South Cambridgeshire District Council

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| **REPORT TO:** | Audit & Governance | 1 December 2021 |
| **LEAD CABINET MEMBER:** | Councillor John Williams,<br>Lead Cabinet Member for Finance | |
| **LEAD OFFICER:** | Peter Maddock, Head of Finance | |

# MID YEAR 2021/2022 TREASURY MANAGEMENT REPORT

## Executive Summary

1. This report outlines the mid-year treasury management report to 30 September 2021, including performance against the approved Prudential Indicators for Treasury Management.

## Key Decision

2. This is not a key decision as there are no resource implications directly arising from the report at this stage.

## Recommendation

3. **That Committee is invited to review the Treasury Management activity and performance for the period to 30 September 2021.**

## Reason for Recommendation

4. To review the Treasury Management activity and performance for the period 1 April 2021 to 30 September 2021.

## Details

Treasury Management Strategy

5. The Council's Treasury Management Strategy and prudential indicators for 2021/2022 were approved by Full Council on 23 February 2021. The revised version took into account the changes to the rules affecting local authorities borrowing from the Public Works Loan Board (PWLB) introduced by HM Treasury from 26 November 2020. The main purpose of the changes was to restrict the ability of local authorities to borrow for pure investment in commercial property.

6. As part of the Council's Mid-Year Review, the Treasury Management Policy Statement and Treasury Management Strategy for 2021/2022 have been reviewed with regard to their compliance to the CIPFA Prudential Code and the CIPFA Treasury Management Code. They have also been reviewed to ensure their appropriateness in light of the Council's current investment and borrowing portfolios, and the ongoing delivery of the Council service objectives and, following review, they have been found to be appropriate and there are no changes required.

7. In line with established practice, it is intended that a full review of the Treasury Management Policy and Treasury Management Strategy Statement will be presented to Cabinet and Council as part of the 2022/2023 budget determination process.

8. The economic landscape has continued with a degree of uncertainty and volatility during 2021, with the impact of the UK withdrawal from the European Union on 31 January 2020, and the ongoing financial challenges as a result of the Coronavirus pandemic (COVID-19) acting as a dampener to forecast growth and inflation expectations. Buoyed by the easing of virus containment measures and the bounce back of consumer spending, and with the vaccination programme now well advanced, the prospects for economic growth and robust recovery are now more encouraging. But we maintain a cautious approach given the level of uncertainty.

9. In response to the prevailing economic conditions the Bank of England Base Rate has been maintained at 0.1% since its reduction from 0.25% on 19 March 2020. The Government also introduced and has continued a number of financial measures that sought to help businesses survive the crisis caused by the Coronavirus pandemic, including the Coronavirus Job Retention Scheme (Furlough Scheme) which was extended to 30 September 2021. The withdrawal of the Government support packages could impact recovery (e.g. a rise in the level of insolvencies, ability to pay etc) and the effect on Council services, and income and expenditure levels, will need to be fully taken into account as part of the 2022/2023 budget setting process.

10. Any borrowing/investment exposes an organisation to financial risks including the loss of invested funds and the revenue effect of changing interest rates. The successful identification, monitoring and control of risk is, therefore, central to the Council's treasury management strategy This report covers the treasury management activity for the period 1 April 2021 to 30 September 2021 and the associated monitoring and risk management.

11. Following consultation in 2017, CIPFA published new versions of the Prudential Code for Capital Finance in Local Authorities (Prudential Code) and the Ministry for Housing, Communities & Local Government (MHCLG) published its revised investment Guidance which came into effect from April 2018. The framework established by the Prudential Code should support local strategic planning, local asset management planning and proper option appraisal. The objectives of the Prudential Code are to ensure, within this clear framework, that the capital investment plans of local authorities are affordable, prudent and sustainable.

12. The updated Prudential Code included a new requirement for local authorities to provide a Capital Strategy, which is to be an overarching document approved by Full Council. The Council's Capital Strategy was considered and approved by Full Council on 23 February 2021 and is being reviewed as part of the 2022/2023 budget process.

<u>Investment Activity</u>

13. As at 30 September 2021, the Council held £118.5 million of invested funds (nominal basis), representing income received in advance of expenditure plus balances and reserves held. The Council's investment balances during 2021/2022 have averaged £113.4 million over the year.

14. The Statutory Guidance on Local Government Investments in England, issued by the Secretary of State under section 15(1)(a) of the Local Government Act 2003, gives priority to security and liquidity and the Council's aim is to achieve a yield consistent with these key principles.

15. The portfolio has been managed throughout 2021 on the basis that there would be an external borrowing requirement for capital expenditure. In the period to 30 September 2021 there have been commercial investments made at Cambourne Business Park with a value of £13.5 million and, in addition, further loans of £2.8 million have made to Ermine Street Housing. This has been covered by current cashflows. Projected cashflows indicate further external borrowing will be required in the second half of the year. Short term borrowing began in November 2020. This has allowed the Council to increase its allocation to higher yielding Ermine Street Housing loans. The remainder of the portfolio has been held in short term liquid money market funds and fixed deposits with other Local Authorities, Banks, Building Societies and a Housing Association.

