Report to:	**Audit and Governance Committee**
Date:	**24 November 2021**
Title:	**Treasury Management – Q2 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 August to October 2021/22**
Decision type:	**Budget and Policy Framework**
Officer recommendation(s):	**The Committee is recommended to note the report and recommend that Council accepts that Treasury Management Activity for the period 1 August to 31 October 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.**
Contact Officer:	**Name: Ola Owolabi** **Post title: Deputy Chief Finance Officer** **E-mail: ola.owolabi@lewes-eastbourne.gov.uk** **Telephone number: 01323 415083**

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 the Cabinet. 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 took place on 20th October 2021, to support Members' scrutiny role.

1.5 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.

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 October 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. The Council will aim to achieve the optimum return (yield) on its investments commensurate with proper levels of security and liquidity and with the Council'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.

2.3 As shown by the interest rate forecasts in section 5.2, it is now impossible to earn the level of interest rates commonly seen in previous decades as all short-term money market investment rates have only risen weakly since Bank Rate was cut to 0.10% in March 2020. Given this environment and the fact that Bank Rate may only rise marginally, or not at all, before the second half of 2023, investment returns are expected to remain low.

2.4 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.

2.5 Inter-local authority lending and borrowing rates have 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.

3 Treasury Position as at 31 October 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 August to 31 October 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
None held as at 31st October 2021						

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 August to 31 October 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 £13.3m over this period.

Counterparty	Date From	Date To	Days	Principal £'000	Int. Rate %	Long-term
Debt Management Office	19 Jul 2021	03 Aug 21	15	2,700,	0.01	*
Debt Management Office	24 Aug 2021	08 Sep 21	15	4,000	0.01	*
Debt Management Office	01 Sep 2021	13 Sep 21	12	3,000	0.01	*
Debt Management Office	07 Oct 2021	14 Oct 21	7	3,600	0.01	*
Total				**13,300**		

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 £2.877m generating interest of approximately £2.5k.

	Balance at 31 October 2021 £'000	Average balance £'000	Current interest rate %
Santander Business Reserve Account	2,500	4,269	0.17
Lloyds Bank Corporate Account	2,774	2,416	0.00
Lloyds Bank Call Account	900	1,947	0.01

4 TM Borrowing – Q2 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** – None

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
Northern Ireland Housing Executive	7.0	20-Sep-21	20-Jun-22	0.07
West Midlands Combined Authority	10.0	21-May-21	21-Jan-22	0.07
Loans repaid:				
Wokingham Borough Council	10.0	15-Mar-21	15-Sep-21	0.12

5 Interest Rate Forecast

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 forecast on 29th September is compared below to the previous forecast on 10th May. A comparison of these forecasts shows that some PWLB rates have increased marginally and there are now three increases in Bank Rate, to end at 0.75%, instead of one to only 0.25%. However, many PWLB rates were significantly lower than forecast during the earlier part of quarter 2.

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 Additional notes by Link on this forecast table: -

- LIBOR and LIBID rates will cease from the end of 2021. Work is currently progressing to replace LIBOR with a rate based on SONIA (Sterling Overnight Index Average). In the meantime, Link forecasts are based on expected average earnings by local authorities for 3 to 12 months.
- Link forecasts for average earnings are averages i.e., rates offered by individual banks may differ significantly from these averages, reflecting their different needs for borrowing short term cash at any one point in time.

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.

5.3 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.

5.4 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.

5.5 **Forecasts for Bank Rate**

Bank Rate is not expected to go up fast after the initial rate rise as the supply potential of the economy has not generally taken a major hit during the pandemic, so should be able to cope well with meeting demand 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 surge to around 4% towards the end of 2021. Three increases in Bank rate are forecast in the period to March 2024, ending at 0.75%. However, these forecasts may well need changing within a relatively short time frame 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 which way to face.
- Will some current key supply shortages e.g., petrol and diesel, 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 around £200bn of excess savings left over from the pandemic so when will they spend this sum, in part or in total?
- There are 1.6 million people coming off furlough at the end of September; how many of those will not have jobs on 1st October and will, therefore, be available to fill labour shortages 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 the MPC's current concerns.
- There is a risk that there could be further nasty surprises on the COVID-19 front, on top of the flu season this winter, which could depress economic activity.

