Report to:	**Audit and Governance Committee**
Date:	**29 September 2021**
Title:	**Treasury management – Q1 2021/22**
Report of:	**Homira Javadi, Chief Finance Officer**
Cabinet member:	**Councillor Stephen Holt, Cabinet Member for Finance**
Ward(s):	**All**
Purpose of report:	**To report on the activities and performance of the Treasury Management service during April to July 2021/22**
Decision type:	**Budget and Policy Framework**
Officer recommendation(s):	**The Committee is recommended to note and recommend that Council accepts that Treasury Management Activity for the period 1 April to 31 July 2021 has been in accordance with the approved Treasury Strategies.**
Reasons for recommendations:	**Requirement of CIPFA Treasury Management in the Public Sector Code of Practice (the Code) and this has to be reported to Full Council.**
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1. Introduction

1.1 This Council's approved Treasury Strategy Statement requires the Audit and Governance Committee to review details of Treasury Strategy transactions against the criteria set out in the Strategy and make observations to Cabinet as appropriate.

1.2 The Treasury Strategy Statement also requires the Audit and Governance Committee to review a formal summary report detailing the recent Treasury Management activity before it is considered by Council, in accordance with best practice and guidance issued by the Chartered Institute of Public Finance and Accountancy.

1.3 In addition, Treasury Management updates are included in the quarterly performance management reports, considered by both the Cabinet and Scrutiny Committee. The regulatory environment places a much greater responsibility on Members for the review and scrutiny of treasury management policy and activities.

1.4 This Council also confirms that it has complied with the requirement under the Code to give prior scrutiny to all of the above treasury management reports by the Audit & Governance Committee before they were reported to the full Council. Member training on treasury management issues has been scheduled for 20th October 2021, to support Members' scrutiny role.

1.6 Treasury Management is an integral part of the Council's overall finances and the performance of this area is very important. Whilst individual years obviously matter, performance is best viewed on a medium / long term basis. The action taken in respect of the debt portfolio in recent years has been extremely beneficial and has resulted in savings. Short term gains might, on occasions, be sacrificed for longer term certainty and stability.

1.7 The criteria for lending to Banks are derived from the list of approved counter parties provided by the Council's Treasury Management advisors, Link Asset Services. The list is amended to reduce the risk to the Council by removing the lowest rated counterparties and reducing the maximum loan duration.

2. Annual Investment Strategy

2.1 The Treasury Management Strategy Statement (TMSS) for 2021/22 which includes the Annual Investment strategy, was approved by the Full Council on Monday, 22 February 2021. It sets out the Council's investment priorities as being:

- Security of Capital;
- Liquidity;
- Yield.

Approved limits within the Annual Investment Strategy were not breached during the period ending 31 July 2021, except for the balance held with Lloyds Bank, which exceeded the £5m limit for 13 days during the period.

2.2 Investment rates available in the market have continued at historically low levels. Investment funds are available on a temporary basis and arise mainly from the timing of the precept payments, receipts of grants and the progress of the capital programme.

2.3 As shown by the interest rate forecasts, 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 risky 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

2.4 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.

2.5 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.

2.6 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.

3 Treasury Position as at 31 July 2021

3.1 The Council's debt and investment position is organised by staff within Financial Services in order to ensure adequate liquidity for revenue and capital activities, security for investments and to manage risks within all treasury management activities.

3.2 In a relatively short period since the onset of the COVID-19 pandemic, the global economic fallout was sharp and large. Market reaction was extreme with large falls in equities, corporate bond markets and, to some extent, real estate echoing lockdown-induced paralysis and the uncharted challenges for governments, businesses, and individuals.

3.3 **Fixed Term Deposits pending maturity –**

The following table shows the fixed term deposits held between 1 April to 31 July 2021 and identifies the long-term credit rating of counterparties at the date of investment. It is important to note that credit ratings are only one of the criteria that are taken into account when determining whether a potential counterparty is suitable. All the deposits met the necessary criteria the minimum rating required for deposits made in terms of long-term A- (Fitch).

