

Appendix C

The Treasury Management Activity Mid-Year Report – 2022/23

1. Background

- 1.1 The Treasury Management and Annual Investment Strategy for 2022/23 were approved by the Cabinet 25 January 2022. The 2022/23 strategy maintained the approved instruments adopted previously to improve yield and diversify the investment portfolio. Changes to the strategy are summarised below.

Investment options	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23
Money Market Funds (Including LVNAV)	✓	✓	✓	✓	✓	✓
Bank Notice Accounts	✓	✓	✓	✓	✓	✓
Fixed Term Bank Deposits	✓	✓	✓	✓	✓	✓
UK Local Authorities	✓	✓	✓	✓	✓	✓
Enhanced Money Market Funds (VNAV)	✓	✓	✓	✓	✓	✓
Building Societies	✗	✓	✓	✓	✓	✓
Pooled Property Funds	✗	✓	✓	✓	✓	✓
Corporate Bond Funds (Including Short Dated Bond Funds)	✗	✓	✓	✓	✓	✓
Multi Asset Funds	✗	✓	✓	✓	✓	✓
Equity Funds	✗	✗	✓	✓	✓	✓

- 1.2 This report considers treasury management activity over six months of the financial year.

2. Treasury Management Strategy

- 2.1 The Council approved the 2022/23 treasury management strategy at its meeting on 25 January 2022. The Council's stated investment strategy is to prudently manage an investment policy achieving first of all, security (protecting the Capital sum from loss), liquidity (keeping money readily available for expenditure when needed), and to consider what yield can be obtained consistent with those priorities.

- 2.2 The 2022/23 Investment Strategy has been set in the context of diminishing returns and opportunities in the current economic environment. The provides the framework for officers to seek new opportunities to invest long-term cash in suitable longer term instruments in order to assist in delivering treasury efficiencies by securing a level of investment income.

- 2.3 The pandemic, and resultant market uncertainty, has limited the scope for new investments. Actions to explore the available options for Short Dated Bond Funds and Multi Asset Funds have been paused but will be explored in the future when appropriate.

- 2.4 In response to the Council declaring a Climate Emergency, the Annual Investment Strategy for 2021/22 included Environmental Social and Governance (ESG) as a factor when undertaking investment decisions to allow the Treasury Management Strategy to actively support the Council's aspirations to tackle climate change and other ESG factors. Officers have been exploring how the Council's current counterparties are contributing to this area and

are being asked how investment solutions can complement this strategy. In reality, the market for green and ESG investments is relatively immature, which reduces the ability to actively invest in products that support the Council's aspirations. However, research and the consideration of suitability of ESG investment products will continue into 2021/22.

2.5 The Chief Finance Officer is pleased to report that all treasury management activity undertaken from April 2021 to September 2022 period complied with the approved strategy, the CIPFA Code of Practice, and the relevant legislative provisions.

3 Summary of financial implications / activity

3.1 The Bank of England's Monetary Policy Committee (MPC) raised interest rates on four occasions over the period in May, June, August and September. The rate as at 30 September is 2.25%. Our Treasury Advisors Link Asset Services are forecasting MPC to increase interest rates further and faster, from 2.25% to a peak of 5.00% in February 2023.

3.1 During the first half year investments have been held in Money Market Funds, Bank Notice Accounts, other Local Authorities and the CCLA Local Authority Property Fund. Counterparty credit quality remains a primary concern for the treasury team, with security, liquidity and yield in that order a priority.

3.2 Measures have been undertaken to ensure that levels of liquidity are available during the last 6 months but also opportunities explored in this rising interest rate environment to secure investment returns. Several fixed term bank deposits have been reinvested up to 12 months securing a fixed rate of return between 1.50% - 3.90% within a low credit risk parameter.

3.3 Local Authority deposits have been placed in the period at moderate returns compared to the current bank rates, but their inclusion forms part of a balanced portfolio. Deposits held for liquidity purposes in Money Market Funds are providing a return nearing the current base rate, compared to previous years where they performed well below that benchmark.

3.4 The Council is continuing to invest in deposits with regard to ESG and sustainable lending, through Standard Chartered Bank. These investments are assigned to sustainable assets with the aim of addressing the UN sustainable development goals. The offering fulfils the key principle of security, liquidity and yield and is consistent with the banks current other fixed term deposit rates.