5.6 In summary, with the high level of uncertainty prevailing on several different fronts, it is likely that these forecasts will need to be revised again soon - in line with what the new news is. It also needs to be borne in mind that Bank Rate being cut to 0.10% was an emergency measure to deal with the COVID-19 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 the grounds of it 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.

5.7 **Forecasts for PWLB rates and gilt and treasury yields**

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).

5.8 **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 have steadily risen and rose further after the hawkish tone of the MPC's minutes last week. Our forecasts show a steady, but slow, rise in both Bank Rate and gilt yields during the forecast period to March 2024. 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 gilt yields.

5.9 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 keep an eye on.

5.10 **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 pandemic causes major long-term scarring of the economy.
- The Government implements an austerity programme that supresses GDP growth.
- The MPC 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. Central banks become increasingly exposed to the "moral hazard" risks of having to buy shares and corporate bonds to reduce the impact of major financial market sell-offs on the general economy.
- Geo-political risks are widespread e.g. German general election produces an unstable minority government and a void in high-profile leadership in the EU when Angela Merkel steps down as Chancellor of Germany; on-going global power influence struggles between Russia/China/US.

5.11 **A new era – a fundamental shift in central bank monetary policy**

One of the key results of the pandemic has been a fundamental rethinking and shift in monetary policy by major central banks like the Fed, the Bank of England and the ECB, to tolerate a higher level of inflation than in the previous two decades when inflation was the prime target to bear down on so as to stop it going above a target rate. There is now also a greater emphasis on other targets for monetary policy than just inflation, especially on 'achieving broad and inclusive "maximum" employment in its entirety' in the US before consideration would be given to increasing rates.

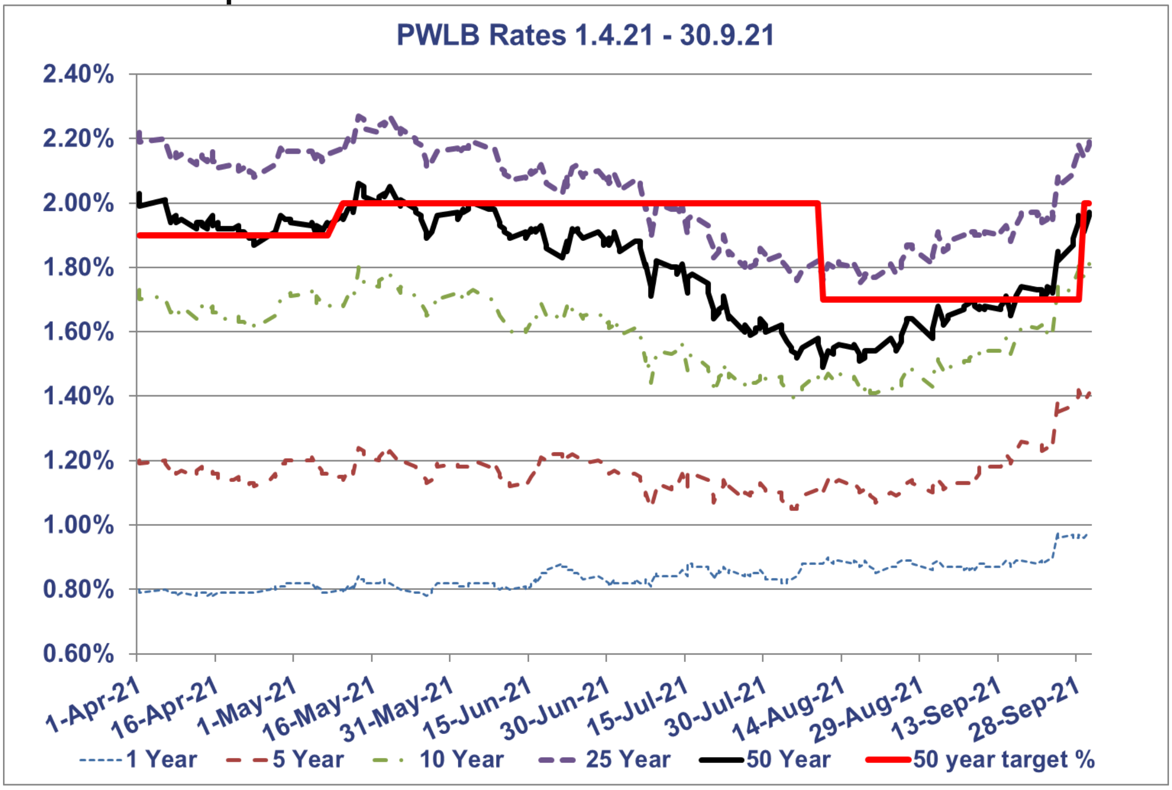
- The Fed in America has gone furthest in adopting a monetary policy based on a clear goal of allowing the inflation target to be symmetrical, (rather than a ceiling to keep under), so that inflation averages out the dips down and surges above the target rate, over an unspecified period of time.

