Report to:	**Cabinet**
Date:	**19 July 2023**
Title:	**Treasury Management Annual Report 2022/23**
Report of:	**Homira Javadi, Director of Finance and Performance (Chief Finance Officer)**
Cabinet Member:	**Councillor Robin Maxted, Cabinet Member for Finance**
Ward(s):	**All**
Purpose of report:	**To report on the activities and performance of the Treasury Management service during 2022/23**
Decision type:	**Budget and policy framework**
Officer recommendation(s):	**To recommend to Full Council (via Cabinet):** **1. That members consider and approve the Annual Treasury Management report 2022/23 for publication.** **2. To approve the 2022/23 Prudential and Treasury Indicators included in the report (Section 10.1).**
Reasons for recommendations:	**Requirement of CIPFA Treasury Management in the Public Sector Code of Practice (the Code).**
Contact Officer:	**Name: Steven Houchin** **Post title: Interim Deputy Chief Finance Officer** **E-mail: steven.houchin@lewes-eastbourne.gov.uk** **Telephone number: 01323 415378**

1 Introduction

1.1 This Council is required through regulations issued under the Local Government Act 2003 to produce an annual treasury report reviewing treasury management activities and the actual prudential and treasury indicators for 2022/23. This report meets the requirements of both the CIPFA Code of Practice on Treasury Management (the Code) and the CIPFA Prudential Code for Capital Finance in Local Authorities (the Prudential Code).

1.2 During 2022/23 the minimum reporting requirements were that the Full Council should receive the following reports:

- an annual treasury strategy in advance of the year (Council 23 February 2022)
- a mid-year (minimum) treasury briefing.

- an annual report following the year describing the activity compared to the strategy (this report).

1.3 In addition, Treasury Management updates are included in the quarterly performance management report and considered by the Cabinet.

1.4 The regulatory environment places responsibility on members for the review and scrutiny of treasury management policy and activities. This report is, therefore, important in that respect, as it provides details of the outturn position for treasury activities and highlights compliance with the Council's policies previously approved by members.

1.5 This Council also confirms that it has complied with the requirement under the Code to give prior scrutiny to all the above treasury management reports by the Audit & Governance Committee before they were reported to the Full Council. Member training on treasury management issues was undertaken on 24 October 2022, which is to support Members' scrutiny role. Further training will be undertaken in October 2023

1.6 This report summarises:

- Capital activities during the year.
- Impact of this activity on the Council's underlying indebtedness (the Capital Financing Requirement).
- The actual prudential and treasury indicators.
- Overall treasury position identifying how the Council has borrowed in relation to this indebtedness, and the impact on investment balances.
- Summary of interest rate movements in the year.
- Debt activity and investment activity.

2 EBC Capitalisation Direction

2.1 Like other local authorities, EBC had discussions with the Department for Levelling Up, Housing and Communities (DLUHC) about Capitalisation Directive to help in dealing with 2020/21 deficit and balance the budget in 2021/22. Other councils that have been harder hit by Covid-19 have also requested support using this means across both years.

2.2 A capitalisation directive permits a Council to capitalise revenue expenditure if it is unable to set a balanced budget, has considered all other options, has limited reserves, and is increasing its Council Tax by the maximum permitted. The direction will only be granted in exceptional circumstances, and only the Secretary of State can permit this action legally

2.3 The capitalisation was agreed by The Minister of State for Regional Growth and Local Government in February 2021 for the financial years 2020/21 and 2021/22. The table below details the allocation and usage of the directions for both years.

	Capitalisation Awarded £m	Capitalisation Utilised £m
2020/21	6.8	4.6
2021/22	6.0	3.0

2.4 These capitalisation figures are yet to be audited and any revisions to this amount will be reported at the relevant future committee meeting.

3 The Council's Capital Expenditure and Financing 2022/23

3.1 The Council undertakes capital expenditure on long-term assets. These activities may either be:

- Financed immediately through the application of capital or revenue resources (capital receipts, capital grants, revenue contributions etc.), which has no resultant impact on the Council's borrowing need; or
- If insufficient financing is available, or a decision is taken not to apply resources, the capital expenditure will give rise to a borrowing need (Capital Financing Requirement).

3.2 The actual capital expenditure forms one of the required prudential indicators. The table below shows the actual capital expenditure and how this was financed.

General Fund £'000	2021/22 Actual	2022/23 Budget	2022/23 Actual
Capital expenditure	23,315	11,442	6,854
Financed in year	(8,421)	(6,144)	(3,397)
Unfinanced capital expenditure	(14,894)	(5,298)	(3,457)

HRA £'000	2021/22 Actual	2022/23 Budget	2022/23 Actual
Capital expenditure	6,948	12,989	12,850
Financed in year	(6,948)	(11,478)	(10,116)
Unfinanced capital expenditure	-	(1,511)	(2,734)

4. The Council's Overall Borrowing Need

4.1 The Capital Financing Requirement (CFR) represents the Council's total underlying need to borrow to finance capital expenditure, i.e. capital expenditure that has not been resourced from capital receipts, capital grants and contributions or the use of reserves. Some of this borrowing is from the internal use of cash balances.

