

Treasury Management Strategy Statement 2015/16

1. Introduction

- 1.1 In March 2011 the Authority adopted the Chartered Institute of Public Finance and Accountancy's *Treasury Management in the Public Services: Code of Practice 2011 Edition* (the CIPFA Code) which requires the Authority to approve a treasury management strategy before the start of each financial year.
- 1.2 In addition, the Welsh Government (WG) issued revised *Guidance on Local Authority Investments* in April 2010 that requires the Authority to approve an investment strategy before the start of each financial year.
- 1.3 This report fulfils the Authority's legal obligation under the *Local Government Act 2003* to have regard to both the CIPFA Code and the WG Guidance.
- 1.4 The Authority has borrowed and invested substantial sums of money and is therefore exposed to financial risks including the loss of invested funds and the revenue effect of changing interest rates. The successful identification, monitoring and control of risk are therefore central to the Authority's treasury management strategy.

2. External Context

2.1 Economic background

There is momentum in the UK economy, with a continued period of growth through domestically-driven activity and strong household consumption. There are signs that growth is becoming more balanced. The greater contribution from business investment should support continued, albeit slower, expansion of GDP. However, inflationary pressure is benign and is likely to remain low in the short-term. There have been large falls in unemployment but levels of part-time working, self-employment and underemployment are significant and nominal earnings growth remains weak and below inflation.

The MPC's focus is on both the degree of spare capacity in the economy and the rate at which this will be used up, factors prompting some debate on the Committee. Despite two MPC members having voted for an 0.25% increase in rates at each of the meetings August 2014 onwards, some Committee members have become more concerned that the economic outlook is less optimistic than at the time of the *August Inflation Report*.

2.2 Credit outlook

The transposition of two European Union directives into UK legislation in the coming months will place the burden of rescuing failing EU banks disproportionately onto unsecured local authority investors. The *Bank Recovery and Resolution Directive* promotes the interests of individual and small businesses covered by the Financial Services Compensation Scheme and similar European schemes, while the recast *Deposit Guarantee Schemes Directive* includes large companies into these schemes. The combined effect of these two changes is to leave public authorities and financial organisations (including pension funds) as the only senior creditors likely to incur losses in a failing bank after July 2015.

The continued global economic recovery has led to a general improvement in credit conditions since last year. This is evidenced by a fall in the credit default swap spreads of banks and companies around the world. However, due to the above legislative changes, **the credit risk associated with making unsecured bank deposits will increase** relative to the risk of other investment options available to the Authority.

2.3 Interest rate forecast

The Authority's treasury management advisor Arlingclose forecasts the first rise in official interest rates in August 2015 and a gradual pace of increases thereafter, with the average for 2015/16 being around 0.75%. Arlingclose believes the normalised level of the Bank Rate post-crisis to range between 2.5% and 3.5%. The risk to the upside (i.e. interest rates being higher) is weighted more towards the end of the forecast horizon. On the downside, Eurozone weakness and the threat of deflation have increased the risks to the durability of UK growth. If the negative indicators from the Eurozone become more entrenched, the Bank of England will likely defer rate rises to later in the year. Arlingclose projects gilt yields on an upward path in the medium term, taking the forecast average 10 year PWLB loan rate for 2015/16 to 3.40%.

2.4 A more detailed economic and interest rate forecast provided by the Authority's treasury management advisor is attached at *Annex A*.

2.5 For the purpose of setting the budget, it has been assumed that new investments will be made at an average rate of 0.67%, and that no new long-term loans will be required.

3. Local Context

- 3.1 The Authority had £110.5m of borrowing and £48.3m of investments as at 31 December 2014. This is set out in further detail at *Annex B*. Forecast changes in these sums are shown in the balance sheet analysis in table 1 below.

