Audit Committee
Tuesday 6 December 2022
Item No 5.1

Treasury Management Mid-Year Review Report 2022/23

Report by David Gladwin, Acting Chief Financial Officer

Report for Decision

1 Recommendations

Audit Committee is invited to comment on this report before it is presented to Council. In particular, Audit Committee should note the following recommendations which are proposed to be put to Council on 13 December 2022:-

a) Note the report and the treasury activity undertaken in the period to 30 September 2022, as outlined in Section 5;
b) Note the actual and forecast activity during the second-half of the year as outlined in Section 6;
c) Note the technical revisions to the Prudential Indicators in Section 7 of this report;
d) Note the updated Treasury Management Practices and the self-assessment tool on the scrutiny of Treasury Management as published by CIPFA and undertake a self-assessment in line with the tool.

2 Purpose of Report/Executive Summary

The purpose of this report is to inform members of the Audit Committee, and subsequently Council, of the Treasury Management activity undertaken during the first half of 2022/23 and the forecast activity for the second half of 2022/23 in accordance with the Treasury Management and Annual Investment Strategy approved by Council in February 2022. It also provides an update to the Treasury and Prudential Indicators for 2022/23.

Date: 21 November 2022
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3 Background

Audit Committee Role

The Prudential Code recommends that the main Treasury Management reports are presented for scrutiny by Audit Committee in advance of consideration by Council. This report is being presented to Audit Committee on 6 December 2022 for consideration prior to being presented to Council on 13 December 2022. Any revisions arising from Audit Committee consideration of the report on 6 December 2022 will be incorporated into the final version of the report to Council on 13 December 2022.

Treasury management

Treasury management is defined in the Prudential Code as:

> *"The management of the local authority's borrowing, investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks."*

The main function of the treasury management service is the funding of the Council's capital investment plans. These capital plans provide a guide to the borrowing need of the Council, essentially the longer term cash flow planning to ensure the Council can meet its capital spending operations. This management of this long term borrowing requirement involves arranging long or short term loans or using cash balances; and on occasion any debt previously drawn may be restructured to meet Council risk or cost objectives.

As the Council operates a balanced budget, this broadly means cash raised during the year will meet its cash expenditure. As part of the treasury management operations, officers ensure this cash flow is adequately planned, with available cash balances being deposited in low risk counterparties, providing adequate liquidity initially before considering optimising return on deposits.

Council, on 15 February 2022, approved the Treasury Management and Annual Investment Strategy Statement for the financial year 2022/23.

4 Economic update for first half of 2022/23

An economic update for the first part of the 2022/23 financial year is included as Appendix 1. PWLB borrowing rates for the first half of the year are outlined in Appendix 2, and Bank Rate / SONIA rates for the first half of the year are outlined in Appendix 3.

5 Treasury Activity during first half of 2022/23

The main points arising from treasury activity in the year to 30 September 2022 were:-

- Long term borrowing of £0.433 million matured, this £0.327 million of Market Loans, £0.083 million of Salix loans and £0.023 million PWLB Annuities;
- £90.000 million of new funds on deposit were placed with high credit-worthy banks, with approved counterparties in line with the 2022-23 Treasury Management and Annual Investment Strategy approved by Council on 15 February 2022;
- The average interest rate earned on external funds on deposit in the first half of the year was 1.37%, exceeding the benchmark rate of 1.01%.

<u>Loan Portfolio</u>

The Council's loan portfolio as at 30 September 2022 is shown in table 1 below (position at 31 March 2022 also shown for comparison):-

Table 1: Council's Loan Portfolio at 31 March 2022 and 30 September 2022.

Loan Type	**31 March 2022**		**30 September 2022**	
	Principal Outstanding £000's	**Weighted Average Rate**	**Principal Outstanding £000's**	**Weighted Average Rate %**
PWLB Annuity	553	8.91%	530	8.91%
PWLB Maturity	284,776	2.92%	284,776	2.92%
LOBO	20,000	4.51%	20,000	4.51%
Market Loans	17,542	2.68%	17,215	2.68%
Temporary Market Loans	0	n/a	0	n/a
Other Loans	400	0.00%	317	0.00%
Total Loans	**323,271**	**3.02%**	**322,838**	**3.01%**
Underlying Borrowing Requirement*	**307,247**		**319,801**	
Future Years' Borrowing Requirement Fully Financed (Over Borrowed)	**16,024**		**3,037**	

* *The Underlying Borrowing Requirement is the Capital Financing Requirement excluding the "Public Private Finance" (PPP) Contract Liabilities*

At 30 September 2022 the Council was over borrowed by £3.037 million (0.95%) – this is the extent to which the Council has financed its current and future borrowing requirement from long term loans. This position reflects the Council's £50.000 million long-term borrowing undertaken in December 2021 at historically low PWLB rates of 1.26%-1.36% to forward finance borrowing arising from the Council's capital plans.

As can be seen from PWLB rates during the first half of 2022/23 (ranging from a low of 2.52% to a high of 5.80% for 25 year borrowing), this strategy to lock into long-term borrowing at historically low interest rates in December 2021 has proved prudent and allowed the Council to defer any new long-term borrowing during the first half of 2022/23 at higher interest rates.

