Borough Council of
King's Lynn &
West Norfolk

Cabinet
Tuesday, 26th March, 2019 at 5.00 pm
in the Council Chamber - Town Hall, Saturday Market Place, King's Lynn PE30 5DQ

Update Treasury Management interest rate outlook as promised at the meeting

1. **TREASURY MANAGEMENT STRATEGY 2019/20** (Pages 2 - 9)

Contact
Democratic Services
Borough Council of King's Lynn and West Norfolk
King's Court
Chapel Street
King's Lynn
Norfolk
PE30 1EX
Tel: 01553 616394
Email: democratic.services@west-norfolk.gov.uk

Prospects for interest rates

The Council has appointed Link Asset Services as its treasury advisor and part of their service is to assist the Council to formulate a view on interest rates. The following table gives our central view.

Link Asset Services Interest Rate View	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22
Bank Rate View	0.75%	0.75%	1.00%	1.00%	1.00%	1.25%	1.25%	1.25%	1.50%	1.50%	1.75%	1.75%	2.00%
3 Month LIBID	0.70%	0.80%	1.00%	1.10%	1.20%	1.40%	1.50%	1.50%	1.60%	1.70%	1.80%	1.90%	2.00%
6 Month LIBID	0.80%	0.90%	1.20%	1.30%	1.40%	1.50%	1.60%	1.70%	1.80%	1.90%	2.00%	2.10%	2.20%
12 Month LIBID	1.00%	1.10%	1.40%	1.50%	1.60%	1.70%	1.80%	1.90%	2.00%	2.10%	2.20%	2.30%	2.40%
5yr PWLB Rate	1.80%	1.90%	2.00%	2.10%	2.20%	2.30%	2.30%	2.40%	2.50%	2.50%	2.60%	2.60%	2.70%
10yr PWLB Rate	2.20%	2.30%	2.40%	2.50%	2.60%	2.60%	2.70%	2.80%	2.90%	2.90%	3.00%	3.00%	3.00%
25yr PWLB Rate	2.70%	2.80%	2.90%	3.00%	3.10%	3.20%	3.20%	3.30%	3.40%	3.40%	3.50%	3.50%	3.60%
50yr PWLB Rate	2.50%	2.60%	2.70%	2.80%	2.90%	3.00%	3.00%	3.10%	3.20%	3.20%	3.30%	3.30%	3.40%

5.2 ECONOMIC BACKGROUND

GLOBAL OUTLOOK. World growth has been doing reasonably well, aided by strong growth in the US. However, US growth is likely to fall back in 2019 and, together with weakening economic activity in China and the eurozone, overall world growth is likely to weaken.

Inflation concerns started building in the UK in 2018 due to unemployment falling to remarkably low levels which led to an acceleration of wage inflation. The US Fed continued to take action to contain potential inflationary pressures in 2018 and has therefore increased rates nine times during the current series, whereas the Bank of England has raised rates twice. However, the ECB is now probably unlikely to make a start on raising rates in 2019.

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

The key issue now is that that period of urgent emphasis on stimulating economic recovery and warding off the threat of deflation, is generally coming towards its close, though the major economies in the developed world are at different parts of the economic cycle. A new period is well advanced in the US, and started more recently in the UK, of reversing those measures i.e. by raising central rates and, (for the US), also reducing central banks' holdings of government and other debt. These measures are now required in order to stop the trend of a reduction in spare capacity in the economy and of unemployment falling to such low levels, that the re-emergence of inflation is viewed as a significant risk. It is, therefore, crucial that central banks get their timing right and do not cause shocks to market expectations that could destabilise financial markets. In particular, a key risk is that because QE-driven purchases of bonds drove up the price of government debt, and therefore caused a sharp drop in income yields, this also encouraged investors into a search for yield and into investing in riskier assets such as equities. Consequently, prices in both bond and equity markets rose to historically high valuation levels simultaneously. This meant that both asset categories were exposed to the risk of a sharp downward correction and we did, indeed, see a sharp fall in equity values in the last quarter of 2018 and into early 2019, which has since been partially reversed. It is important, therefore, that central banks only gradually unwind their holdings of bonds in order to prevent destabilising the financial markets. It is also likely that the timeframe for central banks unwinding their holdings of QE debt purchases will be over several years. They need to balance their timing to neither squash economic recovery, by taking too rapid and too strong action, or, conversely, let inflation run away by taking action that was too slow and/or too weak. **The potential for central banks to get this timing and strength of action wrong are now key risks.** It is particularly notable that, at its 30 January 2019 meeting, the Fed dropped its previous words around expecting further increases in interest rates; it merely said it would be "patient".

