

## ISLE OF ANGLESEY COUNTY COUNCIL

<b>REPORT TO:</b>	<b>AUDIT COMMITTEE</b>
<b>DATE:</b>	<b>3 DECEMBER 2019</b>
<b>SUBJECT:</b>	<b>TREASURY MANAGEMENT MID-YEAR REVIEW REPORT 2019/20</b>
<b>PORTFOLIO HOLDER(S):</b>	<b>COUNCILLOR ROBIN WILLIAMS</b>
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### 1. Background

#### 1.1 Capital Strategy

In December 2017, the Chartered Institute of Public Finance and Accountancy (CIPFA), issued revised Prudential and Treasury Management Codes. As from 2019/20, all local authorities will be required to prepare a Capital Strategy which is intended to provide the following: -

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

A report setting out our Capital Strategy was taken to the Executive Committee on 18 February 2019, and a revised Strategy for 2020/21 will be taken to the full Council before 31st March 2020.

#### 1.2 Treasury Management

The Council operates a balanced budget, which broadly means cash raised during the year will meet its cash expenditure. Part of the treasury management operations ensure this cash flow is adequately planned, with surplus monies being invested in low risk counterparties, providing adequate liquidity initially before considering optimising investment return.

The second main function of the treasury management service is the funding of the Council's capital plans. These capital plans provide a guide to the borrowing need of the Council, essentially, the longer term cash flow planning to ensure the Council can meet its capital spending operations. This management of longer term cash may involve arranging long or short term loans, or using longer term cash flow surpluses and, on occasion, any debt previously drawn may be restructured to meet Council risk or cost objectives.

Accordingly, treasury management is defined as:-

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

## 2. Introduction

This report has been written in accordance with the requirements of CIPFA's Code of Practice on Treasury Management (revised 2017). The primary requirements of the Code are as follows:-

- (i) Creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the Council's treasury management activities.
- (ii) Creation and maintenance of Treasury Management Practices which set out the manner in which the Council will seek to achieve those policies and objectives.
- (iii) Receipt by the full Council of an Annual Treasury Management Strategy Statement, which includes the Annual Investment Strategy and Minimum Revenue Provision Policy for the year ahead, a Mid-year Review Report (this report) and an Annual Report, covering activities during the previous year.
- (iv) 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.
- (v) Delegation by the Council of the role of scrutiny of treasury management strategy and policies to a specific named body. For this Council, the delegated body is the Audit Committee.

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

- An economic update for the first part of the 2019/20 financial year;
- A review of the Treasury Management Strategy Statement and Annual Investment Strategy;
- The Council's capital expenditure as set out in the Capital Strategy, and prudential indicators;
- A review of the Council's investment portfolio for 2019/20;
- A review of the Council's borrowing strategy for 2019/20;
- A review of any debt rescheduling undertaken during 2019/20;
- A summary of activity since Quarter 2; and
- A review of compliance with Treasury and Prudential Limits for 2019/20.

## 3. Economic Update

3.1 The Council's treasury advisers provided an economic update and can be found in Appendix 1. They have also recently provided the following interest rate forecast:-

	Dec 2019	Mar 2020	Jun 2020	Sep 2020	Dec 2020	Mar 2021	Jun 2021	Sep 2021	Dec 2021	Mar 2022
Bank Rate (%)	0.75%	0.75%	0.75%	0.75%	0.75%	1.00%	1.00%	1.00%	1.00%	1.00%
5yr PWLB rate (%)	2.30%	2.40%	2.40%	2.50%	2.50%	2.60%	2.70%	2.80%	2.90%	2.90%
10yr PWLB rate (%)	2.60%	2.70%	2.70%	2.70%	2.80%	2.90%	3.00%	3.10%	3.20%	3.20%
25yr PWLB rate (%)	3.20%	3.30%	3.40%	3.40%	3.50%	3.60%	3.70%	3.70%	3.80%	3.90%
50yr PWLB rate (%)	3.10%	3.20%	3.30%	3.30%	3.40%	3.50%	3.60%	3.60%	3.70%	3.80%

3.2 The Council's treasury advisers recently provided a commentary alongside the interest rate forecast above. This commentary can be found in Appendix 2.

## 4. Treasury Management Strategy Statement and Annual Investment Strategy Update

4.1 The Treasury Management Strategy Statement (TMSS) for 2019/20 was approved by the full Council on 27 February 2019. There are no policy changes to the TMSS; the details in this report update the position in the light of the updated economic position and budgetary changes already approved.