Counterparty	Date From	Date To	Days	Principal £'000	Int Rate %	Long-term Rating
Debt Management Office	19 Jul 21	03 Aug 21	15	2,700,	0.01	*

3.4 **Fixed Term Deposits which have matured in the reporting period**

The table below shows the fixed term deposits which have matured between 1 April to 31 July 2021, in maturity date order. It is important to note that the table includes sums reinvested and that in total the Council's investments have not increased by £21.5m over this period.

Counterparty	Date From	Date To	Days	Principal £'000	Int. Rate	Long-term
					%	
Debt Management Office	07 Apr 2021	13 Apr 2021	6	8,000	0.01	*
Debt Management Office	15 Jun 2021	25 Jun 2021	10	5,000	0.01	*
Debt Management Office	07 Jul 2021	29 Jul 2021	22	2,000	0.01	*
Debt Management Office	15 Jul 2021	19 Jul 2021	4	6,500	0.01	*
Total				**21,500**		

UK Government body and therefore not subject to credit rating

3.5 **Use of Deposit accounts**

In addition to the fixed term deposits, the Council has made use of the following interest-bearing accounts in the period covered by this report, with the average amount held being £2.739m generating interest of approximately £2.5k.

	Balance at 31 July 2021 £'000	**Average balance £'000**	**Current interest rate %**
Santander Business Reserve Account	5,000	4,505	0.17
Lloyds Bank Corporate Account	565	1,590	0.00
Lloyds Bank Call Account	3,310	2,191	0.01

4 TM Borrowing – Q1 2021/22

4.1 In taking borrowing decision, the Council carefully considered achieving best value, the risk of having to borrow at higher rates at a later date, the carrying cost of the difference between interest paid on such debt and interest received from investing funds which would be surplus until used, and that the Council could ensure the security of such funds placed on temporary investment.

- **Rescheduling** – no debt rescheduling was carried out during the quarter as there was no financial benefit to the Council.
- **Repayment** – £2m of long-term money market loans was repaid at maturity on 28 May 2021

4.2 **Borrowing** – The Council has not borrowed more than, or in advance of its needs, purely in order to profit from the investment of the extra sums borrowed. No new loans were drawn down from PWLB (Public Works Loan Board) during the quarter to fund the net unfinanced capital expenditure and/or to replace maturing loans. Various temporary loans were taken to cover cash flow requirements. All loans drawn were for fixed rate as detailed within the table below.

Lender - Temp Debt	£m	Start Date	End Date	Rate
Loans held:				%
North Yorkshire County Council	5.0	23-Nov-20	22-Nov-21	0.25
North Yorkshire County Council	5.0	24-Nov-20	23-Nov-21	0.25
Wokingham Borough Council	10.0	15-Mar-21	15-Sep-21	0.12
West Midlands Combined Authority	10.0	21-May-21	21-Jan-21	0.07
Loans repaid:				
Tendring District Council	3.0	30-Oct-20	30-Jul-21	0.20
Hertfordshire County Council	7.0	23-Nov-20	24-May-21	0.10
Gwynedd Council	5.0	10-Feb-21	10-May-21	0.03

5 <u>Interest Rate Forecast</u>

5.1 The Council appointed Link Group as its treasury advisor and part of their service is to assist the Council to formulate a view on interest rates. The 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.

The latest forecasts on 10th May is shown below. A comparison of forecasts shows that PWLB rates have increased marginally and there is also now a first increase in Bank Rate from 0.10% to 0.25% in quarter 2 of 2023/24.