The world economy also needed to adjust to a sharp change in **liquidity creation** over the last five years where the US moved from boosting liquidity by QE purchases, to reducing its holdings of debt by up to $50bn per month. In addition, the European Central Bank ended its QE purchases in December 2018.

UK. 2018 was a year which started with weak growth of only 0.1% in quarter 1. However, quarter 2 rebounded to 0.4% in quarter 2 followed by quarter 3 being exceptionally strong at +0.6%. Quarter 4 though, was depressed by the cumulative weight of Brexit uncertainty and came in at only +0.2%, (1.3% y/y). Growth is likely to continue being weak until the Brexit fog clears.

The MPC has stated that future Bank Rate increases would be gradual and would rise to a much lower equilibrium rate, (where monetary policy is neither expansionary nor contractionary), than before the crash; indeed they have given a figure for this of around 2.5% in ten years' time but have declined to give a medium term forecast. However, with so much uncertainty around Brexit, the next move could be up or down, even if there was a disorderly Brexit. While it would be expected that Bank Rate could be cut if there was a significant fall in GDP growth as a result of a disorderly Brexit, so as to provide a stimulus to growth, the MPC could also raise Bank Rate in the same scenario if there was a boost to inflation from increases in import prices, devaluation of sterling, and more expensive goods produced in the UK replacing cheaper goods previously imported, and so on. In addition, the Chancellor could provide fiscal stimulus to boost growth.

Inflation. The Consumer Price Index (CPI) measure of inflation has been falling from a peak of 3.1% in November 2017 to reach 1.8% in January 2019. It them ticked up to 1.9% in February. In the February Bank of England quarterly Inflation Report, inflation was forecast to still be marginally above its 2% inflation target two years ahead given a scenario of minimal increases in Bank Rate.

The **labour market** figures in the three months to January were particularly strong with an emphatic increase in total employment of 222,000 over the previous three months, unemployment at 3.9%, a 43 year low on the Independent Labour Organisation measure, and job vacancies continuing near to an all-time high, indicating that employers are having major difficulties filling job vacancies with suitable staff. It was therefore unsurprising that wage inflation held steady at its high point of 3.4%, (3 month average regular pay, excluding bonuses). This means that in real terms, (i.e. wage rates less CPI inflation), earnings are currently growing by about 1.5%, the highest level since 2009. This increase in household spending power is likely to feed through into providing some support to the overall rate of economic growth in the coming months. This tends to confirm that the MPC was right to start on a cautious increase in Bank Rate in August 2018 as it views wage inflation in excess of 3% as increasing inflationary pressures within the UK economy.

Brexit. The Brexit deal put forward by the Conservative minority government was defeated in a vote in the House of Commons on 15 January and its motions were again defeated on 14 and 27 February. In the week beginning 10 March, MPs rejected Mrs May's deal a second time, rejected a no deal, and voted to delay Brexit from 29 March. It is currently expected that in the week beginning 25 March, MPs will hold indicative votes on a number of options so as to ascertain if there is a majority for one way forward; this is likely to focus on a Norway, or Norway plus, soft Brexit where the UK remains closely aligned with the EU on trade. Such an option would mean that no back stop would be needed for the Northern Ireland border. However, this potential outcome could also be the final straw that pushes hard Brexiteers to drop their opposition to the deal if a third meaningful vote is taken on it. The four main options remain unchanged: -

- Deal approved in a third vote: UK leaves EU on 22 May (i.e. before the EU elections on 23 May)
- No deal: UK leaves EU on 12 April
- No Brexit – revoke Article 50

- Another delay for a long (possibly one-year?) period – period to be agreed with the EU. UK would need to participate in the May EU elections to elect British MEPs.

