

# Mid-Year Treasury Management Report 2020/21

AC as at 9-11-19 - LT



## 1. Introduction and Background

The Council operates a balanced budget, which broadly means cash raised during the year will meet its cash expenditure. Part of the treasury management operations ensure this cash flow is adequately planned, with surplus monies being invested in low risk counterparties, providing adequate liquidity initially before considering maximising investment return.

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

As a consequence treasury management is defined as:

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

The Council has adopted the Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management (revised 2017).

The primary requirements of the Code are as follows:

1. Creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the Council's treasury management activities.
2. Creation and maintenance of Treasury Management Practices which set out the manner in which the Council will seek to achieve those policies and objectives.
3. Receipt by the full council of an annual Treasury Management Strategy Statement - including the Annual Investment Strategy and Minimum Revenue Provision Policy - for the year ahead, a **Mid-year Review Report** and an Annual Report (stewardship report) covering activities during the previous year.
4. Delegation by the Council of responsibilities for implementing and monitoring treasury management policies and practices and for the execution and administration of treasury management decisions.
5. Delegation by the Council of the role of scrutiny of treasury management strategy and policies to a specific named body. For this Council the delegated body is the Scrutiny (Audit and Value for Money Council Services) Committee.

## 2. This Annual Treasury Report Covers

This mid-year report has been prepared in compliance with CIPFA's Code of Practice, and covers the following:

- An economic update for 2020/21
- A review of the Treasury Management Strategy Statement and Annual Investment Strategy
- A review of the Council's investment portfolio for 2020/21
- A review of the Council's borrowing strategy for 2020/21
- A review of any debt rescheduling undertaken during 2020/21
- A review of compliance with Treasury and Prudential Limits for 2020/21
- Other treasury matters

## 3. Economic Update

3.1 As expected, the Bank of England's Monetary Policy Committee kept Bank Rate unchanged on 6<sup>th</sup> August. It also kept unchanged the level of quantitative easing at £745bn. Its forecasts were optimistic in terms of three areas:

- The fall in **GDP** in the first half of 2020 was revised from 28% to 23% (subsequently revised to -21.8%). This is still one of the largest falls in output of any developed nation. However, it is only to be expected as the UK economy is heavily skewed towards consumer-facing services – an area which was particularly vulnerable to being damaged by lockdown.
- The peak in the **unemployment rate** was revised down from 9% in Q2 to 7½% by Q4 2020.
- It forecast that there would be excess demand in the economy by Q3 2022 causing CPI **inflation** to rise above the 2% target in Q3 2022, (based on market interest rate expectations for a further loosening in policy). Nevertheless, even if the Bank were to leave policy unchanged, inflation was still projected to be above 2% in 2023.

It also squashed any idea of using **negative interest rates**, at least in the next six months or so. It suggested that while negative rates can work in some circumstances, it would be “less effective as a tool to stimulate the economy” at this time when banks are worried about future loan losses. It also has “other instruments available”, including QE and the use of forward guidance.

- 3.2 The MPC expected the £300bn of **quantitative easing** purchases announced between its March and June meetings to continue until the “turn of the year”. This implies that the pace of purchases will slow further to about £4bn a week, down from £14bn a week at the height of the crisis and £7bn more recently.
- 3.3 In conclusion, this would indicate that the Bank could now just sit on its hands as the economy was recovering better than expected. However, the MPC acknowledged that the “medium-term projections were a less informative guide than usual” and the minutes had multiple references to **downside risks**, which were judged to persist both in the short and medium term. One has only to look at the way in which second waves of the virus are now impacting many countries including Britain, to see the dangers. However, rather than a national lockdown, as in March, any spikes in virus infections are now likely to be dealt with by localised measures and this should limit the amount of economic damage caused. In addition, Brexit uncertainties ahead of the year-end deadline are likely to be a drag on recovery.
- 3.4 Overall, **the pace of recovery** is not expected to be in the form of a rapid V shape, but a more elongated and prolonged one after a sharp recovery in June through to August which left the economy 11.7% smaller than in February. The last three months of 2020 are now likely to show no growth as consumers will probably remain cautious in spending and uncertainty over the outcome of the UK/EU trade negotiations concluding at the end of the year will also be a headwind. If the Bank felt it did need to provide further support to recovery, then it is likely that the tool of choice would be more QE.
- 3.5 There will be some **painful longer term adjustments** as e.g. office space and travel by planes, trains and buses may not recover to their previous level of use for several years, or possibly ever. There is also likely to be a reversal of globalisation as this crisis has shown up how vulnerable long-distance supply chains are. On the other hand, digital services is one area that has already seen huge growth.
- 3.6 One key addition to **the Bank’s forward guidance** 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
- 3.7 The **Financial Policy Committee (FPC)** report on 6<sup>th</sup> August revised down their expected credit losses for the banking sector to “somewhat less than £80bn”. It stated that in its assessment “banks have buffers of capital more than sufficient to absorb the losses that are likely to arise under the MPC’s central projection”. The FPC stated that for real stress in the sector, the economic output would need to be twice as bad as the MPC’s projection, with unemployment rising to above 15%.
- 3.8 For information in relation to the global economic outlook is set out in **Annex 3**.