3.5 The average investment balance to September 2022 was £307m and generated investment income of £1,650,000. The forecast for 2022/23 is £5.4m and is within budgeted provision.

3.7 No short term loan borrowing was arranged during the period. Future short-term borrowing in the current year is not forecasted but remains an option to cover temporary cashflow requirements.

3.8 The level of Council long-term debt at 30 September 2022 was £228.7m, two loans matured with the PWLB during the period on the 30 June (£2.3m) and the 30 September 2022 (£1.98m) held at 5.75% and 7.75%. The next maturity is on the 31 December 2022 a £1.3m PWLB Loan at a rate of 7.625%. The forecast for interest paid on long-term debt in 2022/23 is approximately £10.5m and is within the budgeted provision.

3.9 Opportunities to reduce the cost of carry (interest paid against interest received) are constantly being explored as and when options arise. In October, a LOBO market loan was called by the borrower, Commerzbank. Exercising their option to increase the coupon rate of

the loan from 3.75% to 4.50%. The Council could accept the new borrowing rate for the next 6 months or repay the principal. The Loan was repaid early by the Council at par value £6.45m. This was the last LOBO loan in the Council's wider debt portfolio.

4. Economic Review (provided by Link Asset Services, September 2022)

4.1 The second quarter of 2022/23 saw:

- GDP revised upwards in Q1 2022/23 to +0.2% q/q from -0.1%, which means the UK economy has avoided recession for the time being;
- Signs of economic activity losing momentum as production fell due to rising energy prices;
- CPI inflation ease to 9.9% y/y in August, having been 9.0% in April, but domestic price pressures showing little sign of abating in the near-term;
- The unemployment rate fell to a 48-year low of 3.6% due to a large shortfall in labour supply;
- Bank Rate rise by 100bps over the quarter, taking Bank Rate to 2.25% with further rises to come;
- Gilt yields surge and sterling fall following the "fiscal event of the new Prime Minister and Chancellor on 23rd September.

4.2 The UK economy grew by 0.2% q/q in Q1 2022/23, though revisions to historic data left it below pre-pandemic levels.

4.3 There are signs of higher energy prices creating more persistent downward effects in economic activity. Both industrial production (-0.3% m/m) and construction output (-0.8% m/m) fell in July 2022 for a second month in a row. Although some of this was probably due to the heat wave at the time, manufacturing output fell in some of the most energy intensive sectors (e.g., chemicals), pointing to signs of higher energy prices weighing on production. With the drag on real activity from high inflation having grown in recent months, GDP is at risk of contracting through the autumn and winter months.

4.4 The fall in the composite PMI from 49.6 in August to a 20-month low preliminary reading of 48.4 in September points to a fall in GDP of around 0.2% q/q in Q3 and consumer confidence is at a record low. Retail sales volumes fell by 1.6% m/m in August, which was the ninth fall in 10 months. That left sales volumes in August just 0.5% above their pre-Covid level and 3.3% below their level at the start of the year. There are also signs that households are spending their excess savings in response to high prices. Indeed, cash in households' bank accounts rose by £3.2bn in August, which was below the £3.9bn rise in July and much smaller than the 2019 average monthly rate of £4.6bn.

4.5 The labour market remained exceptionally tight. Data for July and August provided further evidence that the weaker economy is leading to a cooling in labour demand. Labour Force Survey (LFS) employment rose by 40,000 in the three months to July (the smallest rise since February). But a renewed rise in inactivity of 154,000 over the same period meant that the unemployment rate fell from 3.8% in June to a new 48-year low of 3.6%. The single-month data showed that inactivity rose by 354,000 in July itself and there are now 904,000 more inactive people aged 16+ compared to before the pandemic in February 2020. The number of vacancies has started to level off from recent record highs but there have been few signs of a slowing in the upward momentum on wage growth. Indeed, in July, the 3my/y rate of average earnings growth rose from 5.2% in June to 5.5%.

