ARGYLL AND BUTE COUNCIL	PERFORMANCE REVIEW AND SCRUTINY COMMITTEE
STRATEGIC FINANCE	3 MARCH 2017

TREASURY MANAGEMENT MONITORING REPORT 31 DECEMBER 2016

1. EXECUTIVE SUMMARY

1.1 This report sets out the Council's treasury management position for the period 1 November 2016 to 31 December 2016 and includes information on:

- Overall Borrowing Position
- Borrowing Activity
- Investment Activity
- Economic Background
- Interest Rate Forecast
- Prudential Indicators.

1.2 Borrowing is below the Capital Financing Requirement for the period to 31 December 2016, however, there are substantial internal balances, of which £76.5m is currently invested.

1.3 The Council drew down £0.3m of funding from Salix in respect of the LED Street Lighting Project with an interest rate of 0% during the period 1 November 2016 to 31 December 2016.

1.4 The net movement in external borrowing during the period was a decrease of £0.8m.

1.5 The levels of investments have decreased to £76.5m at 31 December 2016. The rate of return achieved was 0.579% which compares favourably with the target of 7 day LIBID which was 0.116%.

1.6 This report is for noting.

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2. INTRODUCTION

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3. RECOMMENDATIONS

3.1 The treasury management monitoring report is noted.

4. DETAIL

Overall Borrowing Position

4.1 The table below details the estimated capital financing requirement (CFR) and compares this with the estimated level of external debt at 31 March 2017. The CFR represents the underlying need for the Council to borrow to fund its fixed assets and accumulated capital expenditure.

	Forecast 2016/17 £000's	**Budget 2016/17 £000's**	**Forecast 2017/18 £000's**	**Forecast 2018/19 £000's**
CFR at 1 April	253,896	259,000	260,580	261,395
Net Capital Expenditure	17,855	17,937	11,059	2,656
Less Loans Fund Principal Repayments	(9,236)	(9,236)	(8,236)	(8,236)
Less: NPDO Repayment	(1,935)	(1,935)	(2,008)	(2,117)
Estimated CFR 31 March	**260,580**	**265,766**	**261,395**	**253,698**
Less Funded by NPDO	(74,059)	(74,059)	(72,051)	(69,934)
Estimated Net CFR 31 March	**186,521**	**191,707**	**189,344**	**183,764**
Estimated External Borrowing at 31 March	169,589	169,589	179,589	181,589
Gap	**16,932**	**22,118**	**9,755**	**2,175**

4.2 Borrowing is below the CFR for the period to 31 March 2017. This reflects the approach taken to minimise surplus cash on deposit in order to avoid overdue exposure to investment / credit worthiness risks.

4.3 The Council's estimated net capital financing requirement at the 31 December 2016 is £186.5m. The table below shows how this has been financed. Whilst borrowing is less than the CFR there are substantial internal balances (mainly the General Fund) of which £76.5m is currently invested.

	Position at 31/10/2016 £000's	**Position at 31/12/2016 £000's**
Loans	167,141	166,296
Internal Balances	97,061	96,740
Less Investments & Deposits	(77,901)	(76,515)
Total	**186,301**	**186,521**

Borrowing Activity

4.4 The table below summarises the borrowing and repayment transactions in the period 1 November 2016 to 31 December 2016.

	Actual £000's
External Loans Repaid 1st November 2016 to 31st December 2016	(1,145)
Borrowing undertaken 1st November 2016 to 31st December 2016	300
Net Movement in External Borrowing	**(845)**

4.5 The external borrowing of the Council decreased by £0.8m during the period due to the repayment of PWLB loans offset by new long borrowing of £0.3m at 0% from Salix in respect of the LED Street Lighting Project.

