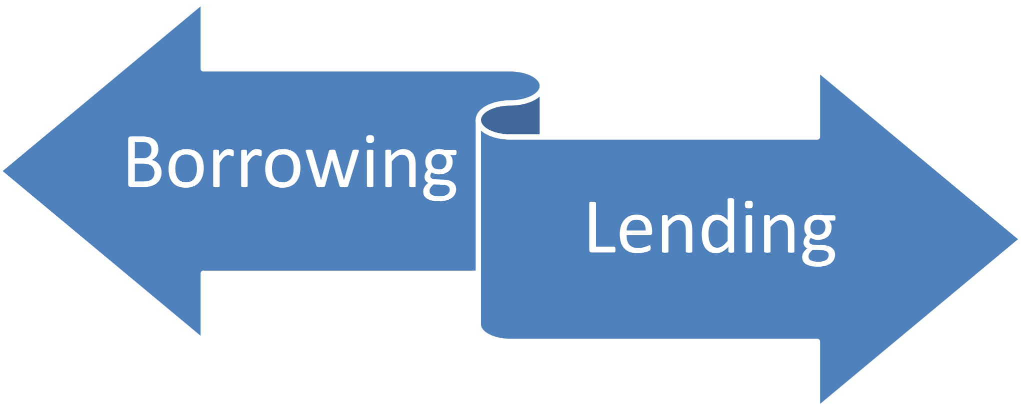
FAREHAM
BOROUGH COUNCIL

TREASURY MANAGEMENT STRATEGY AND PRUDENTIAL INDICATORS 2016/17



INTRODUCTION

WHAT IS TREASURY MANAGEMENT?

1. Treasury Management is defined as:

> *The management of the organisation's 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. The Council operates a balanced budget, which broadly means cash raised during the year will meet its cash expenditure. There are two aspects to the treasury management service:

   a) To ensure the cash flow is adequately planned, with **cash being available when it is needed**. Surplus monies are invested in low risk counterparties or instruments commensurate with the Council's low risk appetite, providing adequate liquidity initially before considering investment return.

   b) To ensure the cash flow meets the Council's **capital plans**. These capital plans provide a guide to the **borrowing need** of the Council. Essentially this is the longer term cash flow planning to ensure that the Council can meet its capital spending requirements. The management of longer term cash may involve arranging long or short term loans, or using longer term cash flow surpluses. On occasion any debt previously drawn may be restructured to meet Council risk or cost objectives.

CONTENT OF THE ANNUAL TREASURY MANAGEMENT STRATEGY

3. This strategy sets out the expected approach to treasury management activities for 2016/17 in light of the anticipated financial climate. It covers two main areas:

Capital Issues

- Capital Expenditure and Financing
- Prudential Indicators
- Minimum Revenue Provision (MRP) policy

Treasury Management Issues

- Investment Strategy
- Borrowing Strategy
- Treasury Indicators
- Prospects for Interest Rates

4. The content of the Strategy is designed to cover the requirements of the Local Government Act 2003, the CIPFA Prudential Code, the CIPFA Treasury Management Code and the DCLG Investment Guidance.

REPORTING REQUIREMENTS

5. The Council receives and approves three main reports each year in relation to Treasury Management, which incorporate a variety of polices, estimates and actuals. The three reports are:

6. The Executive Commmittee is responsible for the implementation and monitoring of these reports whilst the Audit and Governance Committee is responsible for the effective scrutiny of the treasury management strategy and policies.

TRAINING

7. The CIPFA Code requires the responsible officer to ensure that members with responsibility for treasury management receive adequate training in treasury management. This especially applies to members responsible for scrutiny.

8. Treasury management officers regularly attend training courses, seminars and conferences provided by the Council's treasury management advisors and CIPFA.

USE OF TREASURY MANAGEMENT CONSULTANTS

9. The Council currently uses Capita Asset Services as its external treasury management advisors. From July 2016, this will change to Arlingclose, following a recent competitive tender exercise.

10. The Council recognises that responsibility for treasury management decisions remains with the organisation at all times and will ensure that undue reliance is not placed upon our external service providers.

11. It also recognises that there is value in employing external providers of treasury management services in order to acquire access to specialist skills and resources. The Council will ensure that the terms of their appointment and the methods by which their value will be assessed are properly agreed and documented, and subjected to regular review.

CAPITAL ISSUES

CAPITAL EXPENDITURE AND FINANCING

12. The objectives of the CIPFA Prudential Code are to ensure that capital investment plans are **affordable**, **prudent** and **sustainable**, and that treasury decisions are taken in accordance with good professional practice.

PRUDENTIAL INDICATORS

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

1) Level of Planned Capital Expenditure

This prudential indicator is a summary of the Council's capital expenditure plans and shows how these plans are being financed by capital or revenue resources.

