Treasury Management Report Q3 2022/23

Introduction

In March 2012 the Council adopted the Chartered Institute of Public Finance and Accountancy's *Treasury Management in the Public Services: Code of Practice* (the CIPFA Code) which requires the Authority to approve treasury management semi-annual and annual reports. This quarterly report provides an additional update.

The Council's treasury management strategy for 2022/23 was approved at a meeting on 2nd March 2022. The Council has borrowed and 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 remains central to the Council's treasury management strategy.

The 2021 Prudential Code includes a requirement for local authorities to provide a Capital Strategy, a summary document approved by full Council covering capital expenditure and financing, treasury management and non-treasury investments. The Council's Capital Strategy, complying with CIPFA's requirement, was approved by full Council on 2nd March 2022.

External Context

Economic background: The conflict in Ukraine continued to keep global inflation elevated and the UK and global economic outlook remains weak. Political uncertainty in the UK improved in the later part of the period following a change in government to what financial markets perceived as being more fiscally prudent.

The economic backdrop during the April to December period continued to be characterised by high energy and commodity prices, high inflation and the associated impact on consumers' cost of living, as well as little likelihood that the Russia-Ukraine hostilities will end any time soon. China started to lift some of its zero-Covid policy restrictions at the end of the period causing a sharp increase in infections, but also leading to questions over potential under reporting of the number of cases by the Chinese government due to how it is counting the figures.

Central Bank rhetoric and action continued to remain robust. The Bank of England, Federal Reserve and the European Central Bank all increased interest rates over the period and committed to fighting inflation, even in the face of potential recessions in those regions.

UK inflation remained high, but there were tentative signs it may have peaked. Annual headline CPI registered 10.7% in November, down modestly from 11.1% in October. RPI was 14% in November, down from 14.2% in October, but slightly above expectations for a larger fall to 13.9%.

The UK government under Rishi Sunak and Jeremy Hunt reversed some of the support to household energy bills announced under the previous Liz Truss leadership. The previous support package which would have seen average consumption cost £2,500 annually until 2024 was replaced by a less generous scheme which was only maintained at this level until March 2023, to be replaced by a higher cap of £3,000 per year for the typical household from April onwards.

The labour market remained tight but with some evidence of softening demand for new labour. The unemployment rate 3m/year for April-June was 3.8%, which declined to 3.6% in July-September and picked up again to 3.7% in October-December. The inactivity rate was 21.5% in the latest quarter, down by 0.1% compared to the previous period. Pay growth in October-December was 6.1%

for both total pay (including bonuses) and for regular pay. Once adjusted for inflation, however, both measures fell by 2.7%.

Household disposable income remained under pressure, pushing consumer confidence down to a record low of –49 in September, but following months showed registered modest improvements to December's reading of –42. Quarterly GDP for the April-June quarter was revised upwards to 0.2% (from -0.1%), following revisions to household and government spending, but fell by -0.3% in the July-September quarter, a larger decline than the -0.2% predicted.

The Bank of England increased the official Bank Rate to 3.5% over the period. From 0.75% in March, the Monetary Policy Committee (MPC) pushed through rises at every subsequent meeting over the period, with outsized hikes of 50bps in August and September, 75bps in November and then another 50bps in December. November's rise was voted by a majority of 7-2, with one MPC member preferring a 0.5% rise and another a 0.25% rise. The December vote was 6-3, with two members preferring to keep Bank Rate on hold at 3% while one member wanted a larger increase of 0.75%. Once again, the Committee noted that domestic inflationary pressures are expected to remain strong and continuing rhetoric around combating inflation means further rate rises are predicted.

After hitting 9.1% in June, annual US inflation slowed for a further five consecutive months, with relatively strong falls in October to 7.7% and then in November to 7.1%. The Federal Reserve continued raising interest rates over the period with four consecutive increases of 0.75% in June, July, September, and November respectively, followed by 50bp in December taking policy rates to a range of 4.25% - 4.50%.

Eurozone CPI inflation hit a record-high of 10.6% y/y in October following rises in each month over the period. In November inflation fell to 10.1%, the first decline since June 2021. Energy prices remained the largest upward contribution to the price increase. The European Central Bank continued increasing interest rates over the period, pushing rates up by 0.50% in December following two consecutive months of 0.75% rises, taking the deposit facility rate to 2% and the main refinancing rate to 2.5%.