4.6 The table below summarises the movement in level and rate of temporary borrowing at the start and end of the period.

	£000s	**% Rate**
Temp borrowing at 31st October 2016	600	0.10%
Temp borrowing at 31st December 2016	600	0.10%

Investment Activity

4.7 The average rate of return achieved on the Council's investments to 31 December 2016 was 0.579% compared to the average LIBID rate for the same period of 0.116% which demonstrates that the Council is achieving a reasonable rate of return on its cash investments. At 31 December 2016 the Council had £66.5m of short term investments at an average rate of 0.682% and £10m placed in Enhanced Money Market Funds with an unrealised gain of £23,259 at 31 December 2016. The table below details the counterparties that the investments were placed with, the maturity date, the interest rate and the credit rating applicable for each of the counterparties.

Counterparty	Maturity	Amount £000s	Interest Rate	Rating
Clydesdale Bank Instant	Instant Access	3,505	0.25%	Short Term A-2, Long Term BBB+
BOS Corp	Instant Access	10	0.40%	Short Term A-1, Long Term A
Santander 95D	95 Day Notice	5,000	0.65%	Short Term A-1, Long Term A
Helaba Landesbank	31/08/2016	5,000	0.65%	Short Term A-1, Long Term A
Helaba Landesbank	19/04/2017	2,500	0.93%	Short Term A, Long Term A-1
Toronto Dominion	19/04/2017	2,500	0.90%	Short Term A-1+, Long Term AA-
Goldman Sachs	06/12/2016	2,500	0.59%	Short Term A-1, Long Term A
Goldman Sachs	08/03/2017	2,500	0.74%	Short Term A-1, Long Term A
Goldman Sachs	06/04/2017	5,000	0.78%	Short Term A-1, Long Term A
Commonwealth Bank of Australia	02/06/2017	5,000	0.99%	Short Term A-1+, Long Term AA-
Commonwealth Bank of Australia	22/06/2017	2,500	0.96%	Short Term A-1+, Long Term AA-
Nationwide BS	13/01/2017	5,000	0.49%	Short Term A-1, long Term A
BOS 6mth FTD	20/01/2017	2,500	0.80%	Short Term A-1, Long Term A
BOS 6mth FTD	08/03/2017	2,500	0.65%	Short Term A-1, Long Term A
BOS 6mth FTD	18/04/2017	5,000	0.65%	Short Term A-1, Long Term A
CD - Toronto Dominion	12/01/2017	5,000	0.97%	Short Term A-1+, Long Term AA-
Standard Chartered 95D	95 Day Notice	5,000	0.57%	Short Term A-1, Long Term A
MMF - BNP Paribas	Instant Access	5,500	0.34%	AAA
ENH MMF - Federated Cash Plus (T+1)	T+1	5,000	0.00%	AAA
ENH MMF - Standard Life Short Duration (T+3)	T+3	5,000	0.00%	AAA
MMF - Standard Life (formerly Ignis)	Instant Access	0	0.00%	AAA
MMF - Invesco AIM	Instant Access	0	0.00%	AAA
MMF- Federated	Instant Access	0	0.00%	AAA
MMF - Insight	Instant Access	0	0.00%	AAA
Total		**76,515**		

4.8 All investments and deposits are in accordance with the Council's approved list of counterparties and within the limits and parameters defined in the Treasury Management Practices. The counterparty list is constructed based on assessments by leading credit reference agencies adjusted for additional market information available in respect of counterparties.

4.9 The current market conditions have made investment decisions more difficult as the number of counterparties which meet the Council's parameters has reduced making it harder to achieve reasonable returns while limiting the exposure to any one institution.

Economic and Interest Rate Forecasts

4.10 The latest economic background is shown in appendix 1 with the interest rate forecast in appendix 2.

Prudential Indicators

4.11 The prudential indicators for 2016-17 are attached in appendix 3.

5. CONCLUSION

5.1 The Council's borrowing decreased by £0.8m but it is still below the Capital Financing Requirement for the period to 31 December 2016. There are substantial internal balances, of which £76.5m is currently invested. The investment returns were 0.579% which is above the target of 0.116%.

