Police and Crime Commissioner
CAMBRIDGESHIRE AND PETERBOROUGH

Strategy Statement and Annual Investment Strategy

Mid-year Review Report

Cambridgeshire Police And Crime Commissioner
2020/21

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1 Background

1.1 Capital Strategy

In December 2017, the Chartered Institute of Public Finance and Accountancy, (CIPFA), issued revised Prudential and Treasury Management Codes. As from 2020/21, all local authorities will be required to prepare a Capital Strategy which is intended 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

1.2 Treasury Management

The Police and Crime Commissioner (the Commissioner) operates a balanced budget, which broadly means cash raised during the year will meet its cash expenditure. Part of the treasury management operations ensure this cash flow is adequately planned, with surplus monies being invested in low risk counterparties, providing adequate liquidity initially before considering optimising investment return.

The second main function of the treasury management service is the funding of the Commissioner's capital plans. These capital plans provide a guide to the borrowing need of the Commissioner, essentially the longer-term cash flow planning to ensure the Commissioner can meet the capital spending operations. This management of longer-term cash may involve arranging long or short-term loans, or using longer term cash flow surpluses, and on occasion any debt previously drawn may be restructured to meet the Commissioner's risk or cost objectives.

Accordingly, treasury management is defined as:

> "The management of the local authority's borrowing, investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks."

2 Introduction

This report has been written in accordance with the requirements of the Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management (revised 2017).

The primary requirements of the Code are as follows:

1. Creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the Commissioner's treasury management activities.
2. Creation and maintenance of Treasury Management Practices which set out the manner in which the Commissioner will seek to achieve those policies and objectives.
3. Receipt by the Commissioner 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.
4. Delegation by the Commissioner of responsibilities for implementing and monitoring treasury management policies and practices and for the execution and administration of treasury management decisions.

5. Delegation by the Commissioner of the role of scrutiny of treasury management strategy and policies to a specific named body. The named body delegated by the Commissioner is the Business Co-ordination Board with reports subsequently being presented to the Joint Audit Committee.

This mid-year report has been prepared in compliance with CIPFA's Code of Practice on Treasury Management, and covers the following:

- An economic update for the first part of the financial year;
- A review of the Treasury Management Strategy Statement and Annual Investment Strategy;
- The Commissioner's capital expenditure, as set out in the Capital Strategy, and prudential indicators;
- A review of the Commissioner's investment portfolio for the first part of the financial year;
- A review of the Commissioner's borrowing strategy for the first part of the financial year;
- A review of any debt rescheduling undertaken during the first part of the financial year;
- A review of compliance with Treasury and Prudential Limits for the first part of the financial year.

Recommendation

The Business Co-ordination Board is asked to recommend that the Commissioner notes the report and the treasury activity.

3 Economics and interest rates

3.1 Economics update

This provides the update for the UK with commentary on the global economic position being provided in Appendix 1.

As expected, the Bank of England's Monetary Policy Committee (MPC) kept Bank Rate unchanged on 6th August. It also kept unchanged the level of quantitative easing at £745bn. Its forecasts were optimistic in terms of three areas:

- The fall in **GDP** in the first half of 2020 was revised from 28% to 23%. This is still one of the largest falls in output of any developed nation. However, it is only to be expected as the UK economy is heavily skewed towards consumer-facing services – an area which was particularly vulnerable to being damaged by lockdown.
- The peak in the **unemployment rate** was revised down from 9% in Q2 to 7½% by Q4 2020.
- It forecast that there would be excess demand in the economy by Q3 2022 causing CPI **inflation** to rise above the 2% target in Q3 2022, (based on market interest rate expectations for a further loosening in policy). Nevertheless, even if the Bank were to leave policy unchanged, inflation was still projected to be above 2% in 2023.

It also squashed any idea of using **negative interest rates**, at least in the next six months or so. It suggested that while negative rates can work in some circumstances, it would be "less effective as a tool to stimulate the economy" at this time when banks are worried about future loan losses. It also has "other instruments available", including Quantitative Easing (QE) and the use of forward guidance (the bank's clear indication to its use of monetary policy which helps ease market uncertainties).

