8. TREASURY MANAGEMENT STRATEGY STATEMENT AND ANNUAL INVESTMENT STRATEGY 2018/19 TO 2020/21

REPORT OF:	Head of Corporate Resources
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Wards Affected:	All
Key Decision:	No
Report to:	Council 28 March 2018

Purpose of Report

1. This report sets out the Council's investment and borrowing strategy for the forthcoming three years and reports the counterparty list with which investments may be made. It also sets out the Prudential Limits that provide the parameters for approved future lending and borrowing, including the incidental cost of so doing.

Summary

2. The purchase of the Orchard Shopping Centre head lease in November 2016 necessitated borrowing of £22m from other Local Authorities. £10m was repaid in 2017 and £5m will be repaid in November 2018, using the cash flow generated by matured fixed term deposits.

3. Except for the addition of the UK registered Goldman Sachs International Bank, which was approved together with the half year treasury management report in November 2017, lending is restricted to the same counterparties and within the same limits as in the previous strategy approved in March 2017.

4. The Audit Committee considered this Strategy Statement at its meeting on 8th March and, after some questions which were satisfactorily answered, were content to recommend its agreement by Council.

Recommendations

5. The Council is recommended to agree:

- **(i) the proposed Treasury Management Strategy Statement (TMSS) for 2018/19 and the following two years;**
- **(ii) the Annual Investment Strategy (AIS) and the Minimum Revenue Provision Statement (MRP) as contained in Sections 5 and 3.3 respectively of the report;**
- **(iii) the Prudential Indicators contained within this report.**

Background

6. The Council applies and upholds the Chartered Institute of Public Finance and Accountancy's Code of Practice for Treasury Management in Public Services (the "CIPFA TM Code"). CIPFA has defined Treasury Management as:

"the management of the organisation's investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks

associated with those activities; and the pursuit of optimum performance consistent with those risks."

7. The Code requires local authorities to produce an annual Treasury Management Strategy Statement (TMSS), which documents the Council's approach to capital financing and investments for the forthcoming financial year (2018/19) and the following two years. This report fulfils that requirement.

8. In producing the TMSS, The Local Government Act 2003 (the Act) and supporting regulations require the Council to 'have regard to' the CIPFA Prudential Code and the CIPFA Treasury Management Code of Practice to set Prudential and Treasury Indicators for the next three years. The indicators are established to ensure that the Council's capital investment plans are affordable, prudent and sustainable.

9. Additionally, the Act and its subsequent Investment Guidance require the Council to set out its treasury management strategy for borrowing, and to prepare an Annual Investment Strategy (AIS). The Council's borrowing position is reported in Section 4, with arrangements for making Minimum Revenue Provision (MRP) for repayment of debt explained in Section 3.3. The AIS is contained in Section 5 of this report, and describes the Council's policies for managing its investments, and for giving priority to the security and liquidity of those investments.

10. Statute requires that the AIS, MRP Statement, and Prudential Indicators are approved by full Council before the start of the new financial year.

Policy Context

11. Providing transparency and approval of the strategies contained in this report is an important part of the Council's statutory role. Treasury Management has become increasingly topical given the nature of the world's financial markets in recent years, and Members are expected to have a basic understanding of how the Council uses its reserves and cash flows which are in the stewardship of the Head of Corporate Resources.

Other Options Considered

12. None – this report is statutorily required.

Financial Implications

13. This report has no quantifiable financial implications. Interest payable and interest receivable arising from treasury management operations, and annual revenue provisions for repayment of debt, form part of the revenue budget but are not required to support the provision of services.

Risk Management Implications

14. This report has no specific implications for the risk profile of the Authority.

Equality and Customer Service Implications

15. None.

Background Papers

- Treasury Management Strategy Statement & Annual Investment Strategy 2017/18 to 2019/20 (March 2017)
- Annual Review of Treasury Management 2016-17 (August 2017)
- Review of Treasury Management Activity 1 April – 30 September 2017 (Nov. 2017)
- Treasury Management in the Public Services: Code of Practice and Cross Sectoral Guidance Notes (CIPFA, December 2017)
- The Prudential Code for Capital Finance in Local Authorities (CIPFA, December 2017)
- Department for Communities & Local Government Investment Guidance (Revised) April 2010)
- Link Asset Services report template (January 2018)

Treasury Management Strategy Statement & Annual Investment 2018/19 to 2020/21

INTRODUCTION

1.1 **Background**

The Council is required to operate a balanced budget, which broadly means that cash raised during the year will meet cash expenditure. Part of the treasury management operation is to ensure that this cash flow is adequately planned, with cash being available when it is needed. Surplus monies are invested in low risk counterparties or instruments commensurate with the Council's low risk appetite, providing adequate liquidity initially before considering 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 that the Council can meet its capital spending obligations. This management of longer term cash may involve arranging long or short term loans, or using longer term cash flow surpluses. On occasion any debt previously drawn may be restructured to meet Council risk or cost objectives.

1.2 **Reporting requirements**

The Council is required to receive and approve, as a minimum, three main reports each year, which incorporate a variety of policies, estimates and actuals:

Prudential and treasury indicators and treasury strategy (this report) - the first, and most important report covers:

- the capital plans (including prudential indicators);
- a minimum revenue provision (MRP) policy (how residual capital expenditure is charged to revenue over time);
- the treasury management strategy (how the investments and borrowings are to be organised) including treasury indicators; and
- an investment strategy (the parameters on how investments are to be managed).

The approval of the Treasury Management Strategy and Annual Investment Strategy is the function of the Council, however the Head of Corporate Resources shall also report to the Audit Committee on treasury management activity performance as follows:

A mid year treasury management report – This will update Members with the progress of the capital position, amending prudential indicators as necessary, and whether any policies require revision. The report will be submitted as soon after 30 September as practically possible.

An annual treasury report – This provides details of a selection of actual prudential and treasury indicators and actual treasury operations compared to the estimates within the strategy. The report will be submitted no later than 30 September after the financial year end.

Scrutiny - The above reports are required to be adequately scrutinised before being recommended to the Council. This role is undertaken by the Audit Committee, which may make recommendations regarding any aspects of treasury management policy and practices it considers appropriate in fulfilment of its scrutiny role. Such recommendations, as may be made shall be incorporated within the above named reports and submitted to meetings of the Council for consideration at the next available opportunity.

The Council's Scheme of Delegations is set out in Appendix 4

Capital Strategy

In December 2017, CIPFA issued revised Prudential and Treasury Management Codes. As from 2019-20, all local authorities will be required to prepare an additional report, a Capital Strategy report, 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
- the implications for future financial sustainability

The aim of this report is to ensure that all elected Members on the full council fully understand the overall strategy, governance procedures and risk appetite entailed by this Strategy. The Capital Strategy will include capital expenditure, investments and liabilities and treasury management in sufficient detail to allow all Members to understand how stewardship, value for money, prudence, sustainability and affordability will be secured.

1.3 **Treasury Management Strategy for 2018/19**

The strategy for 2018/19 covers two main areas:

Capital issues

- the capital plans and the prudential indicators;
- the minimum revenue provision (MRP) policy.