Capital Expenditure and Financing	2015/16 Revised £'000	2016/17 Estimate £'000	2017/18 Estimate £'000	2018/19 Estimate £'000
Public Protection	0	0	0	0
Streetscene	48	434	175	0
Leisure & Community	8,256	1,922	552	0
Health & Housing	1630	560	480	480
Planning & Development	32	48	17	0
Policy & Resources	2,945	11,048	1260	540
Total General Fund	**12,911**	**14,012**	**2,484**	**1,020**
HRA	**10,353**	**6,621**	**2,475**	**2,715**
Total Expenditure	**23,264**	**20,633**	**4,959**	**3,735**
Capital Receipts	5,551	675	230	230
Capital Grants	4,022	4,563	957	250
Capital Reserves	10,810	5,986	2,081	1,324
Revenue	1,381	3,569	1,691	1,931
Borrowing	1,500	5,840	0	0
Total Financing	**23,264**	**20,633**	**4,959**	**3,735**

2) The Council's Borrowing Need (Capital Financing Requirement)

This prudential indicator is the Council's Capital Financing Requirement (CFR). The CFR is the total historic outstanding capital expenditure which has not yet been paid for from either revenue or capital resources. It is essentially a measure of the Council's underlying borrowing need. Any capital expenditure financed by borrowing will increase the CFR.

The CFR does not increase indefinitely, as the minimum revenue provision (MRP) is a statutory annual revenue charge which broadly reduces the borrowing in line with the asset's life.

The CFR projections are as follows:

£'000	**2015/16 Revised**	**2016/17 Estimate**	**2017/18 Estimate**	**2018/19 Estimate**
General Fund	2,872	8,942	9,172	9,402
HRA	52,879	52,649	52,419	52,189
Total CFR	**55,751**	**61,591**	**61,591**	**61,591**

3) Financing Costs as % of Net Revenue Stream

This is an indicator of affordability and identifies the trend in the cost of capital (borrowing and other long term obligation costs net of investment income) against the net revenue stream.

The positive percentage for the Housing Revenue Account (HRA) reflects the net borrowing costs for the HRA settlement.

	2015/16 Revised	**2016/17 Estimate**	**2017/18 Estimate**	**2018/19 Estimate**
General Fund	-8%	-6%	-7%	-7%
HRA	15%	15%	15%	15%
Total	**5%**	**6%**	**6%**	**6%**

4) Incremental Impact of Capital Decisions on Council Tax and Housing Rents

This indicator shows the impact of capital decisions on council tax and housing rent levels. The incremental impact is the difference between the total revenue budget requirement of the current approved capital programme and the proposed capital programme to be approved during this budget cycle.

	2015/16 Revised	**2016/17 Estimate**	**2017/18 Estimate**	**2018/19 Estimate**
Council tax band D	£0.34	£2.35	£0.29	£0.00
Weekly housing rent levels	-£0.06	£0.23	£0.02	£0.02

HOUSING REVENUE ACCOUNT (HRA) RATIOS

14. As a result of the HRA Reforms in 2012, the Council moved from a subsidy system to self-financing and was required to take on **£49.3 million** of debt. The table below shows additional local indicators relating to the HRA in respect of this debt.

	2015/16 Revised	2016/17 Estimate	2017/18 Estimate	2018/19 Estimate
HRA debt £'000	49,268	49,268	49,268	49,268
HRA revenues £'000	11,200	11,180	11,271	11,107
Number of HRA dwellings	2,424	2,465	2,454	2,443
Ratio of debt to revenues %	4.40:1	4.41:1	4.37:1	4.44:1
Debt per dwelling £	£20,325	£19,987	£20,077	£20,167

MINIMUM REVENUE PROVISION (MRP) POLICY STATEMENT

15. Where the Council finances capital expenditure by debt, it must **put aside resources to repay that debt** in later years. The amount charged to the revenue budget for the repayment of debt is known as **Minimum Revenue Provision (MRP)**.

16. The Council is required to set an annual policy on the way it calculates the prudent provision for the repayment of General Fund borrowing. It will be determined by charging the expenditure over the **expected useful life** of the relevant assets on an **annuity basis** starting in the year after the asset becomes operational.

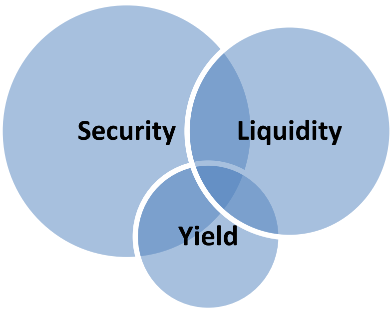
17. No MRP will be charged in respect of assets held within the HRA, in accordance with DCLG Guidance and capital expenditure incurred during 2016/17 will not be subject to a MRP charge until 2017/18.