### 3.7 Interest rate forecasts

The Council's treasury advisor, Link Asset Services, have provided the interest rate forecasts and commentary, which is attached at **Annex 4**.

## 4. The Treasury Management Strategy and Annual Investment Strategy Update

### 4.1 Background

The Treasury Management Strategy Statement (TMSS) for 2020/21 was approved by this Council on 24th February 2020. The Council's Annual Investment Strategy, which is incorporated in the TMSS, outlines the Council's investment priorities as follows:

- Security of capital
- Liquidity

The Council will also aim to achieve the optimum return (yield) on investments commensurate with the proper levels of security and liquidity. In the current economic climate it is considered appropriate to keep investments short term to cover cash flow needs, but also to seek out value available in periods up to 12 months with high credit rated financial institutions, using the Link suggested creditworthiness approach, including a minimum sovereign credit rating and Credit Default Swap (CDS) overlay information.

As shown by the interest rate forecasts in **Annex 4**, it is now impossible to earn the level of interest rates commonly seen in previous decades as all investment rates are barely above zero now that Bank Rate is at 0.10%, while some entities, including more recently the Debt Management Account Deposit Facility (DMADF), are offering negative rates of return in some shorter time periods. Given this risk environment and the fact that increases in Bank Rate are unlikely to occur before the end of the current forecast horizon of 31<sup>st</sup> March 2023, investment returns are expected to remain low.

### 4.2 Negative investment rates

While the Bank of England has said that it is unlikely to introduce a negative Bank Rate, at least in the next 6 -12 months, some deposit accounts are already offering negative rates for shorter periods. As part of the response to the pandemic and lockdown, the Bank and the Government have provided financial markets and businesses with plentiful access to credit, either directly or through commercial banks. In addition, the Government has provided large sums of grants to local authorities to help deal with the Covid crisis; this means many local authorities like East Staffordshire have had large increases in investment balances which required searching for an investment home, some of which was only very short term until those sums were able to be passed on.

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

4.4 Inter-local authority lending and borrowing rates have also declined due to the surge in the levels of cash seeking a short-term home at a time when many local authorities are probably having difficulties over accurately forecasting when disbursements of funds received will occur or when further large receipts will be received from the Government.

#### 4.5 Creditworthiness

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

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

Link have conducted some stress testing on the Link credit methodology based list of counterparties supplied to clients, to test for the results of a 1 notch downgrade to all Long Term Ratings from all agencies. Under such a scenario, only Commerzbank, Norddeutsche Landesbank, NatWest Markets Plc (non-ring-fenced entity), Leeds, Skipton and Yorkshire Building Societies moved from Green to No Colour. While there are a further 17 drops in other entities' suggested durations, in these instances, these entities still remain potentially available for use.

#### 4.6 Overview

The Council held £42.1m of investments as at 30 September 2020 (£36.4m at 30 September 2019) and the investment portfolio yield for the first six months of the year is 0.32% (0.82% 2019/20). A breakdown of the Council's investment portfolio is shown at **Annex 2** of this report.

The Chief Financial Officer confirms that the approved limits within the Annual Investment Strategy were not breached during the first six months of 2020/21.

The current investment counterparty criteria selection approved in the Treasury Management Strategy Statement is meeting the requirements of the treasury function. However, it is proposed to update the Treasury Management Strategy to encompass a clarification in respect of intra-local authority lending limits. The establishment of a maximum limit of £5m with an individual local authority, this equates to 10% of estimated average balances during the year. Intra-local authority lending is common place and has increased in recent times due to the market conditions. Whilst local authorities are seen to have high credit worthiness and therefore represent a low credit risk the authority will undertake suitable due-diligence procedures before each investment is authorised.