6. IMPLICATIONS

6.1 Policy – None
6.2 Financial - None
6.3 Legal - None.
6.4 HR - None.
6.5 Equalities - None.
6.6 Risk - None.
6.7 Customer Service - None.

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Appendix 1 – Economic Background
Appendix 2 – Interest Rate Forecast
Appendix 3 – Prudential Indicators

Appendix 1

Economic background:

- During the quarter ended 31 December 2016:
  - The economy maintained its momentum, despite Brexit;
  - Households continued to drive overall economic growth;
  - The labour market showed some signs of weakening;
  - CPI inflation rose above 1% for the first time in two years;
  - The Chancellor eased the planned fiscal squeeze, but the MPC kept policy unchanged;
  - Monetary policy in the US and the Euro-zone diverged.
- Economic growth appears to have barely lost pace, despite the vote for Brexit. Indeed, quarterly GDP growth in Q3 of 2016 is now estimated to have been 0.6%, up from the initial estimate of 0.5%: Q2's growth rate was also nudged down from 0.7% to 0.6%. Moreover, the average level of the Markit/CIPS all-sector PMI in October and November was 54.8, compared to an average of 51.4 in Q3. On the basis of past form, this is consistent with quarterly GDP growth of about 0.5%. And the sharp rise in the manufacturing PMI in December suggests the sector ended the year solidly.
- Consumer spending continued to be the key driver of growth in Q4. Admittedly, retail sales only rose by a monthly 0.2% in November. But this followed a whopping 1.8% monthly increase in October. As a result, even if sales volumes were flat in December, they would have risen by 2.1% over Q4 as a whole, the largest increase since Q2 2014 and up from Q3's 1.9% rise.
- This does not look sustainable though. Q3's National Accounts revealed a fall in households' real disposable incomes, and as a result the 0.7% rise in overall household spending was funded entirely through a fall in the household saving ratio. With inflation having picked up and employment growth having slowed in Q4, it looks likely that the saving ratio may have fallen further.
- The labour market's recent strength seems to be waning. Employment actually fell in the three months to October, the first fall since Q2 2015. Annual growth in employment remained positive, albeit weak, at 1.1%. Granted, the unemployment rate held steady at its post-crisis low of 4.8%. But note that this was due to people moving into inactivity rather than employment.
- Note that some slowdown in employment growth was inevitable, regardless of the outcome of the referendum, as labour market slack has diminished. Indeed the unemployment rate is now around the level often

thought to be its “natural” rate. Looking ahead, we doubt that any job losses will be particularly severe or sustained. Survey measures of firms’ employment intentions are consistent with annual growth in private sector employment of about 1% over the coming months.

- Meanwhile, perhaps in response to past tightening in the labour market, there have been some more optimistic signs on the wages front, with annual growth in average weekly earnings (including bonuses) holding broadly stable at 2.5% in the three months to October, following a 2.4% rise in Q3.

- At the current time, this is enough to outpace inflation. CPI inflation picked up from 0.7% in Q3 to average 1.1% in October and November. The 1.2% level reached in November was the highest since October 2014, although this still remains low by historical standards. However, inflation is on a steep upward trajectory. Components of inflation that typically respond quite quickly to exchange rate movements, such as petrol and food prices, have had big upward influences on the headline rate recently, and will continue to do so as the drop in the pound makes its way through the inflation pipeline.

- Price pressures at the beginning of the pipeline are already building rapidly. Producer input price inflation rose from 6.5% in Q3 to an average of 12.6% in October and November. There is typically quite a long lag between producer prices and CPI inflation, but we should start to see this feed through to higher prices on the high street over the course of 2017. Indeed, CPI inflation is still on track to breach the 2% inflation target in spring 2017, and should peak at around 3% by spring 2018.

