Audit Committee
Tuesday 5 December 2023
Item No 5.2

Treasury Management Mid-Year Review Report 2023/24

Report by David Gladwin, Chief Financial Officer & Section 95 Officer

Report for Consideration

1 Recommendations

The 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 19 December 2023:-

a) Note the report and the treasury activity undertaken in the period to 30 September 2023, 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) Approve the technical revisions to the Prudential Indicators in Section 7 of this report;
d) Note the loans fund rate performance relative to other Scottish Local authorities, as outlined in Section 8, and the cash saving (compared to the Scottish Average) that the Treasury Management function brings to support the Council's in-year revenue budget.

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 2023/24 and the forecast activity for the second half of 2023/24 in accordance with the Treasury Management and Annual Investment Strategy approved by Council on 21 February 2023. It also provides an update to the Treasury and Prudential Indicators for 2023/24.

Date: 20 November 2023
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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 5 December 2023 for consideration prior to being presented to Council on 19 December 2023. Any revisions arising from Audit Committee consideration of the report on 5 December 2023 will be incorporated into the final version of the report to Council on 19 December 2023.

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. The 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.

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 2023/24 financial year;
- A review of the Treasury Management Strategy Statement and Annual Investment Strategy 2023/24 (TM&AIS 2023/24) approved by Council on 21 February 2023;
- The Council's capital expenditure, as set out in the General Services and HRA Capital Plan reports, and prudential indicators;
- A review of the Council's borrowing strategy for 2023/24;
- A review of the Council's deposit portfolio for 2023/24;
- A review of any debt rescheduling undertaken during 2023/24;

- A review of compliance with Treasury and Prudential Limits for 2023/24.

4 Economic update for first half of 2023/24

An economic update for the first part of the 2023/24 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 2023/24

The main points arising from treasury activity in the year to 30 September 2023 were:-

- Long term borrowing of £0.440 million matured, this being £0.331 million of Market Loans, £0.083 million of Salix loans and £0.026 million PWLB Annuities;
- £55.000 million of new funds on deposit were placed with approved counterparties (high credit-worthy banks), refinancing existing maturing deposits in line with the 2023/24 Treasury Management and Annual Investment Strategy approved by Council on 21 February 2023;
- The average interest rate earned on external funds on deposit in the first half of the year was 4.65%.

<u>Loan Portfolio</u>

The Council's loan portfolio as at 30 September 2023 is shown in table 1 below (position at 31 March 2023 also shown for comparison):-

Table 1: Council's Loan Portfolio at 31 March 2023 and 30 September 2023.

Loan Type	31 March 2023		30 September 2023	
	Principal Outstanding £000's	**Weighted Average Rate**	**Principal Outstanding £000's**	**Weighted Average Rate %**
PWLB Annuity	505	8.91%	479	8.91%
PWLB Maturity	284,128	2.90%	284,128	2.90%
LOBO	20,000	4.51%	20,000	4.51%
Market Loans	16,886	2.68%	16,555	2.68%
Temporary Market Loans	0	n/a	0	n/a
Other Loans	235	0.00%	152	0.00%
Total Loans	**321,754**	**3.00%**	**321,314**	**3.00%**
Underlying Borrowing Requirement*	**347,661**		**363,850**	
Over/(Under) Borrowing	**-25,908**		**-42,537**	

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

The balance of external and internal borrowing is generally driven by market conditions.

At 30 September 2023 the Council was under borrowed by £42.537 million – this is the extent to which the Council has yet to finance its current borrowing requirement from long term loans. This position reflects the Council's use of working capital to fund part of the prior year and current in-year borrowing requirement.

This strategy of using internal borrowing (working capital) to fund the in-year CFR is prudent given the current plateau in medium to longer-term PWLB borrowing rates of c. 5.00%+, and the expected gradual drop in these medium to longer-term PWLB borrowing rates over the remainder of the current and forthcoming financial years as outlined in Appendix 4.

Debt Rescheduling

No Debt Rescheduling has taken place to date in the financial year.

However, now that the whole of the yield curve has shifted higher there may be opportunities for debt rescheduling in the future. See Section 6 below for more detail.

Funds on Deposit

The Council's funds on deposit portfolio as at 30 September 2023 is shown in table 2 below (position at 31 March 2023 also shown for comparison):-

Table 2: Council's Funds on Deposit Portfolio at 31 March 2023 and 30 September 2023

Type	**31 March 2023**		**30 September 2023**	
	Principal Outstanding £000's	**Weighted Average Rate**	**Principal Outstanding £000's**	**Weighted Average Rate %**
Money Market Funds	15,980	3.96%	35,491	5.32%
Bank Call Accounts	2	3.80%	853	5.09%
Bank Fixed Term Deposits	86,000	3.93%	75,000	4.81%
Bank Certificates of Deposit	10,000	2.85%	0	n/a
Deposits with other Local Authorities	2,000	1.60%	0	n/a
Total Deposits	**113,982**	**3.80%**	**111,344**	**4.98%**

£55.000 million of Bank Fixed Term Deposits were placed in May/June 2023, refinancing existing maturing deposits. These deposits were placed with approved counterparties in line with the TM&AIS 2023/24 approved by Council on 21 February 2023, with maturity of these funds extending into the latter half of the 2023/24 financial year.

The Chief Financial Officer & Section 95 Officer confirms that the approved limits within the Annual Investment Strategy were not breached during the first 6 months of 2023/24.

6 Actual/Expected Treasury Activity during second half of 2023/24

There are no proposed policy changes to the TMSS at this stage; the expected activity in the second half of 2023/24 as outlined below updates the treasury management position in light of the updated economic position and Capital Plan budgetary changes already approved by full Council.

