Report of the Director of Finance & IT to the meeting of Governance and Audit to be held on 9 June 2022

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Subject:

Annual Treasury Management Report 2021-22

Summary statement:

This report shows the Council's Treasury Management activities for the year ending 31 March 2022

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Portfolio: Corporate

Overview & Scrutiny Area:

Corporate

Annual Treasury Management Review 2021-22

1. Introduction

This 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).

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 (Governance and Audit Committee 25/03/2021 and Council 25/01/2022)
- a mid-year, (minimum), treasury update report (Governance and Audit Committee 25/11/2021 and Council 25/01/2022)
- 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 is, therefore, important in that respect, as it provides details of the outturn position for treasury activities and highlights compliance with the Council's policies previously approved by members.

This Council confirms that it has complied with the requirement under the Code to give prior scrutiny to all of the above treasury management reports by the Governance and Audit Committee before they were reported to the full Council.

Member training on treasury management issues was undertaken during the year on 11th November 2021 in order to support members' scrutiny role.

2. Overall Treasury Position as at 31st March 2022

The Council's treasury management debt and investment position is organised by the treasury management service, in order to ensure adequate liquidity for revenue and capital activities, security for investments and to manage risks within all treasury management activities. 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.

At the end of 2021-22 the Council's treasury, (including borrowing by PFI and finance leases), position was as follows:

	31 March 2021 Principal £'m	Rate/ Return	31 March 2022 Principal £'m	Rate/ Return
Fixed rate funding:				
-PWLB	297.8		292.3	
-Market	36.2	4.86%	36.2	4.79%
-Other	0.4		0.4	
PFI and other finance leases	154.9		146.9	
Short term borrowing	0.0		37.0	
Total debt	**489.3**		**512.8**	
CFR	698.8		708.7	
Over / (under) borrowing	(209.5)		(195.9)	
Total investments	133.3	0.14%	186.1	0.13%
Net debt	**356.0**		**326.7**	

3. Prudential Indicators

3.1 The Council's Capital Expenditure and Financing

The Council undertakes capital expenditure on long-term assets. These activities may either be:

- Financed immediately through the application of capital or revenue resources (capital receipts, capital grants, revenue contributions etc.), which has no resultant impact on the Council's borrowing need; or
- If insufficient financing is available, or a decision is taken not to apply resources, the capital expenditure will give rise to a borrowing need.

Actual capital expenditure forms one of the required prudential indicators. The table below shows the actual capital expenditure and how this was financed. Capital expenditure has increased compared to the previous year, which was impacted by Covid-19.

	2020-21 Actual £'m	2021-22 Estimate as at Q2 £'m	2021-22 Actual £'m
Capital expenditure	**63.9**	**139.4**	**104.7**
Financed in year	49.3	73.0	70.1
Unfinanced capital expenditure	**14.6**	**66.4**	**34.6**

3.2 The Council's Overall Borrowing Need

The Council's underlying need to borrow for capital expenditure is termed the Capital Financing Requirement (CFR). The CFR is simply the total historic outstanding capital expenditure, which has not yet been paid for from either revenue or capital resources. It is essentially a measure of the Council's indebtedness and so the underlying borrowing need. Any capital expenditure above, which is not immediately paid for through a revenue or capital resource, will increase the CFR.

Part of the Council's treasury activities is to address the funding requirements for this borrowing need. Depending on the capital expenditure programme, the treasury service organises the Council's cash position to ensure that sufficient cash is available to meet the capital plans and cash flow requirements. This may be sourced through borrowing from external bodies, (such as the Government, through the Public Works Loan Board [PWLB], or the money markets), or utilising temporary cash resources within the Council.

To ensure that borrowing levels are prudent over the medium term and only for a capital purpose, the Council should ensure that its gross external borrowing does not, except in the short term, exceed the total of the capital financing requirement in the preceding year (20-21), plus the estimates of any additional capital financing requirement for the current year (2021-22) and next two financial years. This essentially means that the Council is not borrowing to support revenue expenditure. The Council has complied with this prudential indicator.