The MPC still expects the £300bn of **quantitative easing** (QE) purchases announced between its March and June meetings to continue until the "turn of the year". This implies that the pace of purchases will slow further to about £4bn a week, down from £14bn a week at the height of the crisis and £7bn more recently.

In conclusion, this would indicate that the Bank can for now take a less active role as the economy is recovering better than expected. However, the MPC acknowledged that the "medium-term projections were a less informative guide than usual" and the minutes had multiple references to **downside risks**, which were judged to persist both in the short and medium term. One has only to look at the way in which second waves of the virus are now impacting many countries including Britain, to see the dangers. However, rather than a national lockdown, as in March, any spikes in virus infections are now likely to be dealt with by localised measures and this should limit the amount of economic damage caused.

In addition, Brexit uncertainties ahead of the year-end deadline are likely to adversely impact recovery. The wind down of the initial generous furlough scheme through to the end of October is another development that could cause the Bank to review the need for more support for the economy later in the year. Admittedly, the Chancellor announced in late September a second six-month package from 1st November of government support for jobs whereby it will pay up to 22% of the costs of retaining an employee working a minimum of one third of their normal hours. There was further help for the self-employed, freelancers and the hospitality industry. However, this is a much less generous scheme than the furlough package and will inevitably mean there will be further job losses from the 11% of the workforce still on furlough in mid-September.

Overall, the **pace of recovery** is not expected to be in the form of a rapid V shape, but a more elongated and prolonged one after a sharp recovery in June through to August which left the economy 11.7% smaller than in February. The last three months of 2020 are now likely to show no growth as consumers will probably remain cautious in spending and uncertainty over the outcome of the UK/EU trade negotiations concluding at the end of the year will also be a headwind. If the Bank felt it did need to provide further support to recovery, then it is likely that the tool of choice would be more QE.

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. There is also likely to be a reversal of globalisation as this crisis has shown up how vulnerable long-distance supply chains are. On the other hand, digital services is one area that has already seen huge growth.

One key addition to the **Bank's forward guidance** 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". So, 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.

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%.

3.2 Interest rate forecasts

The Commissioner's treasury advisor, Link Asset Services, has provided the following forecast (Public Works Loan Board (PWLB) rates are certainty rates, gilt yields plus 180bps):

	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22	Mar-23
Bank Rate View	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
3 month average earnings	0.05	0.05	0.05	0.05	0.05	-	-	-	-	-
6 month average earnings	0.10	0.10	0.10	0.10	0.10	-	-	-	-	-
12 month average earnings	0.15	0.15	0.15	0.15	0.15	-	-	-	-	-
5yr PWLB Rate	1.90	2.00	2.00	2.00	2.00	2.00	2.10	2.10	2.10	2.10
10yr PWLB Rate	2.10	2.10	2.10	2.10	2.20	2.20	2.20	2.30	2.30	2.30
25yr PWLB Rate	2.50	2.50	2.50	2.60	2.60	2.60	2.70	2.70	2.70	2.70
50yr PWLB Rate	2.30	2.30	2.30	2.40	2.40	2.40	2.50	2.50	2.50	2.50

The coronavirus outbreak has done huge economic damage to the UK and around the world. After the Bank of England took emergency action in March to cut Bank Rate to first 0.25%, and then to 0.10%, it left Bank Rate unchanged at its last meeting on 6th August, although some forecasters had suggested that a cut into negative territory could happen. However, the Governor of the Bank of England has made it clear that he currently thinks that such a move would do more damage than good and that more quantitative easing is the favoured tool if further action becomes necessary. As shown in the forecast table above, no increase in Bank Rate is expected within the forecast horizon ending on 31st March 2023 as economic recovery is expected to be only gradual and, therefore, prolonged.

4 Treasury Management and Annual Investment Strategy Update

There are no policy changes to the Treasury Management Strategy Statement (TMSS) for 2020/21; the details in this report update the position in the light of the economic position and budgetary changes already approved.

Prudential Indicator	**2020/21 Original £m**	**2020/21 Revised £m**
Authorised Limit	41.4	41.4
Operational Boundary	36.0	36.0
Capital Financing Requirement	19.6*	21.5

**original CFR as per the forecast provided in the TMSS AIS 2020/21*

5 The Commissioner's Capital Position

5.1 Capital Expenditure

This table shows the revised estimates for capital expenditure and the changes since the capital programme was agreed at the Budget. This is the position at end of the fifth period of 2020.