<u>Borrowing</u>

Long term borrowing of £0.443 million will mature in the second half of 2023/24, this being £0.333 million of Market Loans, £0.083 million of Salix loans and £0.027 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 table 3 below, with only £4.664 million, or just 1.45%, of the Council's total Loan Portfolio of £321.314 million requiring refinancing over the remainder of the current, and forthcoming four, financial years.

Table 3: Maturity Profile of Existing External Loan Portfolio

Financial Year	**2023/24 Remaining £000's**	**2024/25-2025/26 £000's**	**2025/26-2027/28 £000's**	**2028/29-2032/33 £000's**	**2033/34-2037/38 £000's**	**2038/39+ £000's**
Debt Maturing	443	1,426	2,795	45,136	32,239	239,274
% of total portfolio	0.14%	0.44%	0.87%	14.05%	10.03%	74.47%

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.

The current PWLB yield curve is fully above 5.00% and is bell shaped with a peak in rates around the 20-30 year tenor (5.50%). 5-10 year rates at 5.00-5.10% and 50 year rates are c. 5.30%.

The yield curve is expected to remain bell shaped over the short-medium term, with a gradual shift downwards of the entire curve by c. 60-80bps over the next 12 months and a further 60bps over the subsequent 12 months. This is forecast to bring longer-term borrowing rates down to between 4.40%-4.70% by December 2024 and between 3.70%-4.10% by December 2025. Further commentary on this is provided in Appendix 4: Link Treasury Solutions Limited Interest Rate Forecasts.

The funding of the Council's in-year and forward CFR is typically for infrastructure with long asset lives (50-60 years), and the tenor of PWLB and market loans are typically drawn with this in mind.

Consideration for any new borrowing in the remainder of the 2023/24 financial year, to fund the Council's in-year CFR, will seek to balance:-

a) the security/certainty of current relatively high longer-term borrowing rates of upwards of 5.30% in the 30-50 year duration (which are forecast to drop by 80bps within one year and 140bps within 24 months) and the potential additional budgetary pressure that this brings in both the short/medium and longer term; with
b) the option to borrow initially for a shorter-term duration from PWLB or other markets, for 2 to 5 years (at say c. 5.00%), to allow the Council to fund the immediate in-year borrowing requirement. Based on current interest rate forecasts (see Appendix 4), this would then allow the Council the option to refinance this borrowing at initial maturity with less expensive, longer term borrowing, e.g. a 45 to 48 year tenor in, say, 36 months at a forecast rate of c. 3.80%.

As noted above, the Council's proactive Treasury Management over the last decade has put the Council in a strong refinancing position for its external debt portfolio which allows the Council to slot in shorter dated external borrowing into the current debt maturity profile to fund the in-year borrowing required, to allow the Council to navigate past the current expected hump in longer-term borrowing rates.

It is expected that any further long-term borrowing that is undertaken in 2023/24 to finance the current & future year capital plans will be sourced by drawing new PWLB loans at the Certainty Rate (which has been available to the Council since 2012 and is priced at Gilts+80bps), and/or the HRA rate. The HRA rate is available to all Councils (for a minimum period of 12 months from 15 June 2023) to fund HRA capital expenditure, at a rate that is 40bps lower than the current certainty rate available from the PWLB.

Both the General Services and HRA capital programmes are being kept under regular review due to the effects of inflationary pressures, shortages of materials and labour, and the ratios of financing costs to the net revenue streams. The Council's borrowing strategy will, therefore, also be regularly reviewed and then revised, if necessary, to achieve optimum value and risk exposure in the long-term. The impact particularly of the General Services Capital Plan Prioritisation – which is being reported to Council in December – will have a significant bearing on this.

Appendix 4 provides forecasts for interest rates from the Council's Treasury Management advisor, Link Treasury Solutions Limited. Council officers, in conjunction with Link, will continue to monitor daily long-term borrowing rates in order to take advantage of any dips in the market or to de-risk any change in the medium-longer term forecast for gilt yields.

Debt Rescheduling

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

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; with only prudent and affordable debt rescheduling that considers both the short and medium-longer term impact being 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
- liquidity, and
- finally to obtain an appropriate level of return which is consistent with the Council's risk appetite.

In the current economic climate, it is considered appropriate to keep deposits short term to cover cash flow needs, but also to seek out value available in periods up to 12 months with high credit quality financial institutions, using the Link suggested creditworthiness approach, which includes a minimum sovereign credit rating and Credit Default Swap (CDS) overlay information.

£75.000 million of fixed term deposits held at 30 September 2023 mature in the latter half of the 2023/24 financial year. Based on the expected future profile of the Council's reserves, and particularly the HRA and Capital Fund balances, it is expected that £70.000 million of these fixed term 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 21 February 2023 in the 2023/24 Treasury Management and Annual Investment Strategy, and with maturity of these funds extended into the latter half of the 2024/25 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 5.27% to 5.36%, reflective of the increases to the Bank of England Base Rate during the early part of the 2023/24 financial year.

Given the expected plateauing 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 21 February 2023 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.

An updated list of Countries for Deposits as at 17 November 2023 is included as Appendix 5.