## 5. Investment Portfolio 2019/20

- 5.1 In accordance with the Code, it is the Council's priority to ensure security of capital and liquidity, and to obtain an appropriate level of return which is consistent with the Council's risk appetite. As set out in Section 3, it is a very difficult investment market in terms of earning the level of interest rates commonly seen in previous decades as rates are very low and in line with the current 0.75% Bank Rate. The continuing potential for a re-emergence of a Eurozone sovereign debt crisis, and its impact on banks, prompts a low risk and short term strategy. Given this risk environment and the fact that increases in Bank Rate are likely to be gradual and unlikely to return to the levels seen in previous decades, investment returns are likely to remain low.
- 5.2 The Council held £18.551m of investments as at 30 September 2018 (£14.333m at 31 March 2019) and the investment portfolio yield for the first six months of the year was 0.62%. A full list of investments as at 30<sup>th</sup> September 2019 can be found in Appendix 3. A summary of the investments and rates can be found in Appendix 4.
- 5.3 The approved limits within the Annual Investment Strategy were not breached during the first six months of 2019/20.
- 5.4 The Council's budgeted investment return for the whole of 2019/20 is £0.031m and performance for the year to date exceeds the budget, with £0.041m received to the end of Quarter 2. The reason for this is that we invest surplus cash in other Local Authorities, creating a better investment return than a bank call account.
- 5.5 The current investment counterparty criteria selection approved in the TMSS is meeting the requirement of the treasury management function.
- 5.6 The approved countries for investments can be seen in Appendix 5.
- 5.7 The table below shows a list of investments made to other Local Authorities during the first half of this financial year. Given that security of funds is the key indicator of this Council, other Local Authorities is seen as the most secure way of investing funds, and this gives a greater rate of return than most bank call accounts.

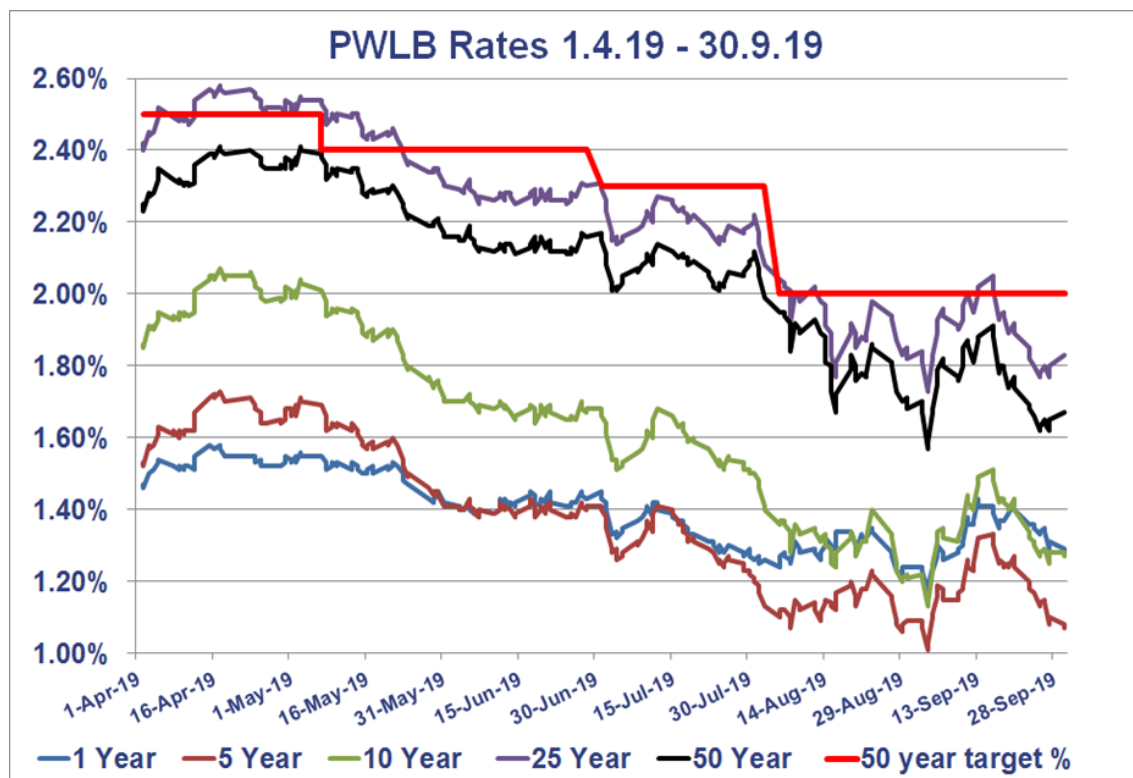
Local Authority	Start Date	End Date	Interest Rate %	Amount (£)
Central Bedfordshire Council	04/04/2019	05/07/2019	0.75%	5,000,000.00
Cheltenham Borough Council	21/08/2019	20/09/2019	0.68%	5,000,000.00
Cheltenham Borough Council	20/09/2019	25/10/2019	0.63%	5,000,000.00
Wirral Council	31/07/2019	30/08/2019	0.68%	2,000,000.00
Wirral Council	30/08/2019	30/09/2019	0.63%	2,000,000.00
Wirral Council	30/09/2019	29/10/2019	0.63%	2,000,000.00
Sutton London Borough Council	29/08/2019	25/09/2019	0.60%	5,000,000.00
Mid Suffolk District Council	24/09/2019	25/11/2019	0.65%	3,000,000.00

## 6. Borrowing

- 6.1 The projected capital financing requirement (CFR) for 2019/20 is £140.2m. The CFR denotes the Council's underlying need to borrow for capital purposes. If the CFR is positive, the Council may borrow from the PWLB or the market (external borrowing) or from internal balances on a temporary basis (internal borrowing). The balance of external and internal borrowing is generally driven by market conditions. The Council has projected year end borrowings of £127.6m and will have used £12.6m of cash flow funds in lieu of borrowing. This is a prudent and cost effective approach in the current economic climate but will require ongoing monitoring in the event that upside risk to gilt yields prevails.

