

MEETING: PENSIONS COMMITTEE

DATE: 17 NOVEMBER 2021

**TITLE: TREASURY MANAGEMENT 2021 –2022
MID YEAR REVIEW**

PURPOSE: CIPFA’s Code of Practice recommends that a report on the Council’s actual Treasury Management during the current financial year is produced.

RECOMMENDATION: RECEIVE THE REPORT FOR INFORMATION

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EXECUTIVE SUMMARY

During the six month period between 1 April and 30 September 2021, the Council’s investments remained well within the limits originally set. There were no new defaults by banks in which the Council deposited money. Furthermore, it is estimated that the Council’s actual investment income will be higher than the expected income in the 2021/22 budget.

1. INTRODUCTION

The Chartered Institute of Public Finance and Accountancy’s Treasury Management Code (CIPFA’s TM Code) requires that Authorities report on the performance of the treasury management function at least twice yearly (mid-year and at year end). This report provides a mid-year update.

The Council’s treasury management strategy for 2021/22 was approved by full Council on 4th March 2021. The Council has invested substantial sums of money and is therefore exposed to financial risks including the loss of invested funds and the revenue effect of changing interest rates. The successful identification, monitoring and control of risk are therefore central to the Council’s treasury management strategy.

It was decided at the Pensions Committee, 25 March 2021 to allow the surplus funds of the Pension Fund to be pooled and co-invested with the Council's overall cash flow for the financial year 2021/22.

2. EXTERNAL CONTEXT

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

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

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

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

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

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

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

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

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

internationally focused FTSE 100 saw more modest gains over the period and remains below its pre-crisis peak.

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

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

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

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

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

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

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

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

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

3. TREASURY INVESTMENT ACTIVITY

The Council holds invested funds, representing income received in advance of expenditure plus balances and reserves held. During the 6 months, the Council's investment balance ranged between £62.9 and £147.9 million due to timing differences between income and expenditure. The investment position during the period is shown in the table below.

Treasury Investment Position

	31.3.21 Balance £m	6 month Movement £m	30.9.21 Balance £m	30.9.21 Income Returns %
Banks & building societies (unsecured)	8.6	15.8	24.4	0.10
Local authorities	20.0	5.0	25.0	0.07
Debt Management Office	0.0	24.0	24.0	0.01
Money Market Funds	26.0	(7.5)	18.5	0.01
Pooled Funds	8.9	0.3	9.2	4.10
Total investments	63.5	37.6	101.1	

Both the CIPFA Code and government guidance require the Council to invest its funds prudently, and to have regard to the security and liquidity of its treasury investments before seeking the optimum rate of return, or yield. The Council's objective when investing money is to strike an appropriate balance between risk and return, minimising the risk of incurring losses from defaults and the risk of receiving unsuitably low investment income.

Ultra-low short-dated cash rates which have been a feature since March 2020 when Bank Rate was cut to 0.1% have resulted in the return on sterling low volatility net asset value money market funds (LVNAV MMFs) being close to zero even after some managers have temporarily waived or lowered their fees. At this stage net negative returns are not the central case of most MMF managers over the short-term, and fee cuts or waivers should result in MMF net yields having a floor of zero, but the possibility cannot be ruled out.

Deposit rates with the Debt Management Account Deposit Facility (DMADF) are also largely around zero.

£10m of the Authority's investments are held in externally managed strategic pooled property and equity funds where short-term security and liquidity are lesser consideration, and the objectives instead are regular revenue income and long-term price stability. Because these funds have no defined maturity date, but are available for withdrawal after a notice period, their performance and continued stability in meeting the Authority's investment objective are regularly reviewed.

The performance of our pooled property and equity funds at 30 September 2021 can be seen below:

STRATEGIC POOLED FUND PORTFOLIO				GWYNEDD				From:	22/02/2019	To:	30/09/2021
FUND NAME	ASSET CLASS	No of Units Held in Period	Current Value £	Capital Growth £	Dividends Earned £	Holding Period (yrs)	Capital Return	Income Return	Total Return	Volatility	
AEGON (KAMES) DIVERSIFIED MONTHLY INCOME FUND	MULTI ASSET	1,158,480	1,254,947	-4,947	157,264	2.6	0.40%	12.58%	12.98%	15.6%	
CCLA - LAMIT PROPERTY FUND	PROPERTY	1,524,344	4,713,881	-286,119	493,097	2.6	-5.72%	9.86%	4.14%	5.7%	
NINETY ONE (INVESTEC) DIVERSIFIED INCOME FUND	MULTI ASSET	1,209,599	1,207,116	-42,884	136,604	2.6	-3.43%	10.93%	7.50%	7.8%	
SCHRODER INCOME MAXIMISER FUND	EQUITY - UK	5,173,994	2,067,528	-447,780	428,897	2.5	-17.80%	17.05%	-0.75%	17.7%	
GRAND TOTAL			9,243,472	-771,837	1,215,861	2.6	-7.71%	12.14%	4.43%	8.0%	
				Unrealised capital loss since purchase:	-756,529	Annualised income return:		4.53%			