Link Group Interest Rate View 10.5.21	Jun-21	Sep-21	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24
BANK RATE	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.25	0.25	0.25
3 month ave earnings	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.30	0.30	0.30
6 month ave earnings	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.20	0.30	0.40	0.40	0.40
12 month ave earnings	0.20	0.20	0.20	0.20	0.20	0.20	0.30	0.30	0.40	0.50	0.50	0.50
5 yr PWLB	1.20	1.20	1.30	1.30	1.30	1.40	1.40	1.40	1.40	1.50	1.50	1.50
10 yr PWLB	1.70	1.70	1.70	1.80	1.80	1.90	1.90	1.90	2.00	2.00	2.00	2.00
25 yr PWLB	2.20	2.20	2.30	2.40	2.40	2.40	2.50	2.50	2.50	2.50	2.50	2.60
50 yr PWLB	2.00	2.00	2.10	2.20	2.20	2.20	2.30	2.30	2.30	2.30	2.30	2.40

5.2 The coronavirus outbreak has done huge economic damage to the UK and to economies around the world. After the Bank of England took emergency action in March 2020 to cut Bank Rate to 0.10%, it left Bank Rate unchanged at its subsequent meetings, although some forecasters had suggested that a cut into negative territory could have happened prior to more recent months when strong recovery started kicking in. However, the minutes of the Monetary Policy Committee in February 2021 made it clear that commercial banks could not implement negative rates within six months; by that time the economy would be expected to be recovering strongly and so there would be no requirement for negative rates.

5.3 As shown in the forecast table above, one tentative increase in Bank Rate from 0.10% to 0.25% has now been pencilled in for quarter 2 of 2023/24 as an indication that the Bank of England will be moving towards some form of monetary tightening around this time. However, it could well opt for reducing its stock of quantitative easing purchases of gilts as a first measure to use before increasing Bank Rate so it is quite possible that we will not see any increase in Bank Rate in the three-year forecast period shown.

5.4 **Significant risks to the forecasts**

- COVID vaccines do not work to combat new mutations and/or new vaccines take longer than anticipated to be developed for successful implementation.
- The lockdowns cause major long-term scarring of the economy.
- The Government implements an austerity programme that supresses GDP growth.
- The MPC (Monetary Policy Committee of the Bank of England) raises tightens monetary policy too early – by raising Bank Rate or unwinding QE.
- The MPC tightens monetary policy too late to ward off building inflationary pressures.
- Major stock markets e.g. in the US, become increasingly judged as being over-valued and susceptible to major price corrections.

5.5 **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.

5.6 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 year prior to the coronavirus crisis, this resulted in many bonds yields up to 10 years turning negative in the Eurozone. In addition, there was, at times, an inversion of bond yields in the US whereby 10-year yields fell below shorter-term yields. In the past, this has been a precursor of a recession.

5.7 Gilt yields had, therefore, already been on a generally falling trend up until the coronavirus crisis hit western economies during March 2020. After gilt yields initially spiked upwards in March, yields fell sharply in response to major western central banks taking rapid policy action to deal with excessive stress in financial markets during March and starting massive quantitative easing driven purchases of government bonds: these actions also acted to put downward pressure on government bond yields at a time when there was 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.