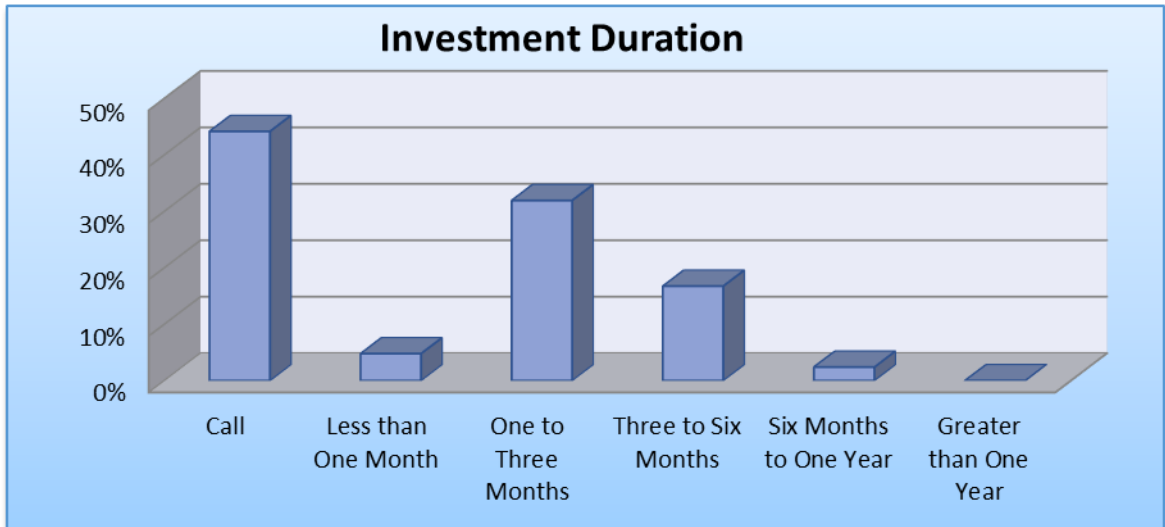
### 5. **Investment Portfolio**

- 5.1 In accordance with the Code, it is the Council's priority to ensure security of capital and liquidity, and to obtain an appropriate level of return which is consistent with the Council's risk appetite.
- 5.2 The investment portfolio yield for the first six months of the year is 0.32%.

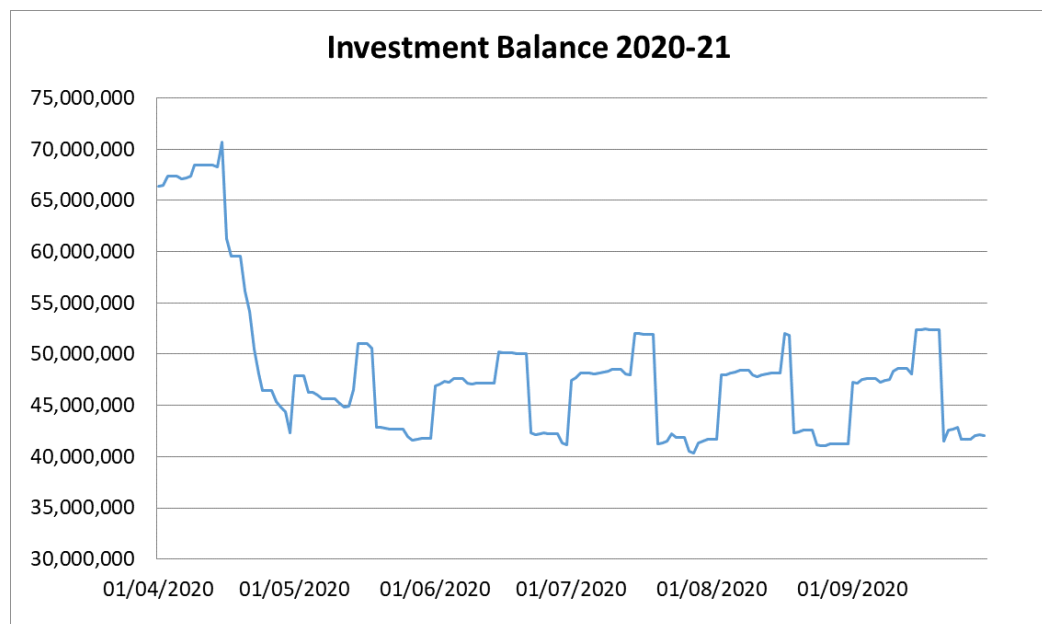
	<i>Average Rate Year to 30/09/20</i>
ESBC	0.32%
LIBID – 6 month	0.21%
Base Rate	0.10%

The bank rate remains at a historically low level. Despite this, the above table demonstrates that the authority has outperformed both the average base rate and the average 6 month LIBID benchmark. The Council's budgeted investment return for 2020/21 is 0.65%. Performance is therefore currently forecast to be lower than the budgeted rate of return, which is directly as a result of the emergency base rate reductions in March 2020 implemented due to the Covid-19 Pandemic.

