

Economic Background and Interest Rates

Financial Review and Outlook for 2017/18

Global equity markets continued to be supported by expectations of strengthening economic activity, although this was tempered towards the end of the quarter following comments from the Bank of England that interest rates could rise in the relatively near future, although the pace is expected to be gradual. Other factors that have contributed to the current interest environment are:

- Progress on Brexit has been slow with EU and UK having different priorities
- Inflation has remained higher than expected, thereby limiting purchasing power
- Housing market remains subdued
- Debt being used to support spending
- The government has eased public sector pay cap but has indicated it remains committed to tight fiscal policy

Our financial advisors, Arlingclose have reservations that the UK's economic outlook justifies an increase in interest rates at this stage. Their central case is for gilt yields to remain broadly stable in the across the medium term, but there may be near term volatility due to shifts in interest rate expectations.

However on 2nd November 2017 the Bank of England raised the Bank Rate by 0.25% to 0.50%.

Credit Developments and Credit Risk Management

UK bank credit default swaps continued their downward trend, reaching three-year lows by the end of June. Bank share prices have not moved in any particular pattern.

There were a few credit rating changes during the quarter. The significant change was the downgrade by Moody's to the UK sovereign rating in September from Aa1 to Aa2 which resulted in subsequent downgrades to sub-sovereign entities including local authorities. Moody's downgraded Standard Chartered Bank's long-term rating to A1 from Aa3 on the expectation that the bank's profitability will be lower following management's efforts to de-risk their balance sheet. The agency also affirmed Royal Bank of Scotland's and NatWest's long-term ratings at Baa1, placed Lloyds Bank's A1 rating on review for upgrade, revised the outlook of Santander UK plc, and Nationwide building society from negative to stable.

Ring-fencing, which requires the larger UK banks to separate their core retail banking activity from the rest of their business, is expected to be implemented within the next year. In May, we were advised to reduce the maximum duration of unsecured investments with Bank of Scotland, HSBC Bank and Lloyds Bank from 13 months to 6 months as until banks' new structures are finally determined and published, the different credit risks of the 'retail' and 'investment' banks cannot be known for certain.

The new EU regulations for Money Market Funds were finally approved and published in July and existing funds will have to be compliant by no later than 21st January 2019. The key features include Low Volatility NAV (LVNAV) Money Market Funds which will be permitted to maintain a constant dealing NAV, providing they meet strict new criteria and minimum liquidity requirements. MMFs will not be prohibited from having an external fund rating (as had been suggested in draft regulations). Arlingclose expects most of the short-term MMFs it recommends to convert to the LVNAV structure and awaits confirmation from each fund.

Southampton Benchmarking Scores 30th September 2017



Investment Benchmarking

30 September 2017

Southampton 20 English Unitaries Average 135 LAs Average

Internal Investments	£49.8m	£66.0m	£63.5m
External Funds	£26.4m	£12.2m	£10.3m
TOTAL INVESTMENTS	£76.2m	£77.2m	£73.7m

Security

Average Credit Score	3.72	4.80	4.44
Average Credit Rating	AA-	A+	AA-
Average Credit Score (time-weighted)	1.38	4.53	4.32
Average Credit Rating (time-weighted)	AAA	A+	AA-
Number of Counterparties / Funds	18	14	16
Proportion Exposed to Bail-in	72%	70%	64%

Liquidity

Proportion Available within 7 days	41%	49%	44%
Proportion Available within 100 days	41%	68%	67%
Average Days to Maturity	211	100	40

Market Risks

Average Days to Next Rate Reset	172	115	66
External Fund Volatility	1.6%	1.2%	1.8%

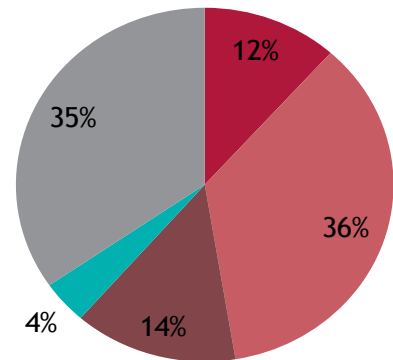
Yield

Internal Investment Return	0.72%	0.54%	0.48%
External Funds - Income Return	4.55%	4.15%	3.48%
External Funds - Capital Gains/Losses	-3.10%	1.78%	1.17%
External Funds - Total Return	1.46%	5.92%	4.65%
Total Investments - Income Return	2.05%	1.09%	0.89%

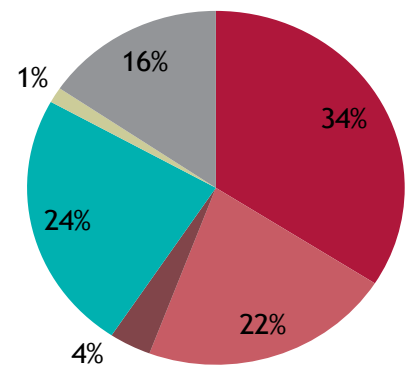
Notes

- Unless otherwise stated, all measures relate to internally managed investments only, i.e. excluding external pooled funds.
- Averages within a portfolio are weighted by size of investment, but averages across authorities are not weighted.
- Credit scores are calculated as AAA = 1, AA+ = 2, etc.
- Volatility is the standard deviation of weekly total returns, annualised.

Southampton



All Arlingclose Clients



English Unitaries