**6.2** No borrowing was undertaken during the first half of this financial year, and, it is not anticipated that any additional external borrowing will need to be undertaken during the second half of the financial year. There will be a borrowing requirement to fund a part of the 2019/20 capital programme, but this will be through internal borrowing (drawing down cash balances).

The graph and table below show the movement in PWLB certainty rates for the first six months of the year to date. PWLB rates have been on a falling trend during this period and longer rates have almost halved to reach historic lows. The 50 year PWLB target (certainty) rate for new long term borrowing fell from 2.50% to 2.00% during this period: -



	1 Year	5 Year	10 Year	25 Year	50 Year
Low	1.17%	1.01%	1.13%	1.73%	1.57%
Date	03/09/2019	03/09/2019	03/09/2019	03/09/2019	03/09/2019
High	1.58%	1.73%	2.07%	2.58%	2.41%
Date	15/04/2019	17/04/2019	17/04/2019	17/04/2019	17/04/2019
Average	1.40%	1.37%	1.62%	2.20%	2.07%

**6.3** On 9 October 2019, the Treasury and PWLB announced an increase in the borrowing rate by 100 basis points (1%). There was no prior warning that this would happen and it now means that every local authority has to fundamentally reassess how to finance their external borrowing needs and the financial viability of capital projects in their capital programme due to this unexpected increase in the cost of borrowing. Representations are going to be made to HM Treasury to suggest that areas of capital expenditure that the Government are keen to see move forward, e.g. housing, should not be subject to such a large increase in borrowing.

Whereas this Authority has previously relied on the PWLB as its main source of funding, it now has to fundamentally reconsider alternative cheaper sources of borrowing. At the current time, this is a developmental area as this event has also taken the financial services industry by surprise. We are expecting that various financial institutions will enter the market or make products available to local authorities. Members will be updated as this area evolves.

It is possible that the Municipal Bond Agency will be offering loans to local authorities in the future. This Authority may make use of this new source of borrowing as and when appropriate.

- 6.4** Debt rescheduling opportunities have been very limited in the current economic climate, given the consequent structure of interest rates and following the increase in the margin added to gilt yields which has impacted PWLB new borrowing rates since October 2010. No debt rescheduling has, therefore, been undertaken to date in the current financial year. The 100bps increase in PWLB rates from 9 October 2019 only applied to new borrowing rates, not to premature repayment rates.

## **7 The Council's Capital Position (Prudential Indicators)**

**7.1** This part of the report is structured to update:-

- The Council's capital expenditure plans;
- How these plans are being financed;
- The impact of the changes in the capital expenditure plans on the prudential indicators and the underlying need to borrow; and
- Compliance with the limits in place for borrowing activity.

### **7.2 Prudential Indicator for Capital Expenditure**

This table shows the revised estimates for capital expenditure in comparison to the capital budget:-

<b>Capital Expenditure</b>	<b>2019/20 Original Estimate</b>	<b>Position as at 30 September 2019</b>	<b>2019/20 Current Estimate</b>
	<b>£'000</b>	<b>£'000</b>	<b>£'000</b>
Council Fund	25,910	5,768	16,823
HRA	14,117	5,267	14,307
<b>Total</b>	<b>40,027</b>	<b>11,035</b>	<b>31,130</b>

**7.2.1** The projected expenditure shows that the majority of projects are on target to be completed within budget but there are 3 major projects (Gypsy and Travellers Sites, 21st Century School Band A modernization and Holyhead Strategic Infrastructure) which are expected to significantly underspend the budget in 2019/20, and this is reflected in the above table. A full breakdown on the planned capital expenditure for 2019/20 is provided in the Capital Budget Monitoring Report Q2, presented to the Executive on 25 November 2019.

### **7.3 Changes to the Financing of the Capital Programme**

**7.3.1** There are some changes to the financing of the capital programme as can be seen in the table below. The main reason for the change is as noted in paragraph 7.2.1, there will be significant underspend on three capital schemes in 2019/20. However, these three schemes will slip into 2020/21 along with their funding and it is not anticipated, at this point, that any funding will be lost due to the delays.

**7.3.2** The table below draws together the main strategy elements of the capital expenditure plans (above), highlighting the original funding of the capital programme, and the expected funding arrangements of this capital expenditure. The borrowing element of the table increases the underlying indebtedness of the Council by way of the Capital Financing Requirement (CFR), although this will be reduced in part by revenue charges for the repayment of debt (the Minimum Revenue Provision). This direct borrowing need may also be supplemented by maturing debt and other treasury requirements.

<b>Capital Financing</b>	<b>2019/20 Original Estimate £'000</b>	<b>2019/20 Revised Estimate £'000</b>
Capital Grants	22,684	14,381
Capital Receipts	774	1,612
Reserves	186	186
Revenue Contribution	9,952	10,142
Supported Borrowing	5,973	3,942
Unsupported Borrowing	454	863
Loan	4	4
<b>Total</b>	<b>40,027</b>	<b>31,130</b>

#### 7.4 Changes to the Prudential Indicators for the Capital Financing Requirement (CFR), External Debt and the Operational Boundary

7.4.1 Table 7.4.3 below shows the CFR, which is the underlying external need to incur borrowing for a capital purpose. It also shows the expected debt position over the period. This is termed the Operational Boundary, which is set annually by the Council as part of the Treasury Management Strategy Statement.

