

Report for: Cabinet

Date of Meeting:	9 th December 2021
Subject:	Treasury Management Mid-Year Report 2021/22
Key Decision:	No
Responsible Officer:	Dawn Calvert, Director of Finance and Assurance
Portfolio Holder:	Councillor Natasha Proctor, Deputy Leader and Portfolio Holder for Finance and Resources
Exempt:	No
Decision subject to Call-in:	No
Wards affected:	All wards
Enclosures:	Appendix 1 Link Group Economic Commentary Appendix 2 Borrowing and Investment Rate Summary 2021/22

Section 1 – Summary and Recommendations

This report provides a Mid-Year Review of the Council's Treasury Management activities in 2021/22 in compliance with the CIPFA Treasury Management Code of Practice.

Recommendations:

Cabinet is requested to:

1. Note the Treasury Management Mid-Year Review for 2021/22.
2. Refer this report to the Governance, Audit, Risk Management and Standards Committee for review.

Reason: (for recommendations)

- a) To promote effective financial management and comply with regulations issued under the Local Government Act 2003, the CIPFA Code of Practice on Treasury Management, and the CIPFA Prudential Code for Capital Finance, along with meeting the requirements of the Council's Financial Regulations.
- b) To keep Members informed of Treasury Management activities and performance to date for 2021/22.

Section 2 – Report

1.0. Introduction

1.1. The purpose of this report is to update Members with the Council's Treasury Management activity in 2021/22, presenting performance to 30th September 2021 in accordance with the Council's Treasury Management Practices and in compliance with the CIPFA Treasury Management Code of Practice. The Council has complied with all elements of the Treasury Management Strategy Statement (TMSS) as the treasury management function.

1.2. Treasury management comprises:

- Managing the Council's borrowing to ensure funding of the Council's current and future Capital Programme is at optimal cost;
- Investing surplus cash balances arising from the day-to-day operations of the Council to obtain an optimal return while ensuring security of capital and liquidity.

1.3. The annual revenue budget includes the revenue costs that flow from capital financing decisions. Under the CIPFA Treasury Management Code of Practice and the CIPFA Prudential Code, increases in capital expenditure should be

limited to levels whereby increases in interest charges and running costs are affordable within the Council's revenue account.

- 1.4. The Council regards the successful identification, monitoring and control of risk to be the prime criteria by which the effectiveness of its treasury management activities will be measured. Accordingly, the analysis and reporting of treasury management activities will focus on their risk implications for the organisation to ensure the security and liquidity of the Council's treasury investments.
- 1.5. The Council recognises that effective treasury management will provide support towards the achievement of its business and service objectives. It is therefore committed to the principles of achieving value for money in treasury management, and to employing suitable comprehensive performance measurement techniques, within the context of the CIPFA Treasury Management Code of Practice.

2.0. Reporting Requirements

- 2.1. The Council and/or Cabinet are required to receive and approve, as a minimum, three main reports each year, which incorporate a variety of policies, estimates and actuals.
- 2.2. **Treasury Management Strategy Statement Report** – The first, and most important report is presented to the Council in February and covers:
 - The Treasury Management Strategy Statement (TMSS), which details how the investments and borrowings for capital expenditure are to be organised, including Treasury Limits and Prudential Indicators.
 - The Annual Investment Strategy which forms part of the TMSS, (the parameters on how investments are to be managed).
 - the MRP Policy (how capital expenditure is charged to revenue over time).

The 2021/22 TMSS was presented to Council on 25 February 2021.

- 2.3. **Mid-Year Review Report** – This is presented to Cabinet in December/January and updates Members on the progress of the Capital Programme, reporting on Prudential Indicators to give assurance that the treasury management function is operating within the Treasury Limits and Prudential Indicators set out in the TMSS.

This report fulfills the requirements of the the Mid-Year Review for 2021/22.

- 2.4. **Treasury Management Outturn Report** – This is typically presented to Cabinet in June/July and provides details of a selection of actual prudential and treasury indicators and actual treasury operations compared to the estimates within the TMSS and Mid-Year Reports.
- 2.5. **Scrutiny** – The above reports are required to be adequately scrutinised, normally before being recommended to Cabinet/Council, with the role being undertaken by the Governance, Audit, Risk Management and Standards Committee (GARMS). The Council has complied with the CIPFA Treasury

Management Code of Practice to the extent that all Treasury Management reports have been scrutinised through the efficient conduct of the Council's business may require consideration by GARMS subsequent to consideration by Cabinet/Council.

- 2.6. The Council has delegated responsibility for the implementation and regular monitoring of its treasury management policies and practices to the Section 151 Officer. The Section 151 Officer chairs the Treasury Management Group (TMG), which monitors the treasury management activity and market conditions monthly.

3.0. Options considered

- 3.1. The report is in accordance with the reporting requirements of the CIPFA Treasury Management Code of Practice.

4.0. Treasury Management Strategy Statement and Annual Investment Strategy Update

- 4.1. The Treasury Management Strategy Statement, (TMSS), for 2021/22 was approved by Council on 25 February 2021.
- 4.2. There are no policy changes proposed to the TMSS approved for 2021/22; the details in this report update the position in the light of the updated economic environment, budgetary changes and revised capital programme outturn forecast contained in the 2021/22 Q2 Capital Budget Monitoring Report also presented at this meeting.

5.0. GLA Group Investment Syndicate

- 5.1. The Cabinet report dated 15th July 2021, set out a recommendation that the Council becomes a participant in the shared service arrangement operated by the Greater London Authority (GLA) for the provision of treasury management services. This will include the Council transferring its investment balances into the GLA Group Investment Syndicate (GIS).
- 5.2. Work remains ongoing in respect of finalising the associated legal agreement to conclude negotiations to the satisfaction of the Director of Finance and Assurance in consultation with the Portfolio Holder for Finance and Resources together with the Director of Legal and Governance.
- 5.3. It is anticipated that this agreement may be in place for 2022/23.