All figures £'000	B/Fwd from previous years	Original 2020/21 Capital Programme	Revised 2020/21 Capital Budget	Actual & Committed 2020/21	Forecast 2020/21
Capital Payments:-					
Land & Buildings	792	4,998	5,790	916	2,239
Fleet	-	1,478	1,478	1,415	1,478
IT & Communications	459	2,439	2,898	984	2,851
Other Collaboration	51	145	225	136	225
Schemes approved subject to further business case	-	300	300	-	
TOTAL	1,302	9,360	10,691	3,451	6,793

5.2 Changes to the Financing of the Capital Programme

The table below draws together the main strategy elements of the capital expenditure plans (above), highlighting the original supported and unsupported elements of the capital programme, and the expected financing arrangements of this capital expenditure.

All figures £'000	B/Fwd from previous years	Original 2020/21 Capital Programme	Revised 2020/21 Capital Budget
Capital Financing:-			
Capital Grants	280	136	445
Carry Forward Reserve	1,022	-	1,022
Capital Receipts	-	537	537
Estates Reserve	-	862	860
RCCO	-	1,440	1,440
Borrowing (already taken)	-	6,385	2,489
TOTAL	1,302	9,360	6,793
Borrowing Required	-	-	-

The borrowing required increases the underlying indebtedness of the Commissioner 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.

5.3 Changes to the Prudential Indicators for the Capital Financing Requirement (CFR) and External Debt

The table below shows the CFR, which is the underlying external need to incur borrowing for a capital purpose. It also shows the expected debt position over the period.

We are on target to achieve the original forecast Capital Financing Requirement.

Capital Financing Requirement and External Debt	2020/21 Original Estimate £m	2020/21 Current Position £m	2020/21 Revised Estimate £m
Total CFR	19.6	22.2	21.5
Net movement in CFR	**(0.7)**	**0.0**	**(0.7)**
Borrowing	17.3	17.8	17.3
Other long-term liabilities*	0.0	0.0	0.0
Total debt (year end position)	**17.3**	**17.8**	**17.3**

** Includes finance leases*

5.4 Limits to Borrowing Activity

The first key control over the treasury activity is a prudential indicator to ensure that over the medium term, net borrowing (borrowings less investments) will only be for a capital purpose*. 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 next two financial years. This allows some flexibility for limited early borrowing for future years. The Commissioner has approved a policy for borrowing in advance of need which will be adhered to if this proves prudent.

** The management of transferred debt should be excluded from net borrowing.*

Operational Boundary for external debt	2020/21 Original Indicator £m	2020/21 Revised Indicator £m
Borrowing	36.0	36.0
Other long-term liabilities*	0.0	0.0
Total debt	**36.0**	**36.0**
CFR* (year end position)	**22.2**	**22.2**

** Includes finance leases*

The Chief Finance Officer reports that no difficulties are envisaged for the current or future years in complying with this prudential indicator.

A further prudential indicator controls the overall level of borrowing. This is the Authorised Limit which represents the limit beyond which borrowing is prohibited, and needs to be set and revised by the Commissioner. It reflects the level of borrowing which, while not desired, could be afforded in the short term, but is not sustainable in the longer term. It is the expected maximum borrowing need with some headroom for unexpected movements. This is the statutory limit determined under section 3 (1) of the Local Government Act 2003.

Authorised limit for external debt	2020/21 Original Indicator £m	2020/21 Revised Indicator £m
Borrowing	37.6	37.6
Other long-term liabilities*	0.0	0.0
Total	**37.6**	**37.6**

** Includes on balance sheet PFI schemes and finance leases etc.*

6 Borrowing

The Commissioner’s capital financing requirement (CFR) for 2020/21 is £21.5m. The CFR denotes the Commissioner’s underlying need to borrow for capital purposes. If the CFR is positive the Commissioner may borrow from the PWLB or the market (external borrowing) or from internal balances on a temporary basis (internal borrowing). The balance of external and internal borrowing is generally driven by market conditions. Table 5.3 shows the Commissioner has revised year end borrowings, including finance leases, of £17.3m and is under-borrowed by £4.3m. This is a prudent and cost-effective approach in the current economic climate but will require ongoing monitoring in the event that upside risk to gilt yields prevails.