Debt Rescheduling

Debt rescheduling opportunities in the first half of the year have been limited, reflective of the various increases in the margins added to gilt yields which have impacted PWLB new borrowing rates since October 2010. No debt rescheduling has therefore been undertaken in the first half of the financial year.

Funds on Deposit

The Council's funds on deposit portfolio as at 30 September 2022 is shown in table 2 below (position at 31 March 2022 also shown for comparison):-

Table 2: Council's Funds on Deposit Portfolio at 31 March 2022 and 30 September 2022

Type	31 March 2022		30 September 2022	
	Principal Outstanding £000's	Weighted Average Rate	Principal Outstanding £000's	Weighted Average Rate %
Money Market Funds	30,323	0.52%	32,400	2.09%
Bank Call Accounts	31,059	0.64%	14	1.92%
Bank Notice Accounts	14,985	0.73%	14,985	0.87%
Bank Fixed Term Deposits	35,000	0.41%	80,000	1.77%
Bank Certificates of Deposit	0	n/a	10,000	2.85%
Deposits with other Local Authorities	45,000	1.56%	30,000	1.71%
Total Deposits	**156,367**	**0.84%**	**167,399**	**1.80%**

£80.000 million of Bank Fixed Term Deposits and £10.000 million of Bank Certificates of Deposit were placed in May/June 2022. These deposits were placed with approved counterparties in line with the 2022-23 Treasury Management and Annual Investment Strategy approved by Council on 15 February 2022.

Of this, £65.000 million were in relation to significantly higher levels of short-term surplus cash that the Council is holding due to Government Grant and other receipts that have been paid in advance, a position that is reflected across the majority of Scottish Local Authorities. These deposits were placed with strong credit-worthy counterparties for a short term laddered duration of between 5 and 6 months.

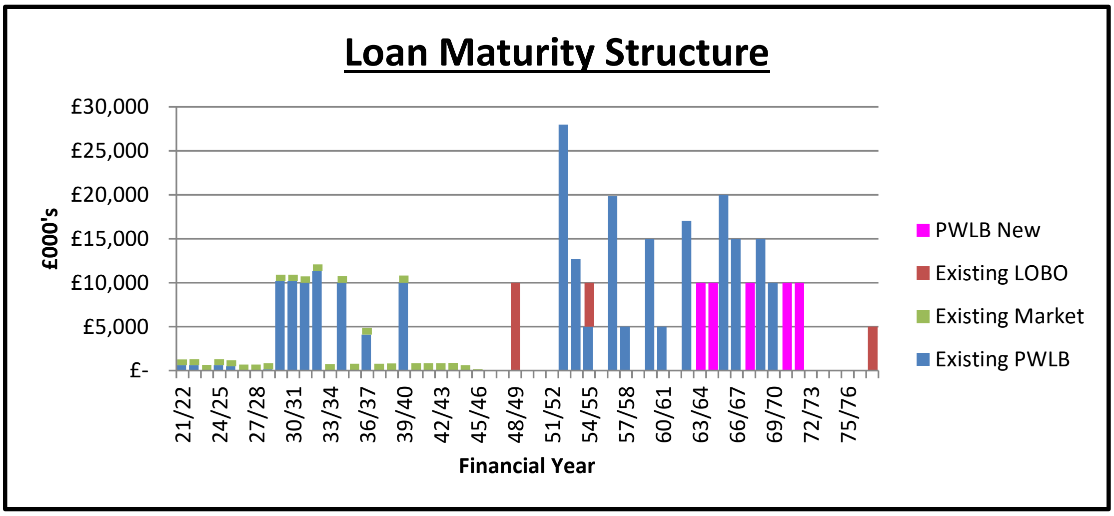
The remainder, £25.000 million, were placed for a period of 12 months, in line with the approved strategy to cash back the Council's useable reserves. These deposits were placed with strong credit-worthy counterparties with maturity of these funds extended into the early part of the 2023/24 financial year.

6 Actual/Expected Treasury Activity during second half of 2022/23

Borrowing

Long term borrowing of £1.084 million will mature in the second half of 2022/23, this being £0.648 million PWLB Maturities, £0.329 million of Market Loans, £0.082 million of Salix loans and £0.025 million PWLB Annuities.

Proactive Treasury Management by the Council in the last decade has placed the Council in an extremely strong refinancing position for its existing external debt portfolio, as can be noted in the table below, with only £5.414 million, or just 1.68%, of the Council's total Loan Portfolio of £322.838 million requiring refinancing over the remainder of the current, and forthcoming four, financial years.



Financial Year	2022/23 Remaining £000's	2023/24-2026/27 £000's	2027/28-2031/32 £000's	2032/33-2036/37 £000's	2037/38+ £000's
Debt Maturing	1,084	4,330	33,857	29,258	274,309
% of total portfolio	0.32%	1.26%	9.88%	8.53%	80.01%

This extremely low short-term exposure to refinancing risk puts the Council in a strong position to plan its borrowings in advance, take advantage of any dips in longer-term borrowing rates from PWLB and other sources, and maintain a low weighted average coupon rate on external debt.

It is expected that any further long-term borrowing that is undertaken in 2022/23 to finance the current & future year capital plans will be sourced by drawing long-term PWLB loans. Consideration for any new borrowing will balance (a) de-risking the longer term borrowing requirement at historically low longer term borrowing rates; against (b) the current year and forthcoming financial year budget projections. Council officers will continue to monitor daily long-term borrowing rates in order to take advantage of any dips in the market.

