

**Treasury Management Outturn 2020/21**

**Cabinet**

**17<sup>th</sup> June 2021**

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## Purpose

The Council is required by regulations issued under the Local Government Act 2003 to produce an annual treasury management review of activities and the actual prudential and treasury indicators for 2020/21. This report meets the requirements of both the CIPFA Code of Practice on Treasury Management, (the Code), and the CIPFA Prudential Code for Capital Finance in Local Authorities, (the Prudential Code). During 2020/21 the minimum reporting requirements were that the full Council should receive the following reports:

- an annual treasury strategy in advance of the year (reported to Council in February 2021)
- a mid-year (minimum) treasury update report (delegated and reported to Cabinet November 2020)
- an annual review following the end of the year describing the activity compared to the strategy (this report):

The regulatory environment places responsibility on members for the review and scrutiny of treasury management policy and activities. This report provides details of the outturn position for treasury activities and highlights compliance with the Council's policies previously approved by members.

Treasury management in the context of this report is defined as:

“The management of the local authority’s 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.” (*CIPFA Code of Practice*).

## Report Summary

During 2020/21, the Council complied with its legislative and regulatory requirements.

The council has an investment portfolio consisting of reserves and cash arising from daily receipts being in excess of payments on a short term basis. Security and liquidity of this cash was prioritised above the requirement to maximise returns.

The financial year 2020/21 was a challenging environment due to the impact of Covid-19 with low or negative investment yields, high volatility in the market place and poor economic growth.

Overall treasury investments have increased and returned positive yield, and debt levels reduced in line with scheduled maturities.

Table 1

| Prudential and treasury indicators      | 31.3.20<br>Actual<br>£m | 2020/21<br>Movement<br>£m | 31.3.21<br>Actual<br>£m |
|---|-------------------------|---------------------------|-------------------------|
| Capital expenditure                     | 109.628                 | 22.900                    | 132.528                 |
|   |                         |                           |                         |
| Capital Financing Requirement (a)       | 289.694                 | - 11.396                  | 278.297                 |
| Gross Borrowing (b)                     | 341.406                 | - 20.000                  | 321.406                 |
| Under / (Over) Borrowed Position (=a-b) | - 51.712                | 8.604 -                   | 43.108                  |
|   |                         |                           |                         |
| <b>Investments</b>                      | <b>353.202</b>          | <b>42.418</b>             | <b>395.620</b>          |

# 1. Treasury Position as at 31st March 2021

The Council's treasury management debt and investment position is managed by the treasury management service in order to ensure adequate liquidity for revenue and capital activities, security for investments and to manage the associated risks that the Council is exposed to. Procedures and controls to achieve these objectives are well established both through member reporting detailed in the summary, and through officer activity detailed in the Council's Treasury Management Practices.

The Council has reduced its debt balance by the forecast £20m during the year, the current debt level is now £321m of external debt.

Investment balances overall have increased during the financial year 2020/21 by £42.4m. Due to the impact of Covid 19 capital expenditure was significantly lower than budgeted spend, therefore the cash balances have increased. However the Council reduced its "over borrowed" position (where Gross Borrowing exceeds the capital financing requirement - CFR) by £8.6m. Total Treasury investments as at 31<sup>st</sup> March 2021 was £396m.

Table 2

| <b>DEBT PORTFOLIO</b>           | 31.3.20 Principal<br>£m | Weighted Average<br>Rate | 31.3.21 Principal<br>£m | Weighted<br>Average Rate |
|---------------------------------|-------------------------|--------------------------|-------------------------|--------------------------|
| Fixed rate funding:             |                         |                          |                         |                          |
| -PWLB                           | 341.406                 | 4.90%                    | 321.406                 | 4.98%                    |
| <b>Total debt</b>               | <b>341.406</b>          | <b>4.90%</b>             | <b>321.406</b>          | <b>4.98%</b>             |
| <b>CFR</b>                      | <b>289.694</b>          |                          | <b>278.297</b>          |                          |
| <b>Over / (under) borrowing</b> | <b>- 51.712</b>         |                          | <b>- 43.109</b>         |                          |
| <b>Total investments</b>        | <b>353.202</b>          |                          | <b>395.620</b>          |                          |
| <b>Net debt</b>                 | <b>11.796</b>           |                          | <b>74.214</b>           |                          |

The Maturity structure of the debt portfolio was as follows:

|                              | 31.3.20<br>£m | 31.3.21<br>£m |
|------------------------------|---------------|---------------|
| Under 12 months              | 20            | 0             |
| 12 months and within 2 years | 0             | 0             |
| 24 months and within 5 years | 0             | 0             |
| 5 years and within 10 years  | 18            | 18            |
| 10 years and within 20 years | 38.7          | 38.7          |
| 20 years and within 30 years | 19            | 19            |
| 30 years and within 40 years | 245.7         | 245.7         |
| <b>Total</b>                 | <b>341.4</b>  | <b>321.4</b>  |

The debt maturity structure includes a concentration of maturities at over 30 years, with very little debt maturing over the next 10 years.

| INVESTMENT PORTFOLIO              | 31.3.20<br>Actual<br>£m | 31.3.20<br>Actual<br>% | 31.3.21<br>Actual<br>£m | 31.3.21<br>Actual<br>% |
|-----------------------------------|-------------------------|------------------------|-------------------------|------------------------|
| <b>Treasury investments</b>       |                         |                        |                         |                        |
| Banks                             | 17.789                  | 5.04%                  | 25.025                  | 6.33%                  |
| Building Societies                | -                       |                        | 50.004                  | 12.64%                 |
| Local authorities                 | 175.223                 | 49.61%                 | 128.157                 | 32.39%                 |
| DMADF (H M Treasury)              | 29.000                  | 8.21%                  | -                       |                        |
| <b>Total managed in house</b>     | <b>222.012</b>          |                        | <b>203.186</b>          |                        |
| Bond funds                        | 32.125                  | 9.10%                  | 33.520                  | 8.47%                  |
| Property funds                    | 10.285                  | 2.91%                  | 10.211                  | 2.58%                  |
| Cash fund managers                | 88.780                  | 25.14%                 | 148.702                 | 37.59%                 |
| <b>Total managed externally</b>   | <b>131.190</b>          |                        | <b>192.433</b>          |                        |
| <b>TOTAL TREASURY INVESTMENTS</b> | <b>353.202</b>          | <b>100%</b>            | <b>395.619</b>          | <b>100%</b>            |

In addition to the cash balances invested in treasury activities set out above the Council also has some cash balances held in other forms, for example in local authority maintained school bank accounts and in office petty cash accounts. These additional cash funds amounted to £21m at 31<sup>st</sup> March 2020 and £24.77m at 31<sup>st</sup> March 2021.

