Warwickshire County Council

Treasury Management Outturn 2021/22

Cabinet
16th June 2022

Contents

1.0 Purpose

1.1 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 2021/22. 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).

1.2 During 2021/22 the minimum reporting requirements were that the full Council should receive the following reports:

- an annual treasury strategy in advance of the year (Council February 2022)
- a mid-year treasury update report (delegated and reported to Cabinet November 2021)
- an annual review following the end of the year describing the activity compared to the strategy, (this report)

1.3 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 as previously approved by members.

1.4 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).

2.0 Report Summary

2.1 During 2021/22, the Council complied with its legislative and regulatory requirements in respect of Treasury Management.

2.2 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, liquidity and yield were prioritised in this order in the management of this portfolio.

2.3 The financial year 2021/22 continued the challenging investment environment of the previous year, namely low investment returns, poor economic growth, and high volatility.

2.4 Overall treasury investments have increased and returned a positive yield, although short of budgeted interest income by £1.13m. Debt levels have remained the same in line with the Council's borrowing strategy.

3.0 Treasury Position as at 31 March 2022

3.1 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.

3.2 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.

3.3 The Council did not take out any new borrowings during the year 2021/22, as forecast, and the level of external debt remains at £321m.

3.4 Investment balances overall have increased during the financial year 2021/22 by £63m. Continued impact of the Covid 19 pandemic has reduced or delayed the capital expenditure plans during the year, therefore cash has not been utilised as expected.

3.5 Total Treasury investments as at 31st March 2022 were £458.62m.

3.6 The tables below show the prudential and treasury indicators, debt portfolio and maturity structure, and the investment portfolio for 2021/22.

Prudential and Treasury Indicators

Prudential and treasury indicators	31.3.21 Actual	2021/22 Movement	31.3.22 Actual
Capital expenditure	99.97	7.61	107.57
Capital Financing Requirement	278.30	- 10.94	267.36
Gross Borrowing	321.42	-	321.42
Investments	395.62	63.00	458.62
Under / (Over) Borrowed Position	- 43.12	- 10.94	- 54.06

Debt Portfolio

DEBT PORTFOLIO	31.3.20 Principal	Weighted Average Rate	31.3.21 Principal	Weighted Average Rate
Fixed rate funding:				
Public Works Loan Board	321.42	4.98%	321.42	4.98%
Total debt	**321.42**	**4.98%**	**321.42**	**4.98%**
Capital Financing Requirement	**278.30**		**267.36**	
Over / (under) borrowing	**- 43.12**		**- 54.06**	
Total investments	**395.62**		**458.62**	
Net debt	**74.20**		**137.20**	

Maturity structure of the debt portfolio was as follows:

	31.3.21 £m	31.3.22 £m
Under 12 months	0	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
Total	**321.4**	**321.4**

Investment Portfolio

INVESTMENT PORTFOLIO £m	31.3.21 Actual 0	31.3.21 Actual %	31.3.22 Actual 0	31.3.22 Actual %
Treasury investments				
Banks	25.03	6.33%	28.60	6.24%
Building Societies	50.00	12.64%	80.10	17.47%
Local authorities	128.16	32.39%	180.09	39.27%
Total managed in house	**203.19**	**51.36%**	**288.79**	**62.97%**
Bond funds	33.52	8.47%	31.87	6.95%
Property funds	10.21	2.58%	12.00	2.62%
Cash fund managers	148.70	37.59%	125.95	27.46%
Total managed externally	**192.43**	**48.64%**	**169.83**	**37.03%**
TOTAL TREASURY INVESTMENTS	**395.62**	**100%**	**458.62**	**100%**

3.7 In addition to the cash balances invested in treasury activities set out above the Council also has 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 £24.77m at 31 March 2021 and £27.2m at 31 March 2022.

4.0 The Strategy for 2021/22

4.1 The impact of the Covid-19 pandemic has challenged the financial markets for a further year. Treasury Management related investment returns, and interest rates remained low, and economic activity continued to be volatile. At the start of the pandemic the approach taken by the Treasury Management team was “flexibility”, allowing for scope to adapt to the volatile and uncertain environment. This took the shape of reducing risk to public funds and maximising liquidity (the ability to access cash quickly).

4.2 As Covid risks have improved during the financial year 2021/22 the level of liquidity has been reassessed. This has allowed the treasury management team to put more emphasis on longer durations investment commitments, which has enabled more investment options to be accessed, enabling the investment portfolio to be adapted to provide better returns where possible. The need to retain a sensible level of liquidity, sustained low interest rates until more recently and market volatility have still generally meant returns are lower than targeted.

4.3 The Treasury team also facilitated the launch of the Council's two new non-treasury investments in Summer 2021, Warwickshire Property and Development Group Limited (WPDG), and the Warwickshire Recovery Investment Fund (WRIF).

4.4 The team continues to improve on Treasury practices and procedures, strengthening controls, efficiency, and accuracy. An audit conducted in July 2021 found a significant improvement from "moderate" to "substantial" assurance in the operation of controls, and in the adequacy of the control framework compared to the previous audit in December 2018.

4.5 Key accomplishments during the year include:

- Lowering the levels of cash held in liquid funds and increasing the levels in longer dated investments, therefore returning more yield whilst maintaining necessary levels of liquidity and without compromising security. These were all completed within the sector limits set out in in Treasury Management Strategy for 21/22.
- Expanding the Council's lending to other local authorities to a maximum 18 month agreement term, using both spot (agreed on the day) and forward (agreed up to 6 months in advance) dates. This has made the Council a more flexible and attractive lender in the marketplace.
- Continued to mitigate the risk of negative yield by monitoring and moving short term investments where necessary.
- Trial running a Treasury Management System "Treasury Live" ahead of purchasing the product in April 2022. This system will enable improvements in the operation of treasury activities.
- Starting the migration process of all Treasury Data from shared drives to SharePoint. This increases security and efficiency in daily operations.
- Supporting the launch of the WRIF and WPDG investments and provided investment guidance and analysis in the early stages of these projects.
- Recruiting capacity to manage the growth in non-treasury investments.

5.0 Borrowing Outturn

5.1 The council has borrowing held with the Public Works Loans Board (PWLB) of £321m of principal as at 31 March 2022 with no outstanding interest due at that date.