Appendix 4 provides forecasts for interest rates from the Council's Treasury Management advisor, Link Treasury Solutions Limited.

Debt Rescheduling

Now that the whole of the yield curve has shifted higher there may be opportunities for debt rescheduling in the future.

This would involve the Council repaying loans prematurely (both market and PWLB) whilst high discount rates on premature repayment prevail.

Any debt rescheduling will be considered when the difference between the refinancing rate and the redemption rate is most advantageous and the situation will be continually monitored in order to take advantage of any perceived anomalies in the yield curve. The reasons for any rescheduling taking place would include:

- the generation of cash savings at minimum risk;
- to reduce the average interest rate;
- to amend the maturity profile and /or the balance of volatility of the debt portfolio.

Council officers will explore debt rescheduling opportunities with Link Treasury Solutions; only prudent and affordable debt rescheduling that considers both the short and medium-longer term impact will be considered.

Funds on Deposit

In accordance with the Prudential and Treasury Management Codes, it is the Council's priority for funds on deposit to ensure security of capital first, then liquidity, and finally to obtain an appropriate level of return which is consistent with the Council's risk appetite.

£65.000 million of fixed term deposits held at 30 September 2022 mature in late October/November.

As noted in Section 5 above, these fixed term deposits were initially placed in early 2022/23 in relation to the significantly higher levels of short-term surplus cash that the Council is holding due to Government Grant and other receipts that have been paid in advance. As such, the expected application/utilisation of these balances are now expected to be longer in duration than normal. It is expected that these maturing deposits will be refinanced with strong credit-worthy counterparties in accordance with the list of Permitted Investments as approved by Council on 15 February 2022 in the 2022-23 Treasury Management and Annual Investment Strategy, with maturity of funds laddered into late 2022/23 and early 2023/24 to ensure the Council's cashflow requirements can be met, and earning a return commensurate with both these factors.

In addition, £27.985 million of fixed term deposits held at 30 September 2022 mature in late October/early December, and £15.000 million in March 2023. These fixed term deposits were originally placed in line with the currently approved strategy to cash-back the Council's reserves. Based on the expected future profile of the Council's reserves, and particularly the HRA and Capital Fund balances, it is expected that these deposits will be refinanced in line with the Council's current approved policy to cash-back reserves, with any new deposits placed with strong credit-worthy counterparties in accordance with the list of Permitted Investments parties as approved by Council on 15 February 2022 in the 2022/23 Treasury Management and Annual Investment Strategy, and with maturity of these funds extended into the latter half of the 2023/24 financial year, earning a return commensurate with the extended duration.

Day to day liquidity to meet cashflow requirements is sourced from the Council's three Money Market Funds, which all operate on an instant access basis. Interest rates receivable from these are currently between 2.83% and 3.00%, reflective of the increases to the Bank of England Base Rate throughout the 2022/23 financial year.

Given the accelerating interest rate environment Council officers, in conjunction with Link Treasury Solutions Limited, will continue to review the range of all options for funds on deposit available to the Council within its stated policy in the Treasury Management & Annual Investment Strategy approved by Council on 15 February 2022 in order to select appropriate creditworthy counterparties to ensure the security of Council funds, and from that list select the range of deposit products that offer best value to the Council's portfolio.

The Acting Chief Financial Officer confirms that the approved limits within the Annual Investment Strategy were not breached during the first 6 months of 2022/23.

An updated list of Countries for Deposits as at 21 November 2022 is included as Appendix 5. There are no changes from the list of Countries for Deposits as approved by Council in the 2022/23 TMSS in February 2022.

Expected Loan & Fund on Deposit Portfolio at 31 March 2023

Taking all of the above into account, the expected loans and funds on deposit portfolio at 31 March 2023 is shown in Tables 3 and 4 below:-

Table 3: Council's forecast Loan Portfolio at 31 March 2023

Loan Type	31 March 2023	
	Principal Outstanding £000's	**Weighted Average Rate**
PWLB Annuity	505	8.90%
PWLB Maturity	314,128	2.97%
LOBO	20,000	4.51%
Market Loans	16,886	2.68%
Temporary Market Loans	0	n/a
Other Loans	235	0.00%
Total Loans	**341,754**	**3.05%**
Underlying Borrowing Requirement	**359,008**	
Borrowing Requirement Financed Internally (Under Borrowed)	**17,254**	

Table 4: Council's forecast Funds on Deposit Portfolio at 31 March 2023

Type	31 March 2023	
	Principal Outstanding £000's	**Weighted Average Rate**
Money Market Funds	19,460	3.75%
Bank Call Accounts	0	n/a
Bank Notice Accounts	0	n/a
Bank Fixed Term Deposit Accounts	105,000	3.89%
Bank Certificates of Deposit	10,000	2.85%
Other Local Authority Fixed Term Deposits	2,000	1.60%
Total Deposits	**136,460**	**3.76%**

7 Prudential Indicators 2022/23

The following prudential indicators have been refreshed from those reported to Council on 15 February 2022 in the original Treasury Management and Annual Investment Strategy Statement 2022/23.

