Treasury Management Strategy Statement

Warwickshire County Council

2021/22

Index

	Section
1	Introduction 1.1 Background 1.2 Reporting Requirements 1.3 Treasury Management Strategy 1.4 Treasury Management Consultants
2	Prudential Indicators 2.1 Capital Expenditure 2.2 Capital Financing Requirement 2.3 Core Funds and Expected Investment Balances 2.4 Minimum Revenue Provision (MRP) Policy
3	Borrowing 3.1 Current Portfolio Position 3.2 Treasury Prudential Indicators 3.3 Prospects for Interest Rates 3.4 Gilt Yields / PWLB Rates 3.5 Investment and Borrowing Rates 3.6 Borrowing Strategy 3.7 Policy on Borrowing in Advance of Need 3.8 Debt Rescheduling 3.9 New Financial Institutions as Borrowing Source
4	Annual Treasury Investment Strategy 4.1 Investment Policy 4.2 Creditworthiness policy 4.3 Other Investment Limits 4.4 Treasury Management Investment Strategy 4.5 Non Treasury Investment Strategy 4.6 Investment Performance/Risk Benchmarking 4.7 End of Year Investment Report 4.8 External Fund Managers 4.9 Environmental Social and Governance Policy 4.10 Pension Fund Cash

	Annexes
1	Prudential and Treasury Indicators
2	Treasury Management - Portfolio
3	Approved Sources of Long and Short Term borrowing
4	Treasury Management - Practice
5	Approved Countries for Investments
6	Treasury Management - Scheme of Delegation
7	Treasury Management - Role of the Section 151 Officer
8	Economic Background

1 Introduction

1.1 Background

The Chartered Institute of Public Finance and Accountancy (CIPFA) defines treasury management as:

"The management of the local authority's borrowing, investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks."

The Council is required to operate a balanced budget, which broadly means that cash raised during the year will meet cash expenditure. Part of the treasury management operation is to ensure that this cash flow is adequately planned, with cash being available when it is needed. Surplus monies are invested in low risk counterparties or instruments commensurate with the Council's low risk appetite, providing adequate liquidity initially before considering investment return.

The second main function of the treasury management service is the funding of the Council's capital plans. These capital plans provide a guide to the borrowing need of the Council, essentially the longer-term cash flow planning, to ensure that the Council can meet its capital spending obligations. This management of longer-term cash may involve arranging long or short-term loans, or using longer-term cash flow surpluses. On occasion, when it is prudent and economic, any debt previously drawn may be restructured to meet Council risk or cost objectives.

The contribution the treasury management function makes to the authority is critical, as the balance of debt and investment operations ensure liquidity or the ability to meet spending commitments as they fall due, either on day-to-day revenue or for larger capital projects. The treasury operations will see a balance of the interest costs of debt and the investment income arising from cash deposits affecting the available budget. Since cash balances generally result from reserves and balances, it is paramount to ensure adequate security of the sums invested, as a loss of principal will in effect result in a loss to the General Fund Balance.

Whilst any commercial initiatives or loans to third parties will impact on the treasury function, these activities are generally classed as non-treasury activities. These are separate from day to day treasury management activities and are covered by a separate Investment Strategy.

1.2 Reporting requirements

1.2.1 Treasury Management reporting

The Council is currently required to receive and approve, as a minimum, three main treasury reports each year, which incorporate a variety of policies, estimates and actuals.

a. **Prudential and treasury indicators and treasury strategy** (this report) - The first, and most important report is forward looking and covers:
   - the capital plans, (including prudential indicators);

- a minimum revenue provision (MRP) policy, (how residual capital expenditure is charged to revenue over time);
- the treasury management strategy, (how the investments and borrowings are to be organised), including treasury indicators; and
- an investment strategy, (the parameters on how investments are to be managed).

b. **A mid-year treasury management report** – This is primarily a progress report and will update members on the capital position, amending prudential indicators as necessary, and whether any policies require revision.

c. **An annual treasury report** – This is a backward looking review document and provides details of a selection of actual prudential and treasury indicators and actual treasury operations compared to the estimates within the strategy.

1.2.2 Capital Strategy and Investment Strategy

The Treasury Management Strategy Statement (TMSS) interacts with both the Capital Strategy and the Investment Strategy.

Capital Strategy

The CIPFA 2017 Prudential and Treasury Management Codes require all local authorities to prepare a capital strategy report which will provide the following:

- a high-level long-term overview of how capital expenditure, capital financing and treasury management activity contribute to the provision of services
- an overview of how the associated risk is managed
- the implications for future financial sustainability

The aim of the capital strategy is to ensure that there is a robust strategy that meets organisational objectives with appropriate governance arrangements, and that the strategy is transparent and understandable to elected members.

The Capital Strategy is reported separately, and the headline capital financing requirements (the need to borrow) feed into this Treasury Management Strategy.

Investment Strategy

The Council is required to set out separately an Investment Strategy (IS) in relation to non-treasury investments. Non-treasury investments must consider security, liquidity, and yield, however the relative priority of these 3 factors does not have to follow treasury management principles as non-treasury investments are by their nature not intended to deliver treasury management objectives.

The Council's Investment Strategy is a separate document, however it does interrelate with the Treasury Management Strategy and Capital Strategy.

The table below summarises these different strategies.

Capital Strategy	Treasury Management Strategy – including Treasury Investment Strategy	Investment Strategy
Traditional capital expenditure to directly meet service objectives.	Management of cash and debt to service the delivery of day to day operations and the long-term financing of investments.	Non-treasury investments with the primary objective of meeting service objectives.

1.3 Treasury Management Strategy for 2021/22

The strategy for 2021/22 covers two main areas:

Capital issues

- the capital expenditure plans and the associated prudential indicators;
- the minimum revenue provision (MRP) policy.

Treasury management issues

- the current treasury position;
- treasury indicators which limit the treasury risk and activities of the Council;
- prospects for interest rates;
- the borrowing strategy;
- policy on borrowing in advance of need;
- debt rescheduling;
- the investment strategy;
- creditworthiness policy; and
- the policy on use of external service providers.

These elements cover the requirements of the Local Government Act 2003, the CIPFA Prudential Code, Ministry of Housing, Communities and Local Government (MHCLG) MRP Guidance, the CIPFA Treasury Management Code and MHCLG Investment Guidance.

1.4 Treasury management consultants

The Council uses Link Group, Treasury solutions as its external treasury management advisor.

The Council recognises that responsibility for treasury management decisions remains with the organisation at all times and will ensure that undue reliance is not placed upon the services of external service providers.

The Council also recognises that there is value in employing external providers of treasury management services in order to acquire access to specialist skills and resources. The Council will ensure that the terms of their appointment and the methods by which their value will be assessed are properly agreed and documented and subjected to regular review.

The scope of investments within the Councils operations includes treasury, service and commercial investments. Specialist advice is sought as appropriate for the undertaking of different types of investment.

2 Prudential Indicators

The Council's capital expenditure plans are the key driver of treasury management activity. The output of the capital expenditure plans is reflected in the prudential indicators, which are designed to assist members' overview and confirm capital expenditure plans.

2.1 Capital expenditure

This prudential indicator is a summary of the Council's capital expenditure plans, both those agreed previously, and those forming part of this budget cycle. More detail is provided in the Capital Strategy, the high-level headlines are reproduced below:

Table 1 – Total Capital Programme

£m	2020/21 Actual	2021/22 Estimate	2022/23 Estimate	2023/24 Estimate	2024/25 Estimate	2025/26 Estimate
Capital Expenditure	132.528	253.196	127.106	67.427	59.451	65.628
Non-Treasury Investment WPDG*	0.000	0.000	13.716	27.216	41.153	38.015
Non-Treasury Investment WRIF*	0.000	20.000	30.000	30.000	30.000	20.000
Total	**132.528**	**273.196**	**170.822**	**124.643**	**130.604**	**123.643**

***WPDG Warwickshire Property and Development Group**

***WRIF Warwickshire Recovery and Investment Fund**

The table below summarises the above capital expenditure plans and how these plans are being financed by capital or revenue resources. Any shortfall of resources results in a need to borrow.

Table 2 – Financing of Capital Expenditure

£m	2020/21 Actual	2021/22 Estimate	2022/23 Estimate	2023/24 Estimate	2024/25 Estimate	2025/26 Estimate
Capital receipts	(28.613)	(15.292)	(3.907)	0.000	0.000	0.000
Capital grants	(104.022)	(121.912)	(44.949)	(23.014)	(22.739)	(22.739)
Self Financed Borrowing	1.919	(0.995)	0.000	0.000	0.000	0.000
Revenue	(1.811)	(1.133)	0.000	0.000	0.000	0.000
Sub Total - General Capital Programme Funding	(132.528)	(139.332)	(48.857)	(23.014)	(22.739)	(22.739)
Capital Receipts from WPDG	0.000	0.000	(0.038)	(25.972)	(22.966)	(60.557)
Capital Receipts from WRIF	0.000	(2.350)	(10.112)	(16.375)	(19.698)	(17.054)
Sub Total - WPDG and WRIF Investment Related Income	0.000	(2.350)	(10.150)	(42.347)	(42.664)	(77.610)
Total Capital Funding/Income	(132.528)	(141.682)	(59.007)	(65.361)	(65.403)	(100.349)
Total Capital Expenditure	132.528	273.196	170.822	124.643	130.604	123.643
Net financing need for the year	**0.000**	**131.514**	**111.816**	**59.282**	**65.201**	**23.294**
Minimum Revenue Provision (MRP)	(11.396)	(10.941)	(15.763)	(19.606)	(21.193)	(22.953)
Borrowing Requirement	**(11.396)**	**120.573**	**96.052**	**39.677**	**44.009**	**0.341**

** MRP is a revenue provision made each year to contribute towards financing costs, so reducing the need for new borrowing

The net financing need split between capital expenditure and non-treasury investments is shown below in order to show the relative scale of non-treasury investment.

Table 3 – Financing of Non-Treasury Investments

£m	2021/22 Estimate	2022/23 Estimate	2023/24 Estimate	2024/25 Estimate	2025/26 Estimate
WPDG Capital Investment	0.000	13.716	27.216	41.153	38.015
Less: WDPG Related Receipts and Repayments	0.000	(0.038)	(25.972)	(22.966)	(60.557)
WRIF Capital Investment	20.000	30.000	30.000	30.000	20.000
Less: WRIF Related Receipts and Repayments	(2.350)	(10.112)	(16.375)	(19.698)	(17.054)
Net financing need for the year	**17.650**	**33.566**	**14.869**	**28.489**	**(19.595)**
Percentage of total net financing need %	100.0%	30.0%	25.1%	43.7%	0.0%

Further details in respect of non-treasury investments are set out in a separate Investment Strategy document.

2.2 The Council's borrowing need (the Capital Financing Requirement)

The Capital Financing Requirement (CFR) represents capital expenditure financed by external debt and not by capital receipts, revenue contributions, capital grants or third-party contributions at the time of spending. The CFR measures the Authority's underlying need to borrow externally for a capital purpose.

Table 4 – Capital Financing Requirement

£m	2020/21 Actual	2021/22 Estimate	2022/23 Estimate	2023/24 Estimate	2023/24 Estimate	2025/26 Estimate
CFR – Capital Programme	278.297	381.220	443.706	468.514	484.034	503.970
CFR - WPDG	0.000	0.000	13.678	14.922	33.109	10.567
CFR - WRIF	0.000	17.650	37.538	51.163	61.465	64.412
Total CFR	**278.297**	**398.870**	**494.922**	**534.599**	**578.608**	**578.948**
Movement in CFR - Capital Programme		102.923	62.486	24.808	15.520	19.936
Movement in CFR - WPDG		0.000	13.678	1.243	18.187	(22.542)
Movement in CFR - WRIF		17.650	19.888	13.625	10.302	2.946
Movement in CFR - Total		**120.573**	**96.052**	**39.677**	**44.009**	**0.341**
Movement in CFR represented by						
Net financing need for the year	0.000	131.514	111.816	59.282	65.201	23.294
Less MRP and other financing movements	(11.396)	(10.941)	(15.763)	(19.606)	(21.193)	(22.953)
Movement in CFR net of MRP	**(11.396)**	**120.573**	**96.052**	**39.677**	**44.009**	**0.341**

*The MRP calculation is explained in section 2.4 of this report.