5.3 A full list of investments held as at 30th September 2020, totalling £42.1m is shown in **Annex 2**. The graph below demonstrates the maturity profile of investments. The investment listing includes fixed deposits and call accounts held with a number of UK banks, as well as UK Government Treasury Bills/Deposit account and AAA rated money market funds. These instruments offer significant counterparty strength as well as diversification of the portfolio.



5.4 Average cash balances in the first six months of 2020/21 were £48.2m. The graph below demonstrates how these balances have fluctuated so far this year. This demonstrates a significant spike in funds from central government during late March and April in relation to the Covid-19 funding packages that the Council has administered.

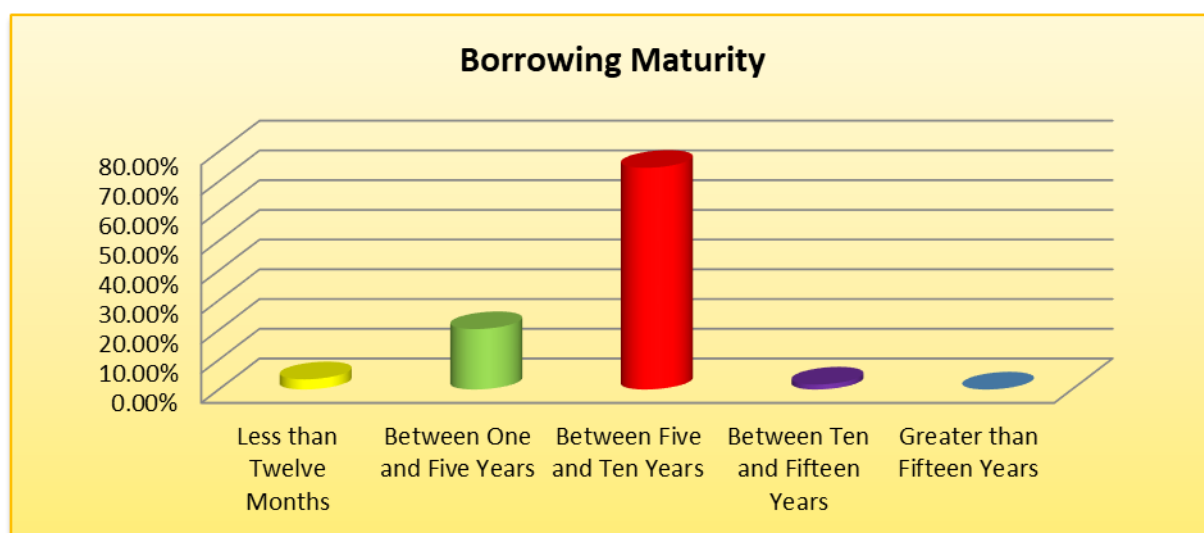




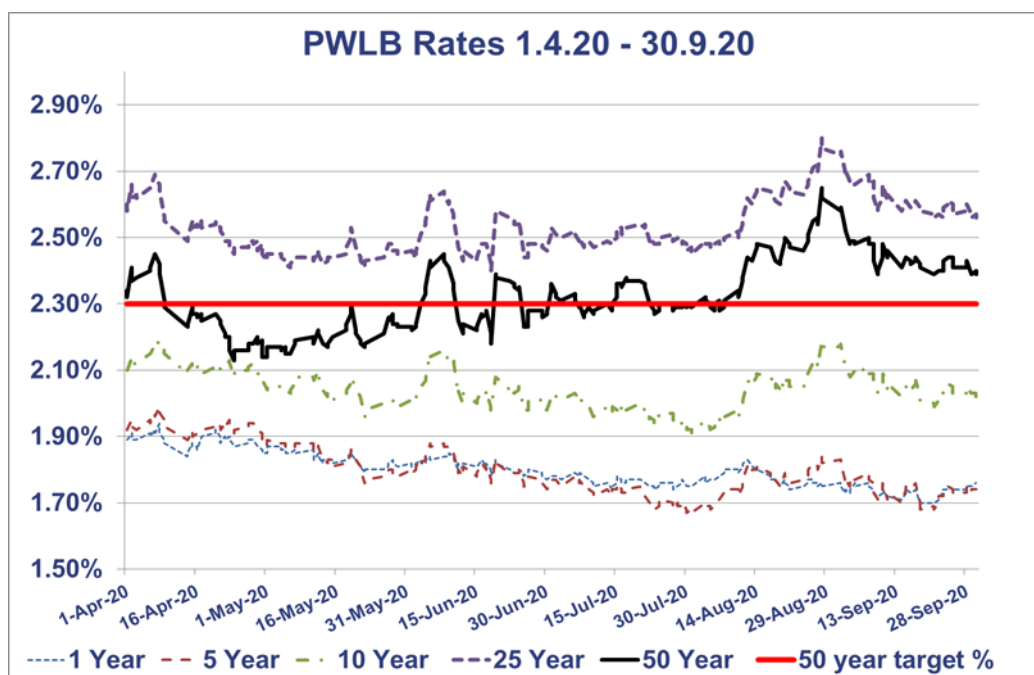
## 6. Borrowing

- 6.1 The Council's Capital Financing Requirement (CFR) as at 31<sup>st</sup> March 2021 is estimated to be £13m (£15m as at 31<sup>st</sup> March 2020). Excluding finance leases, the CFR is estimated to be £13m as at 31<sup>st</sup> March 2021 (£14.7m at 31<sup>st</sup> March 2020). The CFR denotes the Council's underlying need to borrow for capital purposes. If the CFR is positive the Council may borrow from the PWLB or the market (external borrowing) or from internal balances on a temporary basis (internal borrowing). The balance of external and internal borrowing is generally driven by market conditions.
- 6.2 The forecast CFR is now higher than when the budget and treasury management strategy was set, this reflects the latest information in relation to the timing of capital receipts that are planned to be partially utilised to repay internal debt, which in turn will deliver savings to the revenue budget. There remains an ongoing the risk that this could impact on the MTFs in 2021/22 and beyond.
- 6.3 Consistent with the strategy, no new borrowing has been undertaken during the first half of 2020/21. The current borrowing levels and maturity profile are set out in the table and graph below.

Debt Type	Principal Outstanding (£)	Average Rate
<b>Total Fixed Debt</b>		
PWLB Maturity	5,700,000	4.646%
PWLB Annuity	489,554	8.612%
<b>Total Variable Debt</b>		
Market	4,500,000	5.914%
GBSLEP Loan	375,000	-
<b>Total External Debt</b>	<b>11,064,554</b>	<b>5.362%</b>