Expected Loan & Fund on Deposit Portfolio at 31 March 2024

Taking all of the above into account, the expected loan and funds on deposit portfolio at 31 March 2024 is shown in Tables 4 and 5 below:-

Table 4: Council's forecast Loan Portfolio at 31 March 2024

Loan Type	31 March 2024	
	Principal Outstanding £000's	**Weighted Average Rate**
PWLB Annuity	452	8.91%
PWLB Maturity	351,032	3.35%
LOBO	20,000	4.51%
Market Loans	16,221	2.68%
Temporary Market Loans	0	n/a

Other Loans	70	0.00%
Total Loans	**387,775**	**3.35%**
Underlying Borrowing Requirement	**413,683**	
Over/(Under) Borrowing	**-25,908**	

Table 5: Council's forecast Funds on Deposit Portfolio at 31 March 2024

Type	**31 March 2024**	
	Principal Outstanding £000's	**Weighted Average Rate**
Money Market Funds	20,000	5.25%
Bank Fixed Term Deposits	70,000	5.30%
Total Deposits	**90,000**	**5.29%**

7 Prudential & Treasury Management Indicators 2023/24

It is a statutory duty for the Council to determine and keep under review the affordable capital expenditure and borrowing limits as outlined in the prudential and treasury management indicators reported as part of the Council's suite of treasury management reports.

The following prudential indicators have therefore been refreshed from those reported to Council on 21 February 2023 in the original Treasury Management and Annual Investment Strategy Statement 2023/24.

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 2022/23, and revisions to the capital expenditure and income budgets for 2023/24.

Table 6: Prudential Indicators 2023/24 – Mid Year Update

Indicator	**2023/24 Original Estimate £000's**	**2023/24 Current Position £000's**	**2023/24 Revised Estimate £000's**
2023/24 Capital Expenditure	181,186	29,898	126,406
2023/24 Required Borrowing	128,715	20,393	75,130
2023/24 Underlying Borrowing Requirement*	472,662	363,850	413,683
2023/24 Gross External Borrowing	472,662	321,313	387,775
2023/24 Over/(Under) Borrowing	0	-42,537	-25,908
Operational Boundary – Borrowing	472,662	413,683	413,683
2023/24 Capital Financing Requirement**	561,401	452,589	502,422
2023/24 Authorised Limit***	472,662	472,662	472,662
Net Income from Service Investments as % of Net Revenue Stream	0.01%		0.01%
Ratio of Financing Costs to Net Revenue Stream – General Services	1.57%		0.69%
Ratio of Financing Costs to Net Revenue Stream – HRA	43.67%		41.86%
Ratio of HRA Debt to Net Revenue Stream	886%		745%
Ratio of HRA Debt per Dwelling	38		32

* *Excludes "On balance sheet" PPP schemes.*
** *Includes "On balance sheet" PPP schemes.*
*** *Equates to the original estimate of the 2023/24 Underlying Borrowing Requirement*

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.

The **Authorised Limit** represents the statutory limit determined under section 3 (1) of the Local Government Act 2003, and is the limit beyond which borrowing is prohibited. This limit needs to be set and revised by Members. For 2023/24 this was calculated to equate to the forecast value of the 2023/24 Underlying Borrowing Requirement.

During the half year ended 30th September 2023, the Council has operated within the treasury and prudential indicators set out in the Council’s Treasury Management Strategy Statement for 2023/24.

All treasury management operations have also been conducted in full compliance with the Council's Treasury Management Practices.

8 Performance Indicators 2022/23 – Comparison with Other Scottish Local Authorities

The Treasury Management Forum collates performance indicators for all Scottish Local Authorities. The indicators relating to financial year 2022/23 have been published and once again demonstrate the continuing effectiveness of the Council's Treasury function in maximising efficiency in Treasury Management activity, with the Council having the lowest weighted average borrowing & investment (loans fund) rate across all Scottish mainland authorities in 2022/23 (2.41%).

The Council has consistently maintained the loans fund rate as one of the lowest across all Scottish mainland authorities for the last decade and more. Appendix 6 outlines the loans fund rate for each Scottish Local Authority in 2022/23.

Were the internal loans fund rate for 2022/23 to have equated to the Scottish weighted average for 2022/23 of 3.49%, this would have generated loan charges for Midlothian Council in 2022/23 of £16.9m. The Council's actual 2022/23 loan charges for General Services and HRA were £13.7m, representing a cash saving (compared to the Scottish average) of £3.2m in 2022/23.

The forecast loans fund rate of 2.29% for 2023/24 is expected to once again be one of the lowest for all Scottish Local Authorities.

9 Summary

Treasury Management activity during the year to 30 September 2023 has been effective within the parameters set by the strategy for the year.

Any further long-term borrowing for the remainder of 2023/24 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 21 November 2023.

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

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

10 Report Implications

10.1 Resource

Expenditure from Treasury Management activity i.e. loan charges, was reported in the quarterly financial positions to Council, with Quarter 2 monitoring reflected in the Financial Monitoring 2023/24 – General Fund Revenue report that was presented to Council on 21 November 2023.

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 were reviewed and approved by Audit Committee as part of the presentation of the 2022/23 Mid-Year Review Report on 6 December 2022.

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 2023/24 financial year
Appendix 2: PWLB Borrowing Rates 1 April 2023 to 30 September 2023
Appendix 3: Bank Rate and SONIA Rates 1 April 2023 to 30 September 2023
Appendix 4: Link Treasury Solutions Limited Interest Rate Forecasts
Appendix 5: Approved Countries for Deposits as at 17 November 2023
Appendix 6: Loans Fund Rate Comparison Scottish Local Authorities 2022/23

Appendix 1: Economic Update for first part of 2023/24 financial year

The first half of 2023/24 saw:

- Interest rates rise by a further 100bps, taking Bank Rate from 4.25% to 5.25% and, possibly, the peak in the tightening cycle.
- Short, medium and long-dated gilts remain elevated as inflation continually surprised to the upside.
- A 0.5% m/m decline in real GDP in July, mainly due to more strikes.
- CPI inflation falling from 8.7% in April to 6.7% in August, its lowest rate since February 2022, but still the highest in the G7.
- Core CPI inflation declining to 6.2% in August from 7.1% in April and May, a then 31 years high.
- A cooling in labour market conditions, but no evidence yet that it has led to an easing in wage growth (as the 3myy growth of average earnings rose to 7.8% in August, excluding bonuses).