TREASURY MANAGEMENT ISSUES

INVESTMENTS

Investment Policy

18. Both the CIPFA Code and DCLG Guidance require the Council 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**.



19. The Council'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.

20. The Council applies minimum acceptable credit criteria in order to generate a list of highly creditworthy counterparties which will also enable diversification and avoid concentration risk. The key ratings used to monitor counterparties are the **short term** and **long term** ratings.

21. Ratings will not be the sole determinant of the quality of an institution. It is important to continually assess and monitor the financial sector on both a micro and macro basis and in relation to the economic and political environments in which institutions operate. The assessment will also take account of information that reflects the opinion of the markets. To this end the Council will engage with its advisors to maintain a monitor on market pricing, such as credit default swaps, and overlay that information on top of the credit ratings.

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

23. The following internal measures are also in place:

    - Investment decisions formally recorded and endorsed using a Counterparty Decision Document.

    - Monthly officer reviews of the investment portfolio and quarterly reviews with the Chief Executive Officer.

Counterparty Selection Criteria

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

    - It maintains a policy covering the **categories of investment types** it will invest in, **criteria for choosing investment counterparties** with adequate security, and **monitoring** their security.

    - It has **sufficient liquidity** in its investments. For this purpose it will set out procedures for determining the maximum periods for which funds may prudently be committed.

25. Officers will **maintain a counterparty list** in compliance with the below criteria and will revise the criteria and submit them to Council for approval as necessary.

26. Credit rating information is supplied by the Council's Treasury Management Consultants on all active counterparties that comply with the criteria below. Any counterparty failing to meet the criteria would be omitted from the counterparty list. Any rating changes, rating watches (notification of a likely change), rating outlooks (notification of a possible longer term change) are provided to officers almost immediately after they occur and this information is considered before dealing.

27. The criteria for providing a pool of high quality investment counterparties (both specified and non-specified investments) is:

- **Banks 1** - good credit quality. The Council will use banks which are UK banks and/or are non-UK and domiciled in a country which has a **minimum sovereign rating of AA** and have, as a minimum, the following Fitch, Moody's and Standard and Poor's credit ratings (where rated):

	Fitch	Moody's	Standard and Poor's
Short Term	F1	P-1	A-1
Long Term	A	A2	A

- **Banks 2** - Part nationalised UK banks (Royal Bank of Scotland). This bank can be included provided it continues to be part nationalised or it meets the ratings in Banks 1 above.

- **Building Societies** - The Council will use all societies which meet the ratings for banks outlined above and/or have **assets in excess of £5 billion**.

- **Other Investment Counterparties** -
  - UK Government (including gilts and the Debt Management Account Deposit Facility)
  - Local authorities
  - Money market funds
  - Enhanced cash funds

28. Where cash flows determine it necessary, the **Council's bankers, NatWest**, (part of the RBS group) will be used on **an unlimited basis**. If their credit quality is reduced, the Council will continue to use their banking services but no investments will be placed with them.

Time and Monetary Limits Applying to Investments

29. The time and monetary limits for institutions on the Council's counterparty list are as follows (these will cover both specified and non-specified investments):

	Fitch Long Term Rating	Money Limit	Time Limit
Banks 1 - good credit quality	A	£6m	5 years
Banks 2 - part-nationalised	N/A	£8m	3 years
Building Societies	N/A	£2m	1 year
Debt Management Account Deposit Facility	AAA	Unlimited	6 months
Local Authorities	N/A	Unlimited	5 years
Money Market Funds	AAA	£6m per fund	Liquid
Enhanced Cash Funds	AAA	£6m per fund	Liquid

Country and Sector Considerations

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

31. The Council will only use approved counterparties from countries with a minimum **sovereign credit rating of AA from Fitch**. Countries that qualify using these credit criteria, as at the date of this report, are listed in the table below. The list will be added to, or deducted from by officers should ratings change in accordance with this policy:

AAA:	AA+:	AA:
Australia	Finland	Abu Dhabi (UAE)
Canada	UK	France
Denmark	USA	Qatar
Germany		
Netherlands		
Singapore		
Sweden		
Switzerland		

32. In addition, the following sector limits will apply:

- No more than **25%** will be placed with any **non-UK country** at any time.
- No more than **25%** will be placed with **building societies**.
- **Limits** in place will **apply to a group** of companies.
- Sector limits will be monitored regularly for appropriateness.
- As far as possible, the Council will aim to maintain at least **25%** of investments **maturing within 1 year**, and no more than **50% maturing over 1 year**.

Investment Strategy

33. The Council's in-house managed funds are mainly existing resources earmarked to finance future capital expenditure and resources derived from favourable cash flow, with a **core balance of £10 - £15 million** available for investment over a year.