Financial markets: Uncertainty remained a key driver of financial market sentiment and bond yields remained relatively volatile due to concerns over elevated inflation and higher interest rates. In September and October, volatility in financial markets was significantly exacerbated by the fiscal plans of the then UK government (under Liz Truss), leading to an acceleration in the rate of the rise in gilt yields and decline in the value of sterling. However, the subsequent change of government leadership to Rishi Sunak and Jeremy Hunt lead to gilts yields falling in November and December, albeit at higher levels compared to earlier in the period.

Over the period the 5-year UK benchmark gilt yield rose from 1.41% to peak at 4.70% in September before ending the calendar year at 3.62%. Over the same timeframe the 10-year gilt yield rose from 1.61% to peak at 4.51% before falling back to 3.67%, while the 20-year yield rose from 1.82% to 4.96% and then declined to 4.03%. The Sterling Overnight Rate (SONIA) averaged 1.75% over the period.

Credit review: During the last few months of the period, in October Fitch revised the outlook on the UK sovereign to negative from stable following the largely unfunded fiscal package announced at the time, and a few weeks prior revised the outlook on HSBC to stable from negative.

Over the same timeframe Moody's also revised the UK sovereign to negative from stable, following swiftly after with a similar move for a number of local authorities and UK banks including Barclays Bank, National Westminster Bank (and related entities) and Santander.

Having completed its full review of its credit advice on unsecured deposits at UK and non-UK banks earlier in the year (May), Arlingclose extended the maximum duration limit for five UK banks, four Canadian banks and four German banks to six months. The maximum duration for unsecured deposits with other UK and non-UK banks on Arlingclose's recommended list is 100 days. These recommendations were unchanged at the end of the period.

Although local authorities remain under financial pressure, Arlingclose continues to take a positive view of the sector, considering its credit strength to be high. Section 114 notices have been issued by only a handful of authorities with specific issues. While Arlingclose's advice for local authorities on its counterparty list remains unchanged, a degree caution is merited with certain authorities.

Arlingclose continued to monitor and assess credit default swap levels for signs of credit stress but made no changes to the counterparty list or recommended durations. Nevertheless, market volatility is expected to remain a feature, at least in the near term and, as ever, the institutions and durations on the Authority's counterparty list recommended by Arlingclose remains under constant review.

Local Context

On 31st March 2022, the Council had net borrowing of £14.5 m arising from its revenue and capital income and expenditure. The underlying need to borrow for capital purposes is measured by the Capital Financing Requirement (CFR), while usable reserves and working capital are the underlying resources available for investment. These factors are summarised in Table 1 below.

Table 1: Balance Sheet Summary

	31.3.22 Actual £000
General Fund CFR	57,189
HRA CFR	84,523
Total CFR	**141,712**
Less: Usable reserves	(105,845)
Less: Working capital	(21,345)
Net borrowing	**14,522**

The treasury management position on 31st December 2022 and the change during over the year is shown in Table 2 below.

Table 2: Treasury Management Summary

	31.3.22 Balance £000	**Movement £000**	**31.12.22 Balance £000**	**31.12.22 Rate %**
Long-term borrowing	70,666	1,270	71,936	
Short-term borrowing	2,521	7,746	10,000	
Total borrowing	73,187	8,749	81,936	3.46%
Long-term investments Short-term investments Cash and cash equivalents	49,959 4 8,702	41 0 (4,225)	50,000 4 4,478	
Total investments	58,665	(4,184)	54,482	3.25%
Net borrowing	14,522	**12,933**	27,454	

Borrowing Update

CIPFA's 2021 Prudential Code is clear that local authorities must not borrow to invest primarily for financial return and that it is not prudent for local authorities to make any investment or spending decision that will increase the capital financing requirement, and so may lead to new borrowing, unless directly and primarily related to the functions of the Council. PWLB loans are no longer available to local authorities planning to buy investment assets primarily for yield unless these loans are for refinancing purposes.

Borrowing Strategy and Activity

As outlined in the treasury strategy, the Council's chief objective when borrowing has been to strike an appropriately low risk balance between securing low interest costs and achieving cost certainty over the period for which funds are required, with flexibility to renegotiate loans should the Council's long-term plans change being a secondary objective. The Council's borrowing strategy continues to address the key issue of affordability without compromising the longer-term stability of the debt portfolio.