16. The table below shows the opening balances of investments held at the beginning of the financial year and the movements on each fund up to 30 September 2021:

| Investment Counterparty | 01 April 2021 | New | Matured | 30 Sept 2021 |
|---|---|---|---|---|
| **Short Term:** | **£000** | **£000** | **£000** | **£000** |
| Banks – Call/Liquidity Accounts | 6,265 | 90,515 | (87,955) | 8,825 |
| AAA Rated Money Market Fund | 0 | 36795 | (34,795) | 2,000 |
| Clearing Banks | 14,000 | 5,000 | (9,000) | 10,000 |
| Other Banks | 0 | 1,000 | 0 | 1,000 |
| UK Local Authorities | 0 | 14,000 | (12,000) | 2,000 |
| Building Societies | 0 | 74,460 | (74,460) | 0 |
| Housing Associations | 5,000 | 2,500 | (2,500) | 5,000 |
| **Total Short-Term Investments** | **25,265** | | | **28,825** |

| Investment Counterparty | 01 April 2021 | New | Matured | 30 Sept 2021 |
|---|---|---|---|---|
| **Long Term:** | **£000** | **£000** | **£000** | **£000** |
| South Cambs Ltd | 83,993 | 2,797 | 0 | 86,790 |
| Cambridge Leisure and Ice | 2,400 | 0 | 0 | 2,400 |
| Cambourne Town Council | 0 | 500 | 0 | 500 |
| **Total Long-Term Investments** | **86,393** | | | **89,690** |

| | | | | |
|---|---|---|---|---|
| **Total Investments** | **111,658** | | | **118,515** |

17. The upward movement in value of £6.9 million is due to the reasons reflected in paragraph 15 above.

18. The most significant movements in the portfolio are an increase of £2.6 million placed on Call accounts, £2m on Money Market Funds, £2m with a Local Authority and a further £2.8 million loaned to Ermine Street Housing. A more detailed analysis of the investment portfolio as at 30 September 2021 is shown at **Appendix A.**

19. Both the CIPFA Code and government guidance require the Authority to invest its funds prudently, and to have regard to the security and liquidity of its treasury investments before seeking the optimum rate of return, or yield. The Council's objective when investing money is to strike an appropriate balance between risk and return, minimising the risk of incurring losses from defaults and the risk of receiving low investment income.

20. In order to achieve these objectives, the Council's portfolio is diversified. The majority of the portfolio is invested in fixed deposits where Financial Institutions return 0.30%

and Ermine Street Housing returns 3.71%. Liquidity assets typically return 0.05%. This has to 30 September 2021 generated the Council a blended return of 2.86%.

21. This has been achieved whilst maintaining a low level of credit risk. Counterparty credit quality is assessed and monitored with reference to credit ratings (the Council's minimum long-term counterparty rating is [A-] across all major agencies); credit default swap prices, financial statements, information on potential government support and reports in the quality financial press. This is shown below.

| | **Weighted Average Risk Number** | **Investment Portfolio** | **Bail-In Exposure** | | **Average Balance** | **Rate of Return** |
|---|---|---|---|---|---|---|
| | | £000 | £000 | % | | |
| 30 September 2021 | 4.62 | 118,515 | 18,825 | 15.9 | 113,449 | 2.86 |
| 31 March 2021 | 5.20 | 111,658 | 21,265 | 19.0 | 108,395 | 2.95 |

22. The table also shows how the Council's exposure to Bail in Risk has reduced in year as the portfolio has diversified.

<u>Borrowing Strategy</u>

23. As at 30 September 2021, the Council held £205.123 million of long term debt (principal borrowed, excluding lease liabilities), no change on 31 March 2021. The Council held £44 million of short-term debt at 30 September 2021.

24. Affordability and the "cost of carry" remained important influences on the Council's borrowing strategy alongside the consideration that, for any borrowing undertaken ahead of need, the proceeds would have to be invested in the money markets at rates of interest significantly lower than the cost of borrowing. As short-term interest rates have remained low and are likely to remain at these levels over the forthcoming two years, the Authority has determined it is more cost effective in the short-term to use internal resources instead of external borrowing.

25. The benefits of internal borrowing are monitored regularly against the potential for incurring additional costs by deferring borrowing into future years when long-term borrowing rates are forecast to rise. Link Asset Services (Treasury Management Advisers) assist the Council with this 'cost of carry' and breakeven analysis.

Borrowing Activity

26. As at 31 March 2021 the Council had short-term local authority borrowing of £44 million in addition to £205.123 million of PWLB loans for HRA self-financing. The table below sets out the movement in the Council's borrowing over the year to date. The Capital Financing Requirement (CFR) is unchanged in the six-month period to 30 September 2021.

| | 01/04/2021 | Maturing Debt | Interest Paid | Lease Payments | CFR Movement | 30/09/2021 |
|---|---|---|---|---|---|---|
| | £000 | £000 | % | £000 | | £000 |
| **CFR** | 336,734 | | | | 0 | 336,734 |
| | | | | | | |
| Short Term Borrowing (a) | 44,000 | 0 | 0.65 | 0 | | 44,000 |
| Long Term Borrowing (b) | 205,123 | 0 | 3.51 | 0 | | 205,123 |
| **Total Borrowing (a+b)** | **249,123** | **0** | **0** | **0** | | **205,123** |
| Other Long Term Liabilities (c) | 0 | 0 | 0 | 0 | | 0 |
| **Total External Debt (a+b+c)** | **249,123** | **0** | **2.86** | **0** | | **249,123** |

PWLB Certainty Rate and Project Rate Update

27. Authorities are required to notify DLUCH of any potential future borrowing and in order to obtain the 'Certainty Rate' (0.20% below the PWLB standard rate) the Council has submitted an application to borrow at this rate until 31 March 2022. There is no penalty if the facility is not used.