Repayments

5.2 As per the schedule, no loan repayments were made during the year 2021/22. The profile of when remaining debt is due to mature is set out in Annex 3.

New borrowing

5.3 No new loans were drawn to fund the net unfinanced capital expenditure and naturally maturing debt.

Borrowing in Advance of Need

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

Rescheduling

5.5 No debt rescheduling was done during the year. Fixed interest rates currently being paid on debt are higher 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 Central Government from the loss of income that would result if local authorities did refinance to lower rates. This position is being kept under regular review though.

Sensitivity Analysis

5.6 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.

5.7 The following table shows the results of the sensitivity analysis:

Sensitivity Analysis £ms	Actual Fair Value 31.03.22	+1% increase in discount rate	Difference
Debt (new borrowing)	477.02	401.92	75.11
Debt (early repayment)	565.80	470.78	95.02

5.8 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 2022) arising from a commitment to pay interest to lenders above current market rates, which would only be realised if the debt was repaid early.

6.0 Treasury Investment Outturn

Treasury Investment Policy

6.1 The Council's treasury investment policy is governed by DLUHC investment guidance, which has been implemented in the annual Treasury Management strategy approved by the Council in February 2022. 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.).

6.2 Treasury 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. In terms of performance:

Investments held by the Council

- The Council maintained an average balance of £237m of internally managed funds. These comprised of funds in bank accounts, deposit accounts and loans to other local authorities. The average weighted term these funds were invested for was 195 days.
- The internally managed funds earned an average rate of return of 0.15%, which exceeds the 30 day LIBID rate of 0.05%, and comparable performance indicator of SONIA 180 day compounded rate at 0.14%.

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 £207.4m, the average weighted term these funds were invested for was 9 days (the majority of these being overnight funds).
- The externally managed funds earned an average rate of return of 0.45%, which exceeds the 30 day LIBID of 0.05%, and exceeds the comparable performance indicator (based on weighted average investment duration) of SONIA 7 day compounded rate at 0.13%.

6.3 Overall, the investments made during the year returned 0.29%. The original target interest for the year 2021/22 was 30 day LIBID + 46bps, agreed at Council in February 2021. This measure equates to 0.51% at 31 March 2022. Whilst the investment returns did not exceed this, they did exceed the 30 day LIBID of 0.05%, and also the equivalent SONIA rate for the weighted average term of 0.14%. SONIA will replace LIBID in future treasury strategies.

6.4 The total investments, including non treasury investments (£180k), achieved a cash income of £1.47m during the year, which compares to a budget of £2.23m. The short fall in this return is covered by the interest rate volatility reserve.

6.5 ***Treasury Investment Portfolio***

Treasury investments are split between internal and externally managed funds. This is to diversify the risk of the portfolio, meet the liquidity needs of the council and finally, maximise the return available.

- Cash fund managers make up 27.5% of treasury investments, and these are short dated, overnight investments. The funds used have high credit ratings to maximise security of the Councils investment. This makes sure that at any given time, the Council has access to same day cash. By placing these funds overnight, it generates the most yield for the shorted period possible, however this yield is typically low.
- Investments in other local authorities, banks and building societies make up 63% of treasury investments. These are low risk investments, set in advance with fixed terms and interest rates. Typically, the yield on these investments follows the market interest levels.
- Bond and Property funds are higher risk in nature but often yield higher return and a small investment in each are held by the Council.

- During the year 21/22, the balance between in house and externally managed funds changed in line with the decreased need to hold high levels of liquid investments. The shift from liquid (overnight) investments to fixed term investments can be seen in the graphs 4 and 5 in Annex 2.

	Average Investments Held	Average Return	Benchmark	Benchmark	Target
External Fund Manager	£m		LIBID 30 day	SONIA Comparative*	30 Day LIBID +46bps
Bond funds	33.30	**1.42%**	0.05%	0.13%	0.51%
Property funds	10.90	**3.63%**	0.05%	0.13%	0.51%
Cash fund managers	163.20	**0.04%**	0.05%	0.13%	0.51%
	207.40	**0.45%**	0.05%	0.13%	0.51%
Internally Managed Funds					
Banks	27.00	**0.28%**	0.05%	0.14%	0.51%
Building Societies	73.20	**0.19%**	0.05%	0.14%	0.51%
Local Authorities	136.50	**0.11%**	0.05%	0.14%	0.51%
	236.70	**0.15%**	0.05%	0.14%	0.51%
Average Total Investments	**444.10**	**0.29%**	**0.05%**	**0.14%**	**0.51%**

***The comparative benchmarks are based on weighted average total duration of the investment, using SONIA rates.**

6.6 The performance of individual funds (both externally and internally managed) is detailed in the Annex 2.

Management Fees Costs

6.7 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.

6.8 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.

6.9 The total management fee costs during the year are shown in the below table:

Management Fees £m	YTD Gross Interest	Manager Fees	YTD Net
Internally Managed Funds	0.363	-	0.363
Bond Funds	0.581	0.107	0.474
Property Funds	0.456	0.071	0.385
Cash Fund Managers	0.216	0.151	0.065
Total	1.616	0.329	1.287

Deposit Value

6.10 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 2021/22 are illustrated in Annex 2.

7.0 Non-Treasury Investments

7.1 During the year 2021/22 the Warwickshire Recovery Investment Fund and Warwickshire Property Development Group investments were launched and are reported on below.

7.2 Several smaller non-treasury investments are also held in property, business loans, shareholder interest in several companies and 2 additional wholly owned local authority trading companies.

7.3 Interest earned on Non-Treasury Investments totalled £180k for the year 2021/22.

Warwickshire Recovery and Investment Fund (WRIF)

7.4 The WRIF was launched in Summer 2021 and is a 5-year fund. The total fund of £140m is divided into 3 pillars, each focused on a specific area of the economy the WRIF is aiming to help.