## 2. The Strategy for 2020/21

The last financial year presented a unique challenge for financial markets and departments. The Covid-19 pandemic has caused exceptional hardship for people and businesses across the UK and the economic impact has been far reaching.

The Councils Treasury Management team adopted a flexible approach to the changing circumstances, ensuring the security of public funds, prioritising access to them and, finally, looking to generate yield wherever possible given the first 2 requirements.

Several Treasury Management improvements were made during the year to increase efficiency, accuracy, and strengthen security controls. The team also made changes to facilitate the Councils response to the pandemic, and to ensure it could continue to operate smoothly.

- Holding higher levels of liquid cash at the start of the year, making sure that funds were readily available during the first national lockdown in a time of uncertainty.
- Ensuring funds were available to meet maturing debt requirements (£20m).
- Onboarded a new investment platform, FIS Sungard, for use with money market funds, for efficiency and greater security in daily operations.
- Implemented a new process for payment authorising to improve on an inefficient email-based-process, and speeding up the approval process without compromising controls.
- Appointing new lending brokers for greater access to the Local Authority lending market (Warwickshire County Council acting as lender).
- Opening of 2 new Money Market Fund accounts to reduce and diversify risk in our short term (overnight) fund investments.
- Opening two fixed term deposit accounts to maximise returns on excess cash balances without compromising cash availability.
- Changing the investment mix during the year to reduce the impact of very low variable rates of investing.
- Strategic assessment of general market conditions and the potential for negative interest rates.
- Closed down our investment in money market fund accounts that we considered to be at greatest risk of negative yield.  
Resetting our committee reporting format to be based on best practice guidance and templates from our treasury advisers.

### 3. Borrowing Outturn

The council has borrowing held with the Public Works Loans Board (PWLB) of £321m of principal as at 31st March 2021 with no outstanding interest due at that date. The weighted average interest payable on the loans during 2020/21 was 4.90%. Total interest payable for the year was £16,569,806.25. These rates are relatively high compared to currently available rates because these loans were long-term fixed rate loans taken out some time ago when rates were higher.

#### Repayments

During the year the Council repaid £20,000,000 of external debt in line with the forecast debt maturity. The profile of when remaining debt is due to mature is set out in Appendix 3.

**New borrowing** – no loans were drawn to fund the net unfinanced capital expenditure and naturally maturing debt.

#### Borrowing in advance of need

The Council has not borrowed more than, or in advance of its needs during the year.

#### Rescheduling

No rescheduling was done during the year. Fixed interest rates currently being paid on debt are high compared to rates currently available for new borrowing. However it was not appropriate to refinance this debt due to the early redemption fees put in place by HM Treasury to protect from the loss of income that would result if local authorities did refinance to lower rates. This position will be kept under regular review.

#### Sensitivity Analysis

For the purposes of disclosure on Market Risk a sensitivity analysis has been carried out to show the impact of a change in interest rates of + 1% on the debt portfolio.

The following table shows the results of the sensitivity analysis:

Table 5

| Sensitivity Analysis £ms | Actual Fair Value 31.03.21 | +1% increase in discount rate | Difference |
|--------------------------|----------------------------|-------------------------------|------------|
| Debt (new borrowing)     | 520.55                     | 434.56                        | 85.99      |
| Debt (early repayment)   | 623.07                     | 513.32                        | 109.75     |

The fair value of debt if it was to be repaid early is greater than the value if that new debt was taken out today because the Council's portfolio of loans includes a number of fixed rate loans where the interest rate payable is higher than the rates available for similar loans in the current market. This shows a notional future loss (based on economic conditions at 31 March 2021) arising from a commitment to pay interest to lenders above current market rates, which would only be realised if the debt was repaid early.

## 4. Investment Outturn

**Investment Policy** – the Council's investment policy is governed by MHCLG investment guidance, which has been implemented in the annual Treasury Management strategy approved by the Council in February 2021. This policy sets out the approach for choosing investment counterparties, and is based on credit ratings provided by the three main credit rating agencies, supplemented by additional market data, (such as rating outlooks, credit default swaps, bank share prices etc.).

The investment activity during the year conformed to the approved strategy, and the Council had no liquidity difficulties. During the year the council maintained a position of not making investments primarily for a financial return. All treasury investments are made primarily for security and liquidity of public funds.

### **Investments held by the Council**

- The Council maintained an average balance of £162m of internally managed funds. These comprised of funds in bank accounts, deposit accounts and investments in other local authorities.
- The internally managed funds earned an average rate of return of 0.52%, which exceeds the comparable performance indicator of 1 month LIBID +46bps, 0.41%.

### **Investments held by fund managers**

- The Council uses several external fund managers to invest part of its cash balances, these include money market funds (cash funds), bond funds and property funds. During the year the average investment in externally managed funds was £228m.
- The externally managed funds earned an average rate of return of 0.65%, which exceeds the comparable performance indicator of 1 month LIBID +46bps, 0.41%.