Debt Rescheduling

28. The premium charge for early repayment of PWLB debt has become very expensive for the loans in the Council's portfolio and, therefore, unattractive for debt rescheduling activity. As a consequence, no rescheduling activity has been undertaken.

2021/2022 Budget Monitoring

29. The Finance Team monitor and report on the Capital Financing budget on a regular basis. The latest position as at 30 September 2021 is shown in the table below:

| | Current Budget | Forecast Outturn | Forecast Variance |
|---|---|---|---|
| | £000 | £000 | £000 |
| Interest Payments | 1,205 | 229 | (976) |
| Minimum Revenue Provision | 1,363 | 1,360 | (3) |
| **Total Expenditure** | **2,568** | **1,589** | **(979)** |
| Investment Income | (3,281) | (3,351) | (70) |
| Commercial Property Rental Income | (2,360) | (1,680) | 680 |
| **Total Income** | **(5,641)** | **(5,031)** | **610** |
| **Net Budget** | **(3,073)** | **(3,442)** | **(369)** |

30. Interest Payments are forecast to be lower than originally budgeted as the expectation of long-term borrowing during the year will not be required, due to higher investment balances and use of short-term borrowing in the near term.

31. Minimum Revenue Provision forecast outturn is in line with estimate with a very small saving expected.

32. Investment Income is forecast to come in ahead of budget. Although rates with Banks and Money Market funds are at historic lows, this has been balanced by further lending to Ermine Street Housing. Ermine Street Housing continues to make a significant contribution, with a slightly higher forecast outturn of £3.226 million versus original forecast of £3.166 million as Ermine Street Housing completes its acquisition programme. The income from the Commercial Property portfolio in the financial year will be lower than budgeted, in part due to vacant areas which are being marketed. The other factor is the change to the investment strategy away from acquisitions for yield to regeneration projects, due to the change in the PWLB borrowing rules meaning that we have invested less than planned. Overall, income is expected to exceed budget by £0.369 million as a result of lower borrowing costs.

External Economic Impact on Portfolio

33. The external economic context and market rate data is referenced in the Treasury Advisers report reproduced at **Appendix B.**

34. In response to the prevailing economic conditions the Bank of England Base Rate has been maintained at its record low of 0.1% since its reduction from 0.25% on 19 March 2020. This low rate has decreased the return on the Council's Money Market Fund holdings and gives a reduced return on maturing deposits when reinvested.

Compliance with Performance Indicators

35. The Council has been compliant with the 2021/2022 Prudential Indicators approved by Full Council on 23 February 2021 except where indicated. All exceptions are due to the high levels of investments held in short term money market funds and overnight bank accounts.

36. The Council measures and manages its exposures to treasury management risks using the following indicators:

37. Performance against prudential indicators in 2021/2022 is as follows:

**(1) Interest Rate Exposure**: This indicator is set to control the Council's exposure to interest rate risk. The upper limits on fixed and variable interest rate exposures are set out in the table below:

| Maturity structure of borrowing | Under 12 months | More than 12 months | Under 12 months - Actual | More than 12 months - Actual |
|---|---|---|---|---|
| Upper limit for fixed interest rate exposure | 100% | 100% | 100% | 100% |
| Upper limit for variable rate exposure | 100% | 0% | 0% | 0% |

**(2) Maturity Structure of Borrowing**: The structure of the Council's borrowing is set out below.

| **Fixed Rate Borrowing** | | |
|---|---|---|
| Lender | Repayable within | Amount £,000 |
| Local Authorities | <12 Months | 19,000 |
| Local Authorities | >12 Months <2 years | 25,000 |
| PWLB | 10 – 15 years | 5,000 |
| PWLB | 15 – 20 years | 50,000 |
| PWLB | 20 – 25 years | 50,000 |
| PWLB | 25 – 30 years | 50,000 |
| PWLB | 30 – 35 years | 50,123 |

**(3) Principal Sums Invested for Periods Longer than 364 Days**: The purpose of this indicator is to control the Council's exposure to the risk of incurring losses by seeking early repayment of its investments. The Council takes in consideration the advice of its Treasury Advisers when determining the duration of investments with financial institutions (excluding Ermine Street Housing and Cambridge Leisure and Ice Centre) The suggested duration for our counterparties are:

| Counterparty | Suggested maximum duration | Actual duration | Total investments £000 |
|---|---|---|---|
| Local Authorities | 5 years | 182 days | 2,000 |
| Close Brothers | 6 months | 183 days | 1,000 |
| Places for People[1] | N/A | 364 days | 5,000 |
| Santander | 6 months | 35 days notice | 10,000 |