4.2 Part of the Council's treasury activities is to address the funding requirements for this borrowing need. Depending on the capital expenditure programme, the treasury service organises the Council's cash position to ensure sufficient cash is available to meet the capital plans and cash flow requirements. This may be sourced through borrowing from external bodies such as the Government, through the Public Works Loan Board (PWLB), the money markets, or utilising temporary cash resources within the Council.

4.3 **Reducing the CFR** – the Council's underlying borrowing need (CFR) is not allowed to rise indefinitely, with the exception of the Housing Revenue Account (HRA) CFR. Statutory controls are in place to ensure that capital assets are broadly charged to revenue over the life of the asset.

4.4 The Council is required to make an annual revenue charge, called the Minimum Revenue Provision (MRP), to reduce the CFR. This is effectively a repayment of the non-HRA borrowing need (there is no statutory requirement to reduce the HRA CFR). This differs from the treasury management arrangements which ensure that cash is available to meet capital commitments. External debt can also be borrowed or repaid at any time, but this does not change the CFR. The total CFR can also be reduced by:

- the application of additional capital financing resources (such as unapplied capital receipts); or
- charging more than the statutory revenue charge (MRP) each year through a Voluntary Revenue Provision (VRP).

4.5 The Council's 2022/23 MRP Policy (as required by Department for Levelling Up, Housing and Communities Guidance) was approved as part of the Treasury Management Strategy Report for 2022/23 on 23 February 2022. The Council's CFR for the year is shown below and represents a key prudential indicator.

CFR (£'000): General Fund	2021/22 Actual	2022/23 Budget	2022/23 Actual
Opening balance	130,996	135,586	135,181
Add unfinanced capital expenditure	14,894	5,298	3,457
Less MRP	(1,012)	(1,182)	-
Less Loan repayments	(9,291)	-	(191)
Closing balance	**135,586**	**139,702**	**138,447**

CFR (£'000): HRA	2021/22 Actual	2022/23 Budget	2022/23 Actual
Opening balance	47,804	47,804	48,210
Add unfinanced capital expenditure	-	1,511	2,734
Less MRP	-	-	-
Less Loan repayments	-	-	-
Closing balance	**47,804**	**49,315**	**50,944**

4.6 The borrowing activity is constrained by prudential indicators for net borrowing and the CFR, and by the Authorised Limit.

Net borrowing and the CFR - to ensure that borrowing levels are prudent over the medium term, the Council's external borrowing net of investments, must only be for a capital purpose. This essentially means that the Council is not borrowing to support revenue expenditure.

Net borrowing should not therefore, except in the short term, have exceeded the CFR for 2021/22 plus the expected changes to the CFR over 2022/23 and 2023/24. This indicator allows the Council some flexibility to borrow in advance of its immediate capital need in 2022/23. The table below highlights the Council's net borrowing position against the CFR. The Council has complied with this prudential indicator.

£'000	2021/22 Actual	2022/23 Budget	2022/23 Actual
General Fund Borrowing	71,027		62,838
HRA Borrowing	48,210		50,944
Total Gross borrowing position	119,237	119,700	113,784
CFR	183,391	189,018	189,391
Over / (Under) Funding of CFR	(64,154)	(69,318)	(75,607)

4.7 **The Authorised limit** - the Authorised limit is the "affordable borrowing limit" required by s3 of the Local Government Act 2003. The Council does not have the power to borrow above this level. The table below demonstrates that during 2022/23 the Council has maintained gross borrowing within its Authorised limit.

The operational boundary – the operational boundary is the expected borrowing position of the Council during the year. Periods where the actual position is either below or over the boundary is acceptable subject to the Authorised limit not being breached.

Actual financing costs as a proportion of net revenue stream - this indicator identifies the trend in the cost of capital (borrowing and other long-term obligation costs net of investment income) against the net revenue stream.

£'000	2022/23
Authorised limit	230,900
Maximum gross borrowing position during the year	119,237
Operational boundary	209,900
Average gross borrowing position	116,510
GF Financing costs as a proportion of net revenue stream	2.8%
HRA financing costs as a proportion of rental income	10.7%
Income from Commercial and Service Delivery Investments as a proportion of net revenue stream	11.9%

5 Treasury Position as at 31 March 2023

5.1 The Council's debt and investment position is organised by staff within Financial Services to ensure adequate liquidity for revenue and capital activities, security for investments and to manage risks within all treasury management activities.

