

Treasury Management Annual Report 2017/18

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1 Purpose of the Report

- 1.1 The purpose of this report is to summarise the Treasury Management performance for the financial year to 31 March 2018.

2 Background

- 2.1 The annual performance of Treasury Management activity is reported in line with CIPFA's Code of Practice on Treasury Management and the 2017/18 Treasury Management Strategy Statement.

- 2.2 The Police and Crime Commissioner (PCC) operates a balanced revenue 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. The priority is to provide adequate security and liquidity before considering optimising investment return.

- 2.3 The second main function of the treasury management service is the funding of the PCC's capital programme. The capital programme provides a guide to the borrowing need of the PCC over a longer term cash flow period, ensuring the PCC can fulfil the capital spending plans.

- 2.4 Accordingly, treasury management is defined as:

"The management of the PCC'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."

- 2.5 This annual report has been prepared in compliance with CIPFA's Code of Practice on Treasury Management, and covers the following:
 - Economic update for the 2017/18 financial year;
 - Review of the Treasury Management Strategy Statement and Annual Investment Strategy;
 - The PCC's capital expenditure (prudential indicators);
 - Review of the PCC's investment portfolio for 2017/18;
 - Review of the PCC's borrowing strategy for 2017/18;
 - Review of any debt rescheduling undertaken during 2017/18;
 - Review of compliance with Treasury and Prudential Limits for 2017/18.

3 Treasury Management Strategy Update

- 3.1 The Treasury Management Strategy Statement (TMSS) for 2017/18 was approved by the PCC on 23 March 2017 and is underpinned by adoption of the Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management (revised 2017).
- 3.2 The primary requirements of the Code are as follows:
- Creation and maintenance of a Treasury Management Policy Statement, stating the policies, objectives and approach to risk management of the PCC's treasury management activities.
 - Creation and maintenance of Treasury Management Practices (TMPs), setting out the manner in which the PCC will seek to achieve those policies and objectives, and prescribing how it will manage and control those activities.
 - The PCC will receive reports on its treasury management policies, practices and activities, including, as a minimum, an **annual strategy** and plan in advance of the year, a **mid-year review** and an **annual report** after its close, in the form prescribed in its TMPs.
 - The PCC nominates the Joint Audit Committee (JAC) to be responsible for ensuring effective scrutiny of the treasury management strategy and policies.
 - The PCC nominates the Chief Finance Officer as the responsible officer for implementing and monitoring treasury management policies and practices and for the execution and administration of treasury management decisions.
- 3.3 The TMSS for 2017/18 was approved by the Commissioner following recommendation from JAC on 23 March 2017 (no revisions were made to this strategy during the year).
- <https://www.sussex-pcc.gov.uk/about/transparency/pcc-decisions/decisions/0122017-approval-of-the-201718-treasury-management-strategy-statement/>
- 3.4 The TMSS covers the specific activities proposed in relation to both borrowing and investments and ensures a wide range of advice is taken to maintain and preserve all principal sums, whilst obtaining a reasonable rate of return. The primary objective of the investment strategy is to maintain the security of investments at all times.
- 3.5 Credit ratings are one of the controls required by the strategy.

4 Investment Performance

4.1 Interest Receivable

4.1.1 The PCC's budgeted investment return for the 2017/18 year was £500,000 and actual interest received by the PCC for the year to 31 March 2018 was higher than expected at £576,184 (£756,640 2016/17).

4.1.2 The PCC's daily average investment portfolio of £77.9m for the year generated a gross investment return of 0.74%. This exceeded the average 7 Day LIBID benchmark of 0.22% by 0.52% and the UK Bank Rate which increased to 0.5% from 0.25% on 2 November 2017. This is illustrated in Appendix III.

