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 2021/22 was approved at both full Councils in February 2021. 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 2021/22, complying with CIPFA's Code requirement, was approved by both full Councils in February 2021.

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 2021/22, was also approved by both full Councils in February 2021.

2. External Context

2.1 Economic background:

2.1.1 The economic recovery from the coronavirus pandemic continued to dominate the first half of the financial year. By the end of the period over 48 million people in the UK had received their first dose of a COVID-19 vaccine and almost 45 million their second dose.

2.1.2 The Bank of England (BoE) held the Bank Rate at 0.1% throughout the period and maintained its Quantitative Easing programme at £895 billion, unchanged since the November 2020 meeting. In its September 2021 policy announcement, the BoE noted it now expected the UK economy to grow at a slower pace than was predicted in August, as the pace of the global recovery had shown signs of slowing and there were concerns inflationary pressures may be more persistent. Within the announcement, Bank expectations for GDP growth for the third (calendar) quarter were revised down to 2.1% (from 2.9%), in part reflecting tighter supply conditions. The path of CPI inflation is now expected to rise slightly above 4% in the last three months of 2021, due to higher energy prices and core goods inflation. While the Monetary Policy Committee meeting ended with policy rates unchanged, the tone was more hawkish.

2.1.3 Government initiatives continued to support the economy over the quarter but came to an end on 30 September 2021, with businesses required to either take back the 1.6 million workers on the furlough scheme or make them redundant.

2.1.4 The latest labour market data showed that in the three months to July 2021 the unemployment rate fell to 4.6%. The employment rate increased, and economic activity rates decreased, suggesting an improving labour market picture. Latest data showed growth in average total pay (including bonuses) and regular pay (excluding bonuses) among employees was 8.3% and 6.3% respectively over the period. However, part of the robust growth figures is due to a base effect from a decline in average pay in the spring of last year associated with the furlough scheme.

2.1.5 Annual CPI inflation rose to 3.2% in August, exceeding expectations for 2.9%, with the largest upward contribution coming from restaurants and hotels. The BoE now expects inflation to exceed 4% by the end of the calendar year owing largely to developments in energy and goods prices. The Office of National Statistics' (ONS') preferred measure of CPIH which includes owner-occupied housing was 3.0% year on year, marginally higher than expectations for 2.7%.

2.1.6 The easing of restrictions boosted activity in the second quarter of the calendar year, helping push GDP up by 5.5% quarter on quarter (final estimate compared with 4.8% quarter on quarter initial estimate). Household consumption was the largest contributor. Within the sector breakdown production contributed 1.0% quarter on quarter, construction 3.8% quarter on quarter and services 6.5% quarter on quarter, taking all these close to their pre-pandemic levels.

2.1.7 The US economy grew by 6.3% in Q1 2021 (Jan-Mar) and then by an even stronger 6.6% in Q2 as the recovery continued. The Federal Reserve maintained its main interest rate at between 0% and 0.25% over the period but in its most recent meeting made suggestion that monetary policy may start to be tightened soon.

2.1.8 The European Central Bank maintained its base rate at 0%, deposit rate at -0.5%, and asset purchase scheme at €1.85 trillion.

2.2 **Financial markets:**

2.2.1 Monetary and fiscal stimulus together with rising economic growth and the ongoing vaccine rollout programmes continued to support equity markets over most of the period, albeit with a bumpy ride towards the end. The Dow Jones hit another record high while the UK-focused FTSE 250 index continued making gains over pre-pandemic levels. The more internationally focused FTSE 100 saw more modest gains over the period and remains below its pre-crisis peak.

2.2.2 Inflation worries continued during the period. Declines in bond yields in the first quarter of the financial year suggested bond markets were expecting any general price increases to be less severe, or more transitory, than was previously thought. However, an increase in gas prices in the UK and EU, supply shortages and a dearth of HGV and lorry drivers, with companies willing to pay more to secure their services, has caused problems for a range of industries and, in some instances, lead to higher prices.