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

35. The Bank Rate is forecast to remain unchanged at 0.5% before starting to rise from quarter 4 of 2016. The Bank Rate forecasts from Capita Asset Services for financial year ends (March) are:

Year	Bank Rate
2016/17	0.75%
2017/18	1.25%
2018/19	1.75%

36. The overall balance of risks to the above forecasts is currently to the downside (i.e. start of increases in Bank Rate occurs later). However, should the pace of growth quicken and/or forecasts for increases in inflation rise, there could be an upside risk.

Investment Treasury Indicator and Limit

37. Total principal funds invested for greater than 364 days. These limits are set with regard to the Council's liquidity requirements and are based on the availability of funds after each year-end.

£M	2015/16 Revised	2016/17 Estimate	2017/18 Estimate	2018/19 Estimate
Principal sums invested > 364 days	22	17	14	14

38. For its cash flow generated balances, the Council will seek to utilise its **call accounts, money market funds and short-dated deposits** (overnight to three months) in order to benefit from the compounding of interest.

External Fund Managers

39. Up to £13 million of the Council's investments are externally managed on a discretionary basis by **Tradition**. This arrangement was put in place in 2000 to improve the financial returns of the Council's core cash balances. This chargeable arrangement will come to an end in April 2016 as the level of financial returns has reduced significantly since the economic crisis.

BORROWING

Current Portfolio Position

40. The Council's treasury portfolio position at 31 March 2015, with forward projections are summarised below. The table shows the actual external borrowing (the treasury management operations), against the capital borrowing need (the Capital Financing Requirement), highlighting any under or over borrowing.

£'000	2015/16 Revised	2016/17 Estimate	2017/18 Estimate	2018/19 Estimate
Debt at 1 April	41,782	43,082	48,722	48,722
Expected change in debt	1,300	5,640	0	0
Gross Debt at 31 March	**43,082**	**48,722**	**48,722**	**48,722**
Capital Financing Requirement (CFR)	55,751	61,591	61,591	61,591
Under/(Over) Borrowing	**12,669**	**12,869**	**12,869**	**12,869**
CFR for last, current and next 2 years	**233,184**	**240,524**	**246,364**	**246,364**

41. The Council is currently maintaining **an under-borrowed position**. This means that the capital borrowing need (the Capital Financing Requirement), has not been fully funded with loan debt as cash supporting the Council's reserves, balances and cash flow has been used as a temporary measure.

42. Within the prudential indicators there are a number of key indicators to ensure that the Council operates its activities within well-defined limits. One of these is that the Council needs to ensure that its gross debt does not, except in the short term, exceed the total of the CFR in the preceding year plus the estimates of any additional CFR for 2016/17 and the following two financial years.

43. The Council complied with this prudential indicator in the current year and does not envisage difficulties for the future. This view takes into account current commitments, existing plans, and the proposals in the budget report.