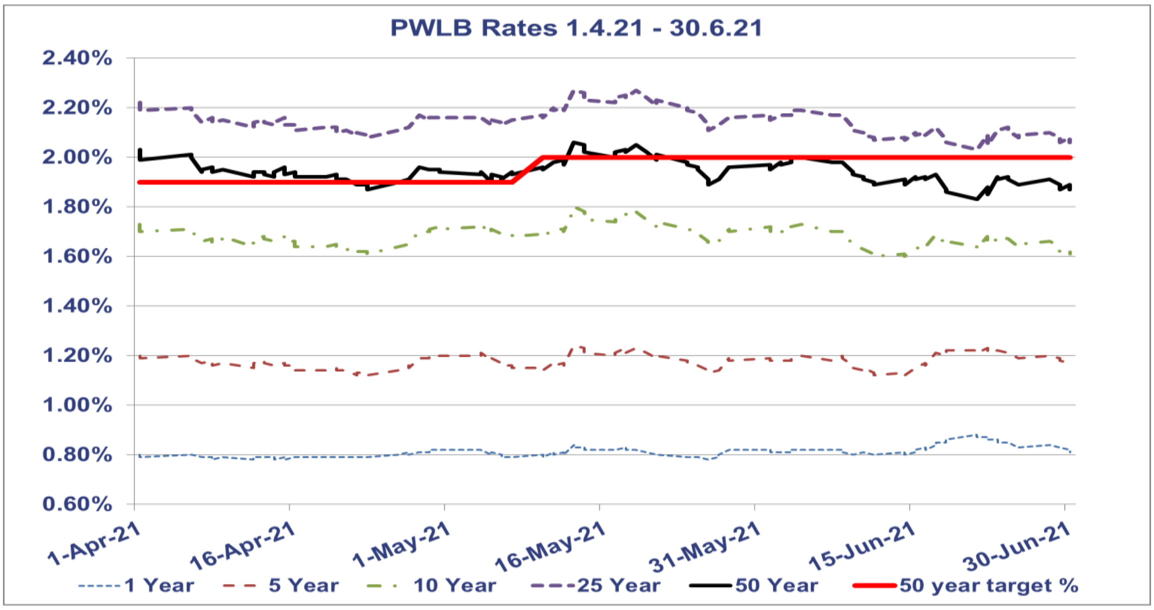
5.8 The current PWLB rates are set as margins over gilt yields as follows: -.

- **PWLB Standard Rate** is gilt plus 100 basis points (G+100bps)
- **PWLB Certainty Rate** is gilt plus 80 basis points (G+80bps)
- **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)

As the interest forecast table for PWLB certainty rates, (gilts plus 80bps), above shows, there is likely to be little upward movement in PWLB rates over the next three years as the Bank of England is not expected to raise Bank Rate above 0.25% during that period as inflation is not expected to be sustainably over 2%.

PWLB maturity certainty rates year to date to 30th June 2021

5.9 Gilt yields and PWLB rates rose sharply during the first three months of 2021 but have lacked any consistent direction since then over the last three months to 30th June. The 50-year PWLB target certainty rate for new long-term borrowing started at 1.90% in this quarter but then rose to 2.00% in May.



	1 Year	5 Year	10 Year	25 Year	50 Year
Low	0.78%	1.12%	1.60%	2.03%	1.83%
Date	08/04/2021	22/04/2021	11/06/2021	21/06/2021	21/06/2021
High	0.88%	1.24%	1.80%	2.27%	2.06%
Date	21/06/2021	13/05/2021	13/05/2021	13/05/2021	13/05/2021
Average	0.81%	1.18%	1.68%	2.14%	1.94%
Spread	0.10%	0.12%	0.20%	0.24%	0.23%

Outlook for the remainder of 2021/22

5.10 The medium-term global economic outlook has continued to improve with the rollout of vaccination programmes. The UK has continued to benefit from its initial rapid vaccine rollout and has shifted focus onto second vaccinations to increase protection to counter a third wave of COVID-19 variant.

5.11 The opening up of the UK economy in Q2/Q3 will continue to prompt a sharp increase in GDP. While downside risks seem to have fallen somewhat after recent trends in GDP and labour, the upside risks remain relatively balanced with the MPC reiterating its commitment not to tighten policy until there is clear evidence that the recovery is eliminating spare capacity in the economy.

5.12 Inflation has moved above the Bank of England's 2% target. Alongside the increase in commodity prices, the MPC has acknowledged the prospect of a sharper upturn in inflation, with the potential CPI (Consumer Price Inflation) could rise above 3% in the coming months. However, the nature of the commodity price rise and the base effect easing, this is likely a more transitory effect. Upward pressure on gilt yields could continue in the short term due to the preponderance of strong data, but this is likely to ease once inflation fears recede as the effect of weak base effects subsides and growth figures return to more normal levels. Bank Rate is expected to remain at the current 0.10% level. The risk of movement in Bank Rate in the short term is low.