4.1.3 The Police and Crime Commissioner for Sussex is a member of a Benchmarking Analysis group with data collected by our treasury advisors Link Asset Services which includes data from 10 other Local Authorities. The return on investment results for the year to 31 March 2018 indicate the performance for the PCC for Sussex exceeded that of the benchmarking group and the majority of other peer returns collated by Link Asset Services including 16 other police forces. March 2018 benchmarking results on a Weighted Average Rate of Return (WARoR) basis were as follows:

Performance Group	WARoR
The PCC for Sussex	0.88%
Benchmarking Group 8	0.82%
Police	0.52%
Model	0.73%

4.1.4 Extrapolation of the income forecast based on actual interest received during 2017/18 as compared with the original budget is summarised in the table below:

Movement from original investment income budget	£'000
Original Budget	500
Higher average investment portfolio than budget (£7.9m)	56
Higher rate of return than budget estimate (0.026%)	20
Net Interest receivable forecast	576

4.2 Investment Portfolio Activity 2017/18

4.2.1 In accordance with the Code and the Treasury Management Strategy Statement (TMSS) for 2017/18, the PCC gives priority to the security of capital followed by liquidity, and then to obtain an appropriate level of return which is consistent with the PCC's risk appetite.

4.2.2 The PCC held £57.29m of investments as at 31 March 2018 (£64.99m at 31 March 2017).

4.2.3 During 2017/18 the PCC for Sussex operated instant access call accounts with UK-regulated banks (NatWest Reserve and Santander) and five Sterling Money Market Funds, where funds can be deposited and withdrawn without notice.

4.2.4 The following table illustrates the portfolio movement during the year. Appendix II gives a full list of Investments held at 31 March 2018.

Investment	2016/17 Balance 31-Mar-17 £m	2017/18 Purchased £m	2017/18 Redeemed £m	2017/18 Balance 31-Mar-18 £m
UK Banks – Fixed Deposits	25.0	15.0	(20.0)	20.0
Non UK Banks – Fixed Deposits	10.0	15.0	(20.0)	5.0
UK Banks – Call Accounts	20.0	10.0	(10.0)	20.0
Money Market Funds	9.9	328.65	(326.35)	12.2
Heritable Bank (i)	0.1	0.0	0.0	0.1
TOTAL	65.0	368.65	(376.35)	57.3

(i) Excludes £0.1m remaining impairment recognised in the 2008-09 accounts

4.2.5 The decrease in average investment portfolio at 31 March 2018 reflects timing of receipt of government grants and precepts from local authorities, along with timing and use of reserves for capital and revenue expenditure in year.

4.3 Liquidity

4.3.1 The maximum period for investments with UK Banks of medium quality (Fitch long term rating of A or equivalent) was set at 364 days within the TMSS for 2017/18. Explicit approval from the PCC is required to extend beyond this time period for this category of Bank. There were no long term investments place during the 2017/18 year.

The maturity profile of the PCC's investments is shown in the following table:

Deposits with financial institutions	2016/17 31-Mar-17 £m	2017/18 31-Mar-18 £m
Instant Access Call	29.9	12.2
Less than 1 month	10.0	10.0
1 month to 3 months	0.0	15.0
3 months to 6 months	5.0	10.0
6 months to 1 year	10.0	10.0
1 year to 2 years	10.0	0.0
Heritable Bank(i)	0.1	0.1
TOTAL	65.0	57.3

(i) Heritable deposits not shown in specific time periods as final repayment dates unknown

4.4 Heritable Bank

- 4.4.1 The former Sussex Police Authority had three deposits with Heritable Bank totalling £6.8m when Heritable was taken into administration in October 2008. An original claim of £6.8m was submitted to the administrators Ernst & Young in November 2008, which included interest accrued of £44,828.
- 4.4.2 Total repayments received to date amount to £6.7m representing 98.6% of the total claim against investments in Heritable Bank.
- 4.4.3 Full recovery is expected but timing is uncertain.
- 4.4.4 A loan impairment of £1.360m (20%) was recognised in the 2008-09 accounts as a prudent forecast of potential loss. This provision was reversed to the extent of £0.994m in 2013/14 and £0.273m in 2015/16 to reflect repayment amounts received in excess of expectations at the time of impairment. The remaining impairment of £0.093m reflects the Principal Value of the investment not yet recovered as at 31 March 2018 and the overall carrying value of the Heritable bank investment in the books of the PCC is £Nil.