Whilst there is an underlying need to borrow for capital purposes, it is anticipated that further borrowing will not be undertaken during this financial year.

There are large-scale projects held in the capital programme that will require extensive borrowing so it is prudent to note current factors affecting borrowing. PWLB rates varied within a relatively narrow range between April and July but the longer end of the curve rose during August. This increase came in two periods; the first in the second week of the month was on the back of hopes for fresh US stimulus. This saw investors switch monies out of government bonds and into equities. The second shift higher at the longer end of the curve came in the latter stages of the month as investors reacted to the announcement of the tweak to the Fed’s inflation target. Despite moves further out in the yield curve, the short end remained anchored on the basis of no fundamental change to the interest rate outlook.

The 50-year PWLB target rate for new long-term borrowing was unchanged at 2.30%.

7 Debt Rescheduling

Debt rescheduling opportunities have been very limited in the current economic climate given the consequent structure of interest rates, and following the increase in the margin added to gilt yields which has impacted PWLB new borrowing rates since October 2010. No debt rescheduling has therefore been undertaken to date in the current financial year.

8 Compliance with Treasury and Prudential Limits

It is a statutory duty for the Commissioner to determine and keep under review the affordable borrowing limits. During the half year ended 30th September 2020, the Commissioner has operated within the treasury and prudential indicators set out in the Commissioner's Treasury Management Strategy Statement for 2020. The Director of Finance reports that no difficulties are envisaged for the current or future years in complying with these indicators.

All treasury management operations have also been conducted in full compliance with the Commissioner's Treasury Management Practices.

9 Annual Investment Strategy

In accordance with the CIPFA Treasury Management Code of Practice, it is the Commissioner's priority to ensure security of capital and liquidity, and to obtain an appropriate level of return which is consistent with the Commissioner's risk appetite.

In the current economic climate, it is considered appropriate to keep investments short term to cover cash flow needs, but also to seek out value available in periods up to 12 months with high credit rated financial institutions, using the Link suggested creditworthiness approach, including a minimum sovereign credit rating and Credit Default Swap (CDS) overlay information.

As shown by the interest rate forecasts in section 3.2, it is now impossible to earn the level of interest rates commonly seen in previous decades as all investment rates are barely above zero now that Bank Rate is at 0.10%, while some entities, including more recently the Debt Management Account Deposit Facility (DMADF), are offering negative rates of return in some shorter time periods. 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 31st March 2023, investment returns are expected to remain low.

Negative investment rates

While the Bank of England has said that it is unlikely to introduce a negative Bank Rate, at least in the next 6 -12 months, some deposit accounts are already offering negative rates for shorter periods. As part of the response to the pandemic and lockdown, the Bank and the Government have provided financial markets and businesses with plentiful access to credit, either directly or through commercial banks. In addition, the Government has provided large sums of grants to local authorities to help deal with the Covid crisis; this has caused some local authorities to have sudden large increases in investment balances searching for an investment home, some of which was only very short term until those sums were able to be passed on.

As for money market funds (MMFs), yields have continued to drift lower. Some managers have suggested that they might resort to trimming fee levels to ensure that net yields for investors remain in positive territory where possible and practical. Investor cash flow uncertainty, and the need to maintain liquidity in these unprecedented times, has meant there is a glut of money swilling around at the very short end of the market. This has seen a number of market operators, now including the DMADF, offer nil or negative rates for very short-term maturities. This is not universal, and MMFs are still offering a marginally positive return, as are a number of financial institutions.

Inter-local authority lending and borrowing rates have also declined due to the surge in the levels of cash seeking a short-term home at a time when many local authorities are probably having difficulties over accurately forecasting when disbursements of funds received will occur or when further large receipts will be received from the Government.