Treasury Indicators: Limits to Borrowing Activity

44. The treasury indicators includes two limits to borrowing activity:

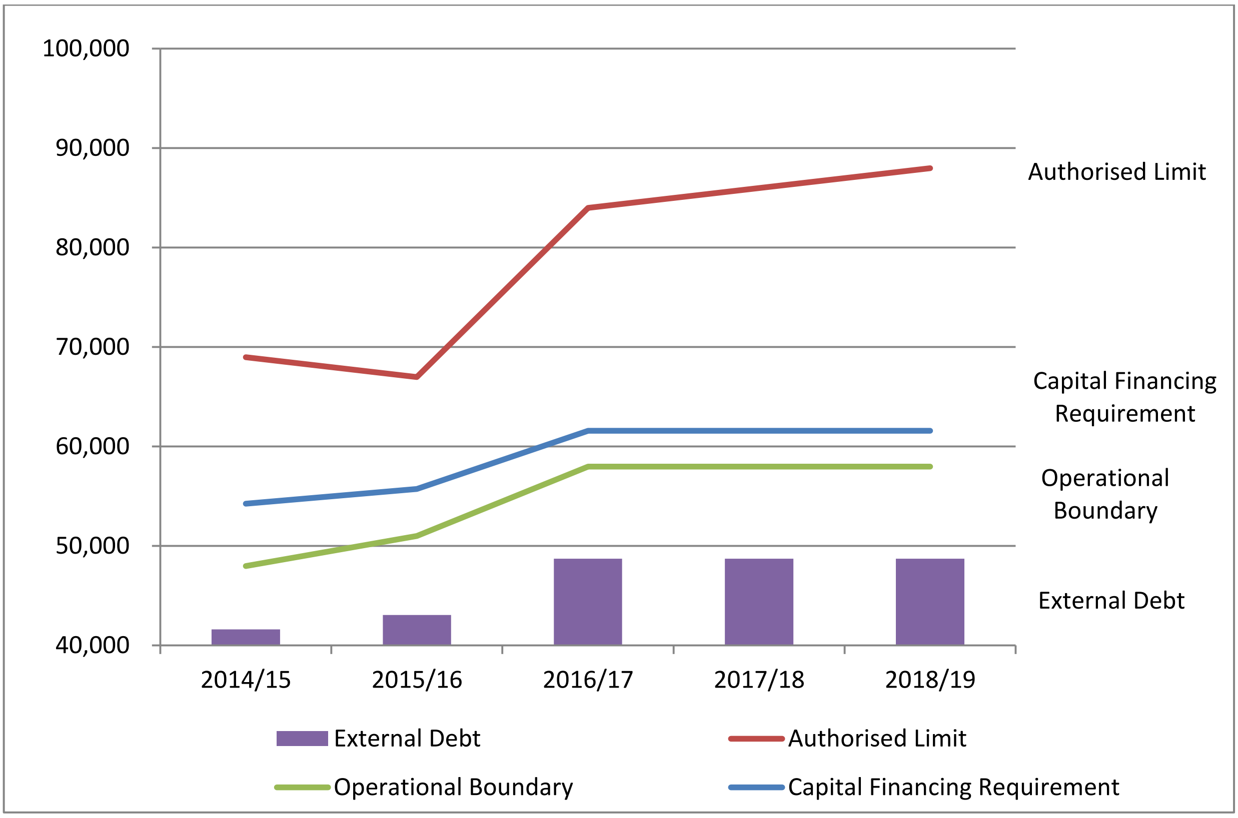
    1) The **operational boundary** is based on the Council's estimate of the most likely (i.e. prudent but not worst case) scenario for external debt. This is the limit beyond which external borrowing is not normally expected to exceed. In most cases, this would be a similar figure to the CFR, but may be lower or higher depending on the levels of actual borrowing.

    2) The **authorised limit** is the affordable borrowing limit determined in compliance with the Local Government Act 2003. It is the maximum amount of debt that the Council can legally owe. The authorised limit provides headroom over and above the operational boundary for unusual cash movements.

45. The limits are:

£'000	2015/16 Revised	2016/17 Estimate	2017/18 Estimate	2018/19 Estimate
Operational Boundary				
Borrowing	47,000	53,000	58,000	58,000
Other long term liabilities	4,000	5,000	5,000	5,000
Total	**51,000**	**58,000**	**58,000**	**58,000**
Authorised Limit				
Borrowing	61,000	77,000	79,000	81,000
Other long term liabilities	6,000	7,000	7,000	7,000
Total	**67,000**	**84,000**	**86,000**	**88,000**

46. The graph below shows the projections for the CFR and borrowing limits:



47. Separately, the Council is also limited to a maximum HRA CFR through the HRA self-financing regime. This limit is currently:

£'000	2015/16 Revised	2016/17 Estimate	2017/18 Estimate	2018/19 Estimate
HRA Debt Cap	56,851	56,851	56,851	56,851
HRA CFR	52,879	52,649	52,419	52,189
HRA Headroom	**3,972**	**4,202**	**4,432**	**4,662**

Borrowing Strategy

48. The Council's main objective when borrowing money is to strike an appropriately low risk balance between **securing low interest costs** and achieving **certainty of those costs** over the period for which funds are required. The flexibility to renegotiate loans should the Council's long-term plans change is a secondary objective.

49. The Council has been in a debt free position for the General Fund for many years mainly due to having sufficient capital reserves to meet the Council's capital programme. However this position will change over the coming years as borrowing is required for large capital schemes such as Holly Hill Leisure Centre, Daedalus and new property investment opportunities.

50. 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.

51. By doing so, the Council is able to reduce net borrowing costs (despite foregone investment income) and **reduce overall treasury risk**. The benefits of internal borrowing or short term 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.

52. Our treasury advisors will assist the Council with this **'cost of carry'** and breakeven analysis. Its output may determine whether the Council borrows additional sums at long-term fixed rates in 2016/17 with a view to keeping future interest costs low, even if this causes additional cost in the short-term.

53. Alternatively, the Council may arrange forward starting loans during 2016/17, where the interest rate is fixed in advance, but the cash is received in later years. This would enable certainty of cost to be achieved without suffering a cost of carry in the intervening period.

54. In addition, the Council may borrow short-term loans (normally for up to one month) to cover unexpected cash flow shortages.

Sources of Borrowing

55. The approved sources of long-term and short-term borrowing are:

- Public Works Loan Board (PWLB) and any successor body.
- Any institution approved for investments, including other local authorities.
- Any other bank or building society authorised to operate in the UK.
- UK public and private sector pension funds (except the Hampshire County Council Pension Fund).
- Capital market bond investors.
- UK Municipal Bonds Agency plc and other special purpose companies created to enable local authority bond issues.