- 6.4 The graph and table below show the movement in PWLB certainty rates for the first six months of the year to date. PWLB rates varied within a relatively narrow range between April and July but the longer end of the curve rose during August. This increase came in two periods; the first in the second week of the month was on the back of hopes for fresh US stimulus. This saw investors switch monies out of government bonds and into equities. The second shift higher at the longer end of the curve came in the latter stages of the month as investors reacted to the announcement of the tweak to the Fed's inflation target. Despite moves further out in the yield curve, the short end remained anchored on the basis of no fundamental change to the interest rate outlook.
- 6.5 The 50-year PWLB target rate for new long-term borrowing was unchanged at 2.30%.



- 6.6 As set out in the Treasury Management Strategy Statement for 2020/21, it is not currently anticipated that any external borrowing will be undertaken in the remainder of the year. Nevertheless, the Financial Management Unit will continue to monitor interest rates in financial markets and adopt a pragmatic approach to changing circumstances, including the possibility of early repayment and any decisions will be reported to the appropriate decision making body at the next available opportunity.

## 7. Debt Re-Scheduling

Debt re-scheduling opportunities have been limited in the current economic climate and consequent structure of interest rates. As a consequence there has not been any re-scheduling undertaken. Nevertheless any opportunities for early repayment will be assessed in light of changing circumstances and economic forecasts.

## **8. Compliance with Treasury and Prudential Limits**

It is a statutory duty for the Council to determine and keep under review the "Affordable Borrowing Limits". Council's approved Treasury and Prudential Indicators (affordability limits) are outlined in the approved TMSS.

During the financial year to date the Council has operated within the treasury limits and Prudential Indicators set out in the Council's Treasury Management Strategy Statement and in compliance with the Council's Treasury Management Practices. The Prudential and Treasury Indicators are shown in **Annex 1**.

## **9. Other Treasury Matters**

### Icelandic Deposit/Administration

This authority currently has £0.267m investments frozen in the Icelandic bank (KSF). We anticipate further dividend repayments from the administration process and Members will be informed in the normal manner.

## Annex 1: Prudential and Treasury Indicators

PRUDENTIAL INDICATOR	2019/20	2020/21	2020/21
	Outturn	Estimate	Probable
	£'000	£'000	£'000
<b>Capital Expenditure</b>	2,104	4,597	<b>2,628</b>
<b>Ratio of financing costs to net revenue stream</b>	11.1%	7.8%	<b>8.2%</b>
<b>Capital Financing Requirement#</b>	15,047	10,794	<b>13,017</b>
<b>External Debt*</b> (including finance leases)	11,545	11,155	<b>11,230</b>