- For now at least, the MPC doesn’t appear to be too fazed by this overshoot of the 2% inflation target: it left interest rates unchanged at 0.25% during Q4. Given the uncertainty about the economic outlook, and especially the impact from the two year window for Brexit negotiations from March 2017, interest rates look set to remain on hold for a long while yet.

- By contrast, the US Fed pressed ahead and raised interest rates by 25bp in December, as expected, taking the Fed funds target range to between 0.50% and 0.75%. At the same time, the ECB announced that it would slow the pace of its asset purchases from April 2017, but committed to extending the purchases by another nine months (to December 2017). This highlights the unusual divergence in western monetary policy set to occur over the next year or so.

- Meanwhile, the latest data suggests that the public finances are broadly on track to meet the recently revised OBR’s near-term forecasts. Borrowing on the PSNB ex measure in the first eight months of the fiscal year so far was about 11% lower than last year. This compares to the OBR’s expectations of a 10% fall for the fiscal year as a whole.

- But hopes of a complete "reset" of fiscal policy were dashed in November's Autumn Statement. Chancellor Philip Hammond did lessen the fiscal squeeze a bit, but the UK still faces another bout of austerity over the coming years. Of course, the new fiscal rules – which include achieving a cyclically-adjusted budget deficit of below 2% by 2020/21 – do offer the Chancellor a bit of room for manoeuvre if the economy were to turn out much weaker. On the basis of the OBR's new forecasts, the deficit will be about 0.8% on this measure by that point, leaving him about 1.2% of GDP to play with.

- Ongoing deficit reduction in the UK is in contrast to the US, where we expect a major fiscal stimulus on the back of Trump's victory. Indeed, we have revised up our US GDP growth forecast for 2017 from 2% to 2.7%.

- Meanwhile, in financial markets, the FTSE 100 rose by 2.4% between Q3 and Q4 of 2016, taking it to a record high. This partly reflected the 3.5% drop in the trade-weighted value of sterling, (which boosts the sterling value of UK firms' overseas profits), but also the generally positive market reaction to Trump's victory in the US election. That said, Brexit worries are still lingering, with the FTSE UK Local Index, which only includes firms of which more than 70% of their sales are generated in the UK, falling by 5.4%. Meanwhile, reflecting a combination of rising US Treasury yields on the back of Trump's victory, as well as fears about the sterling-driven rise in inflation over the next few years in the UK, 10-year UK government bond yields rose by close to 50bp during Q4.

- Finally, the UK government still plans to trigger Article 50 and begin Brexit negotiations by the end of March, and has promised to lay out its plans before it does so. A soft(ish) form of Brexit still looks in prospect. Granted, controlling immigration and ending the influence of the European Court of Justice appear to be key priorities, but the government has stated it wants to retain a very close trading relationship, and that a transitional deal may be considered in order to smooth the process.

Appendix 2

Interest Rate Forecast:

Our treasury management advisers, Capita Asset Services have provided us with the following update to their interest rate forecasts.

November quarterly inflation report and post US Presidential election review

- We updated our forecasts to take into account the Bank of England quarterly Inflation Report for November 2016, the decision of the MPC meeting of 3 November, and the US Presidential election of 8 November. We also felt that we should allow financial markets to settle down for a few days after the result of that election, which provided a surprise outcome. We therefore undertook a review of our forecasts on 14 November.

- Despite many ominous warnings that there could be significant turbulence in financial markets if ***Donald Trump won the election***, markets have surprised by their lack of such a reaction. In fact, stock markets in America hit a new record high in the first few days after the election and have reached further highs since then. However, Treasury yields have risen sharply in expectation of a significant rise in inflation, as an economy which is already working near to full capacity could be in line for a significant boost to economic growth if Trump's expansion of infrastructure expenditure plans become a reality.