- 4.6 CPI inflation eased from 10.1% in July to 9.9% in August, though inflation has not peaked yet. The easing in August was mainly due to a decline in fuel prices reducing fuel inflation from 43.7% to 32.1%. And with the oil price now just below \$90pb, we would expect to see fuel prices fall further in the coming months.
- 4.7 However, utility price inflation is expected to add 0.7% to CPI inflation in October when the Ofgem unit price cap increases to, typically, £2,500 per household (prior to any benefit payments). But, as the government has frozen utility prices at that level for two years, energy price inflation will fall sharply after October and have a big downward influence on CPI inflation.
- 4.8 Nonetheless, the rise in services CPI inflation from 5.7% y/y in July to a 30-year high of 5.9% y/y in August suggests that domestic price pressures are showing little sign of abating. A lot of that is being driven by the tight labour market and strong wage growth. CPI inflation is expected to peak close to 10.4% in November and, with the supply of workers set to remain unusually low, the tight labour market will keep underlying inflationary pressures strong until early next year.
- 4.9 During H1 2022, there has been a change of both Prime Minister and Chancellor. The new team (Liz Truss and Kwasi Kwarteng) have made a step change in government policy. The government's huge fiscal loosening from its proposed significant tax cuts will add to existing domestic inflationary pressures and will potentially leave a legacy of higher interest rates and public debt. Whilst the government's utility price freeze, which could cost up to £150bn (5.7% of 4.10 GDP) over 2 years, will reduce peak inflation from 14.5% in January next year to 10.4% in November this year, the long list of tax measures announced at the "fiscal event" adds up to a loosening in fiscal policy relative to the previous government's plans of £44.8bn (1.8% of GDP) by 2026/27. These included the reversal of April's national insurance tax on 6th November, the cut in the basic rate of income tax from 20p to 19p in April 2023, the cancellation of next April's corporation tax rise, the cut to stamp duty and the removal of the 45p tax rate, although the 45p tax rate cut announcement has already been reversed.
- 4.10 Fears that the government has no fiscal anchor on the back of these announcements has meant that the pound has weakened again, adding further upward pressure to interest rates. Whilst the pound fell to a record low of \$1.035 on the Monday following the government's "fiscal event", it has since recovered to around \$1.12. That is due to hopes that the Bank of England will deliver a very big rise in interest rates at the policy meeting on 3rd November and the government will lay out a credible medium-term plan in the near term. This was originally expected as part of the fiscal statement on 23rd November but has subsequently been moved forward to an expected release date in October. Nevertheless, with concerns over a global recession growing, there are downside risks to the pound.
- 4.11 The MPC has now increased interest rates seven times in as many meetings in 2022 and has raised rates to their highest level since the Global Financial Crisis. Even so, coming after the Fed and ECB raised rates by 75 basis points (bps) in their most recent meetings, the Bank of England's latest 50 basis points hike looks relatively dovish. However, the UK's status as a large importer of commodities, which have jumped in price, means that households in the UK are now facing a much larger squeeze on their real incomes.
- 4.12 Since the fiscal event on 23rd September, we now expect the Monetary Policy Committee (MPC) to increase interest rates further and faster, from 2.25% currently to a peak of 5.00% in February 2023. The combination of the government's fiscal loosening, the tight labour market and sticky inflation expectations means we expect the MPC to raise interest rates by 100bps at the policy meetings in November (to 3.25%) and 75 basis points in December (to 4%) followed by further 50 basis point

hikes in February and March (to 5.00%). Market expectations for what the MPC will do are volatile. If Bank Rate climbs to these levels the housing market looks very vulnerable, which is one reason why the peak in our forecast is lower than the peak of 5.50% - 5.75% priced into the financial markets at present.

4.13 Throughout 2022/23, gilt yields have been on an upward trend. They were initially caught up in the global surge in bond yields triggered by the surprisingly strong rise in CPI inflation in the US in May. The rises in two-year gilt yields (to a peak of 2.37% on 21st June) and 10-year yields (to a peak of 2.62%) took them to their highest level since 2008 and 2014 respectively. However, the upward trend was exceptionally sharply at the end of September as investors demanded a higher risk premium and expected faster and higher interest rate rises to offset the government's extraordinary fiscal stimulus plans. The 30-year gilt yield rose from 3.60% to 5.10% following the "fiscal event", which threatened financial stability by forcing pension funds to sell assets into a falling market to meet cash collateral requirements. In response, the Bank did two things. First, it postponed its plans to start selling some of its quantitative easing (QE) gilt holdings until 31st October. Second, it committed to buy up to £65bn of long-term gilts to "restore orderly market conditions" until 14th October. In other words, the Bank is restarting QE, although for financial stability reasons rather than monetary policy reasons.

4.14 Since the Bank's announcement on 28th September, the 30-year gilt yield has fallen back from 5.10% to 3.83%. The 2-year gilt yield dropped from 4.70% to 4.30% and the 10-year yield fell back from 4.55% to 4.09%.