6.0. CIPFA Treasury Management Code of Practice and Prudential Code consultations

- 6.1. CIPFA are currently consulting on revisions to the Treasury Management Code of Practice and Prudential Code. The second stage of the consultation process closed on the 16 November 2021 and we are awaiting the outcome of the consultation. CIPFA have indicated that due to the timing of the

consultations the introduction of changes from the revised Codes will be in the form of a soft launch with full implementation expected from 2023/24.

7.0. Compliance with Prudential Indicators

- 7.1. It is a statutory duty for the Council to determine and keep under review its affordable borrowing limits. The Council has operated within the Treasury and Prudential Indicators set out in the Council's Treasury Management Strategy Statement for 2021/22 during the half year ended 30 September 2020 (and up to 29 November 2021 at the point this report was despatched).
- 7.2. All treasury management operations have been conducted in full compliance with the Council's Treasury Management Practices.

Prudential Indicator for Capital Expenditure

- 7.3. The Council's Capital Programme is a key driver of Treasury Management activity. The output of the Capital Programme is reflected in the statutory prudential indicators, which are designed to provide Member's with an overview of the impact of the capital expenditure plans and ensure that these remain prudent, affordable and sustainable.
- 7.4. Table 1 shows the revised estimates for capital expenditure to reflect updates to the 2021/22 capital programme since the capital programme was agreed as part of the 2021/22 Budget.

Table 1

Capital expenditure £'000	2021/22 Original Estimate	2021/22 Revised Estimate
- Resources and Commercial	14,731	14,583
- People's	22,803	11,528
- Community	48,092	62,716
General Fund	85,626	88,827
HRA	90,823	99,595
Total	176,449	188,422

- 7.5. The 2021/22 Q2 Capital Budget Monitoring Report provides further details of the updated forecast outturn position.

Changes to the Financing of the Capital Programme

- 7.6. Table 2 illustrates how the Council's capital expenditure plans (table 1) will be funded. The net financing need for the year increases the underlying indebtedness of the Council 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). This direct borrowing need may also be supplemented by maturing debt and other treasury requirements.

Table 2

Financing of capital expenditure £'000	2021/22 Original Estimate	2021/22 Revised Estimate
General Fund		
Capital Receipts	2,641	
Capital Grants	27,362	17,365
BCiL	4,027	4,085
NCiL	500	588
Section 106		1,091
Revenue		425
External Funding	34,530	23,554
Net financing need for year (GF)	51,096	65,273
HRA		
Capital Receipts	7,848	13,727
Capital Grants	21,488	17,997
Section 106	3,165	3,020
Revenue	12,143	12,950
External Funding	44,644	47,694
Net financing need for year (HRA)	46,179	51,901
Total net financing need for year	97,274	117,174

Capital Financing Requirement

- 7.7. The CFR is the total historic outstanding capital expenditure incurred by the Council, which has not yet been paid for from either revenue or capital resources. It is essentially a measure of the Council's underlying borrowing need. Any new capital expenditure, which has not immediately been paid for, will increase the CFR. The Council makes an annual charge to the revenue budget for the repayment of its debt liability, the Minimum Revenue Provision, which acts to reduce the CFR and charge prudential borrowing to the General Fund over time.
- 7.8. The Authority's CFR at 31 March 2021 was £573m (GF £422m/HRA £151m). Table 3 reflects the latest projections for the CFR based on the forecast outturn from the 2021/22 Q2 Capital Budget Monitoring Report, summarised in tables 1 and 2, and the Minimum Revenue Provision included within the 2021/22 Revenue Budget.

Table 3

Capital Financing Requirement £'000	2021/22 Original Estimate	2021/22 Revised Estimate
CFR – General Fund	467,891	461,913
CFR – HRA	198,224	202,575
Total CFR	666,115	664,488
Movement in CFR	71,721	91,621

Movement in CFR represented by		
Net financing need for the year (table 2)	97,274	117,174
Less MRP/VRP and other financing movements	-25,553	-25,553
Movement in CFR	71,721	91,621

Authorised Limit and Operational Boundary

- 7.9. No changes have been proposed to the Council's Operational Boundary and Authorised Limit which were approved as part of the 2021/22 TMSS on 25 February 2021.

Operational Boundary

- 7.10. This limit is based on the Council's programme for capital expenditure, Capital Financing Requirement and cash flow needs for the year. It is the limit beyond which external debt is not normally expected to exceed.

Table 4

Operational boundary £'000	2021/22
Borrowing	666,115
Other long term liabilities	17,370
Total	683,485

Authorised Limit

- 7.11. This is a key prudential indicator and represents a control on the maximum level of borrowing. This represents a legal limit beyond which external debt is prohibited, and this limit needs to be set or revised by full Council.
- 7.12. It is the statutory limit determined under section 3(1) of the Local Government Act 2003. Under the Act, the Government retains an option to control either the total of all councils' plans, or those of a specific council, although this power has not yet been exercised.