These are technical revisions to the Prudential Indicators as a consequence of the revisions to the Council's General Services and HRA Capital Plans and are based on the actual capital plan outturns for 2021/22, and revisions to the capital expenditure and income budgets for 2022/23.

Table 5: Prudential Indicators 2022/23 – Mid Year Update

Indicator	**2022/23 Original Estimate £000's**	**2022/23 Current Position £000's**	**2022/23 Revised Estimate £000's**
2022/23 Capital Expenditure	193,134	21,010	93,433
2022/23 Required Borrowing	153,098	15,317	57,427
2022/23 Underlying Borrowing Requirement*	460,381	319,801	359,008
2022/23 Gross External Borrowing	460,381	322,838	341,754
2022/23 Over/(Under) Borrowing	0	3,037	-17,254
Operational Boundary – Borrowing	460,381	359,008	359,008
2022/23 Capital Financing Requirement**	552,814	417,135	451,441

** Excludes "On balance sheet" PPP schemes.*
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The **Capital Financing Requirement (CFR)** denotes the Council's underlying need to borrow for capital purposes. The CFR includes borrowing arising as a result of the Council's Capital Plans, plus the long-term liability arising from the Council's PPP and DBFM contracts. The Underlying Borrowing Requirement strips out the latter of these (long-term liability arising from the two PPP contracts) from the CFR.

8 Other Treasury related issues

Prudential and Treasury Management Code Revisions

CIPFA, in late 2021 and early 2022, released the new editions of the Treasury Management Code and Prudential Code, along with the Treasury Management Guidance Note for Local Authorities.

CIPFA expect the Codes to be fully effective from the start of the 2023/24 financial year.

The main areas of the Code that have been updated are as previously noted to Council, including TMP 1 for Environmental, Social & Governance considerations, TMP 10 Knowledge and Skills schedule, and the separation of Treasury Management Investments and Non-Treasury Management Investments. The Council's updated Treasury Management Practices are included as Appendix 6 to this report, which reflects these updates to the Code.

The revised suite of Prudential & Treasury Management Indicators (including new indicators for (i) Long-Term Investments, (ii) Net Income as a Percentage of Net General Services Revenue Stream, and (iii) The Liability Benchmark), will be reported as part of the Treasury Management and Investment Strategy & Prudential Indicators 2023/24 presented to Council in February 2023, to ensure full implementation of the requirements of the Codes for the 2023/24 financial year.

In addition, CIPFA have recently published a document covering Effective Scrutiny of Treasury Management, which is a self-assessment tool to support the development of effective scrutiny. This is attached as Appendix 7 to this report. There are several ways in which it can be used, as noted in the CIPFA publication, and Audit Committee are recommended to undertake a self-assessment using the tools within the CIPFA publication.

9 Summary

Treasury Management activity during the year to 30 September 2022 has been effective within the parameters set by the strategy for the year.

Any further long-term borrowing for the remainder of 2022/23 will be in line with the approved strategy, and reflective of the borrowing requirement arising from the General Services and HRA capital plans reported to Council on 15 November 2022.

Officers will continue to review the opportunities available to the Council for deposit of funds as governed by the approved strategy.

The Prudential Indicators have been updated to reflect current capital expenditure and income projections.

10 Report Implications

10.1 Resource

Revenue expenditure and variance against revenue budget as a consequence of treasury management activity is reported to Council in the regular quarterly financial reports. The quarter 2 positions for the General Fund and the Housing Revenue account were presented to Council on 15 November 2022.

10.2 Digital

None.

10.3 Risk

As the Council follows the requirements of the CIPFA Code of Practice for Treasury Management, and the Prudential Code, there is a reduced level of risks involved in Treasury Management activities. Those risks that do exist are further controlled through written Treasury Management Practices which define the responsibilities of all staff involved, which are updated and attached as Appendix 5 of this report, reflecting the revised Prudential and Treasury Management Codes.

As part of their wider scope audit procedures for 2021/22, the Council's external auditors carried out an interim review of the Council's Treasury Management activity in 2021/22. This reviewed four key areas, with no material findings reported.

10.4 Ensuring Equalities

There are no equalities issues arising directly from this report.

10.5 Additional Report Implications

See Appendix A.

Appendix A: Report Implications

A.1 Key Priorities within the Single Midlothian Plan

Not applicable.

A.2 Key Drivers for Change

A.3 Key Delivery Streams

Themes addressed in this report:

- ☐ One Council Working with you, for you
- ☒ Preventative and Sustainable
- ☐ Efficient and Modern
- ☐ Innovative and Ambitious
- ☐ None of the above

A.4 Delivering Best Value

The report does not directly impact on Delivering Best Value.

A.5 Involving Communities and Other Stakeholders

Although no external consultation has taken place, cognisance has been taken of professional advice obtained from Link Treasury Solutions Limited, the Council's appointed Treasury Consultants.

A.6 Impact on Performance and Outcome

The strategies adopted are an integral part of the corporate aim to achieve Best Value as they seek to minimise the cost of borrowing by exercising prudent debt management and investment. This in turn helps to ensure that the Council's capital expenditure is sustainable in revenue terms.

A.7 Adopting a Preventative Approach

Not applicable.

A.8 Supporting Sustainable Development

Not applicable.