The 0.5% m/m fall in GDP in July suggests that underlying growth has lost momentum since earlier in the year. Some of the weakness in July was due to there being almost twice as many working days lost to strikes in July (281,000) than in June (160,000). But with output falling in 10 out of the 17 sectors, there is an air of underlying weakness.

The fall in the composite Purchasing Managers Index from 48.6 in August to 46.8 in September left it at its lowest level since COVID-19 lockdowns reduced activity in January 2021. At face value, it is consistent with the 0.2% q/q rise in real GDP in the period April to June, being followed by a contraction of up to 1% in the second half of 2023.

The 0.4% m/m rebound in retail sales volumes in August is not as good as it looks as it partly reflected a pickup in sales after the unusually wet weather in July. Sales volumes in August were 0.2% below their level in May, suggesting much of the resilience in retail activity in the first half of the year has faded.

As the growing drag from higher interest rates intensifies over the next six months, the economy is likely to continue to lose momentum and fall into a mild recession. Strong labour demand, fast wage growth and government handouts have all supported household incomes over the past year. And with CPI inflation past its peak and expected to decline further, the economy has got through the cost-of-living crisis without recession. But even though the worst of the falls in real household disposable incomes are behind us, the phasing out of financial support packages provided by the government during the energy crisis means real incomes are unlikely to grow strongly. Higher interest rates will soon bite harder too. The Bank Rate is expected to remain at the probable peak of 5.25% until the second half of 2024. Mortgage rates are likely to stay above 5.0% for around a year.

The tightness of the labour market continued to ease, with employment in the three months to July falling by 207,000. The further decline in the number of job vacancies from 1.017m in July to 0.989m in August suggests that the labour market has loosened a bit further since July. That is the first time it has fallen below 1m since July 2021. At 3.0% in July, and likely to have fallen to 2.9% in August, the job vacancy rate is getting closer to 2.5%, which would be consistent with slower wage growth. Meanwhile, the 48,000 decline in the supply of workers in the three months to July offset some of the loosening in the tightness of the labour market. That was due to a 63,000 increase in inactivity in the three months to July as more people left the labour market due to long term sickness or to enter education. The supply of labour is still 0.3% below its pre-pandemic February 2020 level.

But the cooling in labour market conditions still has not fed through to an easing in wage growth. While the monthly rate of earnings growth eased sharply from an upwardly revised +2.2% in June to -0.9% in July, a lot of that was due to the one-off bonus payments for NHS staff in June not being repeated in July. The headline 3myy rate rose from 8.4% (revised up from 8.2%) to 8.5%, which meant UK wage growth remains much faster than in the US and in the Euro-zone. Moreover, while the Bank of England's closely watched measure of regular private sector wage growth eased a touch in July, from 8.2% 3myy in June to 8.1% 3myy, it is still well above the Bank of England's prediction for it to fall to 6.9% in September.

CPI inflation declined from 6.8% in July to 6.7% in August, the lowest rate since February 2022. The biggest positive surprise was the drop in core CPI inflation, which declined from 6.9% to 6.2%. That reverses all the rise since March and means the gap between the UK and elsewhere has shrunk (US core inflation is 4.4% and in the Euro-zone it is 5.3%). Core goods inflation fell from 5.9% to 5.2% and the further easing in core goods producer price inflation, from 2.2% in July to a 29-month low of 1.5% in August, suggests it will eventually fall close to zero. But the really positive development was the fall in services inflation from 7.4% to 6.8%. That also reverses most of the rise since March and takes it below the forecast of 7.2% the Bank of England published in early August.

In its latest monetary policy meeting on 20 September, the Bank of England left interest rates unchanged at 5.25%. The weak August CPI inflation release, the recent loosening in the labour market and the downbeat activity surveys appear to have convinced the Bank of England that it has already raised rates far enough. The minutes show the decision was "finely balanced". Five MPC members (Bailey, Broadbent, Dhingra, Pill and Ramsden) voted for no change and the other four (Cunliffe, Greene, Haskel and Mann) voted for a 25bps hike.

Like the US Fed, the Bank of England wants the markets to believe in the higher for longer narrative. The statement did not say that rates have peaked and once again said if there was evidence of more persistent inflation pressures "further tightening in policy would be required". Governor Bailey stated, "we'll be watching closely to see if further increases are needed". The Bank also retained the hawkish guidance that rates will stay "sufficiently restrictive for sufficiently long".

This narrative makes sense as the Bank of England does not want the markets to decide that a peak in rates will be soon followed by rate cuts, which would loosen financial conditions and undermine its attempts to quash inflation. The language also gives the Bank of England the flexibility to respond to new developments. A rebound in services inflation, another surge in wage growth and/or a further leap in oil prices could conceivably force it to raise rates at the next meeting on 2nd November, or even pause in November and raise rates in December.

The yield on 10-year Gilts fell from a peak of 4.74% on 17th August to 4.44% on 29th September, mainly on the back of investors revising down their interest rate expectations. But even after their recent pullback, the rise in Gilt yields has exceeded the rise in most other Developed Market government yields since the start of the year. Looking forward, once inflation falls back, Gilt yields are set to reduce further. A (mild) recession over the next couple of quarters will support this outlook if it helps to loosen the labour market (higher unemployment/lower wage increases).