Table 5

Authorised limit £'000	2021/22
Borrowing	696,115
Other long term liabilities	28,520
Total	724,635

8.0. Economic Update

- 8.1. The Monetary Policy Committee (MPC) on the 4th November voted 7-2 to leave Bank Rate unchanged at 0.10% with two members voting for an increase to 0.25% and made no changes to its programme of quantitative easing purchases due to finish by the end of this year at a total of £895bn by a vote of 6-3.
- 8.2. After the Governor and other MPC members had made speeches prior to the November MPC meeting in which they stressed concerns over inflation, (the Bank is now forecasting inflation to reach 5% in April when the next round of capped gas prices will go up), thus reinforcing their strong message from the September MPC meeting, financial markets had confidently built in an expectation that Bank Rate would go up from 0.10% to 0.25% in November.
- 8.3. While the Bank refrained from raising rates at the November meeting, the MPC did comment, however, that Bank Rate would have to go up in the short term. It is, therefore, relatively evenly balanced as to whether Bank Rate will be increased in December, February or May. Much will depend on how the statistical releases for the labour market after the end of furlough on 30th September 2021 turn out when published.
- 8.4. Over the next year the MPC will be doing a delicate balancing act of weighing combating inflation being higher for longer against growth being held back by significant headwinds. Those headwinds are due to supply shortages (pushing prices up and holding back production directly), labour shortages, surging fuel prices and tax increases. However, those headwinds could potentially be offset – at least partially - by consumers spending at least part of the £160bn+ of “excess savings” accumulated during the pandemic. Conversely, there is also the possibility that people may be content to hold onto elevated savings and investments and, therefore, not support the economic recovery to the extent that the MPC may forecast.
- 8.5. The MPC pointedly chose to reaffirm its commitment to the 2% inflation target in its statement after the MPC meeting in September yet at its August meeting it had emphasised a willingness to look through inflation overshooting the target for limited periods to ensure that inflation was ‘sustainably over 2%’. On balance, once this winter is over and world demand for gas reduces - so that gas and electricity prices fall back - and once supply shortages of other goods are addressed, the MPC is forecasting that inflation would return to just under the 2% target within 3 years.

- 8.6. The MPC's forward guidance on its intended monetary policy on raising Bank Rate versus selling (quantitative easing) holdings of bonds is as follows: -
1. Raising Bank Rate as "the active instrument in most circumstances".
 2. Raising Bank Rate to 0.50% before starting on reducing its holdings.
 3. Once Bank Rate is at 0.50% it would stop reinvesting maturing gilts.
 4. Once Bank Rate had risen to at least 1%, it would start selling its holdings
- 8.7. Since the start of 2021, there has been volatility in gilt yields, and hence PWLB rates. During September, gilt yields from 5 – 50 years rose steadily and after the hawkish tone of the MPC's minutes on 23rd September. Gilt yields then fell sharply after the Budget on 27th October cancelled nearly all gilt sales until the end of the financial year. Forecasts from Link Group, the Councils treasury advisor show a steady, but slow, rise in both Bank Rate and gilt yields during the forecast period to March 2025.

Interest Rate Forecast

- 8.8. The Council's treasury advisor, Link Group, provided the following forecasts on 8th November 2021 (PWLB rates are based on PWLB Certainty Rates, which are gilt yields plus 80bps):

Link Group Interest Rate View		8.11.21												
	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	Mar-25
BANK RATE	0.25	0.25	0.50	0.50	0.50	0.75	0.75	0.75	0.75	1.00	1.00	1.00	1.00	1.25
3 month ave earnings	0.30	0.40	0.50	0.50	0.50	0.60	0.80	0.90	1.00	1.00	1.00	1.00	1.00	1.00
6 month ave earnings	0.40	0.50	0.60	0.60	0.70	0.80	0.90	1.00	1.10	1.10	1.10	1.10	1.10	1.10
12 month ave earnings	0.50	0.60	0.70	0.70	0.80	0.90	1.00	1.10	1.20	1.20	1.20	1.20	1.20	1.20
5 yr PWLB	1.50	1.50	1.60	1.60	1.70	1.70	1.70	1.80	1.80	1.80	1.90	1.90	2.00	2.00
10 yr PWLB	1.80	1.90	1.90	2.00	2.00	2.10	2.10	2.20	2.20	2.20	2.30	2.30	2.30	2.40
25 yr PWLB	2.10	2.20	2.30	2.40	2.40	2.40	2.50	2.50	2.60	2.60	2.60	2.60	2.70	2.70
50 yr PWLB	1.90	2.00	2.10	2.20	2.20	2.20	2.30	2.30	2.40	2.40	2.40	2.40	2.50	2.50

9.0. Treasury Position as at 30 September 2021

Investments

- 9.1. In accordance with the CIPFA Treasury Management Code of Practice and MHCLG Investment Guidance, the TMSS sets out the Council's investment priorities as being:
- Security of capital
 - Liquidity
 - Yield
- 9.2. It is now impossible to earn the level of interest rates commonly seen in previous decades as short-term money market investment rates have continued to remain low following the cut in Bank Rate to 0.10% in March 2020. After the MPC meeting on 24th September 2021 6 month to 12 month deposit rates rose in anticipation of Bank Rate going up in 2022, and while the MPC didn't raise Bank Rate in November in line with market expectations, it has continued to price in an increase which have impacted yields for durations in all but the short term liquidity periods, albeit marginally. Given this low starting point and the fact that Bank Rate is still only forecast to rise incrementally

through to March 2025 means that investment returns are expected to remain low for the foreseeable future.