Table 1: Balance Sheet Summary and Forecast

	31.3.14 Actual £'000	31.3.15 Estimate £'000	31.3.16 Estimate £'000	31.3.17 Estimate £'000	31.3.18 Estimate £'000
Borrowing CFR	173,308	175,228	179,510	185,052	185,069
Less: External borrowing *	(114,581)	(110,758)	(110,559)	(108,584)	(106,034)
Internal borrowing	58,727	64,470	68,951	76,468	79,035
Less: Usable reserves	(68,664)	(65,610)	(60,280)	(58,280)	(56,280)
Less: Working capital	(38,287)	(23,102)	(23,082)	(23,077)	(23,070)
Investments	(48,224)	(24,242)	(14,411)	(4,889)	(315)

* shows only loans to which the Authority is committed and excludes optional refinancing

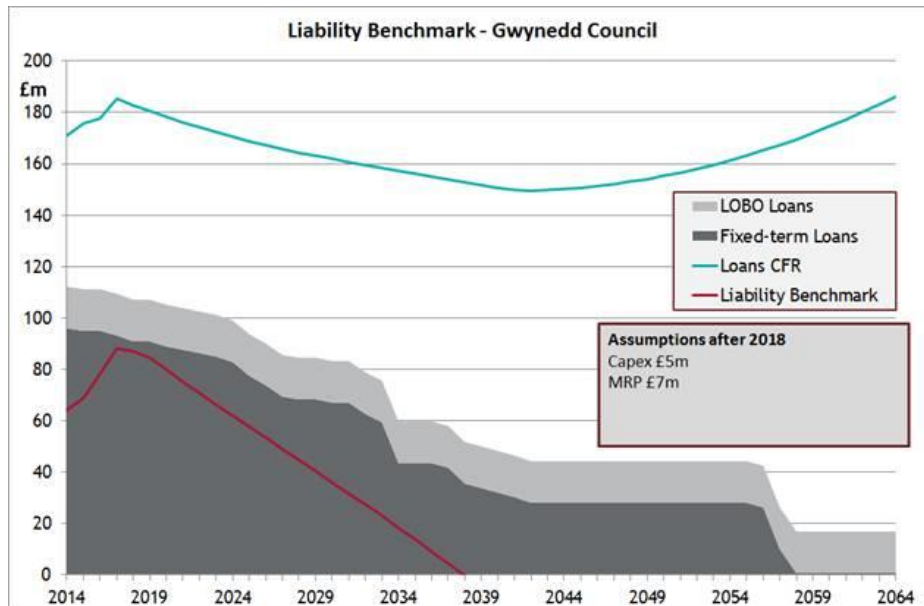
- 3.2 The underlying need to borrow for capital purposes is measured by the Capital Financing Requirement (CFR), while usable reserves and working capital are the underlying resources available for investment. The Authority's current strategy is to maintain borrowing and investments below their underlying levels, sometimes known as internal borrowing, subject to holding a minimum investment balance of £40m.

Table 1 shows that the Council should not need to borrow during the next three years.

- 3.3 CIPFA's *Prudential Code for Capital Finance in Local Authorities* recommends that the Authority's total debt should be lower than its highest forecast CFR over the next three years. Table 1 shows that the Authority expects to comply with this recommendation during 2015/16.

3.4 To assist with its long-term treasury management strategy, the Authority and its advisers have created a liability benchmark, which forecasts the Authority’s need to borrow over a 50 year period. Following on from the medium term forecasts in table 1 above, the benchmark assumes:

- capital expenditure funded by borrowing of £5m a year
- minimum revenue provision on new capital expenditure based on a 25 year asset life
- income, expenditure and reserves all increase by 2.5% inflation a year



The chart shows that borrowing is much lower than the CFR and that the Council has funds to invest. On the assumptions noted above this is likely to continue to be the position in the long term.

4. Borrowing Strategy

4.1 The Authority currently holds £111 million of loans, a decrease of £1 million on the previous year, as part of its strategy for funding previous years’ capital programmes. The balance sheet forecast in table 1 shows that the Authority does not expect to need to borrow in 2015/16. The Authority may however borrow to pre-fund future years’ requirements, providing this does not exceed the authorised limit for borrowing of £190 million.

4.2 The Authority’s chief objective when borrowing money is to strike an appropriately low risk balance between securing low interest costs and achieving cost certainty over the period for which funds are required. The flexibility to renegotiate loans should the Authority’s long-term plans change is a secondary objective.

4.3 Given the significant cuts to public expenditure and in particular to local government funding, the Authority’s borrowing strategy continues to address the key issue of affordability without compromising the longer-term stability of the debt portfolio. With short-term interest rates currently much lower than long-term rates, it is likely to

be more cost effective in the short-term to either use internal resources, or to borrow short-term loans instead.

