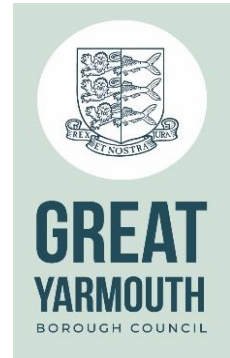


**Subject: 2021/22 TREASURY MANAGEMENT MID YEAR REPORT**

**Report to: Policy and Resources Committee - 2 November 2021**

**Report by: Financial Services Manager**



## **SUBJECT MATTER/RECOMMENDATIONS**

This report presents for the 2021/22 financial year the following:

- the mid-year position for treasury management;
- the borrowing requirement and debt for the current financial year;
- the mid-year borrowing position;  
compared with the Treasury Management Strategy.

### **Recommendations:**

**Members are asked to approve the treasury management half yearly report for 2021/22.**

## **1. INTRODUCTION AND BACKGROUND**

- 1.1. The Council adopted the Chartered Institute of Public Finance and Accountancy's Treasury Management in the Public Services: Code of Practice (the CIPFA Code) which requires the Council to approve treasury management semi-annual and annual reports.
- 1.2. The Council's treasury management strategy for 2021/22 was approved by Council on 23 February 2021. The Council has borrowed and invested substantial sums of money and is therefore exposed 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 remains central to the Council's treasury management strategy.
- 1.3. This report provides a monitoring position for the first six months of the 2021/22 financial year.

## **2. LOCAL CONTEXT**

- 2.1. On 31 March 2021, the Council had net borrowing of £100.422 million arising from its revenue and capital income and expenditure. The underlying need to borrow for capital purposes is measured by the Capital Financing Requirement (CFR), while usable reserves and working capital are the underlying resources available for investment. These factors are summarised in Table 1 below.

<b>Table 1: Balance Sheet Summary</b>	<b>31.3.21 Actual £m</b>
<b>General Fund CFR</b>	<b>£58.881</b>

<b>Table 1: Balance Sheet Summary</b>	<b>31.3.21 Actual £m</b>
<b>HRA CFR</b>	<b>£88.261</b>
<b>Total CFR</b>	<b>£147.142</b>
<b>Less: *Other debt liabilities</b>	<b>(£0.536)</b>
<b>Borrowing CFR</b>	<b>£146.606</b>
<b>Less: Long term investments</b>	<b>(£1.000)</b>
<b>Less: Usable reserves</b>	<b>(£38.400)</b>
<b>Less: Working capital</b>	<b>(£6.784)</b>
<b>Net borrowing</b>	<b>£100.422</b>

*\* finance leases, transferred debt that form part of the Councils total debt*

- 2.2. Lower official interest rates have lowered the cost of short-term, temporary loans and investment returns from cash assets that can be used in lieu of borrowing. The Council pursued its strategy of keeping borrowing and investments below their underlying levels, sometimes known as internal borrowing, in order to reduce risk. The treasury management position on 30 September 2021 and the change over the period is shown in Table 2 below.

<b>Table 2: Treasury Management Summary</b>	<b>31.3.21 Balance £m</b>	<b>2021/22 Movement £m</b>	<b>30.9.21 Balance £m</b>	<b>30.9.21 Rate %</b>
<b>Long-term borrowing</b>	£82.583	(£0.46)	£82.537	<b>3.15%-4.95%</b>
<b>Short-term borrowing</b>	£51.592	(£18.500)	£33.092	<b>0.09%-4.44%</b>
<b>Total borrowing</b>	<b>£134.175</b>	<b>(£18.546)</b>	<b>£115.629</b>	
<b>Long-term investments (CCLA Property Fund)</b>	£1.000	£0	£1.000	<b>N/A</b>
<b>Cash and cash equivalents</b>	£32.753	(£6.974)	£25.779	<b>0.00%-0.15%</b>
<b>Total investments</b>	<b>£33.753</b>	<b>(£6.974)</b>	<b>£26.779</b>	
<b>Net borrowing</b>	<b>£100.422</b>	<b>(£11.572)</b>	<b>£88.850</b>	

- 2.3. The decrease in net borrowing in table 2 is result of a fall in short term borrowing and cash and cash equivalents held. The requirement to borrow has reduced due to increased internal resources because of remaining funding balances of Government COVID business grants held which are due to be repaid by the end of 2021/22.