Table 6

Investment Portfolio £'000	31-Mar-21			30-Sep-21		
	Principal	Average Rate (%)	Average Life (days)	Principal	Average Rate (%)	Average Life (days)
- MMFs	1,616	0.00%	1	1,616	0.01%	1
- Banks	80,838	0.01%	4	118,115	0.01%	4
Total Investments	82,454	0.01%	4	119,731	0.01%	4

- 9.3. The Council held £120m of investments as at 30 September 2021 compared with £82m at 31 March 2021. The portfolio remains highly liquid with the yield reflecting the current market for liquid investments. Cashflow forecasting has been challenging during 2021/22 due to the continued response to the pandemic and the impact this has had on the Authority along with the Council's continued role within that response. The internal borrowing strategy of the Authority, focusing on minimising the net cost of borrowing, also prevents longer term investment with a consequential impact on investment return.
- 9.4. The Council's investment income budget for 2021/22 is £1.256m and the forecast outturn is £1.2m. This includes income from the £15m loan to the West London Waste Authority which the Council approved in July 2013 to finance the cost of a new energy waste plant. The term of the loan is 25 years at an interest rate of 7.604% on a reducing balance basis. The loan balance at the 31 March 2021 was £15.8m which includes interest accrued to date.
- 9.5. During the period cash investments have been held with Deutsche and Fidelity Money Market Funds, Lloyds, Royal Bank of Scotland PLC, and Svenska Handelsbanken. Counterparty use has been consistent with previous years and in accordance with the credit criteria set out in the TMSS. Officers can confirm that the approved limits within the Annual Investment Strategy have not been breached to the period of 29th November 2021.
- 9.6. There are no changes proposed to the Council's Investment Counterparty Criteria approved in the 2021/22 TMSS.
- Borrowing**
- 9.7. The Council continues to run an internal borrowing strategy with a borrowing portfolio of £422m (excluding £17.6m of PFI and Finance Lease Liabilities) below the actual CFR of £573m as at 31 March 2021 and the revised estimate of the CFR for 31 March 2022 of £664m, based on the forecast outturn for the from the 2021/22 Q2 Capital Budget Monitoring Report.
- 9.8. The Authority's current borrowing portfolio remains unchanged from 31 March 2021, with no new borrowing undertaken in 2021/22 to date up to 29 November 2021.

9.9. The forecast outturn on borrowing costs is £14.929m, a favourable variance of £4.008m on the budget of £18.937m, reflecting the continued internal borrowing strategy adopted by the Authority.

Table 7

Borrowing Portfolio £'000	31-Mar-21			30-Sep-21		
	Principal	Average Rate (%)	Average Life (yrs)	Principal	Average Rate (%)	Average Life (yrs)
- PWLB	348,461	3.45%	36.0	348,461	3.45%	35.5
- Market	73,800	3.53%	41.7	73,800	3.53%	41.2
Total borrowing	422,261	3.46%	37.0	422,261	3.46%	36.5

9.10. The Director of Finance will continue to keep borrowing decisions under review.

9.11. The maturity structure of the debt portfolio remained within the Prudential Indicator limits set as part of the 2021/22 Treasury Management Strategy. The maturity structure table (8) below includes one Lenders Option Borrowers Option (LOBO) market loan at its next call date, which is the earliest date the lender can require repayment.

Table 8

Maturity structure of borrowing 2021/22	Lower Limit	Upper Limit	Actual 31.03.21	Actual 30.09.21
Under 12 months	0%	40%	5%	5%
12 months to 2 years	0%	30%	1%	1%
2 years to 5 years	0%	30%	0%	0%
5 years to 10 years	0%	40%	5%	5%
10 years and above	30%	100%	89%	89%

10.0. Implications of the Recommendation

11.0. Risk Management Implications

This report is for noting and Cabinet are not being asked to make any decisions hence there are no direct risk management implications to this report.

12.0. Procurement Implications

There are no procurement implications arising from this report.

13.0. Legal Implications

The Local Government Act 2003 requires the Council to 'have regard to' the Prudential Code and to set Prudential Indicators for the next three years to

ensure that the Council's capital investment plans are affordable, prudent and sustainable. These are contained within this report.

The Act, accompanying statutory guidance and Codes of Practice referred to through capital financing regulations requires the Council to set out its treasury strategy for borrowing and to prepare an Annual Investment Strategy. This sets out the Council's policies for managing its investments and for giving priority to the security and liquidity of those investments. This report assists the Council in fulfilling its statutory obligation under the Local Government Act 2003 to monitor its borrowing and investment activities.

14.0. Financial Implications

In addition to supporting the Council's revenue and capital programmes the Treasury Management interest budget is an important part of the revenue budget. Any savings achieved, or overspends incurred, have a direct impact on the financial performance of the budget.

15.0. Equalities implications / Public Sector Equality Duty

There is no direct equalities impact.

16.0. Council Priorities

This report deals with the Treasury Management Strategy which plays a significant part in supporting the delivery of all the Council's corporate priorities.

Section 3 - Statutory Officer Clearance

Statutory Officer: Dawn Calvert

Chief Financial Officer

Date: 30/11/2021

Statutory Officer: Jessica Farmer

Signed by the Monitoring Officer

Date: 1/12/2021

Chief Officer: Charlie Stewart

Signed off by the Corporate Director

Date: 30/11/2021

Head of Procurement: Nimesh Mehta

Signed off by the Head of Procurement

Date: 30/11/2021

Head of Internal Audit: Susan Dixon

Signed off by the Head of Internal Audit

Date: 26/11/2021

Mandatory Checks

Ward Councillors notified: NO, as it impacts on all Wards

EqlA carried out: NO – report is for information and not decision making.