##### 7.4.2 Prudential Indicator – Capital Financing Requirement

	<b>2019/20 Operational Boundary as per TMSS 2018/19  £000</b>	<b>2019/20 Opening Borrowing Position  £000</b>	<b>Amount Within the Boundary  £000</b>	<b>2019/20 Estimated Borrowing Position  £000</b>	<b>Amount Within The Boundary  £000</b>
<b><i>Prudential Indicator – External Debt/ The Operational Boundary</i></b>					
Borrowing	170,000	132,549	37,451	126,404	43,596
Other long term liabilities	3,000	1,133	1,867	1,214	1,786
<b>Total Debt 31 March</b>	<b>173,000</b>	<b>133,682</b>	<b>39,318</b>	<b>127,618</b>	<b>45,382</b>

##### 7.4.3 Prudential Indicator – Capital Financing Requirement (CFR)

7.4.3.1 We are currently slightly below the original forecast Capital Financing Requirement due to the forecast underspend in borrowing, mainly down to the 21<sup>st</sup> Century Schools Programme.

	<b>2019/20 Original Estimate £000</b>	<b>2019/20 Revised Estimate £000</b>
<b><i>Prudential Indicator – Capital Financing Requirement</i></b>		
CFR – Council Fund	104,103	100,171
CFR – HRA	40,998	39,998
Total CFR	145,101	140,169
<b>Net movement in CFR</b>	<b>3,910</b>	<b>1,509</b>

<b>Original CFR Forecast</b>	<b>145,101</b>
Reduced MRP due to underspend in Borrowing in 2018/19	154
Underspend in Unsupported Borrowing for HRA in 2019/20	-1,000
Increase in Unsupported Borrowing in 2018/19 and 2019/20 due to higher weighting of funding through unsupported borrowing in the 21 <sup>st</sup> Century Schools programme. Also, an additional 2 leisure schemes funded by Unsupported Borrowing in 2018/19 capital programme.	915
Underspend in Supported Borrowing in 2018/19 due to additional grant received in 2018/19 as substitute funding which reduced the need for Supported Borrowing. Also there was a reduced weighting of funding through Supported Borrowing in the 21 <sup>st</sup> Century Schools programme.	-5,001
<b>Revised CFR Forecast</b>	<b>140,169</b>

## 7.5 Limits to Borrowing Activity

**7.5.1** The first key control over the treasury activity is a prudential indicator to ensure that, over the medium term, net borrowing (borrowings less investments) will only be for a capital purpose. Gross external borrowing should not, except in the short term, exceed the total of CFR in the preceding year plus the estimates of any additional CFR for 2019/20 and the next two financial years. This allows some flexibility for limited early borrowing for future years. The Council has approved a policy for borrowing in advance of need, which will be adhered to if this proves prudent. The current borrowing position is £126.409m, which is below the CFR forecast for this and the next two financial years (see table below), therefore, this indicator has not been breached.

	<b>2019/20 £000</b>	<b>2020/21</b>	<b>2021/22 £000</b>
<b>CFR (year-end forecast)</b>	<b>140,169</b>	<b>158,469</b>	<b>174,821</b>

	<b>2019/20 Original Estimate £000</b>	<b>Current Position at 30 September 2019 £000</b>	<b>2019/20 Revised Estimate £000</b>
External Borrowing	132,549	126,409	126,404
Internal Borrowing	11,338	12,546	12,551
Plus other long term liabilities	1,214	1,214	1,214
<b>CFR (year-end position)</b>	<b>145,101</b>	<b>140,169</b>	<b>140,169</b>

**7.5.2** It is not envisaged that there will be any difficulties for the current year in complying with this prudential indicator.

**7.5.3** A further prudential indicator controls the overall level of borrowing. This is the Authorised Limit which represents the limit beyond which borrowing is prohibited, and needs to be set and revised by Members, currently £178m. It reflects the level of borrowing which, while not desired, could be afforded in the short term, but is not sustainable in the longer term. It is the expected maximum borrowing need with some headroom for unexpected movements. This is the statutory limit determined under Section 3 (1) of the Local Government Act 2003.