Our central position is that the Government will prevail, despite various setbacks, along the route to reaching an orderly Brexit.. UK economic growth is likely to be lethargic until a deal is agreed but growth could then pick up as businesses return to investing once the Brexit fog clears. This, in turn, could cause the MPC to raise rates quicker than currently forecast. On the other hand, a long delay to Brexit could also cause the MPC to take some action to raise Bank Rate as wage inflation is currently a cause for some concern. If, however, the UK faces a general election in the next 12 months, this could result in a potential loosening of monetary and fiscal policy and therefore medium to longer dated gilt yields could rise on the expectation of a weak pound and concerns around inflation picking up.

USA. President Trump's massive easing of fiscal policy has fuelled a temporary boost in consumption during 2018 and caused an upturn in the rate of strong growth from 2.2% (annualised rate) in quarter 1 to 4.2% in quarter 2, and 3.4%, in quarter 3, followed by a tailing off to 2.6% in quarter 4. This left the overall growth rate for 2018 at 2.9%, which was the best performance since 2015. However, forward indicators are headed downwards, confirming that the stimulus looks likely to have only caused a temporary spurt of exceptionally strong growth. The strong growth in employment numbers over the last year and an unemployment rate of 3.8%, a recent 49 year low, has fed through to an upturn in wage inflation which hit 3.4% in February. However, CPI inflation overall fell to 1.6% in January and looks to be on a falling trend to continue below the Fed's target of 2% during 2019.

The Fed continued on its series of increases in interest rates with another 0.25% increase in December to between 2.25% and 2.50%, which was the fifth increase in 2018 and the ninth in this cycle. However, they dropped any specific reference to expecting further increases at their January 30 meeting. The last increase in December compounded investor fears that the Fed could overdo the speed and level of increases in rates in 2019 and so cause a US recession as a result. There is also much evidence in previous monetary policy cycles of the Fed's series of increases doing exactly that. Consequently, we saw stock markets around the world falling under the weight of fears around the Fed's actions, the trade war between the US and China and an expectation that world growth will slow. Since the more reassuring words of the Fed at their January meeting, equity values have rebounded on a return of investor confidence and positive news on progress in the US – China tariff talks, which appear to be heading towards a positive resolution. The Fed caught up with investor concerns at its March 19 meeting when it announced that it would halt its balance sheet run down in September 2019 and also cut the pace of monthly redemptions from up to $30bn to $15bn per month from May 2019.. This measure would provide support to economic growth by putting some upward pressure on the price of Treasuries i.e. lowering Treasury yields and therefore interest rates in financial markets.

Eurozone. Growth was 0.4% in quarters 1 and 2 but fell back to 0.2% in quarters 3 and 4 (1.2% y/y). Germany only narrowly avoided slipping into recession in quarter 4 whereas Italy did slip into recession. The trend of economic statistics is now indicating that growth is likely to weaken further in 2019. Having halved its quantitative easing purchases of debt in October 2018 to €15bn per month, the European Central Bank ended all further purchases in December 2018. In its January meeting, it made a point of underlining that it will be fully reinvesting all maturing debt for an extended period of time past the date at which it starts raising the key ECB interest rates. Then in its March meeting, the ECB took action to counter the downturn in growth by announcing an economic stimulus measure via a third round of TLTROs, a policy measure which enables banks to borrow cheaply from the ECB with a two year maturity. Such loans will be capped at 30% of eligible loans and will be issued every three months from September 2019 until March 2021. The ECB also downgraded its growth forecasts for the EZ from 1.7% to only 1.1% in 2019, It also cut its forecasts for core CPI inflation to 1.2% for 2019, 1.4% in 2020 and 1.6% in 2021, i.e. comfortably within its target range of 0 to 2%.

China. Economic growth has been weakening over successive years, despite repeated rounds of central bank stimulus; medium term risks are increasing. Major progress still needs to be made to eliminate excess industrial capacity and the stock of unsold property, and to address the level of non-performing loans in the banking and credit systems. Progress has been made in reducing the rate of credit creation, particularly from the shadow banking sector, which is feeding through into lower economic growth. There are concerns that official economic statistics are inflating the published rate of growth.

Japan - has been struggling to stimulate consistent significant GDP growth and to get inflation up to its target of 2%, despite huge monetary and fiscal stimulus. It is also making little progress on fundamental reform of the economy. It is likely that loose monetary policy will endure for some years yet to try to stimulate growth and modest inflation.