- 4.4 By doing so, the Authority is able to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk. Whilst such a strategy is most likely to be beneficial over the next 2-3 years as official interest rates remain low, it is unlikely to be sustained in the medium-term. The benefits of internal borrowing will be monitored regularly against the potential for incurring additional costs by deferring borrowing into future years when long-term borrowing rates are forecast to rise. Arlingclose will assist the Authority with this 'cost of carry' and breakeven analysis. Its output may determine whether the Authority borrows additional sums at long-term fixed rates in 2015/16 with a view to keeping future interest costs low, even if this causes additional cost in the short-term.
- 4.5 In addition, the Authority may borrow short-term loans (normally for up to one month) to cover unexpected cash flow shortages.
- 4.6 The approved sources of long-term and short-term borrowing are:
- Public Works Loan Board
 - UK local authorities
 - any institution approved for investments (see paragraph 5.3 below)
 - any other bank or building society authorised by the *Prudential Regulation Authority* to operate in the UK
 - special purpose companies created to enable joint local authority bond issues.

In addition, capital finance may be raised by the following methods that are not borrowing, but may be classed as other debt liabilities:

- operating and finance leases
- hire purchase
- Private Finance Initiative
- sale and leaseback

The Authority has previously raised the majority of its long-term borrowing from the Public Works Loan Board, but it may consider other sources of finance, such as local authority loans and bank loans, that may be available at more favourable rates.

- 4.7 The Authority holds £16.2m as a LOBO (Lender's Option Borrower's Option) loan where the lender has the option to propose an increase in the interest rate as set dates, following which the Authority has the option to either accept the new rate or to repay the loan at no additional cost. There is no option during 2015/16. Total borrowing via LOBO loans will be limited to £16.2m.

4.8 **LGA Bond Agency**

The Local Capital Finance Company was established in 2014 by the Local Government Association as an alternative to the PWLB. It plans to issue bonds on the capital markets and lend the proceeds to local authorities. This will be a more complicated source of finance than the PWLB for three reasons:

- borrowing authorities may be required to provide bond investors with a joint and several guarantee over the very small risk that other local authority borrowers default on their loans;
- there will be a lead time of several months between committing to borrow and knowing the interest rate payable;
- up to 5% of the loan proceeds will be withheld from the Authority and used to bolster the Agency's capital strength instead. Any decision to borrow from the Agency will therefore be the subject of a separate report to full Council.

4.9 Short-term and variable rate loans leave the Authority exposed to the risk of short-term interest rate rises and are therefore subject to the limit on the net exposure to variable interest rates in the treasury management indicators below.

4.10 **Debt Rescheduling**

The PWLB allows authorities to repay loans before maturity and either pay a premium or receive a discount according to a set formula based on current interest rates. Some bank lenders may also be prepared to negotiate premature redemption terms. The Authority may take advantage of this and replace some loans with new loans, or repay loans without replacement, where this is expected to lead to an overall saving or reduction in risk.

5. **Investment Strategy**

5.1 The Authority holds invested funds, representing income received in advance of expenditure plus balances and reserves held. In the past 12 months, the Authority's investment balance has ranged between £45 and £78 million, and similar levels are expected to be maintained in the forthcoming year. This includes the cash balances of Gwynedd Pension Fund which are pooled with the Council's funds for investment purposes. The Pension Fund requests this annually as the returns received are improved and the risks reduced by combining the cash with the Council's funds. The Pensions Committee will approve the relevant elements of this Strategy Statement and request the continuation of the pooling arrangements for 2015/16 at its meeting on 24 March 2015.

5.2 **Objectives**

Both the CIPFA Code and the WG Guidance require the Authority to invest its funds prudently, and to have regard to the security and liquidity of its investments before seeking the highest rate of return, or yield. The Authority's objective when investing money is to strike an appropriate balance between risk and return, minimising the risk of incurring losses from defaults and the risk of receiving unsuitably low investment income.

5.3 Strategy

Given the increasing risk and continued low returns from short-term unsecured bank investments, the Authority aims to further diversify into more secure and/or higher yielding asset classes during 2015/16. The majority of the Authorities surplus cash is currently invested in short-term unsecured bank deposits, certificates of deposit and money market funds. This diversification will therefore represent a substantial change in strategy over the coming year.