Treasury management issues

- the current treasury position;
- treasury indicators which limit the treasury risk and activities of the Council;
- prospects for interest rates;
- the borrowing strategy;
- policy on borrowing in advance of need;
- debt rescheduling;
- the investment strategy;
- creditworthiness policy; and
- policy on use of external service providers.

These elements cover the requirements of the Local Government Act 2003, the CIPFA Prudential Code, CLG MRP Guidance, the CIPFA Treasury Management Code and CLG Investment Guidance.

1.4 **Training**

The CIPFA Code requires the responsible officer to ensure that Members with responsibility for treasury management receive adequate training. This especially applies to Members responsible for scrutiny. During 2018/19 appropriate mandatory treasury management training will be provided to the Audit Committee by Link Asset Services. The training needs of the treasury management officers at Adur District Council, who provide the shared treasury service to Mid Sussex District Council, are periodically reviewed. Officers attend courses provided by appropriate trainers such as CIPFA and Link Asset Services.

1.5 **External Service Providers**

The Council obtains treasury management services under a Shared Services Arrangement (SSA) from the in-house treasury management team formed out of the partnership working between Adur District and Worthing Borough Councils. The operation for all three councils' treasury management is based at Worthing Town Hall, utilising similar banking arrangements.

The SSA is provided under a Service Level Agreement (SLA) that commenced in October 2016 and which defines the respective roles of the client and provider authorities for a period of three years. In making this arrangement the Council recognises that responsibility for treasury management decisions remains with the organisation at all times and will ensure that reliance beyond the terms and arrangements specified in the SLA is not placed upon the shared service providers. The SSA uses Link Assets Services (formerly Capita) as its external treasury management advisors.

The Council will ensure that the terms of the appointment of the shared services providers, and the methods by which their value will be assessed, are properly agreed and documented and subjected to regular review.

2. RECENT DEVELOPMENTS IN TREASURY MANAGEMENT

2.1 MIFID II Reforms

From 3 January 2018, under the MIFID II regulations, all institutions which invest in MIFID II products are required to opt up from retail investor status to professional status. Although the Council currently does not invest in MIFID II products, many of the financial institutions that we deal with do not have authorisation to transact with retail clients. Consequently the Council was required to opt up to professional status in order to be able to continue to invest with many of our counterparties. Appendix 5 lists these counterparties. The main implications are that the financial institutions are entitled to assume that the Council has the expertise to make the relevant investments and that the information provided may not be as comprehensive as for retail clients. As the Council currently invests only in fixed term deposits in high quality counterparties, this does not present a risk to the security of our funds.

2.2 Money Market Funds

The EU approved Money Market Fund Regulation comes into force on 21 July 2018. Only funds that invest 99.5% of their assets into government debt instruments and similar instruments will be permitted to maintain a Constant Net Asset Value (CNAV) fund. The CNAV funds that the Council currently uses will be re-classified as Low Volatility NAV (LVNAV) funds and will be permitted to maintain a constant dealing NAV provided that they meet more stringent criteria than at present. Consequently our approved investment schedules have been amended to include reference to appropriate LVNAV funds.

3. THE CAPITAL PRUDENTIAL INDICATORS 2018/19 – 2020/21

The Council's capital expenditure plans are the key driver of treasury management activity. The output of the capital expenditure plans is reflected in the prudential indicators, which are designed to assist Members' overview and confirm capital expenditure plans.

3.1 Capital expenditure

This prudential indicator is a summary of the Council's capital expenditure plans, both those agreed previously, and those forming part of this budget cycle. Members are asked to approve the capital expenditure forecasts:

Capital expenditure	2016/17 Actual	2017/18 Estimate	2018/19 Estimate	2019/20 Estimate	2020/21 Estimate
	£m	£m	£m	£m	£m
General Fund	*28.631	4.402	2.313	2.161	0.809

*The Capital expenditure in 2016/17 includes the purchase of the Orchard Shopping Centre.

The above financing need excludes other long term liabilities, such as leasing arrangements which already include borrowing instruments.
The table below summarises the above capital expenditure plans and how these plans are being financed by capital or revenue resources. Any shortfall of resources results in a funding borrowing need.

Capital expenditure	2016/17 Actual	2017/18 Estimate	2018/19 Estimate	2019/20 Estimate	2020/21 Estimate
	£m	£m	£m	£m	£m
Total	28.631	4.402	2.313	2.161	0.809
Financed by:					
Capital receipts	0.000	0.000	0.179	0.000	0.000
Capital grants, Contributions & S106 receipts	0.994	2.539	0.827	1.683	0.600
General Reserves, Specific Reserves & Revenue Contributions	2.915	1.863	1.307	0.478	0.209
Net financing need for the year	24.722	0.000	0.000	0.000	0.000

3.2 **The Council's borrowing need (the Capital Financing Requirement)**

The second prudential indicator is the Council's Capital Financing Requirement (CFR). The CFR is simply 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 capital expenditure above, which has not immediately been paid for, will increase the CFR. The CFR does not increase indefinitely, as the minimum revenue provision (MRP) is a statutory annual revenue charge which broadly reduces the borrowing need in line with each asset's life, and so charges the economic consumption of capital assets as they are used.

The CFR includes any other long term liabilities (e.g. finance leases). Whilst these increase the CFR, and therefore the Council's borrowing requirement, these types of scheme include a borrowing facility and so the Council is not required to separately borrow for these schemes.

The Council is asked to approve the CFR projections below:

Capital Financing Requirement	2016/17 Actual	2017/18 Estimate	2018/19 Estimate	2019/20 Estimate	2020/21 Estimate
	£m	£m	£m	£m	£m
Total CFR	25.736	25.357	5.130	4.897	4.658
Movement in CFR	24.453	(0.379)	(20.227)	(0.233)	(0.239)
Movement in CFR represented by:					
Net financing need for the year (above)	24.722	0.000	0.000	0.000	0.000
Less MRP and other financing movements	(0.269)	(0.379)	(20.227)	(0.233)	(0.239)
Movement in CFR	24.453	(0.379)	(20.227)	(0.233)	(0.239)

3.3 **Minimum revenue provision (MRP) policy statement**

The Council is required to pay off an element of the accumulated General Fund capital spend each year (the CFR) through a revenue charge (the minimum revenue provision - MRP), although it is also allowed to undertake additional voluntary payments if required (voluntary revenue provision - VRP).

CLG regulations have been issued which require the full Council to approve an MRP Statement in advance of each year. A variety of options is provided to councils, so long as there is a prudent provision. The Council is recommended to approve the following MRP Statement:

The Council's policy for MRP relating to unfunded capital expenditure prior is to provide for MRP on an annuity basis over the life of the loans (except as detailed below for the Orchard Shopping Centre). As an annuity is a fixed annual sum comprising interest and principal, the MRP for repayment of debt will increase each year over the asset life as the proportion of interest calculated on the principal outstanding reduces as the debt is repaid.

The purchase of the Orchard Shopping Centre head lease in November 2016 increased the Capital Financing Requirement. However, as the Council is forecasting possible capital receipts of £20m in 2018/19, MRP will only be provided on the balance of nearly £5m. This will be done on a level basis of £100,000 per year. In the event that such receipts are not forthcoming we will need to amend the calculation in future years.

Repayments included in finance leases are applied as MRP.