4.15 There is a possibility that the Bank continues with QE at the long-end beyond 14th October or it decides to delay quantitative tightening beyond 31st October, even as it raises interest rates. So far at least, investors seem to have taken the Bank at its word that this is not a change in the direction of monetary policy nor a step towards monetary financing of the government's deficit. But instead, that it is a temporary intervention with financial stability in mind.

5.0 Link Asset Services interest rate forecasts (27/09/2022)

5.1 The latest forecast sets out a view that both short and long-dated interest rates will be elevated for some little while, as the Bank of England seeks to squeeze inflation out of the economy, whilst the government is providing a package of fiscal loosening to try and protect households and businesses from the ravages of ultra-high wholesale gas and electricity prices.

5.2 The increase in PWLB rates reflects a broad sell-off in sovereign bonds internationally but more so the disaffection investors have with the position of the UK public finances after September's "fiscal event". To that end, the MPC has tightened short-term interest rates with a view to trying to slow the economy sufficiently to keep the secondary effects of inflation – as measured by wage rises – under control, but its job is that much harder now.

5.3 We now expect the MPC to swiftly increase Bank Rate during the remainder of 2022 and into Q1 2023 to combat the sharp increase in inflationary pressures. We do not think that the MPC will embark on a series of increases in Bank Rate that would take it to more than 5%, but it is possible.

Link Group Interest Rate View 27.09.22												
	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24	Jun-24	Sep-24	Dec-24	Mar-25	Jun-25	Sep-25
BANK RATE	4.00	5.00	5.00	5.00	4.50	4.00	3.75	3.25	3.00	2.75	2.75	2.50
3 month ave earnings	4.50	5.00	5.00	5.00	4.50	4.00	3.80	3.30	3.00	2.80	2.80	2.50
6 month ave earnings	4.70	5.20	5.10	5.00	4.60	4.10	3.90	3.40	3.10	3.00	2.90	2.60
12 month ave earnings	5.30	5.30	5.20	5.00	4.70	4.20	4.00	3.50	3.20	3.10	3.00	2.70
5 yr PWLB	5.00	4.90	4.70	4.50	4.20	3.90	3.70	3.50	3.40	3.30	3.20	3.20
10 yr PWLB	4.90	4.70	4.60	4.30	4.10	3.80	3.60	3.50	3.40	3.30	3.20	3.20
25 yr PWLB	5.10	4.90	4.80	4.50	4.30	4.10	3.90	3.70	3.60	3.60	3.50	3.40
50 yr PWLB	4.80	4.60	4.50	4.20	4.00	3.80	3.60	3.40	3.30	3.30	3.20	3.10

5.4 Our central forecast for interest rates was previously updated on 9th August and reflected a view that the MPC would be keen to further demonstrate its anti-inflation credentials by delivering a succession of rate increases. This has happened but Friday's "Fiscal Event" has complicated the picture for the MPC, who will now need to double-down on counteracting inflationary pressures stemming from the Government's widespread fiscal loosening.

5.5 Further down the road, we anticipate the Bank of England will be keen to loosen monetary policy when the worst of the inflationary pressures are behind us – but that timing will be one of fine judgment: cut too soon, and inflationary pressures may well build up further; cut too late and any downturn or recession may be prolonged

5.6 The CPI measure of inflation will peak at close to 11% in Q4 2022. Despite the cost-of-living squeeze that is still taking shape, the Bank will want to see evidence that wages are not spiralling upwards in what is evidently a very tight labour market.

5.7 Regarding the "provisional" plan to sell £10bn of gilts back into the market each quarter, starting in September, this is still timetabled to take place but given the large-scale funding of the priorities set out in the Government's "Fiscal Event", the Bank may be reticent to add to an already high supply of gilts for investors to purchase.

5.8 In the upcoming months, our forecasts will be guided not only by economic data releases and clarifications from the MPC over its monetary policies and the Government over its fiscal policies, but the on-going conflict between Russia and Ukraine. (More recently, the heightened tensions between China/Taiwan/US also have the potential to have a wider and negative economic impact.)

5.9 On the positive side, consumers are still estimated to be sitting on over £160bn of excess savings left over from the pandemic so that will cushion some of the impact of the above challenges. However, most of those are held by more affluent people whereas lower income families already spend nearly all their income on essentials such as food, energy and rent/mortgage payments.