The CFR is increasing significantly as a result of general capital programme plans plus new non-treasury investment plans.

2.3 Core funds and expected investment balances

The application of resources (capital receipts, reserves etc.) to either finance capital expenditure or other budget decisions to support the revenue budget will have an ongoing impact on investments unless resources are supplemented each year from new sources (asset sales etc.). Detailed below are estimates of the year-end balances for each resource and anticipated day-to-day cash flow balances.

Table 5 – Expected Investments

£m	2020/21 Actual	2021/22 Estimate	2022/23 Estimate	2023/24 Estimate	2024/25 Estimate	2025/26 Estimate
Fund balances / reserves	193.023	186.200	160.200	143.200	134.200	125.200
Capital receipts	20.200	0.000	0.000	0.000	0.000	0.000
Other	4.300	4.300	4.300	4.300	4.300	4.300
Total core funds	**217.523**	**190.500**	**164.500**	**147.500**	**138.500**	**129.500**
Working capital	137.000	125.000	125.000	125.000	125.000	125.000
(Under)/over borrowing	43.109	(77.464)	(123.516)	(123.193)	(137.202)	(127.542)
Expected treasury investments	**397.632**	**238.036**	**165.984**	**149.307**	**126.298**	**126.958**

2.4 Minimum Revenue Provision (MRP) Policy

Capital expenditure is generally expenditure on assets which have a life expectancy of more than one year e.g. buildings, vehicles, machinery etc. It would be impractical to charge the entirety of such expenditure to revenue in the year in which it was incurred and so such expenditure is spread over several years so as to try to match the years over which such assets benefit the local community through their useful life. The manner of spreading these costs is through an annual Minimum Revenue Provision (MRP).

The MRP should be designed to make prudent provision to redeem debt liabilities over a period which is reasonably commensurate with the associated capital expenditure benefits.

Having regard to these requirements, the MRP provision will be calculated as set out below.

2.4.1 MRP for Capital Programme Expenditure

The MRP provision will be calculated on the average remaining useful life of the Council's asset portfolio. We will calculate and apply the remaining useful life over two categories of asset:

- Land, buildings and infrastructure;
- Vehicles, plant and equipment and intangible assets.

The proportion of debt outstanding in each category of asset will be determined by the value of assets included in the balance sheet at the end of each financial year.

The 2020 review shows that the remaining useful life of our assets is now 22 years. By using an average life of 25 years for our assets equates to an annual provision of 4% straight line MRP.

For vehicles, plant and equipment, the remaining useful life is assumed to be 6 years e.g. 5 years average remaining useful life will result in 20% straight line MRP.

2.4.2 MRP for the Warwickshire Property Development Group (WPDG)

Unlike mainstream capital spending where provision for purchase of replacement assets has to be made in order to have funding available for replacement assets, expenditure (investment) in the WPDG will at a later date be repaid in full.

It is possible to assume that these repayments of principal amount to the necessary revenue provision. However, there is a risk that repayment of principal is not made, or not made in full. In order to mitigate this risk the MRP policy for the WPDG will be to make a provision as follows:

- No MRP will be charged to the revenue account on any equity land or asset transfers into Wholly Owned subsidiaries.
- No MRP will be charged on working capital loans. Any anticipated impairments will be treated following the relevant accounting standards (namely IFRS9 - Financial Instruments), and not charged through the capital financing regime.
- MRP on development loans made to DevCo (a subsidiary of WPDG) will be charged over 25 years of equivalent to 4% per year, in line with the existing MRP policy for the capital programme.
- MRP on loans to ManCo (a subsidiary of WPDG for purchase of assets from DevCo) will be charged to the revenue account over 25 years (4% per year) in order to match the repayment profile of senior lending and operating life of those assets.
- Any capital receipts then received as repayment of the loan principal from ManCo and Dev Co will be used to offset "traditional" borrowing requirements for financing the wider capital programme.

2.4.3 MRP for the Warwickshire Recovery Investment Fund (WRIF)

Unlike mainstream capital spending where provision for purchase of replacement assets has to be made in order to have funding available for replacement assets, expenditure (investment) in the WRIF will at a later date be repaid in full.

It is possible to assume that these repayments of principal amount to the necessary revenue provision. However, there is a risk that repayment of principal is not made, or not made in full. In order to mitigate this risk the MRP policy for the WRIF will be to make a provision as follows:

- MRP on WRIF loans that are capital in nature will be 4% per year. This aligns with the intention for MRP to be associated with the underlying asset life rather than the duration of the loan.

- Any capital receipts then received as repayment of the loan principal from WRIF will be used to offset "traditional" borrowing requirements for financing the wider capital programme.

2.4.4 MRP Calculation

The actual calculation of MRP will be based on the [Total Capital Financing Requirement x 4%]. This is deemed to be a prudent overall level of provision based upon the requirements set out above.

The Council has the option to directly and specifically link internal borrowing to specific investments and where this is the case a MRP would not be made. This would mean that repayments associated of the loan would not be capital and would therefore not be ringfenced to financing capital spending. Any anticipated impairments will be treated following the relevant accounting standards (namely IFRS9 - Financial Instruments), and not charged through the capital financing regime. However, the default position is that specific funding sources are not directly linked to specific

investments therefore an express decision to link specific funding to a specific investment would need to be made for this to happen.

3 Borrowing

Capital expenditure plans are set out in detail in the Capital Strategy. The treasury management function ensures that the Council's cash is managed in accordance with the relevant professional codes, so that sufficient cash is available to meet the Council's capital strategy and revenue service activity. This will involve both the organisation of the cash flow and, where capital plans require, the organisation of appropriate borrowing facilities. The strategy covers the relevant treasury / prudential indicators, the current and projected debt positions and the annual treasury investment strategy.

The council currently holds an over borrowed position (meaning external borrowing is greater than the total capital financing requirement), however this is forecast to change based on capital expenditure plans in the coming years. The need for further borrowing will be kept under review.

3.1 Current portfolio position

The overall treasury management portfolio as at 31st March 2020 and 31st December 2020 are shown below for both borrowing and investments.

Table 6 Investment and Borrowing Portfolio

Treasury Portfolio				
	actual 31.03.2020 £m	actual 31.03.2020 %	**actual 31.03.2021 £m**	**actual 31.03.2021 %**
Treasury investments				
Banks	-	0%	20.021	5%
Building Societies	-	0%	50.004	13%
Local Authorities	175.222	47%	128.157	32%
DMADF (H.M.Treasury)	29.000	8%	-	0%
Lloyds Secondary Account and Cash	38.833	10%	5.004	1%
Subtotal - managed in house	**243.055**	**65%**	**203.186**	**51%**
Money Market Funds	88.779	24%	148.702	38%
CCLA Property Fund	10.285	3%	10.211	3%
Columbia Threadneedle Social Bond Fund	32.125	9%	33.520	8%
Subtotal - managed externally	**131.189**	**35%**	**192.433**	**49%**
Total treasury investments	**374.244**	**100%**	**395.619**	**100%**
Treasury external borrowing				
PWLB	342.000	100%	321.406	100%
Total external borrowing	**342.000**		**321.406**	
Net treasury investments / (borrowing)	**32.244**		**74.213**	

Annex 2 sets out the current maturity profile of investments held, and the borrowing portfolio. Currently there is a significant concentration of debt maturities across the period 2050-2060.

The Council's forward projections for borrowing are summarised below. The table shows the actual external debt, against the underlying capital borrowing need, (the Capital Financing Requirement - CFR), highlighting any over or under borrowing.

Table 7 – External Debt Forecast

£m	2020/21 Actual	2021/22 Estimate	2022/23 Estimate	2023/24 Estimate	2024/25 Estimate	2025/26 Estimate
External Debt						
Debt at 1 April	341.406	321.406	321.406	371.406	411.406	441.406
New Debt			50.000	40.000	30.000	10.000
Debt Repaid	- 20.000		-	-	-	
Other long-term liabilities (OLTL)	-	-	-	-	-	-
Expected change in OLTL	-	-	-	-	-	-
Actual gross debt at 31 March	**321.406**	**321.406**	**371.406**	**411.406**	**441.406**	**451.406**
The Capital Financing Requirement	278.297	398.870	494.922	534.599	578.608	578.948
Under / (over) borrowing	**- 43.109**	**77.464**	**123.516**	**123.193**	**137.202**	**127.542**

Internal Debt

The Council will seek to hold efficient levels of cash and will therefore run down external investment balances and use cash to finance a share of the Capital Financing Requirement. This is referred to as internal borrowing and when implemented it will improve our annual net interest costs, as the loss of interest on investment is currently lower than the cost of interest on external loans. The level of internal borrowing will be kept under review to ensure that the level of total treasury investments (a liquidity buffer) does not fall below £125m.

Table 8 – Internal Debt Forecast

£m	2020/21 Actual	2021/22 Estimate	2022/23 Estimate	2023/24 Estimate	2024/25 Estimate	2025/26 Estimate
External Debt	321.406	321.406	371.406	411.406	441.406	451.406
Internal Debt (internal borrowing)	-	77.464	123.516	123.193	137.202	127.542
Internal borrowing as % of CFR	**0.0%**	**19.4%**	**25.0%**	**23.0%**	**23.7%**	**22.0%**

Where it is deemed appropriate to add to the level of current external loan finance, any risks associated with such borrowing will be subject to prior appraisal (including borrow now or borrow later analysis) and subsequent reporting through the mid-year or annual reporting mechanism.

The prudential indicators set out a number of key indicators to ensure that the Council operates its activities within well-defined limits. One of these is that the Council needs to ensure that its gross debt does not, except in the short term, exceed the total of the CFR in the preceding year plus the estimates of any additional CFR for 2021/22 and the following two financial years. This allows some flexibility for limited early borrowing for future years but ensures that borrowing is not undertaken for revenue or speculative purposes.

The Council complied with this prudential indicator in the current year and does not envisage difficulties for the future. This view takes into account current commitments, existing plans, and the proposals in this report.

3.2 Treasury Prudential Indicators: limits to borrowing activity

The operational boundary. This is the limit which external debt is not normally expected to exceed. In most cases, this would be a similar figure to the CFR, but may be lower or higher depending on the levels of actual debt and the ability to fund borrowing by other cash resources.

Table 9 – Operational Boundary

£m	2020/21	2021/22	2022/23	2023/24	2024/25	2025/26
External Debt	321.406	398.870	494.922	534.599	578.608	578.948
Total	**321.406**	**398.870**	**494.922**	**534.599**	**578.608**	**578.948**

The authorised limit for external debt. This is a key prudential indicator and represents a control on the maximum level of borrowing. This represents a legal limit beyond which external debt is prohibited, and this limit needs to be set or revised by the full Council. It reflects the level of external debt which, while not desired, could be afforded in the short term, but is not sustainable in the longer term.

1. This is the statutory limit determined under section 3 (1) of the Local Government Act 2003. The Government retains an option to control either the total of all councils' plans, or those of a specific council, although this power has not yet been exercised.
2. The Council is asked to approve the following authorised limit:

Table 10 – Authorised Borrowing Limit

£m	2020/21	2021/22	2022/23	2023/24	2024/25	2025/26
External Debt	386.000	479.000	594.000	642.000	694.000	695.000
Total	**386.000**	**479.000**	**594.000**	**642.000**	**694.000**	**695.000**

Note that the net debt position is affected by capital receipts and the repayment of debt principal. Where income such as this is not received, the requirement to borrow is increased. For non-treasury investments, where all investments are expected to be repaid ultimately, it is possible for non-repayment of investments to result in the authorised limit being reached and no further borrowing being possible. This mechanism limits exposure to risk.

