ANNEX 1 – Economic Context & Regulatory Changes

Economic commentary

1. 2018/19 has been a year dominated globally by continuing tensions between US and China over trade policies, and more locally by continued uncertainty over the UK leaving the EU.

2. The UK economy reflected many of these tensions. After rising to 0.6% in the third calendar quarter from 0.4% in the second, the 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.

3. UK Consumer Price Inflation (CPI) for February 2019 was up 1.9% year on 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%.

4. 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 from downturns in manufacturing alongside continued domestic political unrest in France. The International Monetary Fund downgraded its forecasts for global economic growth in 2019 and beyond as a consequence.

5. **Financial markets:** The FTSE 100 (a good indicator of global corporate sentiment) fell in pure price terms by around 13% during 2018. 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.

6. 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 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.

7. 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 ended 2018 by falling 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.

Credit background:

8. Credit Default Swap (CDS), which are a form of insurance against loan defaults, drifted up towards the end of 2018 on the back of Brexit uncertainty before declining again in 2019 and continuing to remain low in historical terms.

9. The deadline for new EU regulations for Money Market Funds (MMFs) was no later than 21st January 2019. The ring-fencing of the big four UK banks (Barclays, Bank of Scotland/Lloyds, HSBC and RBS/NatWest Bank plc) transferred their business lines into retail (ring-fenced) and investment banking (non-ring-fenced) entities during the year.

10. In February, Fitch put the UK AA sovereign long-term rating on Rating Watch Negative as a result of Brexit uncertainty, following this move with the same treatment for UK banks and a number of government-related entities.

11. There were minimal other credit rating changes during the period. Moody's revised the outlook on Santander UK to positive from stable to reflect the bank's expected issuance plans which will provide additional protection for the its senior unsecured debt and deposits.

<u>Local Authority Regulatory Changes</u>

12. Following the significant changes to regulations on local authority treasury management in 2017/18, there were very few changes for the year ending 31 March 2019. The main change was the introduction of International Financial Reporting Standard (IFRS) 9 – Financial Instruments, which was brought in due to the previous standard being viewed as too complex, inconsistent in the management of risk and also deferred the recognition of credit losses.

13. The largest impact of this new standard is to financial assets and includes new classification tests for the categories of financial assets based on the purposes behind holding them. Existing financial assets are reclassified and re-measured as at the transition date (01/04/2018), and an annual impairment assessment carried out each year-end based on forward looking expectations and expected future losses. This may result in additional charges to the general fund as well as additional disclosure requirements within the Statement of Accounts. Financial liabilities remain largely unchanged by the new standard.

14. For Surrey County Council, this has led to an assessment of its loans to and equity investments in local authority commercial entities and other third parties into the likelihood of any potential loss. A provision for this has been charged to the general fund.