External Factors Impacting on Treasury During 2018/19

A summary of the external factors in 2018-19 is provided by the council's treasury advisor, Arlingclose Ltd, and is detailed below.

Economic background; after spiking at over $85/barrel in October 2018, oil prices fell back sharply by the end of the year, declining to just over $50 in late December before steadily climbing toward $70 in April 2019. UK Consumer Price Inflation (CPI) for February 2019 was up 1.9% year/year, just above the consensus forecast but broadly in line with the Bank of England's February Inflation Report. The most recent labour market data for the three months to January 2019 showed the unemployment rate fell to a new low 3.9% while the employment rate of 76.1% was the highest on record. The 3-month average annual growth rate for pay excluding bonuses was 3.4% as wages continue to rise steadily and provide some upward pressure on general inflation. Once adjusted for inflation, real wages were up 1.4%.

After rising to 0.6% in the third calendar quarter from 0.4% in the second, fourth quarter economic growth slowed to 0.2% as weaker expansion in production, construction and services dragged on overall activity. Annual GDP growth at 1.4% continues to remain below trend. Following the Bank of England's decision to increase Bank Rate to 0.75% in August, no changes to monetary policy have been made since.

The US Federal Reserve continued its tightening bias throughout 2018, pushing rates to the 2.25%-2.50% range in December. However, a recent softening in US data caused the Fed to signal a pause in hiking interest rates at the last Federal Open Market Committee (FOMC) meeting in March.

With the 29th March 2019, the original EU 'exit day' now been and gone, having failed to pass a number of meaningful votes in Parliament and an extension has been given to the end of October 2019. The ongoing uncertainty continues to weigh on sterling and UK markets.

While the domestic focus has been on Brexit's potential impact on the UK economy, globally the first quarter of 2019 has been overshadowed by a gathering level of broader based economic uncertainty. The US continues to be set on a path of protectionist trade policies and tensions with China in particular, but with the potential for this to spill over into wider trade relationships, most notably with EU. The EU itself appeared to be show signs of a rapid slowdown in economic growth with the major engines of its economy, Germany and France, both suffering misfires from downturns in manufacturing alongside continued domestic/populist unrest in France. The International Monetary Fund downgraded its forecasts for global economic growth in 2019 and beyond as a consequence.

Financial markets: December was a month to forget in terms of performance of riskier asset classes, most notably equities. The FTSE 100 (a good indicator of global corporate sentiment) returned -8.8% assuming dividends were reinvested; in pure price terms it fell around 13%. However, since the beginning of 2019 markets have rallied, and the FTSE 100 and FTSE All share indices were both around 10% higher than at the end of 2018.

Gilt yields continued to display significant volatility over the period on the back of ongoing economic and political uncertainty in the UK and Europe. After rising in October, gilts regained their safe-haven status throughout December and into the new year - the 5-year benchmark gilt yield fell as low as 0.80% and there were similar falls in the 10-year and 20-year gilts over the same period dropping from 1.73% to 1.08% and from 1.90% to 1.55%. The increase in Bank Rate pushed up money markets rates over the year and 1-month, 3-month and 12-month LIBID (London Interbank Bid) rates averaged 0.53%, 0.67% and 0.94% respectively over the period.

Recent activity in the bond markets and PWLB interest rates highlight that weaker economic growth is not just a UK phenomenon but a global risk. During March the US yield curve inverted (10-year Treasury

yields were lower than US 3 month money market rates) and German 10-year Bund yields turned negative. The drivers are a significant shift in global economic growth prospects and subsequent official interest rate expectations given its impact on inflation expectations. Further to this is world trade growth which collapsed at the end of 2018 falling by 1.8% year-on-year. A large proportion of this downturn in trade can be ascribed to the ongoing trade tensions between the US and China which despite some moderation in January does suggest that the International Monetary Fund's (IMF) and Organisation for Economic Co-Operation & Development's (OECD) forecasts for global growth in 2019 of 3.5% might need to be revised downwards.