The chart below illustrates the relationship between actual debt, the CFR, and the prudential limits.

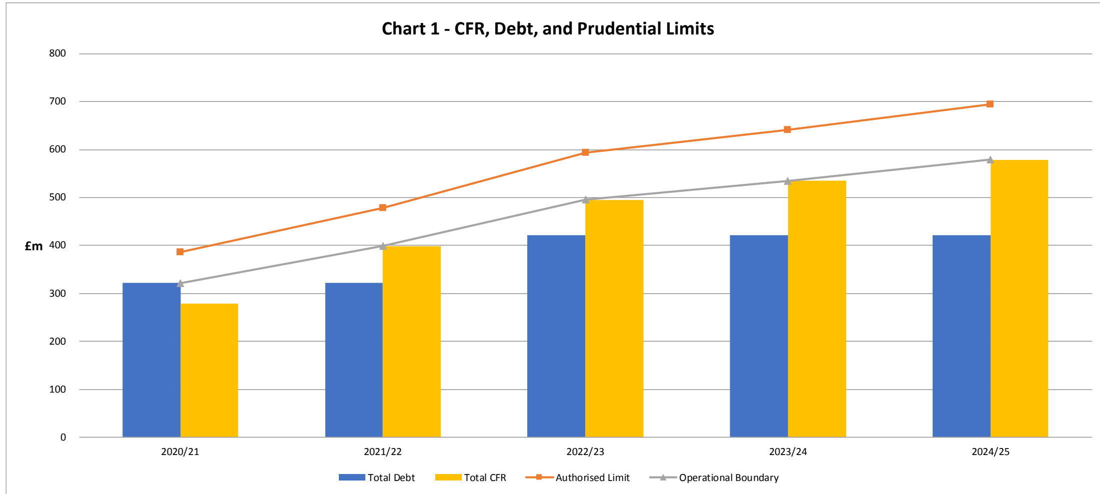


Chart 1 - CFR, Debt, and Prudential Limits
£m
800
700
600
500
400
300
200
100
0
2020/21
2021/22
2022/23
2023/24
2024/25
Total Debt
Total CFR
Authorised Limit
Operational Boundary

3.3 Prospects for interest rates

The Council has appointed Link Group as its treasury advisor and part of their service is to assist the Council to formulate a view on interest rates. Link provided the following forecasts on 9.2.21. These are forecasts for certainty rates, gilt yields plus 80 bps.

Link Group Interest Rate View	8.3.21												
	Mar-21	Jun-21	Sep-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	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
3 month ave earnings	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
6 month ave earnings	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
12 month ave earnings	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20
5 yr PWLB	1.20	1.20	1.20	1.20	1.20	1.20	1.20	1.30	1.30	1.40	1.40	1.40	1.40
10 yr PWLB	1.60	1.60	1.60	1.60	1.70	1.70	1.70	1.80	1.80	1.90	1.90	1.90	1.90
25 yr PWLB	2.10	2.10	2.10	2.20	2.30	2.30	2.30	2.40	2.40	2.50	2.50	2.50	2.50
50 yr PWLB	1.90	1.90	1.90	2.00	2.10	2.10	2.10	2.20	2.20	2.30	2.30	2.30	2.30

The coronavirus outbreak has done huge economic damage to the UK and economies around the world. After the Bank of England took emergency action in March to cut Bank Rate to first 0.25%, and then to 0.10%, it subsequently left Bank Rate unchanged at its subsequent meetings, including its last meeting on 4th February 2021, although some forecasters had suggested that a cut into negative territory could happen. However, at that last meeting, we were informed that financial institutions were not prepared for implementing negative rates. The Monetary Policy Committee (MPC), therefore, requested that the Prudential Regulation Authority require financial institutions to prepare for such implementation if, at any time in the future, the MPC may wish to use that as a new monetary policy tool. The MPC made it clear that this did not in any way imply that they were about to use this tool in the near future. As shown in the forecast table above, no increase in Bank Rate is expected in the near-term as it is unlikely that inflation will rise sustainably above 2% during this period so as to warrant increasing Bank Rate.

3.4 Gilt yields / PWLB rates

Pre the pandemic. There was much speculation during the second half of 2019 that bond markets were in a bubble which was driving bond prices up and yields down to historically very low levels. The context for that was a heightened expectation that the US could have been heading for a recession in 2020. In addition, there were growing expectations of a downturn in world economic growth, especially due to fears around the impact of the trade war between the US and China, together with inflation generally at low levels in most countries and expected to remain subdued. Combined, these conditions were conducive to very low bond yields. While inflation targeting by the major central banks has been successful over the last 30 years in lowering inflation expectations, the real equilibrium rate for central rates has fallen considerably due to the high level of borrowing by consumers. This means that central banks do not need to raise rates as much now to have a major impact on consumer spending, inflation, etc.

The consequence of this has been the gradual lowering of the overall level of interest rates and bond yields in financial markets over the last 30 years. Over the year prior to the coronavirus crisis, this has seen many bond yields up to 10 years turn negative in the Eurozone. In addition, there has, at times, been an inversion of bond yields in the US whereby 10 year yields have fallen below shorter term yields. In the past, this has been a precursor of a recession. The other side of this coin was that bond prices

were elevated as investors would have been expected to be moving out of riskier assets i.e. shares, in anticipation of a downturn in corporate earnings and so selling out of equities.

March 2020 crisis. Gilt yields had, therefore, already been on a generally falling trend up until the coronavirus crisis hit western economies during March 2020. After gilt yields spiked up in March 2020, we have subsequently seen these yields fall sharply to unprecedented lows as investors panicked during March 2020 in selling shares in anticipation of impending recessions in western economies, and moved cash into safe haven assets i.e. government bonds. However, major western central banks took rapid action to deal with excessive stress in financial markets during March, and started massive quantitative easing purchases of government bonds: this also acted to put downward pressure on government bond yields at a time when there has been a huge and quick expansion of government expenditure financed by issuing government bonds. Such unprecedented levels of issuance in "normal" times would have caused bond yields to rise sharply.

April 2020 to date. Gilt yields and PWLB rates were at remarkably low rates during the first three quarters of 2020/21. However, since the start of 2021 there has been a major swing of sentiment in financial markets which are now focused on the increased risks of rising inflation in the US as a result of the victory of the Democrats in the US Presidential and Congress elections. In addition to the passing of a $900bn stimulus package in December (pre-Biden), the new administration has subsequently pushed through another $1.9 trn coronavirus rescue package in March 2021 which provides additional shorter term stimulus to economic recovery. This could be followed in late 2021 by a longer term $2trn 10 year infrastructure renewal package. There are widespread concerns that all this stimulus on top of that already provided by the Fed with its quantitative easing (QE) purchases of $120bn of bonds per month, could rapidly eliminate excess capacity in the economy during 2021 and so drive up asset prices as buyers compete for scarce resources. In previous years, this would have caused the Fed to counter rising inflation by tapering or stopping QE purchases, and/or raising the Fed Rate so as to cool the economy down. However, the Fed has repeatedly made clear since September 2020, that its new average inflation targeting policy means that it will tolerate transitory peaks of inflation above its inflation target of 2% to counter balance periods when inflation has been below its target. It has also emphasised that it now has a wider mandate beyond just inflation, in terms of targeting full employment across all sectors of society, including disadvantaged sectors. There is, therefore, tension in financial markets about how this is all going to work out in practice and during Q1 2021, bond yields have risen significantly in anticipation that the time is drawing closer when the Fed will have to start tapering its own stimulus programme of QE purchases of bonds. There is currently no sign that the Fed will take any action to suppress this rise in bond yields, though that remains a potential option if they were to rise further significantly.

During 2021, a sharp rise in US bond yields has caused bond yields to rise in many western countries. However, in the UK, the MPC meeting of 4th February ruled out the use of negative interest rates for at least six months and was optimistic in its forecasts of economic recovery. This gave an earlier impetus to rises in gilt yields which have also risen more than in Europe as a result of economic recovery being expected earlier in the UK. The UK Budget will also have added further optimism to the prospects of the domestic economic recovery in the UK. Meanwhile, the avoidance of a "no deal" Brexit at the close of 2020 had also removed some market concerns over the economic outlook.

Forecasts for PWLB rates. As the interest forecast table for PWLB certainty rates above shows, there is expected to be little upward movement in PWLB rates over the next two years as government bond yields of major countries around the world are expected to rise little during this time in an environment where central bank policy rates are also expected to remain low for some years; this is the result of a change of inflation targeting policy of central banks to one based on average inflation over a number of years, (see appendix 5.3 for further explanation). From time to time, gilt yields, and therefore PWLB rates, can be subject to exceptional levels of volatility due to geo-political, sovereign debt crisis, emerging market developments and sharp changes in investor sentiment, (as shown on 9th November 2020 when the first results of a successful COVID-19 vaccine trial were announced). Such volatility could occur at any time during the forecast period.

3.5 Investment and Borrowing Rates

- **Investment returns** are likely to remain exceptionally low during 2021/22 with little increase in the following two years.

- **Borrowing interest rates** fell to historically very low rates as a result of the COVID crisis and the quantitative easing operations of the Bank of England: indeed, gilt yields up to 6 years were negative during most of the first half of 20/21. The policy of avoiding new borrowing by running down spare cash balances has served local authorities well over the last few years. The unexpected increase of 100 bps in PWLB rates on top of the then current margin over gilt yields of 80 bps in October 2019, required an initial major rethink of local authority treasury management strategy and risk management. However, in March 2020, the Government started a consultation process for reviewing the margins over gilt rates for PWLB borrowing for different types of local authority capital expenditure. *(Please note that Link has concerns over this approach, as the fundamental principle of local authority borrowing is that borrowing is a treasury management activity and individual sums that are borrowed are not linked to specific capital projects.)* It also introduced the following rates for borrowing for different types of capital expenditure: -

    - **PWLB Standard Rate** is gilt plus 200 basis points (G+200bps)
    - **PWLB Certainty Rate** is gilt plus 180 basis points (G+180bps)
    - **PWLB HRA Standard Rate** is gilt plus 100 basis points (G+100bps)
    - **PWLB HRA Certainty Rate** is gilt plus 80bps (G+80bps)
    - **Local Infrastructure Rate** is gilt plus 60bps (G+60bps)

- As a consequence of these increases in margins, many local authorities decided to refrain from PWLB borrowing unless it was for HRA or local infrastructure financing, until such time as the review of margins was concluded.

- On 25th November 2020, the Chancellor announced the conclusion to the review of margins over gilt yields for PWLB rates; the standard and certainty margins were reduced by 1% but a prohibition was introduced to deny access to borrowing from the PWLB for any local authority which had purchase of assets for yield in its three year capital programme. The new margins over gilt yields are as follows: -.

    - **PWLB Standard Rate** is gilt plus 100 basis points (G+100bps)
    - **PWLB Certainty Rate** is gilt plus 80 basis points (G+80bps)
    - **PWLB HRA Standard Rate** is gilt plus 100 basis points (G+100bps)
    - **PWLB HRA Certainty Rate** is gilt plus 80bps (G+80bps)
    - **Local Infrastructure Rate** is gilt plus 60bps (G+60bps)

- **Borrowing for capital expenditure.** As Link's long-term forecast for Bank Rate is 2.00%, and all PWLB rates are under 2.00%, there is now value in borrowing from the PWLB for all types of capital expenditure for all maturity periods, especially as current rates are at historic lows. However, greater value can be obtained in borrowing for shorter maturity periods so the Council will assess its risk appetite in conjunction with budgetary pressures to reduce total interest costs. Longer-term borrowing could also be undertaken for the purpose of certainty, where that is desirable.

3.6 Borrowing strategy

The Council is currently maintaining an over-borrowed position. This means that more external borrowing exists than is necessary which results in higher cash balances being held by the council. However the borrowing position is forecast to change based on the capital expenditure planned over the next 5 years and beyond, switching to an "under-borrowed" position. This is planned in order to make efficient use of cash balances. By, in effect, borrowing from internal balances the cost of borrowing is lower than borrowing from an external lender.