The pound weakened from its cycle high of $1.30 in the middle of July to $1.21 in late September. In the first half of the year, the pound bounced back strongly from its position last autumn. That rebound was in large part driven by the substantial shift up in UK interest rate expectations. However, over the past couple of months, interest rate expectations have dropped sharply as inflation started to come down, growth faltered, and the Bank of England called an end to its hiking cycle.

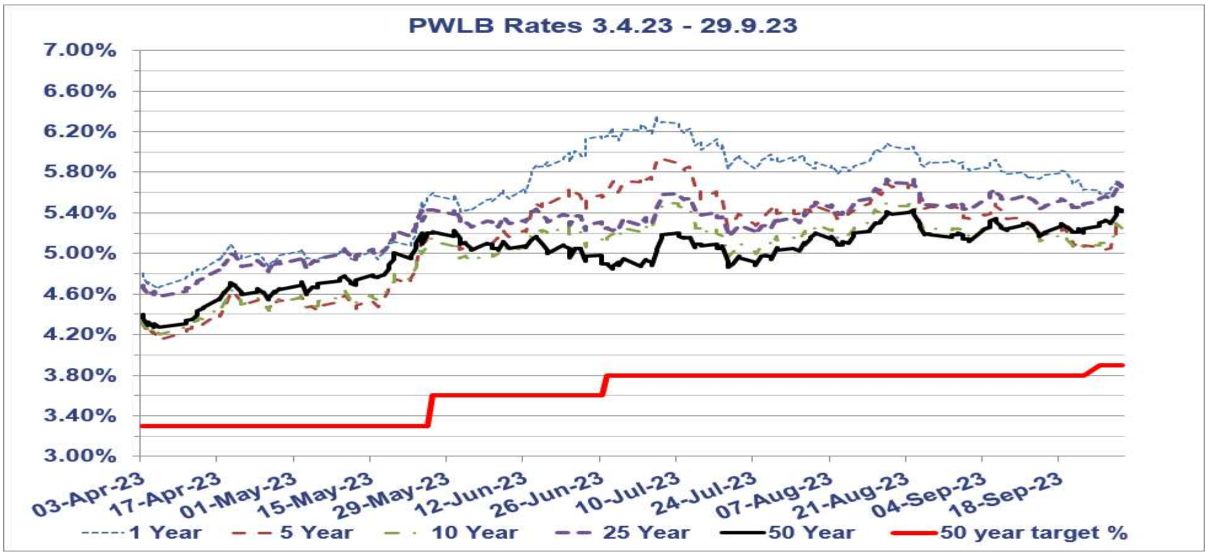
The FTSE 100 has gained more than 2% since the end of August, from around 7,440 on 31st August to 7,608 on 29th September. The rebound has been primarily driven by higher energy prices which boosted the valuations of energy companies. The FTSE 100's relatively high concentration of energy companies helps to explain why UK equities outperformed both US and Euro-zone equities in September. Nonetheless, as recently as 21st April the FTSE 100 stood at 7,914.

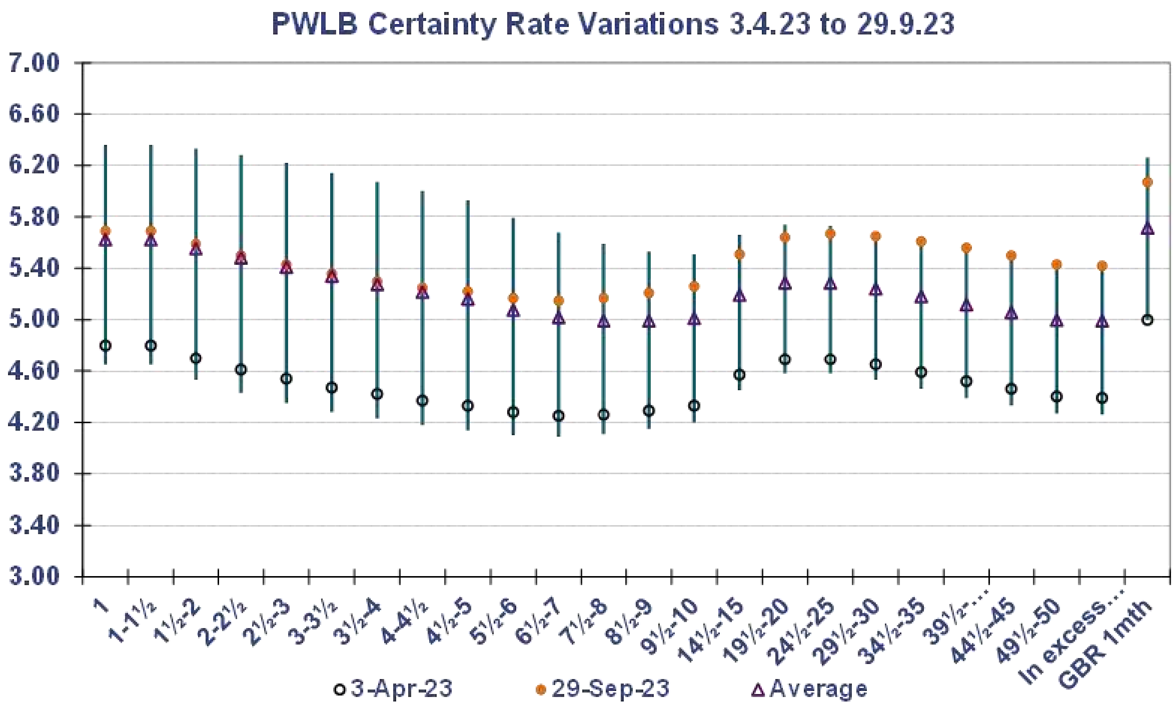
Appendix 2: PWLB Borrowing Rates 1 April 2022 to 30 September 2022