4.5 Credit Risk

- 4.5.1 Analysis of the PCC's investment portfolio by long term credit rating is shown in the following table:

Deposits with financial institutions	2016/17 31-Mar-17	2017/18 31-Mar-18
	£m	
AAA rated counterparties (i)	9.9	12.2
AA- rated counterparties (ii)	10.0	0.0
A+ rated counterparties (iii)	10.0	5.0
A rated counterparties (iv)	35.0	40.0
<i>Heritable Bank (v)</i>	0.1	0.1
TOTAL	65.0	57.3

- (i) Money Market Funds
(ii) Qatar
(iii) Santander UK Plc, Close Brothers and Goldman Sachs International Bank
(iv) Close Brothers, Goldman Sachs International Bank and Santander UK Plc

4.6 Borrowing

- 4.6.1 The PCC's capital financing requirement (CFR) for 2017/18 is £18.359m. The CFR denotes the PCC's underlying need to borrow for capital purposes. If the CFR is positive the PCC may borrow from the PWLB or the market (external borrowing) or from internal balances on a temporary basis (internal borrowing).
- 4.6.2 At 31 March 2018 the PWLB long-term borrowing held by the PCC for Sussex amounted to £4.5m which will be fully matured in 13 years.
- 4.6.3 Total interest of £0.201m was payable to PWLB in 2017/18 relating to the long-term borrowing by the PCC, representing an average interest rate of 4.5%.

PWLB LOAN	PWLB No.	Date of Advance	Maturity Date	Interest Rate	Amount £	Annual Interest £
Loan 1	489785	31-Mar-05	01-Mar-31	4.85	1,250,000	60,625
Loan 2	490633	24-Oct-05	01-Jun-31	4.45	1,250,000	55,625
Loan 3	491430	31-Mar-06	01-Mar-32	4.25	1,000,000	42,500
Loan 4	492302	02-Oct-06	01-Jun-32	4.25	1,000,000	42,500
TOTAL					4,500,000	201,250

- 4.6.4 No new external borrowing was taken in the 2017/18 financial year. All daily cash flow shortages are funded by withdrawals from instant access accounts and Money Market Funds held by the PCC.
- 4.6.5 Use of internal resources in lieu of borrowing by the PCC continued to be the most cost effective means of funding capital expenditure. This also lowers overall treasury risk by reducing both external debt and temporary investments.
- 4.6.6 The long-term borrowing requirement continues to be periodically reviewed in consultation with treasury management advisors (Link Asset Services). Whilst there are several claims that competitive alternative borrowing sources to the PWLB are available, the PWLB remains the preferred source of borrowing given the transparency and control that its facilities continue to provide.
- 4.6.7 Trends and variations in the PWLB interest rates are illustrated in Appendix V.

4.7 Debt Rescheduling

- 4.7.1 Debt rescheduling opportunities have been limited in the current economic climate and consequent structure of interest rates.
- 4.7.2 The long term borrowing portfolio was reviewed during the year with our advisors Link Asset Services. The premium is still very expensive to

redeem the loans in the PCC's portfolio and therefore we concluded that debt rescheduling remains unattractive at this time. No debt rescheduling activity was undertaken as a consequence.

4.7.3 The PCC will continue to first assess early repayment or rescheduling against the requirements of the medium term financial plan and any future borrowing requirements. Where rescheduling is appropriate, the PCC will consider alternative refinancing to achieve cost savings and a reduction in risk.

5 Prudential Indicators

5.1 The PCC's Capital Position

5.1.1 The following table shows the final revised budget for capital & investment expenditure and the adjustments approved since the original capital budget was agreed by the PCC in February 2017.