[1] Not assessed by the Council's appointed Treasury Advisers

**(4) Liquidity**: The Council has adopted a voluntary measure of its exposure to liquidity risk by maintaining a minimum £7 million working cash balance (total investment balance less loans to Ermine Street Housing and Cambridge Leisure & Ice). This liquidity is available to meet unexpected payments without additional borrowing.

| Counterparty Type | Amount £000 | % of Portfolio at 30 September |
|---|---|---|
| **Long term (>1yr)** | | |
| Ermine St Housing | 86,790 | 73 |
| CLIC + Cambourne Town Council | 2,900 | 2 |
| **Total Long term** | **89,690** | **75** |
| | | |
| **Short term (<365 days)** | | |
| Banks (Clearing) | 18,825 | 16 |
| Other Banks | 1,000 | 1 |
| Housing Assoc. | 5,000 | 4 |
| Local Authorities | 2,000 | 2 |
| Money Market Funds | 2,000 | 2 |
| **Short Term (Working Cash Balance)** | **28,825** | **25** |

Outlook for Quarter 4 2021/2022

38. The Council will continue to make acquisitions under the Investment Strategy and make further loans to Ermine Street Housing. The Council will receive minimal receipts from Council Tax and National Non-Domestic Rates during February and March 2021 and has £19 million of short term loans to be repaid in the second half of the year. It is forecast that £40 million in new short term loans will be required to externalise our internal borrowing. The expected outturn on short term borrowing is £65 million.

39. The view is that the UK economy still faces a challenging outlook as the Government continues to respond to the country's exit from the European Union and the economic conditions caused by COVID-19.

## Implications

40. In the writing of this report, taking into account the financial, legal, staffing, risk management, equality and diversity, climate change, community safety and any other key issues, the following implications have been considered:

**Legal**

41. It is a statutory duty, under Section 3 of the Local Government Act 2003 and supporting regulations, for the Council to approve a range of prudential indicators as part of its approval of the General Fund Revenue Budget and Capital Programme.

42. The Chartered Institute of Public Finance and Accountancy's Treasury Management Code (CIPFA's TM Code) requires that authorities report on the performance of the treasury management function at least twice yearly (mid-year and at year end).

**Policy**

43. There are no specific policy implications associated with the recommendations contained in this report. The Chartered Institute of Public Finance & Accountancy (CIPFA) Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes (the CIPFA Code) and the CIPFA Prudential Code for Capital Finance in Local Authorities 2017 (as amended) have been used in the preparation of this report.

**Finance**

44. There are no new resource implications associated with the recommendations contained in this report.

**Risks**

45. There are no specific risk implications associated with the recommendations contained in this report.

**Environmental**

46. There are no specific environmental implications associated with the recommendations contained in this report.

**Equality and Diversity**

47. In preparing this report, due consideration has been given to the Council's statutory Equality Duty to eliminate unlawful discrimination, advance equality of opportunity and foster good relations, as set out in Section 149(1) of the Equality Act 2010.

48. A relevance test for equality has determined that the activity has no relevance to South Cambridgeshire District Council's statutory equality duty to eliminate unlawful discrimination, advance equality of opportunity and foster good relation. An equality impact assessment is not needed.

**Effect on Council Priority Areas**

49. Timely and robust consideration of the Council's treasury management activities is vital to ensure that financial performance is in line with expectations.

## Background Papers

Where the Local Authorities (Executive Arrangements) (Meetings and Access to Information) (England) Regulations 2012 require documents to be open to inspection by members of the public, they must be available for inspection:

(a) at all reasonable hours at the offices of South Cambridgeshire District Council;

(b) on the Council's website; and

(c) in the case of documents to be available for inspection pursuant to regulation 15, on payment of a reasonable fee required by the Council by the person seeking to inspect the documents at the offices of South Cambridgeshire District Council.

The following documents are relevant to this report:

- Medium Term Financial Strategy – Report to Cabinet: 7 December 2020
- Medium Term Financial Strategy – Report to Council: 23 February 2021
- General Fund Budget – Report to Cabinet: 3 February 2021
- General Fund Budget – Report to Council: 23 February 2021
- Treasury Management Strategy – Report to Cabinet: 3 February 2021
- Treasury Management Strategy – Report to Council: 23 February 2021