Whilst overall the investments made during the year performed over the current benchmark, the benchmark has dropped because interest rates have dropped and our relative performance has been positive in comparison. However the absolute interest rates experienced were considerably lower than budgeted due to the economic effects of the Covid-19 pandemic. As total investments generated a cash income of £2.030m during the year, which compares to a budget of £3.763m.



|                                 | Average Investments Held | Average Return | Benchmark               |
|---------------------------------|--------------------------|----------------|-------------------------|
| <b>External Fund Manager</b>    | £m                       |                | 1 month LIBID<br>+46bps |
| Bond funds                      | 33.60                    | 2.50%          | 0.41%                   |
| Property funds                  | 9.98                     | 4.50%          | 0.41%                   |
| Cash fund managers              | 184.12                   | 0.11%          | 0.41%                   |
|                                 | 227.70                   | 0.65%          | 0.41%                   |
| <b>Internally Managed Funds</b> |                          |                |                         |
| Banks                           | 11.80                    | 0.18%          | 0.41%                   |
| Building Societies              | 33.30                    | 0.07%          | 0.41%                   |
| Local Authorities               | 117.10                   | 0.64%          | 0.41%                   |
|                                 | 162.20                   | 0.49%          | 0.41%                   |
| <b>Total Investments</b>        | <b>389.90</b>            | <b>0.52%</b>   | <b>0.41%</b>            |

The performance of individual funds (both externally and internally managed) are detailed in the Appendix 2.

#### Costs - Management Fees

- Externally managed funds carry a management fee that is subtracted from gross returns. The external fund return numbers in the table above are net of management fees. With the decreasing interest rates during the year, several fund managers opted to reduce management fees where possible, in order to avoid the net return going to zero or below (known as negative interest).
- Internally managed funds do not present fees in the same way, either county council cash is lent to other institutions (e.g. other local authorities) who pay fees as the borrower or are invested in deposit funds that present net returns rather than gross returns with costs.
- The total management fee costs during the year is shown in the below table.

Table 7

| Management Fees                 | YTD Gross Interest | Manager Fees  | YTD Net     |
|---------------------------------|--------------------|---------------|-------------|
| <b>Internally Managed Funds</b> | 0.831              | -             | 0.831       |
| Bond Funds                      | 0.730              | - 0.124       | 0.606       |
| Property Funds                  | 0.406              | - 0.065       | 0.341       |
| Cash Fund Managers              | 0.397              | - 0.145       | 0.252       |
| <b>Total</b>                    | <b>2.36</b>        | <b>- 0.33</b> | <b>2.03</b> |

#### Deposit Value

- Most of the deposits simply provide a return and the deposit value is static. However, some funds are of a nature where the deposit itself has a value which can rise or fall, presenting an opportunity for higher returns but with higher risk. These are the CCLA Property Fund and Threadneedle Social Bond Fund. The changes in the underlying asset value of these investments are not reflected in investment returns above but

would be realised upon selling. The movements in asset value during 2020/21 are illustrated in Appendix 2.

## 5. Non Treasury Investments

In 2020/21 the Council approved an investment strategy for non-treasury management purposes. During the year small non treasury investments were held in property, business loans, shareholder interest in several companies and 2 wholly owned local authority trading companies.

### 5.1 Property

- As at the 31<sup>st</sup> March 2021 investment property was valued at £4.915m which represents 0.4% of the full asset value in the balance sheet of £1.135bn.
- Capital receipts of £16.4m were generated by sales during the year. Revaluation losses on sales amounted to -£2.3m. Revaluations on remaining properties amounted to +£22k.
- Net rental income of these properties was £50k.

### 5.2 Business Loans

- Loans to the value of £1.5m were in issue to small businesses at the end of the year. These are managed by the Coventry and Warwickshire Reinvestment Trust to whom the Council issues funding via the capital programme,
- Loans to the value of £2.5m were issued by the Coventry and Warwickshire Reinvestment Trust in respect of the Covid Business Interruption Loan Scheme.

### 5.3 Shareholder Interest

- At the 31<sup>st</sup> March the Council held shareholder interest totalling £2.046 in the following companies-
  - University of Warwick Science Park Innovation Centre Ltd (£1.811m) •
  - Coventry and Solihull Waste Disposal Company (£0.035m) •
  - Municipal Bonds Agency (£0.200m) •
  - Eastern Shires Purchasing Organisation (£100) •

### 5.4 Local Authority Trading Companies (LATCs)

- The Council has two wholly owned local authority trading companies, owning the single £1 share in each:
  - Warwickshire Legal Services Ltd
  - Educaterers Ltd
    - Educaterers has a loan facility in place with The Council. As the 31<sup>st</sup> March the loan balance was £1.8m.
    - Interest charged on this loan is 5.85% (base rate + 5.75%). A total of £69,313.10 was invoiced to Educaterers in respect of this loan for the year 2020/21.

## Appendix 1

### Prudential and Treasury Management Indicators

| PRUDENTIAL INDICATORS                            | 2019/20<br>actual<br>£m | 2020/21<br>actual<br>£m | 2021/22<br>estimate<br>£m |
|--|-------------------------|-------------------------|---------------------------|
| Capital Expenditure                              | 109.628                 | 132.528                 | 273.196                   |
| Capital Financing Requirement as at 31 March (a) | 289.694                 | 278.297                 | 398.870                   |
| Gross Debt (b)                                   | 341.406                 | 321.406                 | 321.406                   |
| Under/(Over) Borrowing (=a-b)                    | - 51.712                | - 43.108                | 77.464                    |