5.13 Gilt yields could continue to increase in the short term but will begin to plateau and reduce once the market's expectation of rises in Bank Rate and inflation fears subside. Longer term yields may face upward pressure towards the end of the forecast period as the economy moves back to a sustained footing and policy expectations start to strengthen.

5.14 Downside risks remain – the damage from the pandemic will have lasting effects and there is the risk of further virus mutations due to the uneven global rollout of vaccines. Downside risks also arise from potential future vaccine shortages as the global demand for vaccines increases.

6. Compliance with Treasury and Prudential Limits

6.1 It is a statutory duty for the Council to determine and keep under review the affordable borrowing limits. The Council's approved Treasury and Prudential Indicators (affordability limits) are included in the approved TMSS. As at 31 July 2021, the Council has operated within the treasury limits and Prudential Indicators set out in the Council's Treasury Management Strategy Statement and in compliance with the Council's Treasury Management Practices.

Treasury Prudential Indicators	**2021/22 Estimate Indicator**	**31 July Actual Indicator**	**RAG Status/Reason**
Authorised limit for external debt (Capital Strategy 4.2.4)	£219m	£219m	GREEN
Operational boundary for external debt (CS 4.2.4)	£199m	£199m	GREEN
Gross external debt (CS 4.2.2)	£179m	£179m	GREEN
Capital Financing Requirement (CS 2.3.4)	£199m	£199m	GREEN
Debt vs CFR (Capital Financing Requirement) under/(over) borrowing	£20m	£20m	GREEN
Investments (Average)	£6.6k	£1.6k	AMBER
Investment returns expectations	0.10%	0.04%	AMBER
Upper limit for principal sums invested for longer than 365 days			
Maturity structure of fixed rate borrowing - upper limits:			
Under 12 months	25%	25%	GREEN
12 months to 2 years	40%	40%	GREEN
2 years to 5 years	50%	50%	GREEN
5 years to 10 years	75%	75%	GREEN
10 years and above	100%	100%	GREEN
Revised Capital expenditure (CS 2.1.3)			
General Fund	£14.3m	£0.7m	GREEN
HRA (Housing Revenue Accounts)	£21.8m	£1.7m	GREEN

Commercial Activities/ non-financial investments	£18.8m	£11m	GREEN
Ratio of financing costs to net revenue stream (CS 8.1.1):			GREEN
Proportion of Financing Costs to Net Revenue Stream (General Fund)	17.4%	17.4%	GREEN
Proportion of Financing Costs to Net Revenue Stream (HRA)	13.1%	13.1%	GREEN

7 Economic Background

7.1 As expected, the Bank of England's Monetary Policy Committee kept Bank Rate unchanged and a detailed economic commentary on developments during period ended 31 June 2021 is attached as **Appendix A**.

8 Financial appraisal

8.1 Financial appraisals were considered as part of the overall Capital Programme which forms part of the Treasury Management Strategy.

9 Legal implications

9.1 Comment from the Legal Services Team is not necessary for this routine monitoring report.

10 Risk management implications

10.1 Risks relating to the timing of borrowing and terms of borrowing are considered and advice is provided by Link. Risk management is considered for each of the schemes within the Capital Programme.

11 Equality analysis

11.1 Equality issues are considered

12 Appendices

12.1 Appendix A - Detailed economic commentary

13 Background papers

13.1 Treasury Management Strategy Statements 2021/22.

Appendix A

Link Treasury Services Limited - Detailed economic commentary on developments during quarter ended 30th June 2021

During the quarter ended 30th June 2021 *(quarter 1 of financial year 2021/22):*

- GDP rose by 2.3% m/m in April as restrictions were lifted on non-essential retailers;
- There were signs that activity was given another boost in May as indoor hospitality resumed;
- Sharply increasing virus cases in June delayed the final easing of lockdown restrictions by four weeks;
- Inflation accelerated to 2.1% in May due to energy effects and a surge in reopening inflation;
- Gilt yields and sterling made little headway, while the FTSE 100 failed to catch up on the S&P 500.