Background Papers:

Appendix 1: Economic Update for first part of 2022/23 financial year
Appendix 2: PWLB Borrowing Rates 1 April 2022 to 30 September 2022
Appendix 3: Bank Rate and SONIA Rates 1 April 2022 to 30 September 2022
Appendix 4: Link Treasury Solutions Limited Interest Rate Forecasts
Appendix 5: Approved Countries for Deposits as at 18 November 2022
Appendix 6: Treasury Management Practices
Appendix 7: Effective Scrutiny of Treasury Management (CIPFA)

Appendix 1: Economic Update for first part of 2022/23 financial year

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 fall 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.

The UK economy grew by 0.2% q/q 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% 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.

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.

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%.

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.

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% 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.

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 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.

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.

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.

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.

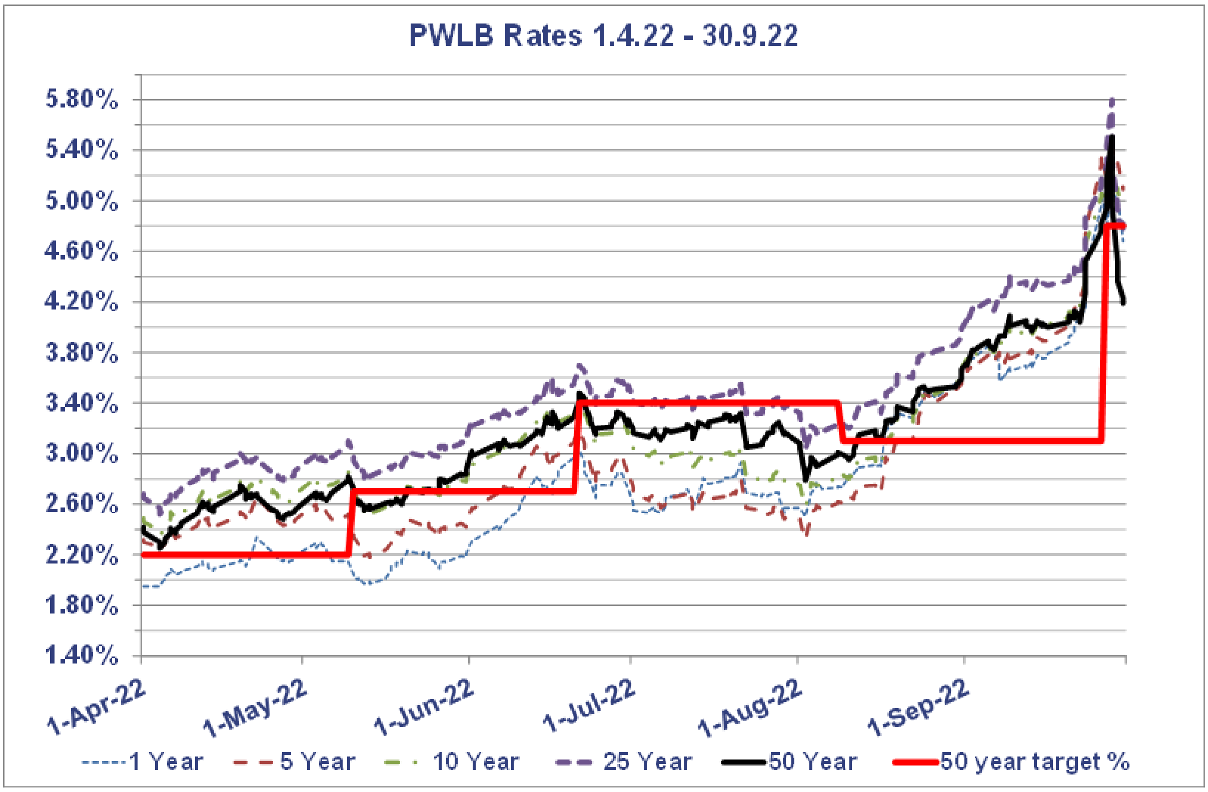
After a shaky start to the year, the S&P 500 and FTSE 100 climbed in the first half of Q2 2022/23 before falling to their lowest levels since November 2020 and July 2021 respectively. The S&P 500 is 7.2% below its level at the start of the quarter, whilst the FTSE 100 is 5.2% below it as the fall in 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.