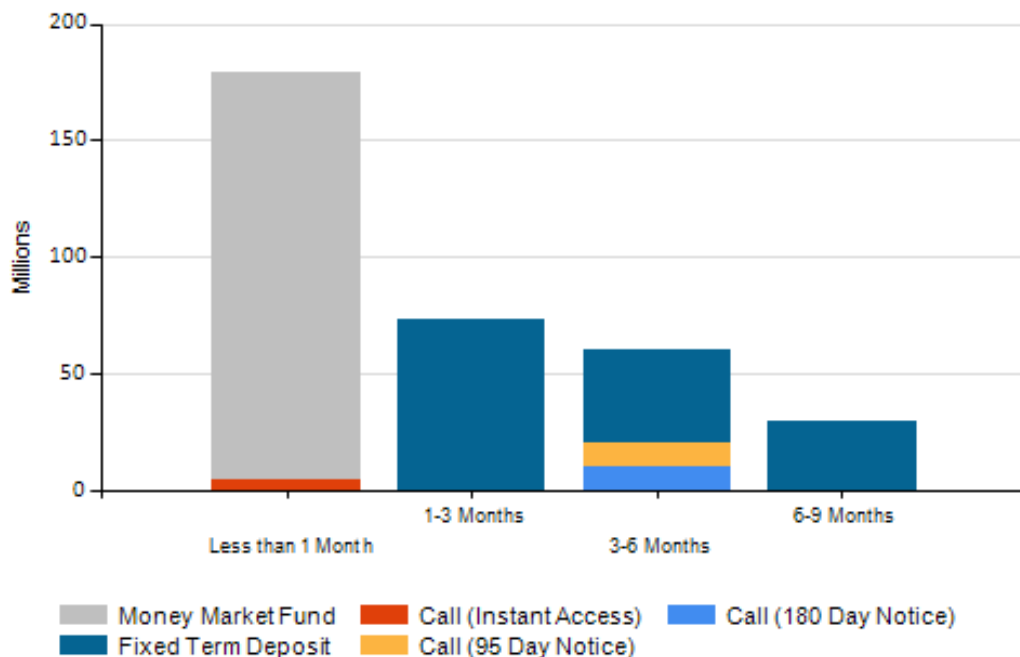
| TREASURY MANAGEMENT INDICATORS         | 2019/20<br>actual<br>£m | 2020/21<br>actual<br>£m | 2021/22<br>estimate<br>£m |
|--|-------------------------|-------------------------|---------------------------|
| Authorised Limit for external debt     | 420.482                 | 420.899                 | 479.000                   |
| Operational Boundary for external debt | 350.405                 | 350.749                 | 398.870                   |
| Actual external debt                   | 341.406                 | 321.406                 | 321.406                   |

| Maturity structure of the debt portfolio | 31.3.20<br>£m | 31.3.21<br>£m |
|--|---------------|---------------|
| Under 12 months                          | 20.00         | 0.00          |
| 12 months and within 2 years             | 0.00          | 0.00          |
| 24 months and within 5 years             | 0.00          | 0.00          |
| 5 years and within 10 years              | 18.00         | 18.00         |
| 10 years and within 20 years             | 38.70         | 38.70         |
| 20 years and within 30 years             | 19.00         | 19.00         |
| 30 years and within 40 years             | 245.70        | 245.70        |
| <b>Total</b>                             | <b>341.40</b> | <b>321.40</b> |

| Maturity structure of investments | 31.3.20<br>£m | 31.3.21<br>£m |
|-----------------------------------|---------------|---------------|
| Longer than 1 year                | -             | -             |
| Up to 1 year                      | 353.20        | 395.62        |
| <b>Total</b>                      | <b>353.20</b> | <b>395.62</b> |

