Appendix A

Background, Economy and Outlook

1. Introduction

1.1 In February 2012 both 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 2020/21 was approved at both full Councils in February 2020. Both Councils have borrowed and invested substantial sums of money and 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 are therefore central to the Councils' Treasury Management Strategy.

1.3 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' Capital Strategy, for the financial year 2020/21, complying with CIPFA's Code requirement, was approved by both full Councils in February 2020.

1.4 The Statutory Guidance on Local Government Investments (MHCLG, 2018) requires local authorities to produce an investment strategy, covering investments that are not part of treasury management activity. The Councils' Investment Strategy, for the financial year 2020/21, was also approved by both full Councils in February 2020.

2. External Context

2.1 Economic background:

2.1.1 The spread of the coronavirus pandemic dominated during the first six months of the financial year as countries around the world tried to manage the delicate balancing act of containing transmission of the virus while easing lockdown measures and getting their populations and economies working again.

2.1.2 After a relatively quiet few months of Brexit news it was back in the headlines towards the end of the period as agreement between the UK and EU on a trade deal was looking difficult and the government came under fire, both at home and abroad, as it tried to pass the Internal Market Bill which could override the agreed Brexit deal, potentially breaking international law.

2.1.3 The Bank of England (BoE) maintained Bank Rate at 0.1% and its Quantitative Easing (QE) programme at £745 billion (In November 2020 this was increased to £895 billion). The potential use of negative interest rates was not ruled in or out by BoE policymakers, but then a comment in the September Monetary Policy Committee meeting minutes that the central bank was having a harder look at its potential impact than was previously suggested took financial markets by surprise.

2.1.4 Government initiatives continued to support the economy, with the furlough (Coronavirus Job Retention) scheme keeping almost 10 million workers in jobs, grants and loans to businesses and 100 million discounted meals being claimed during the 'Eat Out to Help Out' (EOHO) offer.

2.1.5 GDP growth contracted by a massive 19.8% (revised from first estimate -20.4%) in Q2 2020 (Apr-Jun) according to the Office for National Statistics, pushing the annual growth rate down to -21.5% (first estimate -21.7%). Construction output fell by 35% over the quarter, services output by almost 20% and production by 16%. Recent monthly estimates of GDP have shown growth recovering, with the latest rise of almost 7% in July, but even with the two previous monthly gains this still only makes up half of the lost output.

2.1.6 The headline rate of UK Consumer Price Inflation (CPI) fell to 0.2% year on year in August, further below the Bank of England's 2% target, with the largest downward contribution coming from restaurants and hotels influenced by the EOHO scheme. The Office for National Statistics' preferred measure of CPIH which includes owner-occupied housing was 0.5% year on year.

2.1.7 In the three months to July, labour market data showed the unemployment rate increased from 3.9% to 4.1% while wages fell 1% for total pay in nominal terms (0.2% regular pay) and was down 1.8% in real terms (-0.7% regular pay). Despite only a modest rise in unemployment over the period, the rate was expected to pick up sharply when the furlough scheme was due to end in October. On the back of this, the BoE forecast unemployment was predicted to peak between 8% and 9%. This forecast may now be revised, as the furlough scheme has since been extended to 31 March 2021.

2.1.8 The US economy contracted at an annualised rate of 31.7% in Q2 2020 (Apr-Jun). The Federal Reserve maintained the Fed Funds rate at between 0% and 0.25% but announced a change to its inflation targeting regime. The move is to a more flexible form of average targeting which will allow the central bank to maintain interest rates at low levels for an extended period to support the economy even when inflation is 'moderately' above the 2% average target, particularly given it has been below target for most of the last decade.

2.1.9 The European Central Bank maintained its base rate at 0% and deposit rate at -0.5%.

2.2 Financial markets:

2.2.1 Equity markets continued their recovery, with the Dow Jones climbing to not far off its pre-crisis peak, albeit that performance being driven by a handful of technology stocks including Apple and Microsoft, with the former up 75% in 2020. The FTSE 100 and 250 have made up around half of their losses at the height of the pandemic in March. Central bank and government stimulus packages continue to support asset prices, but volatility remains.

2.2.2 Ultra-low interest rates and the flight to quality continued, keeping gilts yields low but volatile over the period with the yield on some short-dated UK government bonds remaining negative. The 5-year UK benchmark gilt yield started and ended the June–September period at -0.06% (with much volatility in between). The 10-year gilt yield also bounced around, starting at 0.21% and ending at 0.23% over the same period, while the 20-year rose from 0.56% to 0.74%. 1-month, 3-month and 12-month bid rates averaged 0.02%, 0.06% and 0.23% respectively over the period.

2.2.3 At the end of September, the yield on 2-year US treasuries was around 0.13% while that on 10-year treasuries was 0.69%. German bund yields remain negative across most maturities.

2.3 Credit background:

2.3.1 Credit Default Swap spreads eased over most of the period but then started to pick up again through September. In the UK, the spreads between ringfenced and non-ringfenced entities remains, except for retail bank Santander UK whose CDS spread remained elevated and the highest of those we monitor at 85bps while Standard Chartered was the lowest at 41bps. The ringfenced banks are currently trading between 45 and 50bps.