3.4 **Affordability prudential indicators**

Prudential indicators are required to assess the affordability of the capital investment plans. These provide an indication of the impact of the capital investment plans on the Council's overall finances. The Council is asked to approve the following indicators:

3.5 **Ratio of financing costs to 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.

	2016/17 Actual	2017/18 Estimate	2018/19 Estimate	2019/20 Estimate	2020/21 Estimate
	%	%	%	%	%
Ratio	-1.76%	-0.28%	-0.78%	-2.50%	-3.44%

The estimates of financing costs include current commitments and the proposals in this budget report.

4.0 BORROWING

The capital expenditure plans set out in Section 3 provide details of the service activity of the Council. The treasury management function ensures that the Council's cash is organised in accordance with the the relevant professional codes, so that sufficient cash is available to meet this service activity. This will involve both the organisation of the cash flow and, where capital plans require, the organisation of appropriate borrowing facilities. The strategy covers the relevant treasury / prudential indicators, the current and projected debt positions and the annual investment strategy.

4.1 **Current portfolio position**

The Council's treasury portfolio position at 31 March 2017, with forward projections, is summarised below. The table shows the actual external debt (the treasury management operations), against the underlying capital borrowing need (the Capital Financing Requirement - CFR), highlighting any over or under borrowing. The Council's debt comprises one loan from the Public Works Loan Board (PWLB), which matures on 1 March 2023 and 3 loans with other local authorities, totalling £12m, with remaining lives of between 1 and 4 years, to fund the purchase of the Orchard Shopping Centre head lease. The local authority loans are at rates lower than those available from the PWLB, ranging from 0.6% to 1.1% (average rate), and they will be repaid using capital receipts (if available) (£20m) and maturing investments. The "other long term liability" is in respect of capital assets acquired by finance leases.

External Debt	2016/17 Actual	2017/18 Estimate	2018/19 Estimate	2019/20 Estimate	2020/21 Estimate
	£m	**£m**	**£m**	**£m**	**£m**
Debt at 1 April	0.936	22.977	12.856	7.729	7.595
Expected change in Debt	21.883	(10.121)	(5.127)	(0.134)	(2.139)
Other long-term liabilities (OLTL)	0.310	0.157	0.000	0.000	0.000
Expected change in OLTL	(0.152)	(0.157)	0.000	0.000	0.000
Actual gross debt at 31 March	22.977	12.856	7.729	7.595	5.456
The Capital Financing Requirement	25.736	25.357	5.130	4.897	4.658
Under/(over) borrowing	2.759	12.501	(2.599)	(2.698)	(0.798)

Within the prudential indicators there are a number of key indicators to ensure that the Council operates its activities within well-defined limits. One of these is that the Council needs to ensure that its gross debt does not, except in the short term, exceed the total of the CFR in the preceding year plus the estimates of any additional CFR for 2017/18 and the following two financial years. This allows some flexibility for limited early borrowing for future years, but ensures that borrowing is not undertaken for revenue purposes.

The Head of Corporate Resources reports that the Council complied with this prudential indicator in the current year. The respective timing of capital receipts and repayment of debt results in a projected over borrowing position in subsequent years. However this is due to the Council's ability to fully fund its capital expenditure from grants and other resources and is not an indication of imprudent borrowing. In addition, both the CFR and the outstanding debt are small relative to the size of the Council's budget. This view takes into account current commitments, existing plans, and the proposals in this budget report.

4.2 **Treasury Indicators: limits to borrowing activity**

The operational boundary - This is the limit which external debt is not normally expected to exceed. In most cases, this would be a similar figure to the CFR, but may be lower or higher depending on the levels of actual debt.

Operational Boundary	2017/18	2018/19	2019/20	2020/21
	£m	**£m**	**£m**	**£m**
Debt	£28.0m	£28.0m	£28.0m	£28.0m
Other long term liabilities	£1.0m	£1.0m	£1.0m	£1.0m
Total	**£29.0m**	**£29.0m**	**£29.0m**	**£29.0m**

The authorised limit for external debt - A further key prudential indicator represents a control on the maximum level of borrowing. This represents a limit beyond which external debt is prohibited, and this limit needs to be set or revised by the full Council. It reflects the level of external debt which, while not desired, could be afforded in the short term, but is not sustainable in the longer term.

1. This is the statutory limit determined under section 3 (1) of the Local Government Act 2003. The Government retains an option to control either the total of all councils' plans, or those of a specific council, although this power has not yet been exercised.

2. The Council is asked to approve the following authorised limit:

Authorised Limit	2017/18	2018/19	2019/20	2020/21
	£m	**£m**	**£m**	**£m**
Debt	£30.0m	£30.0m	£30.0m	£30.0m
Other long term liabilities	£1.0m	£1.0m	£1.0m	£1.0m
Total	**£31.0m**	**£31.0m**	**£31.0m**	**£31.0m**

The Head of Corporate Resources has delegated authority, within the total limit for any individual year, to effect movement between the separately agreed limits for borrowing and other long-term liabilities. Decisions will be based on the outcome of financial option appraisals and best value considerations. Any movement between these separate limits will be reported to the next meeting of the Council at the earliest opportunity.

4.3 Prospects for interest rates and the economy

This section contains a commentary for the economic outlook provided by the Council's shared service provider's treasury management consultants, Link Asset Services (previously Capita Asset Services). This includes a central view of forecast interest rates as follows:

	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21
Bank rate	0.50%	0.75%	0.75%	1.00%	1.00%	1.00%	1.00%	1.25%	1.25%	1.25%	1.50%	1.50%	1.50%
5yr PWLB rate	1.90%	2.00%	2.10%	2.10%	2.20%	2.30%	2.30%	2.40%	2.40%	2.50%	2.50%	2.60%	2.60%
10yr PWLB rate	2.50%	2.50%	2.60%	2.70%	2.70%	2.80%	2.80%	2.90%	3.00%	3.00%	3.10%	3.10%	3.20%
25yr PWLB rate	2.80%	2.90%	3.00%	3.10%	3.20%	3.20%	3.30%	3.30%	3.40%	3.50%	3.50%	3.60%	3.60%
50yr PWLB rate	2.60%	2.70%	2.80%	2.90%	3.00%	3.00%	3.10%	3.10%	3.20%	3.30%	3.30%	3.40%	3.40%

As expected, the Monetary Policy Committee (MPC) delivered a 0.25% increase in Bank Rate at its meeting on 2 November. This removed the emergency cut in August 2016 after the EU referendum. The MPC also gave forward guidance that they expected to increase Bank rate only twice more by 0.25% by 2020 to end at 1.00%. At its February 2018 meeting, there was no change in Bank Rate but the forward guidance changed significantly to warn of "earlier and greater than anticipated" rate of increases in Bank Rate. The Link Asset Services forecast as above includes increases in Bank Rate of 0.25% May in November 2018, November 2019 and August 2020.

The overall longer run trend is for gilt yields and PWLB rates to rise, albeit gently. It has long been expected, that at some point, there would be a more protracted move from bonds to equities after a historic long-term trend, over about the last 25 years, of falling bond yields. The action of central banks since the financial crash of 2008, in implementing substantial Quantitative Easing, added further impetus to this downward trend in bond yields and rising bond prices. Quantitative Easing has also directly led to a rise in equity values as investors searched for higher returns and took on riskier assets. The sharp rise in bond yields since the US Presidential election in November 2016 has called into question whether the previous trend may go into reverse, especially now the Fed. has taken the lead in reversing monetary policy by starting, in October 2017, a policy of not fully reinvesting proceeds from bonds that it holds when they mature. We have also seen a sharp selloff in equities and bonds in February 2018 which has given further impetus to a rise in bond yields.