## Appendices

A Schedule of Investments as at 30 September 2021

B Treasury Management Adviser – External Economic Context and Market Rate Data

**Report Authors:** Peter Maddock – Head of Finance
*e-mail: peter.maddock@scambs.gov.uk*

Daniel Hasler – Accountancy Assistant
*e-mail: daniel.hasler@scambs.gov.uk*

## Appendix A – Schedule of Investments as at 30 September 2021

| | Amount | Interest | Total | Term | Rate | Maturity Date |
|---|---|---|---|---|---|---|
| | £000 | £000 | £000 | Days | % | |
| **Counterparty** | | | | | | |
| | | | | | | |
| Barclays FIBCA (Call ac) | 8,825 | | 8,825 | Overnight | 0.05 | 01/10/2021 |
| Federated Cashplus (MMF) | 2,000 | | 2,000 | T+1 | 0.05 | 02/10/2021 |
| Santander 35d Notice ac | 10,000 | | 10,000 | 35 | 0.25 | 05/11/2021 |
| Slough Borough Council | 2,000 | 1.995 | 2,002 | 182 | 0.20 | 07/10/2021 |
| Places for People | 1,000 | 2.521 | 1,003 | 184 | 0.50 | 26/11/2021 |
| Places for People | 2,500 | 19.534 | 2,520 | 547 | 1.55 | 31/12/2021 |
| Places for People | 1,500 | 3.781 | 1,504 | 184 | 0.50 | 05/01/2022 |
| Close Brothers | 1,000 | 1.253 | 1,001 | 184 | 0.25 | 31/12/2021 |
| | | | | | | |
| Ermine Street Housing | 82,588 | | | | 3.85 | Various |
| Ermine Street Housing | 4,202 | | | | 1.00 | Various |
| Cambridge Leisure & Ice | 2,400 | | | 25 Years | 4.31 | 31/03/2043 |
| Cambourne Town Council[1] | 500 | | | | | TBC |
| **Total** | 118,515 | | | | | |

[1] Interest will be charged when the loan is repaid and will be at an equivalent rate to that required to recoup the Council's debt management costs in relation to this loan.

# Appendix B – Treasury Management Adviser – External Economic Context and Market Rate Data

## Economics Update

### MPC meeting 24.9.21

- The Monetary Policy Committee (MPC) voted unanimously to leave Bank Rate unchanged at 0.10% and made no changes to its programme of quantitative easing purchases due to finish by the end of this year at a total of £895bn; two MPC members voted to stop the last £35bn of purchases as they were concerned that this would add to inflationary pressures.

- There was a major shift in the tone of the MPC's minutes at this meeting from the previous meeting in August which had majored on indicating that some tightening in monetary policy was now on the horizon, but also not wanting to stifle economic recovery by too early an increase in Bank Rate. In his press conference after the August MPC meeting, Governor Andrew Bailey said, "the challenge of avoiding a steep rise in unemployment has been replaced by that of ensuring a flow of labour into jobs" and that "the Committee will be monitoring closely the incoming evidence regarding developments in the labour market, and particularly unemployment, wider measures of slack, and underlying wage pressures." In other words, it was flagging up a potential danger that labour shortages could push up wage growth by more than it expects and that, as a result, CPI inflation would stay above the 2% target for longer. It also discounted sharp increases in monthly inflation figures in the pipeline in late 2021 which were largely propelled by events a year ago e.g., the cut in VAT in August 2020 for the hospitality industry, and by temporary shortages which would eventually work their way out of the system: in other words, **the MPC had been prepared to look through a temporary spike in inflation.**

- So, in August the country was just put on alert. However, this time the MPC's words indicated there had been a marked increase in concern that more recent increases in prices, particularly the increases in gas and electricity prices in October and due again next April, are, indeed, likely to lead to **faster and higher inflation expectations and underlying wage growth, which would in turn increase the risk that price pressures would prove more persistent next year than previously expected. Indeed, to emphasise its concern about inflationary pressures, the MPC pointedly chose to reaffirm its commitment to the 2% inflation target in its statement;** this suggested that it was now willing to look through the flagging economic recovery during the summer to prioritise bringing inflation down next year. This is a reversal of its priorities in August and a long way from words at earlier MPC meetings which indicated a willingness to look through inflation overshooting the target for limited periods to ensure that inflation was 'sustainably over 2%'. Indeed, whereas in August the MPC's focus was on getting through a winter of temporarily high energy prices and supply shortages, believing that inflation would return to just under the 2% target after reaching a high around 4% in late 2021, now its primary concern is that underlying price pressures in the economy are likely to get embedded over the next year and elevate future inflation to stay significantly above its 2% target and for longer.

- Financial markets are now pricing in a first increase in Bank Rate from 0.10% to 0.25% in February 2022, but this looks ambitious as the MPC has stated that it wants to see what happens to the economy, and particularly to employment once furlough ends at the end of September. At the MPC's meeting in February it will only have available the employment figures for November: to get a clearer picture of employment trends, it would need to wait until the May meeting when it would have data up until February. At its May meeting, it will also have a clearer understanding of the likely peak of inflation.

- **The MPC's forward guidance on its intended monetary policy** on raising Bank Rate versus selling (quantitative easing) holdings of bonds is as follows: -
    1. Placing the focus on raising Bank Rate as "the active instrument in most circumstances".
    2. Raising Bank Rate to 0.50% before starting on reducing its holdings.
    3. Once Bank Rate is at 0.50% it would stop reinvesting maturing gilts.
    4. Once Bank Rate had risen to at least 1%, it would start selling its holdings.

- **COVID-19 vaccines.** These have been the game changer which have enormously boosted confidence that **life in the UK could largely return to normal during the summer** after a third wave of the virus threatened to overwhelm hospitals in the spring. With the household saving rate having been exceptionally high since the first lockdown in March 2020, there is plenty of pent-up demand and purchasing power stored up for services in hard hit sectors like restaurants, travel and hotels. The big question is whether mutations of the virus could develop which render current vaccines ineffective, as opposed to how quickly vaccines can be modified to deal with them and enhanced testing programmes be implemented to contain their spread.