The table below highlights the Council's gross borrowing position against the CFR. It includes PFI and leasing schemes on the balance sheet, which increase the Council's borrowing need. No borrowing is actually required against these schemes as a borrowing facility is included in the contract. The CFR figure is less than budgeted due to slippage on the capital programme, which has resulted in a lower requirement to borrow.

	31 March 2021 Actual £'m	**31 March 2022 Budget £'m**	**31 March 2022 Actual £'m**
Capital Financing Requirement	698.8	741.0	708.7
Gross borrowing position	489.3	497.0	512.8
(Under) / over funding of CFR	**(209.5)**	**(244.0)**	**(195.9)**

The Council's underlying borrowing need (CFR) is not allowed to rise indefinitely. Statutory controls are in place to ensure that capital assets are broadly charged to revenue over the life of the asset. The Council is required to make an annual revenue charge, called the Minimum Revenue Provision – MRP, to reduce the CFR. This is effectively a repayment of the non-Housing Revenue Account (HRA) borrowing need. This differs from the treasury

management arrangements which ensure that cash is available to meet capital commitments. External debt can also be borrowed or repaid at any time, but this does not change the CFR.

The total CFR can also be reduced by:

- the application of additional capital financing resources, (such as unapplied capital receipts); or
- charging more than the statutory revenue charge (MRP) each year through a Voluntary Revenue Provision (VRP).

The Council's 2021-22 MRP Policy, (as required by the Department for Levelling Up, Housing and Communities (DLUHC) Guidance), was approved as part of the Budget Report for 2021-22 on 18th February 2021.

3.3 Treasury Indicators

The authorised limit - the authorised limit is the "affordable borrowing limit" required by section 3 of the Local Government Act 2003. Once this has been set, the Council does not have the power to borrow above this level. The table below demonstrates that during 2021-22 the Council has maintained gross borrowing within its authorised limit.

The operational boundary – the operational boundary is the expected borrowing position of the Council during the year. Periods where the actual position is either below or over the boundary are acceptable, subject to the authorised limit not being breached.

Actual financing costs as a proportion of net revenue stream - this indicator identifies the trend in the cost of capital, (borrowing and other long term obligation costs net of investment income), against the net revenue stream to be met from government grants and local taxpayers.

	2021-22 £'m
Authorised limit	852.0
Maximum gross borrowing position during the year	512.8
Operational boundary	850.0
Financing costs as a proportion of net revenue stream	14.2%

The maturity structure of the debt portfolio was as follows:

	31 March 2021 Actual £'m	**31 March 2022 Actual £'m**
Under 12 months	19.8	66.8
12 months and within 24 months	15.5	6.5
24 months and within 5 years	22.3	33.1

5 years and within 10 years	59.3	54.3
10 years and within 20 years	56.9	45.0
20 years and within 30 years	5.0	15.0
30 years and within 40 years	87.3	86.4
40 years and within 50 years	67.9	58.8

