AUDIT, GOVERNANCE & STANDARDS COMMITTEE	16 January 2023

Treasury Management Mid-Year Review 2022/23

Final Decision-Maker	Audit, Governance & Standards Committee
Lead Head of Service	Adrian Lovegrove– Head of Finance
Lead Officer and Report Author	John Owen – Finance Manager
Classification	Public
Wards affected	All

Executive Summary

This report sets out the activities of the Treasury Management Function for the first 6 months of the 2022/23 financial year in accordance with CIPFA's Code of Practice on Treasury Management in Local Authorities.

Purpose of Report

This report requires a decision from the Committee.

This report makes the following recommendations to this Committee:

- That the position of the Treasury Management Strategy as at 30 September 2022 be noted;
- That no amendments to the current procedures are necessary as a result of the review of activities in 2022/23.

Timetable	
Meeting	***Date***
Audit, Governance & Standards Committee	16 January 2023

Treasury Management Mid-Year Review 2022/23

- **CROSS-CUTTING ISSUES AND IMPLICATIONS**

Issue	Implications	Sign-off
Impact on Corporate Priorities	The Treasury Management Function ensures the safeguarding of Council finances and the liquidity of funds when liabilities become due to support the strategic plan objectives.	Head of Finance
Cross Cutting Objectives	The report recommendations support the achievements of all the cross-cutting objectives in the way stated above.	Head of Finance
Risk Management	Covered in the risk section of this report.	Head of Finance
Financial	This report relates to the financial activities of the council in respect of treasury management and specific financial implications are therefore detailed within the body of the report.	Section 151 Officer & Finance Team
Staffing	None	Head of Finance
Legal	Under Section 151 of the Local Government Act 1972 (LGA 1972) the Section 151 Officer has statutory duties in relation to the financial administration and stewardship of the authority, including securing effective arrangements for treasury management. The legal implications are detailed within the body of the report which is compliant with statutory and legal regulations such as the CIPFA Code of Practice on Treasury Management in Local Authorities. Appropriate remedial action should be taken if at any time it appears likely that expenditure will exceed available resources. The S151 Officer has a personal duty under Section 114(3) of the Local Government Finance Act 1988 to report to the Council if it appears that the set budget will be exceeded. Having received a S114 report, members are obliged to take all reasonable practical measures to bring the budget back into balance.	Interim Team Leader (Contentious and Corporate Governance)

Privacy and Data Protection	None	Policy and Information Team
Equalities	The recommendations do not propose a change in service therefore will not require an equalities impact assessment.	Equalities & Communities Officer
Public Health	None	Public Health Officer
Crime and Disorder	None	Head of Finance
Procurement	None	Head of Finance and Section 151 Officer
Biodiversity and Climate Change	There are no direct implications on biodiversity and climate change.	Biodiversity and Climate Change Manager

2. INTRODUCTION AND BACKGROUND

The Council has 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.

The Authority's Treasury Management Strategy for 2022/23 was approved at Council on 23rd February 2022. The Authority 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 is therefore central to the Authority's treasury management strategy.

This report has been written in accordance with the requirements of the Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management (revised 2017).

The primary requirements of the Code are as follows:

- Creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the Council's treasury management activities.

- Creation and maintenance of Treasury Management Practices which set out the manner in which the Council will seek to achieve those policies and objectives.

- Receipt by the full council of an annual Treasury Management Strategy Statement - including the Annual Investment Strategy and Minimum Revenue Provision Policy - for the year ahead, a Mid-year Review Report and an Annual Report, (stewardship report), covering activities during the previous year.

- Delegation by the Council of responsibilities for implementing and monitoring treasury management policies and practices and for the execution and administration of treasury management decisions.

- Delegation by the Council of the role of scrutiny of treasury management strategy and policies to a specific named body. For this Council the delegated body is the Audit, Governance and Standards Committee.

This mid-year report has been prepared in compliance with CIPFA's Code of Practice on Treasury Management, and covers the following:

An economic update for the first half of the 2022/23 financial year;

- A review of the Treasury Management Strategy Statement and Annual Investment Strategy;
- A review of the Council's investment portfolio for 2022/23;
- A review of the Council's borrowing strategy for 2022/23;
- A review of compliance with Treasury and Prudential Limits for 2022/23.

Economics Update

The second quarter of 2022/23 saw:

- Growth Domestic Product (GDP) revised upwards in Q1 2022/23 to +0.2% quarter on quarter 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;
- Consumer Price Inflation (CPI) increased to 9.9% year on year in August, having been 9.0% in April, but domestic price pressures showing little sign of abating in the near-term;
- The unemployment rate fall to a 48-year low of 3.6% due to a large shortfall in labour supply;
- Bank Rate rise by 100 basis points (bps) 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.

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

There are signs of higher energy prices creating more persistent downward effects in economic activity. Both industrial production (-0.3% month on month) and construction output (-0.8% month on month) 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.

The fall in the composite Purchasing Managers Index (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% quarter on quarter in Q3 and consumer confidence is at a record low. Retail sales volumes fell by 1.6% month on month 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.

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 3month year on year rate of average earnings growth rose from 5.2% in June to 5.5%.

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 $90per barrel, we would expect to see fuel prices fall further in the coming months.

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.