Section 4 - Contact Details and Background Papers

Contact: Dawn Calvert – Director of Finance & Assurance,
dawn.calvert@harrow.gov.uk,

Background Papers:

Call-in waived by the Chair of Overview and Scrutiny Committee

NO

Appendix 1 Link Group Economic Commentary

MPC meeting 4th November 2021

- 1.0. The Monetary Policy Committee (MPC) voted 7-2 to leave Bank Rate unchanged at 0.10% with two members voting for an increase to 0.25% and made no changes to its programme of quantitative easing purchases due to finish by the end of this year at a total of £895bn by a vote of 6-3.
- 1.1. After the Governor and other MPC members had made speeches prior to the MPC meeting in which they stressed concerns over inflation, (the Bank is now forecasting inflation to reach 5% in April when the next round of capped gas prices will go up), thus reinforcing the strong message from the September MPC meeting, financial markets had confidently built in an expectation that Bank Rate would go up from 0.10% to 0.25% at this meeting. However, these were not messages that the MPC would definitely increase Bank Rate at the first upcoming MPC meeting as no MPC member can commit the MPC to make that decision ahead of their discussions at the time. The MPC did comment, however, that Bank Rate would have to go up in the short term. It is, therefore, relatively evenly balanced as to whether Bank rate will be increased in December, February or May. Much will depend on how the statistical releases for the labour market after the end of furlough on 30th September 2021 turn out.
- 1.2. Information available at the December MPC meeting will be helpful in forming a picture but not conclusive, so this could cause a delay until the February meeting. At the MPC's meeting in February it will only have available the employment figures for November: to get a clearer picture of employment trends, it would, therefore, need to wait until the May meeting (although it also meets in March) when it would have data up until February. At its May meeting, it will also have a clearer understanding of the likely peak of inflation expected around that time. If the statistics show the labour market coping well during the next six months, then it is likely there will be two increases in these three meetings.
- 1.3. Over the next year the MPC will be doing a delicate balancing act of weighing combating inflation being higher for longer against growth being held back by significant headwinds. Those headwinds are due to supply shortages (pushing prices up and holding back production directly), labour shortages, surging fuel prices and tax increases. However, those headwinds could potentially be offset – at least partially - by consumers spending at least part of the £160bn+ of “excess savings” accumulated during the pandemic. However, it is also possible that more affluent people may be content to hold onto elevated savings and investments and, therefore, not support the economic recovery to the extent that the MPC may forecast.
- 1.4. The latest forecasts by the Bank showed inflation under-shooting the 3 years ahead 2% target (1.95%), based on market expectations of Bank Rate hitting 1% in 2022. This implies that rates don't need to rise to market expectations of 1.0% by the end of next year.
- 1.5. It is worth recalling that the MPC pointedly chose to reaffirm its commitment to the 2% inflation target in its statement after the MPC meeting in September yet

at its August meeting it had emphasised a willingness to look through inflation overshooting the target for limited periods to ensure that inflation was 'sustainably over 2%'. On balance, once this winter is over and world demand for gas reduces - so that gas prices and electricity prices fall back - and once supply shortages of other goods are addressed, the MPC is forecasting that inflation would return to just under the 2% target.

- 1.6. The MPC's forward guidance on its intended monetary policy on raising Bank Rate versus selling (quantitative easing) holdings of bonds is as follows: -
 1. Raising Bank Rate as "the active instrument in most circumstances".
 2. Raising Bank Rate to 0.50% before starting on reducing its holdings.
 3. Once Bank Rate is at 0.50% it would stop reinvesting maturing gilts.
 4. Once Bank Rate had risen to at least 1%, it would start selling its holdings.
- 1.7. Gilt yields fell after the budget led to a reduction of £57.8bn in the forecast by the OBR for the deficit this year and a cancellation of nearly all gilt sales for the remainder of the financial year. There is a delicate balancing act in forecasting gilt yields and PWLB rates over the forecast period as when Bank Rate does increase to 0.50%, the Bank will stop reinvesting maturing gilts – but at a time when the size of gilt sales has just been slashed in the budget.

Our forecasts for Bank Rate

- 1.8. We are not expecting Bank Rate to go up fast after the initial rate rise; our view is that the supply potential of the economy has not taken a major hit during the pandemic: it should, therefore, be able to cope well with meeting demand after supply shortages subside over the next year, without causing inflation to remain elevated in the medium-term, or to inhibit inflation from falling back towards the MPC's 2% target after the spike up to 5%. We are therefore forecasting five increases in Bank Rate over the forecast period to March 2025, ending at 1.25%. However, we are far from confident that these forecasts will not need changing within a relatively short timeframe for the following reasons: -
 - There are increasing grounds for viewing the economic recovery as running out of steam during the summer and now into the autumn. This could lead into stagflation which would create a dilemma for the MPC as to whether to focus on combating inflation or supporting economic growth through keeping interest rates low.
 - Will some current key supply shortages spill over into causing economic activity in some sectors to take a significant hit?
 - Rising gas and electricity prices in October and next April and increases in other prices caused by supply shortages and increases in taxation next April, are already going to deflate consumer spending power without the MPC having to take any action on Bank Rate to cool inflation.
 - On the other hand, consumers are sitting on over £160bn of excess savings left over from the pandemic so when will they spend this sum, in part or in total?
 - It is estimated that there were around 1 million people who came off furlough at the end of September; how many of those would not have had jobs on 1st October and would therefore be available to fill labour shortages which are creating a major headache in many sectors of the economy? So, supply shortages which have been driving up both wages

and costs, could reduce significantly within the next six months or so and alleviate one of the MPC's key current concerns.

- We also recognise there could be further nasty surprises on the Covid front, on top of the flu season this winter, and even the possibility of another lockdown, which could all depress economic activity.
- If the UK invokes article 16 of the Brexit deal over the dislocation in trading arrangements with Northern Ireland, this has the potential to end up in a no deal Brexit.

1.9. In summary, with the high level of uncertainty prevailing on several different fronts, we expect to have to revise our forecasts again - in line with what the new news is.