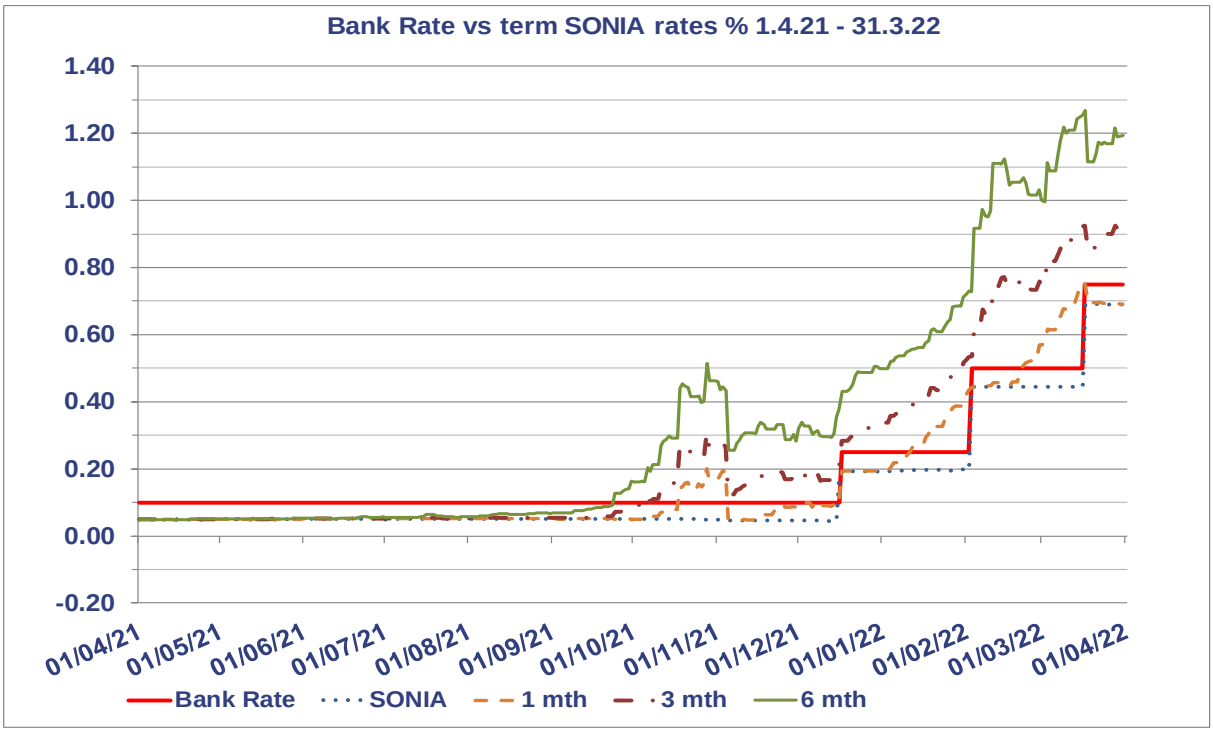
4.The Treasury Strategy for 2021-22

4.1 Investment strategy and control of interest rate risk

Investment returns remained close to zero for much of 2021-22. Most local authority lending managed to avoid negative rates and one feature of the year was the continued growth of inter local authority lending. The expectation for interest rates within the treasury management strategy for 2021-22, was that Bank Rate would remain at 0.1% until it was clear to the Bank of England that the emergency level of rates introduced at the start of the Covid-19 pandemic were no longer necessitated.

The Bank of England and the Government also maintained various monetary and fiscal measures, supplying the banking system and the economy with massive amounts of cheap credit, so that banks could help cash-starved businesses to survive the various lockdowns/negative impact on their cash flow. The Government also supplied huge amounts of finance to local authorities to pass on to businesses. This meant that for most of the year there was much more liquidity in financial markets than there was demand to borrow, with the consequent effect that investment earnings rates remained low until towards the turn of the year when inflation concerns indicated central banks, not just the Bank of England, would need to lift interest rates to combat the second-round effects of growing levels of inflation (CPI was 6.2% in February).

The graph and table below illustrate bank rates for the 2021-22 year.



	Bank Rate	SONIA	1 mth	3 mth	6 mth
High	0.75	0.69	0.75	0.93	1.27
High Date	17/03/2022	18/03/2022	16/03/2022	28/03/2022	17/03/2022
Low	0.10	0.05	0.05	0.05	0.05
Low Date	01/04/2021	15/12/2021	10/11/2021	14/04/2021	09/04/2021
Average	0.19	0.14	0.17	0.24	0.34
Spread	0.65	0.65	0.71	0.88	1.22

While the Council has taken a cautious approach to investing, it is also fully appreciative of changes to regulatory requirements for financial institutions in terms of additional capital and liquidity that came about in the aftermath of the financial crisis. These requirements have provided a far stronger basis for financial institutions, with annual stress tests by regulators evidencing how institutions are now far abler to cope with extreme stressed market and economic conditions.

Investment balances have been kept to a minimum through the agreed strategy of using reserves and balances to support internal borrowing, rather than borrowing externally from the financial markets. External borrowing would have incurred an additional cost, due to the differential between borrowing and investment rates as illustrated in the charts shown above and below. Such an approach has also provided benefits in terms of reducing counterparty risk exposure, by having fewer investments placed in the financial markets.