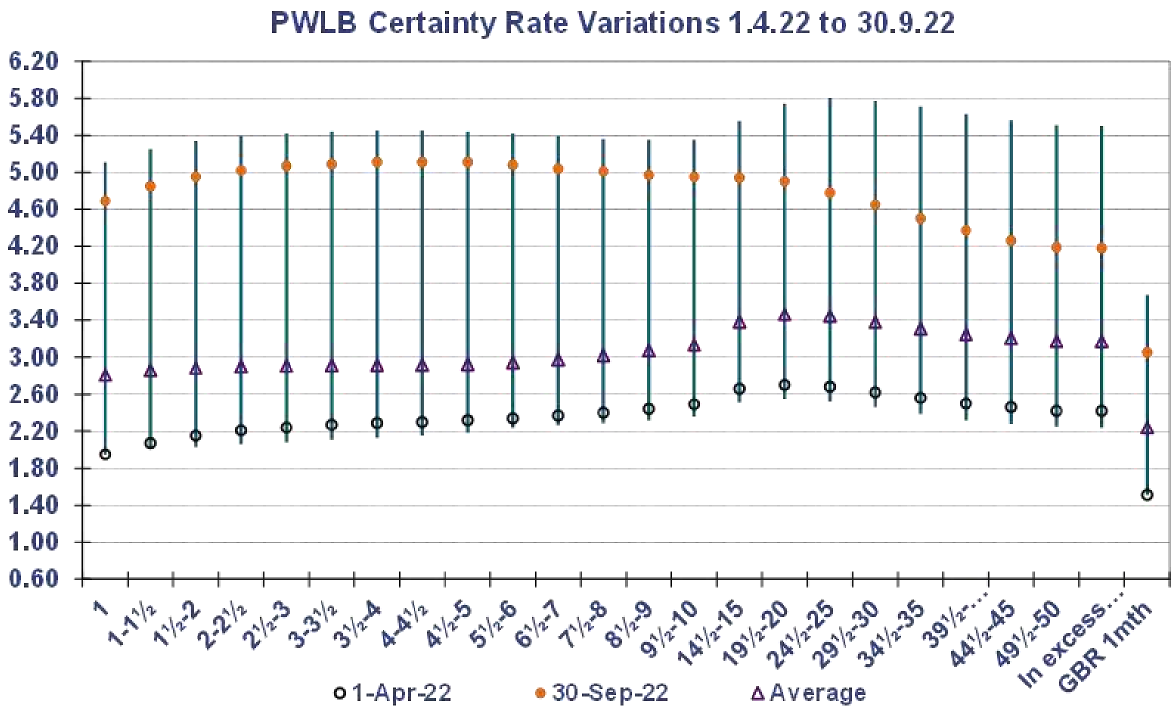
Appendix 2: PWLB Borrowing Rates 1 April 2022 to 30 September 2022

The graphs and table below show the movement in PWLB certainty rates for the first six months of the year to date:

PWLB certainty rates 1 April 2022 to 30th September 2022

	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%	5.35%	5.80%	5.51%
Date	28/09/2022	28/09/2022	28/09/2022	28/09/2022	28/09/2022
Average	2.81%	2.92%	3.13%	3.44%	3.17%
Spread	3.16%	3.26%	2.99%	3.28%	3.26%



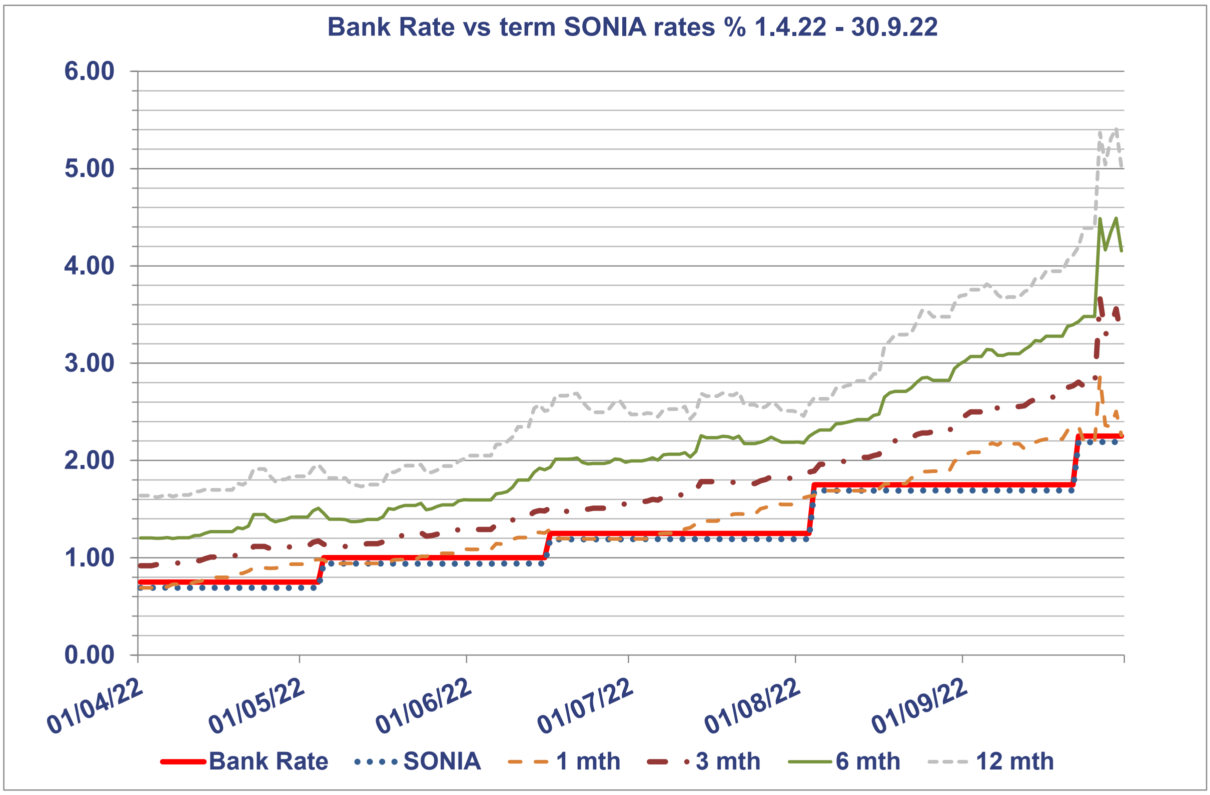


Gilt yields and PWLB rates were on a rising trend between 1st April and 30th September.