It is evident that the combined capital value of £9.243m is less than the initial investment of £10m. Strategic fund investments are made in the knowledge that capital values will move both up and down on months, quarters, and even years; but with the confidence that over a three to five-year period total returns will exceed cash interest rates. Investment in these funds will be maintained in the medium term.

Investment Benchmarking

The progression of risk and return metrics are shown in the extracts from Arlingclose's quarterly investment benchmarking in the table below.

	Credit Score	Credit Rating	Bail-in Exposure	Weighted Average Maturity (days)	Rate of Return %
30.06.2021	4.66	A+	51%	35	1.43
30.09.2021	4.52	A+	41%	34	1.74
Similar LAs	4.73	A+	58%	48	0.48
All LAs	4.69	A+	69%	10	2.35

Treasury Management Performance

The Council measures the financial performance of its treasury management activities both in terms of its impact on the revenue budget and its relationship to benchmark interest rates.

The Council's budgeted investment income for the year is £0.4m, however the actual expected investment income for the year 2021/22 is slightly higher, estimated at £0.44m.

4. COMPLIANCE

I can confirm that the treasury management activities undertaken during the period complied fully with CIPFA Code of Practice and the Council's approved Treasury Management Strategy.

The Council's investments remained well within the limits originally set.

Investment Limits

	Counterparty Maximum during period	Counterparty 30.9.21 Actual	Counterparty 2021/22 Limit	Complied
The UK Government	£50m	£24m	Unlimited	✓
Local authorities & other government entities	£5m	£5m	£10m	✓
Secured investments	£0	£0m	£10m	✓
Banks (unsecured)	£5m	£5m	£5m	✓
Building societies (unsecured)	£0	£0	£5m	✓

Registered providers (unsecured)	£0m	£0m	£5m	✓
Money market funds	£7m	£7m	£10m	✓
Strategic pooled funds	£5m	£5m	£10m	✓
Real Estate Investment Trusts	£0	£0	£10m	✓
Other investments	£0m	£0m	£5m	✓

Treasury Management Indicators

The Council measures and manages its exposures to treasury management risks using the following indicators.

Security: The Council has adopted a voluntary measure of its exposure to credit risk by monitoring the value-weighted average credit rating or credit score of its investment portfolio. This is calculated by applying a score to each investment (AAA=1, AA+=2, etc.) and taking the arithmetic average, weighted by the size of each investment.

	Target	Actual	Complied
Portfolio average credit score	6.0	4.52	✓

Liquidity: The Council has adopted a voluntary measure of its exposure to liquidity risk by monitoring the amount of cash available to meet unexpected payments.

	30.9.21 Actual	2021/22 Target	Complied
Total cash available within 3 months	£76.9m	£10m	✓

Interest Rate Exposures: This indicator is set to control the Council's exposure to interest rate risk. The upper limits on the one-year revenue impact of a 1% rise or fall in interest was:

Interest rate risk indicator	30.9.21 Actual	2021/22 Limit	Complied
Upper limit on one-year revenue impact of a 1% <u>rise</u> in interest rates	£573,968	£635,000	✓
Upper limit on one-year revenue impact of a 1% <u>fall</u> in interest rates	£0	£24,000	✓

Principal Sums Invested for Periods Longer than 364 days: The purpose of this indicator is to control the Council's exposure to the risk of incurring losses by seeking early repayment of its investments. The limits on the total principal sum invested to final maturities beyond the period end will be:

	2021/22	2022/23	2023/24
Actual principal invested beyond year end	£0m	£0m	£0m
Limit on principal invested beyond year end	£20m	£20m	£20m
Complied	✓	✓	✓

5. INVESTMENT TRAINING

During the period, officers have attended investment training with Arlingclose and CIPFA relevant to their roles.

6. OUTLOOK FOR THE REMAINDER OF 2021/22

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

Arlingclose expects Bank Rate to rise in Q2 2022. We believe this is driven as much by the Bank of England's desire to move from emergency levels as by fears of inflationary pressure.

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

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

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

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

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

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

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