- The Bank of England has also amended its target for monetary policy so that inflation should be 'sustainably over 2%' and the ECB now has a similar policy.
- ***For local authorities, this means that investment interest rates and very short term PWLB rates will not be rising as quickly or as high as in previous decades when the economy recovers from a downturn and the recovery eventually runs out of spare capacity to fuel continuing expansion.***
- Labour market liberalisation since the 1970s has helped to break the wage-price spirals that fuelled high levels of inflation and has now set inflation on a lower path which makes this shift in monetary policy practicable. In addition, recent changes in flexible employment practices, the rise of the gig economy and technological changes, will all help to lower inflationary pressures.
- Governments will also be concerned to see interest rates stay lower as every rise in central rates will add to the cost of vastly expanded levels of national debt; (in the UK this is £21bn for each 1% rise in rates). On the other hand, higher levels of inflation will help to erode the real value of total public debt.

5.12 **PWLB maturity certainty rates year to date to 30th September 2021**

Gilt yields and PWLB rates were on a falling trend between May and August. However, they rose sharply towards the end of September. The 50-year PWLB target certainty rate for new long-term borrowing started 2021/22 at 1.90%, rose to 2.00% in May, fell to 1.70% in August and returned to 2.00% at the end of September after the MPC meeting of 23rd September.

Year to 30th September 2021



	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%

5.13 **Debt Rescheduling**

Debt rescheduling opportunities have been very limited in the current economic climate and following the various increases in the margins added to gilt yields which have impacted PWLB new borrowing rates since October 2010. As short-term borrowing rates will be considerably cheaper than longer term fixed interest rates, there may be potential opportunities to generate savings by switching from long term debt to short term debt.

5.14 However, these savings will need to be considered in the light of the current treasury position and the size of the cost of debt repayment (premiums incurred). The reasons for any rescheduling to take place will include:

- The generation of cash savings and / or discounted cash flow savings;
- Helping to fulfil the treasury strategy;
- Enhance the balance of the portfolio (amend the maturity profile and/or the balance of volatility).

Consideration will also be given to identify if there is any residual potential for making savings by running down investment balances to repay debt prematurely as short term rates on investments are likely to be lower than rates paid on current debt. No debt rescheduling has therefore been undertaken to date in the current financial year.

5.15 **Budget and Outlook for the remainder of 2021/22**

Chancellor Rishi Sunak outlined his budget in October 2021, outlining the government’s tax and spending plans for the year ahead. The Government were trying to push ahead with a post-COVID-19 focus. The Chancellor outlined the current situation in the economy and the state of public finances. It wasn’t as grim listening as some forecasters had expected, however there were some still rather punchy numbers issued by the Office for Budget. The remainder of the budget speech focused on adjustments to universal credit taper rate, a confirmation of business rates and the associated reform, and significantly an increase to the national living wage of 6.6% to £9.50/hour.

5.16 Government spending is set to increase totalling £150 billion over the course of this Parliament. The Levelling Up fund will mean £1.7bn invested in local areas across the UK. Various tax adjustments including tax relief for museums, alcohol duty changes and domestic air travel. In what some will consider a boost for the housing market, £24bn has been earmarked for housing, including £11.5bn for up to 180,000 affordable homes, with brownfield sites targeted for development. Also included was a 4% levy on high rise property developer with profits over £25 million to help fund the removal of unsafe cladding.

5.17 Ahead is a significant engagement for climate action, the COP26 conference in Glasgow will see leaders from around the world agree on climate action. Releases should indicate the direction of motion for agreements to come.

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**	**30 October 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	£2.5k	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	£1.9m	GREEN

HRA (Housing Revenue Accounts)	£21.8m	£3.3m	GREEN
Commercial Activities/ non-financial investments	£18.8m	£12.5m	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 3o September 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.
Appendix B – Glossary - Local Authority Treasury Management Terms.