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 2023 to 30th September 2023

	1 Year	5 Year	10 Year	25 Year	50 Year
Low	4.65%	4.14%	4.20%	4.58%	4.27%
Date	06/04/2023	06/04/2023	06/04/2023	06/04/2023	05/04/2023
High	6.36%	5.93%	5.51%	5.73%	5.45%
Date	06/07/2023	07/07/2023	22/08/2023	17/08/2023	28/09/2023
Average	5.62%	5.16%	5.01%	5.29%	5.00%
Spread	1.71%	1.79%	1.31%	1.15%	1.18%

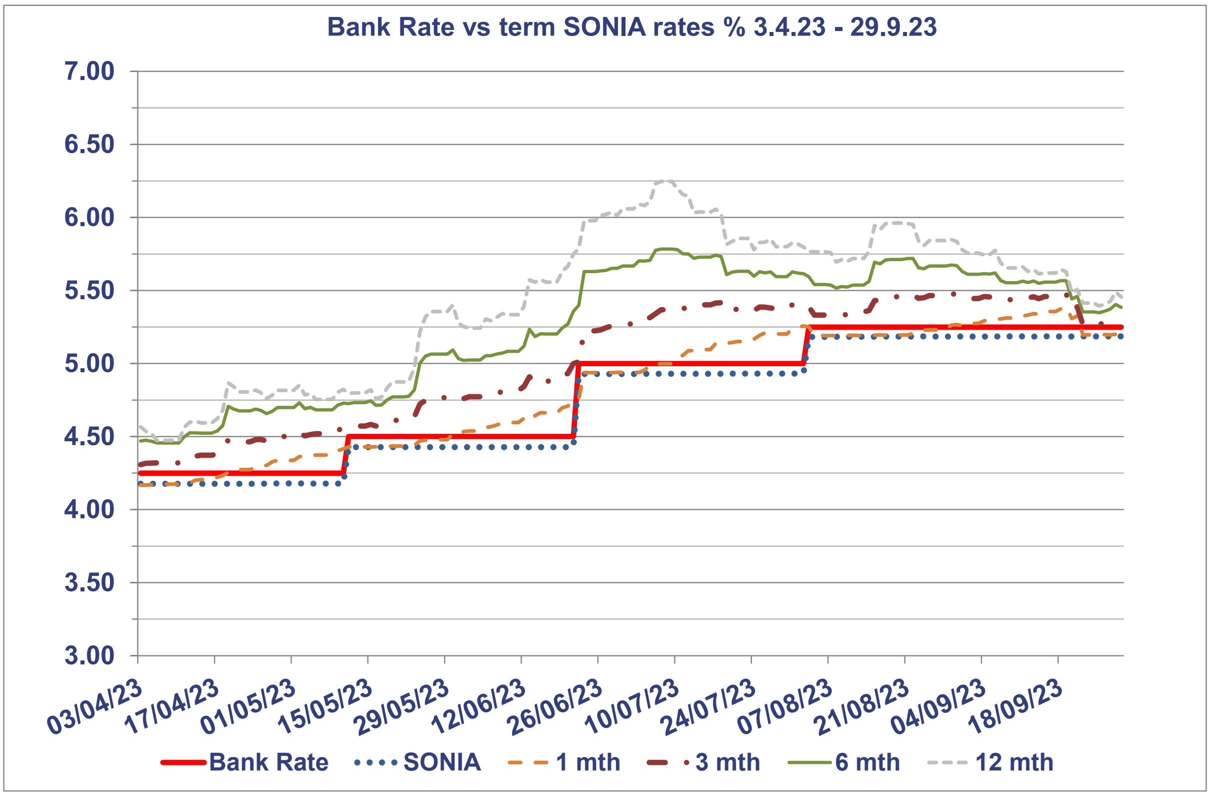




- The current PWLB rates are set as margins over gilt yields as follows: -.
- PWLB Standard Rate is gilt plus 100 basis points (G+100bps)
- PWLB Certainty Rate (GF) is gilt plus 80 basis points (G+80bps)
- PWLB Local Infrastructure Rate is gilt plus 60 basis points (G+60bps)
- PWLB Certainty Rate (HRA) is gilt plus 40bps (G+40bps)

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:



	Bank Rate	SONIA	1 mth	3 mth	6 mth	12 mth
High	5.25	5.19	5.39	5.48	5.78	6.25
High Date	03/08/2023	29/09/2023	19/09/2023	30/08/2023	07/07/2023	07/07/2023
Low	4.25	4.18	4.17	4.31	4.46	4.47
Low Date	03/04/2023	04/04/2023	03/04/2023	03/04/2023	06/04/2023	06/04/2023
Average	4.81	4.74	4.83	5.03	5.26	5.45
Spread	1.00	1.01	1.22	1.17	1.33	1.77

Creditworthiness: Following the Government's fiscal event on 23rd September 2022, both S&P and Fitch 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 a challenging economic outlook. Nothing further has evolved in the first half of 2023/24.

Deposit Counterparty criteria: The current deposit counterparty criteria selection approved in the TMSS is meeting the requirement of the treasury management function.

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 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 latest forecast from Link for interest rates on 7th November sets out a view that short, medium and long-dated interest rates will be elevated for some little while, as the Bank of England seeks to continue to squeeze inflation out of the economy.