Until 2015, monetary policy was focused on providing stimulus to economic growth but has since started to refocus on countering the threat of rising inflationary pressures as stronger economic growth becomes more firmly established. The Fed. has started raising interest rates and this trend is expected to continue during 2018 and 2019. These increases will make holding US bonds much less attractive and cause their prices to fall, and therefore bond yields to rise. Rising bond yields in the US are likely to exert some upward pressure on bond yields in the UK and other developed economies. However, the degree of that upward pressure is likely to be dampened by how strong or weak the prospects for economic growth and rising inflation are in each country, and on the degree of progress towards the reversal of monetary policy away from quantitative easing and other credit stimulus measures.

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

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

The overall balance of risks to economic recovery in the UK is probably to the downside, particularly with the current level of uncertainty over the final terms of Brexit.

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

- Bank of England monetary policy takes action too quickly 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.

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

- A resurgence of the Eurozone sovereign debt crisis, possibly Italy, due to its high level of government debt, low rate of economic growth and vulnerable banking system.

- Weak capitalisation of some European banks

- Germany is still without a fully agreed and stable coalition government after the inconclusive result of the general election in October. In addition, Italy is to hold a general election on 4 March and the anti EU populist Five Star party is currently in the lead in the polls, although it is unlikely to get a working majority on its own. Both situations could pose major challenges to the overall leadership and direction of the EU as a whole and of the individual respective countries. Hungary will hold a general election in April 2018.

- Rising protectionism under President Trump

- A sharp Chinese downturn and its impact on emerging market countries

The potential for upside risks to current forecasts for UK gilt yields and PWLB rates, especially for longer term PWLB rates include: -

- The Bank of England is too slow in its pace and strength of increases in Bank Rate and, therefore, allows inflation 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 returning to sustained significantly higher levels causing an increase in the inflation premium inherent to gilt yields.

- The Fed causing a sudden shock in financial markets through misjudging the pace and strength of increases in its Fed. Funds Rate and in the pace and strength of reversal of Quantitative Easing, which then leads to a fundamental reassessment by investors of the relative risks of holding bonds, as opposed to equities. This could lead to a major flight from bonds to equities and a sharp increase in bond yields in the US, which could then spill over into impacting bond yields around the world.

Investment and borrowing rates:

- Investment returns are likely to remain low during 2018/19 but to be on a gently rising trend over the next few years.

- Borrowing interest rates have been volatile so far in 2017-18 and increased sharply after the result of the general election in June and then also after the September MPC meeting (when financial markets reacted by accelerating their expectations for the timing of Bank Rate increases) and again in January and February 2018 Increases have been sharper in periods up to 10 years than in longer maturities. The policy of avoiding new borrowing by running down spare cash balances has served well over the last few years. However, this needs to be carefully reviewed to avoid incurring higher borrowing costs in the future when authorities may not be able to avoid new borrowing to finance capital expenditure and/or the refinancing of maturing debt;

- There will remain a cost of carry to any new long-term borrowing that causes a temporary increase in cash balances as this position will, most likely, incur a revenue cost – the difference between borrowing costs and investment returns.

4.4 Borrowing strategy

The financing of the capital programme forms part of the Prudential Indicators. The Council does not anticipate any new borrowing within the capital programme up to 2020/21 inclusive, but any change to this position will be reported to the appropriate decision making body. If borrowing is required, the Head of Corporate Resources will monitor interest rates in financial markets and adopt a pragmatic approach to changing circumstances.

Treasury indicators for debt

The Council has set three debt related treasury activity limits. The purpose of these are to restrain the activity of the treasury function within certain limits, thereby managing risk and reducing the impact of any adverse movement in interest rates. However, if these are set to be too restrictive they will impair the opportunities to reduce costs / improve performance. The indicators are:

- Upper limits on variable interest rate exposure - this identifies a maximum limit for variable interest rates for both debt and investments

- Upper limits on fixed interest rate exposure. - this is similar to the previous indicator and covers a maximum limit on fixed interest rates;

- Maturity structure of borrowing - these gross limits are set to reduce the Council's exposure to large fixed rate sums falling due for refinancing, and are required for upper and lower limits.

The limits below provide the necessary flexibility to make decisions based on the expectations of anticipated interest rate movements as set out in the Council's treasury management strategy.

The Council is asked to approve the following treasury indicators and limits:

Interest rate exposures	2018/19	2019/20	2020/21
	Upper	Upper	Upper
Limits on fixed interest rates:			
Debt only	100%	100%	100%
Investments only	-100%	-100%	-100%
Limits on variable interest rates:			
Debt only	25%	25%	25%
Investments only	-100%	-100%	-100%

Maturity structure of fixed interest rate borrowing 2018/19		
	Lower	Upper
Under 12 months	0%	50%
12 months to 2 years	0%	60%
2 years to 5 years	0%	80%
5 years to 10 years	0%	60%
Over 10 years	0%	50%

The Council has no variable interest rate borrowing		

Policy on borrowing in advance of need

The Council will not borrow more than or in advance of its needs purely in order to profit from the investment of the extra sums borrowed. Any decision to borrow in advance will be within forward approved Capital Financing Requirement estimates, and will be considered carefully to ensure that value for money can be demonstrated and that the Council can ensure the security of such funds. Risks associated with any borrowing in advance activity will be subject to prior appraisal and subsequent reporting through the mid-year or annual reporting mechanism. As stated above, there is no intention to borrow up to 2020/21.

4.5 **Debt rescheduling**

The Council has one loan from the Public Works Loan Board, repaid by fixed annuities over the life of the loan. As it would not be possible to prematurely repay the existing loan without incurring a premium charge for early settlement, there is currently no intention to redeem the loan early. The loans for the purchase of the Orchard Shopping Centre head lease will be repaid within 4 years and are all at competitively low interest rates.

All rescheduling will be reported to the Council at the earliest meeting following its action.

5.0 ANNUAL INVESTMENT STRATEGY

5.1 Investment policy

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

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

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

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

The Head of Corporate Resources, under delegated powers, will undertake through the Shared Service Arrangement the most appropriate form of investments in keeping with the investment objectives, income and risk management requirements, and Prudential Indicators. As conditions in the financial markets remain uncertain, the proposed maximum limits for Specified and Unspecified Investments for 2018/19 are the same as for 2017/18.

Investment instruments identified for use in the financial year are listed in Appendices 1-3 under the 'specified' and 'non-specified' investments categories. Counterparty limits will be as set through the Council's treasury management practices.

5.2 Creditworthiness policy

The primary principle governing the Council's investment criteria through the Shared Services Arrangement (SSA) is the security of its investments, although the yield or return on the investment is also a key consideration. After this main principle, the SSA will ensure that:

- It maintains a policy covering both the categories of investment types it will invest in, criteria for choosing investment counterparties with adequate security, and monitoring their security. This is set out in the specified and non-specified investment sections in Appendices 1-3; and

- It has sufficient liquidity in its investments. For this purpose it will set out procedures for determining the maximum periods for which funds may prudently be committed. These procedures also apply to the Council's prudential indicators covering the maximum principal sums invested.