### **3. BORROWING UPDATE**

- 3.1. Local authorities can borrow from the PWLB provided they can confirm they are not planning to purchase 'investment assets primarily for yield' in the current or next two financial years, with confirmation of the purpose of capital expenditure from the Section 151 Officer. Authorities that are purchasing or intending to purchase investment assets primarily for yield will not be able to access the PWLB except to refinance existing loans or externalise internal borrowing.

- 3.2. Acceptable use of PWLB borrowing includes service delivery, housing, regeneration, preventative action, refinancing and treasury management.
- 3.3. Competitive market alternatives may be available for authorities with or without access to the PWLB. However, the financial strength of the individual authority and borrowing purpose will be scrutinised by commercial lenders. Further changes to the CIPFA Prudential Code expected in December 2021 are likely to prohibit borrowing for the primary purpose of commercial return even where the source of borrowing is not the PWLB.
- 3.4. The Council is not planning to purchase any investment assets primarily for yield within the next three years and so is able fully access the PWLB.
- 3.5. **Revised PWLB Guidance** - HM Treasury published further guidance on PWLB borrowing in August 2021 providing additional detail and clarifications predominantly around the definition of an 'investment asset primarily for yield'. The principal aspects of the new guidance are:
- Capital expenditure incurred or committed to before 26th November 2020 is allowable even for an 'investment asset primarily for yield'.
  - Capital plans should be submitted by local authorities via a DELTA return. These open for the new financial year on 1st March and remain open all year. Returns must be updated if there is a change of more than 10%.
  - An asset held primarily to generate yield that serves no direct policy purpose should not be categorised as service delivery.
  - Further detail on how local authorities purchasing investment assets primarily for yield can access the PWLB for the purposes of refinancing existing loans or externalising internal borrowing.
  - Additional detail on the sanctions which can be imposed for inappropriate use of the PWLB loan. These can include a request to cancel projects, restrictions to accessing the PLWB and requests for information on further plans.
- 3.6. **Changes to PWLB Terms and Conditions from 8th September 2021** - The settlement time for a PWLB loan has been extended from two working days (T+2) to five working days (T+5). In a move to protect the PWLB against negative interest rates, the minimum interest rate for PWLB loans has also been set at 0.01% and the interest charged on late repayments will be the higher of Bank of England Base Rate or 0.1%.
- 3.7. **Municipal Bonds Agency (MBA)**: The MBA is working to deliver a new short-term loan solution, available in the first instance to principal local authorities in England, allowing them access to short-dated, low rate, flexible debt. The minimum loan size is expected to be £25 million. Importantly, local authorities will borrow in their own name and will not cross guarantee any other authorities. If the Authority intends future borrowing through the MBA, it will first ensure that it has thoroughly scrutinised the legal terms and conditions of the arrangement and is satisfied with them.
- 3.8. **UK Infrastructure Bank**: £4bn has been earmarked for of lending to local authorities by the UK Infrastructure Bank which is wholly owned and backed by HM Treasury. The availability of this lending to local authorities, for which there will be a bidding process, is yet to commence. Loans will be available for qualifying projects at gilt yields plus 0.6%, which is 0.2% lower than the PWLB certainty rate.

#### 4. **BORROWING ACTIVITY – MID YEAR**

- 4.1. At 30<sup>th</sup> September 2021 the Council held £115.6m of loans, an decrease of £18.6m to 31<sup>st</sup> March 2021, as part of its strategy for funding previous and current years' capital programmes. Outstanding loans on 30<sup>th</sup> September are summarised in Table 3 below.