Against this background and the risks within the economic forecast, caution will be adopted with the 2021/22 treasury operations. Interest rates will be monitored in financial markets and a pragmatic approach taken to changing circumstances:

- if it was felt that there was a significant risk of a sharp FALL in borrowing rates, then borrowing will be postponed.
- if it was felt that there was a significant risk of a much sharper RISE in borrowing rates than that currently forecast, perhaps arising from an acceleration in the rate of increase in central rates in the USA and UK, an increase in world economic activity, or a sudden increase in inflation risks, then the portfolio position will be re-appraised. Fixed rate funding would be likely to be drawn if interest rates are considered to be lower than they are projected to be in the next few years.

Any borrowing decisions will be reported to the appropriate decision-making body at the next available opportunity.

With the current over-borrowed position, but also being mindful of the volatile economic outlook for 2021/22 the following assumptions will be adopted in the borrowing strategy:

- The cheapest borrowing will be internal borrowing by running down cash balances and foregoing interest earned at historically low rates.
- Internal borrowing will be weighed against potential long-term costs that will be incurred if market loans at long term rates are higher in future years.
- Long term fixed rate market loans at rates significantly below PWLB rates will be considered where available, to ensure the best rates and to maintain an appropriate balance between PWLB and market debt in the debt portfolio. A list of the possible sources of borrowing is detailed in point 3.7.
- PWLB borrowing for periods under ten years will be considered where rates are expected to be significantly lower than rates for longer periods. This offers a range of options for new borrowing which will spread debt maturities away from a current concentration in longer dated debt.

- To ensure that the Council considers all options to secure long term certainty, the Council may also look to make use of forward starting loans as this will allow us to lock into a known financing rate out of a future date. These loans tend to be offered by Financial institutions (primarily insurance companies and pension funds but also some banks, where the objective is to use the forward loan with a mix of internal loans/temporary borrowing to avoid a "cost of carry" or to achieve refinancing certainty over the next few years).

3.7 Policy on Borrowing in Advance of Need

The Council will not borrow more than or in advance of its needs purely in order to profit from the investment of the extra sums borrowed. Any decision to borrow in advance will be within forward approved Capital Financing Requirement estimates and will be considered carefully to ensure that value for money can be demonstrated and that the Council can ensure the security of such funds.

However, the Council may borrow in advance of need for risk management or borrowing efficiency purposes. In determining whether borrowing will be undertaken in advance of need, the Council will:

- Ensure that there is a clear link between the capital programme and maturity profile of the existing debt portfolio which supports the need to fund in advance of need;
- Ensure the ongoing revenue liabilities created, and the implications on future plans and budgets have been considered;
- Evaluate the economic and market factors that might influence the manner and timing of any decision;
- Consider the merits and demerits of alternative forms of funding;
- Consider the alternative interest rate bases available, the most appropriate time periods and repayment profiles;
- Consider the impact of temporarily increasing cash balances until cash is required to finance capital expenditure, and the consequent increase in exposure to counterparty and other risks.

3.8 Debt Rescheduling

As short-term borrowing rates are cheaper than longer term rates, there may be opportunities to generate savings by switching from long term debt to short term debt. However, these savings will need to be considered in the light of their short-term nature and the cost of debt repayments. Reasons for debt rescheduling would include:

- The generation of cash savings and/or discounted cash flow savings;
- Helping to fulfil the strategy
- Enhancing the balance of the portfolio, for example reducing concentration of the debt maturity profile.

The option to make repayment of some external debt to the PWLB in order to reduce the difference between its gross and net debt position will be kept under review. However, the

penalty premiums that would be incurred by doing so means there currently is no net financial benefit from such early repayment.

3.9 New Financial Institutions as a Source of Borrowing and / or Types of Borrowing

Currently the PWLB Certainty Rate is set at gilts + 80 basis points for both HRA and non-HRA borrowing. However, consideration may still need to be given to sourcing funding from the following sources for the following reasons:

- Local authorities (primarily shorter dated maturities out to 3 years or so – still cheaper than the Certainty Rate).
- Financial institutions (primarily insurance companies and pension funds but also some banks, out of forward dates where the objective is to avoid a “cost of carry” or to achieve refinancing certainty over the next few years).
- Municipal Bonds Agency (possibly still a viable alternative depending on market circumstances prevailing at the time).

Our advisors will keep us informed as to the relative merits of each of these alternative funding sources.

4 Annual Treasury Investment Strategy

4.1 Investment Policy

The MHCLG and CIPFA have extended the meaning of 'investments' to include both financial and non-financial investments. This report deals solely with financial investments, (as managed by the treasury management team). Non-financial investments, essentially the purchase of income yielding assets, are covered in the Capital Strategy and the Investment Strategy.

The Council's treasury investment policy has regard to the following: -

- MHCLG's Guidance on Local Government Investments ("the Guidance")
- CIPFA Treasury Management in Public Services Code of Practice and Cross Sectoral Guidance Notes 2017 ("the Code")
- CIPFA Treasury Management Guidance Notes 2018

The Council's treasury investment priorities will be security first, portfolio liquidity second and then yield, (return). The Council will aim to achieve the optimum return (yield) on its investments commensurate with proper levels of security and liquidity. In the current economic climate it is considered appropriate to keep investments shorter term to ensure cover for cash flow needs. However, where appropriate (from an internal as well as external perspective), the Council will also consider the value available in periods up to 12 months with high credit rated financial institutions, as well as wider range fund options.

The above guidance from the MHCLG and CIPFA places a high priority on the management of risk. This authority has adopted a prudent approach to managing risk and defines its risk appetite by the following means: -

1. Minimum acceptable **credit criteria** are applied in order to generate a list of highly creditworthy counterparties. This also enables diversification and thus avoidance of concentration risk. The key ratings used to monitor counterparties are the short term and long-term ratings.

2. **Other information:** ratings will not be the sole determinant of the quality of an institution; it is important to continually assess and monitor the financial sector on both a micro and macro basis and in relation to the economic and political environments in which institutions operate. The assessment will also take account of information that reflects the opinion of the markets. To achieve this consideration the Council will engage with its advisors to maintain a monitor on market pricing such as **"credit default swaps"** and overlay that information on top of the credit ratings.

3. **Other information sources** used will include the financial press, share price and other such information pertaining to the financial sector in order to establish the most robust scrutiny process on the suitability of potential investment counterparties.

This authority has defined the list of **types of investment instruments** that the treasury management team are authorised to use. There are two lists in Annex 4 under the categories of 'specified' and 'non-specified' investments.

However, this authority will also pursue **value for money** in treasury management and will monitor the yield from investment income against appropriate benchmarks for investment performance. Regular monitoring of investment performance will be carried out during the year.

4.2 Creditworthiness Policy

The primary principle governing the Council's investment criteria is the security of its investments

- It maintains a policy covering both the categories of investment types it will invest in, criteria for choosing investment counterparties with adequate security, and monitoring their security. This is set out in the specified and non-specified investment sections below; and
- It has sufficient liquidity in its investments. For this purpose, it will set out procedures for determining the maximum periods for which funds may prudently be committed. These procedures also apply to the Council's prudential indicators covering the maximum principal sums invested.

  The Strategic Director for Resources will maintain a counterparty list in compliance with the following criteria and will revise the criteria and submit them to Council for approval as necessary.

  Credit rating information is supplied by the Link Group, our treasury advisors, on all active counterparties that comply with the criteria below. Any counterparty failing to meet the criteria would be omitted from the counterparty (dealing) list. Any rating changes, rating Watches (notification of a likely change), rating Outlooks (notification of the longer-term bias outside the central rating view) are provided to officers almost immediately after they occur and this information is considered before dealing.

The criteria for providing a pool of high-quality investment counterparties, (both specified and non-specified investments) is:

- Banks - good credit quality – the Council will only use banks which:
  1. are UK banks
  2. are non-UK and domiciled in a country which has a minimum sovereign Long Term rating of A-

  and have, as a minimum, the following Fitch Ratings:
  1. Short Term – F1
  2. Long Term – A-
- Banks 3 – The Council's own banker for transactional purposes if the bank falls below the above criteria, although in this case balances will be minimised in both monetary size and time invested.
- Building societies - The Council will use all societies which meet the ratings for banks outlined above;
- Money Market Funds (MMFs) CNAV – AAA
- Money Market Funds (MMFs) LVNAV – AAA
- Money Market Funds (MMFs) VNAV – AAA
- Property Funds - CCLA (refer to table D and E in annexes)
- Social Bond Funds - Threadneedle (refer to table D and E in annexes)
- Ultra-Short Dated Bond Funds with a credit rating of at least – AA
- Local authorities, parish councils (both spot and forward dates)
- Housing Associations?

Use of additional information other than credit ratings. Additional requirements under the Code require the Council to supplement credit rating information. Whilst the above criteria rely primarily on the application of credit ratings to provide a pool of appropriate counterparties for officers to use, additional operational market information will be applied before making any specific investment decision from the agreed pool of counterparties.

The time and monetary limits for institutions on the Council's counterparty list are detailed in Annex 4.

Creditworthiness- Although the credit rating agencies changed their outlook on many UK banks from Stable to Negative during the quarter ended 30th June 2020 due to upcoming risks to banks' earnings and asset quality during the economic downturn caused by the pandemic, the majority of ratings were affirmed due to the continuing strong credit profiles of major financial institutions, including UK banks. However, during Q1 and Q2 2020, banks made provisions for *expected* credit losses and the rating changes reflected these provisions. As we move into future quarters, more information will emerge on *actual* levels of credit losses. (Quarterly earnings reports are normally announced in the second half of the month following the end of the quarter.) This has the potential to cause rating agencies to revisit their initial rating adjustments earlier in the current year. These adjustments could be negative or positive, although it should also be borne in mind that banks went into this pandemic with strong balance sheets. This is predominantly a result of regulatory changes imposed on banks following the Great Financial Crisis. Indeed, the Financial Policy Committee (FPC) report on 6th August revised down their expected credit losses for the UK banking sector to "somewhat less than £80bn". It stated that in its assessment, "banks have buffers of capital more than sufficient to absorb the losses that are likely to arise under the MPC's central projection". The FPC stated that for real stress in the sector, the economic output would need to be twice as bad as the MPC's projection, with unemployment rising to above 15%.

All three rating agencies have reviewed banks around the world with similar results in many countries of most banks being placed on Negative Outlook, but with a small number of actual downgrades.

CDS prices- Although bank CDS prices (these are market indicators of credit risk) spiked upwards at the end of March / early April 2020 due to the heightened market uncertainty and ensuing liquidity crisis that affected financial markets, they have returned to more average levels since then. Nevertheless, prices are still elevated compared to end-February 2020. Pricing is likely to remain volatile as uncertainty continues. However, sentiment can easily shift, so it will remain important to undertake continual monitoring of all aspects of risk and return in the current circumstances.

4.3 Other Investment Limits

Due care will be taken to consider the exposure of the Council's total investment portfolio to non-specified investments, countries, and sectors.

a) **Non-specified treasury management investment limit.** The Council has determined that it will limit the maximum total exposure non specified investments to £80m.

b) **Country limit.** The Council has determined that it will only use approved counterparties from the UK and from countries with a **minimum sovereign credit**

rating of *AA-* from Fitch Ratings. The list of countries that qualify using this credit criteria as at the date of this report are shown in Annex 3. This list will be added to, or deducted from, by officers should ratings change in accordance with this policy.

c) **Sector Limit. The Council has determined that it will limit the maximum exposure within different sectors of investments to the following-**

- £250m aggregate in overnight investments such as money market funds and instant access funds/bank accounts.
- Maximum holding in any one money market fund should not represent more than 2% of that fund's total asset value.
- £200m aggregate in short term investments such as 7-95 day lending deposit, call and notice accounts, and property and social bond funds.
- £100m aggregate in medium term investments such as 95-365 day lending, deposit, call and notice accounts.
- Additionally a maximum total limit of £250m held in Money Market Funds.
- Additionally a maximum total limit of £200m to other local authorities.
- Investments made with other Local Authorities may be agreed in advance of the loan issue date subject to the total duration of the loan and the notice to lend not being more than 18 months.