4.2 Investment Outturn 21-22

The Councils investment position at the end of 2021-22 is summarised below

INVESTMENT PORTFOLIO	2020-21		2021-22	
	£m	%	£m	%
Treasury investments				
Banks	87.5	66	£103.5m	55
Building Societies - rated	9.3	7	£0m	0
DMADF	36.5	27	£5.0m	3
Treasury Bills	0	0	£0m	0
Money Market Funds	0.0	0	£77.6m	42
Total managed in house	**133.3**	**100**	**£186.1m**	**100**

The maturity structure of the investment portfolio was as follows:

	2020-21 Actual £'m	2021-22 Actual £'m
Investments		
Longer than 1 year	0.0	0.0
Up to 1 year	133.3	186.1

The Council's investment policy is governed by DLUHC investment guidance, which has been implemented in the annual investment strategy approved by the Council on 17/05/22. 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.

Investments held by the Council - The Council maintained an average balance of £174m of internally managed funds. The internally managed funds earned an average rate of return of 0.13%. The comparable performance indicator is the average 7-day LIBID rate, which was 0.135%. The total investment income was £234k.

5.Borrowing

5.1 Borrowing strategy and control of interest rate risk

Borrowing is undertaken to fund net unfinanced capital expenditure and naturally maturing debt and also to maintain cash flow liquidity requirements. During 2021-22, the Council maintained an under-borrowed position. This meant that the capital borrowing need, (the Capital Financing Requirement), was not fully funded with loan debt as cash supporting the Council's reserves, balances and cash flow was used as an interim measure. This strategy was prudent as investment returns were very low and minimising counterparty risk on placing investments also needed to be considered.

A cost of carry remained during the year on any new long-term borrowing that was not immediately used to finance capital expenditure, as it would have caused a

temporary increase in cash balances; this would have incurred a revenue cost – the difference between (higher) borrowing costs and (lower) investment returns.

The policy of avoiding new borrowing by running down spare cash balances has served well over the last few years. However, this was kept under review to avoid incurring higher borrowing costs in the future when this council may not be able to avoid new borrowing to finance capital expenditure and/or the refinancing of maturing debt.

Against this background and the risks within the economic forecast, caution was adopted with the treasury operations. The Director of Finance & IT therefore monitored interest rates in financial markets and adopted a pragmatic strategy based upon the following principles to manage interest rate risks:

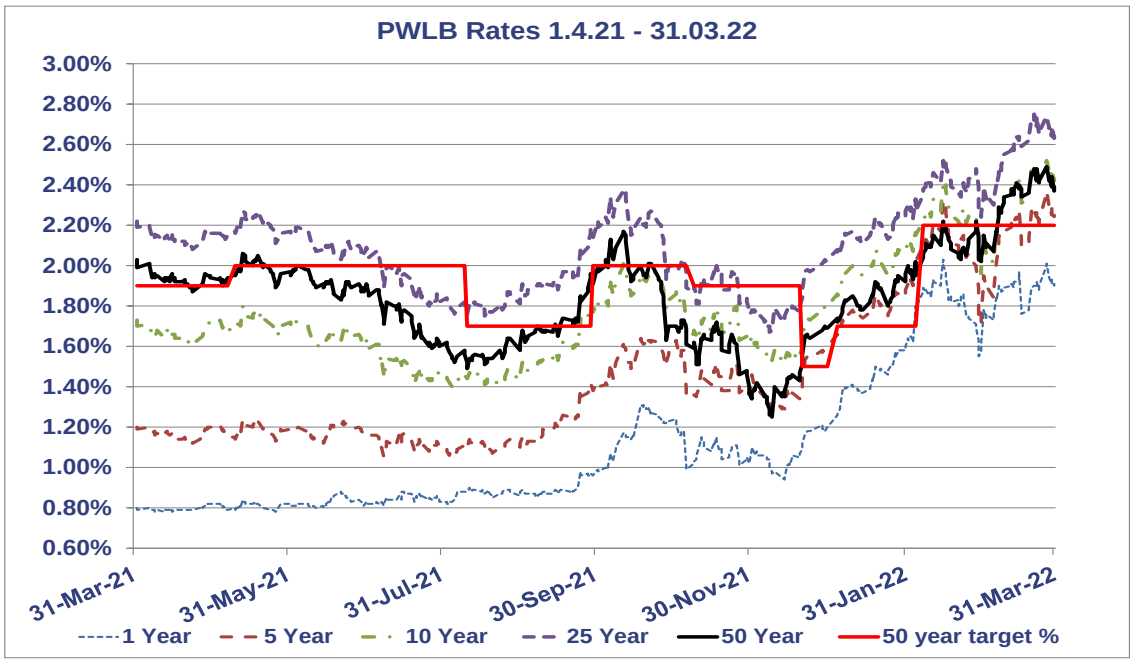
- if it had been felt that there was a significant risk of a sharp FALL in long and short term rates, (e.g. due to a marked increase of risks around relapse into recession or of risks of deflation), then long term borrowings would have been postponed, and potential rescheduling from fixed rate funding into short term borrowing would have been considered.