56. 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

57. The Council has previously raised all of its long-term borrowing from the PWLB but it will investigate other sources of finance, such as local authority loans and bank loans that may be available at more favourable rates.

Borrowing in Advance of Need

58. The Council will not borrow more than or in advance of its needs purely in order to profit from the investment of the extra sums borrowed. Any decision to borrow in advance will be within forward approved Capital Financing Requirement estimates, and will be considered carefully to ensure that value for money can be demonstrated and that the Council can ensure the security of such funds.

59. Risks associated with any borrowing in advance of activity will be subject to prior appraisal and subsequent reporting through the mid-year or annual reporting mechanism.

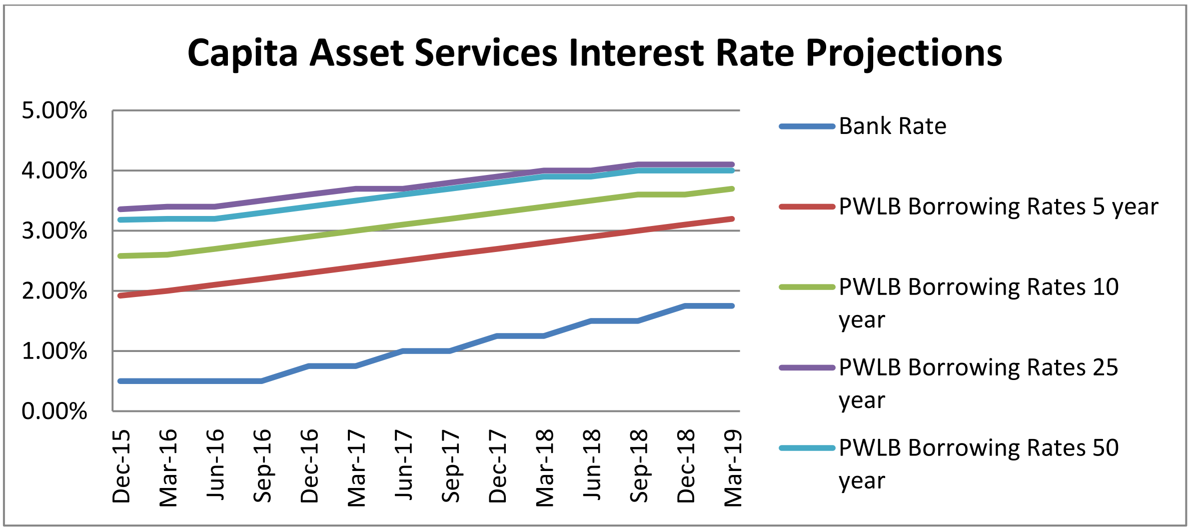
DEBT RESCHEDULING

60. 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. The Council 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 cost saving or a reduction in risk.

PROSPECTS FOR INTEREST RATES

61. The Council's Treasury Management Consultants assist the Council to formulate a view on interest rates. The latest detailed economic and interest rate forecast provided by Capita Asset Services is attached at Annex A.

62. The following graph and commentary gives the Capita Asset Services central view on interest rates and economic update.



63. Investment returns are likely to remain relatively low during 2016/17 and beyond.

64. Borrowing interest rates have been highly volatile during 2015 as alternating bouts of good and bad news have promoted optimism, and then pessimism, in financial markets.

65. There will remain a cost of carry to any new borrowing which causes an increase in investments as this will incur a revenue loss between borrowing costs and investment returns.

TREASURY MANAGEMENT LIMITS ON ACTIVITY

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

- Upper limits on **variable interest rate exposure**. This identifies a maximum limit for variable interest rates based upon the debt position net of investments;
- Upper limits on **fixed interest rate exposure**. This is similar to the previous indicator and covers a maximum limit on fixed interest rates;
- **Maturity structure of borrowing**. These gross limits are set to reduce the Council's exposure to large fixed rate sums falling due for refinancing, and are required for upper and lower limits.