	Max. Investment Over 5yr Period
Business Investment Growth Fund (BIG)	£90m
Property and Infrastructure Fund (PIF)	£40m
Local Communities Enterprise Fund (LCE)	£10m
Total	£140m

Business Investment and Growth Fund

7.5 The first loan from the WRIF Business Investment Growth (BIG) pillar was approved by Cabinet in January 2022 to Forge Care Limited:

- Loan approved for £1m to Forge Care Limited, for the development and opening of residential children’s homes in Warwickshire, the first of which is based in Nuneaton.
- This loan has been split into 2 parts, the first tranche has been issued to the subsidiary “The Forge (Nuneaton) Ltd” on the 16 March 2022, for £400k.
- This loan carries interest and has a 5-year term.

7.6 Several other business cases are also in “Stage 1” of the WRIF process and having preliminary discussions ahead of a formal document being brought to the investment panel.

Local Communities Enterprise Fund

7.7 This fund is managed externally and the award for the contract was given to Coventry and Warwickshire Reinvestment Trust. The fund was launched in April 2022.

Property and Infrastructure Fund

7.8 This fund is due to be launched in Q1 of 2022.

Investment Panel and Governance

7.9 A monthly Investment Panel meeting was established in September 2021. Standing items on the agenda include an update on pipeline and due diligence processes as well as a risk register. Items such as training plans, communication and marketing plans, performance monitoring and business case documents are brought on an ad hoc basis. Due diligence reports are brought to interim panels for full discussion.

7.10 A Member Oversight Group (MOG) also meets quarterly to discuss the governance of both the WRIF and WPDG.

Warwickshire Property Development Group (WPDG)

WPDG Business Plan 2022

7.11 The 2022 business plan for WPDG was approved by Cabinet in January 2022. This included detailed arrangements for the governance of the company and potential investments in the pipeline for the coming years.

7.12 The first site business case was developed and approved in February 2022 for the development of medium sized business units a site in Southam, Warwickshire. At 31st March 2022 the agreements for this development loan were being drafted, with the loan expected to begin in June 2022. Due to WPDG focusing on establishing itself in 2021/22, there was no other development site activity.

Working Capital Facility

7.13 In place at the end of March 2022 was a working capital loan to WPDG amounting to £200,000. This was utilised from a total facility of £404,000 available for 2021/22. The interest charged on this facility is 3.44% above UK 3-year GILT rate (calculated daily), with a non-utilisation fee of 0.50% over the same UK GILT rate. As at 31 March 2022 a total interest amount of £4,800 was generated in relation to this working capital loan.

7.14 The Council holds shareholder interest of £100 (100%) in WPDG.

Other Property

7.15 The Council holds investment property for rental purposes, capital value appreciation or both. These properties are not used for the delivery of services.

- As at the 31 March 2022 investment property was valued at £5.688 million which represents 0.4% of the full asset value in the balance sheet of £1.340 billion.
- Net rental income of these properties was £0.050m.

Business Loans

7.16 The Council provides finance to local businesses through various funds or schemes, for example the “Duplex Investment Fund” or “Coronavirus Business Interruption Loan Scheme (CBILS)”.

- Loans to the value of £0.2m 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 £2.2m are in issue by the Coventry and Warwickshire Reinvestment Trust in respect of CBILS.
- Interest of £42k was received in respect of these loans during 21/22.

Local Authority Trading Companies (LATCs)

7.17 In addition to WPDG, the Council has two additional wholly owned local authority trading companies, owning a single £1 share in each:

- Warwickshire Legal Services Ltd
- Educaterers Ltd - a loan facility is in place with The Council. As at the 31 March 2022 the loan balance was £1.6m. Interest charged on this loan is 5.85% (base rate + 5.75%). A total of £134k was invoiced to Educaterers in respect of interest on this loan in the year 2021/22.

Shareholder Interest

7.18 At the 31 March the Council held shareholder interest totalling £2.075m in the following companies:

- University of Warwick Science Park Innovation Centre Ltd (£1.841m). Dividends of £75k were received in 21/22 from this company.
- Coventry and Solihull Waste Disposal Company (£35k)
- Local Capital Finance Company Ltd (£200k)
- Eastern Shires Purchasing Organisation (£100). Dividends of £1.072m were received in 21/22 from this company.
- SCAPE (£75k)

Annexes

Annex: 1 Prudential and Treasury Indicators
Table 1 Prudential Indicators
Table 2 Treasury Management Indicators
Table 3 Maturity Structure of Debt Portfolio

Annex 2: Treasury Investment Portfolio
Graph 1 Investment Balances
Graph 2 Investment Average Interest
Graph 3 Liquidity of Investments
Graph 4 In House Funds during year
Graph 5 Externally Managed Funds during year
Graph 6 CCLA and Threadneedle Asset Values

Annex 3: Debt Portfolio
Graph 7 Debt Maturity Profile

Annex 4: The Economy and Interest Rates commentary provided by the Councils Treasury Advisors.