Capital Expenditure by Investment Portfolio	Original Budget £m	Approved Adjustments £m	Final Budget £m
IT Strategy	2.997	0.810	3.807
Fleet Strategy	3.460	0.948	4.408
Estates Strategy	8.819	(0.951)	7.868
Emergency Services Network	2.355	0	2.355
Video Enabled Justice	0.000	0.283	0.283
Digital Policing	0.000	4.155	4.155
Operational Investments	0.831	2.435	3.266
Total Planned Spend	18.462	7.680	26.142

The above adjustments include;

- £7.956m increase for PCC approved carried forward from 2016/17
- £0.827m increase to reflect a revenue to capital transfer in Estates
- £0.410m increase to reflect revenue to capital transfers in Fleet
- £0.255m increase to reflect revenue to capital transfers in Operational Investments
- £0.283m increase for Video Enabled Justice funded by Home Office transformation grant
- £4.155m increase for Digital Policing funded by Home Office transformation grant
- £6.206m decrease for PCC approved slippage to 2018/19

5.1.2 The table below illustrates planned financing of the capital expenditure budget for 2017/18.

	Original Estimate £000	Approved Adjustments £000	Revised Estimate £000
Total Planned Spend	18.462	7.680	26.142
Financed by:			
Capital Grants	0.906	4.272	5.178
Revenue contribution	2.025	0	2.025
Capital Receipts	6.300	(3.898)	2.402
Reserves	9.231	7.306	16.537
Total Financing	18.462	7.680	26.142
Borrowing Requirement	0	0	0

5.1.3 The following table shows the final capital and investment outturn position and the source of funding for the 2017/18 year.

Capital and Investment Budget Outturn 2017/18

	Actual £m	Revised Budget £m	Variance over/ (under)spend	
			£m	%
IT Strategy	2.585	3.807	(1.222)	(32%)
Fleet Strategy	4.482	4.408	0.074	2%
Estates Strategy	7.800	7.868	(0.068)	(1%)
Emergency Services Network	0.425	2.355	(1.930)	(82%)
Video Enabled Justice	0.217	0.283	(0.066)	(23%)
Digital Policing	3.487	4.155	(0.668)	(16%)
Operational Investments	3.804	3.266	0.538	17%
Total	22.800	26.142	(3.342)	(13%)
Net Carry Forward Requests			(2.9)	

Capital and Investment Funding 2017/18

Source of Funding	Revenue Sources £m	Capital Sources £m	Total Financing £m
Home Office Capital Grant	0.000	0.906	0.906
Other Grants and Income	0.318	3.954	4.272
Capital Receipts	0.000	2.402	2.402
Revenue Funding	2.025	0.000	2.025
Reserves	8.208	4.987	13.195
Total	10.551	12.249	22.800

5.2 Prudential Indicators for the Capital Financing Requirement (CFR), External Debt and the Operational Boundary

5.2.1 The CFR indicates the underlying external need to incur borrowing for a capital purpose. The Operational Boundary shows the expected debt position over the period.

5.2.2 The following table illustrates 2017/18 performance against the original Prudential Indicator forecasts for the Capital Financing Requirement, External Debt and Operational Boundary.

	2017/18 Budget £m	2017/18 Amendments £m	2017/18 Actual £m
Prudential Indicator – Capital Financing Requirement			
Total CFR	18.359	0	18.359
Net movement in CFR	(0.923)	0	(0.923)
Prudential Indicator – External Debt / the Operational Boundary			
Long Term Borrowing	4.500	0	4.500
Long Term PFI Liability	15.052	0	15.052
Long Term Finance Lease Liability	0.649	0	0.649
Total debt 31 March	20.201	0	20.201
15% External Debt allowance	3.030	0	3.030
Operational Borrowing Limit	23.231	0	23.231

5.3 Limits to Borrowing Activity

5.3.1 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 2017/18 and next two financial years. This allows some flexibility for limited early borrowing for future years. The PCC has approved a policy for borrowing in advance of need which will be adhered to if this proves prudent.