- His plans to cut taxes, at the same time as boosting expenditure, could also lead to a sharp rise in total debt issuance from the current level of around 72% of GDP towards 100% during his term in office. However, although the Republicans now have a monopoly of power for the first time since the 1920s, in having a President and a majority in both Congress and the Senate, there is by no means any certainty that the politicians and advisers he has been appointing to his team, and both houses, will implement the more extreme policies that Trump outlined during his election campaign. Indeed, Trump may even rein back on some of those policies himself.

- The ***MPC meeting of 3 November*** left Bank Rate unchanged at 0.25% and other monetary policy measures also remained unaltered. This was in line with market expectations, but a major change from the previous quarterly Inflation Report MPC meeting of 4 August, which had given a strong steer in its forward guidance that it was likely to cut Bank Rate again, probably by the end of the year if economic data turned out as forecast by the Bank.

- The November MPC decision included a forward view that ***Bank Rate*** could go either up or down depending on how economic data evolve in the coming months. Our central view remains that Bank Rate will remain unchanged at 0.25% until the first increase to 0.50% in June 2019, (unchanged from our previous forecast). However, we would not, as yet, discount the risk of a cut in Bank Rate if economic growth were to take a significant dip downwards, though we think this is unlikely, especially given the run of strong economic data since then. We would also point out that forecasting as far ahead as mid 2019 is highly fraught as there are many potential economic headwinds which could blow the UK economy one way or the other as well as political developments in the UK, (especially over the terms of Brexit), EU, US and beyond, which could have a major impact on our forecasts.

- The pace of Bank Rate increases in our forecasts has been slightly increased beyond the three year time horizon to reflect higher inflation expectations.

- The August quarterly Inflation Report was based on a pessimistic forecast of near to zero ***GDP growth*** in quarter 3 of 2016 i.e. a sharp slowdown in growth from +0.6% in quarter 2, in reaction to the shock of the result of the referendum in June. However, consumers have very much stayed in a 'business as usual' mode and there has been no sharp downturn in spending; it is consumer expenditure that underpins the services sector which comprises about 75% of UK GDP. After a fairly flat three months leading up to October, retail sales in October surged at the strongest rate since September 2015 before levelling off in November. In addition, the GfK consumer confidence index has recovered moderately to -7 in December after an initial sharp plunge in July to -12 in reaction to the referendum result. GDP growth in quarter 3 of 2016 has therefore come in at a robust +0.6% q/q, +2.2% y/y while business surveys are indicating reasonable continuing strength into quarter 4 and into the start of 2017.

- Bank of England GDP forecasts in the November quarterly Inflation Report were as follows, (August forecasts in brackets) - 2016 +2.2%, (+2.0%); 2017 1.4%, (+0.8%); 2018 +1.5%, (+1.8%). There has, therefore, been a sharp increase in the forecast for 2017, a marginal increase in 2016 and a small decline in growth, now being delayed until 2018, as a result of the impact of Brexit.

- Capital Economics' forecasts for economic growth are as follows: 2016 +2.0%; 2017 +1.5%; 2018 +2.5%. They feel that pessimism is still being overdone by the Bank and Brexit will not have as big an effect as initially feared by some commentators.

- The other key factor in forecasts for Bank Rate is ***inflation*** where the MPC aims for a target for CPI of 2.0%. The November Inflation Report included an increase in the peak forecast for inflation from 2.3% to 2.7% during 2017; (Capital Economics are forecasting a peak of 3.2% in 2018). This increase was largely due to the effect of the sharp fall in the value of sterling since the referendum, though the December MPC meeting reported a 6% recovery on a trade weighted basis since its 3 November meeting to leave sterling 15%, (was 16%), down against the US dollar and 8%, (was 11%), down against the euro; this will feed through into a sharp increase in the cost of imports and materials used in production in the UK. However, the MPC is expected to look through the acceleration in inflation caused by external, (outside of the UK), influences, although it has given a clear warning that if wage inflation were to rise significantly as a result of these cost pressures on consumers, then they would take action to raise Bank Rate. The MPC also commented that the partial recovery in the value of sterling, if maintained, would cause a small reduction in their November forecast rise in CPI inflation above the 2% target rate.