<b>Table 3: Borrowing Position</b>	<b>31.3.21 Balance £m</b>	<b>Movement £000</b>	<b>30.9.21 Balance £000</b>	<b>30.9.21 Rate %</b>	<b>30.9.21 Maturity (years)</b>
Public Works Loan Board	£71.387	£0	£71.387	3.15%-4.40%	10-40
*Banks (LOBO)	£3.000	£0	£3.000	4.95%	1-2
Banks (fixed term)	£7.000	£0	£7.000	3.35%-3.98%	<1-60
Local authorities (long-term)	£1.196	£(0.045)	£1.151	4.44%	>1
Local authorities (short-term)	£51.592	£(18.500)	£33.092	0.09%-4.44%	<1
<b>Total borrowing</b>	<b>£134.175</b>	<b>£(18.545)</b>	<b>£115.630</b>		

*\*the LOBO has a call option which the lender can exercise every 5 years the next call date is November 2024*

- 4.2. The Councils chief objective when borrowing has been to strike an appropriately low risk balance between securing low interest costs and achieving cost certainty over the period for which funds are required, with flexibility to renegotiate loans should the Councils long-term plans change being a secondary objective.
- 4.3. In furtherance of keeping with these objectives, £3.5m of long-term loans were replaced with short-term borrowing. The short-term borrowing undertaken and repaid during the period totalled £28.5m This strategy enabled the Council to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk.
- 4.4. With short-term interest rates remaining much lower than long-term rates the Council considered it to be more cost effective in the near term to use internal resources or borrowed short-term loans instead. The net movement in short-term loans is shown in table 3 above.
- 4.5. The Councils borrowing decisions are not predicated on any one outcome for interest rates and a balanced portfolio of short- and long-term borrowing was maintained.
- 4.6. PWLB funding margins have lurched quite substantially and there remains a strong argument for diversifying funding sources, particularly if rates can be achieved on alternatives which are below gilt yields plus 0.80%, i.e. the PWLB HRA borrowing rate. The Council will evaluate and pursue these lower cost solutions and opportunities with its advisor Arlingclose.
- 4.7. LOBO loans: The Council continues to hold £3m of LOBO (Lender's Option Borrower's Option) loans where the lender has the option to propose an increase in the interest rate as set dates, following which the Council has the option to either accept the new rate or to repay the loan at no additional cost. No banks exercised their option during this period.

## **5. TREASURY INVESTMENT ACTIVITY**

- 5.1. The Council received approximately £80m in central government funding to support small and medium businesses during the coronavirus pandemic through grant schemes. This was temporarily invested in short-dated, liquid instruments such as the DMADF, call accounts and Money Market Funds. Most of the grant schemes are now closed with only £0.5m of additional restrictions still being administered. Presently £14m remains to be passed back to Central Government once the reconciliation process is complete.
- 5.2. The Council holds significant invested funds, representing income received in advance of expenditure plus balances and reserves held. During the year, the Councils investment

balances ranged between £55 and £27 million due to timing differences between income and expenditure. The investment position is shown in table 4 below.

<b>Table 4: Treasury Investment Position</b>	<b>31.3.21 Balance £m</b>	<b>Net Movement £m</b>	<b>30.9.21 Balance £m</b>	<b>Average Rate %</b>
Banks & building societies (unsecured)	£1.355	£0.065	£1.420	0.00%
Government (incl. local authorities)	£19.290	(£10.530)	£8.760	0.00%-0.15%
Money Market Funds	£12.000	£3.820	£15.820	0.00%-0.02%
Other Pooled Funds - Property funds	£1.000	£0	£1.000	N/A
<b>Total investments</b>	<b>£33.645</b>	<b>(£6.645)</b>	<b>£27.000</b>	

- 5.3. Both the CIPFA Code and government guidance require the Council 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 Councils 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 unsuitably low investment income.
- 5.4. Ultra-low short-dated cash rates which have been a feature since March 2020 when Bank Rate was cut to 0.1% have resulted in the return on sterling low volatility net asset value money market funds (LVNAV MMFs) being close to zero even after some managers have temporarily waived or lowered their fees. At this stage net negative returns are not the central case of most MMF managers over the short-term, and fee cuts or waivers should result in MMF net yields having a floor of zero, but the possibility cannot be ruled out.
- 5.5. Deposit rates with the Debt Management Account Deposit Facility (DMADF) are also largely around zero.
- 5.6. The return on Money Market Funds net of fees also fell over the six months and for many funds net returns range between 0% and 0.1%. In many instances, the fund management companies have temporarily lowered or waived fees to maintain a positive net return.
- 5.7. Given the continuing risk and low returns from short-term unsecured bank investments, the Council is looking into more secure and/or higher yielding asset classes and review opportunities to do this where cash flow allows. However, in the light of the pandemic crisis and the likelihood of unexpected calls on cash flow, the Council kept more cash available at very short notice than is normal. Liquid cash was diversified over several counterparties and/or Money Market Funds to manage both credit and liquidity risks.
- 5.8. The progression of risk and return metrics are shown in the extracts from Arlingclose's quarterly investment benchmarking in Table 5 below.