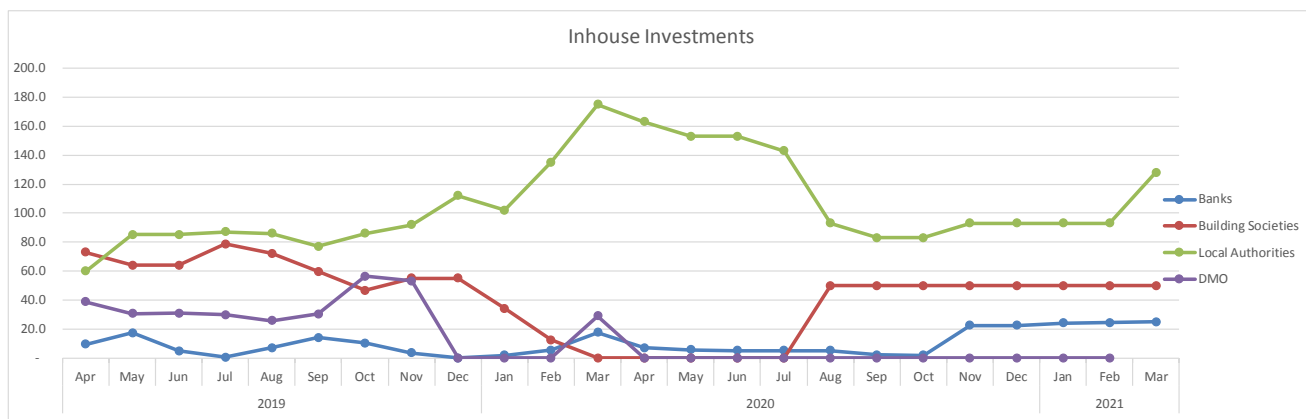
## Appendix 2 - Investment Graphs

### Treasury Investments Portfolio

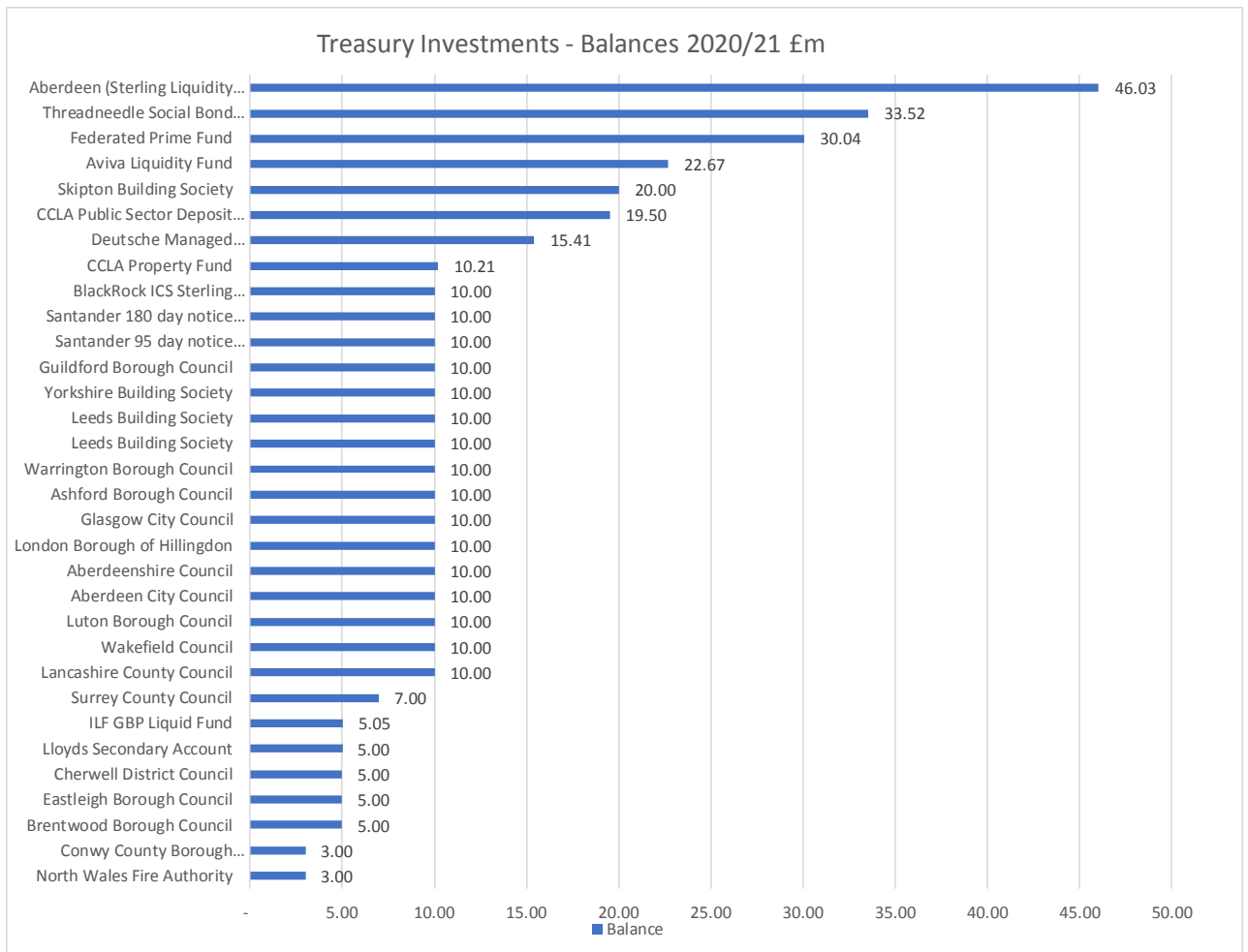


Note: This graph only includes funds that have a fixed term in nature (e.g same day liquidity, notice accounts or fixed investments in other local authorities). It does not include the investments in CCLA Property Fund or Threadneedle Social Bond Fund. These 2 funds are assumed rolling until notice is given by the Council. As at the 31<sup>st</sup> March 2021 the Council has no intention of withdrawing from these funds in the near future.

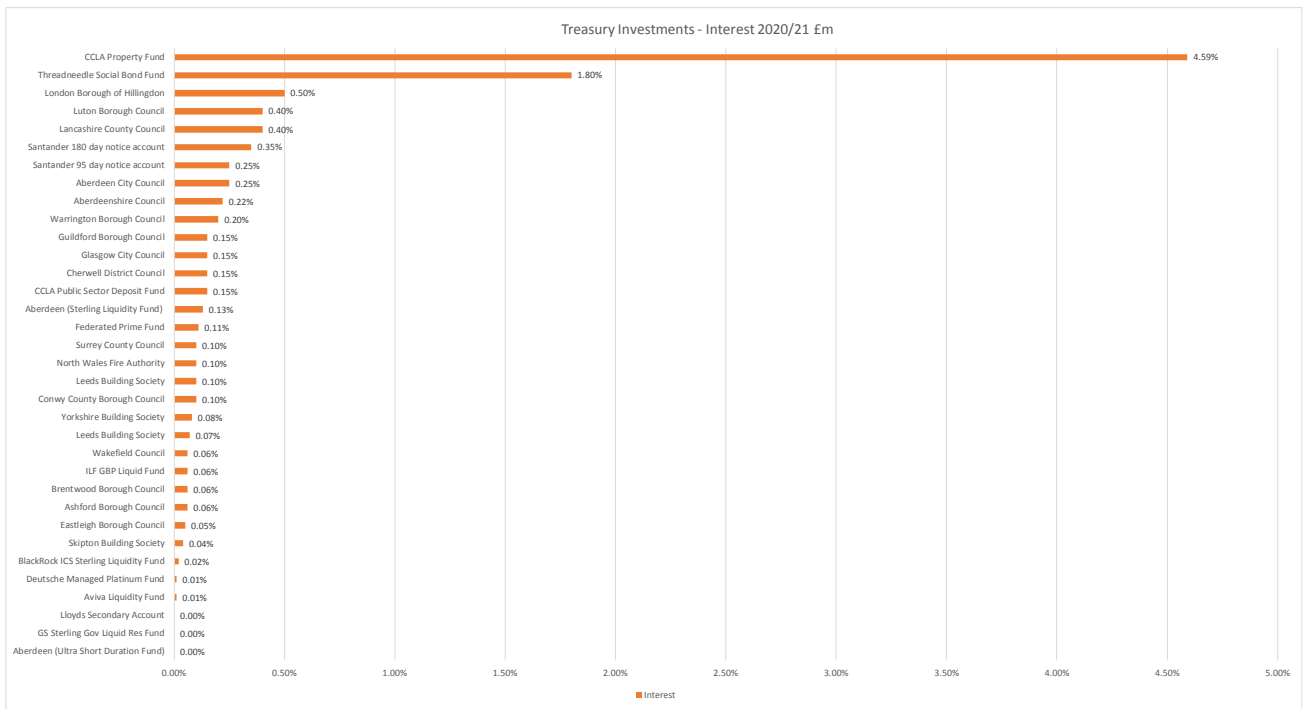
### Average Balance of Internally Managed Investments



