Croydon Council

REPORT TO:	**General Purposes and Audit Committee** **14 January 2021**
SUBJECT:	**Treasury Management Strategy Statement and Annual Investment Strategy Mid-Year Review 2020/2021**
LEAD OFFICER:	**Lisa Taylor, Director of Finance, Investment and Risk (S151 Officer)**
CABINET MEMBER	**Councillor Callton Young** **Cabinet Member for Resources and Financial Governance**
WARDS:	**All**
CORPORATE PRIORITY/POLICY CONTEXT: This Report details the Council's Treasury Management activities during the first half of 2020/21 and its compliance with the 2017 Prudential Code for Capital Finance.	
FINANCIAL SUMMARY: This Report details the Council's Treasury Management activities during the first half of 2020/2021 and demonstrates its compliance with the 2017 Prudential Code for Capital Finance.	
FORWARD PLAN KEY DECISION REFERENCE NO.: N/A	

1. RECOMMENDATION

1.1 The Committee are asked to note the contents of this report.

2. EXECUTIVE SUMMARY

2.1 This Report is prepared in accordance with the requirements of the Chartered Institute of Public Finance and Accountancy (CIPFA) codes of practice in respect of capital finance and treasury management. The codes recommend that members are advised of treasury management activities of the first six months of each financial year and of compliance with various strategies and policies agreed by the Council. The report:

- Reviews compliance with the Treasury Management Strategy Statement, Capital Strategy and Annual Investment Strategy as agreed by Council on 2 March 2020 (Minute 87/20 applies);
- Reviews treasury borrowing and investment activity for the period 1 April 2020 to 30 September 2020; and
- Demonstrates compliance with agreed Prudential Indicators;

3 DETAIL

3.1 Background

3.1.1 In December 2017, CIPFA issued codes of practice as follows:

- The Prudential Code for Capital Finance in Local Authorities; and
- Treasury Management in the Public Services: Code of Practice (the Code) and Cross-Sectoral Guidance Notes.

3.1.2 The Code, from 2019/20, requires all local authorities to prepare a Capital Strategy which is to provide the following:

- A high-level overview of how capital expenditure, capital financing and treasury management activity contribute to the provision of services;
- An overview of how the associated risk is managed;
- The implications for future financial sustainability.

3.1.3 As regards Treasury Management, the primary requirements of the Code are:

- Creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the Council's treasury management activities.
- Creation and maintenance of Treasury Management Practices which set out the manner in which the Council will seek to achieve those policies and objectives.
- 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.
- 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.
- 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 General Purposes and Audit Committee.

3.1.4 This mid-year report has been prepared in compliance with the Codes and covers the following:

- An economic update for the first half of the 2020/21 financial year (Section 3.2);
- A medium term interest rates forecast (Section 3.3)
- A review of the Council's Treasury Management Strategy Statement and Annual Investment Strategy (Section 3.4);
- The Council's capital expenditure, as set out in the Capital Strategy, and prudential indicators (Section 3.5);
- A review of the Council's borrowing strategy (Section 3.6);
- A review of the Council's investment strategy (Section 3.7);
- A review of any debt re-scheduling undertaken (Section 3.8);

3.2 Economic update

3.2.1 A commentary provided by the Council's independent treasury advisers Link Asset Services (Link) in the first week of November 2020 is included as Appendix A.

3.3 Interest rate forecasts

3.3.1 Link Treasury Services have provided forecasts of key interest rates as detailed in Table 1. These inform decisions as to the timing and duration of borrowing decisions

Table 1 Interest rates forecast

Link Group Interest Rate View	9.11.20													
	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24
BANK RATE	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
3 month ave earnings	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
6 month ave earnings	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
12 month ave earnings	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20
5yr PWLB	1.80	1.80	1.80	1.80	1.80	1.90	1.90	1.90	1.90	1.90	2.00	2.00	2.00	2.00
10 yr PWLB	2.10	2.10	2.10	2.10	2.20	2.20	2.20	2.30	2.30	2.30	2.30	2.30	2.30	2.30
25 yr PWLB	2.50	2.50	2.60	2.60	2.60	2.60	2.70	2.70	2.70	2.70	2.80	2.80	2.80	2.80
50 yr PWLB	2.30	2.30	2.40	2.40	2.40	2.40	2.50	2.50	2.50	2.50	2.60	2.60	2.60	2.60

3.3.2 A commentary by Link is included as Appendix B.

3.4 Treasury Management Strategy Statement and Annual Investment Strategy

3.4.1 The Treasury Management Strategy Statement and Annual Investment Strategy for 2020/2021 were approved by full Council on 2 March 2020 (Minute 87/20 applies). It is entirely possible that the several reviews, prompted by the Report in the Public Interest and the publication of the Section 114 Notice, will impact on these strategies and that these may need to be revised in the future as a result.