<b>Authorised Limit for External Debt</b>	<b>2019/20 Original Indicator</b>	<b>Current Borrowing Position as at 30 September 2019 £'000</b>	<b>Estimated Borrowing Position as at 31 March 2020 £'000</b>
Borrowing	175,000	126,409	126,404
Other long term liabilities	3,000	1,214	1,214
<b>Total</b>	<b>178,000</b>	<b>127,623</b>	<b>127,918</b>

## **8. Recommendation**

**8.1** To consider the content of the report and forward any comments onto the Executive.



## Diweddariad ar yr Economi hyd yma a'r rhagolygon / Economic Update & Forecasts

**United Kingdom** - This first half year has been a time of upheaval on the political front as Theresa May resigned as Prime Minister to be replaced by Boris Johnson on a platform of the UK leaving the EU on or 31 October, with or without a deal. However, in September, his proroguing of Parliament was overturned by the Supreme Court and Parliament carried a bill to delay Brexit until 31 January 2020 if there is no deal by 31 October. MPs also voted down holding a general election before 31 October, though one is likely before the end of 2019. So far, there has been no majority of MPs for any one option to move forward on enabling Brexit to be implemented. At the time of writing the whole Brexit situation is highly fluid and could change radically by the day. Given these circumstances and the likelihood of an imminent general election, any interest rate forecasts are subject to material change as the situation evolves. If the UK does soon achieve a deal on Brexit agreed with the EU 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; this could cause wage inflation to accelerate which would then feed through into general inflation. On the other hand, if there was a no deal Brexit and there was a significant level of disruption to the economy, then growth could weaken even further than currently and the MPC would be likely to cut Bank Rate in order to support growth. However, with Bank Rate still only at 0.75%, it has relatively little room to make a big impact and the MPC 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 first half of 2019/20 has seen UK **economic growth** fall as Brexit uncertainty took a toll. In its Inflation Report of 1 August, the Bank of England was notably downbeat about the outlook for both the UK and major world economies. The MPC meeting of 19 September reemphasised their concern about the downturn in world growth and also expressed concern that prolonged Brexit uncertainty would contribute to a build-up of spare capacity in the UK economy, especially in the context of a downturn in world growth. This mirrored investor concerns around the world which are now expecting a significant downturn or possibly even a recession in some major developed economies. It 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 the new Prime Minister is making some significant promises 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. It is likely to remain close to 2% over the next two years and so it does not pose any immediate concern to the MPC at the current time. However, if there was a no deal Brexit, inflation could rise towards 4%, primarily as a result of imported inflation on the back of a weakening pound.

With regard to the **labour market**, despite the contraction in quarterly GDP growth of -0.2% q/q, (+1.3% y/y), in quarter 2, employment continued to rise, but at only a muted rate of 31,000 in the three months to July after having risen by no less than 115,000 in quarter 2 itself: the latter figure, in particular, suggests that firms are preparing to expand output and suggests there could be a return to positive growth in quarter 3. Unemployment continued at a 44 year low of 3.8% on the Independent Labour Organisation measure in July and the participation rate of 76.1% achieved a new all-time high. Job vacancies fell for a seventh consecutive month after having previously hit record levels. However, with unemployment continuing to fall, this month by 11,000, employers will still be having difficulty filling job vacancies with suitable staff. It was therefore unsurprising that wage inflation picked up to a high point of 3.9% in June before easing back slightly to 3.8% in July, (3 month average regular pay, excluding bonuses). This meant that in real terms, (i.e. wage rates higher than CPI inflation), earnings grew by about 2.1%. As the UK economy is very much services sector driven, an increase in household spending power is likely to feed through into providing some support to the overall rate of economic growth in the coming months. The latest GDP statistics also included a revision of the savings ratio from 4.1% to 6.4% which provides reassurance that consumers' balance sheets are not over stretched and so will be able to support growth going forward. This would then mean that the MPC will need to consider carefully at what point to take action to raise Bank Rate if there is an agreed Brexit deal, as the recent pick-up in wage costs is consistent with a rise in core services inflation to more than 4% in 2020.

In the **political arena**, if there is a general election soon, this 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.

**United States of America** - President Trump's massive easing of fiscal policy in 2018 fuelled a temporary boost in consumption in that year which generated an upturn in the rate of strong growth to 2.9% y/y. Growth in 2019 has been falling back after a strong start in quarter 1 at 3.1%, (annualised rate), to 2.0% in quarter 2. Quarter 3 is expected to fall further. The strong growth in employment numbers during 2018 has reversed into a falling trend during 2019, indicating that the economy is cooling, while inflationary pressures are also weakening. The 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 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. Investor confidence has been badly rattled by the progressive ramping up of increases in tariffs. President Trump has made on Chinese imports and China has responded with increases in tariffs on American imports. This trade war is seen as depressing US, Chinese and world growth. In the EU, it is also particularly impacting Germany as exports of goods and services are equivalent to 46% of total GDP. It will also impact developing countries dependent on exporting commodities to China.

**Eurozone** - Growth has been slowing from +1.8 % during 2018 to around half of that in 2019. Growth was +0.4% q/q (+1.2% y/y) in quarter 1 and then fell to +0.2% q/q (+1.0% y/y) in quarter 2; there appears to be little upside potential to the growth rate in the rest of 2019. German GDP growth fell to -0.1% in quarter 2; industrial production was down 4% y/y in June with car production down 10% y/y. Germany would be particularly vulnerable to a no deal Brexit depressing exports further and if President Trump imposes tariffs on EU produced cars. The European Central Bank (ECB) ended its programme of quantitative easing purchases of debt in December 2018, which meant that the central banks in the US, UK and EU had all ended the phase of post financial crisis expansion of liquidity supporting world financial markets by purchases of debt. However, the downturn in 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 is 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 so at its meeting on 12 September, it cut its deposit rate further into negative territory, from -0.4% to -0.5%, and announced a resumption of quantitative easing purchases of debt. It also increased the maturity of the third round of TLTROs from two to three years. However, it is doubtful whether this loosening of monetary policy will have much impact on growth and unsurprisingly, the ECB stated that governments will need to help stimulate growth by fiscal policy. On the political front, Austria, Spain and Italy are in the throes of forming coalition governments with some unlikely combinations of parties i.e. this raises questions around their likely endurance. The recent results of two German state elections will put further pressure on the frail German CDU/SPD coalition government.