1.10. It should also be borne in mind that Bank Rate being cut to 0.10% was an emergency measure to deal with the Covid crisis hitting the UK in March 2020. At any time, the MPC could decide to simply take away that final emergency cut from 0.25% to 0.10% on no other grounds than it being no longer being warranted and as a step forward in the return to normalisation. In addition, any Bank Rate under 1% is both highly unusual and highly supportive of economic growth.

Our forecasts for PWLB rates and gilt and treasury yields

1.11. Gilt yields. Since the start of 2021, we have seen a lot of volatility in gilt yields, and hence PWLB rates. During September, gilt yields from 5 – 50 years rose steadily and rose further after the hawkish tone of the MPC's minutes on 23rd September. Gilt yields then fell sharply after the Budget on 27th October cancelled nearly all gilt sales until the end of the financial year. Our forecasts show a steady, but slow, rise in both Bank Rate and gilt yields during the forecast period to March 2025.

1.12. While monetary policy in the UK will have a major impact on gilt yields, there is also a need to consider the potential impact that rising treasury yields in America could have on our gilt yields. As an average since 2011, there has been a 75% correlation between movements in US 10 year treasury yields and UK 10 year gilt yields. This is a significant UPWARD RISK exposure to our forecasts for longer term PWLB rates. However, gilt yields and treasury yields do not always move in unison.

1.13. US treasury yields. During the first part of the year, US President Biden's, and the Democratic party's, determination to push through a \$1.9trn (equivalent to 8.8% of GDP) fiscal boost for the US economy as a recovery package from the Covid pandemic was what unsettled financial markets. However, this was in addition to the \$900bn support package already passed in December 2020. This was then followed by additional Democratic ambition to spend \$1trn on infrastructure, which has just been passed by both houses, and an even larger sum on an American families plan over the next decade; this is still caught up in Democrat / Republican haggling. Financial markets were alarmed that all this stimulus was happening at a time when:

1. A fast vaccination programme has enabled a rapid opening up of the economy.
2. The economy has been growing strongly during 2021.

3. It started from a position of little spare capacity due to less severe lockdown measures than in many other countries.
4. And the Fed was still providing stimulus through monthly QE purchases.

1.14. These factors could cause an excess of demand in the economy which could then unleash strong inflationary pressures. This could then force the Fed to take much earlier action to start increasing the Fed rate from near zero, despite their stated policy being to target average inflation.

1.15. At its 3rd November Fed meeting, the Fed decided to make a start on tapering QE purchases with the current \$80bn per month of Treasury securities to be trimmed by \$10bn in November and a further \$10bn in December. The \$40bn of MBS purchases per month will be trimmed by \$5bn in each month. If the run-down continued at that pace, the purchases would cease entirely next June but the Fed has reserved the ability to adjust purchases up or down. This met market expectations. These purchases are currently acting as downward pressure on treasury yields and so it would be expected that Treasury yields would rise as a consequence over the taper period, all other things being equal.

1.16. However, on the inflation front it was still insisting that the surge in inflation was "largely" transitory. In his post-meeting press conference, Chair Jerome Powell claimed that "the drivers of higher inflation have been predominantly connected to the dislocations caused by the pandemic" and argued that the Fed's tools cannot address supply constraints. However, with the Fed now placing major emphasis on its mandate for ensuring full employment, (besides containing inflation), at a time when employment has fallen by 5 million and 3 million have left the work force, resignations have surged due to the ease of getting better paid jobs and so wage pressures have built rapidly.

1.17. With wage growth at its strongest since the early 1980s, inflation expectations rising and signs of a breakout in cyclical price inflation, particularly rents, the FOMC's insistence that this is still just a temporary shock "related to the pandemic and the reopening of the economy", does raise doubts which could undermine market confidence in the Fed and lead to higher treasury yields.

1.18. As the US financial markets are, by far, the biggest financial markets in the world, any upward trend in treasury yields will invariably impact and influence financial markets in other countries. Inflationary pressures and erosion of surplus economic capacity look much stronger in the US compared to those in the UK, which would suggest that Fed rate increases eventually needed to suppress inflation, are likely to be faster and stronger than Bank Rate increases in the UK. This is likely to put upward pressure on treasury yields which could then spill over into putting upward pressure on UK gilt yields.

1.19. There are also possible downside risks from the huge sums of cash that the UK populace have saved during the pandemic; when savings accounts earn little interest, it is likely that some of this cash mountain could end up being invested in bonds and so push up demand for bonds and support their prices i.e., this would help to keep their yields down. How this will interplay with the Bank of England eventually getting round to not reinvesting maturing gilts and then later selling gilts, will be interesting to monitor.