5.4 The Authority may invest its surplus funds with any of the counterparties in table 2 below, subject to the cash and time limits shown.

Table 2: Approved Investment Counterparties

Credit Rating	Banks Unsecured	Banks Secured	Government	Corporates	Registered Providers
UK Govt	n/a	n/a	£ Unlimited 50 years	n/a	n/a
AAA	£4m 5 years	£8m 20 years	£8m 50 years	£4m 20 years	£4m 20 years
AA+	£4m 5 years	£8m 10 years	£8m 25 years	£4m 10 years	£4m 10 years
AA	£4m 4 years	£8m 5 years	£8m 15 years	£4m 5 years	£4m 10 years
AA-	£4m 3 years	£8m 4 years	£8m 10 years	£4m 4 years	£4m 10 years
A+	£4m 2 years	£8m 3 years	£4m 5 years	£4m 3 years	£4m 5 years
A	£4m 13 months	£8m 2 years	£4m 5 years	£4m 2 years	£4m 5 years
A-	£4m 6 months	£8m 13 months	£4m 5 years	£4m 13 months	£4m 5 years
BBB+	£2m 100 days	£4m 6 months	£2m 2 years	£2m 6 months	£2m 2 years
BBB or BBB-	£2m next day only	£4m 100 days	n/a	n/a	n/a
None	£1m 6 months	n/a	£4m 25 years	£50,000 5 years	£4m 5 years
Pooled funds	£8m per fund				
Business loans to local companies*			£3m in total 10 years		

* Advancement of these loans will be approved by the procedure detailed in paragraph 5.9 below. Evaluation of the Business Loans is not part of the advice or services from the Council's treasury advisor.

5.5 **Credit Rating**

Investment decisions are made by reference to the lowest published long-term credit rating from Fitch, Moody's or Standard & Poor's. Where available, the credit rating relevant to the specific investment or class of investment is used, otherwise the counterparty credit rating is used.

5.6 **Banks Unsecured**

Accounts, deposits, certificates of deposit and senior unsecured bonds with banks and building societies, other than multilateral development banks. These investments are subject to the risk of credit loss via a bail-in should the regulator determine that the bank is failing or likely to fail. Unsecured investment with banks rated BBB or BBB- are restricted to overnight deposits at the Authority's current account bank Barclays Bank plc.

5.7 **Banks Secured**

Covered bonds, reverse repurchase agreements and other collateralised arrangements with banks and building societies. These investments are secured on the bank's assets, which limits the potential losses in the unlikely event of insolvency, and means that they are exempt from bail-in. Where there is no investment specific credit rating, but the collateral upon which the investment is secured has a credit rating, the highest of the collateral credit rating and the counterparty credit rating will be used to determine cash and time limits. The combined secured and unsecured investments in any one bank will not exceed the cash limit for secured investments.

5.8 **Government**

Loans, bonds and bills issued or guaranteed by national governments, regional and local authorities and multilateral development banks. These investments are not subject to bail-in, and there is an insignificant risk of insolvency. Investments with the UK Central Government may be made in unlimited amounts for up to 50 years.

5.9 **Corporates**

Loans, bonds and commercial paper issued by companies other than banks and registered providers. These investments are not subject to bail-in, but are exposed to the risk of the company going insolvent. Loans to unrated companies will only be made as part of a diversified pool in order to spread the risk widely.

5.10 **Registered Providers**

Loans and bonds issued by, guaranteed by or secured on the assets of Registered Providers of Social Housing, formerly known as Housing Associations. These bodies are tightly regulated by the Homes and Communities Agency and, as providers of public services, they retain a high likelihood of receiving government support if needed.

5.11 **Pooled Funds**

Shares in diversified investment vehicles consisting of the any of the above investment types, plus equity shares and property. These funds have the advantage of providing wide diversification of investment risks, coupled with the services of a professional fund manager in return for a fee. Money Market Funds that offer same-day liquidity and aim for a constant net asset value will be used as an alternative to instant access bank accounts, while pooled funds whose value changes with market prices and/or have a notice period will be used for longer investment periods.