3.5 Capital Strategy and Prudential Indicators

3.5.1 Table 2 below shows the original capital budget as agreed by full Council on 2 March 2020 (Minute 86/20 applies) and the revised budget and the current estimated outturn. The revised figures are based on the report to Cabinet, 21st September; the outturn projection will be updated to reflect any subsequent changes as they become apparent.

Table 2 Capital expenditure by service

	Original Estimate £m	Revised Estimate £m	Outturn Projection £m
Health, Wellbeing and Adults	3.0	7.6	7.6
Children, Families and Education	25.3	41.0	41.0
Place	159.4	120.6	120.6
Resources	113.8	19.6	19.6
HRA	35.7	127.4	127.4
Total	**337.2**	**316.2**	**316.2**

3.5.2 The table below details the funding sources of the capital programme. The borrowing element of the table increases the underlying need to borrow for capital purposes by way of the Capital Financing Requirement (CFR), although this will be reduced in part by revenue charges for the repayment of debt (the Minimum Revenue Provision).

Table 3 Financing of capital expenditure

	Original Estimate £m	Revised Estimate £m	Outturn Projection £m
Capital receipts		21.8	21.8
Capital grants	25.0	29.2	29.2
Community Infrastructure Levy	7.3	8.6	8.6
Capital reserves	3.3	3.3	3.3
Section 106 receipts		5.0	5.0
Revenue	23.7	23.6	23.6
Total financing	**59.3**	**91.5**	**91.5**
Borrowing requirement	**277.9**	**224.7**	**224.7**

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3.5.3 The key controls over treasury management activity are prudential indicators to ensure that, over the medium term, borrowing will only be for a capital purposes. Gross external borrowing should not, except in the short term, exceed the total of CFR in the preceding year plus the estimates of any additional CFR for 2020/21 and the next two financial years. This allows some flexibility for limited early borrowing for future years. Full Council has approved a policy for borrowing in advance of need which will be adhered to if this proves prudent. The table below shows changes in the CFR and borrowing requirements arising from the changes in the capital programme described above.

Table 4 Borrowing and CFR

	Original Estimate £m	Outturn Projection £m
Borrowing	1,708.0	1,654.8
Other long term liabilities	82.8	75.8
Total debt	1,790.8	1,730.6
CFR (year end position)	1,799.5	1,730.6

3.5.4 The Prudential Indicators relevant to the capital programme and its borrowing implications are the Operational Boundary (the expected debt position) and the Authorised Limit (the limit beyond which borrowing is prohibited).

Table 5 Operational Boundary and Authorised Limit

	Original Estimate £m	Outturn Projection £m
Operational Boundary	1,790.8	1,730.6
Authorised Limit	1,840.8	1,780.6

3.5.5 Members will note that the Authorised Limit includes a buffer of £50m to cover unexpected cashflow shortages.

3.6 Borrowing Strategy

3.6.1 During 2020/21 the Council has been operating in accordance with the borrowing limits approved by full Council on 2 March 2020. As discussed above, the current limits for the year are:

- Operational Boundary - £1,790.8m
- Authorised Limit - £1,840.8m

3.6.2 The level of the Council’s borrowing, which is measured against these limits, was £1,445m on 1 April 2020 and currently stands at £1.446.5m. The unique circumstances experienced over recent months have created an environment whereby capital expenditure has been significantly reduced. Such spend as has been seen has been financed from internal cash balances or loans taken out in previous periods in advance of need. Borrowing in advance of need is an established method of managing interest payments and mitigating interest rate increases.

3.6.3 Borrowing will be taken up as required based on a continuing analysis of actual and projected expenditure over the different components of the capital programme and interest rates forecasts. It is likely that the Council will use a mixture of long term borrowing from the PWLB, short term borrowing from other local authorities and internal balances. Borrowing will be undertaken to fit into the Council’s existing debt maturity profile to move towards a more even distribution of maturities. Appendix C shows the movements in PWLB interest rates for various loan periods during the first six months of the financial year.