2.2.3 The 5-year UK benchmark gilt yield began the financial year at 0.36% before declining to 0.33% by the end of June 2021 and then climbing to 0.64% on 30 September. Over the same period the 10-year gilt yield fell from 0.80% to 0.71% before rising to 1.03% and the 20-year yield declined from 1.31% to 1.21% and then increased to 1.37%.

2.2.4 The Sterling Overnight Rate (SONIA) averaged 0.05% over the quarter.

2.3 **Credit background:**

2.3.1 Credit Default Swap spreads were flat over most of the period and are broadly in line with their pre-pandemic levels. In late September spreads rose by a few basis points due to concerns around Chinese property developer Evergrande defaulting but are now falling back. The gap in spreads between UK ringfenced and non-ringfenced entities continued to narrow, but Santander UK remained an outlier compared to the other ringfenced/retail banks. At the end of the period Santander UK was trading the highest at 53bps and Lloyds Banks Plc the lowest at 32bps. The other ringfenced banks were trading between 37-39bps and Nationwide Building Society was 39bps.

2.3.2 Over the period Fitch and Moody's upwardly revised to stable the outlook on a number of UK banks and building societies on our counterparty list, recognising their improved capital positions compared to last year and better economic growth prospects in the UK.

2.3.3 Fitch also revised the outlooks for Nordea, Svenska Handelsbanken and Handelsbanken plc to stable from negative. The rating agency considered the improved economic prospects in the Nordic region to have reduced the baseline downside risks it previously assigned to the lenders.

2.3.4 The successful vaccine rollout programme is credit positive for the financial services sector in general and the improved economic outlook has meant some institutions have been able to reduce provisions for bad loans. While there is still uncertainty around the full extent of the losses banks and building societies will suffer due to the pandemic-related economic slowdown, the sector is in a generally better position now compared to earlier this year and 2020.

2.3.5 At the end of the period Arlingclose had completed its full review of its credit advice on unsecured deposits. The outcome of this review included the addition of NatWest Markets plc to the counterparty list together with the removal of the suspension of Handelsbanken plc. In addition, the maximum duration for all recommended counterparties was extended to 100 days.

2.3.6 As ever, the institutions and durations on the Councils' counterparty list recommended by treasury management advisors Arlingclose remain under constant review.

3 Outlook for the remainder of 2021/22:

3.1 The Councils' treasury advisor, Arlingclose expects Bank Rate to rise in Q2 2022. They believe this is driven as much by the Bank of England's desire to move from emergency levels as by fears of inflationary pressure.

3.2 Investors have priced in multiple rises in Bank Rate to 1% by 2024. While Arlingclose believes Bank Rate will rise, it is by a lesser extent than expected by markets.

3.3 The global economy continues to recover from the pandemic but has entered a more challenging phase. The resurgence of demand has led to the expected rise in inflationary pressure, but disrupted factors of supply are amplifying the effects, increasing the likelihood of lower growth rates ahead. This is particularly apparent in the UK due to the impact of Brexit.

3.4 While Q2 UK GDP expanded more quickly than initially thought, the 'pingdemic' and more latterly supply disruption will leave Q3 GDP broadly stagnant. The outlook also appears weaker. Household spending, the driver of the recovery to date, is under pressure from a combination of retail energy price rises, the end of government support programmes and soon, tax rises. Government spending, the other driver of recovery, will slow considerably as the economy is taken off life support.

3.5 Inflation rose to 3.2% in August. A combination of factors will drive this to over 4% in the near term. While the transitory factors affecting inflation, including the low base effect of 2020, are expected to unwind over time, the MPC has recently communicated fears that these transitory factors will feed longer-term inflation expectations that require tighter monetary policy to control. This has driven interest rate expectations substantially higher.

3.6 The supply imbalances are apparent in the labour market. While wage growth is currently elevated due to compositional and base factors, stories abound of higher wages for certain sectors, driving inflation expectations. It is uncertain whether a broad-based increase in wages is possible given the pressures on businesses.