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 30 September 2021

During the quarter ended 30th September 2021 ***(quarter 2 of financial year 2021/22):***

- *There was only a 0.1% m/m rise in GDP in July as rising virus cases and product/labour shortages stalled the recovery;*
- *There were signs that activity failed to pick up momentum in August and September as shortages worsened;*
- *Virus restrictions were lifted in full and the ending of the furlough scheme;*
- *There was a sharp acceleration in CPI inflation to a nine-year high of 3.2% in August;*
- *Strong gains in gilt yields, while sterling weakened and the FTSE 100 made little headway.*

The economic recovery stalled in Q3, despite the full lifting of COVID-19 restrictions on activity. The 0.1% m/m gain in GDP in July was much weaker than the 1.0% m/m increase in June and left the economy 1.0% below its February 2020 pre-pandemic level. Services output was particularly weak, falling by 0.3% m/m. In part, this was due to a rise in consumer caution prompted by the uptick in COVID-19 cases.

But the bigger drag on output in July came from product and labour shortages. Manufacturing and construction output were held back by shortages of semiconductors and construction materials, respectively. In addition, the acute labour shortages caused by the so-called ‘pingdemic’, which meant that 1.1 million people were asked by the NHS App or Test & Trace system to self-isolate at its peak in mid-July, may have knocked between 0.5%-1.0% off the level of GDP in one month.

Despite the easing of the ‘pingdemic’ since July, recent business surveys have indicated that **product and labour shortages have continued to drag on activity.** For example, the IHS Markit/CIPS composite activity PMI slipped from 59.2 in July to 54.1 in September, with survey respondents highlighting difficulties hiring workers and acquiring materials.

And there are signs that consumer confidence has taken a knock. Retail sales volumes fell by 0.9% m/m in August, which was the fourth consecutive month of declines. There is little sign that this fall in retail spending was offset by rises in spending elsewhere. The Bank of England CHAPS data show the value of consumer spending on electronic cards has stagnated in recent months, while consumer credit rose by a tepid £0.4bn in August, compared to the average monthly increase of £1.2bn in the two years before the pandemic. Meanwhile, households are refraining from dipping into the large stock of savings amassed during the pandemic. Cash in households’ bank accounts picked up by £9.1bn in August, which was well above the average monthly increase of £4.7bn in the year before the pandemic. Given that these data refer to the period before the recent energy crisis and petrol shortages, we would not be surprised if households became even more cautious in September.

Meanwhile, the government seems intent on unwinding fiscal stimulus. Public finances data for August revealed that the government's financial position isn't as bad as the Office for Budget Responsibility predicted back in March. But any windfall looks set to be used to reduce borrowing at a faster pace, rather than provide any extra support to the economy. Indeed, the £12bn rise in annual spending on social care announced in September is set to be fully funded by the new health and social care levy.

Trade flows have picked up following the easing of Brexit trade frictions, but the rebound in imports has outpaced that of exports. In fact, export values *declined* by 0.1% m/m in July – compared to growth of 1.1% in import values, which may at least in part be attributable to the UK's product and labour shortages. Total trade flows remain well below pre-crisis levels, with export values to the EU, excluding erratics, 4.4% below their December level in July, while imports were 16.4% below. Given that Brexit trade frictions will take a while to clear fully, we don't anticipate trade with the EU to recover to pre-virus levels soon.

Putting all this together, **we expect GDP growth petered out in Q3. In levels terms, we have pencilled in the economy hovering around 1.0% below its February 2020 peak for the next few months.** Indeed, our CE BICS indicator supports our view that the economy failed to make much headway over the quarter.

We now expect the economy to return to its pre-virus level by January, which is a few months later than we previously thought. For one thing, the end of summer has brought an uptick in new COVID-19 infections. Although these are yet to translate into more hospitalisations, this could be a headwind for consumer-facing services if households become more cautious. For another, the combined effect of September's petrol shortages, higher household energy bills, and the ending of the furlough scheme threaten to depress (non-fuel) consumption.