Emerging countries. Argentina and Turkey are currently experiencing major headwinds and are facing challenges in external financing requirements well in excess of their reserves of foreign exchange. However, these countries are small in terms of the overall world economy, (around 1% each), so the fallout from the expected recessions in these countries will be minimal.

INTEREST RATE FORECASTS

The interest rate forecasts provided by Link Asset Services in paragraph 3.3 are **predicated on an assumption of an agreement being reached on Brexit between the UK and the EU.** On this basis, while GDP growth is likely to be subdued in 2019 due to all the uncertainties around Brexit depressing consumer and business confidence, an agreement is likely to lead to a boost to the rate of growth in subsequent years which could, in turn, increase inflationary pressures in the economy and so cause the Bank of England to resume a series of gentle increases in Bank Rate. Just how fast, and how far, those increases will occur and rise to, will be data dependent. The forecasts in this report assume a modest recovery in the rate and timing of stronger growth and in the corresponding response by the Bank in raising rates.

- In the event of an **orderly non-agreement exit**, it is likely that the Bank of England would take action to cut Bank Rate from 0.75% in order to help economic growth deal with the adverse effects of this situation. This is also likely to cause short to medium term gilt yields to fall.
- If there was a **disorderly Brexit**, then any cut in Bank Rate would be likely to last for a longer period and also depress short and medium gilt yields correspondingly. Quantitative easing could also be restarted by the Bank of England. It is also possible that the government could act to protect economic growth by implementing fiscal stimulus.

However, there would appear to be a majority consensus in the Commons against any form of non-agreement exit so the chance of this occurring has now diminished.

The balance of risks to the UK

- The overall balance of risks to economic growth in the UK is probably neutral.
- The balance of risks to increases in Bank Rate and shorter term PWLB rates, are probably also even and are broadly dependent on how strong GDP

growth turns out, how slowly inflation pressures subside, and how quickly the Brexit negotiations move forward positively.

One risk that is both an upside and downside risk, is that all central banks are now working in very different economic conditions than before the 2008 financial crash as there has been a major increase in consumer and other debt due to the exceptionally low levels of borrowing rates that have prevailed for ten years since 2008. This means that the neutral rate of interest in an economy, (i.e. the rate that is neither expansionary nor deflationary), is difficult to determine definitively in this new environment, although central banks have made statements that they expect it to be much lower than before 2008. Central banks could therefore either over or under do increases in central interest rates.

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

- **Brexit** – if it were to cause significant economic disruption and a major downturn in the rate of growth.
- **Bank of England** takes action too quickly, or too far, over the next three years to raise Bank Rate and causes UK economic growth, and increases in inflation, to be weaker than we currently anticipate.
- A resurgence of the **Eurozone sovereign debt crisis**, possibly **Italy**, due to its high level of government debt, low rate of economic growth and vulnerable banking system, and due to the election in March 2018 of a government which has made a lot of anti-austerity noise. The EU rejected the original proposed Italian budget and demanded cuts in government spending. The Italian government nominally complied with this rebuttal – but only by delaying into a later year the planned increases in expenditure. This particular can has therefore only been kicked down the road. The rating agencies have downgraded Italian debt to one notch above junk level. If Italian debt were to fall below investment grade, many investors would be unable to hold Italian debt. Unsurprisingly, investors are becoming increasingly concerned by the actions of the Italian government and consequently, Italian bond yields have risen sharply – at a time when the government faces having to refinance large amounts of debt maturing in 2019.
- Weak capitalisation of some **European banks**. Italian banks are particularly vulnerable; one factor is that they hold a high level of Italian government debt - debt which is falling in value. This is therefore undermining their capital ratios and raises the question of whether they will need to raise fresh capital to plug the gap.
- **German minority government.** In the German general election of September 2017, Angela Merkel's CDU party was left in a vulnerable minority position dependent on the fractious support of the SPD party, as a result of the rise in popularity of the anti-immigration AfD party. Then in October 2018, the results of the Bavarian and Hesse state elections radically undermined the SPD party and showed a sharp fall in support for the CDU. As a result, the SPD had a major internal debate as to whether it could continue to support a coalition that is so damaging to its electoral popularity. After the result of the Hesse state election, Angela Merkel announced that she would not stand for re-election as CDU party leader at her party's convention in December 2018. However, this makes little practical difference as she has continued as Chancellor. However, there are five more state elections coming up in 2019 and EU parliamentary elections in May/June; these could result in

a further loss of electoral support for both the CDU and SPD which could also undermine her leadership.