5.2 Procedures and controls to achieve these objectives are well established both through Member reporting detailed in the summary, and through officer activity detailed in the Council's Treasury Management Practices. At the beginning and the end of 2022/23, the Council 's treasury position was as follows:

DEBT PORTFOLIO	31/3/22 Principal	Rate/ Return %	31/3/23 Principal	Rate/ Return %
Fixed rate funding:				
-PWLB	119,237		113,784	
-Market	-		-	
Total debt	**119,237**		**113,784**	
CFR	**183,391**		**189,391**	
Over / (under) borrowing	**(64,154)**		**(75,607)**	
Total investments	14,861	0.11%	4,112	1.33%
Net debt	104,375		109,671	

5.3 The maturity structure of the debt portfolio was as follows:

	31/3/22 Actual £'000	2022/23 Original limits £'000	31/3/23 Actual £'000
Under 12 months	3,000	-	-
12 months and within 24 months	-	380	380
24 months and within 5 years	1,141	1,141	1,141
5 years and within 10 years	951	571	571
10 years and within 20 years	31,068	28,616	28,616
20 years and within 30 years	571	761	761
30 years and within 40 years	34,505	40,315	40,315
40 years and within 50 years	48,000	42,000	42,000

The exposure to fixed and variable rates was as follows:

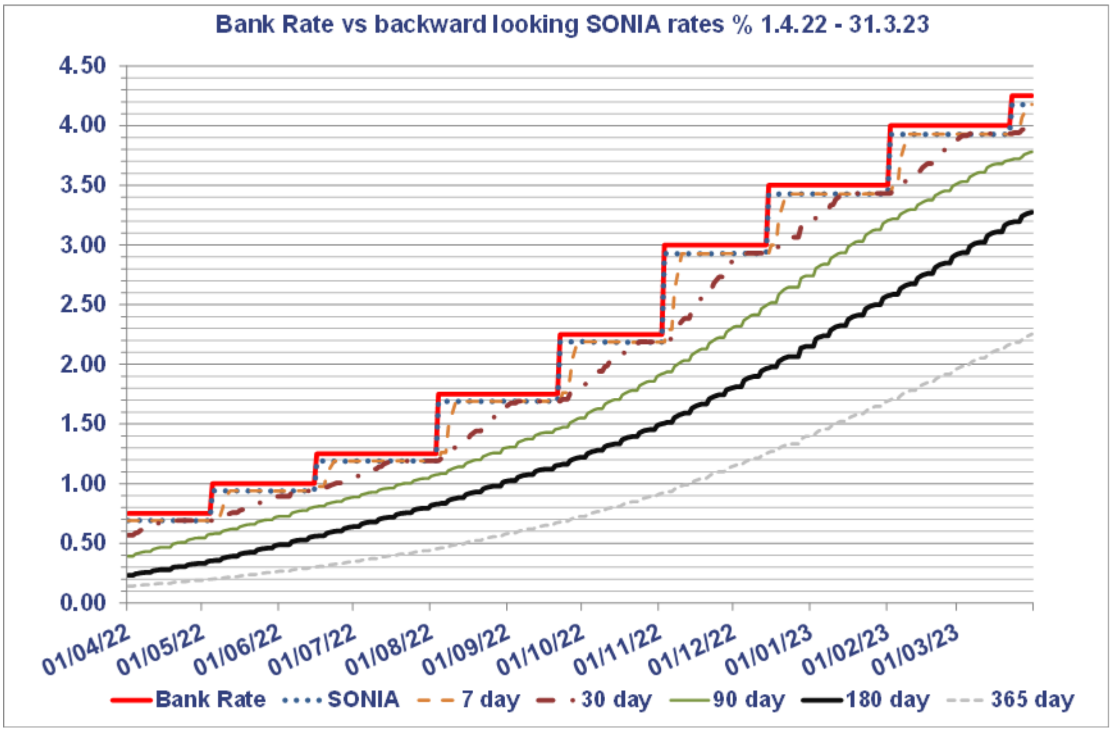
	31 March 2022 Actual £'000	31 March 2023 Actual £'000
Principal - Debt Fixed rate	119,237	113,784
Principal – Investments Variable rate	0	0

6 Investment Strategy and Control of Interest Rate Risk

6.1 The investment strategy during the financial year referred to the core balance and cash flow requirements and the outlook for short-term interest rates (i.e. rates for investments up to 12 months). Whilst greater returns are usually obtainable by investing for longer periods, there was the greater emphasis on ensuring cash balances were available to manage the ups and downs of the council's cash flow. Where cash sums were identified that could be invested for longer periods, the value to be obtained from longer term, investments were carefully assessed.

6.2 Investment returns picked up throughout the course of 2022/23 as central banks, including the Bank of England, realised that inflationary pressures were not transitory, and that tighter monetary policy was called for. Starting in April at 0.75%, the Bank Rate moved up in stepped increases of either 0.25% or 0.5%, reaching 4.25% by the end of the financial year, with the potential for a further one or two increases in 2023/24.

6.3 The tables below illustrate the change in Sterling Overnight Index Average (SONIA) compared to the Bank of England Base Rate throughout the year.