4.4 Treasury Management Investment Strategy

In-house funds. Investments will be made with reference to the core balance and cash flow requirements and the outlook for short-term interest rates (i.e. rates for investments up to 12 months). Greater returns are usually obtainable by investing for longer periods. While most cash balances are required in order to manage the ups and downs of cash flow, where surplus cash sums can be identified that could be invested for longer periods, the value to be obtained from longer term investments will be carefully assessed.

Investment returns expectations.
The Bank Rate is unlikely to rise from 0.10% for a considerable period. It is not possible to say with certainty when it may start rising so it is assumed that investment earnings from money market-related instruments will be below 0.50% for the foreseeable future.

The suggested budgeted investment earnings rates for returns on investments placed for periods up to about three months during each financial year are as follows (the long-term forecast is for periods over 10 years in the future):

Average earnings in each year	
2020/21	0.10%
2021/22	0.10%
2022/23	0.10%
2023/24	0.10%
2024/25	0.25%
Long term later years	2.00%

- The overall balance of risks to economic growth in the UK is probably now skewed to the upside but is subject to major uncertainty due to the virus and how quickly

successful vaccines may become available and widely administered to the population.

- There is relatively little UK domestic risk of increases or decreases in Bank Rate and significant changes in shorter term PWLB rates. The Bank of England has effectively ruled out the use of negative interest rates in the near term and increases in Bank Rate are likely to be some years away given the underlying economic expectations. However, it is always possible that safe haven flows, due to unexpected domestic developments and those in other major economies, or a return of investor confidence in equities, could impact gilt yields, (and so PWLB rates), in the UK.

Negative investment rates

While the Bank of England said in August / September 2020 that it is unlikely to introduce a negative Bank Rate, at least in the next 6 -12 months, and in November omitted any mention of negative rates in the minutes of the meeting of the Monetary Policy Committee, some deposit accounts are already offering negative rates for shorter periods. As part of the response to the pandemic and lockdown, the Bank and the Government have provided financial markets and businesses with plentiful access to credit, either directly or through commercial banks. In addition, the Government has provided large sums of grants to local authorities to help deal with the COVID crisis; this has caused some local authorities to have sudden large increases in cash balances searching for an investment home, some of which was only very short term until those sums were able to be passed on.

As for money market funds (MMFs), yields have continued to drift lower. Some managers have already resorted to trimming fee levels to ensure that net yields for investors remain in positive territory where possible and practical. Investor cash flow uncertainty, and the need to maintain liquidity in these unprecedented times, has meant there is a surfeit of money swilling around at the very short end of the market. This has seen a number of market operators, now including the DMADF, offer nil or negative rates for very short-term maturities. This is not universal, and MMFs are still offering a marginally positive return, as are a number of financial institutions for investments at the very short end of the yield curve.

Inter-local authority lending and borrowing rates have also declined due to the surge in the levels of cash seeking a short-term home. This is magnified by the difficulty local authorities are facing over accurately forecasting the disbursements of funds received, and anticipation of any further large receipts from the Government.

4.5 Non Treasury Investment Strategy

A separate document entitled “Investment Strategy” covers the Council’s position in respect of non-treasury management investments held for service reasons or commercial reasons.

4.6 Investment Performance / Risk Benchmarking

A weighted average target return on treasury management investments is targeted to exceed the 30 day LIBID rate by 0.46%. This will maintain the current overall levels of return above LIBID, having regard to the first priorities being security and liquidity before

return. The Council holds an interest rate volatility reserve to manage fluctuations in interest rates.

The Council is appreciative that the provision of LIBOR and associated LIBID rates is expected to cease at the end of 2021. It will work with its advisors in determining suitable replacement investment benchmark(s) ahead of this cessation.

4.7 End of Year Investment Report

At the end of the financial year, the Council will report on its investment activity as part of its Annual Treasury Report. This will include a separate update on the Non-Treasury Investments held by the Council at the end of each financial year.

4.8 External Fund Managers

The County Council uses a number of external managers to spread risk and obtain maximum market exposure. Current external fund managers actively used during the last year are listed below. This list is not exhaustive and new fund managers may be engaged if necessary. Officers will periodically review the position, performance, and costs of external fund managers, and may meet with client relationship managers or fund managers as appropriate.

- Blackrock
- Deutsche Bank
- Goldman Sachs
- Insight
- Aberdeen
- Federated Hermes
- CCLA
- Threadneedle

4.9 Environmental, Social, and Governance Policy

As a responsible investor, the Council is committed to considering environmental, social, and governance (ESG) issues, and has a particular interest in taking action against climate change and pursuing activities that have a positive social impact.

However, the treasury management function is controlled by statute and by professional guidelines and the first priorities of treasury must remain security, liquidity, and yield. With those priorities kept in place, the following activity will be undertaken in respect of climate change and responsible investing. Steps will be taken to:

- Ensure an understanding of the degree to which investments may contribute towards climate change. This may take the form of measuring the carbon footprint or some similar measure.
- Identify and understand the extent to which investments are exposed to risks driven by climate change, for example investments in assets at risk of weather change (e.g. property or infrastructure at risk of flooding), assets at risk of becoming stranded (e.g. fossil fuel investments), or assets at risk from

geopolitical risks driven by climate change (e.g. water access, the capacity for food production, or economic conflict).

- Keep abreast of new investment opportunities that have regard to ethical investing and climate change as this is a quickly developing arena.
- Understand the ESG policies of funds when considering new investment opportunities.

4.10 Pension Fund Cash

This Council will comply with the requirements of The Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009, implemented 1 January 2010. With effect 1 April 2010, the Council does not pool pension fund cash with its own cash balances for investment purposes. Any investments made by the pension fund directly with this local authority after 1 April 2010 must comply with the requirements of SI 2009 No 393. The council has a separate statement for Pension Fund investment purposes.

ANNEXES

1. Prudential and Treasury Indicators
2. Treasury Management - Portfolio
3. Approved Sources of Long and Short Term borrowing
4. Treasury management - Practice
5. Approved Countries for Investments
6. Treasury Management - Scheme of Delegation
7. Treasury management - Role of the Section 151 Officer
8. Economic background

1. Prudential and Treasury Indicators

The Council's capital expenditure plans are the key driver of treasury management activity. The output of the capital expenditure plans is reflected in the prudential indicators, which are designed to assist members' overview and confirm capital expenditure plans.

The following indicators are set out in the main body of the report:

Prudential Indicator	Reference
Capital Expenditure	Table 1
Gross Debt	Table 7
Capital Financing Requirement	Table 4
Over/Under Borrowing	Table 7
Borrowing - Operational Boundary	Table 9
Borrowing - Authorised Borrowing Limit	Table 10

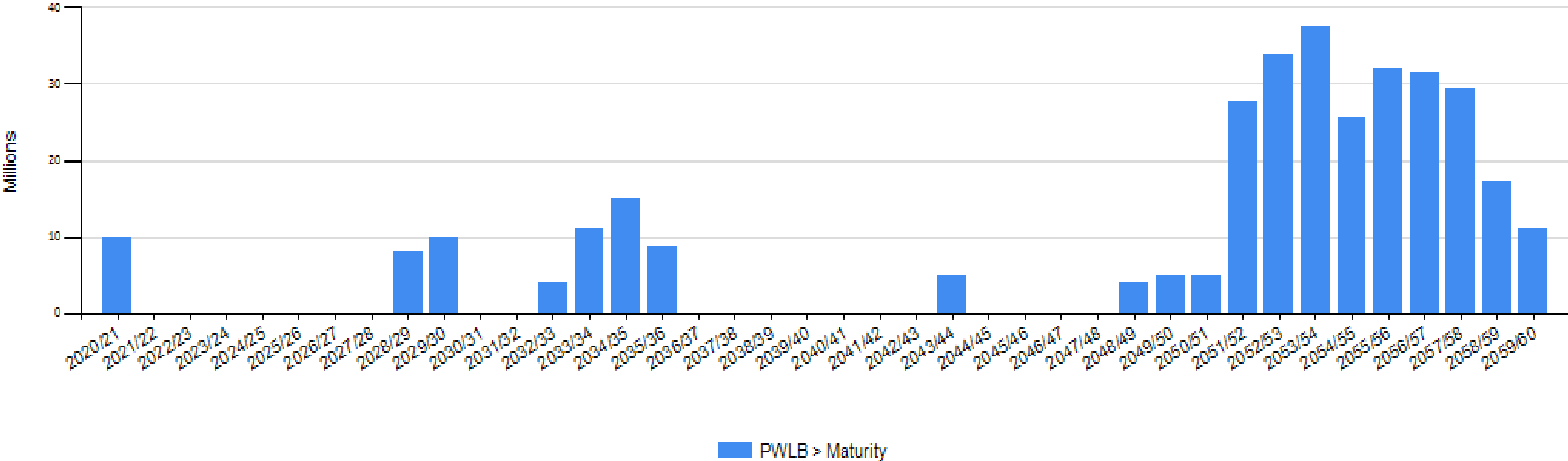
In addition, the prudential indicators below will be applied.

TREASURY MANAGEMENT PRUDENTIAL INDICATORS	2020/21	2021/22	2022/23	2023/24	2024/25	2026/26
Upper limit for fixed interest rate exposure						
Net principal re fixed rate borrowing / fixed term investments	100%	100%	100%	100%	100%	100%
Upper limit for variable rate exposure						
Net principal re fixed rate borrowing / fixed term investments	25%	25%	25%	25%	25%	25%
Upper limit for total principal sums invested for over 365 days	**£'000**	**£'000**	**£'000**	**£'000**	**£'000**	**£'000**
(per maturity date)	80,000	80,000	80,000	80,000	80,000	80,000

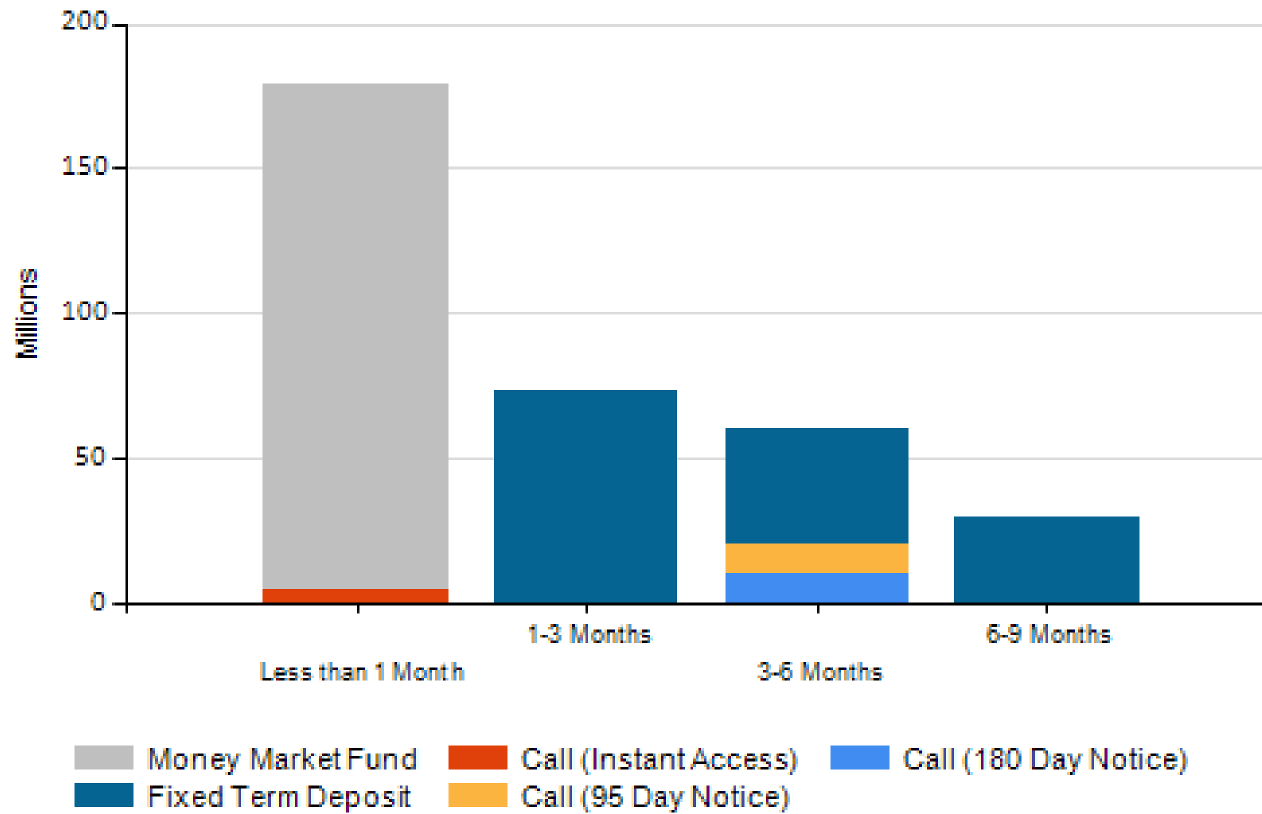
Maturity structure of new external borrowing during year	upper limit	lower limit
under 12 months	35%	0%
12 months and within 24 months	45%	0%
24 months and within 5 years	65%	0%
5 years and within 10 years	100%	0%
10 years and above	100%	0%