The SSA will maintain a counterparty list in compliance with the criteria in the Appendices and will revise the criteria and submit them to Council for approval as necessary. These criteria are separate to that which determines which types of investment instrument are either specified or non-specified as it provides an overall pool of counterparties considered high quality which the Council may use, rather than defining what types of investment instruments are to be used.

Credit rating information is supplied to the SSA by Link Asset Services (formerly Capita), our treasury advisors, on all active counterparties that comply with the criteria below. Any counterparty failing to meet the criteria would be omitted from the counterparty (dealing) list. Any rating changes, rating Watches (notification of a likely change), rating Outlooks (notification of a possible longer term change) are provided to the SSA almost immediately after they occur and this information is considered before dealing. For instance, a negative rating Watch applying to a counterparty at the minimum Council criteria will be suspended from use, with all others being reviewed in light of market conditions.

Use of additional information other than credit ratings

Additional requirements under the Code require the Council to supplement credit rating information. Whilst the above criteria rely primarily on the application of credit ratings to provide a pool of appropriate counterparties for officers to use, additional operational market information will be applied before making any specific investment decision from the agreed pool of counterparties. This additional market information (for example Credit Default Swaps, negative rating Watches/Outlooks) will be applied to compare the relative security of differing investment counterparties.

The proposed criteria for specified and non-specified investments are shown in the Appendices for approval.

5.3 **Country and sector limits**

Due care will be taken to consider the country, group and sector exposure of the Council's investments.

The Council has determined that it will only use approved counterparties from countries with a minimum sovereign credit rating of *AA-* from Fitch (or equivalent).

In addition:

- no more than 25% will be placed with any non-UK financial institutions

5.4 **Investment strategy**

In-house funds - Investments will be made with reference to the core balance and cash flow requirements and the outlook for short-term interest rates (i.e. rates for investments up to 12 months).

Investment returns expectations - Bank Rate is forecast to stay flat at 0.50% until quarter 4 of 2018 and not to rise above 1.25% by quarter 1 2021. Bank Rate forecasts for financial year ends (March) are:

2017/18	:	0.50%
2018/19	:	0.75%
2019/20	:	1.00%
2020/21	:	1.25%

The suggested budgeted investment earnings rates for returns on investments placed for periods up to 100 days during each financial year for the next three years are as follows:

2017/18	:	0.40%
2018/19	:	0.60%
2019/20	:	0.90%
2020/21	:	1.25%
2021/22	:	1.50%

The overall balance of risks to these forecasts is currently skewed to the upside and is dependent on how strong GDP growth turns out, how quickly inflation pressures rise and how quickly the Brexit negotiations move forward positively.

5.5 **Funds available for investment**

The application of resources (capital receipts, reserves etc.) to either finance capital expenditure or other budget decisions to support the revenue budget will have an ongoing impact on investments unless resources are supplemented each year from new sources (asset sales etc.). Detailed below are estimates of the year-end balances.

Investments	2017/18 Estimate	2018/19 Estimate	2019/20 Estimate	2020/21 Estimate
	£m	£m	£m	£m
Balance at 1 April	40.620	34.635	52.668	55.923
Capital Expenditure	(4.402)	(2.313)	(2.161)	(0.809)
Grants, capital receipts & other new funds	8.697	25.474	5.550	5.177
Loan repayments	(10.280)	(5.128)	(0.134)	(2.140)
Balance at 31 March	34.635	52.668	55.923	58.151

5.6 **Investment treasury indicator and limit - total principal funds invested for greater than 365 days**

These limits are set with regard to the Council's liquidity requirements and to reduce the need for early sale of an investment, and are based on the availability of funds after each year-end. In view of the interest rate outlook the Council will not lock into further long term deals unless justified where attractive rates are available with counterparties of particularly high creditworthiness (ie approved counterparties with a minimum credit rating of A- from Fitch Ratings or equivalent, or Building Societies with assets in excess of £1bn, or other local authorities) where the deals are within the risk parameters set by the Council.

The Council is asked to approve the treasury indicator limit: -

Maximum proportion of principal sums invested > 365 days	2018/19	2019/20	2020/21
Principal sums invested > 365 days	50%	50%	50%

For its cash flow generated balances, the Council will seek to utilise its interest paying general account, money market funds, notice accounts and short-dated deposits (overnight to100 days) in order to benefit from the compounding of interest.

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

5.8 **Investment risk benchmarking** – the Council subscribes to Link's Investment Benchmarking Club of 11 local councils in order to review the investment performance and risk of its portfolio. The quarterly report to 31 December 2017 states that the Council's average rate of return for the quarter was 0.92%, excluding the £6m investment in the Local Authority Property Fund. This compares favourably with the benchmark group average of 0.72% and the average of 86 Non Metropolitan Districts rate of 0.54%. The weighted average Credit Risk of 5.73 is higher than the group average of 3.81, mainly due to the Council's strategy of investing in Building Societies with assets in excess of £1 billion. Only the largest few Building Societies have credit ratings, which increases the Council's weighted average risk.

5.9 **External fund managers**

The Council does not use external fund managers, but reserves the option to do so in future should this be deemed to be appropriate. Should consideration be given to exercising this option in the future, the relevant Committee will be advised of the reasons for doing so and the Council requested to consider whether it wishes to proceed with the selection and appointment of external fund managers.

SPECIFIED AND NON SPECIFIED INVESTMENTS

Specified Investments will be those that meet the criteria in the CLG Guidance, i.e. the investment

- is sterling denominated
- has a maximum maturity of 1 year
- meets the "high" credit criteria as determined by the Council or is made with the UK government or is made with a local authority in England, Wales and Scotland.
- the making of which is not defined as capital expenditure under section 25(1)(d) in SI 2003 No 3146 (i.e. the investment is not loan capital or share capital in a body corporate).

"Specified" Investments identified for the Council's use are:

- Deposits in the DMO's Debt Management Account Deposit Facility
- Deposits with UK local authorities
- Deposits with banks and building societies
- *Certificates of deposit with banks and building societies
- *Gilts : (bonds issued by the UK government)
- *Bonds issued by multilateral development banks
- AAA-rated Money Market Funds with a Constant Net Asset Value (Constant NAV) or appropriate Low Volatility Net Asset Value (LVNAV) under the new regulations
- Other Money Market Funds and Collective Investment Schemes– i.e. credit rated funds which meet the definition of a collective investment scheme as defined in SI 2004 No 534 and SI 2007 No 573.

    1. ** Investments in these instruments will be on advice from the Council's Shared Service Provider's treasury management consultants.*
    2. *The use of the above instruments by the Council's fund managers (if appointed) will be by reference to the fund guidelines contained in the agreement between the Council and the individual manager.*

For credit rated counterparties, the minimum criteria, except for the Council's own banker and the specified building societies (see below), will be the short-term/long-term ratings assigned by various agencies which may include Moody's Investors Services, Standard & Poor's, Fitch Ratings, being:

Long-term investments (over 365 days) minimum: A- (Fitch, or equivalent)

Or: Short-term investments (365 days or fewer) minimum: F1 (Fitch, or equivalent)

If the Council's own banker (currently Lloyds Bank) falls below the above criteria, it will still be used for transactional purposes, although in this case balances will be minimised in both monetary size and time.