Link Group Interest Rate View	07.11.23												
	Dec-23	Mar-24	Jun-24	Sep-24	Dec-24	Mar-25	Jun-25	Sep-25	Dec-25	Mar-26	Jun-26	Sep-26	Dec-26
BANK RATE	5.25	5.25	5.25	5.00	4.50	4.00	3.50	3.25	3.00	3.00	3.00	3.00	3.00
3 month ave earnings	5.30	5.30	5.30	5.00	4.50	4.00	3.50	3.30	3.00	3.00	3.00	3.00	3.00
6 month ave earnings	5.60	5.50	5.40	5.10	4.60	4.10	3.60	3.40	3.10	3.10	3.10	3.10	3.10
12 month ave earnings	5.80	5.70	5.50	5.20	4.70	4.20	3.70	3.50	3.30	3.30	3.30	3.30	3.30
5 yr PWLB	5.00	4.90	4.80	4.70	4.40	4.20	4.00	3.80	3.70	3.60	3.50	3.50	3.50
10 yr PWLB	5.10	5.00	4.80	4.70	4.40	4.20	4.00	3.80	3.70	3.70	3.60	3.60	3.50
25 yr PWLB	5.50	5.30	5.10	4.90	4.70	4.50	4.30	4.20	4.10	4.10	4.00	4.00	4.00
50 yr PWLB	5.30	5.10	4.90	4.70	4.50	4.30	4.10	4.00	3.90	3.90	3.80	3.80	3.80

The PWLB rate forecasts above are based on the Certainty Rate (the standard rate minus 20 bps) which has been accessible to Midlothian Council since 2012. The Council also has access to the PWLB HRA rate, which is a further 40bps below the levels outlined in the table below for all tenors across the curve. This is available to fund HRA capital expenditure.

BANK RATE

At its meeting on 2 November 2023, the Bank of England's Monetary Policy Committee (MPC) kept rates on hold for the second time in a row. The decision was a little more clear-cut than in September (5-4), although the 6-3 split vote reflected the new composition of the Committee as opposed to any change in voting patterns. The minority wanted a further 0.25% increase in Bank Rate to counteract on-going inflationary pressures. The stickiness of UK inflation, still the highest in the G7 at 6.7%, is there for all to see - although it is about to fall significantly when the gas/electricity price cap reduction comes into the reckoning next month. CPI is expected to fall to 5% by the end of 2023.

In terms of messaging, the Bank once again said that "further tightening in monetary policy would be required if there were evidence of more persistent inflationary pressures", citing the rise in global bond yields and the upside risks to inflation from "energy prices given events in the Middle East". So, like the Fed, the Bank is keeping the door open to the possibility of further rate hikes. However, it also repeated the phrase that policy will be "sufficiently restrictive for sufficiently long" and that the "MPC's projections indicate that monetary policy is likely to need to be restrictive for an extended period of time". Indeed, Governor Bailey was at pains in his press conference to drum home to markets that the Bank means business in squeezing inflation out of the economy.

As for the Bank's updated forecasts, the November Quarterly Monetary Policy Report saw it revise down its Q3 and Q4 GDP forecasts for this year and its annual forecast for 2024 from 0.4% to 0.0% (2023 stayed at 0.5%). This happened even though the forecasts were based on a lower market implied path of interest rates than in the August Report. Conversely, the CPI inflation forecasts were slightly higher, but the modal CPI inflation forecast in three years' time, based on market rate expectations, was still only 1.51% (1.46% previously). To be honest, though, none of that fine-tuning really matters. We only have to wait until next week to see whether the measures of CPI inflation and wage/employment data are moving in a significant downward direction.

Moreover, a close eye will need to be kept on the housing market data releases, as these are a good barometer of the strength or weakness of the overall economy. Only last week markets were surprised to learn that there was a 0.9% m/m rise in the Nationwide House Price index in October, which confounded the consensus forecast of a fall (-0.4% m/m) and was the largest increase since March 2022. This caused the annual rate of house price growth to rise from -5.3% in September to -3.3% in October. And just this morning, a similar picture emerged from the Halifax house price index, with prices rising 1.1% m/m (-3.2% y/y). Again, economists were caught on the hop, but with c2 million households due a mortgage rate reset (at a higher level) over the next 15 months it should only be a matter of time before we see further weakness in house prices and a general clamour for Bank Rate to be cut as soon as is practicable.

At this juncture, Link's view is that the most favourable time for a rate cut would be in Q3 2024, but, as always, the data will be the key to that decision. Our colleagues at Capital Economics see the CPI measure of inflation dropping comfortably below 2% by mid-2024 and expect wage inflation to dip below 3.5% around then too. There are, of course, significant risks to both central forecasts. First, we are still in the early days of the Gaza-Israel conflict, and a meaningful and prolonged shift up in oil prices from $85-$90 per barrel to something closer to $120 will keep inflation higher for longer. Furthermore, the UK domestic labour market is still having to contend with very low unemployment (4.2%) and the total number of job vacancies is only a smidgen below one million. Even if Labour takes over the governmental reins in the next year or so, it is unlikely that a fundamental overhaul of immigration policy, with a view to addressing staff shortages in various sectors of the economy, is going to be a priority, so keeping a lid on wages is going to be a tough challenge.

In the immediate aftermath of the decision, markets have concluded that rates have more than likely peaked at 5.25%. Interestingly, the markets are also pricing in at least one rate cut before the end of 2024. That is to be expected in so far as, typically, the "terminal rate" remains in situ for some ten months or so before an easing in rates is undertaken.

As noted in the table above, we have fine-tuned our own expectations, primarily in the latter part of the forecast, where we have raised our assumption of the neutral level of Bank Rate from 2.75% to 3%.