- **Other minority EU governments.** Sweden, Spain, Portugal, Netherlands and Belgium all have vulnerable minority governments dependent on coalitions which could prove fragile. The Spanish government failed to pass a national budget in mid February so a snap general election is now scheduled for April 28.
- **Italy, Austria, the Czech Republic and Hungary** now form a strongly anti-immigration bloc within the EU. Elections to the EU parliament are due in May/June 2019.
- The increases in interest rates in the US during 2018, combined with a potential trade war between the USA and China, sparked major volatility in equity markets during the final quarter of 2018 and into 2019. Some **emerging market countries** which have borrowed heavily in dollar denominated debt, could be particularly exposed to investor flight from equities to safe havens, typically US treasuries, German bunds and UK gilts.
- There are concerns around the level of **US corporate debt** which has swollen massively during the period of low borrowing rates in order to finance mergers and acquisitions. This has resulted in the debt of many large corporations being downgraded to a BBB credit rating, close to junk status. Indeed, 48% of total investment grade corporate debt is now rated at BBB. If such corporations fail to generate profits and cash flow to reduce their debt levels as expected, this could tip their debt into junk ratings which will increase their cost of financing and further negatively impact profits and cash flow.
- **Geopolitical risks,** especially North Korea, but also in Europe and the Middle East, which could lead to increasing safe haven flows.

Upside risks to current forecasts for UK gilt yields and PWLB rates

- **Brexit** – if both sides were to agree a compromise that removed all threats of economic and political disruption.
- **The Fed causing a sudden shock in financial markets** through a sharp change of mind from ‘being patient’, to resuming raising the Fed Funds Rate, and in the pace and strength of reversal of QE, which then leads to a fundamental reassessment by investors of the relative risks of holding bonds, as opposed to equities. This could lead to a major flight from bonds to equities and a sharp increase in bond yields in the US, which could then spill over into impacting bond yields around the world.
- The **Bank of England is too slow** in its pace and strength of increases in Bank Rate and, therefore, allows inflationary pressures to build up too strongly within the UK economy, which then necessitates a later rapid series of increases in Bank Rate faster than we currently expect.
- **UK inflation,** whether domestically generated or imported, returning to sustained significantly higher levels causing an increase in the inflation premium inherent to gilt yields.

Brexit timetable and process

- March 2017 UK government notified the European Council of its intention to leave under the Treaty on European Union Article 50 on 29 March 2019.
- 25.11.18 EU27 leaders endorsed the withdrawal agreement
- 21.3.19 European Council summit agrees delay for Brexit from 29 March to April 12 if the deal is rejected by MPs.
- 12.4.19 Either the UK leaves the EU, or asks the EU for agreement to an extension of the Article 50 period if the UK Parliament has been unable to agree on a Brexit deal.
- Long delay until..... If MPs unable to agree a way forward – period to be agreed with EU
- 22.5.19 UK leaves EU if the deal is approved by MPs. This will be followed by a **transition period originally proposed to end around December 2020.** If the UK and EU parliaments agree the deal, the EU Council needs to approve the deal; 20 countries representing 65% of the EU population must agree.
- UK continues as a full EU member until 22.5.19 with access to the single market and tariff free trade between the EU and UK. Different sectors of the UK economy may leave the single market and tariff free trade at different times during the transition period.
- The UK and EU would attempt to negotiate, among other agreements, a bi-lateral trade agreement over that period, (assuming a Norway style deal is not agreed).
- The UK would aim for a negotiated agreed withdrawal from the EU, although the UK could also exit without any such agreements in the event of a breakdown of negotiations.
- If the UK exits without an agreed deal with the EU, World Trade Organisation rules and tariffs could apply to trade between the UK and EU.
- On full exit from the EU: the UK parliament would repeal the 1972 European Communities Act.