



APPENDIX B – Additional commentary from Arlingclose

External Context

Economic background: Economic resurgence from coronavirus pandemic continued to dominate the first quarter of the financial year. In the biggest inoculation programme the country has ever undertaken, over 44 million people in the UK had received their first dose of a COVID-19 vaccine with 32 million also having a 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 June 2021 policy announcement, the BoE expected the economy to experience a temporary period of strong GDP growth and above-target CPI inflation, after which growth and inflation is expected to fall back. There were, however, two-sided risks around this central path, and it is possible that near-term upward pressure on prices could prove somewhat larger than expected. The Bank's Monetary Policy Committee does not intend to tighten monetary policy at least until there is clear evidence that significant progress is being made in eliminating spare capacity and achieving the 2% inflation target sustainably.

Government initiatives continued to support the economy over the quarter, following the range of measures announced by the Chancellor in the 2021 Budget, which included extending the furlough (Coronavirus Job Retention) scheme until September 2021.

The latest labour market data showed that in the three months to April 2021 the unemployment rate fell to 4.7%, although it is likely that labour market slack has remained higher than implied by this measure. Some individuals stopped looking for work during the pandemic and were therefore recorded as inactive. There is uncertainty around how many of these individuals will resume their search for a job, and when. Latest data showed growth in average total pay (including bonuses) and regular pay (excluding bonuses) among employees was 5.6% for the three months February to April 2021. The seemingly high growth partly reflected a base effect from a decline in average pay in the spring of last year, associated with the reduced pay of employees on the furlough scheme.

Annual CPI inflation rose to 2.1% in May on the back of base effects in spring 2020 and partly due to higher energy and commodity prices and supply-side bottlenecks. The BoE expects inflation to exceed 3% for a temporary period. The ONS' preferred measure of CPIH which includes owner-occupied housing was also 2.1% year/year, marginally higher than expectations.

The reimposition of restrictions on activity in the first quarter of calendar 2021 year resulted in GDP falling 1.6% in Q1. GDP growth was strong in April at 2.3% with the partial easing of restrictions on non-essential retail and outdoor hospitality. Housing market activity remained strong, aided by the extension of the stamp duty threshold and an increase in mortgage approvals for house purchases.

The US economy rebounded by 4.3% in Q4 2020 (Oct-Dec) and then an even stronger 6.4% in Q1 as the recovery continued to be fuelled by \$5 trillion worth of pandemic



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stimulus packages. The Federal Reserve maintained its main interest rate at between 0% and 0.25% over the period.

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: Ongoing monetary and fiscal stimulus together with improving economic growth prospects and successful vaccine rollout programmes continued to boost equity markets over the period. The Dow Jones reached a record high during the period while the UK-focused FTSE 250 index was back above pre-pandemic levels and the more internationally focused FTSE 100 had recouped around three-quarters of 2020 losses.

Inflation worries continued during the period but declines in bond yields between April and June suggest bond markets may be expecting any general price increases to be less severe, or more transitory, that was previously thought.

The 5-year UK benchmark gilt yield began the financial year at 0.36% before declining to 0.32% by the end of June 2021. Over the same period the 10-year gilt yield fell from 0.80% to 0.71%, despite jumping to 0.90% in May. The 20-year yield declined from 1.31% to 1.21%.

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

Credit review: Credit default swap spreads were relatively flat over the period and remain only slightly above their pre-pandemic levels. The gap in spreads between UK ringfenced and non-ringfenced entities remained, and Santander UK remained an outlier compared to the other ringfenced/retail banks. At the end of June, Santander UK was trading the highest at 52bps and Standard Chartered the lowest at 31bps. The other ringfenced banks were trading between 32 and 34bps while Nationwide Building Society was 38bps.

There were only a small number of credit rating actions over the period. Fitch revised a number of Singaporean and Australian banks as well as Close Brothers to stable, and also upgraded Coventry Building Society to 'A' (from 'A-'). Towards the end of the period Fitch revised the United Kingdom's outlook to stable from negative.

S&P also revised some Australian banks to stable, as well as Transport for London, which a week or so later received a £1.08 billion bailout from the UK government. S&P also downgraded the long- and short-term ratings of DZ Bank (Germany) to A+ and A-1 from AA- and A-1+ respectively. In late June S&P took further rating actions, upwardly revising the outlooks for a number of UK and European banks from negative to stable, or in the case of Barclays and Nationwide from stable to positive.

The successful vaccine rollout programme is credit positive for the financial services sector in general, but there remains much uncertainty around the extent of the losses banks and building societies will suffer due to the economic slowdown which has resulted due to pandemic-related lockdowns and restrictions. The institutions and durations on the Authority's counterparty list recommended by treasury management advisors Arlingclose remain under constant review, but at the end of the period no changes had been made to the names on the list or the recommended maximum duration of 35 days.