FINANCIAL YEAR TO QUARTER ENDED 31/03/2023							
	Bank Rate	SONIA	7 day	30 day	90 day	180 day	365 day
High	4.25	4.18	4.18	4.00	3.78	3.27	2.25
High Date	23/03/2023	31/03/2023	31/03/2023	31/03/2023	31/03/2023	31/03/2023	31/03/2023
Low	0.75	0.69	0.69	0.57	0.39	0.23	0.14
Low Date	01/04/2022	28/04/2022	29/04/2022	01/04/2022	01/04/2022	01/04/2022	01/04/2022
Average	2.30	2.24	2.20	2.09	1.81	1.42	0.90
Spread	3.50	3.49	3.49	3.43	3.39	3.04	2.11

6.4 The sea-change in investment rates meant local authorities were faced with the challenge of pro-active investment of surplus cash for the first time in over a decade, and this emphasised the need for a detailed working knowledge of cashflow projections so that the appropriate balance between maintaining cash for liquidity purposes, and "laddering" deposits on a rolling basis to lock in the increase in investment rates as duration was extended, became an on-going feature of the investment landscape.

6.5 With bond markets selling off, equity valuations struggling to make progress and, latterly, property funds enduring a wretched Q4 2022, the more traditional investment options, such as specified investments (simple to understand, and less than a year in duration) became more actively used.

6.6 Meantime, through the autumn, and then in March 2023, the Bank of England maintained various monetary policy easing measures as required to ensure specific markets, the banking system and the economy had appropriate levels of liquidity at times of stress.

6.7 This authority does not have sufficient cash balances to be able to place deposits for more than a month to earn higher rates from longer deposits. Nonetheless, while the Council has taken a cautious approach to investing, it is also fully appreciative of changes to regulatory requirements for financial institutions in terms of additional capital and liquidity that came about in the aftermath of the 2008/9 Financial Crisis. These requirements have provided a far stronger basis for financial institutions, with annual stress tests by regulators evidencing how institutions are now far more able to cope with extreme stressed market and economic conditions.

7 <u>Borrowing Strategy and Control of Interest Rate Risk</u>

7.1 During 2022/23, the Council maintained an under-borrowed position. This meant that the capital borrowing need, (the Capital Financing Requirement), was not fully funded with loan debt as cash supporting the Council's reserves, balances and cash flow was used as an interim measure. This strategy was prudent as investment returns were very low and minimising counterparty risk on placing investments also needed to be considered.

7.2 The policy of avoiding new borrowing by running down spare cash balances has served the Council well over the last few years. However, this was kept under review to avoid incurring higher borrowing costs in the future when this authority may not be able to avoid new borrowing to finance capital expenditure and/or the refinancing of maturing debt.

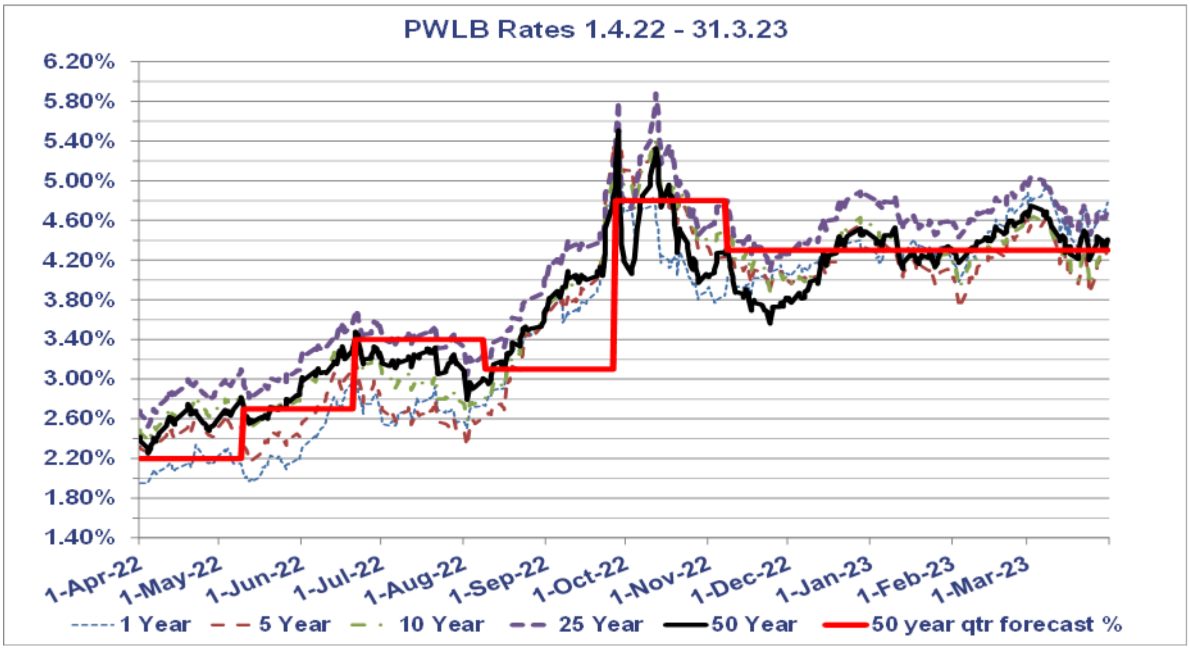
7.3 The Council has not borrowed more than, or in advance of its needs, purely to profit from the investment of the extra sums borrowed. No new loans were drawn down from PWLB in 2022/23 to fund the net unfinanced capital expenditure and/or to replace maturing loans. Various temporary loans were taken to cover cash flow requirements.