- if it had been felt that there was a significant risk of a much sharper RISE in long and short term rates than initially expected, perhaps arising from an acceleration in the start date and 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 would have been re-appraised. Most likely, fixed rate funding would have been drawn whilst interest rates were lower than they were projected to be in the next few years.

Interest rate forecasts expected only gradual rises in medium and longer-term fixed borrowing rates during 2021-22 and the two subsequent financial years until the turn of the year, when inflation concerns increased significantly. Internal, variable, or short-term rates, were expected to be the cheaper form of borrowing until well in to the second half of 2021-22. Forecasts at the time of approval of the treasury management strategy report for 2021-22 were as follows.

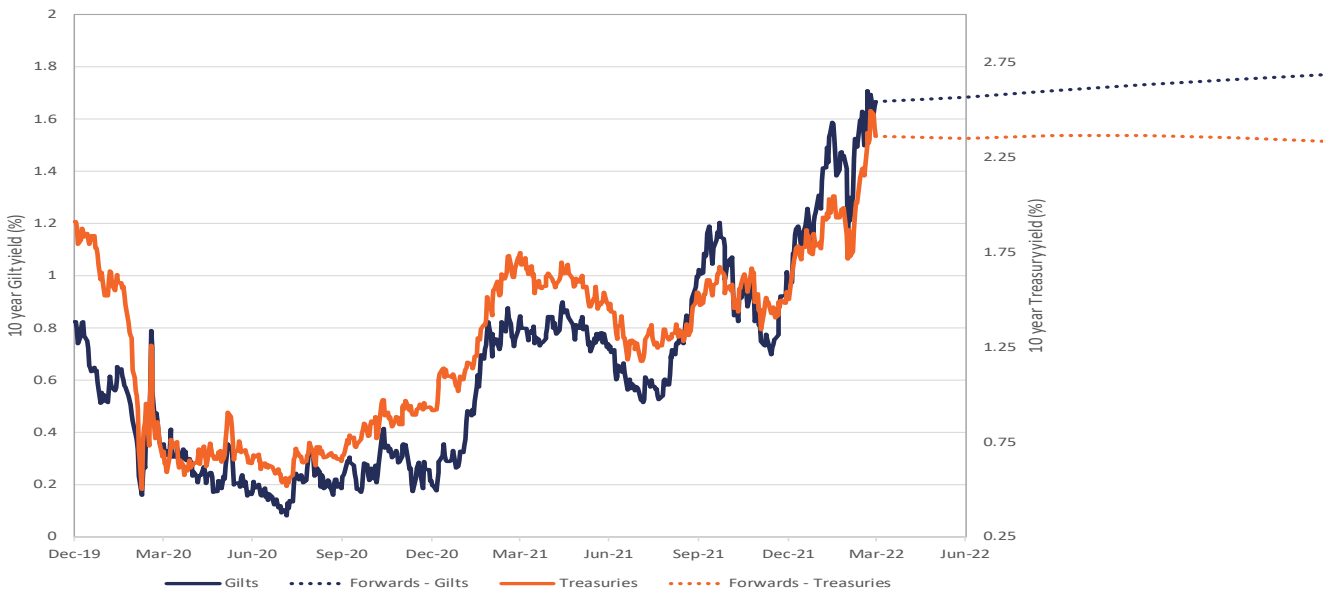
Link Group Interest Rate 8.3.21												
	Jun-21	Sep-21	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24
BANK RATE	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
3 month ave earnings	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
6 month ave earnings	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
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
5 yr PWLB	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	1.70	1.70	1.70	1.80	1.80	1.90	1.90	1.90	1.90
25 yr PWLB	2.10	2.10	2.20	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	2.00	2.10	2.10	2.10	2.20	2.20	2.30	2.30	2.30	2.30