67. The treasury indicators and limits are:

Upper limits on interest rate exposures	**2015/16**	**2016/17**	**2017/18**	**2018/19**
	%	**%**	**%**	%
- Upper limit on variable interest rate exposures	25	25	25	25
- Upper limit on fixed interest rate exposures	100	100	100	100
Maturity structure of borrowing		**Upper Limit**		
	%	**%**	**%**	%
- Loans maturing within 1 year	25	25	25	25
- Loans maturing within 1 - 2 years	25	25	25	25
- Loans maturing within 2 - 5 years	25	25	25	25
- Loans maturing within 5 - 10 years	50	50	50	50
- Loans maturing in over 10 years	100	100	100	100

ECONOMIC BACKGROUND BY CAPITA ASSET SERVICES

UK. UK GDP growth rates in 2013 of 2.2% and 2.9% in 2014 were the strongest growth rates of any G7 country; the 2014 growth rate was also the strongest UK rate since 2006 and although the 2015 growth rate is likely to be a leading rate in the G7 again, it looks likely to disappoint previous forecasts and come in at about 2%. Quarter 1 of 2015 was weak at +0.4% (+2.9% y/y) though there was a slight increase in quarter 2 to +0.5% (+2.3% y/y) before weakening again to +0.4% (2.1% y/y) in quarter 3. The November Bank of England Inflation Report included a forecast for growth to remain around 2.5 – 2.7% over the next three years, driven mainly by strong consumer demand as the squeeze on the disposable incomes of consumers has been reversed by a recovery in wage inflation at the same time that CPI inflation has fallen to, or near to, zero since February 2015. Investment expenditure is also expected to support growth. However, since the August Inflation report was issued, most worldwide economic statistics have been weak and financial markets have been particularly volatile. The November Inflation Report flagged up particular concerns for the potential impact of these factors on the UK.

The Inflation Report was also notably subdued in respect of the forecasts for inflation; this was expected to barely get back up to the 2% target within the 2-3 year time horizon. The increase in the forecast for inflation at the three year horizon was the biggest in a decade and at the two year horizon was the biggest since February 2013. However, the first round of falls in oil, gas and food prices over late 2014 and also in the first half 2015, will fall out of the 12 month calculation of CPI during late 2015 / early 2016 but a second, more recent round of falls in fuel and commodity prices will delay a significant tick up in inflation from around zero: this is now expected to get back to around 1% by the end of 2016 and not get to near 2% until the second half of 2017, though the forecasts in the Report itself were for an even slower rate of increase. However, more falls in the price of oil and imports from emerging countries in early 2016 will further delay the pick up in inflation. There is therefore considerable uncertainty around how quickly pay and CPI inflation will rise in the next few years and this makes it difficult to forecast when the MPC will decide to make a start on increasing Bank Rate.

The weakening of UK GDP growth during 2015 and the deterioration of prospects in the international scene, especially for emerging market countries, have consequently led to forecasts for when the first increase in Bank Rate would occur being pushed back to quarter 4 of 2016. There is downside risk to this forecast i.e. it could be pushed further back.

USA. The American economy made a strong comeback after a weak first quarter's growth at +0.6% (annualised), to grow by no less than 3.9% in quarter 2 of 2015, but then pulled back to 2.1% in quarter 3. The run of strong monthly increases in nonfarm payrolls figures for growth in employment in 2015 has prepared the way for the Fed. to embark on its long awaited first increase in rates of 0.25% at its December meeting. However, the accompanying message with this first increase was that further increases will be at a much slower rate, and to a much lower ultimate ceiling, than in previous business cycles, mirroring comments by our own MPC.

EZ. In the Eurozone, the ECB fired its big bazooka in January 2015 in unleashing a massive €1.1 trillion programme of quantitative easing to buy up high credit quality government and other debt of selected EZ countries. This programme of €60bn of monthly purchases started in March 2015 and it was intended to run initially to September 2016. This appears to have had a positive effect in helping a recovery in consumer and business confidence and a start to an improvement in economic growth. GDP growth rose to 0.5% in quarter 1 2015 (1.0% y/y) but came in at +0.4% (+1.5% y/y) in quarter 2 and +0.3% in quarter 3. However, this lacklustre progress in 2015 together with the recent downbeat Chinese and emerging markets news, has prompted comments by the ECB that it stands ready to strengthen this programme of QE by extending its time frame and / or increasing its size in order to get inflation up from the current level of around zero towards its target of 2% and to help boost the rate of growth in the EZ.

Greece. During July, Greece finally capitulated to EU demands to implement a major programme of austerity and is now cooperating fully with EU demands. An €86bn third bailout package has since been agreed though it did nothing to address the unsupportable size of total debt compared to GDP. However, huge damage has been done to the Greek banking system and economy by the resistance of the Syriza Government, elected in January, to EU demands. The surprise general election in September gave the Syriza government a mandate to stay in power to implement austerity measures. However, there are major doubts as to whether the size of cuts and degree of reforms required can be fully implemented and so Greek exit from the euro may only have been delayed by this latest bailout.

Portugal and Spain. The general elections in September and December respectively have opened up new areas of political risk where the previous right wing reform-focused pro-austerity mainstream political parties have lost power. A left wing / communist coalition has taken power in Portugal which is heading towards unravelling previous pro austerity reforms. This outcome could be replicated in Spain. This has created nervousness in bond and equity markets for these countries which has the potential to spill over and impact on the whole Eurozone project.