Bond, equity and property funds offer enhanced returns over the longer term, but are more volatile in the short term. These allow the Authority to diversify into asset classes other than cash without the need to own and manage the underlying investments. Because these funds have no defined maturity date, but are available for withdrawal after a notice period, their performance and continued suitability in meeting the Authority's investment objectives will be monitored regularly.

5.12 **Local Loans Fund**

The Council has set up a Local Loans Fund which will make loans to local businesses. These investments are included in the Non-Specific Investments table above and will be for a maximum period of 10 years. The total value of the fund for such investments is £3million. Applications for loans under this scheme will not be part of the usual credit assessment for treasury management investment purposes but will be assessed by appointed consultants and any decision to lend will be made by the Investment Panel for the scheme.

5.13 **Risk Assessment and Credit Ratings**

Credit ratings are obtained and monitored by the Authority's treasury advisers, who will notify changes in ratings as they occur. Where an entity has its credit rating downgraded so that it fails to meet the approved investment criteria then:

- no new investments will be made,
- any existing investments that can be recalled or sold at no cost will be, and
- full consideration will be given to the recall or sale of all other existing investments with the affected counterparty.

Where a credit rating agency announces that a credit rating is on review for possible downgrade (also known as "rating watch negative" or "credit watch negative") so that it may fall below the approved rating criteria, then only investments that can be withdrawn on the next working day will be made with that organisation until the outcome of the review is announced. This policy will not apply to negative outlooks, which indicate a long-term direction of travel rather than an imminent change of rating.

5.14 **Other Information on the Security of Investments**

The Authority understands that credit ratings are good, but not perfect, predictors of investment default. Full regard will therefore be given to other available information on the credit quality of the organisations in which it invests, including credit default swap prices, financial statements, information on potential government support and reports in the quality financial press. No investments will be made with an organisation if there are substantive doubts about its credit quality, even though it may meet the credit rating criteria.

When deteriorating financial market conditions affect the creditworthiness of all organisations, as happened in 2008 and 2011, this is not generally reflected in credit ratings, but can be seen in other market measures. In these circumstances, the Authority will restrict its investments to those organisations of higher credit quality and reduce the maximum duration of its investments to maintain the required level of security. The extent of these restrictions will be in line with prevailing financial market conditions. If these restrictions mean that insufficient commercial organisations of high credit quality are available to invest the Authority's cash balances, then the surplus will be deposited with the UK Government, via the Debt Management Office for example, or with other local authorities. This will cause a reduction in the level of investment income earned, but will protect the principal sum invested.

5.15 **Specified Investments**

The WG Guidance defines specified investments as those:

- denominated in pound sterling,
- due to be repaid within 12 months of arrangement,
- not defined as capital expenditure by legislation, and
- invested with one of:
 - the UK Government,
 - a UK local authority, parish council or community council, or
 - a body or investment scheme of “high credit quality”.

The Authority defines “high credit quality” organisations as those having a credit rating of A- or higher that are domiciled in the UK or a foreign country with a sovereign rating of AA+ or higher.

5.16 **Non-specified Investments**

Any investment not meeting the definition of a specified investment is classed as non-specified. The Authority does not intend to make any investments denominated in foreign currencies. Non-specified investments will therefore be limited to long-term investments, i.e. those that are due to mature 12 months or longer from the date of arrangement; those that are defined as capital expenditure by legislation, such as shares in money market funds and other pooled funds; and investments with bodies and schemes not meeting the definition on high credit quality. Limits on non-specified investments are shown in table 3 below.

Table 3: Non-Specified Investment Limits

	Cash limit
Total long-term investments	£40m
Total shares in money market funds	£40m
Total investments without credit ratings or rated below [A-]	£8m
Total investments in foreign countries rated below [AA+]	£8m
Total non-specified investments	£80m

5.17 Investment Limits

The Authority's revenue reserves and Pension Fund cash available to cover investment losses are forecast to be £65 million on 31st March 2015. In order that no more than 10% of available reserves will be put at risk in the case of a single default, the maximum that will be lent to any one organisation (other than the UK Government) will be £8 million. A group of banks under the same ownership or a group of funds under the same management will be treated as a single organisation for limit purposes. Limits will also be placed on investments in brokers' nominee accounts (*e.g. King & Shaxson*), foreign countries and industry sectors as below:

Table 4: Investment Limits

	Cash limit
Any single organisation, except the UK Central Government	£8m each
UK Central Government	unlimited
Any group of organisations under the same ownership	£8m per group
Any group of pooled funds under the same management	£20m per manager
Negotiable instruments held in a broker's nominee account	£40m per broker
Foreign countries	£8m per country
Registered Providers	£20m in total
Unsecured investments with Building Societies	£8m in total
Loans to unrated corporates	£8m in total
Money Market Funds	£40m in total

5.18 **Liquidity management**

The Authority uses prudent cash flow forecasting techniques to determine the maximum period for which funds may prudently be committed.

6. **Treasury Management Indicators**

The Authority measures and manages its exposures to treasury management risks using the following indicators.

6.1 **Security**

The Authority has adopted a voluntary measure of its exposure to credit risk by monitoring the time-weighted average credit score of its investment portfolio. This is calculated by applying a score to each investment (AAA=1, AA+=2, etc.) and taking the arithmetic average, weighted by the size of each investment.

	Target
Portfolio average credit score	7.0

6.2 **Liquidity**

The Authority has adopted a voluntary measure of its exposure to liquidity risk by monitoring the amount of cash available to meet unexpected payments within a rolling three month period, without additional borrowing.

	Target
Total cash available within 3 months	£10m

6.3 **Interest Rate Exposures**

This indicator is set to control the Authority's exposure to interest rate risk. The upper limits on fixed and variable rate interest rate exposures, expressed as the proportion of net principal borrowed will be:

	2015/16	2016/17	2017/18
Upper limit on fixed interest rate exposure	100%	100%	100%
Upper limit on variable interest rate exposure	50%	50%	50%

Fixed rate investments and borrowings are those where the rate of interest is fixed for the whole financial year. Instruments that mature during the financial year are classed as variable rate.

6.4 **Maturity Structure of Borrowing**

This indicator is set to control the Authority's exposure to refinancing risk. The upper and lower limits on the maturity structure of fixed rate borrowing will be:

	Upper	Lower
Under 12 months	25%	0%
12 months and within 24 months	25%	0%
24 months and within 5 years	50%	0%
5 years and within 10 years	75%	0%
10 years and within 20 years	100%	0%
20 years and within 30 years	100%	0%
30 years and within 40 years	100%	0%
40 years and within 50 years	100%	0%
50 years and above	100%	0%

Time periods start on the first day of each financial year. The maturity date of borrowing is the earliest date on which the lender can demand repayment.

6.5 **Principal Sums Invested for Periods Longer than 364 days**

The purpose of this indicator is to control the Authority's exposure to the risk of incurring losses by seeking early repayment of its investments. The limits on the total principal sum invested to final maturities beyond the period end will be:

	2015/16	2016/17	2017/18
Limit on principal invested beyond year end	£40m	£30m	£25m

7. Other Items

7.1 There are a number of additional items that the Authority is obliged by CIPFA or WG to include in its Treasury Management Strategy.

7.2 **Policy on Use of Financial Derivatives**

In the absence of any legal power to do so, the Authority will not use standalone financial derivatives (such as swaps, forwards, futures and options). Derivatives embedded into loans and investments, including pooled funds, may be used, and the risks that they present will be managed in line with the overall treasury risk management strategy.

7.3 **Investment Training**

The needs of the Authority's treasury management staff for training in investment management are assessed every year as part of the staff appraisal process, and additionally when the responsibilities of individual members of staff change.

Staff regularly attend training courses, seminars and conferences provided by Arlingclose and CIPFA. Relevant staff are also encouraged to study professional qualifications from CIPFA and other appropriate organisations.

7.4 **Investment Advisers**

The Authority has appointed Arlingclose Limited as treasury management advisers and receives specific advice on investment, debt and capital finance issues. The quality of this service is monitored by the Head of Finance and the Investment Manager on a regular basis.

7.5 **Investment of Money Borrowed in Advance of Need**

The Authority may, from time to time, borrow in advance of need, where this is expected to provide the best long term value for money. Since amounts borrowed will be invested until spent, the Authority is aware that it will be exposed to the risk of loss of the borrowed sums, and the risk that investment and borrowing interest rates may change in the intervening period. These risks will be managed as part of the Authority's overall management of its treasury risks.