3.6.4 The Council's effective interest payable on long term debt currently stands at 2.89%.

3.7 Investment Strategy

3.7.1 From time to time, under Section 15 (1) of the Local Government Act 2003 the Secretary of State issues statutory guidance on local government investments to which local authorities are required to "have regard." This guidance was taken into account in the investment policy parameters set within the Council's Treasury Management Strategy Statement, Minimum Revenue Provision Policy Statement and Annual Investment Strategy as approved by full Council on 2 March 2020 Minute 87/20 applies).

3.7.2 The current guidance defines investments as "Specified" and "Non-specified"

3.7.3 An investment is a specified investment if all of the following apply:

- the investment and any associated payments or repayments are denominated in sterling;
- the investment has a maximum maturity of one year;
- the investment is not defined as capital expenditure; and
- the investment is made with a body or in an investment scheme described as high quality or with the UK Government, a UK local authority or a parish or community council.

3.7.4 A non-specified investment is any investment that does not meet all the conditions in paragraph 3.7.3 above.

3.7.5 It is the Council's priority when undertaking treasury activities to ensure security of capital and liquidity, and to obtain an appropriate level of return which is consistent with the Council's risk appetite. Investment instruments identified for use by the Council during 2020/21 as advised in the current Treasury Management Strategy are detailed in Appendix D.

3.7.6 As regards investment returns, Link Treasury Services advise as follows:

"As shown by the forecasts in section 3.3, it is now impossible to earn the level of interest rates commonly seen in previous decades as all investment rates up to 12 months are either negative or barely above zero now that Bank Rate is at 0.10%. 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 March 2023, investment returns are expected to remain low."

3.7.7 Investment activity in the first half of the year conformed to the approved strategy with an average monthly balance of £82.6m being maintained in temporary investments.

3.7.8 The Director of Finance confirms that the approved limits within the Annual Investment Strategy were not breached during the first six months of 2020/2021.

3.8 Repayment of Debt and Debt Rescheduling

3.8.1 With Public Works Loans Board rates low during the first half of 2020/2021 and with high premiums being attached to the premature repayment of existing debt, opportunities for debt restructuring were minimal and none were taken.

4. FINANCIAL CONSIDERATIONS

4.1 There are no financial considerations arising from this report.

Approved by: Lisa Taylor, Director of Finance, Investment and Risk, S. 151 Officer.

5 HUMAN RESOURCES CONSIDERATIONS

5.1 There are no direct workforce implications arising from the recommendations within this report.

Approved by: Sue Moorman , Director of Human Resources

6. OTHER CONSIDERATIONS

6.1 There are no Customer Focus, Equalities, Environment and Design, Crime and Disorder or Human Rights considerations arising from this report

7 LEGAL CONSIDERATIONS

7.1 The Head of Litigation and Corporate Law comments on behalf of the Council Solicitor and Monitoring Officer that in relation to the Annual Investment Strategy, the Council is required to have regard to guidance issued by the Secretary of State under the Local Government Act 2003 section 15(1) (a) entitled “Statutory Guidance on Local Government Investments 3rd Edition” which is applicable from and effective for financial years commencing on or after 1 April 2018.

7.2 The Ministry of Housing Communities and Local Government (MHCLG) guidance is complemented by two codes of practice issued by the Chartered Institute of Public Finance and Accountancy (CIPFA) containing investment guidance namely Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes and The Prudential Code for Capital Finance in Local Authorities.

7.3 By regulation 2 and 24 of the Local Authorities (Capital Finance and Accounting) (England) Regulations 2003, as amended, local authorities are required to have regard to the current edition of the CIPFA codes.

7.4 The Local Government Act 2003 section 3(1) and (8) requires the council to determine and keep under review how much money it can afford to borrow. The function of determining and keeping these levels under review is a function reserved to Full Council.

7.5 In determining the Annual Minimum Reserves and the policy around such reserves, the Council shall have regard to guidance issued by the Secretary of State under the Local Government Act 2003 section 21(1A) entitled “Statutory guidance on minimum revenue provision”.

7.6 Subsequent to the approval of the Treasury Management Strategy and Annual Investment Strategy by the Council, the Report in the Public Interest issued by the Council’s auditors under the Local Audit and Accountability Act 2014 and the two reports issued by the Council’s Chief Finance Officer under the Local Government Finance Act 1988 section 114(3) will likely impact and necessitate a review of these strategies.

Approved by: Sandra Herbert, Head of Litigation and Corporate Law on behalf of Jacqueline Harris-Baker Council Solicitor and Monitoring Officer.

8.0 FREEDOM OF INFORMATION

8.1 This report contains only information that can be publicly disclosed.

9 DATA PROTECTION IMPLICATIONS

9.1 Will the subject of the report involve the processing of ‘personal data’?

No.