2. Treasury Management Portfolio

a. Debt Schedule



b. Investment Portfolio as at 31st March 2021



c. Balance Sheet Forecast

Warwickshire County Council
Balance Sheet Projections

2020/21 (£'000)		2021/22 (£'000)	2022/23 (£'000)	2023/24 (£'000)	2024/25 (£'000)	2025/26 (£'000)
CAPITAL FINANCING REQUIREMENT						
278,297	CFR Relating to General Fund	398,870	494,922	534,599	578,608	578,948
278,297	Total CFR	398,870	494,922	534,599	578,608	578,948
-	Finance Lease Liabilities		-	-	-	-
278,297	Underlying Borrowing Requirement	398,870	494,922	534,599	578,608	578,948
(341,406)	External Borrowing c/fwd	(321,406)	(321,406)	(371,406)	(411,406)	(441,406)
20,000	Loan Maturities					
-	New Loans	-	(50,000)	(40,000)	(30,000)	(10,000)
(321,406)	External Borrowing	(321,406)	(371,406)	(411,406)	(441,406)	(451,406)
(43,109)	Under / (Over) Borrowing	77,464	123,516	123,193	137,202	127,542
-15%	*Borrowing as a % of Requirement*	*19%*	*25%*	*23%*	*24%*	*22%*
RESERVES / BALANCES, INVESTMENTS & WORKING CAPITAL (£'000)						
21,223	General Fund Balance	21,200	21,200	21,200	21,200	21,200
-	Collection Fund Adjustment Account	-	-	-	-	-
171,800	Earmarked reserves	165,000	139,000	122,000	113,000	104,000
20,200	Capital Receipts Reserve	-	-	-	-	-
4,300	Provisions (exc. any accumulating absences)	4,300	4,300	4,300	4,300	4,300
-	Capital Grants Unapplied	-	-	-	-	-
43,109	Over / (Under) Borrowing	(77,464)	(123,516)	(123,193)	(137,202)	(127,542)
137,000	Working Capital	125,000	125,000	125,000	125,000	125,000
397,632	Expected Treasury Investments	238,036	165,984	149,307	126,298	126,958

YE balances currently estimated for 2020/21*

3. Approved Sources of Long and Short-Term Borrowing

On Balance Sheet	Fixed	Variable
PWLB	●	●
Municipal bond agency	●	●
Local authorities	●	●
Banks	●	●
Pension funds	●	●
Insurance companies	●	●
Market (long-term)	●	●
Market (temporary)	●	●
Market (LOBOs)	●	●
Stock issues	●	●
Local temporary	●	●
Local Bonds	●	
Local authority bills	●	●
Overdraft		●
Negotiable Bonds	●	●
Internal (capital receipts & revenue balances)	●	●
Commercial Paper	●	
Medium Term Notes	●	
Finance leases	●	●

4. Treasury Management – Practice

4.1 Counterparty Limits

	Fitch Long term Rating	Money Limit	Transaction limit	Time Limit
Banks	*A*	£20m	£20m	1yr
Local authorities	N/A	£10m	£10m	1yr
DMADF	UK sovereign	unlimited	unlimited	6 months
Other Institutions limit	N/A	£10m	£10m	1yr
	Fund rating**	**Money Limit**	**Transaction Limit**	**Time Limit**
Money Market Funds CNAV	AAA	£60m	£60m	liquid
Money Market Funds LVNAV	AAA	£60m	£60m	liquid
Money Market Funds VNAV	AAA	£60m	£60m	liquid
Ultra-Short Dated Bond Funds	AA	£60m	£60m	liquid
Property Fund	N/A	£15m	£15m	90 day
Social Bond Funds	N/A	£40m	£40m	90 day

4.2 Loans to Local Authority Trading Companies

Loans to LATCs	2021/22	2022/23	2023/24	2024/25	2025/26
Lending Limit £m's	**8.00**	**7.00**	**4.00**	**7.00**	**3.00**

4.3 Specified Investments

Investment Type	Credit Criteria (Fitch Ratings)	Limits (per institution)	Use
DMO Deposit Facility	--	No Limit	In-house
Term deposits: Local Authorities	--	£10m	In-house
Nationalised Banks	Short-term F1, Support 1	£20m	In-house and External Manager
Term deposits: UK Banks	Short-term F1, Long-term A, Viability a, Support 3	£20m	In-house and External Manager
Term deposits: Bank Council uses for current account	--	£20m	In-house and External Manager
Term deposits: UK Building Societies	Top five largest societies as reported annually. (To be continually monitored)	£20m	In-house and External Manager
Term deposits: Overseas Banks	Short-term F1+, Long-term AA- Viability aa, Support 1	£20m	In-house and External Manager
Certificates of deposits issued by UK banks and building societies	Short-term F1, Long-term A, Viability a, Support 3	£20m	External Manager
Money Market Funds	AAA	£60m	In-house and External Manager
Ultra Short Dated Bond Funds	AA	£40m	In-house and External Manager
UK Government Gilts, Treasury Bills	--	No Limit	External Manager
Gilt Funds and Bond Funds	Long-term A	No Limit	External Manager

(All such investments will be sterling denominated, with **maturities up to a maximum of 1 year**, meeting the minimum 'high' rating criteria where applicable)

4.4 Non-Specified Investments

Investment Type	Credit Criteria (Fitch Ratings)	Limits (per institution)	Use
Term deposits: UK banks and building societies with maturities in excess of one year with a maximum of three years allowed for in-house deposits	Short-term F1, Long-term A, Viability a, Support 3	£15m	In-house and External Manager
Fixed Term Deposit with Variable Rates and Variable Maturities	Short-term F1, Long-term A, Viability a+, Support 3	£15m	In-house and External Manager
Certificates of Deposits issued by UK banks and building societies	Short-term F1, Long-term A, Viability a, Support 3	£15m	External Manager
UK Government Gilts with maturities in excess of 1 year	--	£15m	External Manager
Local Government Association Municipal Bond Agency	--	£15m	--
CCLA Property Fund	--	£15m	--
Threadneedle Social Bond Fund	--	£40m	--
Local Authority wholly owned trading company	--	£3.9m	In-house

5. Approved Countries for Investments

Investments may be made in UK and in the following countries. This list is based on those countries which have sovereign ratings of AA- or higher, (we show the lowest rating from Fitch, Moody's and S&P) and also, (except - at the time of writing - for Hong Kong, Norway and Luxembourg), have banks operating in sterling markets which have credit ratings of green or above in the Link credit worthiness service.

Based on lowest available rating

AAA

- Australia
- Denmark
- Germany
- Luxembourg
- Netherlands
- Norway
- Singapore
- Sweden
- Switzerland

AA+

- Canada
- Finland
- U.S.A.

AA

- Abu Dhabi (UAE)
- France

AA-

- Belgium
- Hong Kong
- Qatar
- U.K.

6. Treasury Management - Scheme of Delegation

(i) Council

- approval of annual strategy.
- budget consideration and approval.
- approval of the division of responsibilities.

(ii) Cabinet

- scrutinise the proposed annual strategy.
- approval of/amendments to the organisation's adopted clauses, treasury management policy statement and treasury management practices.
- Receiving and reviewing monitoring reports and acting on recommendations.

(iii) Resources and Fire & Rescue Overview and Scrutiny Committee

- Overview and scrutiny of treasury management policy, practice, and activity as required.

7. Treasury Management - Role of the Section 151 Officer

The S151 (responsible) officer

- recommending clauses, treasury management policy/practices for approval, reviewing the same regularly, and monitoring compliance;
- submitting regular treasury management policy reports;
- submitting budgets and budget variations;
- receiving and reviewing management information reports;
- reviewing the performance of the treasury management function;
- ensuring the adequacy of treasury management resources and skills, and the effective division of responsibilities within the treasury management function;
- ensuring the adequacy of internal audit, and liaising with external audit;
- recommending the appointment of external service providers.
- preparation of a capital strategy to include capital expenditure, capital financing, non-financial investments and treasury management, with a long term timeframe.
- Recommending the MRP policy.

`

8. Economic Background

- **UK.** The key quarterly meeting of the Bank of England Monetary Policy Committee kept **Bank Rate** unchanged on 5.11.20. However, it revised its economic forecasts to take account of a second national lockdown from 5.11.20 to 2.12.20 which is obviously going to put back economic recovery and do further damage to the economy. It therefore decided to do a further tranche of **quantitative easing (QE) of £150bn**, to start in January when the current programme of £300bn of QE, announced in March to June, runs out. It did this so that "announcing further asset purchases now should support the economy and help to ensure the unavoidable near-term slowdown in activity was not amplified by a tightening in monetary conditions that could slow the return of inflation to the target".
- Its forecasts appeared, at that time, to be rather optimistic in terms of three areas:
  - The economy would recover to reach its pre-pandemic level in Q1 2022
  - The Bank also expected there to be excess demand in the economy by Q4 2022.
  - CPI inflation was therefore projected to be a bit above its 2% target by the start of 2023 and the "inflation risks were judged to be balanced".
- Significantly, there was no mention of **negative interest rates** in the minutes or Monetary Policy Report, suggesting that the MPC remains some way from being persuaded of the case for such a policy, at least for the next 6 -12 months. However, rather than saying that it "stands ready to adjust monetary policy", the MPC this time said that it will take "whatever additional action was necessary to achieve its remit". The latter seems stronger and wider and may indicate the Bank's willingness to embrace new tools.
- One key addition to **the Bank's forward guidance in August** was a new phrase in the policy statement, namely that "it does not intend to tighten monetary policy until there is clear evidence that significant progress is being made in eliminating spare capacity and achieving the 2% target sustainably". That seems designed to say, in effect, that even if inflation rises to 2% in a couple of years' time, do not expect any action from the MPC to raise Bank Rate – until they can clearly see that level of inflation is going to be persistently above target if it takes no action to raise Bank Rate. Our Bank Rate forecast currently shows no increase, (or decrease), through to quarter 1 2024 but there could well be no increase during the next five years as it will take some years to eliminate spare capacity in the economy, and therefore for inflationary pressures to rise to cause the MPC concern. **Inflation** is expected to briefly peak at just over 2% towards the end of 2021, but this is a temporary short lived factor and so not a concern.
- However, the minutes did contain several references to **downside risks**. The MPC reiterated that the "recovery would take time, and the risks around the GDP projection were judged to be skewed to the downside". It also said "the risk of a more persistent period of elevated unemployment remained material". Downside risks could well include severe restrictions remaining in place in some form during the rest of December and most of January too. **Upside risks** included the early roll out of effective vaccines.