The 50-year PWLB target certainty rate for new long-term borrowing started 2022/23 at 2.20% before increasing to 4.80% in September.

Appendix 3: Bank Rate and SONIA Rates 1 April 2022 to 30 September 2022

The graphs and table below show the movement in Bank and SONIA rates for the first six months of the year to date:



QUARTER ENDED 30/9/2022

	Bank Rate	SONIA	1 mth	3 mth	6 mth	12 mth
High	2.25	2.19	2.86	3.67	4.49	5.41
High Date	22/09/2022	30/09/2022	26/09/2022	26/09/2022	29/09/2022	29/09/2022
Low	0.75	0.69	0.69	0.92	1.20	1.62
Low Date	01/04/2022	28/04/2022	01/04/2022	01/04/2022	07/04/2022	04/04/2022
Average	1.28	1.22	1.39	1.70	2.12	2.62
Spread	1.50	1.50	2.17	2.75	3.29	3.79

Appendix 4: Link Treasury Solutions Limited Interest Rate Forecasts

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.

Link Group Interest Rate View	08.11.22												
	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24	Jun-24	Sep-24	Dec-24	Mar-25	Jun-25	Sep-25	Dec-25
BANK RATE	3.50	4.25	4.50	4.50	4.50	4.00	3.75	3.50	3.25	3.00	2.75	2.50	2.50
3 month ave earnings	3.60	4.30	4.50	4.50	4.50	4.00	3.80	3.30	3.00	3.00	2.80	2.50	2.50
6 month ave earnings	4.20	4.50	4.60	4.50	4.20	4.10	3.90	3.40	3.10	3.00	2.90	2.60	2.60
12 month ave earnings	4.70	4.70	4.70	4.50	4.30	4.20	4.00	3.50	3.20	3.10	3.00	2.70	2.70
5 yr PWLB	4.30	4.30	4.20	4.10	4.00	3.90	3.80	3.60	3.50	3.40	3.30	3.20	3.10
10 yr PWLB	4.50	4.50	4.40	4.30	4.20	4.00	3.90	3.70	3.60	3.50	3.40	3.30	3.20
25 yr PWLB	4.70	4.70	4.60	4.50	4.40	4.30	4.10	4.00	3.90	3.70	3.60	3.50	3.50
50 yr PWLB	4.30	4.40	4.30	4.20	4.10	4.00	3.80	3.70	3.60	3.40	3.30	3.20	3.20

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.

On 2 November 2022, the Bank of England's Monetary Policy Committee (MPC) increased Bank Rate to 3.00% from 2.25%. The increase reflected a split vote – seven members voting for a 75 basis points increase, one for 50 basis points and one for 25 basis points. The MPC continues to grapple with getting inflation back on track over a three-year horizon.

Moreover, the UK has a new Prime Minister, Rishi Sunak, a new Chancellor, Jeremy Hunt, and new fiscal policies that seek to ensure that the public finances are kept on a sound footing and that any projected gaps are fully funded from services efficiencies and/or net tax increases.

In the interim period, since the end of September, the Government scrapped the reduction in the basic rate of income tax by 1p in the £; maintained the higher band 45p in the £ income tax rate; did not reduce Corporation Tax to 19% from 25%; only put in place support for businesses and households for 6 months (October to March) regarding caps on the unit costs of gas and electricity.

In addition, the Bank of England has had to intervene in the longer part of the gilt market to ensure that pension funds did not have to undertake a "fire sale" of assets to raise cash to pay for margin calls, arising from the sell-off of long-dated gilts (yields rising) in the wake of the former Chancellor's policy to seek to boost growth with unfunded tax cuts.

Since then, calm has returned to the markets, the £ has risen from a historic low of $1.03 to $1.19, and the cumulative movement in gilt yields since the turn of the year is now broadly in line with that seen in the US and Euro-zone bond markets.

Turning back to the MPC meeting on 2 November 2022, the Bank's Quarterly Monetary Policy Report detailed that the UK economy is headed for eight quarters of negative growth based on the market's expectation for Bank Rate to increase to 5.25%. Since then, market expectations have been recalibrated, and now view a peak in Bank Rate of between 4.5% and 4.75%. These views are similar to those held by Link Group's Interest Rate Strategy Group (IRSG). IRSG has reduced its view on the peak of Bank Rate from 5% to 4.5%. However, although Link's IRSG see rates peaking in May of 2023, they now also believe there are several challenges to the Bank that could see them leave rates at this level until early 2024.

The first of those challenges is the tight labour market (unemployment is at a 48 year low 3.5%), which shows no signs of dissipating, and that could mean wage increases continue to be north of 5% well into 2023 (the Bank would broadly want wages to be in the range of 3% - 3.5%). There is also the prospect that unless the workforce participation rate increases and/or immigration policies are relaxed, there is no clear route that would give rise to sustainable increases in economic growth. And, of course, inflation could be somewhat "sticky" if the Russian invasion of Ukraine remains unresolved and puts continued pressure on global energy prices and staple foods (e.g., wheat), among the many areas negatively impacted.