Creditworthiness

Although the credit rating agencies changed their outlook on many UK banks from stable to negative outlook during the quarter ended 30th June 2020 due to upcoming risks to banks' earnings and asset quality during the economic downturn caused by the pandemic, the majority of ratings were affirmed due to the continuing strong credit profiles of UK banks. However, during Q1 and Q2 2020, banks made provisions for expected credit losses and the rating changes reflected these provisions. As we move into the next quarters ahead, more information will emerge on actual levels of credit losses. This has the potential to cause rating agencies to revisit their initial rating adjustments earlier in the current year. These adjustments could be negative or positive, although it should also be borne in mind that UK banks went into this pandemic with strong balance sheets. Indeed, the Financial Policy Committee (FPC) report on 6th August revised down their expected credit losses for the banking sector to "somewhat less than £80bn". They stated that in their 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%.

All three rating agencies have reviewed banks around the world with similar results in many countries of most banks being placed on negative watch, but with a small number of actual downgrades. The recent downgrade of the UK's sovereign rating by Moody's is noteworthy and indicative of a weakened UK economy, however, the change does not impact the current Investment Strategy for the Commissioner.

Investment Counterparty criteria

The current investment counterparty criteria selection approved in the TMSS is meeting the requirement of the treasury management function.

Credit Default Swap prices

Credit Default Swap (CDS) prices are used as a market indicator of credit risk and although the CDS prices for UK banks spiked upwards at the end of March / early April, due to the liquidity crisis throughout financial markets, CDS prices have returned to more average levels since then. They are still elevated compared to end-February and pricing is likely to remain volatile as uncertainty continues. However, sentiment can easily shift, so it remains important to undertake continual monitoring of all aspects of risk and return in the current circumstances.

Investment balances

The average level of funds available for investment purposes during the half of the year was £22.3m. These funds were available on a temporary basis, and the level of funds available was mainly dependent on the timing of precept payments, receipt of grants and progress on the capital programme.

TREASURY PORTFOLIO				
	31 March 2020		30 September 2020	
Treasury Investments	**£000**	**%**	**£000**	**%**
Banks (UK)	10,930	100%	9,450	40%
Banks (Rest of World)	0	0%	6,000	25%
Local Authorities	0	0%	0	0%
DMADF (H.M.Treasury)	0	0%	0	0%
Money Market Funds	0	0%	8,240	35%
Certificates of Deposit	0	0%	0	0%
Total Managed In-house	**10,930**	**100%**	**23,690**	**100%**
Bond Funds	0	0%	0	0%
Property Funds	0	0%	0	0%
Total Managed Externally	**0**	**0%**	**0**	**0%**
Total Treasury Investments	**10,930**	**100%**	**23,690**	**100%**
Treasury External Borrowing				
Local Authorities	0	0%	0	0%
PWLB	17,839	100%	17,573	100%
Total External Borrowing	**17,839**	**100%**	**17,573**	**100%**
Net Treasury Investments / (Borrowing)	**(6,909)**		**6,117**	

The Commissioner held £23.7m of investments as at 30^{th} September 2020 (£10.9m at 31^{st} March 2020) and the investment portfolio yield for the year to date is 0.14% against a benchmark (overnight LIBOR - .25%) of 0.0% (the benchmark now lies in negative whilst the overnight LIBOR rate for this year averages just 0.05%).

The Commissioner's budgeted investment return for 2020/21 is £114,000, and performance for the year to date is £25,000 below budget. The projection for the full year, which will account for a number of fixed term deposits maturing in the latter part of year, is showing an expected outturn of £50,000; a shortfall against budget of £64,000.

Approved limits

Officers can confirm that the approved limits within the Annual Investment Strategy were not breached during the half year ended 30th September 2020.

10 Conclusion

Performance of investments for the first half of the year has seen a reasonable rate of return, however, with declining returns offered by the Money Market Funds and little scope to tie money up at an attractive rate, little can be done to improve the outlook for receivable interest. Holding off on any borrowing for the capital projects has served well and, whilst we don't anticipate any borrowing in the remainder of this year, we should keep sight of the trends on gilts (on which PWLB loans are based upon); borrowing currently offering better rates at the short end, with longer term debt costing more. Striking a balance between a shorter-term debt and the prevailing maturity profile would work well. Of course, we should bear in mind, with the PWLB consultation now over, we are likely to better understand the PWLB's position on whether we could obtain cheaper borrowing with changes to their margin.