- **COVID-19 vaccines.** We had been waiting expectantly for news that various COVID-19 vaccines would be cleared as being safe and effective for administering to the general public. The Pfizer announcement on 9th November was very encouraging as its 90% effectiveness was much higher than the 50-60% rate of

effectiveness of flu vaccines which might otherwise have been expected. However, this vaccine has demanding cold storage requirements of minus 70c that impairs the speed of application to the general population. It has therefore been particularly welcome that the Oxford University/AstraZeneca vaccine has now also been approved which is much cheaper and only requires fridge temperatures for storage. The Government has 60m doses on order and is aiming to vaccinate at a rate of 2m people per week starting in January, though this rate is currently restricted by a bottleneck on vaccine production; (a new UK production facility is due to be completed in June).

- These announcements, plus expected further announcements that other vaccines could be approved soon, have enormously boosted confidence that **life could largely return to normal during the second half of 2021**, with activity in the still-depressed sectors like restaurants, travel and hotels returning to their pre-pandemic levels; this would help to bring the unemployment rate down. With the household saving rate having been exceptionally high since the first lockdown in March, there is plenty of pent-up demand and purchasing power stored up for these services. A comprehensive roll-out of vaccines might take into late 2021 to fully complete; but if these vaccines prove to be highly effective, then there is a possibility that restrictions could start to be eased, beginning possibly in Q2 2021 once vulnerable people and front-line workers have been vaccinated. At that point, there would be less reason to fear that hospitals could become overwhelmed any more. Effective vaccines would radically improve the economic outlook once they have been widely administered; it may allow GDP to rise to its pre-virus level a year earlier than otherwise and mean that the unemployment rate peaks at 7% in 2021 instead of 9%.

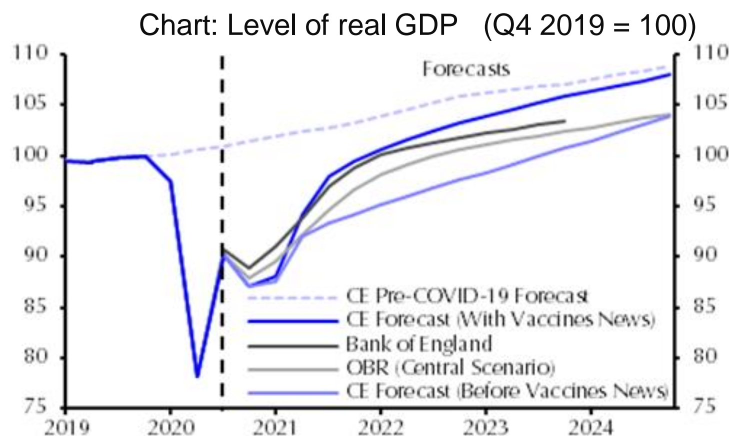
- **Public borrowing** was forecast in November by the Office for Budget Responsibility (the OBR) to reach £394bn in the current financial year, the highest ever peace time deficit and equivalent to 19% of GDP. In normal times, such an increase in total gilt issuance would lead to a rise in gilt yields, and so PWLB rates. However, the QE done by the Bank of England has depressed gilt yields to historic low levels, (as has similarly occurred with QE and debt issued in the US, the EU and Japan). This means that new UK debt being issued, and this is being done across the whole yield curve in all maturities, is locking in those historic low levels through until maturity. In addition, the UK has one of the longest average maturities for its entire debt portfolio, of any country in the world. Overall, this means that the total interest bill paid by the Government is manageable despite the huge increase in the total amount of debt. The OBR was also forecasting that the government will still be running a budget deficit of £102bn (3.9% of GDP) by 2025/26. However, initial impressions are that they have taken a pessimistic view of the impact that vaccines could make in the speed of economic recovery.

- Overall, **the pace of recovery** was not expected to be in the form of a rapid V shape, but a more elongated and prolonged one. The initial recovery was sharp after quarter 1 saw growth at -3.0% followed by -18.8% in quarter 2 and then an upswing of +16.0% in quarter 3; this still left the economy 8.6% smaller than in Q4 2019. It is likely that the one month national lockdown that started on 5th November, will have caused a further contraction of 8% m/m in November so the economy may have then been 14% below its pre-crisis level.

- **December 2020 / January 2021**. Since then, there has been rapid back-tracking on easing restrictions due to the spread of a new mutation of the virus, and severe restrictions were imposed across all four nations. These restrictions were changed on 5.1.21 to national lockdowns of various initial lengths in each of the four nations

as the NHS was under extreme pressure. It is now likely that wide swathes of the UK will remain under these new restrictions for some months; this means that the near-term outlook for the economy is grim. However, the distribution of vaccines and the expected consequent removal of COVID-19 restrictions, should allow GDP to rebound rapidly in the second half of 2021 so that the economy could climb back to its pre-pandemic peak as soon as late in 2022. Provided that both monetary and fiscal policy are kept loose for a few years yet, then it is still possible that in the second half of this decade, the economy may be no smaller than it would have been if COVID-19 never happened. The significant caveat is if another mutation of COVID-19 appears that defeats the current batch of vaccines. However, now that science and technology have caught up with understanding this virus, new vaccines ought to be able to be developed more quickly to counter such a development and vaccine production facilities are being ramped up around the world.

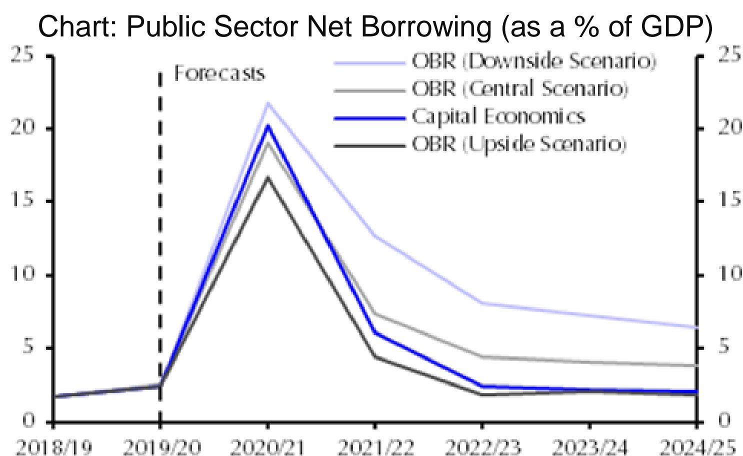
Chart: Level of real GDP (Q4 2019 = 100)



(if unable to print in colour…... the key describing each line in the above graph is in sequential order from top to bottom in parallel with the lines in the graph.

This recovery of growth which eliminates the effects of the pandemic by about the middle of the decade would have major repercussions for public finances as it would be consistent with the government deficit falling to around 2.5% of GDP without any tax increases. This would be in line with the OBR's most optimistic forecast in the graph below, rather than their current central scenario which predicts a 4% deficit due to assuming much slower growth. However, Capital Economics forecasts assumed that there is a reasonable Brexit deal and also that politicians do not raise taxes or embark on major austerity measures and so, (perversely!), depress economic growth and recovery.

Chart: Public Sector Net Borrowing (as a % of GDP)



(if unable to print in colour…... the key describing each line in the above graph is in sequential order from top to bottom in parallel with the lines in the graph.

- There will still be some **painful longer term adjustments** as e.g. office space and travel by planes, trains and buses may not recover to their previous level of use for several years, or possibly ever, even if vaccines are fully successful in overcoming the current virus. There is also likely to be a reversal of globalisation as this crisis has exposed how vulnerable long-distance supply chains are. On the other hand, digital services are one area that has already seen huge growth.

- **Brexit.** While the UK has been gripped by the long running saga of whether or not a deal would be made by 31.12.20, the final agreement on 24.12.20, followed by ratification by Parliament and all 27 EU countries in the following week, has eliminated a significant downside risk for the UK economy. The initial agreement only covers trade so there is further work to be done on the services sector where temporary equivalence has been granted in both directions between the UK and EU; that now needs to be formalised on a permanent basis. As the forecasts in this report were based on an assumption of a Brexit agreement being reached, there is no need to amend these forecasts.

- **Monetary Policy Committee meeting of 17 December.** All nine Committee members voted to keep interest rates on hold at +0.10% and the Quantitative Easing (QE) target at £895bn. The MPC commented that the successful rollout of vaccines had reduced the downsides risks to the economy that it had highlighted in November. But this was caveated by it saying, “Although all members agreed that this would reduce downside risks, they placed different weights on the degree to which this was also expected to lead to stronger GDP growth in the central case.” So, while the vaccine is a positive development, in the eyes of the MPC at least, the economy is far from out of the woods. As a result of these continued concerns, the MPC voted to extend the availability of the Term Funding Scheme, (cheap borrowing), with additional incentives for small and medium size enterprises for six months from 30.4.21 until 31.10.21. (The MPC had assumed that a Brexit deal would be agreed.)

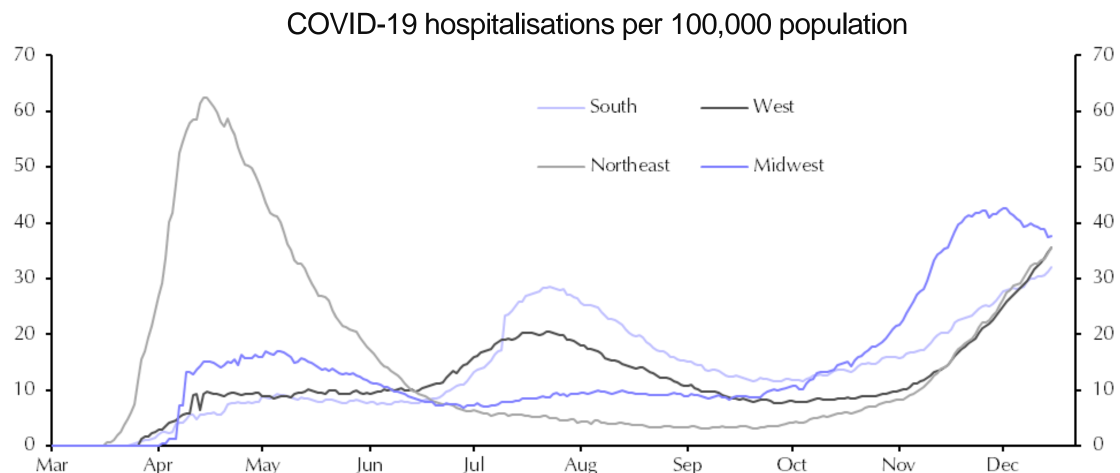
- **Fiscal policy.** In the same week as the MPC meeting, the Chancellor made a series of announcements to provide further support to the economy: -
  - An extension of the COVID-19 loan schemes from the end of January 2021 to the end of March.
  - The furlough scheme was lengthened from the end of March to the end of April.
  - The Budget on 3.3.21 will lay out the “next phase of the plan to tackle the virus and protect jobs”. This does not sound like tax rises are imminent, (which could hold back the speed of economic recovery).

- The **Financial Policy Committee** (FPC) report on 6.8.20 revised down their expected credit losses for the banking sector to “somewhat less than £80bn”. It stated that in its assessment, “banks have buffers of capital more than sufficient to absorb the losses that are likely to arise under the MPC’s central projection”. The FPC stated that for real stress in the sector, the economic output would need to be twice as bad as the MPC’s projection, with unemployment rising to above 15%.

- **US.** The result of **the November elections** meant that while the Democrats gained the presidency and a majority in the House of Representatives, it looks as if the Republicans could retain their slim majority in the Senate provided they keep hold

of two key seats in Georgia in elections in early January. If those two seats do swing to the Democrats, they will then control both Houses and President Biden will consequently have a free hand to determine policy and to implement his election manifesto.