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

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

**World Growth** - The trade war between the US and China is a major concern to financial markets and is depressing worldwide growth, as any downturn in China will spill over into impacting countries supplying raw materials to China. Concerns are focused on the synchronised general weakening of growth in the major economies of the world compounded by fears that there could even be a recession looming up in the US, though this is probably overblown. These concerns have resulted in government bond yields in the developed world falling significantly during 2019. If there were a major worldwide downturn in growth, central banks in most of the major economies will have limited ammunition available, in terms of monetary policy measures, when rates are already very low in most countries, (apart from the US), and there are concerns about how much distortion of financial markets has already occurred with the current levels of quantitative easing purchases of debt by central banks. The latest PMI survey statistics of economic health for the US, UK, EU and China have all been sub 50 which gives a forward indication of a downturn in growth; this confirms investor sentiment that the outlook for growth during the rest of this financial year is weak.

## Sylwadau ar y rhagolygon diweddaraf ar raddfeydd llog / Commentary on the latest interest rates forecasts

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. In its meeting on 1 August, the MPC became more dovish as it was more concerned about the outlook for both the global and domestic economies. That's shown in the policy statement, based on an assumption that there is an agreed deal on Brexit, where the suggestion that rates would need to rise at a "gradual pace and to a limited extent" is now also conditional on "some recovery in global growth". Brexit uncertainty has had a dampening effect on UK GDP growth in 2019, especially around mid-year. If there were a no deal Brexit, then it is likely that there will be a cut or cuts in Bank Rate to help support economic growth. The September MPC meeting sounded even more concern about world growth and the effect that prolonged Brexit uncertainty is likely to have on growth.

**Bond yields / PWLB rates** - There has been much speculation recently that we are currently in a bond market bubble. However, given the context that there are heightened expectations that the US could be heading for a recession, 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 major impact on consumer spending, inflation, etc. This has pulled down the overall level of interest rates and bond yields in financial markets over the last thirty years. We have therefore seen over the last year, many bond yields up to ten years in the Eurozone actually turn negative. In addition, there has, at times, been an inversion of bond yields in the US whereby ten year yields have fallen below shorter term yields. In the past, this has been a precursor of a recession. The other side of this coin is that bond prices are elevated as investors would be expected to be moving out of riskier assets i.e. shares, in anticipation of a downturn in corporate earnings and so selling out of equities. However, stock markets are also currently at high levels as some investors have focused on chasing returns in the context of dismal ultra-low interest rates on cash deposits.

What we saw during the last half year up to 30 September is a near halving of longer term PWLB rates to completely unprecedented historic low levels. (*See paragraph 7 for comments on the increase in margin over gilt yields of 100bps introduced on 9.10.19.*) There is though, an expectation that financial markets have gone too far in their fears about the degree of the downturn in US and world growth. If, as expected, the US only suffers a mild downturn in growth, bond markets in the US are likely to sell off and that would be expected to put upward pressure on bond yields, not only in the US, but due to a correlation between US treasuries and UK gilts, which at various times has been strong but at other times weaker, in the UK. However, forecasting the timing of this and how strong the correlation is likely to be, is very difficult to forecast with any degree of confidence.

One potential danger that may be lurking in investor minds is that Japan has become mired in a twenty year bog of failing to get economic growth and inflation up off the floor, despite a combination of massive monetary and fiscal stimulus by both the central bank and government. Investors could be fretting that this condition might become contagious.

Another danger is that unconventional monetary policy post 2008, (ultra-low interest rates plus quantitative easing), may end up doing more harm than good through prolonged use. Low interest rates have encouraged a debt fuelled boom which now makes it harder for economies to raise interest rates. Negative interest rates could damage the profitability of commercial banks and so impair their ability to lend and / or push them into riskier lending. Banks could also end up holding large amounts of their government's bonds and so create a potential doom loop. (A doom loop would occur where the credit rating of the debt of a nation was downgraded which would cause bond prices to fall, causing losses on debt portfolios held by banks and insurers, so reducing their capital and forcing them to sell bonds – which, in turn, would cause further falls in their prices etc.). In addition, the financial viability of pension funds could be damaged by low yields on holdings of bonds.

## The balance of risks to the UK

- The overall balance of risks to economic growth in the UK is probably to the downside due to the weight of all the uncertainties over Brexit, as well as a softening global economic picture.
- The balance of risks to increases in Bank Rate and shorter term PWLB rates are broadly similarly to the downside.