	2017/18 Budget £m	2017/18 Amendments £m	2017/18 Final £m
Gross borrowing	4.500	0	4.500
Plus other long term PFI liability	15.052	0	15.052
Gross Debt	19.552	0	19.552
CFR* (year-end position)	18.358	0	18.358

* Includes on balance sheet PFI schemes and finance leases

- 5.3.2 In the case of the PCC for Sussex, current gross debt does exceed the CFR. Current gross debt relates to a long term PWLB loan of £4.5m in addition to long term liabilities for PFI contract repayment.
- 5.3.3 The Chief Finance Officer confirms the PCC is not borrowing for revenue purposes. It is not currently cost effective to repay the PWLB loan debt but this situation is under continual review and will be considered when economic circumstances make it viable.
- 5.3.4 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 the PCC. 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.

Authorised limit for external debt	2017/18 Original Indicator £m	2017/18 Amendments £m	2017/18 Final Indicator £m
Borrowing	4.500	0	4.500
PFI long term liability	15.052	0	15.052
Finance lease liability	0.649	0	0.649
Additional external debt	3.030	0	3.030
Additional contingency	15.000	0	15.000
Total	38.231	0	38.231

- 5.3.5 The Chief Finance Officer reports that no difficulties were experienced during the 2017/18 year or are envisaged for future years in complying with this prudential indicator.

A listing of Prudential Indicators can be found at Appendix I.

6 Economic Update

- 6.1 A review of economic performance to date and outlook can be found at Appendix VI.

7 Compliance

- 7.1 During the year to 31 March 2018 the PCC complied with relevant statutory and regulatory stipulations, which require the PCC to identify and where possible quantify the levels of risk associated with its treasury management activities.
- 7.2 Internal Audit core testing provided satisfactory assurance on Treasury Management. It found that;

- Cash flow information was accurate and complete,
- Investment/borrowing decisions were appropriate and to the maximum benefit of the cash flow,
- Notification of rating changes were actioned,
- Payments were appropriately authorised and made accurately only for bona-fide transactions, and
- Treasury management transactions were accurately reflected in the accounting system.

7.3 Bi-weekly meetings take place with the Treasury Management team and the CFO as responsible officer, to provide updates and discuss planning to manage the investment portfolio effectively and efficiently in compliance with the approved TMSS.

7.4 Compliance against Prudential Indicators can be found at Appendix I.

7.5 The Chief Finance Officer confirms compliance with the approved Treasury Management Strategy Statement for 2017/18 and that a prudent investment approach has been followed with priority given to security and liquidity of amounts invested over actual yield achieved.

IAIN McCULLOCH

CHIEF FINANCE OFFICER

30 July 2018

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Prudential Indicators Forecast as at 31 March 2018