The cost of both long and short term borrowing has risen dramatically over the April – December period, with rates at the end of December around 2% - 3% higher than those at the beginning of April. Rate rises have been driven primarily by inflation and the need for central banks to control this by raising interest rates. Particularly dramatic rises were seen in September after Liz Truss' 'mini-budget' included unfunded tax cuts and additional borrowing to fund consumer energy price subsidies: over a twenty-four-hour period some PWLB rates increased to 6%. Rates have now fallen from September peaks but remain well above recent historical norms. The PWLB 10 year maturity certainty rate stood at 4.59% at the end of 2022.

At 31st December 2022 the Council held £81.9m of loans, an increase of £8.7m from 31st March 2022, as part of its strategy for funding previous years' capital programmes. Outstanding loans on 31st December are summarised in Table 3 below.

Table 3: Borrowing Position

	31.3.22 Balance £000	Net Movement £000	31.12.22 Balance £000
Public Works Loan Board	73,187	(1,251)	71,936
Local Authorities (short term)	0	10,000	10,000
Total borrowing	**73,187**	8,749	**81,936**

The Council's borrowing decisions are not predicated on any one outcome for interest rates and a balanced portfolio of short- and long-term borrowing was maintained.

There remains a strong argument for diversifying funding sources, particularly if rates can be achieved on alternatives which are below gilt yields + 0.80%. The Authority will evaluate and pursue these lower cost solutions and opportunities with its advisor Arlingclose.

Treasury Management Investment Activity

CIPFA revised TM Code defines treasury management investments as those which arise from the Authority's cash flows or treasury risk management activity that ultimately represents balances which need to be invested until the cash is required for use in the course of business.

The Council holds significant invested funds, representing income received in advance of expenditure plus balances and reserves held. During the year, the Council's investment balances ranged between £50 and £58m million due to timing differences between income and expenditure. The investment position is shown in table 4 below.

Table 4: Treasury Investment Position

	31.3.22 Balance £000	Net Movement £000	31.12.22 Balance £000	31.12.22 Income Return %
Banks & building societies (unsecured)	8,351	(5,504)	2,847	0.59%
Money Market Funds	355	1,280	1,635	3.23%
Other Pooled Funds				
- Cash plus funds	7,927	73	8,000	
- Strategic bond funds	8,002	(2)	8,000	
- Property funds	6,566	566	6,000	
- Multi asset income funds	27,464	536	28,000	
Other Pooled Funds Sub-total	49,959	1,173	**50,000**	3.69%
Total investments	**58,655**		**54,482**	

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.

Bank Rate has increased from 0.75% at the beginning of the period under review to 3.5% at the end, with the prospect of further increases to come. Short-dated cash rates, which had ranged between 0.7% - 1.5% at the end of March, rose by around 2.7% for overnight/7-day maturities and 3.0% for 6-12 month maturities.

By end December, the rates on DMADF deposits ranged between 3.3% and 3.6%. The return on the Council's sterling Low Volatility Net Asset Value (LVNAV) Money Market Funds ranged between 0.9% - 1.1% p.a. in early April and between 2.8% and 3.0% at the end of December.

Given the risk of short-term unsecured bank investments, the Council has invested £50m in pooled investment funds as shown in table 4 above.

The progression of risk and return metrics are shown in the extracts from Arlingclose's quarterly investment benchmarking in Table 5 below.

Table 5: Investment Benchmarking – Treasury investments managed in-house

	Credit Score	Credit Rating	Bail-in Exposure	Weighted Average Maturity (days)	Rate of Return %
31.03.2022	5.34	A+	100%	1	3.07%
31.12.2022	5.42	A+	100%	1	-6.67%
Similar LAs	4.41	AA-	59%	47	0.61%
All LAs	4.41	AA-	60%	14	1.35%

Externally Managed Pooled Funds: £50m of the Council's investments is invested in externally managed strategic pooled bond, multi-asset and property funds where short-term security and liquidity are lesser considerations, and the objectives instead are regular revenue income and long-term price stability. These funds generated a 3.67% income return which is used to support services in year, and (12.48%) of unrealised capital loss.

During the Q3 October-December period, financial markets experienced some relief from the losses endured through most of the year, although it was a mixed picture. Globally, equities saw positive returns as did some corporate bonds, but government bonds generally suffered. The UK was a bright spot, with some recovery from the tumultuous Liz Truss premiership, with gilt yields falling and the FTSE rising. Commercial property returns, which tend to operate on a lag, saw significant declines over the quarter, as market pricing finally reflected the economic and interest rate environment.