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

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

- **Brexit** – if it were to cause significant economic disruption and a major downturn in the rate of growth.
- **Bank of England** takes action too quickly, or too far, over the next three years to raise Bank Rate and causes UK economic growth, and increases in inflation, to be weaker than we currently anticipate.
- A resurgence of the **Eurozone sovereign debt** crisis. In 2018, Italy was a major concern due to having a populist coalition government which made a lot of anti-austerity and anti-EU noise. However, in September 2019 there was a major change in the coalition governing Italy which has brought to power a much more EU friendly government; this has eased the pressure on Italian bonds. Only time will tell whether this new 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. Then in October 2018, the results of the Bavarian and Hesse state elections radically undermined the SPD party and showed a sharp fall in support for the CDU. As a result, the SPD had a major internal debate as to whether it could continue to support a coalition that is so damaging to its electoral popularity. After the result of the Hesse state election, Angela Merkel announced that she would not stand for re-election as CDU party leader at her party's convention in December 2018. However, this makes little practical difference as she has continued as Chancellor, though more recently concerns have arisen over her health.
- **Other minority EU governments.** Austria, Sweden, Spain, Portugal, Netherlands and Belgium all have vulnerable minority governments dependent on coalitions which could prove fragile.
- **Italy, Austria, the Czech Republic and Hungary** now form a strongly anti-immigration bloc within the EU. There has also been rising anti-immigration sentiment in Germany and France.
- There are concerns around the level of **US corporate debt** which has swollen massively during the period of low borrowing rates in order to finance mergers and acquisitions. This has resulted in the debt of many large corporations being downgraded to a BBB credit rating, close to junk status. Indeed, 48% of total investment grade corporate debt is rated at BBB. If such corporations fail to generate profits and cash flow to reduce their debt levels as expected, this could tip their debt into junk ratings which will increase their cost of financing and further negatively impact profits and cash flow.
- **Geopolitical risks**, for example in North Korea, but also in Europe and the Middle East, which could lead to increasing safe haven flows.

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

- **Brexit** – if agreement was reached all round that removed all threats of economic and political disruption between the EU and the UK.
- **The Bank of England** is too slow in its pace and strength of increases in Bank Rate and, therefore, allows inflationary pressures to build up too strongly within the UK economy, which then necessitates a later rapid series of increases in Bank Rate faster than we currently expect.

**UK inflation**, whether domestically generated or imported, returning to sustained significantly higher levels causing an increase in the inflation premium inherent to gilt yields.

**Crynodeb Benthycyca a Buddsoddi – Chwarteroedd 1 a 2 2019/20**  
**Borrowing and Investment Summary – Quarters 1 and 2 2019/20**

	30 Medi / Sept 2019		30 Mehefin / June 2019	
	£m	% (paid on borrowing and received on investment)	£m	% (paid on borrowing and received on investment)
Benthycyca – graddfa sefydlog Borrowing – fixed rate	126.4	4.73	126.4	4.73
Benthycyca – graddfa amrywiol Borrowing – variable rate	Dim / Nil	d/b / n/a	Dim / Nil	d/b / n/a
Adneuon – galw hyd at 30 diwrnod Deposits – Call to 30 days	8.5	0.57	12.3	0.49
Adneuon – Tymor sefydlog < 1 bl. Deposits – Fixed Term < 1 year	10.0	0.64	5.0	0.75
Adneuon – Tymor sefydlog 1 bl. + Deposits – Fixed Term 1 year +	Dim / Nil	d/b / n/a	Dim / Nil	d/b / n/a
Cyfanswm Adneuon Total Deposits	18.5	0.61	17.3	0.57
Adneuon Uchaf yn y Chwarter Highest Deposits in the Quarter	26.1	d/b / n/a	27.1	d/b / n/a
Adneuon Isaf yn y Chwarter Lowest Deposits in the Quarter	14.0	d/b / n/a	13.7	d/b / n/a
Cyfartaledd Adneuon yn y Chwarter Average Deposits in the Quarter	20.9	0.54	22.9	0.54

Ni dorwyd unrhyw un o'r dangosyddion trysorlys yn ystod hanner cyntaf y flwyddyn.  
None of the treasury indicators were breached during the first half of the year.

**Graddfeydd Credyd Gwrthbartion buddsoddi a'r adneuron a ddelir gyda phob un ar 30 Medi 2019\***  
**Credit ratings of investment counterparties and deposits held with each as at 30 September 2019\***