Consumer price inflation jumped from 2.0% in July to a nine-year high of 3.2% in August and is on track to reach 4.5% by the end of this year. Base effects linked to the sharp fall in prices in August 2020, mainly driven by the Eat Out to Help Out restaurant discount scheme, accounted for around 0.9 percentage points (ppt) of the 1.2 ppt rise. But there were signs that a pick-up in underlying price pressures accounted for the remaining 0.3 ppt, which was driven by inflation in hotels, new and second-hand cars and food. The jump in inflation in August came alongside further signs that cost pressures are still building earlier in the price pipeline. The prices balances of the IHS Markit/CIPS composite PMI rose sharply, suggesting that shortages are increasingly feeding through to higher prices. Meanwhile, manufacturing input producer price inflation (PPI) picked up from 10.4% in July to 11.0% in August and output PPI rose from 5.2% to 6.0%.

The labour market has continued to tighten. Data for July and August brought signs that labour market slack is declining fast, even as firms began to pay 10% of the wages of furloughed workers. LFS employment rose by 183,000 in the three months to July – the largest rise in employment since January 2020 – and the ILO unemployment rate nudged down from 4.7% in June to 4.6%. Vacancies soared above 1m for the first time on record and were 27.5% above their pre-crisis level in July, suggesting that labour shortages have worsened. Meanwhile, underlying annual pay growth is estimated to have risen from a range of 3.5%-4.9% in June to 3.6%-5.1% in July. **While we expect the expiry of the furlough scheme at the end of September to ease some labour shortages, it may not be enough to plug all the gaps in the labour market.**

The Bank of England shares our view that the near-term surge in inflation is likely to prove temporary, but the minutes of September's Monetary Policy Committee (MPC) meeting indicated that it is becoming increasingly worried about the inflation outlook. What's more, the Bank appears less concerned about the faltering economic recovery than we had thought. Instead, the minutes, together with recent comments from Governor Andrew Bailey, emphasised the large weight that the Bank places on inflation expectations and other 'second-round' effects in determining the appropriate stance of monetary policy. On this count, public and market-based measures of inflation expectations have picked up in recent months, with the latter rising especially sharply. We suspect the rise in inflation expectations was the key factor prompting the hawkish shift by the MPC at its September meeting. This, together with the fact that underlying wage growth has risen faster than we anticipated, has **led us to bring forward our forecast for the first interest rate hike from 2023 to May 2022**. But, given that we still think that the pandemic will reduce the UK's supply potential by less than is widely assumed, we expect the pace of tightening thereafter to be slower than most expect.

Investors have also brought forward their expectations of monetary tightening, which – combined with the rise in inflation expectations – has boosted gilt yields. In fact, the 10-year gilt yield has surged to above 1.00% in recent days, which is its highest level since mid-2019. We expect the 10-year yield to remain more-or-less where it is until the end of this year, and to reach 1.25% and 1.50% by end-2021 and end-2022, respectively.

By contrast, sterling and the FTSE 100 have continued to flounder as investors have increasingly discounted the murkier outlook for GDP growth. After a fairly strong start in July, the FTSE 100 struggled to make much headway over the remainder of Q3. We still expect the favourable valuation and composition of the FTSE 100 should help it to make up some ground on the S&P 500 over the rest of 2021, but the faltering domestic recovery adds to the downside risks to this view.

In the US, inflation fell from 5.4% in July to 5.3% in August amid the fading of reopening inflation and the spread of the Delta COVID-19 variant. The FOMC hinted in its September meeting that it would announce a taper to its quantitative easing programme in November and some Fed officials shifted forward their expectations of the first rate hike. Our view is that inflation in the US will prove more persistent than in the UK, underpinning our forecast for the Fed to undertake a more aggressive tightening cycle than the Bank of England from 2023. **That's why we expect Treasury yields to rise by more than gilt yields** and suggests that the risks to our forecast for sterling to rise to $1.40 by end-2023 are to the downside.

Meanwhile, the UK's slowing recovery suggests **the scope for the pound to rise against the euro is limited**. We have pencilled in sterling remaining broadly where it is currently, at €1.16, until end-2023.

In the euro-zone, the recovery appears to be continuing at pace and there is little sign that the spread of the Delta COVID-19 variant or supply shortages are significantly hampering activity. Meanwhile, flash HICP inflation rose to 3.4% in September, and we suspect that it will pick up to 4.0% later this year. But it should drop back sharply in 2022, which is why we expect the ECB to continue with its ultra-loose monetary policy.