2.3.2 After a busy second quarter of the calendar year, the subsequent period has been relatively quiet for credit changes for the names on our counterparty list. Fitch assigned a AA- deposit rating to Netherlands lender Rabobank with a negative outlook and prior to that, while not related to our counterparty list but quite significant, revised the outlook on the US economy to Negative from Stable while also affirming its AAA rating.

2.3.3 There continues to remain much uncertainty around the extent of the losses banks and building societies will suffer due to the impact from the coronavirus pandemic and for the UK institutions on our list there is the added complication of the end of the Brexit transition period on 31st December and what a trade deal may or may not look like. The institutions on Arlingclose's counterparty list and recommended duration remain under constant review, but at the end of the period no changes had been made to the names on the list or the recommended maximum duration of 35 days.

3 Outlook for the remainder of 2020/21:

3.1 The medium-term global economic outlook is weak. While the strict initial lockdown restrictions have eased, coronavirus has not been supressed and second waves have prompted more restrictive measures on a regional and national basis. This ebb and flow of restrictions on normal activity will continue for the foreseeable future, at least until an effective vaccine is produced and importantly, distributed.

3.2 The global central bank and government responses have been significant and are in many cases on-going, maintaining more stable financial, economic and social conditions than otherwise. This has supported a sizeable economic recovery in Q3.

3.3 However, the scale of the economic shock to demand, on-going social distancing measures, regional lock downs and reduced fiscal support will mean that the subsequent pace of recovery is limited. Early signs of this are already evident in UK monthly GDP and Purchasing Managers' Index (PMI) data, even before the latest restrictions.

3.4 This situation will result in central banks maintaining low interest rates for the medium term. In the UK, Brexit is a further complication. Bank Rate is therefore likely to remain at low levels for a very long time, with a distinct possibility of being cut to zero. Money markets have priced in a chance of negative Bank Rate.

3.5 Longer-term yields will also remain depressed, anchored by low central bank policy rates, expectations for potentially even lower rates and insipid inflation expectations. There is a chance yields may follow a slightly different path in the medium term, depending on investor perceptions of growth and inflation, or if the UK leaves the EU without a deal.

3.6 The Councils' treasury advisor, Arlingclose, expects Bank Rate to remain at the current 0.10% level. Additional monetary loosening with further financial asset purchases (QE) has already been announced in November 2020. While Arlingclose's central case for Bank Rate is no change from the current level of 0.1%, further cuts to Bank Rate to zero or even into negative territory cannot be completely ruled out.

3.7 Gilt yields are expected to remain very low in the medium term. Shorter-term gilt yields are currently negative and will remain around zero or below until either the Bank of England expressly rules out negative Bank Rate or growth/inflation prospects improve.

3.8 Downside risks remain in the near term, as the Government dials down its fiscal support measures, reacts to the risk of a further escalation in infection rates and the Brexit transition period comes to an end.

3.9 Arlingclose – Forecast rates

	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
Official Bank Rate													
Upside risk	0.00	0.00	0.00	0.15	0.15	0.15	0.15	0.30	0.30	0.30	0.30	0.30	0.30
Arlingclose Central Case	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
Downside risk	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50

4 Local Context

4.1 On 31 March 2020, Babergh had a net borrowing requirement of £102m and Mid Suffolk had a net borrowing requirement of £111m arising from revenue and capital income and expenditure.

4.2 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 are summarised in Table 1 that follows.

4.3 **Table 1: Balance Sheet Summary**

Balance Sheet Summary	**31.03.20 Babergh £m**	**31.03.20 Mid Suffolk £m**
General Fund CFR	51.680	75.691
HRA CFR	89.585	87.359
Total CFR	**141.265**	**163.050**
(Less): Usable reserves	(34.941)	(48.456)
(Less) / Add: Working capital	(4.164)	(3.285)
Net borrowing requirement	**102.160**	**111.309**

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

4.4 The treasury management position on 30 September 2020 and the change during the half year is show in Table 2 that follows.

4.5 Table 2: Treasury Management Summary

Babergh	**31.03.20 Balance £m**	**Movement £m**	**30.09.20 Balance £m**	**30.09.20 Rate %**
Long-term borrowing	96.023	(0.516)	95.507	3.18%
Short-term borrowing	16.500	(6.000)	10.500	0.67%
Total borrowing	**112.523**	**(6.516)**	**106.007**	
Long-term investments	11.214	(0.048)	11.166	3.59%
Short-term investments	2.000	(2.000)	0.000	0.21%
Cash and Cash equivalents	1.383	0.136	1.519	0.04%
Total Investments	**14.597**	**(1.912)**	**12.685**	
Net borrowing	**97.926**		**93.322**	

Mid Suffolk	**31.03.20 Balance £m**	**Movement £m**	**30.09.20 Balance £m**	**30.09.20 Rate %**
Long-term borrowing	110.939	(11.681)	99.258	2.82%
Short-term borrowing	24.400	(5.400)	19.000	0.96%
Total borrowing	**135.339**	**(17.081)**	**118.258**	
Long-term investments	11.215	(0.053)	11.162	3.40%
Short-term investments	6.000	(5.100)	0.900	0.20%
Cash and Cash equivalents	4.450	(2.264)	2.186	0.03%
Total Investments	**21.665**	**(7.417)**	**14.248**	
Net borrowing	**113.674**		**104.010**	