Against this backdrop, the Link IRSG believe the MPC will have to tread carefully. It will need to evidence to the markets that it sees the reduction in inflation as a primary objective, but also that it remains alert to the fact that it does not want any recession to be deeper and more prolonged than it needs to be. On that basis the Link IRSG forecast sees Bank Rate increasing 50 basis points in both December and February before the MPC scales down the rate of increase to just 25 basis points in both March and May 2023.

Regarding the forecast for PWLB rates, as already stated, the impact of the Truss/Kwarteng fiscal experiment has faded in the past month but Link's IRSG think investors will still remain a little nervous over the UK's future fiscal policy and therefore have reduced the forecast for near-term PWLB rates across the curve, compared to September's forecast, but have left the longer end of the curve slightly higher to reflect the potential demand by foreign investors for a "confidence premium" in the light of recent market volatility.

As for the housing market, the most recent survey by Nationwide Building Society showed house prices starting to fall and the MPC will be very cognisant that affordability could be stretched now that fixed rate mortgages are somewhat higher than they were a few weeks ago. Historically, the MPC has appeared reluctant to tighten monetary policy in a falling housing market, but it may be willing to leave rates less high than the market had been pricing in prior to the 3rd of November Quarterly Monetary Policy Report but keep them there for longer as a compromise of sorts.

Of course, what happens outside of the UK is also critical to movement in gilt yields. The US FOMC has led with increases of 375 basis points in the year to date and is expected to increase rates further before the end of the year, and possibly into 2023. Similarly, the ECB has also started to tighten monetary policy, albeit from an ultra-low starting point, as have all the major central banks apart from Japan. Arguably, though, it is US monetary policies that will have the greatest impact on global bond markets.

Geo-political events continue to lead to frequent whipsawing in equity, bond, commodity and currency markets. And the weather will also play a large part in how high energy prices stay and for how long. Not forgetting developments in Iran, North Korea, Taiwan and China.

The balance of risks to the UK economy: -

- The overall balance of risks to economic growth in the UK is to the downside.

Downside risks to current forecasts for UK gilt yields and PWLB rates include:

- **Labour and supply shortages** prove more enduring and disruptive and depress economic activity (accepting that in the near-term this is also an upside risk to inflation and, thus, rising gilt yields).

- **The Bank of England** acts too quickly, or too far, over the next two years to raise Bank Rate and causes UK economic growth, and increases in inflation, to be weaker than we currently anticipate.

- **UK / EU trade arrangements** – if there was a major impact on trade flows and financial services due to complications or lack of co-operation in sorting out significant remaining issues.

- **Geopolitical risks,** for example in Ukraine/Russia, China/Taiwan/US, Iran, North Korea and Middle Eastern countries, which could lead to increasing safe-haven flows.

Upside risks to current forecasts for UK gilt yields and PWLB rates: -

- The **Bank of England is too slow** in its pace and strength of increases in Bank Rate and, therefore, allows inflationary pressures to build up too strongly and for a longer period within the UK economy, which then necessitates an even more rapid series of increases in Bank Rate faster than we currently expect.

- **The Government** acts too quickly to cut taxes and/or increases expenditure in the light of the cost-of-living squeeze.

- **The pound weakens** because of a lack of confidence in the UK Government's fiscal policies, resulting in investors pricing in a risk premium for holding UK sovereign debt.

- Longer term **US treasury yields** continue to rise strongly and pull gilt yields up even higher than currently forecast.

Gilt yields and PWLB rates

The general situation is for volatility in bond yields to endure as investor fears for inflation and/or recession ebb and flow. The overall longer-run trend is for gilt yields and PWLB rates to remain high in the near-term, given the extent to which market expectations are already priced in and then to fall back once inflation starts to fall through 2023.

Bank Rate

The Link IRSG now expect the MPC to swiftly increase Bank Rate during the remainder of 2022 and into Q2 2023 to combat the sharp increase in inflationary pressures.

The new Government's policy of emphasising fiscal rectitude will however likely mean Bank Rate does not now need to increase to further than 4.5%.
Further down the road, the Link IRSG anticipate the Bank of England will be keen to loosen monetary policy when the worst of the inflationary pressures are behind the UK – 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.

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.

Regarding the plan to sell £10bn of gilts back into the market each quarter (Quantitative Tightening), this has started but will focus on the short to medium end of the curve for the present so as to prevent any further disruption to the longer end of the curve following on from the short-lived effects of the Truss/Kwarteng unfunded dash for growth policy.

In the upcoming months, the Link IRSG 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.)

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.

Creditworthiness

Following the Government's fiscal event on 23rd September, Fitch, Moody's and S&P all 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.

CDS prices

It is noted that sentiment in the current economic climate can easily shift, so it remains important to undertake continual monitoring of all aspects of risk and return in the current circumstances.

Appendix 5: Approved Countries for Deposit as at 18 November 2022

AAA

- Australia
- Denmark
- Germany
- Luxembourg
- Netherlands
- Norway
- Singapore
- Sweden
- Switzerland

AA+

- Canada
- Finland
- U.S.A.

AA

- Abu Dhabi (UAE)
- France

AA-

- Belgium
- Hong Kong
- Qatar
- **U.K.**