*# forecast/probable higher due to timing of capital receipts to repay debt.*

## Annex 1: Prudential and Treasury Indicators

	2019/20	2020/21	2020/21
<b>(2). TREASURY MANAGEMENT PRUDENTIAL INDICATORS</b>	<b>Outturn</b>	<b>Estimate</b>	<b>Probable</b>
<b>Authorised Limit for external debt</b>			
borrowing	16,500	16,500	16,500
other long term liabilities	3,000	3,000	3,000
<b>TOTAL</b>	<b>19,500</b>	<b>19,500</b>	<b>19,500</b>
<b>Operational Boundary for external debt -</b>			
borrowing	15,500	15,500	15,500
other long term liabilities	2,000	2,000	2,000
<b>TOTAL</b>	<b>17,500</b>	<b>17,500</b>	<b>17,500</b>
<b>Upper limit for total principal sums invested for over 1 year</b>	5,000	5,000	<b>5,000</b>

## Annex 2: Investments as at 30<sup>th</sup> September 2020

Borrower	Principal (£)	Interest Rate	Start Date	Maturity Date
<b>Call Accounts and Money Market Funds</b>				
RBS SIBA	89,901	0.01%		
Barclays	73	0.05%		
Santander	3,500,000	0.80%		95 day notice
Bank of Scotland	2,500,000	0.30%		95 day notice
Lloyds	3,500,000	0.30%		95 day notice
MMF Federated	875,000	0.06%		Call
MMF Aberdeen	4,000,000	0.08%		Call
MMF CCLA	4,000,000	0.12%		Call
<b>Fixed Deposits / Certificates of Deposit</b>				
UK Treasury Bill	2,000,000	0.03%	08/06/2020	05/10/2020
UK Treasury Bill	2,000,000	0.14%	04/05/2020	02/11/2020
UK Treasury Bill	2,000,000	0.08%	26/05/2020	23/11/2020
UK Treasury Bill	2,000,000	0.04%	01/06/2020	30/11/2020
National Westminster Bank CD	2,000,000	0.89%	19/02/2020	18/02/2021
National Westminster Bank CD	1,000,000	0.26%	12/08/2020	12/08/2021
DMO (UK Debt Management)	7,350,000	0.01%	26/06/2020	21/12/2020
DMO (UK Debt Management)	5,000,000	0.00%	21/09/2020	22/03/2021

Borrower - Icelandic Exposure	Principal (£)	Interest Rate	Start Date	Maturity Date
Singer	266,000	5.41%		08/10/2008

Investments rate of interest as at 30 <sup>th</sup> June 2020	Principal (£)	Interest Rate
<b>Total Investments</b>	<b>42,081,574</b>	
<b>Total Investments - Excluding Icelandic Exposure</b>	<b>41,814,974</b>	<b>0.19%</b>
<b>Total Investments - Icelandic Exposure Only</b>	<b>266,600</b>	<b>5.41%</b>

Average rate of interest (Year to date)	Principal (£)	Interest Rate
<b>Total Investments</b>	<b>48,161,731</b>	
<b>Total Investments - Excluding Icelandic Exposure</b>	<b>47,895,131</b>	<b>0.32%</b>
<b>Total Investments - Icelandic Exposure Only</b>	<b>266,600</b>	<b>5.41%</b>

## Annex 3: Global Economic Outlook

**USA.** The incoming sets of data during the first week of August were almost universally stronger than expected. With the number of new daily coronavirus infections beginning to abate, recovery from its contraction this year of 10.2% should continue over the coming months and employment growth should also pick up again. However, growth will be dampened by continuing outbreaks of the virus in some states leading to fresh localised restrictions. At its end of August meeting, the Fed tweaked **its inflation target** from 2% to maintaining an average of 2% over an unspecified time period i.e. following periods when inflation has been running persistently below 2%, appropriate monetary policy will likely aim to achieve inflation moderately above 2% for some time. This change is 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 so financial markets took note that higher levels of inflation are likely to be in the pipeline; long term bond yields duly rose after the meeting. The Fed also called on Congress to end its political disagreement over providing more support for the unemployed as there is a limit to what monetary policy can do compared to more directed central government fiscal policy. The FOMC’s updated economic and rate projections in mid-September showed that officials expect to leave the fed funds rate at near-zero until at least end-2023 and probably for another year or two beyond that. There is now some expectation that where the Fed has led in changing its inflation target, other major central banks will follow. The increase in tension over the last year between the US and China is likely to lead to a lack of momentum in progressing the initial positive moves to agree a phase one trade deal.

**EU.** The economy was recovering well towards the end of Q2 after a sharp drop in GDP, (e.g. France 18.9%, Italy 17.6%). However, the second wave of the virus affecting some countries could cause a significant slowdown in the pace of recovery, especially in countries more dependent on tourism. The fiscal support package, eventually agreed by the EU after prolonged disagreement between various countries, is unlikely to provide significant support and quickly enough to make an appreciable difference in weaker countries. The ECB has been struggling to get inflation up to its 2% target and it is therefore expected that it will have to provide more monetary policy support through more quantitative easing purchases of bonds in the absence of sufficient fiscal support.