Regarding PWLB rates, movement in the short part of the curve is expected to be driven by Bank Rate expectations to a large degree, whilst medium to longer-dated PWLB rates will remain influenced not only by the outlook for inflation, but also by the market's appetite for significant gilt issuance.

Furthermore, there is the small matter of a General Election coming into sight on the horizon (late next year?), so Government fiscal policy may potentially loosen at the same time as the Bank's monetary policy is still trying to take momentum out of the economy. That may mean that Bank Rate stays elevated for a little longer than our central forecast.

Of course, what happens outside of the UK remains critical to movement in gilt yields as well. The European Central Bank has made it clear that policy tightening is at, or close to, the terminal rate (currently 4%), whilst the US FOMC has held its Bank Rate equivalent in the range of 5.25% - 5.5%.

SUMMARY OVERVIEW OF THE FUTURE PATH OF BANK RATE

Link's central forecast for interest rates was previously updated on 25 September and reflected a view that the MPC would be keen to further demonstrate its anti-inflation credentials by keeping Bank Rate at 5.25% until at least Q2 2024. We expect rate cuts to start when both the CPI inflation and wage/employment data are supportive of such a move, and that there is a likelihood of the overall economy enduring at least a mild recession over the coming months, although most recent GDP releases have surprised with their on-going robustness.

Naturally, timing on this matter will remain 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.

In the upcoming months, 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 also international factors such as policy development in the US and Europe, the provision of fresh support packages to support the faltering recovery in China as well as the on-going conflict between Russia and Ukraine, and Gaza and Israel.

On the positive side, consumers are still anticipated to be sitting on some excess savings left over from the pandemic, which could cushion some of the impact of the above challenges and may be the reason why the economy is performing somewhat better at this stage of the economic cycle than may have been expected. However, as noted previously, most of those excess savings are held by more affluent households whereas lower income families already spend nearly all their income on essentials such as food, energy and rent/mortgage payments.

PWLB RATES

Gilt yields and PWLB certainty rates were on a generally rising trend throughout the first half of 2023/24. At the beginning of April, the 5-year rate was the cheapest part of the curve and touched 4.14% whilst the 25-year rate was relatively expensive at 4.58%.

July saw short-dated rates peak at their most expensive. The 1-year rate spiked to 6.36% and the 5-year rate to 5.93%. Although, in due course, short-dated rate expectations fell, the medium dates shifted higher through August and the 10-year rate pushed higher to 5.51% and the 25-year rate to 5.73%. The 50-year rate was 4.27% on 5th April but rose to 5.45% on 28th September.

Link forecast that Gilt yields will fall back over the next two to three years as inflation dampens. The CPI measure of inflation is expected to fall below 2% in the second half of 2024, and we forecast 50-year rates to stand at 3.90% by the end of September 2025. However, there is considerable gilt issuance to be digested by the market over the next couple of years, as a minimum, so there is a high degree of uncertainty as to whether rates will fall that far.

Gilt yield curve movements have recently broadened. The short part of the curve has not moved significantly; but the longer-end continues to reflect inflation concerns. At the time of writing there is 25 basis points difference between the 5 and 50 year parts of the curve.

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, could keep gilt yields high for longer).
- The Bank of England has increased Bank Rate too fast and too far over recent months, and subsequently brings about a deeper and longer UK recession 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, the Middle East, China/Taiwan/US, Iran and North Korea, which could lead to increasing safe-haven flows.

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

- Despite the recent tightening to 5.25%, the Bank of England proves too timid in its pace and strength of increases in Bank Rate and, therefore, allows inflationary pressures to remain elevated for a longer period within the UK economy, which then necessitates Bank Rate staying higher for longer than we currently project.

- The pound weakens because of a lack of confidence in the UK Government's pre-election fiscal policies, resulting in investors pricing in a risk premium for holding UK sovereign debt.
- Longer-term US treasury yields rise strongly if inflation remains more stubborn there than the market currently anticipates, consequently pulling gilt yields up higher. (We saw some movements of this type through October although generally reversed in the last week or so.)
- Projected gilt issuance, inclusive of natural maturities and QT, could be too much for the markets to comfortably digest without higher yields compensating.

The overall longer-run trend is for gilt yields and PWLB rates to fall back over the timeline of Link's forecasts, as inflation starts to fall through the remainder of 2023 and into 2024.

Appendix 5: Approved Countries for Deposit as at 17 November 2023

AAA

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

AA+

- Canada
- Finland
- U.S.A.

AA

- Abu Dhabi (UAE)

AA-

- Belgium
- France
- Qatar
- **U.K.**

Appendix 6: Loans Fund Rate Comparison Scottish Local Authorities 2022/23

Authority	Loans Fund Rate
Midlothian	2.41%
West Dunbartonshire	2.47%
Argyll & Bute	2.52%
Aberdeenshire	2.53%
Renfrewshire	2.59%
East Lothian	2.66%
Perth & Kinross	2.71%
North Lanarkshire	2.96%
Scottish Borders	3.22%
East Ayrshire	3.24%
South Ayrshire	3.24%
Orkney	3.32%
East Renfrewshire	3.34%
Dumfries & Galloway	3.43%
North Ayrshire	3.45%
Shetland	3.45%
Dundee City	3.49%
Highland	3.49%
Aberdeen City	3.51%
Fife	3.54%
Moray	3.54%
East Dunbartonshire	3.63%
West Lothian	3.65%
Falkirk	3.66%
Glasgow City	3.68%
Inverclyde	3.85%
Edinburgh City	3.96%
South Lanarkshire	3.96%
Angus	4.03%
Stirling	4.18%
Clackmannanshire	5.07%
Comhairle Nan Eilean Siar	6.75%