	Base: Actual 2016/17	Base: Estimate 2017/18	Base: Actual 2017/18	2017/18 Compliance
Impact of Capital Plans on Council Tax				
Impact on Council Tax (Band D Equivalent)	148.91	153.91	153.91	Yes, no change
Taxbase Increase	3.47%	3.36%	3.36%	
Financial	Actual 2016/17 £ '000s	Estimate 2017/18 £ '000s	Actual 2017/18 £ '000s	
Capital Expenditure	9,483	18,462	12,249	Yes, PCC approved changes
Capital Financing Requirement	19,282	18,358	18,358	Yes, no change
Authorised Borrowing Limit	39,144	38,231	38,231	Yes, no change
Operational Boundary	24,144	23,231	23,231	Yes, no change
Net Borrowing	(63,721)	(65,500)	(54,269)	
Financing costs	1,413	2,400	2,021	
Net revenue Stream	(294,683)	(295,608)	(300,455)	Increase due to Top Up Grant % decrease due to relative impact of Top Up Grant
Financing costs/Net revenue Stream	0.48%	0.81%	0.67%	
Borrowing	Actual 2016/17 £ '000s	Estimate 2017/18 £ '000s	Actual 2017/18 £ '000s	
Long Term Borrowing	4,500	4,500	4,500	Yes, no change
Long Term PFI Liability	15,823	15,052	15,052	Yes, no change
Long Term Finance Lease Liability	672	649	649	Yes, no change
Total Long Term Debt	20,995	20,201	20,201	Yes, no change
<i>15% x External Debt (Long term borrowing)</i>	3,149	3,030	3,030	Yes, no change
Operational borrowing limit	24,144	23,231	23,231	Yes, no change
<i>£15m additional</i>	15,000	15,000	15,000	Yes, no change
Authorised borrowing limit	39,144	38,231	38,231	Yes, no change
Investments	(68,221)	(70,000)	(58,769)	
Maximum investments longer than 1 year	(17,055)	(17,500)	(14,692)	Yes, no investments >1yr
Maximum % investment longer than 1 year	25%	25%	25%	Yes, no investments >1yr
Borrowing (actual external borrowing)	4,500	4,500	4,500	Yes, no extra borrowing in yr
Investments	(68,221)	(70,000)	(58,769)	
Net Borrowing	(63,721)	(65,500)	(54,269)	
Treasury Management	Actual 2016/17	Estimate 2017/18	Actual 2017/18	
Debt Maturity:				
15-20 Years	44%	0%	0%	Yes, no change
10-15 Years	56%	100%	100%	Yes, no change
Actual Debt at Fixed Rates as % Net Borrowing	33%	31%	37%	Yes, below maximum allowed
Actual Debt at Variable Rates as % Net Borrowing	8%	8%	9%	Yes, below maximum allowed
Maximum % Borrowing at Fixed Rates	100%	100%	100%	Yes, 100% fixed (PWLb)
Maximum % Borrowing at Variable Rates	25%	25%	25%	Yes, no variable loans held
Maximum % Investments at Fixed Rates	100%	100%	100%	Yes, can't exceed this limit
Maximum % Investments at Variable Rates	85%	85%	85%	Yes maximum 70% in year
Maximum Investment allowed > 365 days	15%	25%	25%	Yes, £10m investments >1yr

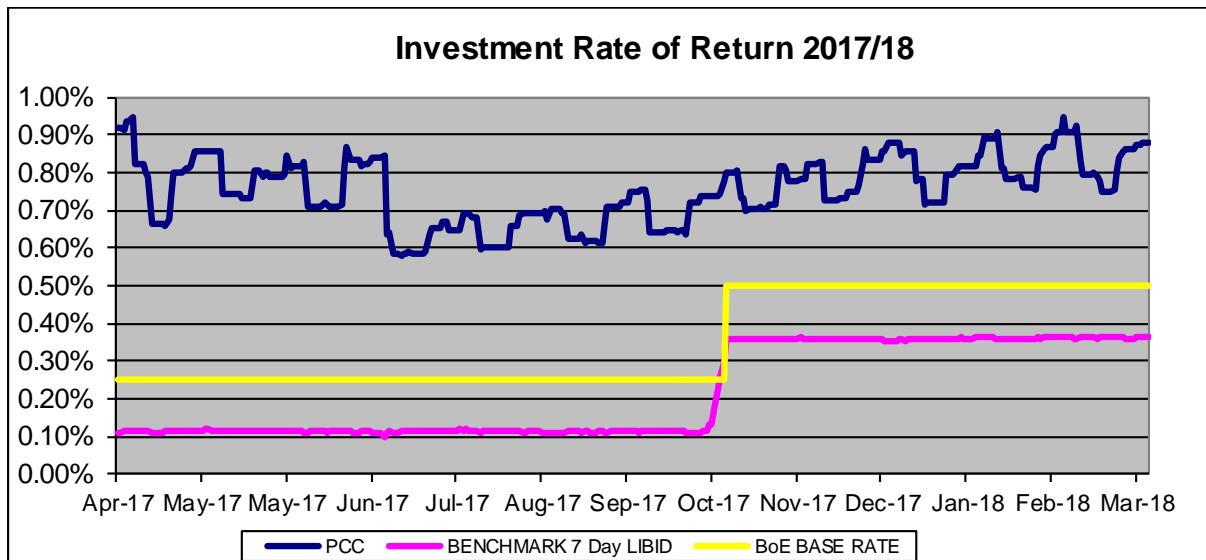
Investment Portfolio as at 31 March 2018