**China.** After a concerted effort to get on top of the virus outbreak in Q1, economic recovery was strong in Q2 and has enabled it to recover all of the contraction in Q1. However, this was achieved by major central government funding of yet more infrastructure spending. After years of growth having been focused on this same area, any further spending in this area is likely to lead to increasingly weaker economic returns. This could, therefore, lead to a further misallocation of resources which will weigh on growth in future years.

**Japan.** There are some concerns that a second wave of the virus is gaining momentum and could dampen economic recovery from its contraction of 8.5% in GDP. It has been struggling to get out of a deflation trap for many years and to stimulate consistent

significant GDP growth and to get inflation up to its target of 2%, despite huge monetary and fiscal stimulus. It is also making little progress on fundamental reform of the economy. The resignation of Prime Minister Abe is not expected to result in any significant change in economic policy.

**World growth.** Latin America and India are currently hotspots for virus infections. World growth will be in recession this year. Inflation is unlikely to be a problem for some years due to the creation of excess production capacity and depressed demand caused by the coronavirus crisis.



## Annex 4: Interest Rate Forecasts

The Council's treasury advisor, Link Group, provided the following forecasts on 11<sup>th</sup> August 2020 (PWLB rates are certainty rates, gilt yields plus 180bps):

Link Group Interest Rate View 11.8.20		Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22	Mar-23
Bank Rate View		0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
3 month average earnings		0.05	0.05	0.05	0.05	0.05	-	-	-	-	-
6 month average earnings		0.10	0.10	0.10	0.10	0.10	-	-	-	-	-
12 month average earnings		0.15	0.15	0.15	0.15	0.15	-	-	-	-	-
5yr PWLB Rate		1.90	2.00	2.00	2.00	2.00	2.00	2.10	2.10	2.10	2.10
10yr PWLB Rate		2.10	2.10	2.10	2.10	2.20	2.20	2.20	2.30	2.30	2.30
25yr PWLB Rate		2.50	2.50	2.50	2.60	2.60	2.60	2.70	2.70	2.70	2.70
50yr PWLB Rate		2.30	2.30	2.30	2.40	2.40	2.40	2.50	2.50	2.50	2.50

The coronavirus outbreak has done huge economic damage to the UK and economies around the world. After the Bank of England took emergency action in March to cut Bank Rate to first 0.25%, and then to 0.10%, it left Bank Rate unchanged at its meeting on 6<sup>th</sup> August (and the subsequent September meeting), although some forecasters had suggested that a cut into negative territory could happen. However, the Governor of the Bank of England has made it clear that he currently thinks that such a move would do more damage than good and that more quantitative easing is the favoured tool if further action becomes necessary. As shown in the forecast table above, no increase in Bank Rate is expected within the forecast horizon ending on 31<sup>st</sup> March 2023 as economic recovery is expected to be only gradual and, therefore, prolonged.

**GILT YIELDS / PWLB RATES.** There was much speculation during the second half of 2019 that bond markets were in a bubble which was driving bond prices up and yields down to historically very low levels. The context for that was heightened expectations that the US could have been heading for a recession in 2020. In addition, there were growing expectations of a downturn in world economic growth, especially due to fears around the impact of the trade war between the US and China, together with inflation generally at low levels in most countries and expected to remain subdued. Combined, these conditions were conducive to very low bond yields. While inflation targeting by the major central banks has been successful over the last 30 years in lowering inflation expectations, the real equilibrium rate for central rates has fallen considerably due to the high level of borrowing by consumers. This means that central banks do not need to raise rates as much now to have a major impact on consumer spending, inflation, etc. The consequence of this has been the gradual lowering of the overall level of interest rates and bond yields in financial markets over the last 30 years. Over the year prior to the coronavirus crisis, this has seen many bond yields up to 10 years turn negative in the Eurozone. In addition, there has, at times, been an inversion of bond yields in the US whereby 10 year yields have fallen below shorter term yields. In the past, this has been a precursor of a recession. The other side of this coin is that bond prices are elevated as investors would be expected to be moving out of riskier assets i.e. shares, in anticipation of a downturn in corporate earnings and so selling out of equities.