Has a data protection impact assessment (DPIA) been completed?

No. This report relates to matters relating to the administration of the LGPS and the Croydon Pension Fund.

Approved by: Lisa Taylor, Director of Finance, Investment and Risk, S151 Officer

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Resources Department, ext. 62552.

BACKGROUND DOCUMENTS:

None

APPENDICES:

A Economic update
B Interest rate forecast update
C PWLB rates
D Investment instruments

APPENDIX A

Economic update (as prepared by Link Asset Services in the first week of November 2020)

- **UK.** The Bank of England's Monetary Policy Committee kept **Bank Rate** unchanged on 5th November. However, it revised its economic forecasts to take account of a second national lockdown from 5th November to 2nd December which is obviously going to put back economic recovery and do further damage to the economy. It therefore decided to do a further tranche of **quantitative easing (QE) of £150bn**, to start in January when the current programme of £300bn of QE announced in March to June, runs out. It did this so that "announcing further asset purchases now should support the economy and help to ensure the unavoidable near-term slowdown in activity was not amplified by a tightening in monetary conditions that could slow the return of inflation to the target".
- Its forecasts appear to be rather optimistic in terms of three areas:
    - The economy would recover to reach its pre-pandemic level in Q1 2022
    - The Bank also expects there to be excess demand in the economy by Q4 2022.
    - CPI inflation is therefore projected to be a bit above its 2% target by the start of 2023 and the "inflation risks were judged to be balanced".
- Significantly, there was no mention of **negative interest rates** in the minutes or Monetary Policy Report, suggesting that the MPC remains some way from being persuaded of the case for such a policy, at least for the next 6 -12 months. However, rather than saying that it "stands ready to adjust monetary policy", the MPC this time said that it will take "whatever additional action was necessary to achieve its remit". The latter seems stronger and wider and may indicate the Bank's willingness to embrace new tools.
- One key addition to **the Bank's forward guidance** in August was a new phrase in the policy statement, namely that "it does not intend to tighten monetary policy until there is clear evidence that significant progress is being made in eliminating spare capacity and achieving the 2% target sustainably". That seems designed to say, in effect, that even if inflation rises to 2% in a couple of years' time, do not expect any action from the MPC to raise Bank Rate – until they can clearly see that level of inflation is going to be persistently above target if it takes no action to raise Bank Rate. Our Bank Rate forecast currently shows no increase through to quarter 1 2024 but there could well be no increase during the next five years due to the slow rate of recovery of the economy and the need for the Government to see the burden of the elevated debt to GDP ratio falling significantly. **Inflation** is unlikely to pose a threat requiring increases in Bank Rate during this period as there is likely to be spare capacity in the economy for a considerable time. It is expected to briefly peak at around 2% towards the end of 2021, but this is a temporary short lived factor and so not a concern.
- However, the minutes did contain several references to **downside risks**. The MPC reiterated that the "recovery would take time, and the risks around the GDP projection were judged to be skewed to the downside". It also said "the risk of a more persistent period of elevated unemployment remained material". Downside risks could well include severe restrictions remaining in place in some form during the rest of December and most of January too. That could involve some or all of the lockdown

being extended beyond 2nd December, a temporary relaxation of restrictions over Christmas, a resumption of the lockdown in January and lots of regions being subject to Tier 3 restrictions when the lockdown ends. Hopefully, restrictions should progressively ease during the spring. It is only to be expected that some businesses that have barely survived the first lockdown, will fail to survive the second lockdown, especially those businesses that depend on a surge of business in the run up to Christmas each year. This will mean that there will be some level of further permanent loss of economic activity, although the extension of the furlough scheme to the end of 31st March will limit the degree of damage done.