<b>Table 5: Investment Benchmarking – Treasury investments managed in-house</b>	<b>Credit Score</b>	<b>Credit Rating</b>	<b>Bail-in Exposure</b>	<b>Weighted Average Maturity (days)</b>	<b>Rate of Return %</b>
31.03.2021	4.26	AA-	41%	4.26	0.04%
30.09.2021	4.77	A+	66%	4.51	0.03%
Similar LAs	4.66	A+	69%	4.57	0.08%
All LAs	4.69	A+	68%	4.53	0.08%
<b>Treasury investments externally managed funds – Income Return</b>					
30.09.2021	N/A	N/A	N/A	N/A	4.46%
Similar LAs	N/A	N/A	N/A	N/A	4.20%
All LAs	N/A	N/A	N/A	N/A	4.27%

*Weighted average maturity will apply to the first five categories above and to cash plus and bond funds.*

*\*The 2021/22 TMSS set the limit per institution at £4m with which the Authority complied. The above table does not include investments with the DMO £5.760m the total investments as of 30th September 2021 was £27m.*

*\*\* £15.820m of the total £27m investments exposed to bail-in on 30/9/2021 was invested in Money Market Funds which are pooled funds which have a highly diversified portfolio of money market and other instruments. The Money Market Funds which are used by the Council to maintain high credit security and liquidity.*

- 5.9. Externally Managed Pooled Funds: £1m of the Councils investments are held in externally managed strategic pooled Property funds where short-term security and liquidity are lesser considerations, and the objectives instead are regular revenue income and long-term price stability. These funds generated a return of £9k which is used to support services in year.
- 5.10. Because these funds have no defined maturity date, but are available for withdrawal after a notice period, their performance and continued suitability in meeting the Council’s investment objectives are regularly reviewed. Strategic fund investments are made in the knowledge that capital values will move both up and down on months, quarters and even years; but with the confidence that over a three- to five-year period total returns will exceed cash interest rates.
- 5.11. In 2021/22 the Council expects to receive significantly lower income from its cash and short-dated money market investments and from its externally managed funds than it did in 2020/21 and earlier years. Dividends and income paid will ultimately depend on many factors including but not limited to the duration of COVID-19 and the extent of its economic impact, the fund’s sectoral asset allocation, securities held/bought/sold and, in the case of equities, the enforced or voluntary dividend cuts or deferral.

## 6. NON-TREASURY INVESTMENTS

- 6.1. The definition of investments in CIPFA's revised Treasury Management Code now covers all the financial assets of the Council as well as other non-financial assets which the Council holds primarily for financial return. This is replicated in the Investment Guidance issued by the Ministry of Housing, Communities and Local Government (MHCLG) and Welsh Government, in which the definition of investments is further broadened to also include all such assets held partially for financial return.
- 6.2. At the balance sheet date of 31st March 2021, the Authority also held £58.1m of investments in directly owned property, loans to homeowners and local bodies and investments in a trading subsidiary. There has been no significant change from 31st March 2021.
- 6.3. These investments are expected to generate £1.9m of investment income for the Council after taking account of direct costs. This income is over a number of properties which provide varying rates of return.

## 7. FINANCIAL IMPLICATIONS – COMPLIANCE REPORT

- 7.1. The Chief Finance Officer reports that all treasury management activities undertaken during the quarter complied fully with the CIPFA Code of Practice and the Councils approved Treasury Management Strategy. Compliance with specific investment limits is demonstrated in table 8 below.
- 7.2. Compliance with the authorised limit and operational boundary for external debt is demonstrated in table 7 below.