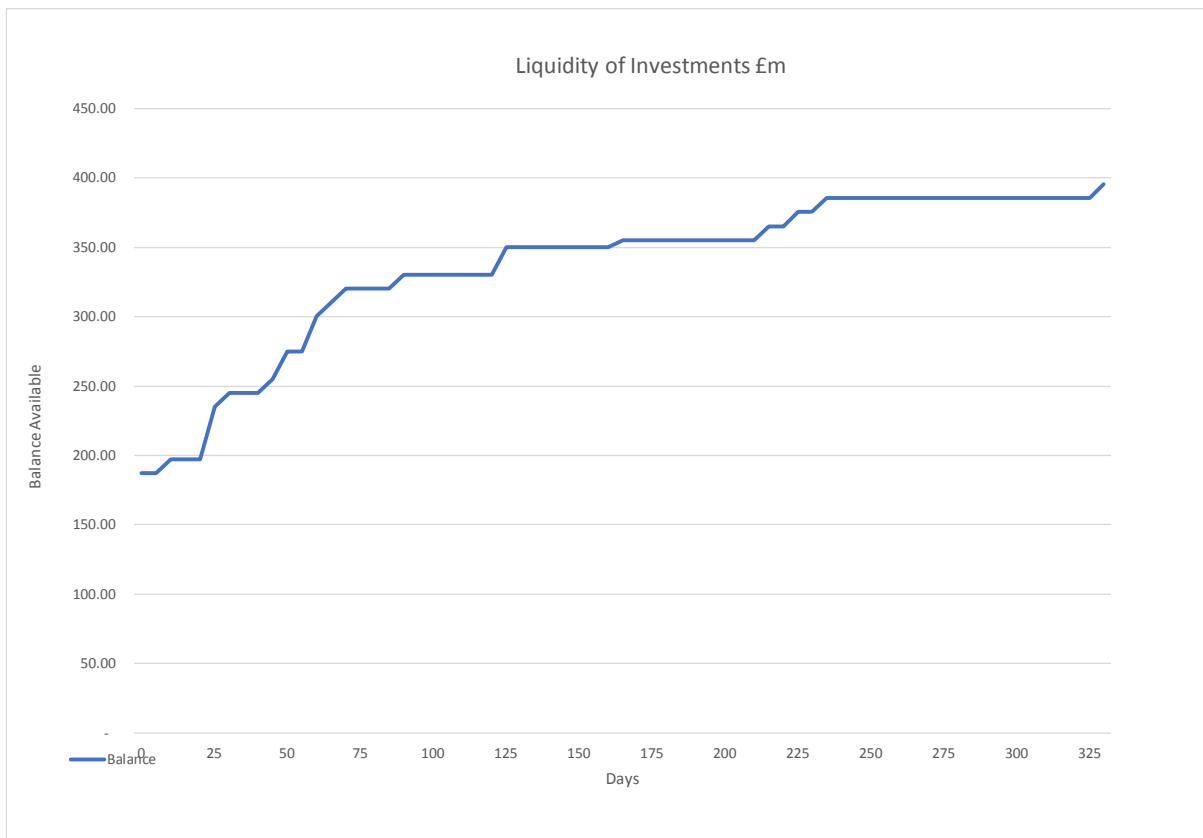
## Individual Investment Balances



## Individual Investment Interest %

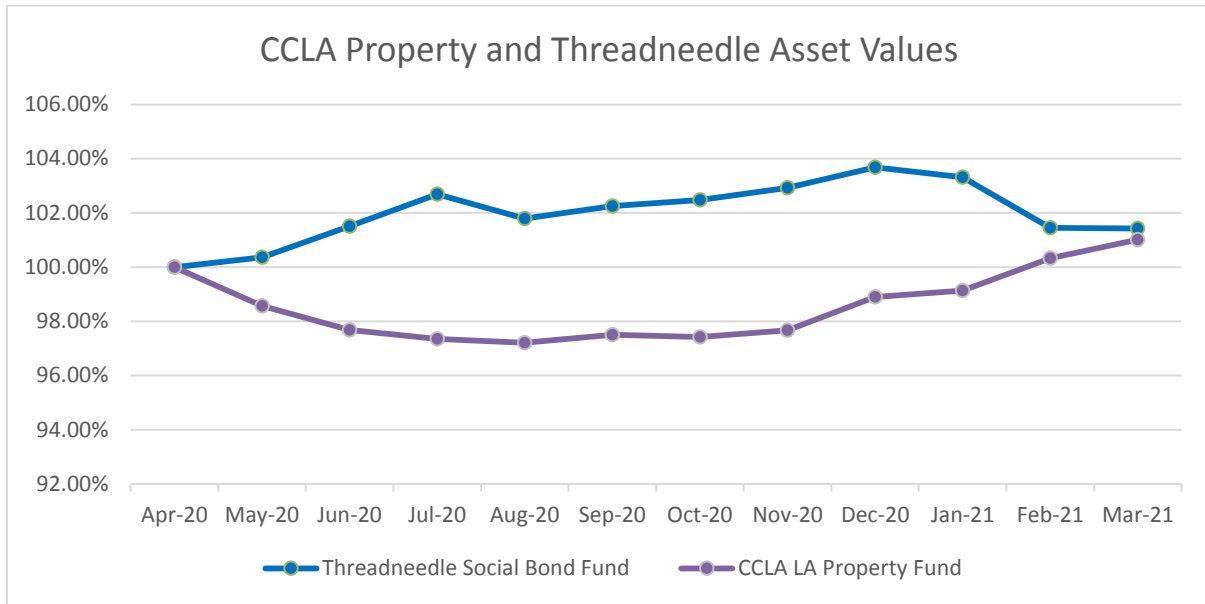


## Liquidity of Investments



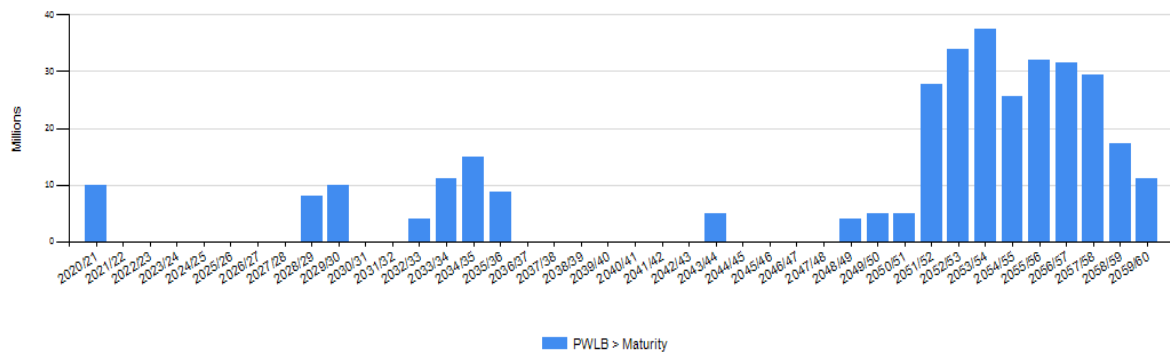
Note: The chart above illustrates liquidity by showing for any given point in the future (in days) how much of the Council's investment balances could be pulled back to instant access cash. The chart climbs over time reflecting the timing of investments returning to the Council upon maturity.

## Asset Values of Property and Bond Funds



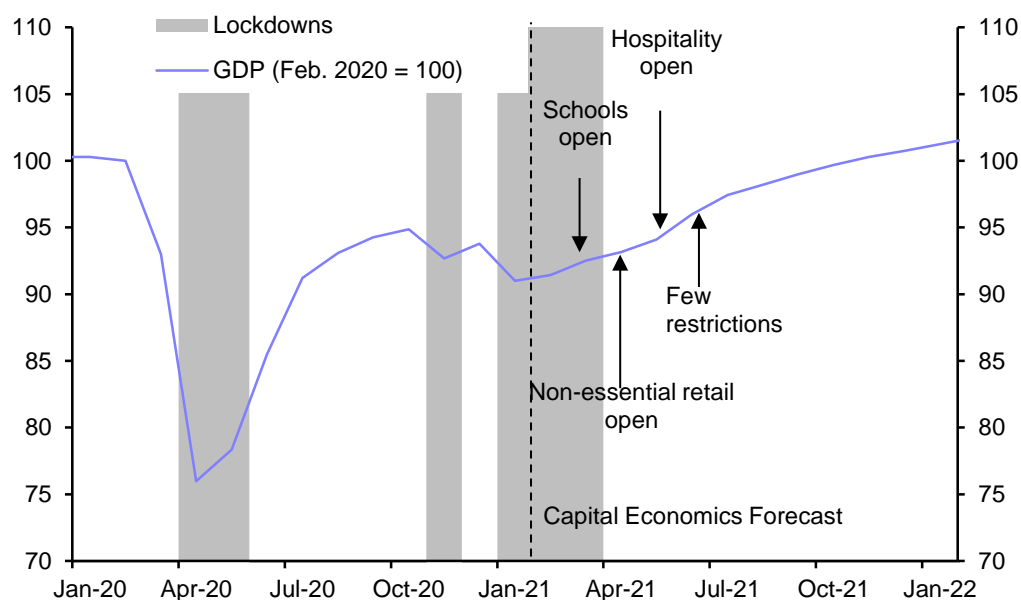
## Appendix 3 – Borrowing Portfolio

### PWLB Maturity Profile



## Appendix 4 – The Economy and Interest Rates

**UK. Coronavirus.** The financial year 2020/21 will go down in history as being the year of the pandemic. The first national lockdown in late March 2020 did huge damage to an economy that was unprepared for such an eventuality. This caused an economic downturn that exceeded the one caused by the financial crisis of 2008/09. A short second lockdown in November did relatively little damage but by the time of the third lockdown in January 2021, businesses and individuals had become more resilient in adapting to working in new ways during a three month lockdown so much less damage than was caused than in the first one. The advent of vaccines starting in November 2020, were a game changer. The way in which the UK and US have led the world in implementing a fast programme of vaccination which promises to lead to a return to something approaching normal life during the second half of 2021, has been instrumental in speeding economic recovery and the reopening of the economy. In addition, the household saving rate has been exceptionally high since the first lockdown in March 2020 and so there is plenty of pent-up demand and purchasing power stored up for services in the still-depressed sectors like restaurants, travel and hotels as soon as they reopen. It is therefore expected that the UK economy could recover its pre-pandemic level of economic activity during quarter 1 of 2022.



Both the Government and the Bank of England took rapid action in March 2020 at the height of the crisis to provide support to financial markets to ensure their proper functioning, and to support the economy and to protect jobs.

The **Monetary Policy Committee** cut Bank Rate from 0.75% to 0.25% and then to 0.10% in March 2020 and embarked on a £200bn programme of quantitative easing QE (purchase of gilts so as to reduce borrowing costs throughout the economy by lowering gilt yields). The MPC increased then QE by £100bn in June and by £150bn in November to a total of £895bn. While Bank Rate remained unchanged for the rest of the year, financial markets were concerned that the MPC could cut Bank Rate to a negative rate; this was firmly discounted at the February 2021 MPC meeting when it was established that commercial banks would be unable to implement negative rates for at least six months – by which time the economy was expected to be making a strong recovery and negative rates would no longer be needed.