The economic recovery stepped up a gear as non-essential retailers and outdoor hospitality reopened on 12th April. The 2.3% m/m gain in GDP in April was the fastest pace of growth since July 2020 and left the economy just 3.8% below its February 2020 level. It was the accommodation and food sector and the retail sector that led the charge with monthly gains of 44.1% and 8.9% respectively.

Activity was given another boost in May as indoor hospitality reopened on 17th May. Households were keen to return to restaurants. The seven-day average of restaurant diners shot up from around 35% below the same period in 2019 to around 30% above it after 17th May. And there were further signs that the recovery shifted up a gear as the IHS Markit/CIPS composite PMI surged to an all-time high of 62.9 in May. Admittedly, there has since been a recent softening in some activity indicators. Retail sales volumes fell by 1.4% m/m in May and the Bank of England CHAPS data showed a dip in the value of consumer spending on electronic cards from 1.3% below the February 2020 value in May to 5.2% below it in the first two weeks of June. What is more, the composite PMI also declined from 62.9 in May to 61.7 in June. But we think that this is a sign that the economic recovery is evolving as consumers substitute spending on goods towards services, rather than a sign that the recovery is spluttering. Indeed, our CE BICS indicator, which has been a reliable barometer since the onset of the pandemic, suggests that growth has been strong in May and June. As a result, we think that GDP rose by around 1.5-2.0% m/m in both May and June.

The final stage of lifting lockdown restrictions on social distancing and large events was delayed in June. This was triggered by a sharp rise in new virus infections. These have increased from a low of around 1,600 per day in early May to over 20,000 by the end of June. Fortunately, this rise has not translated into a sharp increase in hospitalisations. Another reason for the delay was to buy some time to further the vaccine rollout. Currently, nearly half of the total population has received a second vaccine dose and over two thirds have received their first dose. At its current pace, the government is more or less on track to hit its target of vaccinating all adults with a first dose (roughly 53 million) by the end of July.

While Prime Minister Boris Johnson has said that the final domestic restrictions are likely to end on 19th July, this four-week delay is unlikely to prevent the economy from climbing back to its pre-pandemic size by the autumn. This is because the biggest bump to activity came from reopening hospitality in April and May and a delay of four weeks means that the final boost to activity will come only a month later. So, we think that monthly GDP will rise back to the pre-pandemic peak of February 2020 in August, rather than July as we had previously thought.

Meanwhile, households showed that they are willing and able to drive the recovery. Consumer credit increased in May for the first time since August 2020. And the rise in the amount of cash in households' bank accounts of £7.0bn in May was above the 2019 average rise of £4.7bn, suggesting that households are still amassing excess savings. That means there is the potential for faster rises in GDP further ahead should households choose to spend those excess savings.

Some sectors will take longer to recover than consumer spending. Trade flows are still well below pre-crisis levels and trade with the EU remains especially depressed after Brexit. Exports values to the EU, excluding erratic's, were 5.7% below their December level in April, while imports were a whopping 19.1% below. The slower recovery in the euro-zone and lingering Brexit effects are still hampering the recovery in trade with the EU, which will probably continue to lag behind the broader recovery.

After being subdued over much of the pandemic, inflation picked up sharply in this quarter. A large portion of the rise in CPI inflation from 0.7% in March to 1.5% in April was due to temporary energy price effects. Fuel price inflation added 0.3 percentage points (ppts). And the 9.2% increase in Ofgem's gas and electricity price cap from 1st April added 0.3ppts too. Inflation climbed further in May to 2.1% and core CPI inflation rose from 1.3% to 2.0%. Some of this was driven by reopening inflation, with clothing inflation, restaurants/hotels inflation and package holidays inflation all rising and likely rise further. Meanwhile, cost pressures are building earlier in the price pipeline. The input prices and output prices balances of the IHS Markit/CIPS manufacturing PMI both reached record highs in June. Core input producer price inflation picked up from 7.4% in April to 7.8% in May and core output producer price inflation rose from 2.5% to 2.7%.