Globally, our views on economies are as follows: -

- 1.20. **EU.** The slow role out of vaccines initially delayed economic recovery in early 2021 but the vaccination rate then picked up sharply. After a contraction of -0.3% in Q1, Q2 came in with strong growth of 2%. With Q3 at 2.2%, the EU recovery is nearly complete although countries dependent on tourism are lagging. Recent sharp increases in gas and electricity prices have increased overall inflationary pressures but the ECB is likely to see these as being only transitory after an initial burst through to around 4%, so is unlikely to be raising rates for a considerable time.
- 1.21. **German general election.** With the CDU/CSU and SPD both having won around 24-26% of the vote in the September general election, the composition of Germany's next coalition government may not be agreed by the end of 2021. An SPD-led coalition would probably pursue a slightly less restrictive fiscal policy, but any change of direction from a CDU/CSU led coalition government is likely to be small. However, with Angela Merkel standing down as Chancellor as soon as a coalition is formed, there will be a hole in overall EU leadership which will be difficult to fill.
- 1.22. **China.** After a concerted effort to get on top of the virus outbreak in Q1 2020, economic recovery was strong in the rest of the year; this enabled China to recover all the initial contraction. During 2020, policy makers both quashed the virus and implemented a programme of monetary and fiscal support that was particularly effective at stimulating short-term growth. At the same time, China's economy benefited from the shift towards online spending by consumers in developed markets. These factors helped to explain its comparative outperformance compared to western economies during 2020 and earlier in 2021. However, the pace of economic growth has now fallen back after this initial surge of recovery from the pandemic and China is now struggling to contain the spread of the Delta variant through sharp local lockdowns - which will also depress economic growth. There are also questions as to how effective Chinese vaccines are proving. Supply shortages, especially of coal for power generation, which is causing widespread power cuts to industry, are also having a sharp disruptive impact on the economy. In addition, recent regulatory actions motivated by a political agenda to channel activities into officially approved directions, are also likely to reduce the dynamism and long-term growth of the Chinese economy.
- 1.23. **Japan.** 2021 has been a patchy year in combating Covid. However, recent business surveys indicate that the economy is rebounding rapidly now that the bulk of the population is fully vaccinated and new virus cases have plunged. The Bank of Japan is continuing its very loose monetary policy but with little prospect of getting inflation back above 1% towards its target of 2%, any time soon: indeed, inflation was actually negative in July. New Prime Minister Kishida had promised a large fiscal stimulus package after the November general election which his party has now won.
- 1.24. **World growth.** World growth was in recession in 2020 but recovered during 2021. Inflation has been rising due to increases in gas and electricity prices, shipping costs and supply shortages. But these should subside during 2022.

The balance of risks to the UK: -

- 1.25. The overall balance of risks to economic growth in the UK is now to the downside, including residual risks from Covid and its variants - both domestically and their potential effects worldwide.

Downside risks to current forecasts for UK gilt yields and PwLB rates include: -

- 1.26. **Labour and supply shortages** prove more enduring and disruptive and depress economic activity.
- 1.27. **Mutations** of the virus render current vaccines ineffective, and tweaked vaccines to combat these mutations are delayed, resulting in further national lockdowns or severe regional restrictions.
- 1.28. **Bank of England** acts 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.
- 1.29. **The Government** acts too quickly to cut expenditure to balance the national budget.
- 1.30. **UK / EU trade arrangements** – if there was a major impact on trade flows and financial services due to complications or lack of co-operation in sorting out significant remaining issues.
- 1.31. 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 which has still to be disbursed. These actions will help shield weaker economic regions in the near-term. However, in the case of Italy in the longer term, 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.
- 1.32. Weak capitalisation of some **European banks**, which could be undermined further depending on the extent of credit losses resulting from the pandemic.
- 1.33. **German general election in September 2021**. Germany faces months of uncertainty while a new coalition government is cobbled together after the indecisive result of the election. Once that coalition is formed, Angela Merkel’s tenure as Chancellor will end and will leave a hole in overall EU leadership.
- 1.34. **Other minority EU governments**. Austria, Sweden, Spain, Portugal, Netherlands, Ireland and Belgium also have vulnerable minority governments dependent on coalitions which could prove fragile and, therein, impact market confidence/economic prospects and lead to increasing safe-haven flows.

1.35. **Geopolitical risks**, for example in China, Iran or North Korea, but also in Europe and Middle Eastern countries, which could lead to increasing safe-haven flows.

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

1.36. 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.

1.37. Longer term US treasury yields rise strongly and pull gilt yields up higher than forecast.

LINK GROUP FORECASTS

1.38. We do not think that the MPC will embark on a series of increases in Bank Rate of more than 1.15% during the current and next three financial years as we do not expect inflation to return to being sustainably above 2% during this forecast period.

1.39. With unpredictable virus factors now being part of the forecasting environment, there is a risk that forecasts could be subject to significant revision during the next three years.

Gilt yields and PWLB rates

1.40. The general situation is for volatility in bond yields to endure as investor fears and confidence ebb and flow between favouring relatively more “risky” assets i.e., equities, or the safe haven of government bonds. The overall longer-run trend is for gilt yields and PWLB rates to rise.

1.41. There is likely to be exceptional volatility and unpredictability in respect of gilt yields and PWLB rates due to the following factors: -

- How strongly will changes in gilt yields be correlated to changes in US treasury yields?
- Will the Fed take action to counter increasing treasury yields if they rise beyond a yet unspecified level?
- Would the MPC act to counter increasing gilt yields if they rise beyond a yet unspecified level?
- How strong will inflationary pressures turn out to be in both the US and the UK and so impact treasury and gilt yields?
- How will central banks implement their new average or sustainable level inflation monetary policies?
- How well will central banks manage the withdrawal of QE purchases of their national bonds i.e., without causing a panic reaction in financial markets as happened in the “taper tantrums” in the US in 2013?
- Will exceptional volatility be focused on the short or long-end of the yield curve, or both?

1.42. Our forecasts are also predicated on an assumption that there is no break-up of the Eurozone or EU within our forecasting period, despite the major challenges that are looming up, and that there are no major ructions in