7.4 In taking this decision, the Council carefully considered achieving best value, the risk of having to borrow at higher rates at a later date, the carrying cost of the difference between interest paid on such debt and interest received from investing funds which would be surplus until used, and that the Council could ensure the security of such funds placed on temporary investment.

8 Interest Rates

8.1 Interest rate forecasts were initially suggesting only gradual rises in short, medium, and longer-term fixed borrowing rates during 2022/23 but by August it had become clear that inflation was moving up towards 40-year highs, and the Bank of England engaged in monetary policy tightening at every Monetary Policy Committee meeting during 2022, and into 2023, either by increasing Bank Rate by 0.25% or 0.5% each time. Currently the CPI measure of inflation is still above 10% in the UK but is expected to fall back towards 4% by year end. Nonetheless, there remain significant risks to that central forecast.

8.2 The tables below illustrate change in PWLB rates throughout the year.



	1 Year	5 Year	10 Year	25 Year	50 Year
Low	1.95%	2.18%	2.36%	2.52%	2.25%
Date	01/04/2022	13/05/2022	04/04/2022	04/04/2022	04/04/2022
High	5.11%	5.44%	5.45%	5.88%	5.51%
Date	28/09/2022	28/09/2022	12/10/2022	12/10/2022	28/09/2022
Average	3.57%	3.62%	3.76%	4.07%	3.74%
Spread	3.16%	3.26%	3.09%	3.36%	3.26%

8.3 PWLB rates are based on gilt (UK Government bonds) yields through HM Treasury determining a specified margin to add to gilt yields. The main influences on gilt yields are Bank Rate, inflation expectations and movements in US treasury yields.

8.4 Inflation targeting by the major central banks has been successful over the last 30 years in lowering inflation and the real equilibrium rate for central rates has fallen considerably due to the high level of borrowing by consumers: this means that central banks do not need to raise rates as much now to have a major impact on consumer spending, inflation, etc.

8.5 This has pulled down the overall level of interest rates and bond yields in financial markets over the last 30 years. Indeed, in recent years many bond yields up to 10 years in the Eurozone turned negative on expectations that the EU would struggle to get growth rates and inflation up from low levels.

8.6 In addition, there has, at times, been an inversion of bond yields in the US whereby 10-year yields have fallen below shorter-term yields. In the past, this has been a precursor of a recession.

8.7 However, since early 2022, yields have risen dramatically in all the major developed economies, first as economies opened post-Covid; then because of the inflationary impact of the war in Ukraine in respect of the supply side of many goods. In particular, rising cost pressures emanating from shortages of energy and some food categories have been central to inflation rising rapidly. Furthermore, at present the FOMC, ECB and Bank of England are all being challenged by persistent inflation that is exacerbated by very tight labour markets and high wage increases relative to what central banks believe to be sustainable.

8.8 There is likely to be a fall in gilt yields and PWLB rates across the whole curve over the next one to two years as Bank Rate first rises to dampen inflationary pressures and a tight labour market, and is then cut as the economy slows, unemployment rises, and inflation (on the Consumer Price Index measure) moves closer to the Bank of England's 2% target.

8.9 As a general rule, short-dated gilt yields will reflect expected movements in Bank Rate, whilst medium to long-dated yields are driven primarily by the inflation outlook.

8.10 The Bank of England is also embarking on a process of Quantitative Tightening, but the scale and pace of this has already been affected by the Truss/Kwarteng "fiscal experiment" in the autumn of 2022 and more recently by the financial market unease with some US (e.g., Silicon Valley Bank) and European banks (e.g., Credit Suisse).

8.11 The gradual reduction of the Bank's original £895bn stock of gilt and corporate bonds will be sold back into the market over several years. The impact this policy will have on the market pricing of gilts, while issuance is markedly increasing, is an unknown at the time of writing.

9 Investment Outturn for 2022/23

9.1 **Investment Policy** – the Council's investment policy is governed by DLUHC guidance, which was been implemented in the annual investment strategy approved by the Council on 9 February 2022. This policy sets out the approach for choosing investment counterparties and is based on credit ratings provided by the three main credit rating agencies supplemented by additional market data (such as rating outlooks, credit default swaps, bank share prices etc.).

9.2 The investment activity during the year conformed to the approved strategy, and the Council had no liquidity difficulties.

9.3 **Resources** – the Council's longer-term cash balances comprise, primarily, revenue and capital resources, although these will be influenced by cash flow considerations. The Council's core cash resources comprised as follows, and met the expectations of the budget:

Balance Sheet Resources - General Fund (£'000)	31/03/2022	31/03/2023
GF Balances	3,998	3,998
Earmarked reserves	8,791	6,176
Capital Grants & Contributions	3,882	7,373
Provisions	-	-
Usable capital receipts	-	-
Total	**16,672**	**17,547**

Balance Sheet Resources - HRA (£'000)	31/03/2022	31/03/2023
HRA Balances	5,492	3,366
Earmarked reserves	3,172	3,172
Major Repairs Reserve	2,598	2,246
Usable capital receipts	1,291	2,325
Total	**12,554**	**11,109**

9.4 **Investments held by the Council**

9.5 Both the CIPFA Code and government guidance require the Authority 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 Authority'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.