The Council will also take into account information on corporate developments of and market sentiment towards investment counterparties.

APPENDIX 2

APPROVED INVESTMENT INSTITUTIONS

Specified Investments identified for use by the Council

New specified investments will be made within the following limits:

(a) Banks (Approved Investment Regulation 2 (b))

Major U.K. and European Banks and their wholly-owned subsidiaries meeting the Council's approved investment criteria.

	Counterparty	Group	Maximum Sum	Maximum Period *
1	HSBC Bank plc	N/A	£4m	5 years
2	The Royal Bank of Scotland Group:	£5m		
	The Royal Bank of Scotland plc		£4m	5 years
	National Westminster Bank plc		£4m	5 years
	Ulster Bank Belfast Limited		£1m	1 year
3	Lloyds Group::	£5m		
	Lloyds Bank plc		£4m	5 years
	Halifax plc		£4m	5 years
	Bank of Scotland plc		£4m	5 years
	HBOS Treasury Services plc		£4m	5 years
4	Barclays Bank plc	N/A	£4m	5 years
5	Santander UK	N/A	£4m	5 years
6	Clydesdale Bank	N/A	£4m	5 years
7	Svenska Handelsbanken AB	N/A	£4m	1 year
8	Goldman Sachs International Bank	N/A	£4m	5 years
9	Close Brothers Ltd	N/A	£4m	5 years

*Specified investments are for a maximum period of 1 year, the maximum limits shown in this column are for non-specified investments with these institutions.

(b) Building Societies (Approved Investment Regulation 2 (c))

(i) Building Societies (Assets in excess of £1 billion):

Rank	Name of Counterparty	Individual	
		Sum	Period*
1	Nationwide	£4m	3 years
2	Yorkshire	£4m	3 years
3	Coventry	£4m	3 years
4	Skipton	£3m	3 years
5	Leeds	£3m	3 years
6	Principality	£3m	3 years
7	West Bromwich	£3m	3 years
8	Newcastle	£3m	3 years
9	Nottingham	£3m	3 years
10	Cumberland	£3m	3 years
11	National Counties	£3m	3 years
12	Progressive	£3m	3 years
13	Saffron	£3m	3 years
14	Cambridge	£3m	3 years
15	Monmouthshire	£3m	3 years

*Specified investments are for a maximum period of 1 year, the maximum limits shown in this column are for non-specified investments with these institutions.

(c) Money Market Funds (Approved Investment Reg 2(2) and 2(3) (b))

Counterparty	Sum	
Invesco Aim – Sterling	£3m	For Short Term Operational Cash Flow Purposes
Blackrock Institutional Sterling Liquidity Fund	£3m	
Goldman Sachs Sterling Liquidity Reserve Fund	£3m	
Fidelity Institutional Cash Fund plc – Sterling	£3m	
Federated Short-Term Sterling Prime Liquidity Fund	£3m	

The limit for investing in any one Money Market Fund is £3 million. Total investments in Money Market Funds shall not exceed the higher of £9m or 25% of the total investment portfolio, for more than one week at any one time.

(d) Local Authorities (Approved Investment Regulation 2 (i) and Schedule Part II)

(i) All the following local authorities mentioned in the Regulations

Schedule Part II Ref	Details	Individual	
		Sum	Period
1	County Councils (England and Wales)	£3m	5 years
2	District Councils in England and Wales (including Borough, City, Metropolitan Borough Councils and Unitary Councils)	£3m	5 years
3	London Borough Councils	£3m	5 years
4	The Common Council of the City of London	£3m	5 years
5	The Council of the Isles of Scilly	£3m	5 years
7	Combined Police Authorities	£3m	5 years
16	Regional, Islands, or District Councils in Scotland	£3m	5 years
17	Joint boards under s.235 (1) of LG (Scotland) Act 1973	£3m	5 years
28	District Councils in Northern Ireland	£3m	5 years
29	Police Authorities (now Police and Crime Commissioners) under s.3 Police Act 1964 as substituted by s.2 Police & Magistrates Courts Act 1994	£3m	5 years

APPENDIX 3

NON-SPECIFIED INVESTMENTS DETERMINED FOR USE BY THE COUNCIL

Having considered the rationale and risk associated with Non-Specified Investments, the following have been determined for the Council's use.

	In-house use	Use by Fund Managers	Maximum Maturity	Maximum % of portfolio or £m	Capital Expenditure?
• Deposits with banks and building societies • Certificates of deposit with banks and building societies	√ √	 √	5 years	The higher of £10m or 50% of funds	No
Gilts and Bonds: • Gilts • Bonds issued by multilateral development banks • Bonds issued by financial institutions guaranteed by the UK government • Sterling denominated bonds by non-UK sovereign governments	√ √ √ √ (on advice from treasury advisor)	√ √ √ √	5 years	The higher of £3m or 25% of funds	No
Money Market Funds and Collective Investment Schemes (pooled funds which meet the definition of a collective investment scheme as defined in SI 2004 No. 534 and SI 2007, No. 573), but which are not credit rated.	√ (on advice from treasury advisor)	√	These funds do not have a defined maturity date.	The higher of £9m or 25% of funds	No
Government guaranteed bonds and debt instruments (e.g. floating rate notes) issued by corporate bodies	√ (on advice from treasury advisor)	√	5 years	The higher of £2m or 10% of funds	Subject to test
Property Funds approved by HM Treasury and operated by managers regulated by the Financial Conduct Authority – specifically the Local Authorities' Property Fund	√	√	These funds do not have a defined maturity date.	The higher of £4m or 25% of funds	No
Non-guaranteed bonds and debt instruments (e.g. floating rate notes) issued by corporate bodies	√ (on advice from treasury advisor)	√	5 years	The higher of £2m or 10% of funds	Subject to test
Collective Investment Schemes (pooled funds) which do not meet the definition of collective investment schemes in SI 2004 No. 534 or SI 2007, No. 573.	√ (on advice from treasury advisor)	√	These funds do not have a defined maturity date	The higher of £2m or 20% of funds	Subject to test

In determining the period to maturity of an investment, the investment is regarded as commencing on the date of the commitment of the investment rather than the date on which funds are paid over to the counterparty.

Accounting treatment of investments

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

APPENDIX 4

TREASURY MANAGEMENT SCHEME OF DELEGATION

(i) **Full Council**

- approval of annual treasury management strategy and Annual Investment Strategy
- approval of MRP Statement

(ii) **Executive Committee (e.g. Cabinet)**

- approval of/amendments to the organisation's adopted clauses, treasury management policy statement and treasury management practices
- budget consideration and approval
- approval of the division of responsibilities
- receiving and reviewing regular monitoring reports and acting on recommendations
- approving the selection of external service providers and agreeing terms of appointment.

(iii) **Audit Committee**

Receiving and reviewing the following, and making recommendations to the Cabinet

- regular monitoring reports on compliance with the Treasury Management Strategy, practices and procedures.