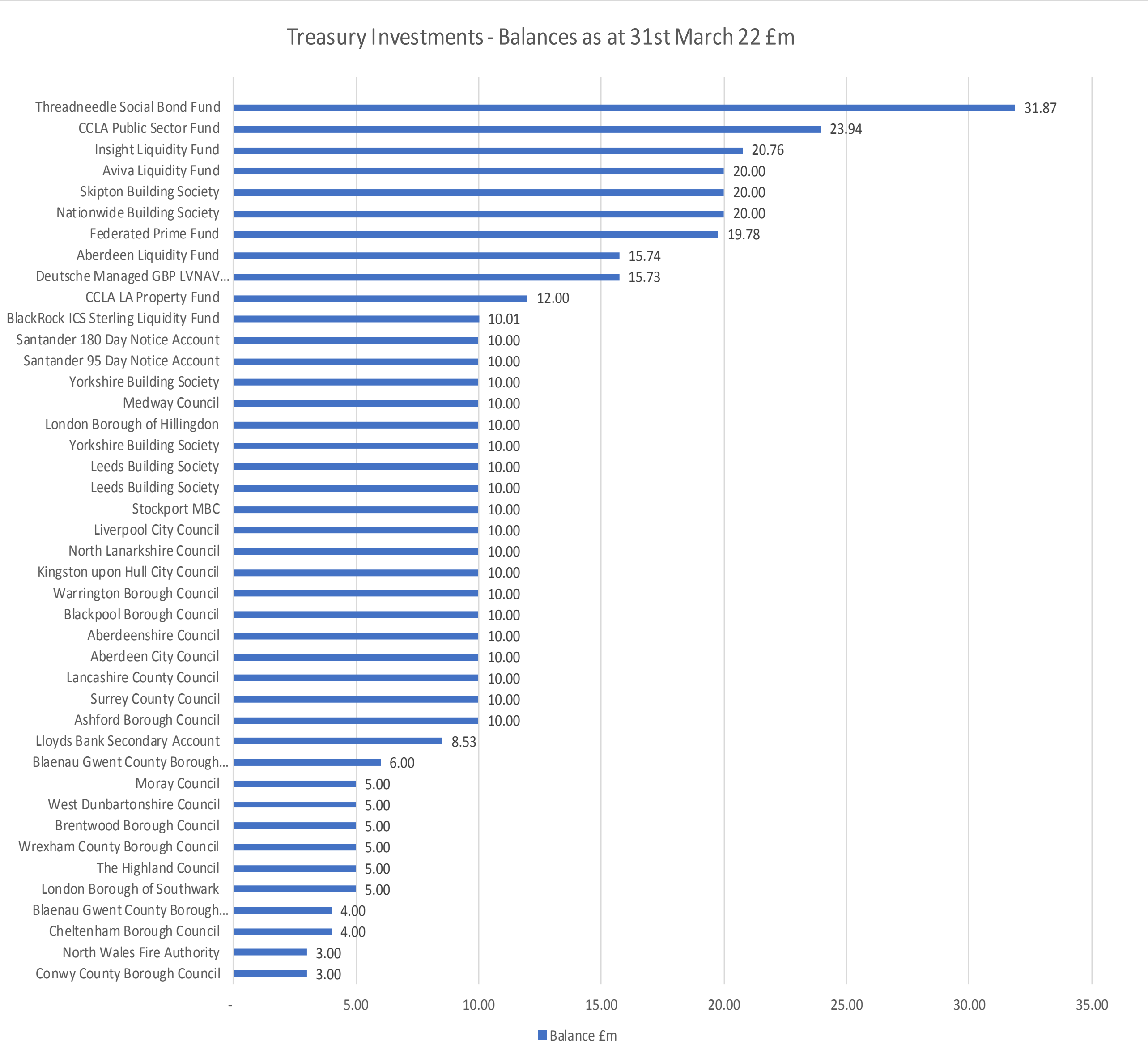
Annex 1: Prudential and Treasury Indicators

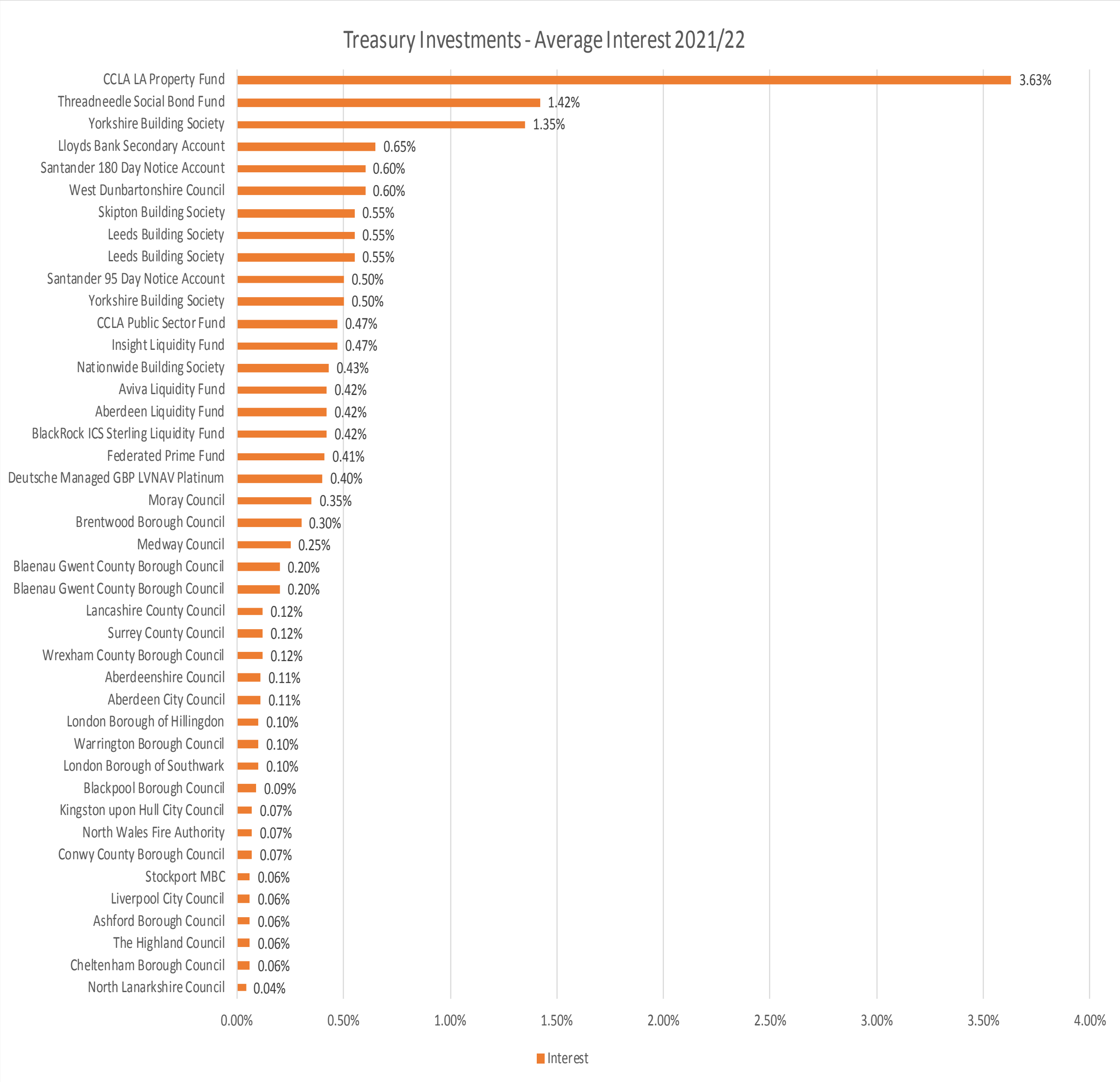
PRUDENTIAL INDICATORS	2020/21 actual 132.53	2021/22 actual £m	2022/23 estimate £m
Capital Expenditure	132.528	107.574	324.644
Capital Financing Requirement as at 31 March (a)	278.297	267.357	324.644
Gross Debt (b)	321.420	321.420	321.420
Under/(Over) Borrowing (=a-b)	- 43.123	- 54.064	3.224