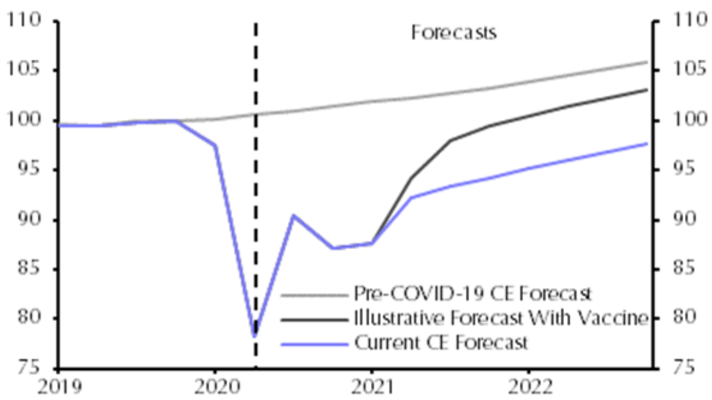
- As for **upside risks**, we have been waiting expectantly for news that various **COVID19 vaccines** would be cleared as being safe and effective for administering to the general public. The Pfizer announcement on 9th November was very encouraging as its 90% effectiveness was much higher than the 50-60% rate of effectiveness of flu vaccines which might otherwise have been expected. However, their phase three trials are still only two-thirds complete. More data needs to be collected to make sure there are no serious side effects. We don't know exactly how long immunity will last or whether it is effective across all age groups. The Pfizer vaccine specifically also has demanding cold storage requirements of minus 70C that might make it more difficult to roll out. However, the logistics of production and deployment can surely be worked out over the next few months.

- What these vaccine results would mean is that **life could largely return to normal during 2021**, with activity in the still-depressed sectors like restaurants, travel and hotels returning to their pre-pandemic levels, which would help to bring the unemployment rate down. With the household saving rate currently being exceptionally high, there is plenty of pent-up demand and purchasing power stored up for these services. A large-scale roll-out of vaccines might take into late 2021 to fully complete; but if the vaccine really is that effective, then there is a possibility that restrictions could begin to be eased once vulnerable people and front-line workers had been vaccinated. At that point, there would be less reason to fear that hospitals could become overwhelmed any more. Effective vaccines would radically improve the economic outlook once they have been widely administered; it may allow GDP to rise to its pre-virus level a year earlier than otherwise and mean that the unemployment rate peaks at 7% next year instead of 9%. But while this would reduce the need for more QE and/or negative interest rates, increases in Bank Rate would still remain some years away. However, until there is clarity on these issues around the Pfizer vaccine, it would be premature to change the overall economic commentary and forecasting in this report. It also raises a potential question as to whether the relatively optimistic outlook of the Monetary Policy Report was swayed by making positive assumptions around effective vaccines being available soon. It should also be borne in mind that as effective vaccines will take time to administer, economic news could well get worse before it starts getting better.
- **Public borrowing** is now likely to increase by about £30bn to around £420bn (23% of GDP) as a result of the new lockdown. In normal times, such an increase in total gilt issuance would lead to a rise in gilt yields, and so PWLB rates. However, the QE done by the Bank of England has depressed gilt yields to historic low levels, (as has similarly occurred with QE and debt issued in the US, the EU and Japan). This means that new UK debt being issued, and this is being done across the whole yield curve in all maturities, is locking in those historic low levels through until maturity. In addition, the UK has one of the longest average maturities for its entire debt portfolio, of any country in the world. Overall, this means that the total interest bill paid by the

Government is manageable. It is also quite possible that the Bank of England will do more QE in 2021 to support the economy, although negative interest rates could also be a usable tool in the tool box later on in 2021.

- Overall, **the pace of recovery** was not expected to be in the form of a rapid V shape, but a more elongated and prolonged one. The initial recovery was sharp but after a disappointing increase in GDP of only 2.1% in August, this left the economy still 9.2% smaller than in February; this suggested that the economic recovery was running out of steam after recovering 64% of its total fall during the crisis. The last three months of 2020 were originally expected to show zero growth due to the impact of widespread local lockdowns, consumers probably remaining cautious in spending, and uncertainty over the outcome of the UK/EU trade negotiations concluding at the end of the year also being a headwind. However, the new national lockdown for one month is now expected to depress GDP by 8% in November while the rebound in December is likely to be muted and vulnerable to the previously mentioned downside risks. Unemployment is also now expected to increase from 4.5% in August to a peak of 9% around the middle of 2021. Due to the number of adverse factors that have built up during the autumn, there is wide expectation that the Bank of England could resort to expanding quantitative easing by a further £100bn during 2021 to sustain momentum in the economy. Even so, it is now expected that the second national lockdown will push back recovery of GDP to pre pandemic levels by six months and into sometime during 2023. However, the graph below shows what Capital Economics forecast could happen if a successful vaccine was widely administered in the UK in the first half of 2021; this would cause a much quicker recovery.