Appendix B

GLOSSARY

Local Authority Treasury Management Terms

Terms	Descriptions
Bond	A certificate of long-term debt issued by a company, government, or other institution, which is tradable on financial markets
Borrowing	Usually refers to the stock of outstanding loans owed, and bonds issued.
CFR	Capital Financing Requirement. A council's underlying need to hold debt for capital purposes, representing the cumulative capital expenditure that has been incurred but not yet financed. The CFR increases with capital expenditure and decreases with capital finance and MRP.
Capital gain or loss	An increase or decrease in the capital value of an investment, for example through movements in its market price.
Collective investment scheme	Scheme in which multiple investors collectively hold units or shares. The investment assets in the fund are not held directly by each investor, but as part of a pool (hence these funds are also referred to as 'pooled funds').
Cost of carry	When a loan is borrowed in advance of need, the difference between the interest payable on the loan and the income earned from investing the cash in the interim.
Counterparty	The other party to a loan, investment or other contract.
Counterparty limit	The maximum amount an investor is willing to lend to a counterparty, in order to manage credit risk.
Covered bond	Bond issued by a financial institution that is secured on that institution's assets, usually residential mortgages, and is therefore lower risk than unsecured bonds.
CPI	Consumer Price Index - the measure of inflation targeted by the Monetary Policy Committee.
Deposit	A regulated placing of cash with a financial institution. Deposits are not tradable on financial markets.

Terms	Descriptions
Diversified income fund	A collective investment scheme that invests in a range of bonds, equity and property in order to minimise price risk, and also focuses on investments that pay income.
Dividend	Income paid to investors in shares and collective investment schemes. Dividends are not contractual, and the amount is therefore not known in advance.
DLUHC	Department for Levelling Up, Housing and Communities (*formerly known as Ministry of Housing, Communities & Local Government - MHCLG*).
DMADF	Debt Management Account Deposit Facility – a facility offered by the DMO enabling councils to deposit cash at very low credit risk. Not available in Northern Ireland.
DMO	Debt Management Office – an executive agency of HM Treasury that deals with central government's debt and investments.
Equity	An investment which usually confers ownership and voting rights
Floating rate note (FRN)	Bond where the interest rate changes at set intervals linked to a market variable, most commonly 3-month LIBOR or SONIA
FTSE	Financial Times stock exchange – a series of indices on the London Stock Exchange. The FTSE 100 is the index of the largest 100 companies on the exchange, the FTSE 250 is the next largest 250 and the FTSE 350 combines the two
GDP	Gross domestic product – the value of the national aggregate production of goods and services in the economy. Increasing GDP is known as economic growth.
Income Return	Return on investment from dividends, interest and rent but excluding capital gains and losses.
GILT	Bond issued by the UK Government, taking its name from the gilt-edged paper they were originally printed on.
LIBID	London interbank bid rate - the benchmark interest rate at which banks bid to borrow cash from other banks, traditionally 0.125% lower than LIBOR.
LIBOR	London interbank offer rate - the benchmark interest rate at which banks offer to lend cash to other banks. Published every London working day at 11am for various currencies and terms. Due to be phased out by 2022.

Terms	Descriptions
LOBO	Lender's Option Borrower's option
MMF	Money Market Funds. A collective investment scheme which invests in a range of short-term assets providing high credit quality and high liquidity. Usually refers to Constant Net Asset Value (CNAV) and Low Volatility Net Asset Value (LVNAV) funds with a Weighted Average Maturity (WAM) under 60 days which offer instant access, but the European Union definition extends to include cash plus funds
Pooled Fund	Scheme in which multiple investors hold units or shares. The investment assets in the fund are not held directly by each investor, but as part of a pool (hence these funds are also referred to as 'pooled funds').
PWLB	Public Works Loan Board – a statutory body operating within the Debt Management Office (DMO) that lends money from the National Loans Fund to councils and other prescribed bodies and collects the repayments. Not available in Northern Ireland.
Quantitative easing (QE)	Process by which central banks directly increase the quantity of money in the economy to promote GDP growth and prevent deflation. Normally achieved by the central bank buying government bonds in exchange for newly created money.
SONIA	Sterling overnight interest average – a benchmark interest rate for overnight deposits.
Short-dated	Usually means less than one year
Total return	The overall return on an investment, including interest, dividends, rent, fees and capital gains and losses.