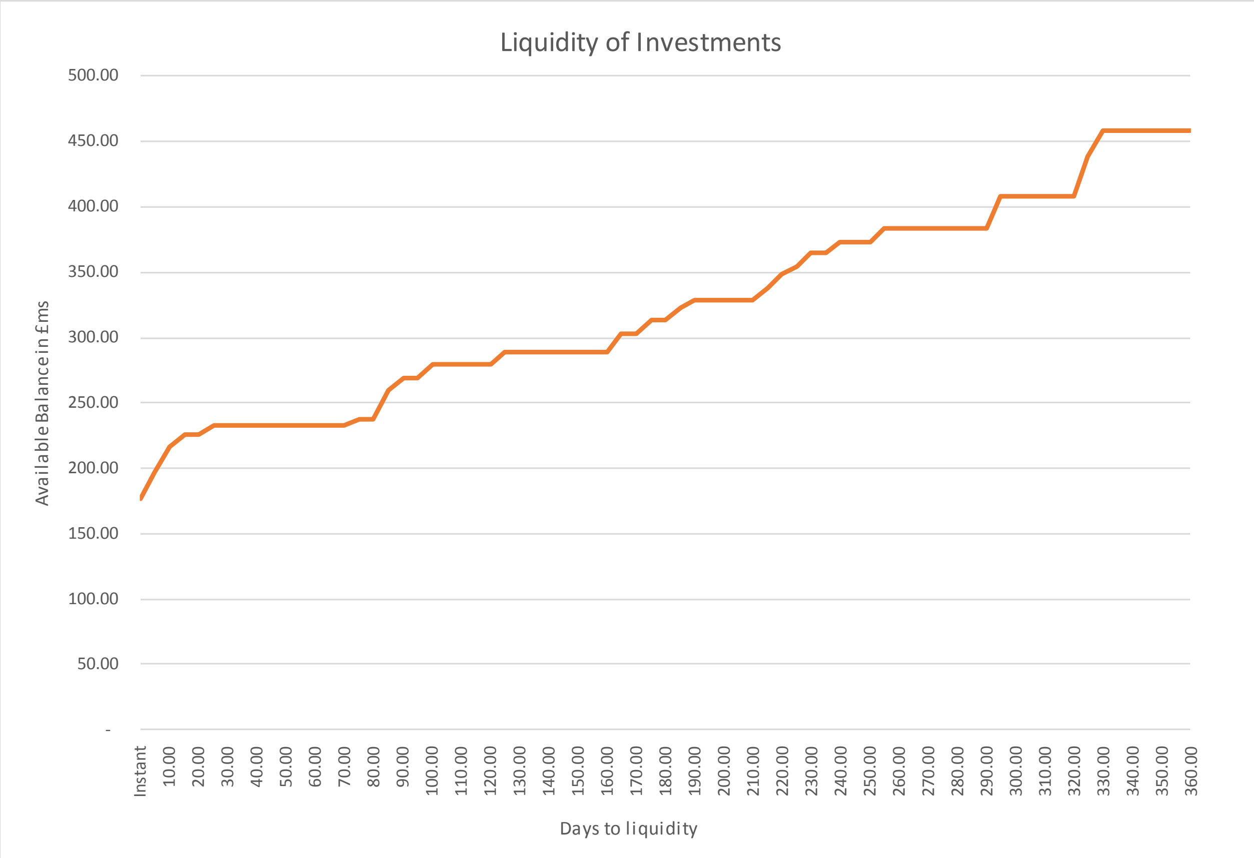
TREASURY MANAGEMENT INDICATORS	2020/21 actual £m	2021/22 actual £m	2022/23 estimate £m
Authorised Limit for external debt	386.000	390.000	472.000
Operational Boundary for external debt	321.420	324.640	393.313
Actual external debt	321.420	321.420	321.420

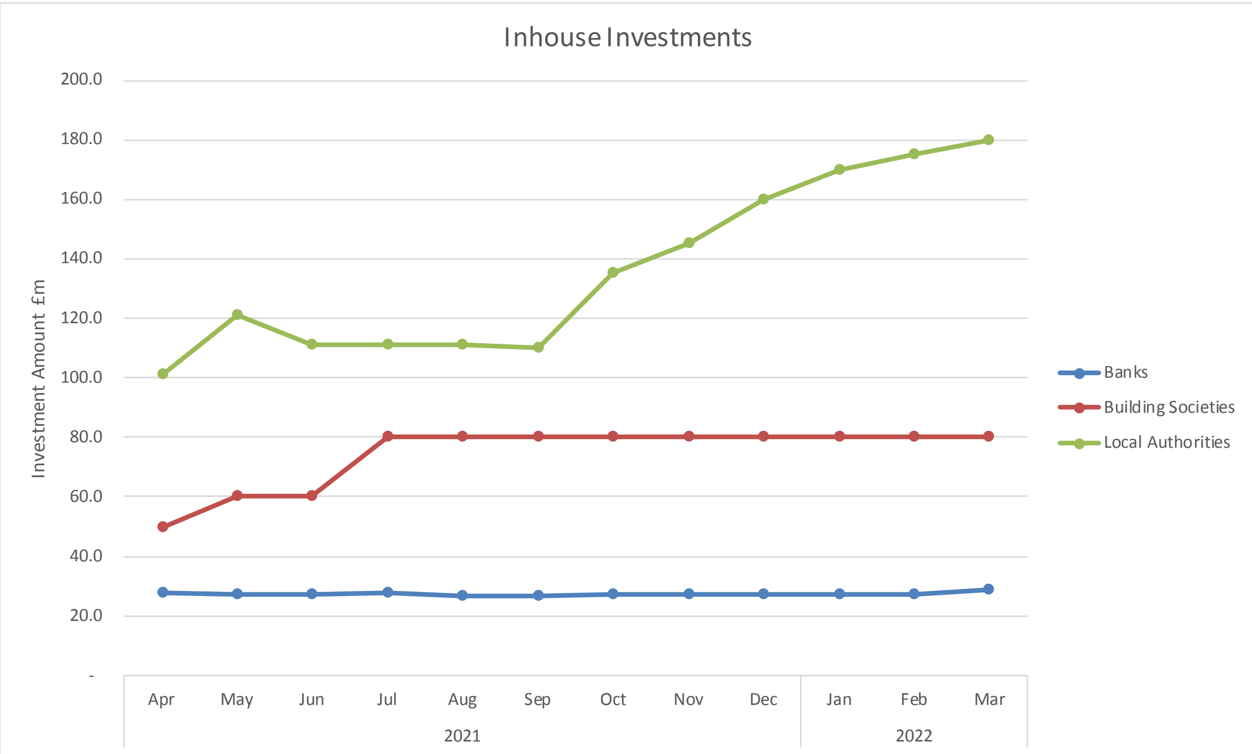
Maturity structure of the debt portfolio	31.3.21 £m	31.3.22 £m
Under 12 months	0.00	0.00
12 months and within 2 years	0.00	0.00
24 months and within 5 years	0.00	0.00
5 years and within 10 years	18.00	18.00
10 years and within 20 years	38.70	38.70
20 years and within 30 years	19.00	19.00
30 years and within 40 years	245.70	245.70
Total	**321.40**	**321.40**