Counterparty	Investments as at 31-Mar-18 £
<i>UK Banks incorporated in UK:</i>	
Lloyds Bank	
Close Brothers	10,000,000
Goldman Sachs	10,000,000
Qatar	5,000,000
Santander UK Plc	20,000,000
NatWest Reserve (RBS Group)	
Total Banks incorporated in UK	45,000,000
<i>Icelandic Banks in Administration*:</i>	
Heritable Bank Ltd	93,049
Total Icelandic Banks	93,049
TOTAL UK BANKS	45,093,049
<i>Money Market Funds:</i>	
SLI Plc	10,000,000
Federated	2,200,000
Total Money Market Funds	12,200,000
Total Investments	57,293,049

*Banks incorporated inside or outside the EEA entitled to accept deposits through a branch in the UK are classified as UK Banks for the purposes of statistical reports to DCLG

Investment Rate of Return

Gross Investment Return as compared with the benchmark (7 day LIBID) and the Bank of England base rate.



Investment Income Budget Performance

	2017/18		
	BUDGET PORTFOLIO	RATE OF RETURN	BUDGET INTEREST
	£'000	%	£'000
Investment Portfolio	70,000	0.71%	500
INVESTMENT INCOME BUDGET	70,000		500
INTEREST SURPLUS COMPARED WITH BUDGET ASSUMPTIONS			(76,894)

Outturn to 31 March 2018

	2017/18		
	£'000	%	£'000
Average Portfolio (excluding PFI reserve)	77,858		
Average Investment Return Rate		0.74%	576
	PORTFOLIO		BUDGET INTEREST
	£'000		£'000
(a) Average investment portfolio > than assumed in original budget	7,858	0.71%	56
(b) Actual rate of return > than assumed in original budget	77,858	0.03%	20
INTEREST SURPLUS/(DEFICIT)			76

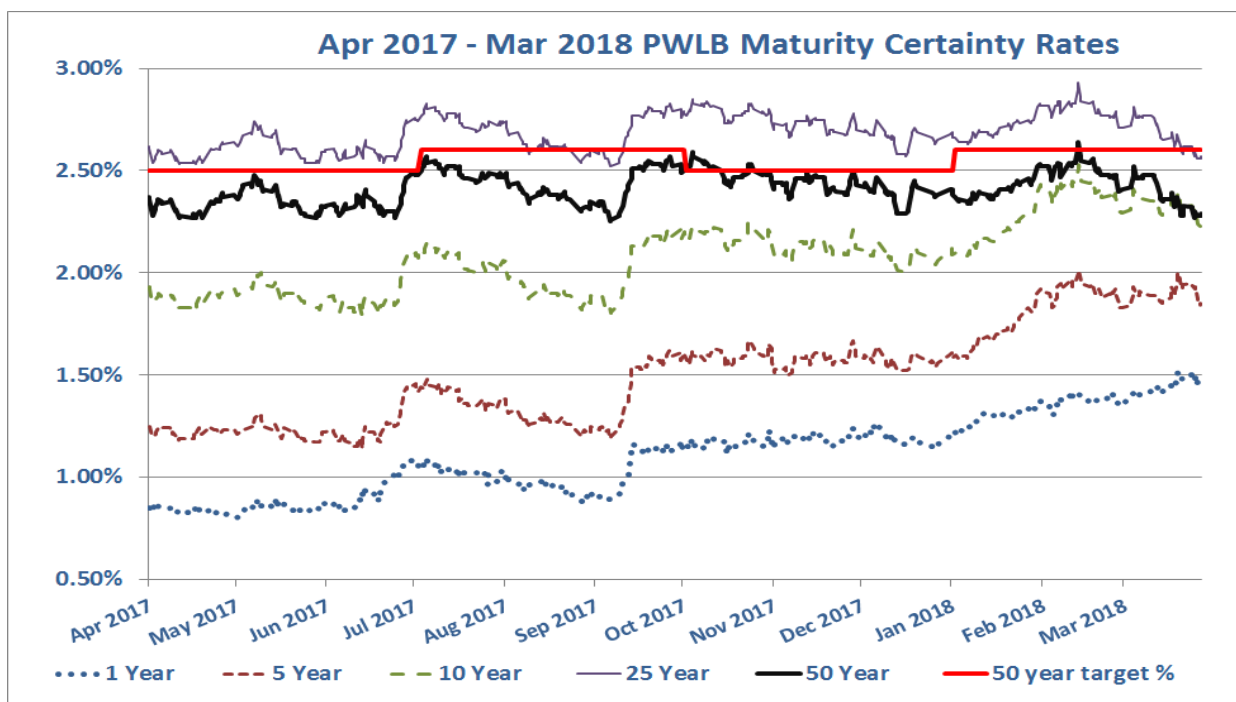
	2017/18		
	ACTUAL	RATE	ACTUAL
	£'000	%	£'000
Average Investment Portfolio	77,858	0.74%	576
INVESTMENT INCOME	77,858		576