Grŵp Bancio/ Banking Group	Sefydliad/ Institution	Adneuron / Deposit £'000	Hyd (Galw/ tymor sefydlog) / Duration (Call / Fixed Term**)	Cyfnod (O / I) / Period (From / To)	Graddfa Dychweliad/ Rate of Return %	Graddfa Tymor Hir Fitch Long Term Rating	Graddfa Tymor Byr Fitch Short Term Rating	Graddfa Tymor Hir Moody's Long Term Rating	Graddfa Tymor Byr Moody's Short Term Rating	Graddfa Tymor Hir Standard & Poor's Long Term Rating	Graddfa Tymor Byr Standard & Poor's Short Term Rating	Lliw Sector/Hyd Awgrymiedig/ Sector Colour / Suggested Duration
Lloyds Banking Group plc	Bank of Scotland plc	7.494	Galw/ Call	n/a	0.65	A+	F1	Aa3	P-1	A+	A-1	Glas – 12 mis/ Blue -12m months
Santander Group plc	Santander UK plc	0.001	Galw/ Call	n/a	0.40	A+	F1	Aa3	P-1	A	A-1	Coch – 6 mis/ Red - 6 months
The Royal Bank of Scotland Group plc	The Royal Bank of Scotland plc (Part / Nationalised)	0.002	Galw/ Call	n/a	0.20	A+	F1	A1	P-1	A	A-1	Glas - 12 mis / Blue - 12 months
The Royal Bank of Scotland Group plc	National Westminster Bank Deposit	1.055	Galw/ Call	n/a	0.30	A+	F1	A1	P-1	A	A-1	Glas - 12 mis / Blue - 12 months
Cheltenham Council	Cheltenham Council	5.000	Sefydlog/ Fixed	20/09/19 - 25/10/19	0.63	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Mid Suffolk Council	Mid Suffolk Council	3.000	Sefydlog/ Fixed	24/09/19 – 25/11/19	0.65	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Wirral Council	Wirral Council	2.000	Sefydlog/ Fixed	30/09/19 – 29/10/19	0.63	n/a	n/a	n/a	n/a	n/a	n/a	n/a

\* Ceir y Rhestr Benthycu Cymeradwyedig yn Atodiad 6 o'r Datganiad Strategaeth Rheoli Trysorlys 2019/20/Strategaeth Buddsoddi Blynnyddol/The Approved Lending List can be found at Appendix 6 of the 2019/20 Treasury Management Strategy Statement / Annual Investment Strategy

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



**Approved countries for investments**

*Based upon lowest available sovereign credit rating*

AAA

- Australia
- Canada
- Denmark
- Germany
- Luxembourg
- Netherlands
- Norway
- Singapore
- Sweden
- Switzerland

AA+

- Finland
- U.S.A.

AA

- Abu Dhabi (UAE)
- France
- Hong Kong
- U.K.

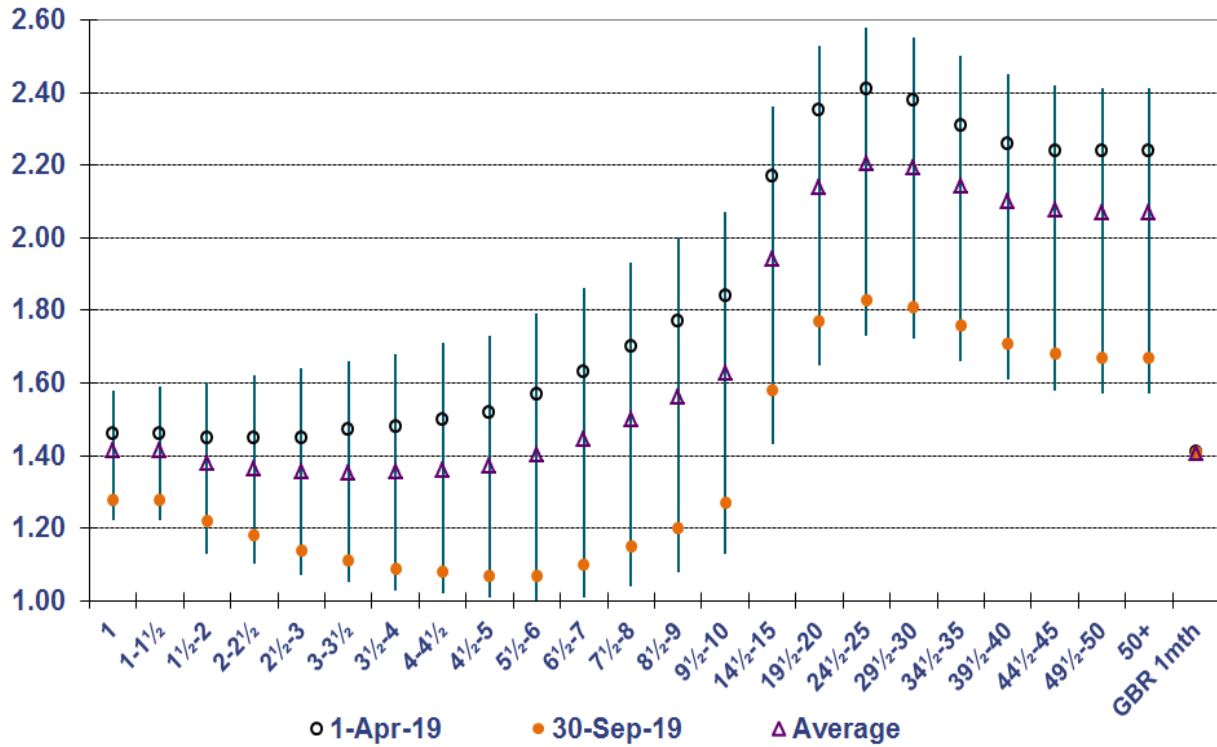
AA-

- Belgium
- Qatar

Graffiau Ychwanegol / Additional Graphs

Comparison of borrowing parameters to actual external borrowing

**PWLB Certainty Rate Variations to 30.9.2019**



**Bank Rate vs LIBID rates % 1.4.19 - 30.9.19**