(iv) **The S151 (responsible) officer**

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

The Revised CIPFA Treasury Management and Prudential Codes have extended the functions of the S151 role in respect of non-financial investments. Guidance notes giving specific information will follow, but additional responsibilities are likely to include:

- preparation of a capital strategy to include capital expenditure, capital financing, non-financial investments and treasury management
- ensuring that the capital strategy is prudent, sustainable and affordable in the long

term and provides value for money

- ensuring that due diligence has been carried out on all treasury and non-financial investments and is in accordance with the risk appetite of the authorities
- ensuring that the authority has appropriate legal powers to undertake expenditure on non-financial assets and their financing
- ensuring the proportionality of all investments so that the authority does not undertake a level of investing which exposes the authority to an excessive level of risk compared to its financial resources
- ensuring that an adequate governance process is in place for the approval, monitoring and ongoing risk management of all non-financial investments and long term liabilities
- provision to members of a schedule of all non-treasury investments including material investments in subsidiaries, joint ventures, loans and financial guarantees
- ensuring that members are adequately informed and understand the risk exposures taken on by an authority
- ensuring that the authority has adequate expertise, either in house or externally provided, to carry out the above
- creation of Treasury Management Practices which specifically deal with how non treasury investments will be carried out and managed

APPENDIX 5

COUNTERPARTIES WHERE THE COUNCIL HAS OPTED UP TO PROFESSONAL INVESTOR STATUS

(i) **Money Market Funds**

Invesco
Federated Investors

(ii) **Building Societies**

Skipton Building Society
Coventry Building Society
Progressive Building Society (paperwork not yet approved)

(iii) **Brokers**

BGC (Sterling)
Tradition
ICAP

(iv) **Other**

ICD (Portal used for money market fund investments)
Link Asset Services

These arrangements will be regularly reviewed as appropriate.

APPENDIX 6

LINK ASSET SERVICES COMMENTARY ON THE GLOBAL ECONOMY

ECONOMIC BACKGROUND

GLOBAL OUTLOOK. World growth looks to be on an encouraging trend of stronger performance, rising earnings and falling levels of unemployment. In October, the IMF upgraded its forecast for world growth from 3.2% to 3.6% for 2017 and 3.7% for 2018.

In addition, inflation prospects are generally muted and it is particularly notable that wage inflation has been subdued despite unemployment falling to historically very low levels in the UK and US. This has led to many comments by economists that there appears to have been a fundamental shift downwards in the Phillips curve (this plots the correlation between levels of unemployment and inflation e.g. if the former is low the latter tends to be high). In turn, this raises the question of what has caused this? The likely answers probably lay in a combination of a shift towards flexible working, self-employment, falling union membership and a consequent reduction in union power and influence in the economy, and increasing globalisation and specialisation of individual countries, which has meant that labour in one country is in competition with labour in other countries which may be offering lower wage rates, increased productivity or a combination of the two. In addition, technology is probably also exerting downward pressure on wage rates and this is likely to grow with an accelerating movement towards automation, robots and artificial intelligence, leading to many repetitive tasks being taken over by machines or computers. Indeed, this is now being labelled as being the start of the fourth industrial revolution.

KEY RISKS - central bank monetary policy measures
Looking back on nearly ten years since the financial crash of 2008 when liquidity suddenly dried up in financial markets, it can be assessed that central banks' monetary policy measures to counter the sharp world recession were successful. The key monetary policy measures they used were a combination of lowering central interest rates and flooding financial markets with liquidity, particularly through unconventional means such as Quantitative Easing (QE), where central banks bought large amounts of central government debt and smaller sums of other debt.

The key issue now is that that period of stimulating economic recovery and warding off the threat of deflation is coming towards its close and a new period has already started in the US, and more recently in the UK, on reversing those measures i.e. by raising central rates and (for the US) reducing central banks' holdings of government and other debt. These measures are now required in order to stop the trend of an on-going reduction in spare capacity in the economy, and of unemployment falling to such low levels that the re-emergence of inflation is viewed as a major risk. It is, therefore, crucial that central banks get their timing right and do not cause shocks to market expectations that could destabilise financial markets. In particular, a key risk is that because QE-driven purchases of bonds drove up the price of government debt, and therefore caused a sharp drop in income yields, this then also encouraged investors into a search for yield and into investing in riskier assets such as equities.

This resulted in bond markets and equity market prices both rising to historically high valuation levels simultaneously. This, therefore, makes both asset categories vulnerable to a sharp correction. It is important, therefore, that central banks only gradually unwind their holdings of bonds in order to prevent destabilising the financial markets. It is also likely that the timeframe for central banks unwinding their holdings of QE debt purchases will be over several years. They need to balance their timing to neither squash economic recovery by taking too rapid and too strong action, or, alternatively, let inflation run away by taking action that was too slow and/or too weak. The potential for central banks to get this timing and strength of action wrong are now key risks.

There is also a potential key question over whether economic growth has become too dependent on strong central bank stimulus and whether it will maintain its momentum against a backdrop of rising interest rates and the reversal of QE. In the UK, a key vulnerability is the low level of productivity growth, which may be the main driver for increases in wages; and decreasing consumer disposable income, which is important in the context of consumer expenditure primarily underpinning UK GDP growth.
A further question that has come to the fore is whether an inflation target for central banks of 2%, is now

realistic given the shift down in inflation pressures from internally generated inflation, (i.e. wage inflation feeding through into the national economy), given the above mentioned shift down in the Phillips curve.

- Some economists favour a shift to a lower inflation target of 1% to emphasise the need to keep the lid on inflation. Alternatively, it is possible that a central bank could simply 'look through' tepid wage inflation, (i.e. ignore the overall 2% inflation target), in order to take action in raising rates sooner than might otherwise be expected.

  However, other economists would argue for a shift UP in the inflation target to 3% in order to ensure that central banks place the emphasis on maintaining economic growth through adopting a slower pace of withdrawal of stimulus. In addition, there is a strong argument that central banks should target financial market stability. As mentioned previously, bond markets and equity markets could be vulnerable to a sharp correction. There has been much commentary, that since 2008, QE has caused massive distortions, imbalances and bubbles in asset prices, both financial and non-financial. Consequently, there are widespread concerns at the potential for such bubbles to be burst by exuberant central bank action. On the other hand, too slow or weak action would allow these imbalances and distortions to continue or to even inflate them further.

- Consumer debt levels are also at historically high levels due to the prolonged period of low cost of borrowing since the financial crash. In turn, this cheap borrowing has meant that other non-financial asset prices, particularly house prices, have been driven up to very high levels, especially compared to income levels. Any sharp downturn in the availability of credit, or increase in the cost of credit, could potentially destabilise the housing market and generate a sharp downturn in house prices. This could then have a destabilising effect on consumer confidence, consumer expenditure and GDP growth. However, no central bank would accept that it ought to have responsibility for specifically targeting house prices.

UK. After the UK surprised on the upside with strong economic growth in 2016, growth in 2017 has confounded pessimistic forecasts of weak growth by coming in at 1.8%, only marginally down on the 1.9% rate for 2016. In 2017, quarter 1 came in at only +0.3% (+1.8% y/y), quarter 2 was +0.3% (+1.5% y/y), quarter 3 was +0.4% (+1.5% y/y) and quarter 4 was +0.5% (+1.5% y/y) The outstanding performance came from the manufacturing sector which showed a 1.3% increase in Q4 and +3.1% y/y helped by an increase in exports due to the lower value of sterling over the last year and robust economic growth in our main trade partners, the EU and US. It is also notable that there has been a progressive acceleration in total GDP growth during the year which gives ground for optimism looking forward into 2018.