**US.** See comments below on US treasury yields.

**EU.** The slow role out of vaccines initially delayed economic recovery in early 2021 but the vaccination rate has picked up sharply since then. After a contraction in GDP of -0.3% in Q1, Q2 came in with strong growth of 2%, which is likely to continue into Q3, though some countries more dependent on tourism may struggle. Recent sharp increases in gas and electricity prices have increased overall inflationary pressures but the ECB is likely to see these as being only transitory after an initial burst through to around 4%, so is unlikely to be raising rates for a considerable time. German general election. With the CDU/CSU and SDP both having won around 24-26% of the vote in the September general election, the composition of Germany's next coalition government may not be agreed by the end of 2021. An SDP-led coalition would probably pursue a slightly less restrictive fiscal policy, but any change of direction from a CDU/CSU led coalition government is likely to be small. However, with Angela Merkel standing down as Chancellor as soon as a coalition is formed, there will be a hole in overall EU leadership which will be difficult to fill.

**China.** After a concerted effort to get on top of the virus outbreak in Q1 2020, economic recovery was strong in the rest of the year; this enabled China to recover all the initial contraction. During 2020, policy makers both quashed the virus and implemented a programme of monetary and fiscal support that was particularly effective at stimulating short-term growth. At the same time, China's economy benefited from the shift towards online spending by consumers in developed markets. These factors helped to explain its comparative outperformance compared to western economies during 2020 and earlier in 2021. However, the pace of economic growth has now fallen back after this initial surge of recovery from the pandemic and China is now struggling to contain the spread of the Delta variant through sharp local lockdowns - which will also depress economic growth. There are also questions as to how effective Chinese vaccines are proving. In addition, recent regulatory actions motivated by a political agenda to channel activities into officially approved directions, are also likely to reduce the dynamism and long-term growth of the Chinese economy.

**Japan.** 2021 has been a patchy year in combating Covid. However, after a slow start, nearly 50% of the population are now vaccinated and Covid case numbers are falling. After a weak Q3 there is likely to be a strong recovery in Q4. The Bank of Japan is continuing its very loose monetary policy but with little prospect of getting inflation back above 1% towards its target of 2%, any time soon: indeed, inflation was negative in July. New Prime Minister Kishida has promised a large fiscal stimulus package after the November general election – which his party is likely to win.

**World growth.** World growth was in recession in 2020 but recovered during 2021 until starting to lose momentum more recently. Inflation has been rising due to increases in gas and electricity prices, shipping costs and supply shortages, although these should subside during 2022. It is likely that we are heading into a period where there will be a reversal of **world globalisation** and a decoupling of western countries from dependence on China to supply products, and vice versa. This is likely to reduce world growth rates from those in prior decades.

**Supply shortages**. The pandemic and extreme weather events have been highly disruptive of extended worldwide supply chains. At the current time there are major queues of ships unable to unload their goods at ports in New York, California and China. Such issues have led to mis-distribution of shipping containers around the world and have contributed to a huge increase in the cost of shipping. Combined with a shortage of semi-conductors, these issues have had a disruptive impact on production in many countries. Many western countries are also hitting up against a difficulty in filling job vacancies. It is expected that these issues will be gradually sorted out, but they are currently contributing to a spike upwards in inflation and shortages of materials and goods on shelves.

## Interest rate forecasts

The Council's treasury advisor, Link Group, provided the following forecasts on 29th September 2021 (PWLB rates are certainty rates, gilt yields plus 80bps):

| Link Group Interest Rate View 29.9.21 | Dec-21 | Mar-22 | Jun-22 | Sep-22 | Dec-22 | Mar-23 | Jun-23 | Sep-23 | Dec-23 | Mar-24 |
|---|---|---|---|---|---|---|---|---|---|---|
| BANK RATE | 0.10 | 0.10 | 0.25 | 0.25 | 0.25 | 0.25 | 0.50 | 0.50 | 0.50 | 0.75 |
| 3 month ave earnings | 0.10 | 0.10 | 0.20 | 0.20 | 0.30 | 0.40 | 0.50 | 0.50 | 0.60 | 0.70 |
| 6 month ave earnings | 0.20 | 0.20 | 0.30 | 0.30 | 0.40 | 0.50 | 0.60 | 0.60 | 0.70 | 0.80 |
| 12 month ave earnings | 0.30 | 0.40 | 0.50 | 0.50 | 0.50 | 0.60 | 0.70 | 0.80 | 0.90 | 1.00 |
| 5 yr PWLB | 1.40 | 1.40 | 1.50 | 1.50 | 1.60 | 1.60 | 1.60 | 1.70 | 1.70 | 1.70 |
| 10 yr PWLB | 1.80 | 1.80 | 1.90 | 1.90 | 2.00 | 2.00 | 2.00 | 2.10 | 2.10 | 2.10 |
| 25 yr PWLB | 2.20 | 2.20 | 2.30 | 2.30 | 2.40 | 2.40 | 2.40 | 2.50 | 2.50 | 2.60 |
| 50 yr PWLB | 2.00 | 2.00 | 2.10 | 2.20 | 2.20 | 2.20 | 2.20 | 2.30 | 2.30 | 2.40 |

