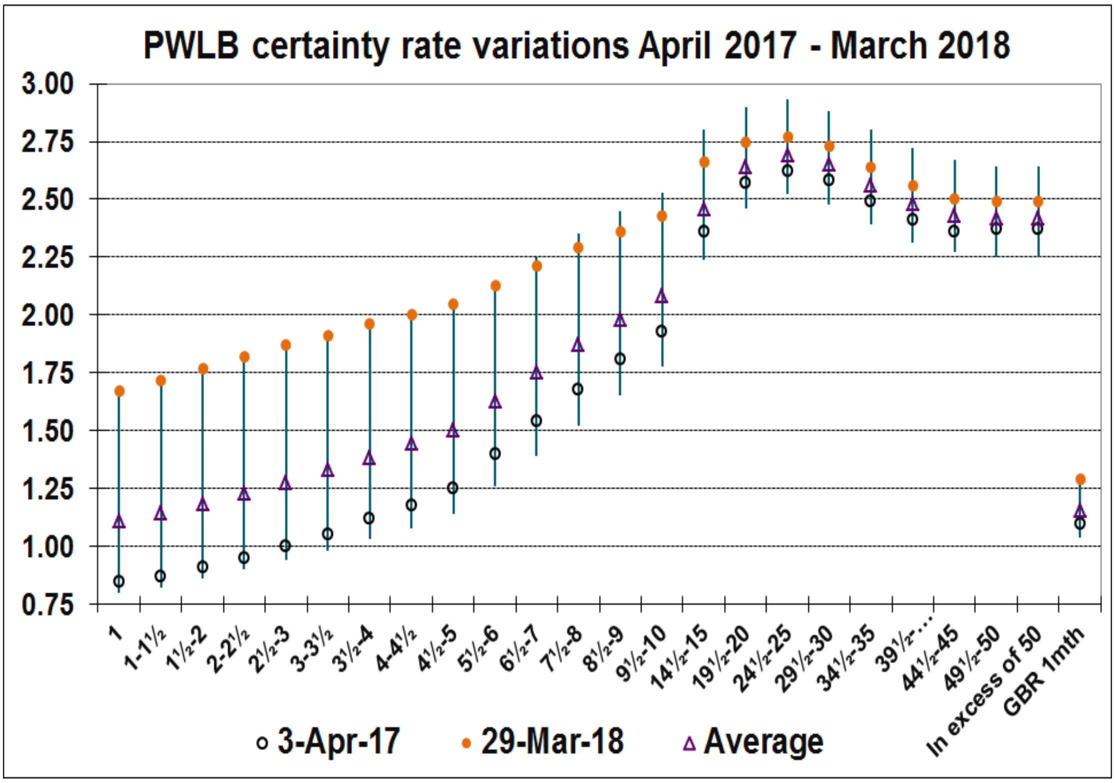


Inflation UK, US, Germany and France



5. Borrowing and investment rates

Below are supplementary graphs and tables, and the PWLB rates are based on the maturity debt certainty rate.



	1	1-1.5	2.5-3	3.5-4	4.5-5	9.5-10	24.5-25	49.5-50	1 month variable
3/4/17	0.850%	0.870%	1.000%	1.120%	1.250%	1.930%	2.620%	2.370%	1.100%
29/3/18	1.670%	1.720%	1.870%	1.960%	2.050%	2.430%	2.770%	2.490%	1.290%
High	1.510%	1.600%	1.790%	1.900%	2.010%	2.530%	2.930%	2.640%	1.310%
Low	0.800%	0.820%	0.940%	1.030%	1.140%	1.780%	2.520%	2.250%	1.040%
Average	1.107%	1.143%	1.276%	1.384%	1.503%	2.083%	2.688%	2.415%	1.157%
Spread	0.710%	0.780%	0.850%	0.870%	0.870%	0.750%	0.410%	0.390%	0.270%
High date	21/03/2018	21/03/2018	21/03/2018	21/03/2018	15/02/2018	15/02/2018	15/02/2018	15/02/2018	21/03/2018
Low date	03/05/2017	03/05/2017	30/05/2017	15/06/2017	15/06/2017	15/06/2017	08/09/2017	08/09/2017	04/04/2017

	1 Year	5 Year	10 Year	25 Year	50 Year
1/4/17	0.85%	1.25%	1.93%	2.62%	2.37%
31/3/18	1.67%	2.05%	2.43%	2.77%	2.49%
Low	0.80%	1.14%	1.78%	2.52%	2.25%
Date	03/05/2017	15/06/2017	15/06/2017	08/09/2017	08/09/2017
High	1.51%	2.01%	2.53%	2.93%	2.64%
Date	21/03/2018	15/02/2018	15/02/2018	15/02/2018	15/02/2018
Average	1.11%	1.50%	2.08%	2.69%	2.41%

6. Money market investment rates 2017/18

	7 day	1 month	3 month	6 month	1 year
1/4/17	0.111	0.132	0.212	0.366	0.593
31/3/18	0.364	0.386	0.587	0.704	0.878
High	0.366	0.390	0.587	0.704	0.879
Low	0.099	0.122	0.140	0.273	0.461
Average	0.215	0.233	0.286	0.401	0.606
Spread	0.267	0.268	0.447	0.432	0.418
High date	27/2/18	22/3/18	29/3/18	29/3/18	28/3/18
Low date	4/7/17	10/8/17	7/8/17	7/9/17	6/9/17

SOURCE LINK GROUP 2018