Appendix A

Background, Economy and Outlook

1. Introduction

1.1. In February 2012 the Councils adopted the Chartered Institute of Public Finance and Accountancy's Treasury Management in the Public Services: Code of Practice (the "CIPFA Code") which requires the Councils to approve treasury management half year and annual reports.

1.2. The Joint Treasury Management Strategy for 2019/20 was approved at both full Councils in February 2019. Babergh District Council and Mid Suffolk District Council have borrowed and invested substantial sums of money and both are therefore exposed to financial risks including the loss of invested funds and the revenue effect of changing interest rates. The successful identification, monitoring and control of risk remains central to the Councils' Treasury Management Strategy.

1.3. Treasury risk management at the Councils is conducted within the framework of the Chartered Institute of Public Finance and Accountancy's Treasury Management in the Public Services: Code of Practice 2017 Edition (the CIPFA Code) which requires the Councils to approve a treasury management strategy before the start of each financial year and, as a minimum, a half year and annual treasury outturn report . This report fulfils the Councils' legal obligation under the Local Government Act 2003 to have regard to the CIPFA Code.

1.4. The 2017 Prudential Code includes a requirement for local authorities to provide a Capital Strategy, a summary document approved by full Council covering capital expenditure and financing, treasury management and non-treasury investments. The Councils' first Capital Strategy, for the financial year 2019/20, complying with CIPFA's Code requirement, was approved by both full Councils in February 2019.

2. External Context

2.1. Economic background:

2.2. The UK's exit from the European Union and future trading arrangements, had remained one of the major influences on the UK economy and sentiment during 2019/20. The 29 March 2019 Brexit deadline was extended to 12 April, then to 31 October and finally to 31 January 2020. Politics played a major role in financial markets over the period as the UK's tenuous progress negotiating its exit from the European Union together with its future trading arrangements drove volatility, particularly in foreign exchange markets. The outcome of December's General Election removed a lot of the uncertainty and looked set to provide a 'bounce' to confidence and activity.

2.3. The headline rate of UK Consumer Price Inflation UK Consumer Price Inflation fell to 1.7% year on year in February, below the Bank of England's target of 2%. Labour market data remained positive. The ILO (International Labour Organisation) unemployment rate was 3.9% in the three months to January 2020 while the employment rate hit a record high of 76.5%. The average annual growth rate for pay excluding bonuses was 3.1% in January 2020 and the same when bonuses were included, providing some evidence that a shortage of labour had been supporting wages.

2.4. GDP growth in Q4 2019 was reported as flat by the Office for National Statistics and service sector growth slowed and production and construction activity contracted on the back of what at the time were concerns over the impact of global trade tensions on economic activity. The annual rate of GDP growth remained below-trend at 1.1%.

2.5. Then coronavirus swiftly changed everything. COVID-19, which had first appeared in China in December 2019, started spreading across the globe causing plummeting sentiment and falls in financial markets not seen since the Global Financial Crisis as part of a flight to quality into sovereign debt and other perceived 'safe' assets.

2.6. In response to the spread of the virus and sharp increase in those infected, the government enforced lockdowns, central banks and governments around the world cut interest rates and introduced massive stimulus packages in an attempt to reduce some of the negative economic impact to domestic and global growth.

2.7. The Bank of England, which had held policy rates steady at 0.75% through most of 2019/20, moved in March to cut rates to 0.25% from 0.75% and then swiftly thereafter brought them down further to the record low of 0.1%. In conjunction with these cuts, the UK government introduced a number of measures to help businesses and households impacted by a series of ever-tightening social restrictions, culminating in pretty much the entire lockdown of the UK.

2.8. The US economy grew at an annualised rate of 2.1% in Q4 2019. After escalating trade wars and a protracted standoff, the signing of Phase 1 of the trade agreement between the US and China in January was initially positive for both economies, but COVID-19 severely impacted sentiment and production in both countries. Against a slowing economic outlook, the US Federal Reserve (the Fed) began cutting rates in August. Following a series of five cuts, the largest of which were in March 2020, the Fed Funds rate fell from of 2.5% to range of 0% - 0.25%. The US government also unleashed a raft of COVID-19 related measures and support for its economy including a $2 trillion fiscal stimulus package. With interest rates already on (or below) the floor, the European Central Bank held its base rate at 0% and deposit rate at -0.5%.

2.9. **Financial Markets:**

2.10. Financial markets sold off sharply as the impact from the coronavirus worsened. After starting positively in 2020, the FTSE 100 fell over 30% at its worst point with stock markets in other countries seeing similar huge falls. In March sterling touch its lowest level against the dollar since 1985. The measures implemented by central banks and governments helped restore some confidence and financial markets have rebounded in recent weeks but remain extremely volatile. The flight to quality caused gilts yields to fall substantially. The 5-year benchmark falling from 0.75% in April 2019 to 0.26% on 31 March 2020. The 10-year benchmark yield fell from 1% to 0.4%, the 20-year benchmark yield from 1.47% to 0.76% over the same period. 1-month, 3-month and 12-month bid rates averaged 0.61%, 0.72% and 0.88% respectively over the period.

2.11. Since the start of the calendar year 2020, the yield on 2-year US treasuries had fallen from 1.573% to 0.20% and from 1.877% to 0.61% for 10-year treasuries. German bund yields remain negative.

2.12. **Credit background:**

2.13. In Q4 2019 Fitch affirmed the UK's AA sovereign rating, removed it from Rating Watch Negative (RWN) and assigned a negative outlook. Fitch then affirmed UK banks' long-term ratings, removed the RWN and assigned a stable outlook. Standard & Poor's also affirmed the UK sovereign AA rating and revised the outlook to stable from negative. The Bank of England announced its latest stress tests results for the main seven UK banking groups. All seven passed on both a common equity Tier 1 (CET1) ratio and a leverage ratio basis. Under the test scenario the banks' aggregate level of CET1 capital would remain twice their level before the 2008 financial crisis.