PWLB RATES 2021-22



PWLB rates are based on gilt (UK Government bonds) yields through H.M.Treasury determining a specified margin to add to gilt yields. The main influences on gilt yields are Bank Rate, inflation expectations and movements in US treasury yields. Inflation targeting by the major central banks has been successful over the last 30 years in lowering inflation and 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. This has pulled down the overall level of interest rates and bond yields in financial markets over the last 30 years. We have seen, over the last two years, many bond yields up to 10 years in the Eurozone turn negative on expectations that the EU would struggle to get growth rates and inflation up from low levels. 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. Recently, yields have risen since the turn of the year on the back of global inflation concerns.

Graph of UK gilt yields v. US treasury yields



Gilt yields fell sharply from the spring of 2021 through to September and then spiked back up before falling again through December. However, by January sentiment had well and truly changed, as markets became focussed on the embedded nature of inflation, spurred on by a broader opening of economies post the pandemic, and rising commodity and food prices resulting from the Russian invasion of Ukraine.

At the close of the day on 31 March 2022, all gilt yields from 1 to 5 years were between 1.11% – 1.45% while the 10-year and 25-year yields were at 1.63% and 1.84%.

Regarding PWLB borrowing rates, the various margins attributed to their pricing 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)

There is likely to be a further rise in short dated gilt yields and PWLB rates over the next three years. Bank base rate are at 1.00% as at 10/05/22 and are expected to increase to 1.75% later this year, with upside risk likely if the economy proves more resilient in the light of the cost of living squeeze. Medium to long dated yields are driven primarily by inflation concerns but the Bank of England is also embarking on a process of Quantitative Tightening when Bank Rate hits 1%, whereby the Bank's £895bn stock of gilt and corporate bonds will be sold back into the market over several years. The impact this policy will have on the market pricing of gilts, while issuance is markedly increasing, is an unknown at the time of writing.

5.2 Borrowing Outturn 2021-22

£5.511m of loans matured in January 2022 with an average rate of 9.25%. Due to the high cash balances no new loans were undertaken this year.

Summary of debt transactions – management of the debt portfolio resulted in a fall in the average interest rate of 0.07%, representing net General Fund savings of £230k p.a.

5.3 Borrowing in advance of need

The Council has not borrowed more than, or in advance of its needs, purely in order to profit from the investment of the extra sums borrowed.

5.4 Rescheduling

No rescheduling was done during the year as the average 1% differential between PWLB new borrowing rates and premature repayment rates made rescheduling unviable.

6. Other Considerations

6.1 None

7.Changes to the Treasury Management Policy

7.1 None

8. Other Issues

8.1 No issues

9. Financial and Resources Appraisal

9.1 The financial implications are set out in section 1 to 8 of this report

10. Risk Management and Governance Issues

10.1 The principal risks associated with treasury management are:

<u>Risk: Loss of investments as a result of failure of counterparties.</u>
Mitigation: Limiting the types of investment instruments used, setting lending criteria for counterparties, and limiting the extent of exposure to individual counterparties.

Risk: That the Council will commit too much of its investments in fixed term investments and might have to recall investments prematurely resulting in possible additional costs or new borrowing (Liquidity risk).
Mitigation: Ensuring that a minimum proportion of investments are held in short term investments for cash flow purposes.

Risk: Increase in the net financing costs of the Council due to borrowing at high rates of interest.
Mitigation: Planning and undertaking borrowing and lending in light of assessments of future interest rate movements, and by undertaking mostly long term borrowing at fixed rates of interest (to reduce the volatility of capital financing costs).

Risk: Higher interest rates increase borrowing making it more difficult to self-finance capital schemes. Debt servicing becomes less affordable and less sustainable and crowds out revenue spend.
Mitigation: To pause, delay or defer capital schemes. Also review opportunities to borrow in the future at current interest rates.