9.6 At 31 March 2023 the Council held investments totalling £34.949m in a mixture of Treasury and Non-Treasury investments illustrated in the tables below. Interest received on Treasury Investments was £0.18m in 2022/23 compared to £0.01m in the previous year because of base rate increases during the financial year. Interest received on Non-Treasury Investments was £1.34m in 2022/23 compared to

£1.12m in the previous year. Additional interest was on loans to a subsidiary company.

	31/03/2022 Actual £'000	31/03/2022 Actual %	31/03/2023 Actual £'000	31/03/2023 Actual %
Treasury investments				
Banks	5,361	36.1%	4,112	100.0%
DMADF (H M Treasury)	9,500	63.9%	-	0.0%
Total managed in house	**14,861**	**100.0%**	**4,112**	**100.0%**
Total managed externally	-	0.0%	-	0.0%
Total Treasury Investments	**14,861**	**100%**	**4,112**	**100%**
Non-Treasury investments				
Third party loans	2,535	8.2%	2,499	8.1%
Subsidiaries	28,493	91.8%	28,338	91.9%
Companies	-	0.0%	-	0.0%
Property	-	0.0%	-	0.0%
Total Non-Treasury Investments	**31,028**	**100.0%**	**30,837**	**100.0%**
Total Investments	**45,889**	**100%**	**34,949**	**100%**

10 Executive Summary and Conclusion

10.1 During 2022/23, the Council complied with its legislative and regulatory requirements. The key actual prudential and treasury indicators detailing the impact of capital expenditure activities during the year, with comparators, are as follows:

Prudential and treasury indicators	31.3.22 Actual £'000	2022/23 Original £'000	31.3.23 Actual £'000
Capital expenditure: Non-HRA	23,315	11,442	6,854
Capital expenditure: HRA	6,948	12,989	12,850
Capital expenditure: **Total**	**30,263**	**24,431**	**19,704**
Capital Financing Requirement: Non-HRA	135,586	139,702	138,447
Capital Financing Requirement: HRA	47,804	49,315	50,944
Capital Financing Requirement: **Total**	**183,391**	**189,018**	**189,391**
Gross borrowing	153,127	164,587	169,687

External debt	119,237	-	113,784
Treasury Investments - Longer than 1 year	9,500	-	-
Treasury Investments - Under 1 year	5,361	-	4,112
Treasury Investments -Total	14,861	-	4,112
Net borrowing	**104,375**		**109,671**

10.2 Other prudential and treasury indicators are to be found in the main body of this report. The Chief Finance Officer also confirms that borrowing was only undertaken for a capital purpose and the statutory borrowing limit (the Authorised limit), was not breached. The financial year 2022/23 continued the challenging environment of previous years; low investment returns, and continuing counterparty risk continued.

11 The Economy and Interest Rates Forecast

11.1 The Council's treasury advisor, Link, provides the Economy and Interest Rates Forecast, which is attached as Appendix A.

12 Other

12.1 **IFRS 9 fair value of investments:** Following the consultation undertaken by the Department of Levelling Up, Housing and Communities [DLUHC] on IFRS 9, the Government has extended the mandatory statutory override for local authorities to reverse out all unrealised fair value movements resulting from pooled investment funds to 31st March 2025. Local authorities are required to disclose the net impact of the unrealised fair value movements in a separate unusable reserve throughout the duration of the override in order for the Government to keep the override under review and to maintain a form of transparency.

12.2 **IFRS 16:** The implementation of the new IFRS 16 Leases accounting standard to currently off-balance sheet leased assets onto the balance sheet was due to come into force for local authorities from 1st April 2022. Following a consultation of CIFPA/LASAAC it was agreed that implementation of the standard would be deferred until 1 April 2024, impacting financial statements for the period 2024/25 onwards.

13 Investment Consultants

13.1 The Council has a contract with Link Treasury Services Limited who act as the Council's Treasury Adviser. The Link Treasury Services has been appointed to support both the Lewes District Council and Eastbourne Borough Council, given that a shared finance team (with treasury management responsibility) has been established. The Link contract was extended on 30 May 2023 for a further two years.

14 Corporate plan and council policies

14.1 The priority themes were considered as part of the overall Capital Programme which forms part of the Treasury Management Strategy.

15 Financial appraisal

15.1 Financial appraisals were considered as part of the overall Capital Programme which forms part of the Treasury Management Strategy.

16 Legal implications

16.1 Comment from the Legal Services Team is not necessary for this routine monitoring report.

17 Risk management implications

17.1 Risks relating to the timing of borrowing and terms of borrowing are considered and advice is provided by Link. Risk management is considered for each of the schemes within the Capital Programme.