Gilt yields had therefore already been on a generally falling trend up until the coronavirus crisis hit western economies during March. After gilt yields spiked up during the initial phases of the health crisis in March, we have seen these yields fall sharply to unprecedented lows as major western central banks took rapid action to deal with excessive stress in financial markets, and started massive quantitative easing purchases of government bonds: this also acted to put downward pressure on government bond yields at a time when there has been a huge and quick expansion of government expenditure financed by issuing government bonds. Such unprecedented levels of issuance in “normal” times would have caused bond yields to rise sharply. At the close of the day on 30<sup>th</sup> September, all gilt yields from 1 to 6 years were in negative territory, while even 25-year yields were at only 0.76% and 50 year at 0.60%.

From the local authority borrowing perspective, HM Treasury imposed **two changes of margins over gilt yields for PWLB rates** in 2019-20 without any prior warning. The first took place on 9<sup>th</sup> October 2019, adding an additional 1% margin over gilts to all PWLB period rates. That increase was then at least partially reversed for some forms of borrowing on 11<sup>th</sup> March 2020, but not for mainstream General Fund capital schemes, at the same time as the Government announced in the Budget a programme of increased infrastructure expenditure. It also announced that there would be a consultation with local authorities on possibly further amending these margins; this was to end on 4<sup>th</sup> June, but that date was subsequently put back to 31<sup>st</sup> July. It is clear HM Treasury will no longer allow local authorities to borrow money from the PWLB to purchase commercial property if the aim is solely to generate an income stream (assets for yield).

Following the changes on 11<sup>th</sup> March 2020 in margins over gilt yields, the current situation is as follows: -

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

It is possible that the non-HRA Certainty Rate will be subject to revision downwards after the conclusion of the PWLB consultation; however, the timing of such a change is currently an unknown, although it would be likely to be within the current financial year.

As the interest forecast table for PWLB certainty rates, (gilts plus 180bps), above shows, there is likely to be little upward movement in PWLB rates over the next two years as it will take economies, including the UK, a prolonged period to recover all the momentum they have lost in the sharp recession caused during the coronavirus shut down period. Inflation is also likely to be very low during this period and could even turn negative in some major western economies during 2020/21.

### **The balance of risks to the UK**

- The overall balance of risks to economic growth in the UK is probably relatively even, but is subject to major uncertainty due to the virus.

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

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

- **UK** - second nationwide wave of virus infections requiring a national lockdown
- **UK / EU trade negotiations** – if it were to cause significant economic disruption and a fresh major downturn in the rate of growth.
- **UK - Bank of England** takes action too quickly, or too far, over the next three years to raise Bank Rate and causes UK economic growth, and increases in inflation, to be weaker than we currently anticipate.
- A resurgence of the **Eurozone sovereign debt crisis**. The ECB has taken monetary policy action to support the bonds of EU states, with the positive impact most likely for “weaker” countries. In addition, the EU recently agreed a €750bn fiscal support package. These actions will help shield weaker economic regions for the next year or so. However, in the case of Italy, the cost of the virus crisis has added to its already huge debt mountain and its slow economic growth will leave it vulnerable to markets returning to taking the view that its level of debt is unsupportable. There remains a sharp divide between northern EU countries favouring low debt to GDP and annual balanced budgets and southern countries who want to see jointly issued Eurobonds to finance economic recovery. This divide could undermine the unity of the EU in time to come.
- Weak capitalisation of some **European banks**, which could be undermined further depending on extent of credit losses resultant of the pandemic.
- **German minority government & general election in 2021**. In the German general election of September 2017, Angela Merkel’s CDU party was left in a vulnerable minority position dependent on the fractious support of the SPD party, as a result of the rise in popularity of the anti-immigration AfD party. The CDU has done badly in subsequent state elections but the SPD has done particularly badly. Angela Merkel has stepped down from being the CDU party leader but she intends to remain as Chancellor until the general election in 2021. This then leaves a major question mark over who will be the major guiding hand and driver of EU unity when she steps down.
- **Other minority EU governments**. Austria, Sweden, Spain, Portugal, Netherlands, Ireland and Belgium also have vulnerable minority governments dependent on coalitions which could prove fragile.
- **Austria, the Czech Republic, Poland and Hungary** now form a strongly anti-immigration bloc within the EU. There has also been a rise in anti-immigration sentiment in Germany and France.

- **Geopolitical risks**, for example in China, Iran or North Korea, but also in Europe and other Middle Eastern countries, which could lead to increasing safe haven flows.
- **US – the Presidential election in 2020:** this could have repercussions for the US economy and SINO-US trade relations.

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

- **UK** - stronger than currently expected recovery in UK economy.
- **Post-Brexit** – if an agreement was reached that removed the majority of threats of economic disruption between the EU and the UK.
- The **Bank of England is too slow** in its pace and strength of increases in Bank Rate and, therefore, allows inflationary pressures to build up too strongly within the UK economy, which then necessitates a later rapid series of increases in Bank Rate faster than we currently expect.