- What is clear is that ***consumer disposable income*** will come under pressure if CPI rises to exceed wage inflation. The CPI figure for November of 1.2% was the highest for over two years, but is expected to rise rapidly above 2% in Q1 of 2017. On the other hand, wage inflation excluding bonuses came in at 2.6% in October. However, growth in real disposable income in Q3 was negative so the robust increase in retail sales was only achieved by consumers running down their savings and increasing borrowing; this looks unsustainable in the longer term and makes consumer expenditure increasingly vulnerable to rises in interest rates on borrowing when they do occur.

- ***Gilt yields, and consequently PWLB rates***, have risen sharply since hitting a low point in mid-August. There has also been huge volatility during 2016 as a whole. The year started with 10 year gilt yields at 1.88%, fell to a low point of 0.53% on 12 August, and finished at the end of December at 1.49% after some peaks higher during that month. The rebound since August reflects the initial combination of the yield-depressing effect of the MPC's new round of quantitative easing on 4 August, together with expectations of a sharp downturn in expectations for growth and inflation as per the pessimistic Bank of England Inflation Report forecast, followed by a sharp rise in growth expectations since August when subsequent business surveys, and GDP growth in quarters 2 and 3 at +0.6% q/q, confounded the pessimism. Inflation expectations also rose sharply as a result of the continuing fall in the value of sterling.

- ***The Chancellor*** has said he will do 'whatever is needed' i.e. to promote growth; there are two main options he can follow – fiscal policy

e.g. cut taxes, increase investment allowances for businesses and/or increase government expenditure on infrastructure, housing etc. While the Autumn Statement contained only moderate measures, the PSBR deficit elimination timetable did slip further into the future, as expected, so as to place the priority on promoting economic growth, (and ultimately boosting tax revenues / reducing the budget deficit in the longer term).

- ***Employment*** had been continuing to grow weakly during 2016 but in the three months to October, there was the first small fall. ***House prices*** are also continuing to rise at a modest pace; but any downturn in prices could dampen consumer confidence and expenditure.

- **Rising EU and geopolitical risks e.g.**

  - ***Greece*** continues to cause major stress in the EU due to its tardiness and reluctance in implementing key reforms required by the EU to make the country more efficient and to make significant progress towards the country being able to pay its way – and before the EU is prepared to agree to release further bail out funds.

  - ***Spain*** has had two general elections in 2015 and 2016, both of which failed to produce a workable government with a majority of the 350 seats. At the eleventh hour on 31 October, before it would have become compulsory to call a third general election, the party with the biggest bloc of seats (137), was given a majority confidence vote to form a government. This is potentially a highly unstable situation, particularly given the need to deal with an EU demand for implementation of a package of austerity cuts which will be highly unpopular.

  - The under capitalisation of ***Italian banks*** poses a major risk with state aid firmly ruled out by the EU as a potential way out. The longer that this issue remains unresolved, the greater the likelihood that exposed banks will suffer an outflow of liquidity and so the bigger the cost will become to remedy the situation.

  - ***4 December Italian constitutional referendum*** on reforming the Senate and reducing its powers; this became a confidence vote on Prime Minister Renzi who duly resigned when the 'no' vote won. The rejection of these proposals will be an impediment to fundamental political and economic reform which is urgently needed to deal with Italy's core problems, especially low growth. They were also intended to give Italy more stable government as no western European country has had such a multiplicity of governments since the Second World War as Italy, due to the equal split of power between the two chambers of the Parliament which are both voted

in by the Italian electorate but by using different voting systems. Paolo Gentiloni has subsequently been appointed as Prime Minister but it is notable how little market reaction there has been to these events – for the time being!