**Average inflation targeting.** This was the major change adopted by the Bank of England in terms of implementing its inflation target of 2%. The 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. This sets a high bar for raising Bank Rate and no increase is expected by March 2024, and possibly for as long as five years. Inflation has been well under 2% during 2020/21; it 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 to the MPC.

**Government support.** The Chancellor has implemented repeated rounds of support to businesses by way of cheap loans and other measures, and has protected jobs by paying for workers to be placed on furlough. This support has come at a huge cost in terms of the Government’s budget deficit ballooning in 20/21 and 21/22 so that the Debt to GDP ratio reaches around 100%. The Budget on 3rd March 2021 increased fiscal support to the economy and employment during 2021 and 2022 followed by substantial tax rises in the following three years to help to pay the cost for the pandemic. This will help further to strengthen the economic recovery from the pandemic and to return the government’s finances to a balanced budget on a current expenditure and income basis in 2025/26. This will stop the Debt to GDP ratio rising further from 100%. An area of concern, though, is that the government’s debt is now twice as sensitive to interest rate rises as before the pandemic due to QE operations substituting fixed long-term debt for floating rate debt; there is, therefore, much incentive for the Government to promote Bank Rate staying low e.g. by using fiscal policy in conjunction with the monetary policy action by the Bank of England to keep inflation from rising too high, and / or by amending the Bank’s policy mandate to allow for a higher target for inflation.

**BREXIT.** The final agreement on 24<sup>th</sup> December 2020 eliminated a significant downside risk for the UK economy. The initial agreement only covered 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. There was much disruption to trade in January as form filling has proved to be a formidable barrier to trade. This appears to have eased somewhat since then but is an area that needs further work to ease difficulties, which are still acute in some areas.

**USA.** The US economy did not suffer as much damage as the UK economy due to the pandemic. The Democrats won the presidential election in November 2020 and have control of both Congress and the Senate, although power is more limited in the latter. This enabled the Democrats to pass a \$1.9trn (8.8% of GDP) stimulus package in March on top of the \$900bn fiscal stimulus deal passed by Congress in late December. These, together with the vaccine rollout proceeding swiftly to hit the target of giving a first jab to over half of the population within the President’s first 100 days, will promote a rapid easing of restrictions and strong economic recovery during 2021. The Democrats are also planning to pass a \$2trn fiscal stimulus package aimed at renewing infrastructure over the next decade. Although this package is longer-term, if passed, it would also help economic recovery in the near-term.

After Chair Jerome Powell spoke on 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 a new inflation target - 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. There is now some expectation that where the Fed has led in changing its policy towards implementing its inflation and full employment mandate, other major central banks will follow, as indeed the Bank of England has done so already. The Fed expects strong economic growth during 2021 to have only a transitory impact on inflation, which explains why the majority of Fed officials project US interest rates to remain near-zero through to the end of 2023. 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 at historically low levels. However, financial markets in 2021 have been concerned that the sheer amount of fiscal stimulus, on top of highly accommodative monetary policy, could be over-kill leading to a rapid elimination of spare capacity in the economy and generating higher inflation much quicker than the Fed expects. They have also been concerned as to how and when the Fed will eventually wind down its programme of monthly QE purchases of treasuries. These concerns have pushed treasury yields sharply up in the US in 2021 and is likely to have also exerted some upward pressure on gilt yields in the UK.

**EU.** Both the roll out and take up of vaccines has been disappointingly slow in the EU in 2021, at a time when many countries are experiencing a sharp rise in cases which are threatening to overwhelm hospitals in some major countries; this has led to renewed severe restrictions or lockdowns during March. This will inevitably put back economic recovery after the economy had staged a rapid rebound from the first lockdowns in Q3 of 2020 but contracted slightly in Q4 to end 2020 only 4.9% below its pre-pandemic level. Recovery will now be delayed until Q3 of 2021 and a return to pre-pandemic levels is expected in the second half of 2022.

Inflation was well under 2% during 2020/21. **The ECB** did not cut its main rate of -0.5% further into negative territory during 2020/21. It embarked on a major expansion of its QE operations (PEPP) in March 2020 and added further to that in its December 2020 meeting when it also greatly expanded its programme of providing cheap loans to banks. The total PEPP scheme of €1,850bn 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.

**China.** After a concerted effort to get on top of the virus outbreak in Q1 of 2020, economic recovery was strong in the rest of the year; 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.

**Japan.** Three rounds of government fiscal support in 2020 together with Japan's relative success in containing the virus without draconian measures so far, and the roll out of vaccines gathering momentum in 2021, should help to ensure a strong recovery in 2021 and to get back to pre-virus levels by Q3.

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

**Deglobalisation.** 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 30 years, which now accounts for nearly 20% of total world GDP, has unbalanced the world economy. In March 2021, western democracies implemented limited sanctions against a few officials in charge of government policy on the Uighurs in Xinjiang; this led to a much bigger retaliation by China and is likely to mean that the China / EU investment deal then being negotiated, will be torn up. After the pandemic exposed how frail extended supply lines were around the world, both factors are now likely to lead to a sharp retrenchment of economies into two blocs of western democracies v. autocracies. 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 and vice versa. This is likely to reduce world growth rates.

**Central banks' monetary policy.** During the pandemic, the governments of western countries have provided massive fiscal support to their economies which has resulted in a big increase in total government debt in each country. It is therefore very important that bond yields stay low while debt to GDP ratios slowly subside under the impact of economic growth. This provides governments with a good reason to amend the mandates given to central banks to allow higher average levels of inflation than we have generally seen over the last couple of decades. Both the Fed and Bank of England have already changed their policy towards implementing their existing mandates on inflation, (and full employment), to hitting an average level of inflation. Greater emphasis could also be placed on hitting subsidiary targets e.g. full employment before raising rates. Higher average rates of inflation would also help to erode the real value of government debt more quickly.