<b>Table 7: Debt Limits</b>	<b>2021/22 Maximum £000</b>	<b>30.9.21 Actual £000</b>	<b>2021/22 Operational Boundary £000</b>	<b>2021/22 Authorised Limit £000</b>	<b>Complied? Yes/No</b>
Borrowing	£132.152	£115.629	£176.000	£181.000	Yes
Long term liabilities, PFI and Finance Leases	(£0.536)	(£0.536)	£2.000	£2.000	Yes
<b>Total debt</b>	<b>£131.616</b>	<b>£115.093</b>	<b>£178.000</b>	<b>£183.000</b>	Yes

*'Maximum' is the highest actual outstanding borrowing at any point during the first six months of 2021/22*

- 7.3. The authorised limit for external debt represents a control on the maximum level of borrowing. This represents a limit beyond which external debt is prohibited, and this limit is set by the Council as part of the annual treasury management strategy. It reflects the level of external debt which, while not desired, could be afforded in the short term, but is not sustainable in the long term. The operational boundary is the limit beyond which external debt is not normally expected to exceed. In most cases this would be similar to the CFR but may be lower or higher depending on the levels of actual debt.
- 7.4. Since the operational boundary is a management tool for in-year monitoring it is not significant if the operational boundary is breached on occasions due to variations in cash flow, and this is not counted as a compliance failure.

<b>Table 8: Investment Limits</b>	<b>30.9.2021 Maximum £m</b>	<b>30.9.21 Actual £m</b>	<b>2021/22 Limit £m</b>	<b>Complied? Yes/No</b>
Any single organisation, except the UK Government	£1.5m	£1.420m	£1.6m each	Yes
Any group of pooled funds under the same management	£5m	£5m	£7m per manager	Yes
UK Central Government	£26.460m	£5.760m	Unlimited	Yes
UK Central Government Local Authorities	£10m	£3m	£3m per LA (2 years)	Yes
Money Market Funds	£20m	£15.820m	£4m per fund - unlimited	Yes

7.5. The financial implications and risks are outlined in the report and are largely related to the impact of interest rate changes. An element of the financial risk implications can be mitigated by the fact that the Council maintains a general reserve balance which includes an allowance for changes in interest rate that can be used in the short term.

## 8. TREASURY MANAGEMENT INDICATORS

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

8.2. **Security:** The Council has adopted a voluntary measure of its exposure to credit risk by monitoring the value-weighted average (credit rating/ credit score) of its investment portfolio. This is calculated by applying a score to each investment (AAA=1, AA+=2, etc.) and taking the arithmetic average, weighted by the size of each investment. Unrated investments are assigned a score based on their perceived risk.

<b>Security</b>	<b>30.9.21 Actual</b>	<b>2021/22 Target</b>	<b>Complied?</b>
Portfolio average credit rating	A+	A	Yes

8.3. **Liquidity:** The Council has adopted a voluntary measure of its exposure to liquidity risk by monitoring the amount of cash available to meet unexpected payments it can borrow each quarter without giving prior notice.

<b>Liquidity</b>	<b>30.9.21 Actual</b>	<b>2021/22 Target</b>	<b>Complied?</b>
Liquid short-term deposits	£17.2m	£12m (minimum)	Yes
Bank Overdraft	£0	£0.250	Yes

8.4. **Interest Rate Exposures:** This indicator is set to control the Councils exposure to interest rate risk. The upper limits on the one-year revenue impact of a 1% rise or fall in interests was:



Interest rate risk indicator	30.9.21 Actual	2021/22 Limit	Complied?
Upper limit on one-year revenue impact of a 1% <u>rise</u> in interest rates	£94	£30	No
Upper limit on one-year revenue impact of a 1% <u>fall</u> in interest rates	£0	£110	Yes

8.5. The impact of a change in interest rates is calculated on the assumption that maturing loans and investment will be replaced at current rates. The impact of a 1% rise in interest rates limit was breached, this is because the limit was set for based on higher short-term loan and investment balances which reflected the Councils portfolio as at 31/12/2020. The Councils short-term loan balances have decreased by 85% and investment balances have decreased by 32% due to Government funding received to assist with pressures relating to the pandemic, the Council has utilised internal resources but the cashflow indicates we have a borrowing requirement in Q4 2021/22.