The total amount borrowed will not exceed the authorised borrowing limit of £195 million. The maximum period between borrowing and expenditure is expected to be two years, although the Authority is not required to link particular loans with particular items of expenditure.

8. **Financial Implications**

The budget for investment income in 2015/16 is £0.5 million, based on an average investment portfolio of £74.6 million at an interest rate of 0.67%. The budget for debt interest paid in 2015/16 is £6.5 million, based on an average debt portfolio of £114.2 million at an average interest rate of 5.71%. If actual levels of investments and borrowing, and actual interest rates differ from those forecast, performance against budget will be correspondingly different.

9. **Other Options Considered**

The WG Guidance and the CIPFA Code do not prescribe any particular treasury management strategy for local authorities to adopt. The Head of Finance, having consulted the Cabinet Member for Resources, believes that the above strategy represents an appropriate balance between risk management and cost effectiveness. Some alternative strategies, with their financial and risk management implications, are listed below.

Alternative	Impact on income and expenditure	Impact on risk management
Invest in a narrower range of counterparties and/or for shorter times	Interest income will be lower	Lower chance of losses from credit related defaults, but any such losses will be greater
Invest in a wider range of counterparties and/or for longer times	Interest income will be higher	Increased risk of losses from credit related defaults, but any such losses will be smaller
Borrow additional sums at long-term fixed interest rates	Debt interest costs will rise; this is unlikely to be offset by higher investment income	Higher investment balance leading to a higher impact in the event of a default; however long-term interest costs will be more certain
Borrow short-term or variable loans instead of long-term fixed rates	Debt interest costs will initially be lower	Increases in debt interest costs will be broadly offset by rising investment income in the medium term, but long term costs will be less certain
Reduce level of borrowing	Saving on debt interest is likely to exceed lost investment income High premia for early redemption of debt may outweigh any savings	Reduced investment balance leading to a lower impact in the event of a default; however long-term interest costs will be less certain

Appendix A – Arlingclose Economic & Interest Rate Forecast January 2015

Underlying assumptions:

- The UK economic recovery slowed towards the end of 2014, with economic and political uncertainty weighing on business investment. However, the Q3 growth rate of 0.7% remains slightly above the long run average, suggesting the recovery remains robust.
- Household consumption is key to the recovery in 2015. While we expect consumption growth to slow, given softening housing market activity and slower employment growth, the fall in inflation and resulting rise in both real (and nominal) wage growth and disposable income should support spending.
- Inflationary pressure is currently low (annual CPI is currently 0.5%) and is likely to remain so in the short-term. The fall in oil prices has yet to feed fully into the prices of motor fuel and retail energy and CPI is expected to fall further. Supermarket price wars are also expected to bear down on food price inflation.
- The MPC's focus is on both the degree of spare capacity in the economy and the rate at which this will be used up, factors prompting some debate on the Committee.
- Nominal earnings growth is strengthening, but remains relatively weak in historical terms, despite large falls in unemployment. Our view is that spare capacity remains extensive. The levels of part-time, self-employment and underemployment are significant and indicate capacity within the employed workforce, in addition to the still large unemployed pool. Productivity growth can therefore remain weak in the short term without creating undue inflationary pressure.
- However, we also expect employment growth to slow as economic growth decelerates. This is likely to boost productivity, which will bear down on unit labour costs and inflationary pressure.
- In addition to the lack of wage and inflationary pressures, policymakers are evidently concerned about the bleak prospects for the Eurozone. These factors will maintain the dovish stance of the MPC in the medium term. The MPC clearly believes the appropriate level for Bank Rate for the post-crisis UK economy is significantly lower than the previous norm. We would suggest this is between 2.5 and 3.5%.
- The ECB has introduced outright QE as expected. While this may alleviate some of the anxiety about the economic potential of the Eurozone, political risk remains significant (e.g. Greek election). Therefore fears for the Eurozone are likely to maintain a safe haven bid for UK government debt.

Forecast:

- We continue to forecast the first rise in official interest rates in Q3 2015, but the risks to this forecast are very much weighted to the downside. The February Inflation Report will be key to our review of the possible path for Bank Rate.
- We project a slow rise in Bank Rate. The pace of interest rate rises will be gradual and the extent of rises limited; we believe the normalised level of Bank Rate post-crisis to range between 2.5% and 3.5%.