18 Equality analysis

18.1 Equality issues are considered.

19 Appendices

19.1

- Appendix A - The Economy and Interest Rates
- Appendix B – Glossary - Local Authority Treasury Management Terms

20 Background papers

20.1 The Background Papers used in compiling this report were as follows:

- CIPFA Treasury Management in the Public Services code of Practice (the Code)
- Cross-sectorial Guidance Notes
- CIPFA Prudential Code
- Treasury Management Strategy and Treasury Management Practices.
- Link Asset Services Citywatch and interest rate forecasts

Appendix A

The Economy and Interest Rates by Link Treasury Services Limited

Against a backdrop of stubborn inflationary pressures, the easing of Covid restrictions in most developed economies, the Russian invasion of Ukraine, and a range of different UK Government policies, it is no surprise that UK interest rates have been volatile right across the curve, from Bank Rate through to 50-year gilt yields, for all of 2022/23.

Market commentators' misplaced optimism around inflation has been the root cause of the rout in the bond markets with, for example, UK, EZ and US 10-year yields all rising by over 200bps in 2022. The table below provides a snapshot of the conundrum facing central banks, inflation is elevated but labour markets are extraordinarily tight, making it an issue of fine judgment as to how far monetary policy needs to tighten.

	UK	Eurozone	US
Bank Rate	4.25%	3%	4.75%-5%
GDP	0.1%q/q Q4 (4.1%y/y)	+0.1%q/q Q4 (1.9%y/y)	2.6% Q4 Annualised
Inflation	10.4%y/y (Feb)	6.9%y/y (Mar)	6.0%y/y (Feb)
Unemployment Rate	3.7% (Jan)	6.6% (Feb)	3.6% (Feb)

Q2 of 2022 saw UK GDP deliver growth of +0.1% q/q, but this was quickly reversed in the third quarter, albeit some of the fall in GDP can be placed at the foot of the extra Bank Holiday in the wake of the Queen's passing.

Q4 GDP was positive at 0.1% q/q. Most recently, January saw a 0.3% m/m increase in GDP as the number of strikes reduced compared to December. In addition, the resilience in activity at the end of 2022 was, in part, due to a 1.3% q/q rise in real household disposable incomes. A big part of that reflected the £5.7bn payments received by households from the government under the Energy Bills Support Scheme.

Nevertheless, CPI inflation picked up to what should be a peak reading of 11.1% in October, although hopes for significant falls from this level will very much rest on the movements in the gas and electricity markets, as well as the supply-side factors impacting food prices. On balance, most commentators expect the CPI measure of inflation to drop back towards 4% by the end of 2023. As of February 2023, CPI was 10.4%.

The UK unemployment rate fell through 2022 to a 48-year low of 3.6%, and this despite a net migration increase of c500k. The fact remains, however, that with many economic participants registered as long-term sickness, the UK labour force shrunk by c500k in the year to June. Without an increase in the labour force participation rate, it is hard to see how the UK economy will be able to grow its way to prosperity, and with average wage increases running at over 6% the MPC will be concerned that wage inflation will prove just as sticky as major supply-side shocks to food (up 18.3% y/y in February 2023) and energy that have endured since Russia's invasion of Ukraine on 22 February 2022.
Bank Rate increased steadily throughout 2022/23, starting at 0.75% and finishing at 4.25%.

In the interim, following a Conservative Party leadership contest, Liz Truss became Prime Minister for a tumultuous seven weeks that ran through September and October. Put simply, the markets did not like the unfunded tax-cutting and heavy spending policies put forward by her Chancellor, Kwasi Kwarteng, and their reign lasted barely seven weeks before being replaced by Prime Minister Rishi Sunak and Chancellor Jeremy Hunt. Their Autumn Statement of the 17th of November gave rise to a net £55bn fiscal tightening, although much of the “heavy lifting” has been left for the next Parliament to deliver. However, the markets liked what they heard, and UK gilt yields have reversed the increases seen under the previous tenants of No10/11 Downing Street, although they remain elevated in line with developed economies.

As noted above, GDP has been tepid throughout 2022/23, although the most recent composite Purchasing Manager Indices for the UK, US, EZ and China have all surprised to the upside, registering survey scores just above 50 (below suggests economies are contracting, and above suggests expansion). Whether that means a shallow recession, or worse, will be avoided is still unclear. Ultimately, the MPC will want to see material evidence of a reduction in inflationary pressures and a loosening in labour markets.

Realistically, that is an unlikely outcome without unemployment rising and wage settlements falling from their current levels. At present, the bigger rise in employment kept the ILO unemployment rate unchanged at 3.7% in January. Also, while the number of job vacancies fell for the ninth consecutive month in February, they remained around 40% above pre-pandemic levels.

Our economic analysts, Capital Economics, expect real GDP to contract by around 0.2% q/q in Q1 and forecast a recession this year involving a 1.0% peak-to-trough fall in real GDP.

Sterling has remained resilient of late, recovering from a record low of $1.035, on the Monday following the Truss government’s “fiscal event”, to $1.23. Notwithstanding sterling’s better run of late, 2023 is likely to see a housing correction of some magnitude as fixed-rate mortgages have moved above 4.5% and affordability has been squeezed despite proposed Stamp Duty cuts remaining in place.