*Additional notes by Link on this forecast table: -*

- *LIBOR and LIBID rates will cease from the end of 2021. Work is currently progressing to replace LIBOR with a rate based on SONIA (Sterling Overnight Index Average). In the meantime, our forecasts are based on expected average earnings by local authorities for 3 to 12 months.*
- *Our forecasts for average earnings are averages i.e., rates offered by individual banks may differ significantly from these averages, reflecting their different needs for borrowing short term cash at any one point in time.*

The coronavirus outbreak has done huge economic damage to the UK and to economies around the world. After the Bank of England took emergency action in March 2020 to cut Bank Rate to 0.10%, it left Bank Rate unchanged at its subsequent meetings.
As shown in the forecast table above, one increase in Bank Rate from 0.10% to 0.25% has now been included in quarter 2 of 2022/23, a second increase to 0.50% in quarter 2 of 23/24 and a third one to 0.75% in quarter 4 of 23/24.

**Significant risks to the forecasts**

- COVID vaccines do not work to combat new mutations and/or new vaccines take longer than anticipated to be developed for successful implementation.
- The pandemic causes major long-term scarring of the economy.
- The Government implements an austerity programme that supresses GDP growth.
- The MPC tightens monetary policy too early – by raising Bank Rate or unwinding QE.
- The MPC tightens monetary policy too late to ward off building inflationary pressures.
- Major stock markets e.g. in the US, become increasingly judged as being over-valued and susceptible to major price corrections. Central banks become increasingly exposed to the "moral hazard" risks of having to buy shares and corporate bonds to reduce the impact of major financial market sell-offs on the general economy.
- Geo-political risks are widespread e.g. German general election in September 2021 produces an unstable coalition or minority government and a void in high-profile leadership in the EU when Angela Merkel steps down as Chancellor of Germany; on-going global power influence struggles between Russia/China/US.

**The balance of risks to the UK economy: -**

- The overall balance of risks to economic growth in the UK is now to the downside, including residual risks from Covid and its variants - both domestically and their potential effects worldwide.

**Forecasts for Bank Rate**

Bank Rate is not expected to go up fast after the initial rate rise as the supply potential of the economy has not generally taken a major hit during the pandemic, so should be able to cope well with meeting demand without causing inflation to remain elevated in the medium-term, or to inhibit inflation from falling back towards the MPC's 2% target after the surge to around 4% towards the end of 2021. Three increases in Bank rate are forecast in the period to March 2024, ending at 0.75%. However, these forecasts may well need changing within a relatively short time frame for the following reasons: -

- There are increasing grounds for viewing the economic recovery as running out of steam during the summer and now into the autumn. This could lead into stagflation which would create a dilemma for the MPC as to which way to face.
- Will some current key supply shortages e.g., petrol and diesel, spill over into causing economic activity in some sectors to take a significant hit?
- Rising gas and electricity prices in October and next April and increases in other prices caused by supply shortages and increases in taxation next April, are already going to deflate consumer spending power without the MPC having to take any action on Bank Rate to cool inflation. Then we have the Government's upcoming budget in October, which could also end up in reducing consumer spending power.
- On the other hand, consumers are sitting on around £200bn of excess savings left over from the pandemic so when will they spend this sum, in part or in total?
- There are 1.6 million people coming off furlough at the end of September; how many of those will not have jobs on 1st October and will, therefore, be available to fill labour shortages in many sectors of the economy? So, supply shortages which have been driving up both wages and costs, could reduce significantly within the next six months or so and alleviate the MPC's current concerns.
- There is a risk that there could be further nasty surprises on the Covid front, on top of the flu season this winter, which could depress economic activity.

In summary, with the high level of uncertainty prevailing on several different fronts, it is likely that these forecasts will need to be revised again soon - in line with what the new news is.

It also needs to be borne in mind that Bank Rate being cut to 0.10% was an emergency measure to deal with the Covid crisis hitting the UK in March 2020. At any time, the MPC could decide to simply take away that final emergency cut from 0.25% to 0.10% on the grounds of it no longer being warranted and as a step forward in the return to normalisation. In addition, any Bank Rate under 1% is both highly unusual and highly supportive of economic growth.

**Forecasts for PWLB rates and gilt and treasury yields**

As the interest forecast table for PWLB certainty rates above shows, there is likely to be a steady rise over the forecast period, with some degree of uplift due to rising treasury yields in the US.

There is likely to be **exceptional volatility and unpredictability in respect of gilt yields and PWLB rates** due to the following factors: -

- How strongly will changes in gilt yields be correlated to changes in US treasury yields?
- Will the Fed take action to counter increasing treasury yields if they rise beyond a yet unspecified level?
- Would the MPC act to counter increasing gilt yields if they rise beyond a yet unspecified level?
- How strong will inflationary pressures turn out to be in both the US and the UK and so impact treasury and gilt yields?
- How will central banks implement their new average or sustainable level inflation monetary policies?
- How well will central banks manage the withdrawal of QE purchases of their national bonds i.e., without causing a panic reaction in financial markets as happened in the "taper tantrums" in the US in 2013?
- Will exceptional volatility be focused on the short or long-end of the yield curve, or both?