The overall April-December period remained a very difficult environment for almost all asset classes, largely driven by central bank rate increases in the fight against high inflation and Russia's continuing invasion of Ukraine. The sell-off in gilts, other sovereign bonds and corporate bonds with a rise in gilt/bond yields (i.e. a fall in price) was reflected in the Council's bond and multi-asset income funds. The increase in policy rates in the UK, US and Eurozone and the prospect of low growth/recessionary period ahead was also challenging for equities, the FTSE All Share index falling from 4187 on 31st March to 4075 on 30th December, whilst the MSCI World Index fell from 3053 to 2602 over the same period. The fall in equity valuations is reflected in the equity and multi-asset income funds. Commercial property prices also fell for similar reasons, and this was reflected in the Council's property funds.

Financial market volatility and uncertainty remain due to stagflation fears, little sight of the war in Ukraine ending soon and ongoing supply chain issues, a lingering problem yet to be fully resolved.

The change in the Council's funds' capital values and income earned over the 9-month period is shown in Table 4.

Because these funds have no defined maturity date, but are available for withdrawal after a notice period, their performance and continued suitability in meeting the Council's medium- to long-term investment objectives are regularly reviewed. 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 should exceed cash interest rates.

The Council had budgeted £1,640k income from these investments in 2022/23.

Non-Treasury Investments

The definition of investments in CIPFA's revised 2021 Treasury Management Code covers all the financial assets of the Council as well as other non-financial assets which the Council holds primarily for financial return. Investments that do not meet the definition of treasury management investments (i.e. management of surplus cash) are categorised as either for service purposes (made explicitly to further service objectives) and or for commercial purposes (made primarily for financial return).

Investment Guidance issued by the Department for Levelling Up Housing and Communities (DLUHC) and Welsh Government also broadens the definition of investments to include all such assets held partially or wholly for financial return.

Following the approval of the Property Investment Strategy in November 2016, work continues to

identify and progress suitable investments to deliver economic regeneration and to generate additional income streams for the future.

The 2022/23 budget includes a forecast of total income (rent and service charges) of £1.94m. Costs including management costs, minimum revenue provision and long term borrowing of £1.30m are forecast resulting in retained income for the General Fund of £640k.

Treasury 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, as shown in table 6 below.

Table 6: Performance

	Actual £000	Budget £000	Over/ under	Actual %
Interest Received	1,718	1,640	78	3.25%
Interest Payable	2,443	2,443	0	3.38%

Compliance

The Strategic Director (Corporate Resources - Finance and Housing) reports that all treasury management activities undertaken during the quarter complied fully with the CIPFA Code of Practice and the Council’s approved Treasury Management Strategy. Compliance with specific investment limits is demonstrated in table 7 below.

Compliance with the authorised limit and operational boundary for external debt is demonstrated in table 8 below.

Table 7: Debt Limits

	31.12.22 Actual	2022/23 Operational Boundary	2022/23 Authorised Limit	Complied?
Borrowing	£81.9	£333m	£338.5m	✓

Since the operational boundary is a management tool for in-year monitoring it is not significant if the operational boundary is breached on occasions due to variations in cash flow, and this is not counted as a compliance failure.

Table 8: Investment Limits

	31.12.22 Actual	2022/23 Limit	Complied?
Local authorities & other government entities	0	unlimited	✓
Banks (unsecured)	<£1m	£8m per bank	✓
Any group of pooled funds under the same management	0	£16m per group	✓

	31.12.22 Actual	2022/23 Limit	Complied?
Negotiable instruments held in a broker's nominee account	0	£15m	✓
Unsecured investments with building societies	0	£8m	✓
Money Market Funds	<£2m	£10m per fund	✓
Strategic pooled funds	£50m	£10m per fund	✓
Operational bank	<£1m	£20m	✓

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 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. Unrated investments are assigned a score based on their perceived risk.

	31.12.22 Actual	2022/23 Target	Complied?
Portfolio average credit rating	**5.42**	**6**	✓

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 within a rolling three-month period, without additional borrowing it can borrow each period without giving prior notice.

	31.12.22 Actual	2022/23 Target	Complied?
Total cash available within 3 months	£4.5m	£8m	✓

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 interests was:

Interest rate risk indicator	31.12.22 Actual £000	2022/23 Limit £000	Complied?
Upper limit on one-year revenue impact of a 1% rise in interest rates	500	500	✓
Upper limit on one-year revenue impact of a 1% fall in interest rates	500	500	✓

The impact of a change in interest rates is calculated on the assumption that maturing loans and investment will be replaced at current rates.