PWLB certainty rates, half year ended 31 March 2018

The graph and table below show the movement in PWLB certainty rates for the first six months of the year to date:

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

As outlined below, the general trend has been a sharp fall in interest rates during the year.



Economic Update

Economic performance to date and outlook

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

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

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

2% target as this was a one off result of the devaluation of sterling caused by the result of the EU referendum. The inflation forecast showed that the MPC expected inflation to come down to near the 2% target over the two to three year time horizon. So this all seemed to add up to cooling expectations of much further action to raise Bank Rate over the next two years.

However, GDP growth in the second half of 2017 came in stronger than expected, while in the new year there was evidence that wage increases had started to rise. The **8 February MPC meeting** minutes therefore revealed another sharp hardening in MPC warnings focusing on a reduction in spare capacity in the economy, weak increases in productivity, higher GDP growth forecasts and a shift of their time horizon to focus on the 18 – 24 month period for seeing inflation come down to 2%. (CPI inflation ended the year at 2.7% but was forecast to still be just over 2% within two years.) This resulted in a marked increase in expectations that there would be another Bank Rate increase in May 2018 and a bringing forward of the timing of subsequent increases in Bank Rate. This shift in market expectations resulted in **investment rates** from 3 – 12 months increasing sharply during the spring quarter.

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

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

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

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

EU. Economic growth in the EU, (the UK's biggest trading partner), was lack lustre for several years after the financial crisis despite the ECB eventually

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

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

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

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

Interest rate forecasts

The PCC's treasury advisor, Link Asset Services, provided the following forecast:

	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%	0.75%	0.75%	1.00%	1.00%	1.00%	1.25%	1.25%	1.25%
5yr PWLB Rate	1.70%	1.80%	1.80%	1.90%	1.90%	2.00%	2.10%	2.10%	2.20%	2.30%	2.30%
10yr PWLB Rate	2.40%	2.40%	2.50%	2.60%	2.60%	2.70%	2.70%	2.80%	2.90%	2.90%	3.00%
25yr PWLB Rate	3.00%	3.10%	3.10%	3.20%	3.20%	3.30%	3.40%	3.50%	3.50%	3.60%	3.60%
50yr PWLB Rate	2.80%	2.90%	2.90%	3.00%	3.00%	3.10%	3.20%	3.30%	3.30%	3.40%	3.40%

Link Asset Services reviewed its interest rate forecasts shortly after quarterly Bank of England Inflation Report and the MPC meeting on 12 February at which the MPC kept the Bank Rate unchanged at 0.50%.