Level of real GDP (Q4 2019 = 100)



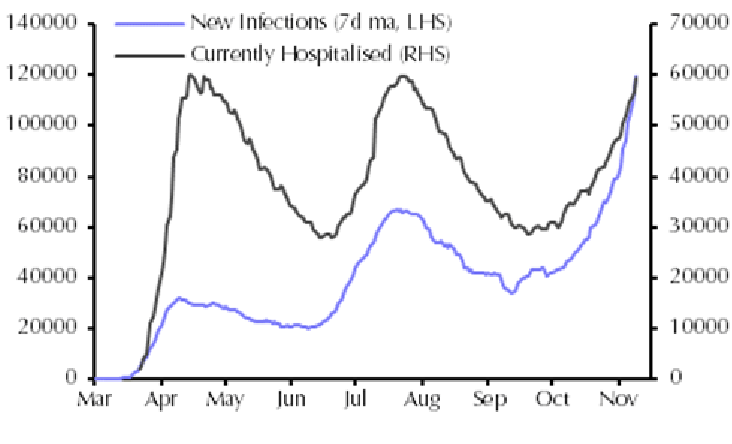
- There will be some **painful longer term adjustments** as e.g. office space and travel by planes, trains and buses may not recover to their previous level of use for several years, or possibly ever, even if vaccines are fully successful in overcoming the current virus. There is also likely to be a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

The **Financial Policy Committee** (FPC) report on 6th 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%.

US. The result of **the November elections** means that while the Democrats have gained the presidency and a majority in the House of Representatives, it looks as if the Republicans will still have a majority on the Senate. This means that the Democrats will not be able to do a massive fiscal stimulus, as they had been hoping to do after the elections, as they now have to get agreement from the Republicans. That would have resulted in another surge of debt issuance and would have put particular upward pressure on debt yields – which could have also put upward pressure on gilt yields. On the other hand, financial markets leapt up on 9th November on the first news of a successful vaccine - so that could cause a big shift in investor sentiment i.e. a swing to sell out of government debt into equities and so cause debt prices to fall and yields to rise. It is too early yet to say how enduring this shift in market expectations will be or whether the Fed would feel it necessary to take action to suppress this jump up in debt yields. However, the next two years, and possibly four years in the US, could be a political stalemate where neither party can do anything radical.

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

COVID-19 New infections & hospitalisations



After Chair Jerome Powell unveiled the **Fed's adoption of a flexible average inflation target** in his Jackson Hole speech in late August, the mid-September meeting of the Fed agreed by a majority to a toned down version of the new inflation target in his speech - that *"it would likely be appropriate to maintain the current target range until labour market conditions were judged to be consistent with the Committee's assessments of maximum employment and inflation had risen to 2% and was on track to moderately exceed 2% for some time."* This change 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, (and this year), so financial markets took note that higher levels of inflation are likely to be in the pipeline; long-term bond yields duly rose after the meeting. The 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. The Fed's meeting on 5 November was unremarkable - but at a politically sensitive time around the elections.

EU. The economy was recovering well towards the end of Q2 and into Q3 after a sharp drop in GDP caused by the virus, (e.g. France 18.9%, Italy 17.6%). However, growth is likely to stagnate during Q4, and Q1 of 2021, as a second wave of the virus has affected many countries, and is likely to hit hardest those countries more dependent on tourism. The €750bn fiscal support package eventually agreed by the EU after prolonged disagreement between various countries, is unlikely to provide significant support, and quickly enough, to make an appreciable difference in the worst affected countries. With inflation expected to be unlikely to get much above 1% over the next two years, the ECB has been struggling to get inflation up to its 2% target. It is currently unlikely that it will cut its central rate even further into negative territory from -0.5%, although the ECB has stated that it retains this as a possible tool to use. 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 from governments. The current PEPP scheme of €1,350bn of QE which started in March 2020 is providing protection to the sovereign bond yields of weaker countries like Italy. There is therefore unlikely to be a euro crisis while the ECB is able to maintain this level of support. However, the PEPP scheme is regarded as being a temporary measure during this crisis so it may need to be increased once the first PEPP runs out during early 2021 - unless vaccines step in quickly enough to head off the need for more action by the ECB. It could also decide to focus on using the Asset Purchase Programme to make more monthly purchases, rather than the PEPP scheme, and it does have other monetary policy options.

China. After a concerted effort to get on top of the virus outbreak in Q1, economic recovery was strong in Q2 and then into Q3 and Q4; this has enabled China to recover all of the contraction in Q1. Policy makers have both quashed the virus and implemented a programme of monetary and fiscal support that has been particularly effective at stimulating short-term growth. At the same time, China's economy has benefited from the shift towards online spending by consumers in developed markets. These factors help to explain its comparative outperformance compared to western economies.