Outlook for 2019/20: The 6-month delay to Brexit has removed the near-term risk of a no-deal situation but the potential for divergent paths for UK monetary policy beyond October remains. The timing of the new leave date and expectation that Brexit negotiations are likely to continue until that date has prompted us push back forecast rises in Bank Rate.

We believe the MPC bias towards tighter monetary policy remains, but Brexit uncertainty and slower global and UK growth/inflation outlook continue to weigh on expectations. Policymakers are unlikely to raise Bank Rate unless there is a withdrawal arrangement and the prospect of a transitionary period.

There is potential for stronger growth following a long-term extension to Article 50 or a withdrawal agreement as business investment/general confidence recovers. Despite this and a no-deal Brexit seeming less likely, we maintain the downside risks to our forecasts. We expect the Bank of England to hold at or reduce interest rates from current levels if Brexit risks materialise.

The UK economic environment appears relatively soft. The strong labour market has provided some support to household consumption, offsetting the Brexit-related downturn in business investment. Our view is that the UK economy faces a challenging outlook as the country exits the European Union and Eurozone/global economic growth softens, notwithstanding a possible short term bounce in activity should a Brexit deal finally be agreed.

Cost pressures have eased due to a fall in oil prices, although rises in energy prices and weaker sterling may feed through into higher inflation. The apparent tight labour market risks longer term domestically-driven inflationary pressure whatever the external inflation effects, although labour market demographics may dampen wage growth compared to historical norms.

Global economic growth has eased and the economic/political outlook has prompted central banks to significantly reduce expectations for on-going monetary tightening. Central bank actions and geopolitical risks will continue to produce significant volatility in financial markets, including bond markets.

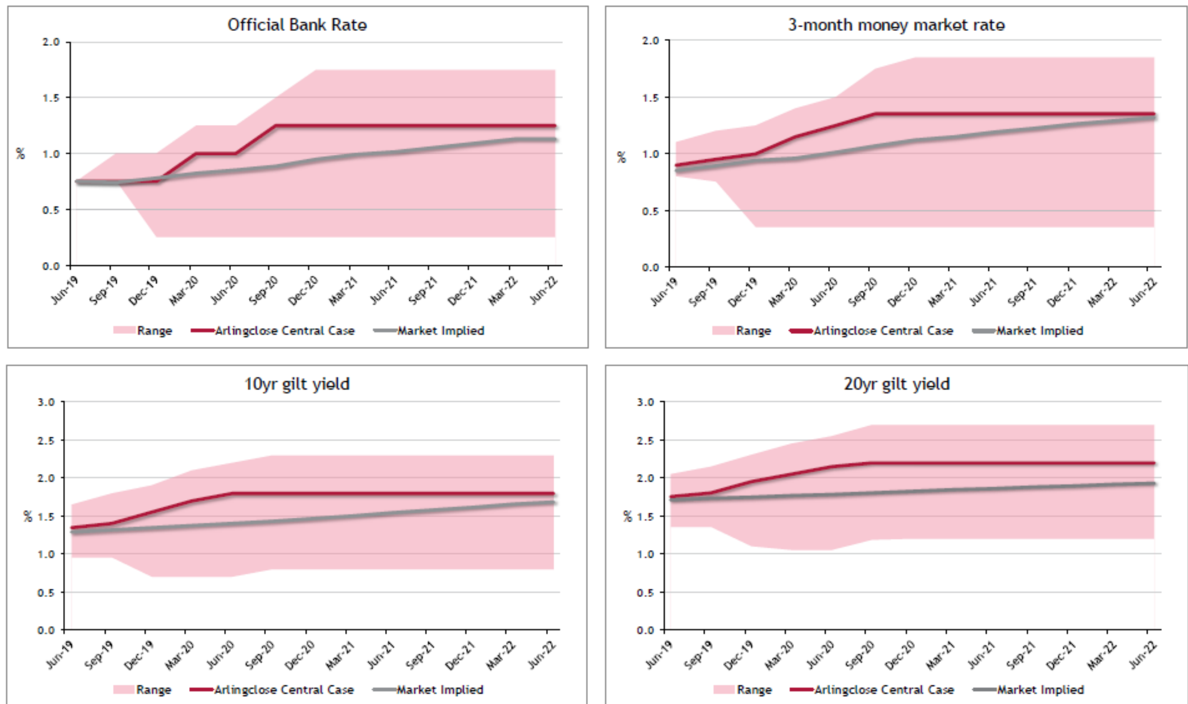
Forecast interest Rates

The following forecast interest forecast are set against a background of:

- The MPC has maintained expectations of a slow rise in interest rates over the forecast horizon. Our central case incorporates the likelihood of the MPC raising rates in the first quarter of 2020 following exit from the EU in October 2019.
- The forecast range encompasses the interest rate responses for various Brexit outcomes, from a no-deal Brexit to remaining in the EU.
- Gilt yields have remained at low levels. We expect some upward movement from current levels based on a Brexit transitionary period. However, our projected weak economic outlook and volatility arising from both economic and political events will continue to offer borrowing opportunities.

	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22	Jun-22
Official Bank Rate													
Upside risk	0.00	0.25	0.25	0.25	0.25	0.25	0.50	0.50	0.50	0.50	0.50	0.50	0.50
Arlingclose Central Case	0.75	0.75	0.75	1.00	1.00	1.25	1.25	1.25	1.25	1.25	1.25	1.25	1.25
Downside risk	0.00	0.00	0.50	0.75	0.75	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
3-month money market rate													
Upside risk	0.20	0.25	0.25	0.25	0.25	0.40	0.50	0.50	0.50	0.50	0.50	0.50	0.50
Arlingclose Central Case	0.90	0.95	1.00	1.15	1.25	1.35	1.35	1.35	1.35	1.35	1.35	1.35	1.35
Downside risk	0.10	0.20	0.65	0.80	0.90	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
1yr money market rate													
Upside risk	0.30	0.35	0.35	0.35	0.35	0.40	0.50	0.50	0.50	0.50	0.50	0.50	0.50
Arlingclose Central Case	1.10	1.15	1.25	1.40	1.45	1.55	1.55	1.55	1.55	1.55	1.55	1.55	1.55
Downside risk	0.10	0.20	0.80	0.90	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
5yr gilt yield													
Upside risk	0.30	0.35	0.35	0.40	0.40	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50
Arlingclose Central Case	0.95	1.00	1.25	1.30	1.45	1.45	1.40	1.40	1.40	1.40	1.40	1.40	1.40
Downside risk	0.35	0.35	0.75	0.80	0.95	0.95	0.90	0.90	0.90	0.90	0.90	0.90	0.90
10yr gilt yield													
Upside risk	0.30	0.40	0.35	0.40	0.40	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50
Arlingclose Central Case	1.35	1.40	1.55	1.70	1.80	1.80	1.80	1.80	1.80	1.80	1.80	1.80	1.80
Downside risk	0.40	0.45	0.85	1.00	1.10	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
20yr gilt yield													
Upside risk	0.30	0.35	0.35	0.40	0.40	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50
Arlingclose Central Case	1.75	1.80	1.95	2.05	2.15	2.20	2.20	2.20	2.20	2.20	2.20	2.20	2.20
Downside risk	0.40	0.45	0.85	1.00	1.10	1.02	1.00	1.00	1.00	1.00	1.00	1.00	1.00
50yr gilt yield													
Upside risk	0.30	0.35	0.35	0.40	0.40	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50
Arlingclose Central Case	1.70	1.75	1.90	2.00	2.10	2.15	2.15	2.15	2.15	2.15	2.15	2.15	2.15
Downside risk	0.40	0.45	0.85	1.00	1.10	1.02	1.00	1.00	1.00	1.00	1.00	1.00	1.00

Charts show the Arlingclose central case along with upside and downside risks:
Arlingclose judges that there is currently a higher risk of outcomes to the downside



PWLB Certainty Rate (Maturity Loans) = Gilt yield + 0.80%   PWLB Infrastructure Rate (Maturity Loans) = Gilt yield + 0.60%