The forecasts are also predicated on an assumption that there is no break-up of the Eurozone or EU within our forecasting period, despite the major challenges that are looming up, and that there are no major ructions in international relations, especially between the US and China / North Korea and Iran, which have a major impact on international trade and world GDP growth.

**Gilt and treasury yields**
Since the start of 2021, there has been a lot of volatility in gilt yields, and hence PWLB rates. During the first part of the year, US President Biden's, and the Democratic party's determination to push through a $1.9trn (equivalent to 8.8% of GDP) fiscal boost for the US economy as a recovery package from the Covid pandemic was what unsettled financial markets. However, this was in addition to the $900bn support package already passed in December 2020 under President Trump. This was then followed by additional Democratic ambition to spend further huge sums on infrastructure and an American families plan over the next decade which are caught up in Democrat / Republican haggling. Financial markets were alarmed that all this stimulus, which is much bigger than in other western economies, was happening at a time in the US when: -

1. A fast vaccination programme has enabled a rapid opening up of the economy.
2. The economy had already been growing strongly during 2021.
3. It started from a position of little spare capacity due to less severe lockdown measures than in many other countries. A combination of shortage of labour and supply bottle necks is likely to stoke inflationary pressures more in the US than in other countries.
4. And the Fed was still providing monetary stimulus through monthly QE purchases.

These factors could cause an excess of demand in the economy which could then unleash stronger and more sustained inflationary pressures in the US than in other western countries. This could then force the Fed to take much earlier action to start tapering monthly QE purchases and/or increasing the Fed rate from near zero, despite their stated policy being to target average inflation. It is notable that some Fed members have moved forward their expectation of when the first increases in the Fed rate will occur in recent Fed meetings. In addition, more recently, shortages of workers appear to be stoking underlying wage inflationary pressures which are likely to feed through into CPI inflation. A run of strong monthly jobs growth figures could be enough to meet the threshold set by the Fed of "substantial further progress towards the goal of reaching full employment". However, the weak growth in August, (announced 3.9.21), has spiked anticipation that tapering of monthly QE purchases could start by the end of 2021. These purchases are currently acting as downward pressure on treasury yields. As the US financial markets are, by far, the biggest financial markets in the world, any trend upwards in the US will invariably impact and influence financial markets in other countries. However, during June and July, longer term yields fell sharply; even the large non-farm payroll increase in the first week of August seemed to cause the markets little concern, which is somewhat puzzling, particularly in the context of the concerns of many commentators that inflation may not be as transitory as the Fed is expecting it to be. Indeed, inflation pressures and erosion of surplus economic capacity look much stronger in the US than in the UK. **As an average since 2011, there has been a 75% correlation between movements in 10 year treasury yields and 10 year gilt yields. This is a significant UPWARD RISK exposure to our forecasts for longer term PWLB rates. However, gilt yields and treasury yields do not always move in unison.**

There are also possible **DOWNSIDE RISKS** from the huge sums of cash that the UK populace have saved during the pandemic; when savings accounts earn little interest, it is likely that some of this cash mountain could end up being invested in bonds and so push up demand for bonds and support their prices i.e., this would help to keep their yields down. How this will interplay with the Bank of England eventually getting round to not reinvesting maturing gilts and then later selling gilts, will be interesting to keep an eye on.

**The balance of risks to medium to long term PWLB rates: -**

- There is a balance of upside risks to forecasts for medium to long term PWLB rates.

**A new era – a fundamental shift in central bank monetary policy**
One of the key results of the pandemic has been a fundamental rethinking and shift in monetary policy by major central banks like the Fed, the Bank of England and the ECB, to tolerate a higher level of inflation than in the previous two decades when inflation was the prime target to bear down on so as to stop it going above a target rate. There is now also a greater emphasis on other targets for monetary

policy than just inflation, especially on ‘achieving broad and inclusive “maximum” employment in its entirety’ in the US before consideration would be given to increasing rates.

- The Fed in America has gone furthest in adopting a monetary policy based on a clear goal of allowing the inflation target to be symmetrical, (rather than a ceiling to keep under), so that inflation averages out the dips down and surges above the target rate, over an unspecified period of time.
- The Bank of England has also amended its target for monetary policy so that inflation should be ‘sustainably over 2%’ and the ECB now has a similar policy.
- ***For local authorities, this means that investment interest rates and very short term PWLB rates will not be rising as quickly or as high as in previous decades when the economy recovers from a downturn and the recovery eventually runs out of spare capacity to fuel continuing expansion.***
- Labour market liberalisation since the 1970s has helped to break the wage-price spirals that fuelled high levels of inflation and has now set inflation on a lower path which makes this shift in monetary policy practicable. In addition, recent changes in flexible employment practices, the rise of the gig economy and technological changes, will all help to lower inflationary pressures.
- Governments will also be concerned to see interest rates stay lower as every rise in central rates will add to the cost of vastly expanded levels of national debt; (in the UK this is £21bn for each 1% rise in rates). On the other hand, higher levels of inflation will help to erode the real value of total public debt.