However, this was achieved by major central government funding of yet more infrastructure spending. After years of growth having been focused on this same area, any further spending in this area is likely to lead to increasingly weaker economic returns in the longer term. This could, therefore, lead to a further misallocation of resources which will weigh on growth in future years.

Japan. Japan's success in containing the virus without imposing draconian restrictions on activity should enable a faster return to pre-virus levels of output than in many major economies. While the second wave of the virus has been abating, the economy has been continuing to recover at a reasonable pace from its earlier total contraction of 8.5% in GDP. However, there now appears to be the early stages of the start of a third wave. It has also 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. There has also been little progress on fundamental reform of the economy. The change of Prime Minister is not expected to result in any significant change in economic policy.

World growth. While Latin America and India have, until recently, been hotspots for virus infections, infection rates have begun to stabilise. 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.

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

Summary

Central banks are, therefore, likely to come under more pressure to support growth by looser monetary policy measures and this is likely to result in more quantitative easing and keeping rates very low for longer. It will also put pressure on governments to provide more fiscal support for their economies.

If there is a huge surge in investor confidence as a result of successful vaccines which leads to a major switch out of government bonds into equities, which, in turn, causes government debt yields to rise, then there will be pressure on central banks to actively manage debt yields by further QE purchases of government debt; this would help to suppress the rise in debt yields and so keep the total

interest bill on greatly expanded government debt portfolios within manageable parameters. It is also the main alternative to a programme of austerity.

The graph below as at 10th November, shows how the 10 year gilt yield in the UK spiked up after the Pfizer vaccine announcement on the previous day: -

APPENDIX B

Interest rate forecast update (as prepared by Link Asset Services in the first week of November 2020)

Brexit. The interest rate forecasts provided by Link in paragraph 3.3 are predicated on an assumption of a reasonable agreement being reached on trade negotiations between the UK and the EU by 31.12.20. However, as the differences between a Brexit deal and a no deal are not as big as they once were, the economic costs of a no deal have diminished. The bigger risk is that relations between the UK and the EU deteriorate to such an extent that both sides start to unravel the agreements already put in place. So what really matters now is not whether there is a deal or a no deal, but what type of no deal it could be.

The differences between a deal and a no deal were much greater immediately after the EU Referendum in June 2016, and also just before the original Brexit deadline of 29.3.19. That's partly because leaving the EU's Single Market and Customs Union makes this Brexit a relatively "hard" one. But it's mostly because a lot of arrangements have already been put in place. Indeed, since the Withdrawal Agreement laid down the terms of the break-up, both the UK and the EU have made substantial progress in granting financial services equivalence and the UK has replicated the bulk of the trade deals it had with non-EU countries via the EU. In a no deal in these circumstances (a "cooperative no deal"), GDP in 2021 as a whole may be only 1.0% lower than if there were a deal. In this situation, financial services equivalence would probably be granted during 2021 and, if necessary, the UK and the EU would probably rollover any temporary arrangements in the future.

The real risk is if the UK and the EU completely fall out. The UK could override part or all of the Withdrawal Agreement while the EU could respond by starting legal proceedings and few measures could be implemented to mitigate the disruption on 1.1.21. In such an "uncooperative no deal", GDP could be 2.5% lower in 2021 as a whole than if there was a deal. The acrimony would probably continue beyond 2021 too, which may lead to fewer agreements in the future and the expiry of any temporary measures.

Relative to the slump in GDP endured during the COVID crisis, any hit from a no deal would be small. But the pandemic does mean there is less scope for policy to respond. Even so, the Chancellor could loosen fiscal policy by about £10bn (0.5% of GDP) and target it at those sectors hit hardest. The Bank of England could also prop up demand, most likely through more gilt and corporate bond purchases rather than negative interest rates.

Brexit may reduce the economy's potential growth rate in the long run. However, much of that drag is now likely to be offset by an acceleration of productivity growth triggered by the digital revolution brought about by the COVID crisis.

So in summary there is not likely to be any change in Bank Rate in 20/21 – 21/22 due to whatever outcome there is from the trade negotiations and while there will

probably be some movement in gilt yields / PWLB rates after the deadline date, there will probably be minimal enduring impact beyond the initial reaction.

