# Treasury Management Financial Outlook and Quarterly Benchmarking

**Financial Review and Outlook for 2018/19**

The UK economy continues to face a challenging outlook as the government negotiates the country's exit from the European Union.

The low for longer interest rate outlook theme that has been at the core of our treasury advisor, Arlingclose, recommended strategic advice for over a decade now remains despite increases in UK official interest rates. The Bank of England's Monetary Policy Committee (MPC) signalled its concerns regarding its inflation outlook around which it frames monetary policy by raising Bank Rate for the second time to 0.75% on 2nd August 2018. This is a much more cautious tightening than the path that has been adopted by the US Federal Reserve. The Fed have raised its equivalent official interest rate nine times since the late 2016 and four times during 2018 much to the increasing chagrin of the President Trump. Elsewhere, central bankers have maintained interest rates at what were initially deemed to be emergency levels but now seem more entrenched as the new-normal. This is particularly the case with the Euro area and in Japan where Quantitative Easing has been the operational focus of its respective central banks although the tapering of this activity is now well underway, for now at least.

December 2018 was volatile in terms of the performance of riskier asset classes, most notably equities. The FTSE100 (a reasonably good indicator of global corporate sentiment) returned -8.8% during 2018 assuming dividends were reinvested, in pure price terms it retreated around 13%. But spreads on corporate bonds also widened reflecting concerns about tougher economic conditions ahead and the abilities of corporates to service their debt obligations. Much of this damage was done in the last few months of the year as investors wrestled with a range of global concerns: an economic slowdown in China, rising trade tensions initiated by the US with China, a sharply lower oil price reflecting lower demand for crude, slowing Euro area output, Italian budget stand-off, continuing momentum in populist political parties and for the UK the ongoing uncertainty surrounding the country's exit from the European Union.

Arlingclose's central case is for Bank Rate to rise twice in 2019, after the UK exits the EU. However, recent events around the UK exit have dampened interest rate expectations and the risks are weighted to the downside. The potential for severe economic outcomes has increased following the poor reception of the Withdrawal Agreement by MPs. The Bank of England will hold at or reduce interest rates from current levels if serious risks materialise.

| | Dec-18 | Mar-19 | Jun-19 | Sep-19 | Dec-19 | Mar-20 | Jun-20 | Sep-20 | Dec-20 | Mar-21 | Jun-21 | Sep-21 | Dec-21 | Average |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Official Bank Rate | | | | | | | | | | | | | | |
| **Upside risk** | 0.00 | 0.00 | 0.00 | 0.00 | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 | **0.17** |
| **Arlingclose Central Case** | **0.75** | **0.75** | **1.00** | **1.00** | **1.25** | **1.25** | **1.25** | **1.25** | **1.25** | **1.25** | **1.25** | **1.25** | **1.25** | **1.13** |
| **Downside risk** | 0.00 | -0.50 | -0.75 | -0.75 | -1.00 | -1.00 | -1.00 | -1.00 | -1.00 | -1.00 | -1.00 | -1.00 | -1.00 | **-0.85** |

Gilt yields have remained at low levels. Arlingclose expects some upward movement from current level but a projected weak economic outlook and volatility arising from both economic and political events will continue to offer borrowing opportunities.

**Credit background:**

There were a few credit rating changes during the quarter, none of which have impacted on our investment strategy.

Credit Default Swap (CDS) spreads drifted up over the period, reflecting the ongoing uncertainty around the UK Exit from the EU, but continuing to remain low in historical terms. The spread on non-ringfenced bank NatWest Markets plc rose sharply to around 129bps while for the ringfenced entity, National Westminster Bank plc, the CDS spread held relatively steady around 44bps. The other main

UK banks, as yet not separated into ringfenced and non-ringfenced from a CDS perspective, traded between 44 and 94 bps at the end of the period.

The ringfencing of the big four UK banks (Barclays, Bank of Scotland/Lloyds, HSBC and RBS/Natwest Bank plc) is complete and the transfer of their business lines into retail (ringfenced) and investment banking (non-ringfenced) continues prior to starting trading as separate entities from 1st January 2019.

The Bank of England released its latest report on bank stress testing, illustrating that all entities tested were deemed to have passed the test once the levels of capital and potential mitigating actions presumed to be taken by management were factored in. The BoE did not require any bank to raise additional capital.

There were minimal credit rating changes during the period. Moody's revised the outlook on Nationwide Building Society to negative from stable as it believes Nationwide may become more reliant on retail deposit funding going forward, reducing the volume of wholesale deposits and senior debt available to a level where only a two-notch uplift is warranted rather than the current three notches.

Our treasury advisor Arlingclose will continue to provide ratings which are specific to wholesale deposits including certificates of deposit, rather than provide general issuer credit ratings. Non-preferred senior unsecured debt and senior bonds are at higher risk of bail-in than deposit products, either through contractual terms, national law, or resolution authorities' flexibility during bail-in. Arlingclose's creditworthiness advice will continue to include unsecured bank deposits and CDs but not senior unsecured bonds issued by commercial banks.

**Investment Performance**

The council's advisors undertake quarterly investment benchmarking across its client base. As reported previously our portfolio was more diversified and at higher interest rates than the average as a result of moving into the bond programme earlier than most clients, but there is now more competition for bonds from both government bodies and other local authorities, so opportunities to replace maturing bonds are limited and we will see a fall in suitable instruments. With this in mind, and following discussions with our advisors, it was decided to move more into property funds, which are a longer term investment, and to restrict temporary borrowing and therefore run our short term investments down.

During the last quarter our investments in bonds remained at £7.62M and we have maintained the property funds at £27M, with all other cash being placed in either Money Market Funds (MMF) or instant access bank accounts. As a result we had 27% (£15M) of our overall investment in Money Market which is in line with other Unitary Authorities for this time of year but this is expected to fall to about £10m by year end.

Due to earlier investment decisions our income return on investments managed internally is 1.30% which is higher than the average of 0.80% whilst still maintaining the average credit rating of AA-. Total income return at 2.84% is also higher than the average for both unitary (1.53%) and LA's (1.27%). Our total investment return at 4.41% is again higher than both unitary (1.31%) and LA's (0.97%) across Arlingclose's client base and is mainly due to the investments made in property funds, but as previously reported the value of the funds are more volatile and can go down as well as up but are less risky than buying individual properties and do not constitute capital spend and it is the income return at 4.47% that is the driver to invest.