Appendix 1 – Global Economics and Interest Rates

USA

The incoming sets of data during the first week of August were almost universally stronger than expected. With the number of new daily coronavirus infections beginning to abate, recovery from its contraction this year of 10.2% should continue over the coming months and employment growth should also pick up again. However, growth will be dampened by continuing outbreaks of the virus in some states leading to fresh localised restrictions. At its end of August meeting, the Fed tweaked its **inflation target** from 2% to maintaining an average of 2% over an unspecified time period i.e. following periods when inflation has been running persistently below 2%, appropriate monetary policy will likely aim to achieve inflation moderately above 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 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.

EUROZONE

The economy was recovering well towards the end of Q2 after a sharp drop in GDP, (e.g. France 18.9%, Italy 17.6%). However, the second wave of the virus affecting some countries could cause a significant slowdown in the pace of recovery, especially in countries more dependent on tourism. The 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 weaker countries. The ECB has been struggling to get inflation up to its 2% target and 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.

CHINA

After a concerted effort to get on top of the virus outbreak in Q1, economic recovery was strong in Q2 and has enabled it to recover all of the contraction in Q1. 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. This could, therefore, lead to a further misallocation of resources which will weigh on growth in future years.

JAPAN

There are some concerns that a second wave of the virus is gaining momentum and could dampen economic recovery from its contraction of 8.5% in GDP. It has 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. It is also making little progress on fundamental reform of the economy. The resignation of Prime Minister Abe is not expected to result in any significant change in economic policy.

WORLD GROWTH

Latin America and India are currently hotspots for virus infections. 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.

GILT YIELDS / PWLB RATES

There was much speculation during the second half of 2019 that bond markets were in a bubble which was driving bond prices up and yields down to historically very low levels. The context for that was heightened expectations that the US could have been heading for a recession in 2020. In addition, there were growing expectations of a downturn in world economic growth, especially due to fears around the impact of the trade war between the US and China, together with inflation generally at low levels in most countries and expected to remain subdued. Combined, these conditions were conducive to very low bond yields. While inflation targeting by the major central banks has been successful over the last 30 years in lowering inflation expectations, the real equilibrium rate for central rates has fallen considerably due to the high level of borrowing by consumers. This means that central banks do not need to raise rates as much now to have a major impact on consumer spending, inflation, etc. The consequence of this has been the gradual lowering of the overall level of interest rates and bond yields in financial markets over the last 30 years. Over the year prior to the coronavirus crisis, this has seen many bond yields up to 10 years turn negative in the Eurozone. In addition, there has, at times, been an inversion of bond yields in the US whereby 10-year yields have fallen below shorter-term yields. In the past, this has been a precursor of a recession. The other side of this coin is that bond prices are elevated as investors would be expected to be moving out of riskier assets i.e. shares, in anticipation of a downturn in corporate earnings and so selling out of equities.

Gilt yields had therefore already been on a generally falling trend up until the coronavirus crisis hit western economies during March. After gilt yields spiked up during the initial phases of the health crisis in March, we have seen these yields fall sharply to unprecedented lows as major western central banks took rapid action to deal with excessive stress in financial markets, and started massive quantitative easing purchases of government bonds: this also acted to put downward pressure on government bond yields at a time when there has been a huge and quick expansion of government expenditure financed by issuing government bonds. Such unprecedented levels of issuance in "normal" times would have caused bond yields to rise sharply. At the close of the day on 30th September, all gilt yields from 1 to 6 years were in negative territory, while even 25-year yields were at only 0.76% and 50 year at 0.60%.

From the local authority borrowing perspective, HM Treasury imposed **two changes of margins over gilt yields for PWLB rates** in 2019-20 without any prior warning. The first took place on 9th October 2019, adding an additional 1% margin over gilts to all PWLB period rates. That increase was then at least partially reversed for some forms of borrowing on 11th March 2020, but not for mainstream General Fund capital schemes, at the same time as the Government announced in the Budget a programme of increased infrastructure expenditure. It also announced that there would be a consultation with local authorities on possibly further amending these margins; this was to end on 4th June, but that date was subsequently put back to 31st July. It is clear HM Treasury will no longer allow local authorities to borrow money from the PWLB to purchase commercial property if the aim is solely to generate an income stream (assets for yield).