8.6. **Maturity Structure of Borrowing:** This indicator is set to control the Councils exposure to refinancing risk. The upper and lower limits on the maturity structure of all borrowing were:

Maturity Structure of Borrowing	30.9.21 Actual	Upper Limit	Lower Limit	Complied?
Under 12 months	29%	50%	0%	Yes
12 months and within 24 months	0%	50%	0%	Yes
24 months and within 5 years	3%	60%	0%	Yes
5 years and within 10 years	4%	80%	0%	Yes
10 years and above	64%	100%	0%	Yes

Time periods start on the first day of each financial year. The maturity date of borrowing is the earliest date on which the lender can demand repayment.

8.7. **Principal Sums Invested for Periods Longer than a year:** The purpose of this indicator is to control the Councils exposure to the risk of incurring losses by seeking early repayment of its investments. The limits on the long-term principal sum invested to final maturities beyond the period end were:

Principal Sums Invested for Periods Longer than a year	2021/22	2022/23	2023/24
Actual principal invested beyond year end	£10m	£10m	£10m
Limit on principal invested beyond year end	£12m	£12m	£12m
Complied?	Yes	Yes	Yes

## 9. OTHER

9.1. Revisions to CIPFA Codes - In February 2021 CIPFA launched two consultations on changes to its Prudential Code and Treasury Management Code of Practice. These followed the Public Accounts Committee's recommendation that the prudential framework should be further tightened following continued borrowing by some authorities for investment purposes. In June, CIPFA provided feedback from this consultation.

9.2. In September CIPFA issued the revised Codes and Guidance Notes in draft form and opened the latest consultation process on their proposed changes. The changes include:

- Clarification that (a) local authorities must not borrow to invest primarily for financial return (b) it is not prudent for authorities to make any investment or spending decision that will increase the Capital Financing Requirement, and so may lead to new borrowing, unless directly and primarily related to the functions of the authority.
- Categorising investments as those (a) for treasury management purposes, (b) for service purposes and (c) for commercial purposes.
- Defining acceptable reasons to borrow money: (i) financing capital expenditure primarily related to delivering a local authority's functions, (ii) temporary management of cash flow within the context of a balanced budget, (iii) securing affordability by removing exposure to future interest rate rises and (iv) refinancing current borrowing, including replacing internal borrowing.
- For service and commercial investments, in addition to assessments of affordability and prudence, an assessment of proportionality in respect of the authority's overall financial capacity (i.e. whether plausible losses could be absorbed in budgets or reserves without unmanageable detriment to local services).
- Prudential Indicators
  - New indicator for net income from commercial and service investments to the budgeted net revenue stream.
  - Inclusion of the liability benchmark as a mandatory treasury management prudential indicator. CIPFA recommends this is presented as a chart of four balances – existing loan debt outstanding; loans CFR, net loans requirement, liability benchmark – over at least 10 years and ideally cover the authority's full debt maturity profile.
  - Excluding investment income from the definition of financing costs.
- Incorporating ESG issues as a consideration within TMP 1 Risk Management.
- Additional focus on the knowledge and skills of officers and elected members involved in decision making

9.3. **MHCLG Improvements to the Capital Finance Framework:** MHCLG published a brief policy paper in July outlining the ways it feels that the current framework is failing and potential changes that could be made. The paper found that “while many authorities are compliant with the framework, there remain some authorities that continue to engage in practices that push the bounds of compliance and expose themselves to excessive risk”.

9.4. The actions announced include greater scrutiny of local authorities and particularly those engaged in commercial practices; an assessment of governance and training; a consideration of statutory caps on borrowing; further regulations around Minimum Revenue Provision (MRP) and ensuring that MHCLG regulations enforce guidance from CIPFA and the new PWLB lending arrangements. A further consultation on these matters is expected soon.

## 10. NATIONAL CONTEXT AND ECONOMIC COMMENTARY

10.1. Economic background: The economic recovery from coronavirus pandemic continued to dominate the first half of the financial year. By the end of the period over 48 million people in

the UK had received their first dose of a COVID-19 vaccine and almost 45 million their second dose.