2.14. After remaining flat in January and February and between a range of 30-55bps, Credit Default Swap spreads rose sharply in March as the potential impact of the coronavirus on bank balance sheets gave cause for concern. Spreads declined in late March and through to mid-April but remain above their initial 2020 levels. NatWest Markets Plc (non-ringfenced) remains the highest at 128bps and National Westminster Bank Plc (ringfenced) still the lowest at 56bps. The other main UK banks are between 65bps and 123bps, with the latter being the thinly traded and volatile Santander UK CDS.

2.15. While the UK and Non-UK banks on the Arlingclose counterparty list remain in a strong and well-capitalised position, the duration advice on all these banks was cut to 35 days in mid-March.

2.16. Fitch downgraded the UK sovereign rating to AA- in March which was followed by a number of actions on UK and Non-UK banks. This included revising the outlook on all banks on the counterparty list to negative, with the exception of Barclays Bank, Rabobank, Handelsbanken and Nordea Bank which were placed on Rating Watch Negative, as well as cutting Close Brothers long-term rating to A-. Having revised their outlooks to negative, Fitch upgraded the long-term ratings on Canadian and German banks but downgraded the long-term ratings for Australian banks. HSBC Bank and HSBC UK Bank, however, had their long-term ratings increased by Fitch to AA-.

3. Local Context

3.1. On 31 March 2020, Babergh had net borrowing of £102.2m and Mid Suffolk had net borrowing of £112.8m arising from revenue and capital income and expenditure activities. This is an increase of £5.6m for Babergh and a reduction of £6.5m for Mid Suffolk from the 31 March 2019 position.

3.2. The underlying need to borrow for capital purposes is measured by the Capital Financing Requirement (CFR), while usable reserves and working capital are the underlying resources available for investment. These factors and the year-on-year change are summarised in Table 1 as follows.

3.3. **Table 1: Borrowing Summary**

Babergh	**31.3.19 Actual £m**	**2019/20 Movement £m**	**31.3.20 Actual £m**
General Fund CFR	45.126	6.554	51.680
HRA CFR	86.673	2.912	89.585
Total CFR	**131.799**	**9.466**	**141.265**
Borrowing CFR			
Less: Usable reserves	(32.552)	(2.747)	(35.298)
Less: Working Capital	(2.681)	(1.105)	(3.786)
Net Borrowing Requirement	**96.566**	**5.614**	**102.181**

Mid Suffolk	**31.3.19 Actual £m**	**2019/20 Movement £m**	**31.3.20 Actual £m**
General Fund CFR	66.285	9.406	75.691
HRA CFR	87.970	0.000	87.970
Total CFR	**154.255**	**9.406**	**163.661**
Borrowing CFR			
Less: Usable reserves	(38.024)	(10.980)	(49.004)
Add / (Less): Working Capital	3.023	(4.920)	(1.897)
Net Borrowing Requirement	**119.254**	**(6.494)**	**112.760**

3.4. Babergh's net borrowing requirement has increased due to a rise in the CFR as capital expenditure was higher than the financing applied, including minimum revenue provision and a reduction in working capital. This was offset by an increase in usable reserves due to the timing of receipts and payments.

3.5. Mid Suffolk's net borrowing requirement has reduced. There was a rise in the CFR as new capital expenditure was higher than the financing applied, including minimum revenue provision and a reduction in working capital. This was covered by an increase in usable reserves due to the timing of receipts and payments.

3.6. The current strategy is to maintain borrowing and investments below their underlying levels, sometimes known as internal borrowing, to reduce risk and keep interest costs low.

3.7. **Table 2: Treasury Management Summary**

3.8. The actual treasury management activity and position at 31 March 2020 and the year-on-year change is shown in Table 2 as follows.

Babergh	**31.3.19 Balance £m**	**2019/20 Movement £m**	**31.3.20 Balance £m**	**31.3.20 Average Rate %**
Long-term borrowing	97.047	(1.024)	96.023	2.82%
Short-term borrowing	7.000	9.500	16.500	0.84%
Total borrowing	**104.047**	**8.476**	**112.523**	
Long-term investments	9.430	1.784	11.214	4.85%
Cash and Cash equivalents	2.421	0.954	3.375	0.65%
Total investments	**11.851**	**2.738**	**14.589**	
Net Borrowing	**92.196**	**5.738**	**97.934**	

Mid Suffolk	**31.3.19 Balance £m**	**2019/20 Movement £m**	**31.3.20 Balance £m**	**31.3.20 Average Rate %**
Long-term borrowing	112.287	(1.348)	110.939	3.07%
Short-term borrowing	18.000	6.400	24.400	0.80%
Total borrowing	**130.287**	**5.052**	**135.339**	
Long-term investments	9.423	1.792	11.215	4.65%
Cash and Cash equivalents	2.880	7.568	10.448	0.67%
Total investments	**12.303**	**9.360**	**21.663**	
Net Borrowing	**117.984**	**(4.308)**	**113.676**	

3.9. The figures in Table 2 are from the balance sheet in the statement of accounts, adjusted to exclude operational cash, accrued interest and other accounting adjustments.

3.10. Babergh and Mid Suffolk have both increased short term borrowing to finance capital expenditure during the year.

3.11. Cash and cash equivalents include funds held in current bank accounts for day to day cashflow purposes and short-term deposits. Babergh held £2m in money market funds. Mid Suffolk held £6m in money market funds and £3m in overnight government deposits.