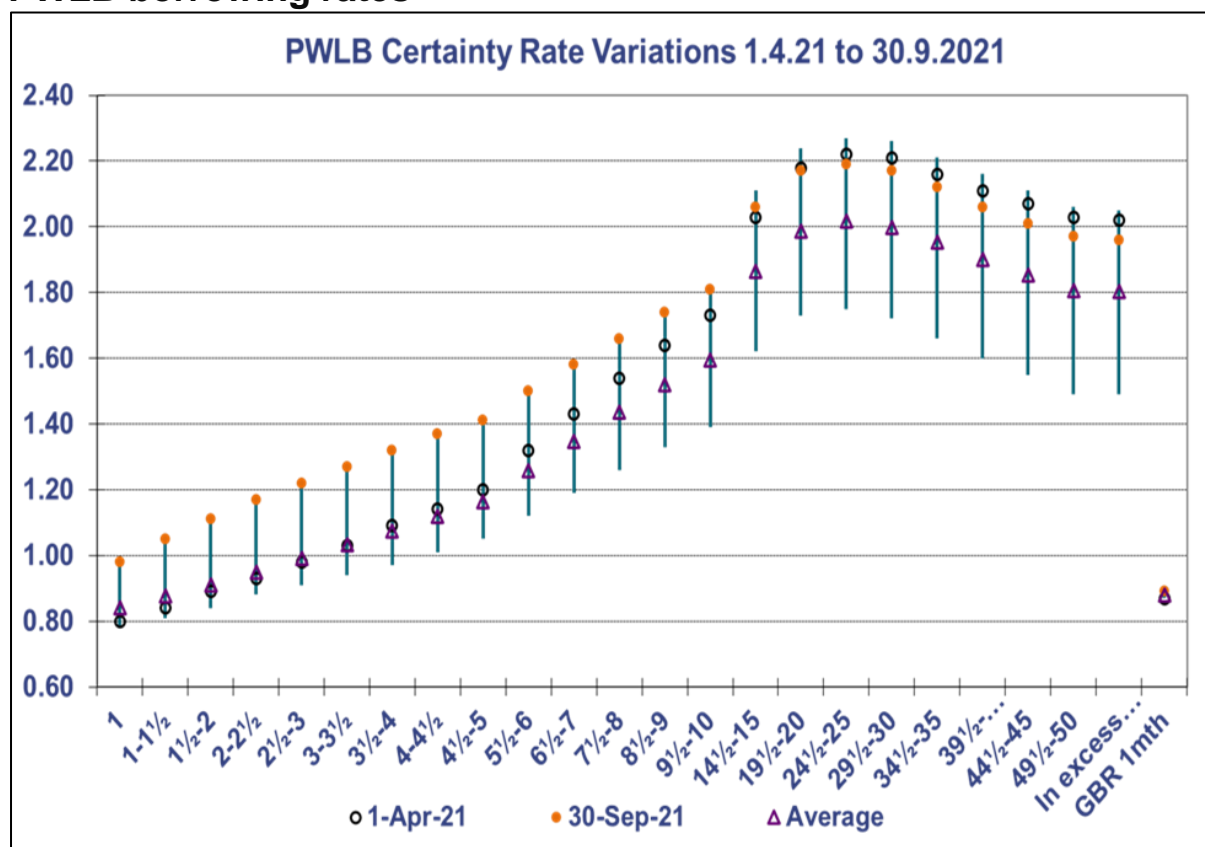
international relations, especially between the US and China / North Korea and Iran, which have a major impact on international trade and world GDP growth.

1.43. Our current and previous PWLB rate forecasts below are based on the Certainty Rate (the standard rate minus 20 bps) which has been accessible to most authorities since 1st November 2012.

Link Group Interest Rate View 8.11.21														
	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	Mar-25
BANK RATE	0.25	0.25	0.50	0.50	0.50	0.75	0.75	0.75	0.75	1.00	1.00	1.00	1.00	1.25
3 month ave earnings	0.30	0.40	0.50	0.50	0.50	0.60	0.80	0.90	1.00	1.00	1.00	1.00	1.00	1.00
6 month ave earnings	0.40	0.50	0.60	0.60	0.70	0.80	0.90	1.00	1.10	1.10	1.10	1.10	1.10	1.10
12 month ave earnings	0.50	0.60	0.70	0.70	0.80	0.90	1.00	1.10	1.20	1.20	1.20	1.20	1.20	1.20
5 yr PWLB	1.50	1.50	1.60	1.60	1.70	1.70	1.70	1.80	1.80	1.80	1.90	1.90	2.00	2.00
10 yr PWLB	1.80	1.90	1.90	2.00	2.00	2.10	2.10	2.20	2.20	2.20	2.30	2.30	2.30	2.40
25 yr PWLB	2.10	2.20	2.30	2.40	2.40	2.40	2.50	2.50	2.60	2.60	2.60	2.60	2.70	2.70
50 yr PWLB	1.90	2.00	2.10	2.20	2.20	2.20	2.30	2.30	2.40	2.40	2.40	2.40	2.50	2.50

Appendix 2 Borrowing and Investment Rate Summary 2021/22

PWLB borrowing rates



	1 Year	5 Year	10 Year	25 Year	50 Year
Low	0.78%	1.05%	1.39%	1.75%	1.49%
Date	08/04/2021	08/07/2021	05/08/2021	17/08/2021	10/08/2021
High	0.98%	1.42%	1.81%	2.27%	2.06%
Date	24/09/2021	28/09/2021	28/09/2021	13/05/2021	13/05/2021
Average	0.84%	1.16%	1.60%	2.02%	1.81%
Spread	0.20%	0.37%	0.42%	0.52%	0.57%

Money market investment rates and forecasts 2021/22

	Bank Rate	7 day	1 mth	3 mth	6 mth	12 mth
High	0.10	-0.08	-0.07	-0.04	0.05	0.25
High Date	01/04/2021	09/04/2021	06/07/2021	01/04/2021	30/09/2021	30/09/2021
Low	0.10	-0.09	-0.08	-0.07	-0.04	0.03
Low Date	01/04/2021	27/08/2021	26/04/2021	08/09/2021	27/07/2021	16/04/2021
Average	0.10	-0.08	-0.07	-0.05	-0.02	0.07
Spread	0.00	0.01	0.01	0.03	0.09	0.22