- ***Dutch general election 15.3.17;*** a far right party is currently polling neck and neck with the incumbent ruling party. However, the proportional voting system means that there are a multiplicity of parties so each general election results in an exercise in gathering a viable coalition after the results are in. In addition, anti-big business and anti-EU activists have already collected two thirds of the 300,000 signatures required to force a referendum to be taken on approving the EU – Canada free trade pact. This could delay the pact until a referendum in 2018 which would require unanimous approval by all EU governments before it can be finalised. In April 2016, Dutch voters rejected by 61.1% an EU – Ukraine cooperation pact under the same referendum law. Dutch activists are concerned by the lack of democracy in the institutions of the EU.

- ***French presidential election;*** first round 23 April; second round 7 May 2017.

- ***French National Assembly election 11 and 18 June 2017.***

- ***German Federal election August – 22 October 2017.*** This could be affected by significant shifts in voter intentions as a result of terrorist attacks, dealing with a huge influx of immigrants and a rise in anti EU sentiment.
- The core EU, (note, not just the Eurozone currency area), principle of free movement of people within the EU is a growing issue leading to major stress and tension between EU states, especially with the Visegrad bloc of former communist states.
- Given the number and type of challenges the EU faces in the next eighteen months, there is an identifiable risk for the EU project to be called into fundamental question. The risk of an electoral revolt against the EU establishment has gained traction after the shock results of the UK referendum and the US Presidential election. But it remains to be seen whether any shift in sentiment will gain sufficient traction to produce any further shocks. The risks are increasing that voter dissatisfaction with the EU could lead to another country lining up after the UK, to leave the EU, unless the

EU positively addresses the major challenges it faces over the next few years

- ***Economic growth in the EU,*** (the UK's biggest trading partner), has been lack lustre at +1.7% y/y in 2016 despite the ECB cutting its main rate to -0.4% and embarking on a massive programme of quantitative easing during 2016. The latest economic statistics give some grounds for optimism that as a result of this aggressive quantitative easing programme, growth could at last be accelerating going into 2017. However, growth could be negatively impacted by adverse political developments - which could then also impact on UK exports and growth.

- The ***US economy*** grew strongly in quarter three of 2016 at 3.5%, (on an annualised basis), after an anaemic 1.4% in quarter 2. The election result is likely to have given the Fed added impetus to go ahead with the rate rise of 0.25%, as expected in December, due to the expansionary plans Trump has been outlining. There could well be three or four further increases in 2017 and 2018 in order to contain inflationary pressures which are expected to increase as a result of Trump's policies.

- In the first week since the US election, there was a ***major shift in investor sentiment away from bonds to equities,*** especially in the US. However, gilt yields in the UK and bond yields in the EU have also been dragged higher. Some commentators are saying that this rise has been an overreaction to the US election result which is likely to be reversed. Other commentators take the view that this could well be the start of the long expected eventual unwinding of bond prices propelled upwards to unrealistically high levels by the artificial and temporary power of quantitative easing.

- ***Japan*** has been struggling to gain consistent significant growth but has achieved an annualised rate in quarter 3 of +2.7%, (Q2 +2.6%). It has also been struggling to put deflation firmly behind it and to get inflation up to reasonable levels, despite huge monetary and fiscal stimulus. It has been making little progress on fundamental reform of the economy.

- ***Chinese economic growth*** has been weakening despite successive 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.

CAPITA ASSET SERVICES' FORWARD VIEW

Economic forecasting remains difficult with so many external influences weighing on the UK. Our Bank Rate forecasts, (and also MPC decisions), will

be liable to further amendment depending on how economic data and developments in financial markets transpire over the next year. Forecasts for average earnings beyond the three year time horizon will be heavily dependent on economic and political developments. Major volatility in bond yields is likely to endure as investor fears and confidence ebb and flow between favouring more risky assets i.e. equities, or the safe haven of bonds.

The overall longer run trend is for gilt yields and PWLB rates to rise, albeit gently. An eventual world economic recovery may also see investors switching from the safe haven of bonds to equities.