Maturity Structure of Borrowing: This indicator is set to control the Council's exposure to refinancing risk. The upper and lower limits on the maturity structure of all borrowing were:

	31.12.22 Actual	Upper Limit	Lower Limit	Complied?
Under 12 months	11,270	25%	0%	✓
12 months and within 24 months	3,935	50%	0%	✓
24 months and within 5 years	8,451	50%	0%	✓
5 years and within 10 years	15,989	100%	0%	✓
10 years and above	42,291	100%	0%	✓

Time periods start on the first day of each financial year. The maturity date of borrowing is the earliest date on which the lender can demand repayment.

Principal Sums Invested for Periods Longer than a year: 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 long-term principal sum invested to final maturities beyond the period end were:

	2022/23	2023/24	2024/25
Actual principal invested beyond year end	0	0	0
Limit on principal invested beyond year end	£30m	£30m	£30m
Complied?	✓	✓	✓

<u>**Arlingclose's Outlook for the remainder of 2022/23 and beyond**</u>

	Current	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24	Jun-24	Sep-24	Dec-24	Mar-25	Jun-25	Sep-25	Dec-25
Official Bank Rate													
Upside risk	0.00	0.50	0.75	1.00	1.00	1.00	1.25	1.50	1.75	1.50	1.25	1.25	1.25
Arlingclose Central Case	3.50	4.00	4.25	4.25	4.25	4.25	4.00	3.75	3.50	3.25	3.25	3.25	3.25
Downside risk	0.00	0.50	0.75	0.75	0.75	0.75	0.75	1.00	1.00	1.00	1.00	1.00	1.00

Arlingclose expects Bank Rate to rise further during the remainder of 2022/23 and to reach 4.25% by around the first quarter of the financial year 2023/24.

The Bank of England's (BoE) Monetary Policy Committee raised Bank Rate by 50bps to 3.5% in December 2022 as expected. There were signs that some Committee members believe that 3% is restrictive enough, however, a majority think further increases in Bank Rate might be required. Arlingclose expects Bank Rate to peak at 4.25%, with further 25bps rises February, March and May 2023.

The MPC will cut rates in the medium term to stimulate the UK economy but will be reluctant to do so until wage growth eases. Arlingclose expects rate cuts will start in the first half of 2024.

Arlingclose expects gilt yields to remain broadly steady over the medium term, although with continued volatility across shorter time periods.

Gilt yields face pressures from hawkish US/euro zone central bank policy on one hand to the weak global economic outlook on the other. BoE bond sales and high government borrowing will provide further underlying support for yields.

<u>Background</u>:

The influence of the mini-budget on interest rates and gilt yields continues to wane following the more fiscally prudent approach shown by the latest incumbents of Downing Street.

Volatility in global markets continues, however, as investors seek the extent to which central banks are willing to tighten monetary policy, as evidence of recessionary conditions builds. Investors have been more willing to price in the downturn in growth, easing financial conditions, to the displeasure of policymakers. This raises the risk that central banks will incur a policy error by tightening too much.

The UK economy is already experiencing recessionary conditions and recent GDP and PMI data suggests the economy entered a technical recession in Q3 2022. The resilience shown by the economy has been surprising, despite the downturn in business activity and household spending. Lower demand should bear down on business pricing power – recent data suggests the UK has passed peak inflation.

The lagged effect of the sharp tightening of monetary policy, and the lingering effects of the mini-budget on the housing market, widespread strike action, alongside high inflation, will continue to put pressure on household disposable income and wealth. The short- to medium-term outlook for the UK economy remains bleak.

Demand for labour appears to be ebbing, but not quickly enough in the official data for most MPC policymakers. The labour market remains the bright spot in the economy and persisting employment strength may support activity, although there is a feeling of borrowed time. The MPC focus is on nominal wage growth, despite the huge real term pay cuts being experienced by the vast majority. Bank Rate will remain relatively high(er) until both inflation and wage growth declines.

Global bond yields remain volatile as investors price in recessions even as central bankers push back on expectations for rate cuts in 2023. The US labour market remains tight, and the Fed wants to see persistently higher policy rates, but the lagged effects of past hikes will depress activity more significantly to test the Fed’s resolve.

While the BoE appears to be somewhat more dovish given the weak outlook for the UK economy, the European Central Banks seems to harbour (worryingly) few doubts about the short term direction of policy. Gilt yields will be broadly supported by both significant new bond supply and global rates expectations due to hawkish central bankers, offsetting the effects of declining inflation and growth.