3.7 Government bond yields increased sharply following the September Federal Open Market Committee (FOMC) and MPC minutes, in which both central banks communicated a lower tolerance for higher inflation than previously thought. The MPC in particular has doubled down on these signals in spite of softer economic data. Bond investors expect higher near-term interest rates but are also clearly uncertain about central bank policy.

3.8 The MPC appears to be playing both sides, but has made clear its intentions to tighten policy, possibly driven by a desire to move away from emergency levels. While the economic outlook will be challenging, the signals from policymakers suggest Bank Rate will rise unless data indicates a more severe slowdown.

3.9 Arlingclose – Forecast rates

	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24	Jun-24	Sep-24	Dec-24
Official Bank Rate													
Upside risk	0.00	0.15	0.00	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25
Arlingclose Central Case	0.10	0.10	0.25	0.25	0.25	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50
Downside risk	0.00	0.00	0.15	0.15	0.15	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.40

4 Local Context

4.1 On 31 March 2021, Babergh had a net borrowing requirement of £117m and Mid Suffolk had a net borrowing requirement of £127m 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	31.03.21 Babergh £m	31.03.21 Mid Suffolk £m
General Fund CFR	71.311	95.260
HRA CFR	89.185	88.509
Total CFR	**160.496**	**183.769**
(Less): Usable reserves	(43.820)	(54.492)
(Less) / Add: Working capital	0.131	(1.812)
Net borrowing requirement	**116.807**	**127.465**

4.4 Lower official interest rates have lowered the cost of short-term, temporary loans and investment returns from cash assets that can be used in lieu of borrowing. 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.

4.5 The treasury management position on 30 September 2021 and the change during the half year is shown in Table 2 that follows.

4.6 **Table 2: Treasury Management Summary**

Babergh	31.03.21 Balance £m	Movement £m	30.09.21 Balance £m	30.09.21 Rate %
Long-term borrowing	95.089	(0.420)	94.669	3.19%
Short-term borrowing	32.000	(5.000)	27.000	0.04%
Total borrowing	**127.089**	**(5.420)**	**121.669**	
Long-term investments	11.166	(0.031)	11.135	5.02%
Short-term investments	0.000	5.700	5.700	0.01%
Cash and Cash equivalents	1.840	(1.203)	0.637	0.00%
Total Investments	**13.006**	**4.466**	**17.472**	
Net borrowing	**114.083**		**104.197**	

Mid Suffolk	31.03.21 Balance £m	Movement £m	30.09.21 Balance £m	30.09.21 Rate %
Medium / Long-term borrowing	98.572	6.809	105.381	2.74%
Short-term borrowing	44.000	(15.800)	28.200	0.07%
Total borrowing	**142.572**	**(8.991)**	**133.581**	
Long-term investments	11.162	(0.031)	11.131	5.03%
Short-term investments	1.500	(1.500)	0.000	0.01%
Cash and Cash equivalents	2.018	(0.006)	2.012	0.00%
Total Investments	**14.680**	**(1.537)**	**13.143**	
Net borrowing	**127.892**		**120.438**	

5 Environmental, Social and Governance (ESG) considerations

5.1 At its meeting on 17th May 2021, the Joint Audit and Standards Committee considered a report on ESG considerations for the Councils' Joint Treasury Management Strategy and recommended that "the Cabinet pushes its fund managers to filter investments in respect of the ESG considerations, looking for positive contributions to tackling our carbon reduction priorities and that the Cabinet considers withdrawing funds from investors who do not adequately address these concerns." It was recognised that any decision to withdraw funds should be balanced against financial prudence. This recommendation will be taken forward to Cabinet in January 2022.

5.2 In October 2021 the Government published a report, Greening Finance: A Roadmap to Sustainable Investing: Greening Finance: A Roadmap to Sustainable Investing (publishing.service.gov.uk). Its aim is to support the financial services sector to align with the UK's net zero commitment and wider environmental goals.

5.3 The roadmap sets out the Governments plans to implement new Sustainability Disclosure Requirements (SDR) to create an integrated framework for decisions-useful disclosures on sustainability across the economy. This will include new requirements for asset managers and investment product disclosures.

5.4 Updates will be provided in future reports on any developments in this area.