- Market sentiment (derived from forward curves) has shifted significantly lower in the past three months; market expectations are now for a later increase in interest rates and a more muted increase in gilt yields.
- The short run path for gilt yields has flattened due to the sharp decline in inflation expectations. We project gilt yields on an upward path in the medium term.
- The short run path for gilt yields is flatter due to the deteriorating Eurozone situation. We project gilt yields on an upward path in the medium term.

	Mar-15	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18
Official Bank Rate													
Upside risk				0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25
Arlingclose Central Case	0.50	0.50	0.75	0.75	1.00	1.00	1.25	1.25	1.50	1.50	1.75	1.75	1.75
Downside risk			0.25	0.25	0.50	0.50	0.75	0.75	1.00	1.00	1.00	1.00	1.00
3-month LIBID rate													
Upside risk	0.10	0.20	0.20	0.30	0.30	0.30	0.30	0.30	0.30	0.30	0.30	0.30	0.30
Arlingclose Central Case	0.55	0.60	0.80	0.90	1.05	1.15	1.30	1.40	1.55	1.65	1.80	1.95	2.00
Downside risk	0.15	0.20	0.30	0.40	0.55	0.65	0.75	0.85	0.95	0.95	0.95	0.95	1.00
1-yr LIBID rate													
Upside risk	0.10	0.20	0.20	0.30	0.30	0.30	0.30	0.30	0.40	0.40	0.40	0.40	0.40
Arlingclose Central Case	0.95	1.00	1.20	1.30	1.45	1.55	1.70	1.80	1.95	2.05	2.20	2.35	2.40
Downside risk	0.15	0.20	0.30	0.50	0.55	0.60	0.65	0.70	0.75	0.80	0.80	0.80	0.80
5-yr gilt yield													
Upside risk	0.35	0.40	0.40	0.40	0.40	0.40	0.40	0.45	0.45	0.45	0.45	0.50	0.50
Arlingclose Central Case	1.10	1.20	1.30	1.40	1.50	1.65	1.80	1.95	2.10	2.20	2.35	2.40	2.50
Downside risk	0.35	0.35	0.40	0.45	0.50	0.50	0.55	0.60	0.65	0.70	0.70	0.70	0.75
10-yr gilt yield													
Upside risk	0.35	0.40	0.40	0.40	0.40	0.45	0.45	0.45	0.45	0.50	0.50	0.55	0.55
Arlingclose Central Case	1.60	1.70	1.80	1.90	2.00	2.15	2.30	2.45	2.60	2.70	2.85	2.90	3.00
Downside risk	0.35	0.35	0.40	0.45	0.50	0.50	0.55	0.60	0.65	0.70	0.70	0.75	0.80
20-yr gilt yield													
Upside risk	0.35	0.40	0.45	0.50	0.50	0.50	0.50	0.50	0.50	0.55	0.55	0.55	0.55
Arlingclose Central Case	2.10	2.20	2.30	2.35	2.45	2.50	2.65	2.75	2.90	3.00	3.15	3.20	3.30
Downside risk	0.35	0.40	0.50	0.60	0.70	0.75	0.75	0.75	0.80	0.85	0.85	0.90	0.90
50-yr gilt yield													
Upside risk	0.35	0.40	0.45	0.50	0.50	0.50	0.50	0.50	0.50	0.55	0.55	0.55	0.55
Arlingclose Central Case	2.15	2.25	2.35	2.40	2.50	2.55	2.70	2.80	2.95	3.05	3.20	3.25	3.35
Downside risk	0.35	0.40	0.50	0.60	0.70	0.75	0.75	0.75	0.80	0.85	0.85	0.90	0.90

Annex B – Existing Investment & Debt Portfolio Position

	31.12.14 Actual Portfolio £m	9 months to 31.12.14 Average Rate %
External Borrowing:		
PWLB – Fixed Rate	94.3	6.06
LOBO Loans	16.2	4.22
Total Gross External Debt	110.5	5.80
Investments:		
Short-term investments	48.3	0.70
Total Investments	48.3	0.70
Net Debt	62.2	