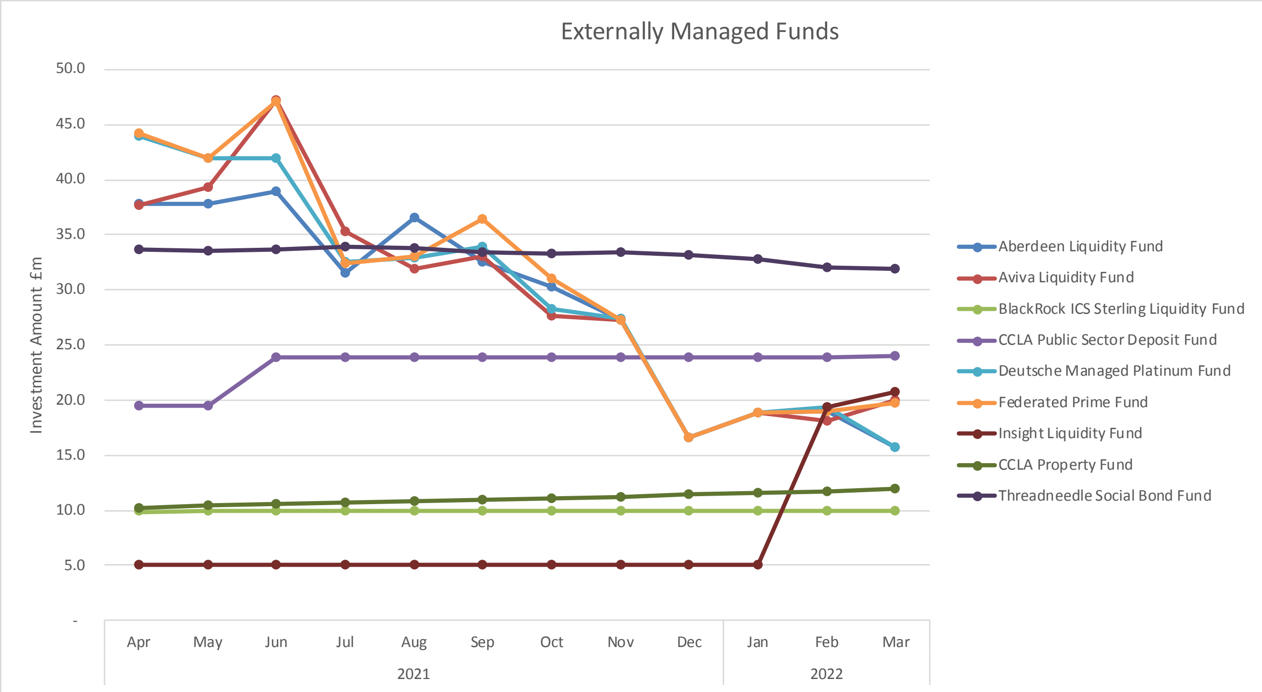
Annex 2: Investment Portfolio

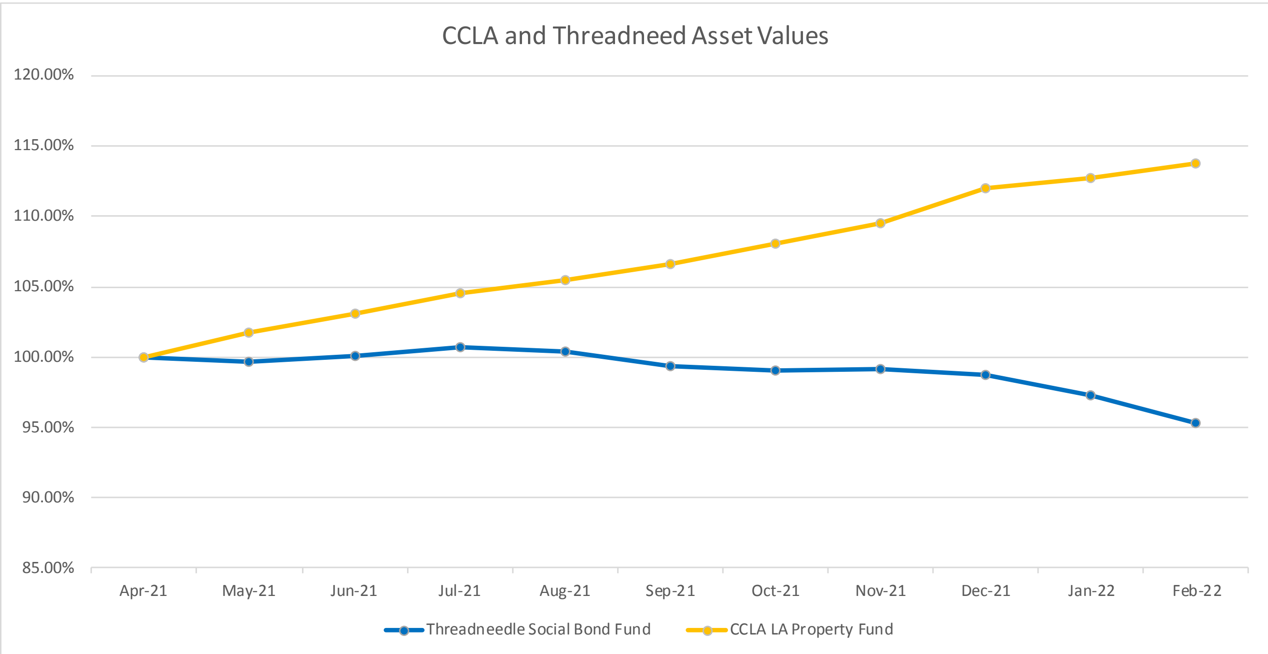



Treasury Investments - Average Interest 2021/22
CCLA LA Property Fund 3.63%
Threadneedle Social Bond Fund 1.42%
Yorkshire Building Society 1.35%
Lloyds Bank Secondary Account 0.65%
Santander 180 Day Notice Account 0.60%
West Dunbartonshire Council 0.60%
Skipton Building Society 0.55%
Leeds Building Society 0.55%
Leeds Building Society 0.55%
Santander 95 Day Notice Account 0.50%
Yorkshire Building Society 0.50%
CCLA Public Sector Fund 0.47%
Insight Liquidity Fund 0.47%
Nationwide Building Society 0.43%
Aviva Liquidity Fund 0.42%
Aberdeen Liquidity Fund 0.42%
BlackRock ICS Sterling Liquidity Fund 0.42%
Federated Prime Fund 0.41%
Deutsche Managed GBP LVNAV Platinum 0.40%
Moray Council 0.35%
Brentwood Borough Council 0.30%
Medway Council 0.25%
Blaenau Gwent County Borough Council 0.20%
Blaenau Gwent County Borough Council 0.20%
Lancashire County Council 0.12%
Surrey County Council 0.12%