- **The economy** had been recovering quite strongly from its contraction in 2020 of 10.2% due to the pandemic with GDP only 3.5% below its pre-pandemic level and the unemployment rate dropping below 7%. However, the rise in new cases during quarter 4, to the highest level since mid-August, suggests that the US could be in the early stages of a fourth wave. While the first wave in March and April was concentrated in the Northeast, and the second wave in the South and West, the third wave in the Midwest looks as if it now abating. However, it also looks as if the virus is rising again in the rest of the country. The latest upturn poses a threat that the recovery in the economy could stall. This is **the single biggest downside risk** to the shorter term outlook – a more widespread and severe wave of infections over the winter months, which is compounded by the impact of the regular flu season and, as a consequence, threatens to overwhelm health care facilities. Under those circumstances, states might feel it necessary to return to more draconian lockdowns.



- The restrictions imposed to control the spread of the virus are once again weighing on the economy with employment growth slowing sharply in November and retail sales dropping back. The economy is set for further weakness in December and into the spring. However, a $900bn fiscal stimulus deal passed by Congress in late December will limit the downside through measures which included a second round of direct payments to households worth $600 per person and a three-month extension of enhanced unemployment insurance (including a $300 weekly top-up payment for all claimants). GDP growth is expected to rebound markedly from the second quarter of 2021 onwards as vaccines are rolled out on a widespread basis and restrictions are loosened.

- After Chair Jerome Powell unveiled the **Fed's adoption of a flexible average inflation target** in his Jackson Hole speech in late August 2020, the mid-September meeting of the Fed agreed by a majority to a toned down version of the new inflation target in his speech - that *"it would likely be appropriate to maintain the current target range until labour market conditions were judged to be consistent with the Committee's assessments of maximum employment and inflation had risen to 2% and was on track to moderately exceed 2% for some*

time." This change was aimed to provide more stimulus for economic growth and higher levels of employment and to avoid the danger of getting caught in a deflationary "trap" like Japan. It is to be noted that inflation has actually been under-shooting the 2% target significantly for most of the last decade, (and this year), so financial markets took note that higher levels of inflation are likely to be in the pipeline; long-term bond yields duly rose after the meeting. The FOMC's updated economic and rate projections in mid-September showed that officials expect to leave the fed funds rate at near-zero until at least end-2023 and probably for another year or two beyond that. There is now some expectation that where the Fed has led in changing its inflation target, other major central banks will follow. The increase in tension over the last year between the US and China is likely to lead to a lack of momentum in progressing the initial positive moves to agree a phase one trade deal.

- The Fed's meeting on **5 November** was unremarkable - but at a politically sensitive time around the elections. At its **16 December** meeting the Fed tweaked the guidance for its monthly asset quantitative easing purchases with the new language implying those purchases could continue for longer than previously believed. Nevertheless, with officials still projecting that inflation will only get back to 2.0% in 2023, the vast majority expect the fed funds rate to be still at near-zero until 2024 or later. Furthermore, officials think the balance of risks surrounding that median inflation forecast are firmly skewed to the downside. The key message is still that policy will remain unusually accommodative – with near-zero rates and asset purchases – continuing for several more years. This is likely to result in keeping Treasury yields low – which will also have an influence on gilt yields in this country.

- **EU.** In early December, the figures for Q3 GDP confirmed that the economy staged a rapid rebound from the first lockdowns. This provides grounds for optimism about growth prospects for next year. In Q2, GDP was 15% below its pre-pandemic level. But in Q3 the economy grew by 12.5% q/q leaving GDP down by "only" 4.4%. That was much better than had been expected earlier in the year. However, growth is likely to stagnate during Q4 and in Q1 of 2021, as a second wave of the virus has affected many countries: it is likely to hit hardest those countries more dependent on tourism. The €750bn fiscal support package eventually agreed by the EU after prolonged disagreement between various countries, is unlikely to provide significant support, and quickly enough, to make an appreciable difference in the countries most affected by the first wave.

- With inflation expected to be unlikely to get much above 1% over the next two years, **the ECB** has been struggling to get inflation up to its 2% target. It is currently unlikely that it will cut its central rate even further into negative territory from -0.5%, although the ECB has stated that it retains this as a possible tool to use. The ECB's December meeting added a further €500bn to the PEPP scheme, (purchase of government and other bonds), and extended the duration of the programme to March 2022 and re-investing maturities for an additional year until December 2023. Three additional tranches of TLTRO, (cheap loans to banks), were approved, indicating that support will last beyond the impact of the pandemic, implying indirect yield curve control for government bonds for some time ahead. The Bank's forecast for a return to pre-virus activity levels was pushed back to the end of 2021, but stronger growth is projected in 2022. The total PEPP scheme of €1,850bn of QE which started in March 2020 is providing protection to the sovereign bond yields of weaker countries like Italy. There is therefore unlikely to be a euro crisis while the ECB is able to maintain

this level of support. However, as in the UK and the US, the advent of highly effective vaccines will be a game changer, although growth will struggle before later in quarter 2 of 2021.

- **China.** After a concerted effort to get on top of the virus outbreak in Q1, economic recovery was strong in Q2 and then into Q3 and Q4; this has enabled China to recover all of the contraction in Q1. Policy makers have both quashed the virus and implemented a programme of monetary and fiscal support that has been particularly effective at stimulating short-term growth. At the same time, China's economy has benefited from the shift towards online spending by consumers in developed markets. These factors help to explain its comparative outperformance compared to western economies. However, this was achieved by major central government funding of yet more infrastructure spending. After years of growth having been focused on this same area, any further spending in this area is likely to lead to increasingly weaker economic returns in the longer term. This could, therefore, lead to a further misallocation of resources which will weigh on growth in future years.

- **Japan.** A third round of fiscal stimulus in early December took total fresh fiscal spending this year in response to the virus close to 12% of pre-virus GDP. That's huge by past standards, and one of the largest national fiscal responses. The budget deficit is now likely to reach 16% of GDP this year. Coupled with Japan's relative success in containing the virus without draconian measures so far, and the likelihood of effective vaccines being available in the coming months, the government's latest fiscal effort should help ensure a strong recovery and to get back to pre-virus levels by Q3 2021 – around the same time as the US and much sooner than the Eurozone.

- **World growth.** World growth will have been in recession in 2020. Inflation is unlikely to be a problem for some years due to the creation of excess production capacity and depressed demand caused by the coronavirus crisis.

- Until recent years, world growth has been boosted by increasing **globalisation** i.e. countries specialising in producing goods and commodities in which they have an economic advantage and which they then trade with the rest of the world. This has boosted worldwide productivity and growth, and, by lowering costs, has also depressed inflation. However, the rise of China as an economic superpower over the last thirty years, which now accounts for nearly 20% of total world GDP, has unbalanced the world economy. The Chinese government has targeted achieving major world positions in specific key sectors and products, especially high tech areas and production of rare earth minerals used in high tech products. It is achieving this by massive financial support, (i.e. subsidies), to state owned firms, government directions to other firms, technology theft, restrictions on market access by foreign firms and informal targets for the domestic market share of Chinese producers in the selected sectors. This is regarded as being unfair competition that is putting western firms at an unfair disadvantage or even putting some out of business. It is also regarded with suspicion on the political front as China is an authoritarian country that is not averse to using economic and military power for political advantage. The current trade war between the US and China therefore needs to be seen against that backdrop. It is, therefore, 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. This is likely to produce a backdrop in the coming years of weak global growth and so weak inflation.

Summary

Central banks are, therefore, likely to support growth by maintaining loose monetary policy through keeping rates very low for longer. Governments could also help a quicker recovery by providing more fiscal support for their economies at a time when total debt is affordable due to the very low rates of interest. They will also need to avoid significant increases in taxation or austerity measures that depress demand in their economies.

If there is a huge surge in investor confidence as a result of successful vaccines which leads to a major switch out of government bonds into equities, which, in turn, causes government debt yields to rise, then there will be pressure on central banks to actively manage debt yields by further QE purchases of government debt; this would help to suppress the rise in debt yields and so keep the total interest bill on greatly expanded government debt portfolios within manageable parameters. It is also the main alternative to a programme of austerity.

INTEREST RATE FORECASTS

Brexit. The interest rate forecasts provided by Link in paragraph 3.3 were predicated on an assumption of a reasonable agreement being reached on trade negotiations between the UK and the EU by 31.12.20. There is therefore no need to revise these forecasts now that a trade deal has been agreed. Brexit may reduce the economy's potential growth rate in the long run. However, much of that drag is now likely to be offset by an acceleration of productivity growth triggered by the digital revolution brought about by the COVID crisis.

The balance of risks to the UK

- The overall balance of risks to economic growth in the UK is probably now skewed to the upside, but is still subject to some uncertainty due to the virus and the effect of any mutations, and how quick vaccines are in enabling a relaxation of restrictions.
- There is relatively little UK domestic risk of increases or decreases in Bank Rate and significant changes in shorter term PWLB rates. The Bank of England has effectively ruled out the use of negative interest rates in the near term and increases in Bank Rate are likely to be some years away given the underlying economic expectations. However, it is always possible that safe haven flows, due to unexpected domestic developments and those in other major economies, could impact gilt yields, (and so PWLB rates), in the UK.

Downside risks to current forecasts for UK gilt yields and PWLB rates currently include:

- **UK government** takes too much action too quickly to raise taxation or introduce austerity measures that depress demand in the economy.
- **UK - Bank of England** takes action too quickly, or too far, over the next three years to raise Bank Rate and causes UK economic growth, and increases in inflation, to be weaker than we currently anticipate.
- A resurgence of the **Eurozone sovereign debt crisis.** The ECB has taken monetary policy action to support the bonds of EU states, with the positive impact most likely for "weaker" countries. In addition, the EU agreed a €750bn fiscal support package. These actions will help shield weaker economic regions for the

next two or three years. However, in the case of Italy, the cost of the virus crisis has added to its already huge debt mountain and its slow economic growth will leave it vulnerable to markets returning to taking the view that its level of debt is unsupportable. There remains a sharp divide between northern EU countries favouring low debt to GDP and annual balanced budgets and southern countries who want to see jointly issued Eurobonds to finance economic recovery. This divide could undermine the unity of the EU in time to come.

- Weak capitalisation of some **European banks**, which could be undermined further depending on extent of credit losses resultant of the pandemic.
- **German minority government & general election in 2021.** In the German general election of September 2017, Angela Merkel's CDU party was left in a vulnerable minority position dependent on the fractious support of the SPD party, as a result of the rise in popularity of the anti-immigration AfD party. The CDU has done badly in subsequent state elections but the SPD has done particularly badly. Angela Merkel has stepped down from being the CDU party leader but she will remain as Chancellor until the general election in 2021. This then leaves a major question mark over who will be the major guiding hand and driver of EU unity when she steps down.
- **Other minority EU governments.** Austria, Sweden, Spain, Portugal, Netherlands, Ireland and Belgium also have vulnerable minority governments dependent on coalitions which could prove fragile.
- **Austria, the Czech Republic, Poland and Hungary** now form a strongly anti-immigration bloc within the EU, and they had threatened to derail the 7 year EU budget until a compromise was thrashed out in late 2020. There has also been a rise in anti-immigration sentiment in Germany and France.
- **Geopolitical risks,** for example in China, Iran or North Korea, but also in Europe and other Middle Eastern countries, which could lead to increasing safe haven flows.

Upside risks to current forecasts for UK gilt yields and PWLB rates

- **UK -** a significant rise in inflationary pressures e.g. caused by a stronger than currently expected recovery in the UK economy after effective vaccines are administered quickly to the UK population, leading to a rapid resumption of normal life and return to full economic activity across all sectors of the economy.
- The **Bank of England is too slow** in its pace and strength of increases in Bank Rate and, therefore, allows inflationary pressures to build up too strongly within the UK economy, which then necessitates a rapid series of increases in Bank Rate to stifle inflation.