The balance of risks to the UK

- The overall balance of risks to economic growth in the UK is probably now skewed to the upside, but is subject to major uncertainty due to the virus and how quickly successful vaccines may become available and widely administered to the population. It may also be affected by what, if any, deal the UK agrees as part of Brexit.
- 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:

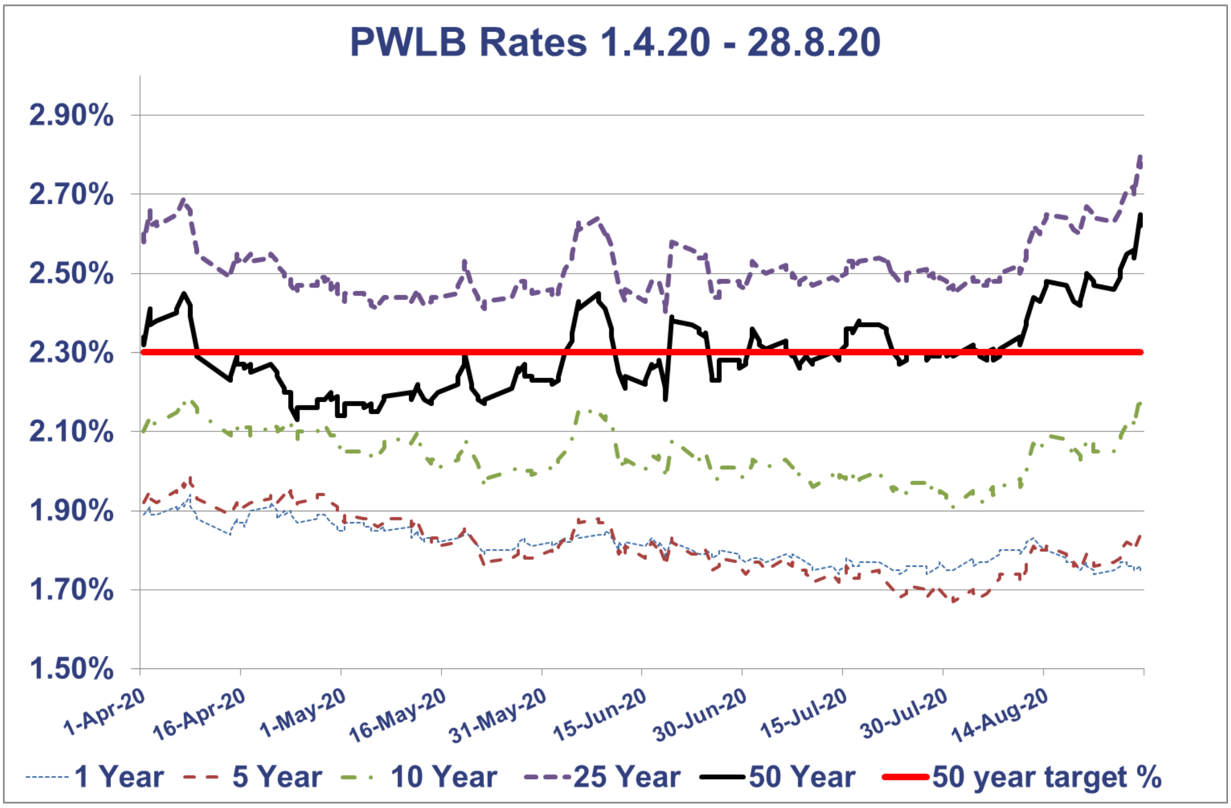
- **UK** - further national lockdowns or severe regional restrictions in major conurbations during 2021.
- **UK / EU trade negotiations** – if it were to cause significant economic disruption and downturn in the rate of growth.
- **UK - Bank of England** takes action too quickly, or too far, over the 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 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.

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

- **UK -** stronger than currently expected recovery in UK economy, especially if effective vaccines are administered quickly to the UK population and lead to a resumption of normal life and a return to full economic activity across all sectors of the 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.

APPENDIX C



	1 Year	5 Year	10 Year	25 Year	50 Year
Low	1.74%	1.67%	1.91%	2.40%	2.13%
Date	14/07/2020	30/07/2020	31/07/2020	18/06/2020	24/04/2020
High	1.94%	1.99%	2.19%	2.80%	2.65%
Date	08/04/2020	08/04/2020	08/04/2020	28/08/2020	28/08/2020
Average	1.81%	1.81%	2.04%	2.52%	2.30%

APPENDIX D

Investment instruments

Specified investments

AAA rated money market funds - limit £20m
Debt Management Office – no limit
Royal Bank of Scotland* – limit £25m
Duration of up to one year.

*Royal Bank of Scotland is included as a specified investment since it is the Council's banker and the UK Government holds a majority stake.

Non-specified investments

All institutions included on Link Asset Services' weekly "Suggested Credit List" – limit £10m
All UK local authorities – limit £10m
Duration to be determined by the "Suggested Credit List" from Link