While the Bank of England is expected to give forward guidance to prepare financial markets for gradual changes in policy, the Monetary Policy Committee, (MPC), meeting of 14 September 2017 managed to shock financial markets and forecasters by suddenly switching to a much more aggressive tone in terms of its words around warning that Bank Rate will need to rise soon. The Bank of England Inflation Reports during 2017 have clearly flagged up that it expected CPI inflation to peak at just under 3% in 2017, before falling back to near to its target rate of 2% in two years' time. The Bank revised its forecast for the peak to just over 3% at the 14 September meeting. (Inflation actually came in at 3.0% in both September and October so that might prove now to be the peak.) This marginal revision in the Bank's forecast can hardly justify why the MPC became so aggressive with its wording; rather, the focus was on an emerging view that with unemployment having already fallen to only 4.3%, the lowest level since 1975, and improvements in productivity being so weak, that the amount of spare capacity in the economy was significantly diminishing towards a point at which they now needed to take action. In addition, the MPC took a more tolerant view of low wage inflation as this now looks like a common factor in nearly all western economies as a result of automation and globalisation. However, the Bank was also concerned that the withdrawal of the UK from the EU would effectively lead to a decrease in such globalisation pressures in the UK, and so this would cause additional inflationary pressure over the next few years.

At Its 2 November meeting, the MPC duly delivered a 0.25% increase in Bank Rate. It also gave forward guidance that they expected to increase Bank Rate only twice more in the next three years to reach 1.0% by 2020. This is, therefore, not quite the 'one and done' scenario but is, nevertheless, a very relaxed rate of increase prediction in Bank Rate in line with previous statements that Bank Rate would only go up very gradually and to a limited extent.

However, some forecasters are flagging up that they expect growth to accelerate significantly towards the end of 2017 and then into 2018. This view is based primarily on the coming fall in inflation, (as the effect of the effective devaluation of sterling after the EU referendum drops out of the CPI statistics), which will bring to an end the negative impact on consumer spending power. In addition, a strong export performance will compensate for weak services sector growth. If this scenario was indeed to materialise, then the MPC would be likely to accelerate its pace of increases in Bank Rate during 2018 and onwards.

It is also worth noting the contradiction within the Bank of England between action in 2016 and in 2017 by two of its committees. After the shock result of the EU referendum, the Monetary Policy Committee (MPC) voted in August 2016 for emergency action to cut Bank Rate from 0.50% to 0.25%, restarting £70bn of QE purchases, and also providing UK banks with £100bn of cheap financing. The aim of this was to lower borrowing costs, stimulate demand for borrowing and thereby increase expenditure and demand in the economy. The MPC felt this was necessary in order to ward off their expectation that there would be a sharp slowdown in economic growth. Instead, the economy grew robustly, although the Governor of the Bank of England strongly maintained that this was because the MPC took that action. However, other commentators regard this emergency action by the MPC as being proven by events to be a mistake. Then in 2017, we had the Financial Policy Committee (FPC) of the Bank of England taking action in June and September over its concerns that cheap borrowing rates, and easy availability of consumer credit, had resulted in too rapid a rate of growth in consumer borrowing and in the size of total borrowing, especially of unsecured borrowing. It, therefore, took punitive action to clamp down on the ability of the main banks to extend such credit! Indeed, a PWC report in October 2017 warned that credit card, car and personal loans and student debt will hit the equivalent of an average of £12,500 per household by 2020. However, averages belie wide variations in levels of debt with much higher exposure being biased towards younger people, especially the 25 -34 year old band, reflecting their lower levels of real income and asset ownership.

One key area of risk is that consumers may have become used to cheap rates since 2008 for borrowing, especially for mortgages. It is a major concern that some consumers may have over extended their borrowing and have become complacent about interest rates going up after Bank Rate had been unchanged at 0.50% since March 2009 until falling further to 0.25% in August 2016. This is why forward guidance from the Bank of England continues to emphasise slow and gradual increases in Bank Rate in the coming years.

However, consumer borrowing is a particularly vulnerable area in terms of the Monetary Policy Committee getting the pace and strength of Bank Rate increases right - without causing a sudden shock to consumer demand, confidence and thereby to the pace of economic growth.

Moreover, while there is so much uncertainty around the Brexit negotiations, consumer confidence, and business confidence to spend on investing, it is far too early to be confident about how the next two to three years will actually pan out.

EZ. Economic growth in the eurozone (EZ), (the UK's biggest trading partner), had been 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 QE. However, growth picked up in 2016 and has now gathered substantial strength and momentum thanks to this stimulus. GDP growth was 0.6% in quarter 1 (2.0% y/y), 0.7% in quarter 2 (2.3% y/y) and +0.6% in quarter 3 (2.5% y/y). However, despite providing massive monetary stimulus, the European Central Bank is still struggling to get inflation up to its 2% target and in November inflation was 1.5%. It is therefore unlikely to start on an upswing in rates until possibly 2019. It has, however, announced that it will slow down its monthly QE purchases of debt from €60bn to €30bn from January 2018 and continue to at least September 2018.

USA. Growth in the American economy was notably erratic and volatile in 2015 and 2016. 2017 is following that path again with quarter 1 coming in at only 1.2% but quarter 2 rebounding to 3.1%, quarter 3 at 3.2% and Q4 2.6%. Unemployment in the US has also fallen to the lowest level for many years, reaching 4.1%, while wage inflation pressures, and inflationary pressures in general, have been building. The Fed has started on a gradual upswing in rates with four increases in all and three increases since December 2016; and there could be one more rate rise in 2017, which would then lift the central rate to 1.25 – 1.50%. There could then be another four increases in 2018. At its September meeting, the Fed said it would start in October to gradually unwind its $4.5 trillion balance sheet holdings of bonds and mortgage backed securities by reducing its reinvestment of maturing holdings.

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.

JAPAN. GDP growth has been gradually improving during 2017 to reach an annual figure of 2.1% in quarter 3. However it has still been struggling to stimulate consistent significant growth and to get inflation up to its target of 2.1%, despite huge monetary and fiscal stimulus. It is also making little progress on fundamental reform of the economy.

Brexit timetable and process

- March 2017: UK government notifies the European Council of its intention to leave under the Treaty on European Union Article 50

- March 2019: initial two-year negotiation period on the terms of exit. In her Florence speech in September 2017, the Prime Minister proposed a two year transitional period after March 2019.

- UK continues as a full EU member until March 2019 with access to the single market and tariff free trade between the EU and UK. Different sectors of the UK economy will leave the single market and tariff free trade at different times during the two year transitional period.

- The UK and EU would attempt to negotiate, among other agreements, a bi-lateral trade agreement over that period.

- The UK would aim for a negotiated agreed withdrawal from the EU, although the UK could also exit without any such agreements in the event of a breakdown of negotiations.

- If the UK exits without an agreed deal with the EU, World Trade Organisation rules and tariffs could apply to trade between the UK and EU - but this is not certain.

- On full exit from the EU: the UK parliament would repeal the 1972 European Communities Act.

- The UK will then no longer participate in matters reserved for EU members, such as changes to the EU's budget, voting allocations and policies.