- 10.2. The Bank of England (BoE) held Bank Rate at 0.1% throughout the period and maintained its Quantitative Easing programme at £895 billion, unchanged since the November 2020 meeting. In its September 2021 policy announcement, the BoE noted it now expected the UK economy to grow at a slower pace than was predicted in August, as the pace of the global recovery had shown signs of slowing and there were concerns inflationary pressures may be more persistent. Within the announcement, Bank expectations for GDP growth for the third (calendar) quarter were revised down to 2.1% (from 2.9%), in part reflecting tighter supply conditions. The path of CPI inflation is now expected to rise slightly above 4% in the last three months of 2021, due to higher energy prices and core goods inflation.
- 10.3. Government initiatives continued to support the economy over the quarter but came to an end on 30th September 2021 when the furlough scheme ends.
- 10.4. The latest labour market data showed that in the three months to July 2021 the unemployment rate fell to 4.6%. The employment rate increased, and economic activity rates decreased, suggesting an improving labour market picture. Latest data showed growth in average total pay (including bonuses) and regular pay (excluding bonuses) among employees was 8.3% and 6.3% respectively over the period. However, part of the robust growth figures is due to a base effect from a decline in average pay in the spring of last year associated with the furlough scheme.
- 10.5. Annual CPI inflation rose to 3.2% in August, exceeding expectations for 2.9%, with the largest upward contribution coming from restaurants and hotels. The Bank of England now expects inflation to exceed 4% by the end of the calendar year owing largely to developments in energy and goods prices. The Office of National Statistics' (ONS') preferred measure of CPIH which includes owner-occupied housing was 3.0% year/year, marginally higher than expectations for 2.7%.
- 10.6. The easing of restrictions boosted activity in the second quarter of calendar year, helping push GDP up by 5.5% quarter/quarter (final estimate vs 4.8% q/q initial estimate). Household consumption was the largest contributor. Within the sector breakdown production contributed 1.0% q/q, construction 3.8% q/q and services 6.5% q/q, taking all of these close to their pre-pandemic levels.
- 10.7. Financial markets: Monetary and fiscal stimulus together with rising economic growth and the ongoing vaccine rollout programmes continued to support equity markets over most of the period, albeit with a bumpy ride towards the end. The Dow Jones hit another record high while the UK-focused FTSE 250 index continued making gains over pre-pandemic levels. The more internationally focused FTSE 100 saw more modest gains over the period and remains below its pre-crisis peak.
- 10.8. Inflation worries continued during the period. Declines in bond yields in the first quarter of the financial year suggested bond markets were expecting any general price increases to be less severe, or more transitory, that was previously thought. However, an increase in gas prices in the UK and EU, supply shortages and a shortage of HGV and lorry drivers with companies willing to pay more to secure their services, has caused problems for a range of industries and, in some instance, lead to higher prices.
- 10.9. The 5-year UK benchmark gilt yield began the financial year at 0.36% before declining to 0.33% by the end of June 2021 and then climbing to 0.64% on 30th September. Over the same period the 10-year gilt yield fell from 0.80% to 0.71% before rising to 1.03% and the 20-year yield declined from 1.31% to 1.21% and then increased to 1.37%. The Sterling Overnight Rate (SONIA) averaged 0.05% over the quarter.

- 10.10. **Credit review:** Credit default swap spreads were flat over most of period and are broadly in line with their pre-pandemic levels. In late September spreads rose by a few basis points due to concerns around Chinese property developer Evergrande defaulting but are now falling back. The gap in spreads between UK ringfenced and non-ringfenced entities continued to narrow, but Santander UK remained an outlier compared to the other ringfenced/retail banks. At the end of the period Santander UK was trading the highest at 53bps and Lloyds Banks Plc the lowest at 32bps. The other ringfenced banks were trading between 37-39bps and Nationwide Building Society was 39bps
- 10.11. Over the period Fitch and Moody's upwardly revised to stable the outlook on a number of UK banks and building societies on our counterparty list, recognising their improved capital positions compared to last year and better economic growth prospects in the UK.
- 10.12. Fitch also revised the outlooks for Nordea, Svenska Handelsbanken and Handelsbanken plc to stable from negative. The rating agency considered the improved economic prospects in the Nordic region to have reduced the baseline downside risks it previously assigned to the lenders.
- 10.13. The successful vaccine rollout programme is credit positive for the financial services sector in general and the improved economic outlook has meant some institutions have been able to reduce provisions for bad loans. While there is still uncertainty around the full extent of the losses banks and building societies will suffer due to the pandemic-related economic slowdown, the sector is in a generally better position now compared to earlier this year and 2020.
- 10.14. At the end of the period Arlingclose had completed its full review of its credit advice on unsecured deposits. The outcome of this review included the addition of NatWest Markets plc to the counterparty list together with the removal of the suspension of Handelsbanken plc. In addition, the maximum duration for all recommended counterparties was extended to 100 days.
- 10.15. As ever, the institutions and durations on the Authority's counterparty list recommended by treasury management advisors Arlingclose remain under constant review.
- 10.16. **Arlingclose's Economic Outlook for the remainder of 2021/22 (based on the October 2021 interest rate forecast)**