Nonetheless, the rise in services CPI inflation from 5.7% year on year in July to a 30-year high of 5.9% year on year 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 was 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.

The Monetary Policy Committee (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 Federal Reserve Board and European Central Bank 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.

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.

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.

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%.

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.

After a shaky start to the year, the Standard & Poors 500 and FTSE 100 climbed in the first half of Q2 2022/23 before falling to their lowest levels since November 2020 and July 2021 respectively. The S&P 500 is 7.2% below its level at the start of the quarter, whilst the FTSE 100 is 5.2% below it as the fall in the pound has boosted the value of overseas earnings in the index. The decline has, in part, been driven by the rise in global real yields and the resulting downward pressure on equity valuations as well as concerns over economic growth leading to a deterioration in investor risk appetite.

<u>Interest Rates</u>

- The Council's treasury advisor, Link Group, provided the following forecasts on 27th September 2022 (PWLB rates are certainty rates, gilt yields plus 80bps):

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

The Council has appointed Link Group as its treasury advisors 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 27th September 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.

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.

<u>Treasury Management Strategy Statement and Annual Investment Strategy Update</u>

The Treasury Management Strategy Statement, (TMSS), for 2020/21 was approved by this Council on 23rd February 2022 in accordance with the CIPFA Treasury Management Code of Practice, it sets out the Council's investment priorities as being:

- Security of capital
- Liquidity
- Yield

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, including a minimum sovereign credit rating and Credit Default Swap (CDS) overlay information.

Creditworthiness.

Following the Government's fiscal event on 23rd September, both S&P and Fitch have placed the UK sovereign debt rating on Negative Outlook, reflecting a downside bias to the current ratings in light of expectations of weaker finances and the economic outlook.

There are no policy changes required to the TMSS for 2022/23. The details in this report update the position of the treasury management function and the economic position.

Investment Portfolio

The council held investments totalling £38.75m at the start of the year which has reduced to £22.75m on 30th September 2022. Investment levels have reduced due to further repayments of grants to Central Government and Section 106 payments to the County Council during the quarter.

A full list of investments held at this time is shown in **Appendix A**. All investments are held in either short term notice accounts or money market funds, to be readily available to fund the Council's liabilities, including the capital programme.

Investment income to 30th September 2022 totals £150k against a budget of £50k with an average rate of 0.92%.

Increase in interest rates by the Bank of England has increased the returns received on the Council's short term investments. With the forecasted interest rate increase, this is set to continue.

Debt Portfolio

The Council's capital financing requirement (CFR) for 2022/23 is £94.093m. The CFR denotes the Council's underlying need to borrow for capital purposes. If the CFR is positive the Council may borrow from the Public Works Loans Board (PWLB) or the market (external borrowing) or from internal balances on a temporary basis (internal borrowing). In practice, owing to slippage in the capital programme, it is unlikely that borrowing on this scale will be required in practice.

The Council has long term borrowing currently external borrowing of £5m from other with the PWLB. It has also committed to £80m future borrowing with Aviva Life & Pensions UK Limited which will be spread as follows;

£40m -	February 2024
£20m -	February 2025
£20m -	February 2026

The interest rate forecast in the table under Interest Rates above show the bank rate peaking at 5% in September 2023, then starting to fall from December 2023. With current rates increasing, the Council are not looking to lock in any further borrowing (with the exception of short term liquidity purposes), and to use the Council's reserves where possible to fund the capital programme.

A list of the Council's current portfolio can also be found in **Appendix A**.

Prudential and Treasury Indicators

It is a statutory duty for the Council to determine and keep under review 'Affordable Borrowing Limits.' During the first six months of financial year 2022/23, the Council has operated within the prudential and treasury indicators set out in the Treasury Management Strategy Statement and in compliance with the Council's Treasury Management Practices. The prudential and treasury indicators can be found in **Appendix B**.

The Director of Finance & Business Improvement confirms no indicator has been breached in the first half of 2022/23.

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3. AVAILABLE OPTIONS

3.1 The Audit, Governance and Standard Committee agrees that no amendments to the current procedures are necessary as a result of a review of activities of the first 6 months of 2022/23.

3.2 The Audit, Governance and Standard Committee proposes changes to the current procedures as the result of a review of activities with the first 6 months of 2022/23.

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4. PREFERRED OPTION AND REASONS FOR RECOMMENDATIONS

4.1 The Audit, Governance and Standard Committee agrees that no amendments to the current procedures are necessary as a result of a review of activities of the first 6 months of 2022/23 as there are no justifications to make any changes.

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5. RISK

5.1 Risks are highlighted for the treasury management function within the Treasury Management Strategy Statement 2022/23 report. This report is purely for information purposes and has no risk management implications.

6. CONSULTATION RESULTS AND PREVIOUS COMMITTEE FEEDBACK

6.1 None

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7. NEXT STEPS: COMMUNICATION AND IMPLEMENTATION OF THE DECISION

7.1 If Audit, Governance and Standards Committee agrees that no change in current procedures with Treasury management will be made, then there will be no further action.

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8. REPORT APPENDICES

8.1 The following documents are to be published with this report and form part of the report:

- Appendix A - Investments-Borrowing 30th September 2022
- Appendix B - Prudential and Treasury Indicators

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9. BACKGROUND PAPERS

9.1 None