Following the changes on 11th March 2020 in margins over gilt yields, the current situation is as follows:

- **PWLB Standard Rate** is gilt plus 200 basis points (G+200bps)
- **PWLB Certainty Rate** is gilt plus 180 basis points (G+180bps)
- **PWLB HRA Standard Rate** is gilt plus 100 basis points (G+100bps)
- **PWLB HRA Certainty Rate** is gilt plus 80bps (G+80bps)
- **Local Infrastructure Rate** is gilt plus 60bps (G+60bps)

It is possible that the non-HRA Certainty Rate will be subject to revision downwards after the conclusion of the PWLB consultation; however, the timing of such a change is currently an unknown, although it would be likely to be within the current financial year.

As the interest forecast table for PWLB certainty rates, (gilts plus 180bps), above shows, there is likely to be little upward movement in PWLB rates over the next two years as it will take economies, including the UK, a prolonged period to recover all the momentum they have lost in the sharp recession caused during the coronavirus shut down period. Inflation is also likely to be very low during this period and could even turn negative in some major western economies during 2020/21.

The balance of risks to the UK

- The overall balance of risks to economic growth in the UK is probably relatively even, but is subject to major uncertainty due to the virus.
- 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** - second nationwide wave of virus infections requiring a national lockdown
- **UK / EU trade negotiations** - if it were to cause significant economic disruption and a fresh major 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 recently 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.

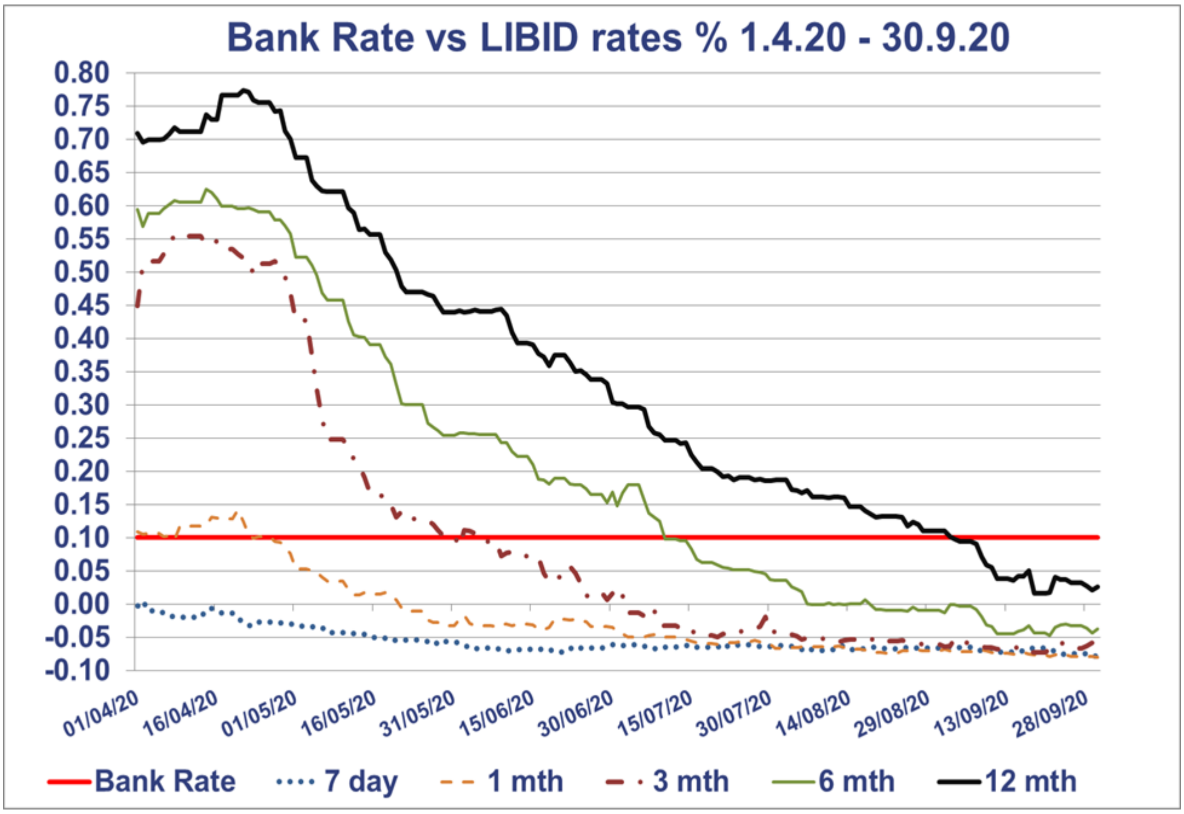
- **Other minority EU governments**. Austria, Sweden, Spain, Portugal, Netherlands, Ireland and Belgium also have vulnerable minority governments dependent on coalitions which could prove fragile.
- **Austria, the Czech Republic, Poland and Hungary** now form a strongly anti-immigration bloc within the EU. There has also been rising 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.
- **US - the Presidential election in 2020**: this could have repercussions for the US economy and SINO-US trade relations.