As for equity markets, the FTSE 100 started 2023 strongly, rising to a record high of 8,014 on 20th February, as resilient data and falling inflation boosted earnings. But global equities fell sharply after concerns over the health of the global banking system emerged early in March. The fall in the FTSE 100 was bigger than the drop in the US S&P 500. Indeed, at around 7,600 now, the FTSE is 5.2% below its record high on 20th February, while the S&P 500 is only 1.9% lower over the same period. That’s despite UK banks having been less exposed and equity prices in the UK’s financial sector not falling as far. It may be due to the smaller decline in UK interest rate expectations and bond yields, which raise the discounted value of future earnings, compared to the US.

Appendix B

GLOSSARY

Local Authority Treasury Management Terms

Terms	Descriptions
Bond	A certificate of long-term debt issued by a company, government, or other institution, which is tradable on financial markets.
Borrowing	Usually refers to the stock of outstanding loans owed, and bonds issued.
CFR	Capital Financing Requirement. A council’s underlying need to hold debt for capital purposes, representing the cumulative capital expenditure that has been incurred but not yet financed. The CFR increases with capital expenditure and decreases with capital finance and MRP.
Capital gain or loss	An increase or decrease in the capital value of an investment, for example through movements in its market price.
Collective investment scheme	Scheme in which multiple investors collectively hold units or shares. The investment assets in the fund are not held directly by each investor, but as part of a pool (hence these funds are also referred to as ‘pooled funds’).
Cost of carry	When a loan is borrowed in advance of need, the difference between the interest payable on the loan and the income earned from investing the cash in the interim.
Counterparty	The other party to a loan, investment, or other contract.
Counterparty limit	The maximum amount an investor is willing to lend to a counterparty, to manage credit risk.
Covered bond.	Bond issued by a financial institution that is secured on that institution’s assets, usually residential mortgages, and is therefore lower risk than unsecured bonds.
CPI	Consumer Price Index - the measure of inflation targeted by the Monetary Policy Committee.
Deposit	A regulated placing of cash with a financial institution. Deposits are not tradable on financial markets.
Diversified income fund	A collective investment scheme that invests in a range of bonds, equity, and property in order to minimise price risk, and also focuses on investments that pay income.
Dividend	Income paid to investors in shares and collective investment schemes. Dividends are not contractual, and the amount is therefore not known in advance.
DMADF	Debt Management Account Deposit Facility – a facility offered by the DMO enabling councils to deposit cash at very low credit risk. Not available in Northern Ireland.
DLUHC	Department for Levelling Up, Housing and Communities (*formerly known as Ministry of Housing, Communities & Local Government - MHCLG*).
DMO	Debt Management Office – an executive agency of HM Treasury that deals with central government’s debt and investments.
Equity	An investment which usually confers ownership and voting rights

Terms	Descriptions
HRA	Housing Revenue Account – The means by which the Council records expenditure and income incurred through the running of the council's own housing stock and closely related services or facilities, which are provided primarily for the benefit of the council's own tenants.
Floating rate note (FRN)	Bond where the interest rate changes at set intervals linked to a market variable, most commonly 3-month LIBOR or SONIA
FTSE	Financial Times stock exchange – a series of indices on the London Stock Exchange. The FTSE 100 is the index of the largest 100 companies on the exchange, the FTSE 250 is the next largest 250 and the FTSE 350 combines the two.
GDP	Gross domestic product – the value of the national aggregate production of goods and services in the economy. Increasing GDP is known as economic growth.
Income Return	Return on investment from dividends, interest and rent but excluding capital gains and losses.
GILT	Bond issued by the UK Government, taking its name from the gilt-edged paper they were originally printed on.
LIBID	London interbank bid rate - the benchmark interest rate at which banks bid to borrow cash from other banks, traditionally 0.125% lower than LIBOR.
LIBOR	London interbank offer rate - the benchmark interest rate at which banks offer to lend cash to other banks. Published every London working day at 11am for various currencies and terms. Due to be phased out by 2022.
LOBO	Lender's Option Borrower's option
MMF	Money Market Funds. A collective investment scheme which invests in a range of short-term assets providing high credit quality and high liquidity. Usually refers to Constant Net Asset Value (CNAV) and Low Volatility Net Asset Value (LVNAV) funds with a Weighted Average Maturity (WAM) under 60 days which offer instant access, but the European Union definition extends to include cash plus funds.
Pooled Fund	Scheme in which multiple investors hold units or shares. The investment assets in the fund are not held directly by each investor, but as part of a pool (hence these funds are also referred to as 'pooled funds').
PWLB	Public Works Loan Board – a statutory body operating within the Debt Management Office (DMO) that lends money from the National Loans Fund to councils and other prescribed bodies and collects the repayments. Not available in Northern Ireland.
Quantitative easing (QE)	Process by which central banks directly increase the quantity of money in the economy to promote GDP growth and prevent deflation. Normally achieved by the central bank buying government bonds in exchange for newly created money.
SONIA	Sterling overnight interest average – a benchmark interest rate for overnight deposits.
Short-dated	Usually means less than one year.
Total return	The overall return on an investment, including interest, dividends, rent, fees and capital gains and losses.