Risk: Return on non-treasury investments lower than expected.
Mitigation: Review and analysis of risk prior to undertaking non-treasury investments.

Risk: Coronavirus future outbreaks. resulting in possible lockdowns etc.
While the risk over coronavirus have reduced at present it is an area we will continue to monitor and report any action we have had to undertake if circumstances change, in the next Treasury report.

Risk: The Council's Minimum Revenue Policy charges an insufficient amount to the Revenue Estimates to repay debt.
Mitigation: Align the Minimum Revenue Policy to the service benefit derived from the Council's assets.

Risk: Associated with cash management, legal requirements and fraud.
Mitigation: These risks are managed through:

- Treasury Management Practices covering all aspects of Treasury management procedures including cash flow forecasting, documentation, monitoring, reporting and division of duties.
- All Treasury management procedures and transactions are subject to inspection by internal and external auditors. The council also employs external financial advisors to provide information on market trends, credit rating alerts, lending criteria advice and investment opportunities.

The Council also employs external financial advisors to provide information on market trends, credit rating alerts, lending criteria advice and investment opportunities.

Risk: Increase in capital financing costs due to inflationary forces resulting in increased cost pressures on current capital projects and higher costs compared to approved budgets.
Mitigation: Regular monitoring of the capital programme through comparison to budgets.

Risk: Anticipated borrowing is lower than expected because the 2022-23 capital programme is underspent. This is explained in more detail below, together with the actions being taken to reduce these risks:
Mitigation: The Council is required to set a balanced budget for its revenue estimates; so in broad terms, income received will match expenditure over the 2022-23 financial year. The 2022-23 revenue estimates cause only temporary cash flow differences, for example when income is received in a different month to when the expenditure is incurred.

However, the 2022-23 capital budget will cause a cash flow shortfall in the long term, which generates a borrowing requirement. While some of the capital budget is funded immediately, mainly with Government grants, other elements are not funded initially, leading to the cash flow deficit that requires borrowing.

Managing borrowing is part of the Treasury Management role. To help in its management, the Treasury Strategy identifies the element within the capital budget that is not funded straightaway, to anticipate the Council's borrowing requirement.

However, when the capital budget is underspent, the Council has a lower borrowing requirement than anticipated. This risk is managed in practice because the Council only borrows when there is an actual cash flow shortage. The uncertainty around spend against the capital budget makes cash flow management more difficult. For example, it is less likely that the Council would take advantage of a short-term fall in interest rates, without more certainty around the timing of any borrowing need. Actions that have taken place to manage the risks relating to this uncertainty in the timing of capital spend are: Councillor and Officer challenge sessions on the capital budget; increased scrutiny of the capital forecasts in the quarterly monitoring, and the collection of additional documentation around the critical paths of individual schemes.

11. Legal Appraisal

11.1 Any relevant legal considerations are set out in the report

12. Other Implications

12.1 Equality & Diversity – no direct implications
12.2 Sustainability implications – no direct implications
12.3 Green house Gas Emissions Impact – no direct implications
12.4 Community safety implications – no direct implications
12.5 Human Rights Act – no direct implications
12.6 Trade Unions – no direct implications
12.7 Ward Implications – no direct implications
12.8 Implication for Corporate Parenting – no direct implications
12.9 Issues arising from Privacy Impact Assessment– no direct implications

13. Not for publications documents

13.1 None

14. Options

14.1 None

15. Recommendations

15.1 That the report be noted and referred to Council for adoption.

16. Appendices

Appendix 1 Prudential and Treasury Indicators
Appendix 2 Borrowing and Investment Rates
Appendix 3 The Economy and Interest Rates
Appendix 4 Approved Counties for Investments as at 31st March 2022