Wrexham County Borough Council 0.12%
Aberdeenshire Council 0.11%
Aberdeen City Council 0.11%
London Borough of Hillingdon 0.10%
Warrington Borough Council 0.10%
London Borough of Southwark 0.10%
Blackpool Borough Council 0.09%
Kingston upon Hull City Council 0.07%
North Wales Fire Authority 0.07%
Conwy County Borough Council 0.07%
Stockport MBC 0.06%
Liverpool City Council 0.06%
Ashford Borough Council 0.06%
The Highland Council 0.06%
Cheltenham Borough Council 0.06%
North Lanarkshire Council 0.04%
0.00% 0.50% 1.00% 1.50% 2.00% 2.50% 3.00% 3.50% 4.00%
Interest

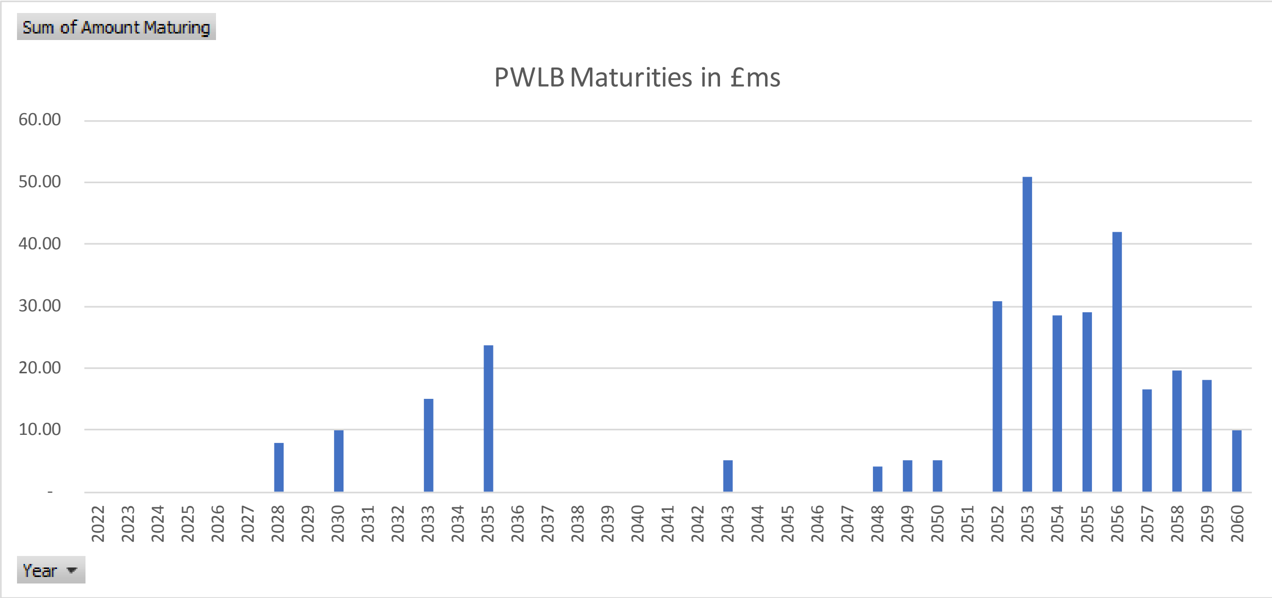

Liquidity of Investments
Available Balance in £ms
500.00
450.00
400.00
350.00
300.00
250.00
200.00
150.00
100.00
50.00
-
Instant
10.00
20.00
30.00
40.00
50.00
60.00
70.00
80.00
90.00
100.00
110.00
120.00
130.00
140.00
150.00
160.00
170.00
180.00
190.00
200.00
210.00
220.00
230.00
240.00
250.00
260.00
270.00
280.00
290.00
300.00
310.00
320.00
330.00
340.00
350.00
360.00
Days to liquidity