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

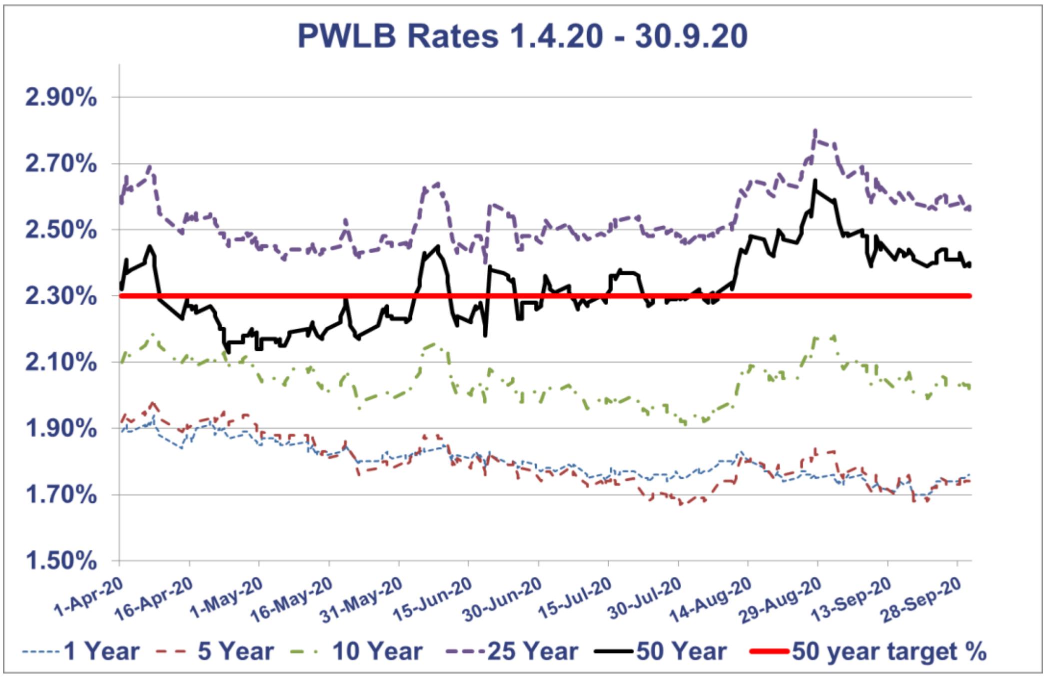
- **UK** - stronger than currently expected recovery in UK economy.
- **Post-Brexit** - if an agreement was reached that removed the majority of threats of economic disruption between the EU and the UK.
- **The Bank of England is too slow** in its pace and strength of increases in Bank Rate and, therefore, 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 2 – Investment and Borrowing Rates

Investment:



Borrowing:



Appendix 3 – Approved countries for investments as at 30th September 2020

The approved Investment Strategy requires a minimum sovereign rating of AA-

AAA

- Australia
- Denmark
- Germany
- Luxembourg
- Netherlands
- Norway
- Singapore
- Sweden
- Switzerland

AA+

- Canada
- Finland
- U.S.A.

AA

- Abu Dhabi (UAE)
- France

AA-

- Belgium
- Hong Kong
- Qatar
- U.K.