Appendix 1: Prudential and Treasury indicators

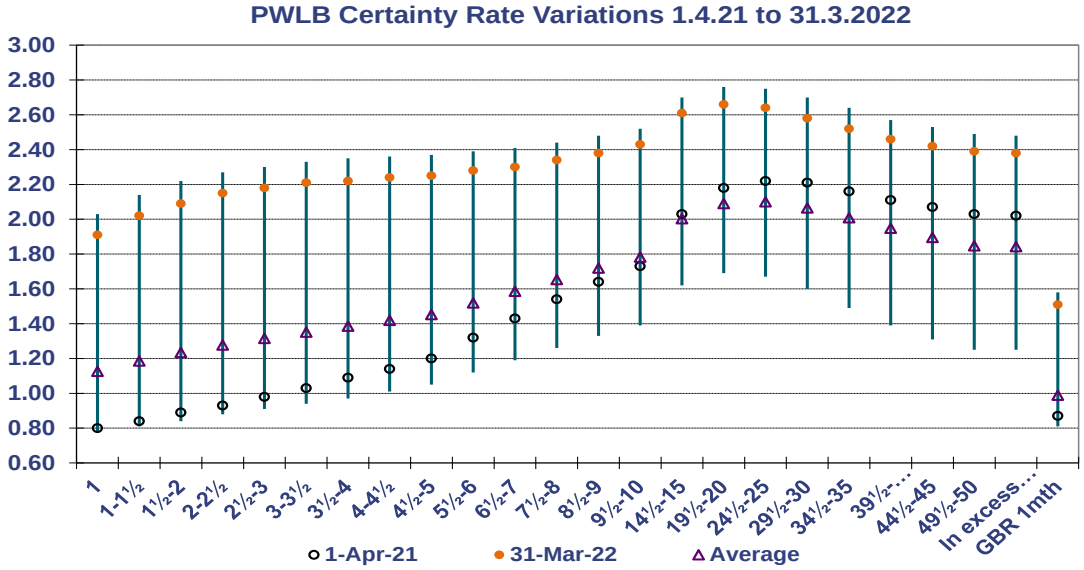
1. PRUDENTIAL INDICATORS	2020-21 Actual £'000	2021-22 Estimate £'000	2021-22 Actual £'000
Capital Expenditure	63,907	139,400	104,706
Ratio of financing costs to net revenue stream	13.1%	14.7%	14.2%*
Gross borrowing requirement General Fund	489,356	497,000	512,800
Capital Financing Requirement	698,764	741,000	708,710

*Note in future years some of the forecast debt will be directly funded by self-financing schemes, where income is generated to meet the cost of investment in the scheme.

2. TREASURY MANAGEMENT INDICATORS	2020-21 Actual £'000	2021-22 Estimate £'000	2021-22 Actual £'000
Authorised Limit for external debt			
borrowing	334,426	709,000	365,900
other long term liabilities	154,930	143,000	146,900
TOTAL	**489,356**	**852,000**	**512,800**
Operational Boundary for external debt			
borrowing	334,426	707,000	365,900
other long term liabilities	154,930	143,000	146,900
TOTAL	**489,356**	**850,000**	**512,800**
Actual external debt	489,356	497,000	512,800

Maturity structure of fixed rate borrowing during 2021-22	upper limit	lower limit
under 12 months	20%	0%
12 months and within 24 months	20%	0%
24 months and within 5 years	50%	0%
5 years and within 10 years	50%	0%
10 years and within 20 years	90%	0%
20 years and within 30 years	90%	0%
30 years and within 40 years	90%	0%
40 years and within 50 years	90%	0%
Maturity structure of investments during 2021-22	upper limit	lower limit
Longer than 1 year	£20m	£0m

Appendix 2: Borrowing and Investment Rates



HIGH/LOW/AVERAGE PWLB RATES FOR 2021-22

	1 Year	5 Year	10 Year	25 Year	50 Year
01/04/2021	0.80%	1.20%	1.73%	2.22%	2.03%
31/03/2022	1.91%	2.25%	2.43%	2.64%	2.39%
Low	0.78%	1.05%	1.39%	1.67%	1.25%
Low date	08/04/2021	08/07/2021	05/08/2021	08/12/2021	09/12/2021
High	2.03%	2.37%	2.52%	2.75%	2.49%
High date	15/02/2022	28/03/2022	28/03/2022	23/03/2022	28/03/2022
Average	1.13%	1.45%	1.78%	2.10%	1.85%
Spread	1.25%	1.32%	1.13%	1.08%	1.24%

Appendix 3: The Economy and Interest Rates

UK. 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.

Appendix 4: Approved Countries for Investments as at 31st March 2022

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.**