A strong recovery is underway in the labour market. The 113,000 rise in LFS employment in the three months to April was the largest rise since February 2020 and the ILO unemployment rate edged down to 4.7% from 4.8%. The strong set of labour market figures for April fed concerns over the anecdotal reports of labour shortages and its possible impact on inflation from higher wage growth. Vacancies rose to just 3.4% below their pre-virus level in May and online Adzuna vacancies suggest that the official measure of vacancies rose to 20% above pre-pandemic levels in June.

The myriad of factors boosting inflation (energy price effects, utility price effects, supply/shipping constraints, commodity prices and reopening), are likely to prove temporary. As such, the Bank of England will probably look through increases in inflation above the 2.0% target due to these factors. Indeed, the minutes of the June meeting emphasised "the medium-term prospects for inflation" and left intact the forward guidance designed to stress the MPC's patience.

So, we still think financial markets are wrong to price in an interest rate rise from next year. **Instead, we think it will not be until late 2023 that inflation breaches 2.0% sustainably, with the Bank tightening policy from 2024. And when the Bank does tighten policy, we think it will unwind QE, (shrink its holdings of gilts), first rather than raise interest rates.** The Bank is likely to proceed very cautiously by simply not reinvesting the proceeds from maturing gilts. The maturity profile of the Bank's assets points to around £45bn of QE being unwound per year. And we suspect the MPC would want to wait to see how unwinding

QE is influencing the economy and financial markets before raising Bank Rate. So, the first rate hike may not come until a year later, perhaps in 2025.

In the wake of the hawkish surprise at the Fed's May meeting, the gilt yield curve flattened in the UK, but not to the same extent as in the US treasury market. That said, most of these moves have since unwound. **Our forecasts that the Bank will tighten policy later than the markets expect, and unwind QE before raising interest rates, will probably lead to a steeper gilt yield curve, driven by rising long yields.**

The FTSE 100 rose by 5% over Q2 but failed to make up any lost ground on the S&P 500 or Dax 30. However, the easing in COVID-19 restrictions in the UK helped the more domestically orientated FTSE 250 to outperform the FTSE 100. And we think that the favourable valuation and composition of UK equities should help them outperform their global peers over the rest of 2021. We expect the FTSE 100 to rise from 7,100 now to 7,500 by the end of 2021 and to 8,250 by the end of 2022.

In the US, CPI inflation accelerated from 4.2% in April to 5.0% in May, including a jump in core CPI inflation from 3.0% to 3.8%. That was mostly driven by categories directly affected by loosening virus restrictions. But there are also signs of pressures in other sectors too. <u>That means not all the upward pressure may prove transitory as the Fed expects.</u> The Fed revised up its median projections for interest rates to include two 25bp hikes in 2023. We think the upward pressure on inflation will be greater and longer lasting in the US than in the UK. **That is why we think the Fed will tighten (in 2023) before the BoE (in 2024), so the risks to our forecast for the pound to stay close to $1.40 for the next couple of years are to the downside.**

The more positive economic outlook this year for the UK compared to the **euro-zone** means there is scope for the pound to rise against the euro from €1.16 now, perhaps to €1.22. But as the economic recovery catches up in the euro-zone, sterling might fall back to €1.17 by the end of 2023. In the euro-zone, the vaccine rollout has picked up considerable speed. The euro-zone is now on track to vaccinate 70% of its adult population by July. And economies have gradually reopened as virus cases have fallen significantly. This progress means that we now think GDP increased by 1.0% q/q in Q2. After HICP inflation rose to 2.0% in May, we think that reopening inflation may push headline inflation above 2.5% in the second half of the year. But as inflation will drop back in 2022, the ECB will persist with its ultra-loose monetary policy.