China and Japan. Japan is causing considerable concern as the increase in sales tax in April 2014 suppressed consumer expenditure and growth. In Q2 2015 quarterly growth shrank by -0.2% after a short burst of strong growth of 1.1% during Q1, but then came back to +0.3% in Q3 after the first estimate had indicated that Japan had fallen back into recession; this would have been the fourth recession in five years. Japan has been hit hard by the downturn in China during 2015 and there are continuing concerns as to how effective efforts by the Abe government to stimulate growth, and increase the rate of inflation from near zero, are likely to prove when it has already fired the first two of its ‘arrows’ of reform but has dithered about firing the third, deregulation of protected and inefficient areas of the economy.

As for China, the Government has been very active during 2015 and the start of 2016 in implementing several stimulus measures to try to ensure the economy hits the growth target of about 7% for 2015. It has also sought to bring some stability after the major fall in the onshore Chinese stock market during the summer and then a second bout in January 2016. Many commentators are concerned that recent growth figures could have been massaged to hide a downturn to a lower growth figure. There are also major concerns as to the creditworthiness of much of bank lending to corporates and local government during the post 2008 credit expansion period. Overall, China is still expected to achieve a growth figure that the EU would be envious of. Nevertheless, there are growing concerns about whether the Chinese economy could be heading for a hard landing and weak progress in rebalancing the economy from an over dependency on manufacturing and investment to consumer demand led services.

There are also concerns over the volatility of the Chinese stock market, which was the precursor to falls in world financial markets in August and September and again in January 2016, which could lead to a flight to quality to bond markets. In addition, the international value of the Chinese currency has been on a steady trend of weakening and this will put further downward pressure on the currencies of emerging countries dependent for earnings on exports of their commodities.

Emerging Countries. There are also considerable concerns about the vulnerability of some emerging countries and their corporates which are getting caught in a perfect storm. Having borrowed massively in dollar denominated debt since the financial crisis (as investors searched for yield by channelling investment cash away from western economies with dismal growth, depressed bond yields and near zero interest rates into emerging countries) there is now a strong flow back to those western economies with strong growth and an imminent rise in interest rates and bond yields.

This change in investors' strategy, and the massive reverse cash flow, has depressed emerging country currencies and, together with a rise in expectations of a start to central interest rate increases in the US, has helped to cause the dollar to appreciate significantly. In turn, this has made it much more costly for emerging countries to service their dollar denominated debt at a time when their earnings from commodities are depressed. There are also likely to be major issues when previously borrowed debt comes to maturity and requires refinancing at much more expensive rates.

Corporates (worldwide) heavily involved in mineral extraction and / or the commodities market may also be at risk and this could also cause volatility in equities and safe haven flows to bonds. Financial markets may also be buffeted by the sovereign wealth funds of those countries that are highly exposed to falls in commodity prices and which, therefore, may have to liquidate investments in order to cover national budget deficits.

CAPITA ASSET SERVICES FORWARD VIEW

Economic forecasting remains difficult with so many external influences weighing on the UK. Capita Asset Services undertook its last review of interest rate forecasts on 19 January 2016. Our Bank Rate forecasts, (and also MPC decisions), will be liable to further amendment depending on how economic data evolves over time. There is much volatility in rates and bond yields as news ebbs and flows in negative or positive ways. This latest forecast includes a first increase in Bank Rate in quarter 4 of 2016.

The overall trend in the longer term will be for gilt yields and PWLB rates to rise when economic recovery is firmly established accompanied by rising inflation and consequent increases in Bank Rate, and the eventual unwinding of QE. At some future point in time, an increase in investor confidence in eventual world economic recovery is also likely to compound this effect as recovery will encourage investors to switch from bonds to equities.

The overall balance of risks to economic recovery in the UK is currently to the downside, given the number of potential headwinds that could be growing on both the international and UK scene. Only time will tell just how long this current period of strong economic growth will last; it also remains exposed to vulnerabilities in a number of key areas.

However, the overall balance of risks to our Bank Rate forecast is probably to the downside, i.e. the first increase, and subsequent increases, may be delayed further if recovery in GDP growth, and forecasts for inflation increases, are lower than currently expected. Market expectations in January 2016, (based on short sterling), for the first Bank Rate increase are currently around quarter 1 2017.

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

- Emerging country economies, currencies and corporates destabilised by falling commodity prices and / or US Federal Reserve rate increases, causing a flight to safe havens (bonds).
- Geopolitical risks in Eastern Europe, the Middle East and Asia, 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.
- Recapitalisation of European banks requiring more government financial support.
- 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:

- Uncertainty around the risk of a UK exit from the EU.
- The pace and timing of increases in the US Federal Reserve 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.