	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24	Jun-24	Sep-24	Dec-24
Official Bank Rate													
Upside risk	0.00	0.15	0.00	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25
Arlingclose Central Case	0.10	0.10	0.25	0.25	0.25	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50
Downside risk	0.00	0.00	0.15	0.15	0.15	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.40

- 10.17. **Arlingclose** expects Bank Rate to rise in Q2 2022. We believe this is driven as much by the Bank of England's desire to move from emergency levels as by fears of inflationary pressure.
- 10.18. Investors have priced in multiple rises in Bank Rate to 1% by 2024. While Arlingclose believes Bank Rate will rise, it is by a lesser extent than expected by markets.
- 10.19. The global economy continues to recover from the pandemic but has entered a more challenging phase. The resurgence of demand has led to the expected rise in inflationary

pressure, but disrupted factors of supply are amplifying the effects, increasing the likelihood of lower growth rates ahead.

- 10.20. While Q2 UK GDP expanded more quickly than initially thought, the ‘pingdemic’ and more latterly supply disruption will leave Q3 GDP broadly stagnant. The outlook also appears weaker. Household spending, the driver of the recovery to date, is under pressure from a combination of retail energy price rises, the end of government support programmes and soon, tax rises. Government spending, the other driver of recovery, will slow considerably as the economy is taken off life support.
- 10.21. Inflation rose to 3.2% in August. A combination of factors will drive this to over 4% in the near term. While the transitory factors affecting inflation, including the low base effect of 2020, are expected to unwind over time, the MPC has recently communicated fears that these transitory factors will feed longer-term inflation expectations that require tighter monetary policy to control. This has driven interest rate expectations substantially higher.
- 10.22. The supply imbalances are apparent in the labour market. While wage growth is currently elevated due to compositional and base factors, stories abound of higher wages for certain sectors, driving inflation expectations. It is uncertain whether a broad-based increased in wages is possible given the pressures on businesses.
- 10.23. Government bond yields increased sharply following the September FOMC and MPC minutes, in which both central banks communicated a lower tolerance for higher inflation than previously thought. The MPC in particular has doubled down on these signals in spite of softer economic data. Bond investors expect higher near-term interest rates but are also clearly uncertain about central bank policy.
- 10.24. The MPC appears to be playing both sides, but has made clear its intentions to tighten policy, possibly driven by a desire to move away from emergency levels. While the economic outlook will be challenging, the signals from policymakers suggest Bank Rate will rise unless data indicates a more severe slowdown.

## 11. CONCLUSIONS

- 11.1. Overall the Council remains in line with the Treasury Management Strategy as approved in February 2021. The treasury activities continue to be monitored on a daily basis.

## 12. BACKGROUND PAPERS

- 12.1. Treasury Management Strategy 2021/22
- 12.2. Treasury Management Outturn report 2020/21
- 12.3. Arlingclose updates and reports

Area for consideration Comment	Comment
Monitoring Officer Consultation	
Section 151 Officer Consultation	
Existing Council Policies See background papers	
Financial Implications eg within existing budgets or funding identified	
Legal Implications (including human rights)	
Risk Implications	
Equality Issues/EQIA assessment (if EQIA not required explain why)	
Details contained in strategy	

Crime & Disorder	
Every Child Matters	