We have pointed out consistently that the Fed. Rate is likely to go up more quickly and more strongly than Bank Rate in the UK . While there is normally a high degree of correlation between treasury and gilt yields, we would expect to see a growing decoupling between the two i.e. we would expect US yields to go up faster than UK yields. We will need to monitor this area closely and the resulting effect on PWLB rates.

The overall balance of risks to economic recovery in the UK remains to the downside, particularly with the current uncertainty over the final terms, and impact, of Brexit.

We would, as always, remind clients of the view that we have expressed in our previous interest rate revision newsflashes of just how unpredictable PWLB rates and bond yields are at present. We are experiencing exceptional levels of volatility which are highly correlated to geo-political and sovereign debt crisis developments. Our revised forecasts are based on the Certainty Rate (minus 20 bps) which has been accessible to most authorities since 1st November 2012.

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

- Geopolitical risks in Europe, the Middle East and Asia, which could lead to increasing safe haven flows.
- UK economic growth and increases in inflation are weaker than we currently anticipate.
- Weak growth or recession in the UK's main trading partners - the EU and US.
- A resurgence of the Eurozone sovereign debt crisis.
- Weak capitalisation of some European banks.
- Monetary policy action failing to stimulate sustainable growth and combat the threat of deflation in western economies, especially the Eurozone and Japan.

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

- The pace and timing of increases in the Fed. funds rate causing a fundamental reassessment by investors of the relative risks of holding bonds as opposed to equities and leading to a major flight from bonds to equities.
- UK inflation returning to significantly higher levels than in the wider EU and US, causing an increase in the inflation premium inherent to gilt yields.

APPENDIX 3 : PRUDENTIAL INDICATORS

PRUDENTIAL INDICATOR	2016/17	2016/17	2017/18	2018/19
(1). EXTRACT FROM BUDGET				
	Forecast Outturn	**Original Estimate**	**Forecast Outturn**	**Forecast Outturn**
Capital Expenditure	**£'000**	**£'000**	**£'000**	**£'000**
Non - HRA	17,855	34,685	25,926	14,758
TOTAL	17,855	34,685	25,926	14,758
Ratio of financing costs to net revenue stream				
Non - HRA	7.80%	7.80%	7.39%	7.39%
Net borrowing requirment				
brought forward 1 April *	253,896	259,000	260,580	261,395
carried forward 31 March *	260,580	265,766	261,395	253,698
in year borrowing requirement	6,684	6,766	815	(7,697)
In year Capital Financing Requirement				
Non - HRA	6,684	6,766	815	(7,697)
TOTAL	6,684	6,766	815	(7,697)
Capital Financing Requirement as at 31 March				
Non - HRA	260,580	265,766	261,395	253,698
TOTAL	260,580	265,766	261,395	253,698
Incremental impact of capital investment decisions	£ p	£ p	£ p	£ p
Increase in Council Tax (band D) per annum	43.30	38.44	17.36	5.57

PRUDENTIAL INDICATOR	2016/17	2017/18	2018/19
(2). TREASURY MANAGEMENT PRUDENTIAL INDICATORS	**£'M**	**£'M**	**£'M**
Authorised limit for external debt -			
borrowing	220	215	215
other long term liabilities	83	83	83
TOTAL	303	298	298
Operational boundary for external debt -			
borrowing	215	210	210
other long term liabilities	80	80	80
TOTAL	295	290	290
Upper limit for fixed interest rate exposure			
Principal re fixed rate borrowing	190%	190%	190%
Upper limit for variable rate exposure			
Principal re variable rate borrowing	60%	60%	60%
Upper limit for total principal sums invested for over 364 days (per maturity date)	£20m	£20m	£20m

Maturity structure of new fixed rate borrowing during 2014/15	upper limit	lower limit
under 12 months	30%	0%
12 months and within 24 months	30%	0%
24 months and within 5 years	30%	0%
5 years and within 10 years	40%	0%
10 years and above	80%	0%