Inhouse Investments
Investment Amount £m
200.0
180.0
160.0
140.0
120.0
100.0
80.0
60.0
40.0
20.0
-
Apr
May
Jun
Jul
Aug
Sep
Oct
Nov
Dec
Jan
Feb
Mar
2021
2022
Banks
Building Societies
Local Authorities


Externally Managed Funds
Investment Amount £m
50.0
45.0
40.0
35.0
30.0
25.0
20.0
15.0
10.0
5.0
-
Apr
May
Jun
Jul
Aug
Sep
Oct
Nov
Dec
Jan
Feb
Mar
2021
2022
Aberdeen Liquidity Fund
Aviva Liquidity Fund
BlackRock ICS Sterling Liquidity Fund
CCLA Public Sector Deposit Fund
Deutsche Managed Platinum Fund
Federated Prime Fund
Insight Liquidity Fund
CCLA Property Fund
Threadneedle Social Bond Fund


CCLA and Threadneed Asset Values
120.00%
115.00%
110.00%
105.00%
100.00%
95.00%
90.00%
85.00%
Apr-21
May-21
Jun-21
Jul-21
Aug-21
Sep-21
Oct-21
Nov-21
Dec-21
Jan-22
Feb-22
Threadneedle Social Bond Fund
CCLA LA Property Fund

Annex 3: Borrowing Portfolio



Annex 4: The Economy and Interest Rates

UK. Economy. Over the last two years, the coronavirus outbreak has done huge economic damage to the UK and to economies around the world. After the Bank of England took emergency action in March 2020 to cut Bank Rate to 0.10%, it left Bank Rate unchanged at its subsequent meetings until raising it to 0.25% at its meeting on 16th December 2021, 0.50% at its meeting of 4th February 2022 and then to 0.75% in March 2022.

The UK economy has endured several false dawns through 2021/22, but with most of the economy now opened up and nearly back to business-as-usual, the GDP numbers have been robust (9% y/y Q1 2022) and sufficient for the MPC to focus on tackling the second-round effects of inflation, now that the CPI measure has already risen to 6.2% and is likely to exceed 8% in April.

Gilt yields fell towards the back end of 2021, but despite the war in Ukraine gilt yields have shot higher in early 2022. At 1.38%, 2-year yields remain close to their recent 11-year high and 10-year yields of 1.65% are close to their recent six-year high. These rises have been part of a global trend as central banks have suggested they will continue to raise interest rates to contain inflation.

Historically, a further rise in US Treasury yields will probably drag UK gilt yields higher. There is a strong correlation between the two factors. However, the squeeze on real household disposable incomes arising from the 54% leap in April utilities prices as well as rises in council tax, water prices and many phone contract prices, are strong headwinds for any economy to deal with. In addition, from 1st April 2022, employees also pay 1.25% more in National Insurance tax. Consequently, inflation will be a bigger drag on real incomes in 2022 than in any year since records began in 1955.

Average inflation targeting. This was the major change in 2020/21 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 2020 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 mantra now seems very dated. Inflation is the "genie" that has escaped the bottle, and a perfect storm of supply side shortages, labour shortages, commodity price inflation, the impact of Russia's invasion of Ukraine and subsequent Western sanctions all point to inflation being at elevated levels until well into 2023.

USA. The flurry of comments from Fed officials following the mid-March FOMC meeting – including from Chair Jerome Powell himself – hammering home the hawkish message from the mid-March meeting, has had markets pricing in a further 225bps of interest rate increases in 2022 on top of the initial move to an interest rate range of 0.25% - 0.5%.

In addition, the Fed is expected to start to run down its balance sheet. Powell noted that the rundown could come as soon as the next meeting in May.

The upward pressure on inflation from higher oil prices and potential knock-on impacts on supply chains all argue for tighter policy (CPI is estimated at 7.8% across Q1), but the hit to real disposable incomes and the additional uncertainty points in the opposite direction.

More recently, the inversion of the 10y-2y Treasury yield spread at the end of March led to predictable speculation that the Fed's interest rate hikes would quickly push the US economy into recession. Q1 GDP growth is likely to be only between 1.0% and 1.5% annualised (down from 7% in Q4 2021). But, on a positive note, the economy created more than 550,000 jobs per month in Q1, a number unchanged from the post-pandemic 2021 average. Unemployment is only 3.8%.

EU. With euro-zone inflation having jumped to 7.5% in March it seems increasingly likely that the ECB will accelerate its plans to tighten monetary policy. It is likely to end net asset purchases in June – i.e., earlier than the Q3 date which the ECB targeted in March. And the market is now anticipating possibly three 25bp rate hikes later this year followed by more in 2023. Policymakers have also hinted strongly that they would re-start asset purchases if required. In a recent speech, Christine Lagarde said “we can design and deploy new instruments to secure monetary policy transmission as we move along the path of policy normalisation.”

While inflation has hit the headlines recently, the risk of recession has also been rising. Among the bigger countries, Germany is most likely to experience a “technical” recession because its GDP contracted in Q4 2021, and its performance has been subdued in Q1 2022. However, overall, Q1 2022 growth for the Eurozone is expected to be 0.3% q/q with the y/y figure posting a healthy 5.2% gain. Finishing on a bright note, unemployment fell to only 6.8% in February.

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; however, 2021 has seen the economy negatively impacted by political policies that have focussed on constraining digital services, restricting individual freedoms, and re-establishing the power of the One-Party state. With the recent outbreak of Covid-19 in large cities, such as Shanghai, near-term economic performance is likely to be subdued. Official GDP numbers suggest growth of c4% y/y, but other data measures suggest this may be an overstatement.

Japan. The Japanese economic performance through 2021/22 is best described as tepid. With a succession of local lockdowns throughout the course of the year, GDP is expected to have risen only 0.5% y/y with Q4 seeing a minor contraction. The policy rate has remained at -0.1%, unemployment is currently only 2.7% and inflation is sub 1%, although cost pressures are mounting.

World growth. World growth is estimated to have expanded 8.9% in 2021/22 following a contraction of 6.6% in 2020/21.

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 18% of total world GDP (the USA accounts for 24%), and Russia’s recent invasion of Ukraine, has unbalanced the world economy. In addition, 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 (and to a much lesser extent Russia) 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.