

Treasury Management Update | Quarter 3 2023/24

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TREASURY MANAGEMENT UPDATE

Quarter Ended 31st December 2023

The CIPFA (Chartered Institute of Public Finance and Accountancy) Code of Practice for Treasury Management 2021 recommends that members be updated on treasury management activities at least quarterly. This report, therefore, ensures this Council is implementing best practice in accordance with the Code

1. ECONOMIC UPDATE

The following information has been received from our Treasury Management advisors.

- The third quarter of 2023/24 saw:
 - A 0.3% m/m decline in real GDP in October, potentially partly due to unseasonably wet weather, but also due to the ongoing drag from higher interest rates. Growth for the second quarter, ending 30th September, was revised downwards to -0.1% and growth on an annual basis was also revised downwards, to 0.3%
 - A sharp fall in wage growth, with the headline 3myy rate declining from 8.0% in September to 7.2% in October, although the ONS “experimental” rate of unemployment has remained low at 4.2%
 - CPI inflation continuing on its downward trajectory, from 8.7% in April to 4.6% in October, then again to 3.9% in November
 - Core CPI inflation decreasing from April and May’s 31 years’ high of 7.1% to 5.1% in November, the lowest rate since January 2022
 - The Bank of England holding rates at 5.25% in November and December
 - A steady fall in 10-year gilt yields as investors revised their interest rate expectations lower.
- Overall, we expect real GDP growth to remain subdued throughout 2024 as the drag from higher interest rates is protracted but a fading of the cost-of-living crisis and interest rate cuts in the second half of 2024 will support a recovery in GDP growth in 2025.
- The labour market remains tight by historical standards, but the sharp fall in wage growth seen in October will reinforce the growing belief in markets that interest rates will be cut mid-2024. Wage growth eased in October much faster than the consensus expected. Total earnings fell by 1.6% m/m, which meant the headline 3myy rate eased from 8.0% in September to 7.2% in October. This news will be welcomed by the Bank of England.

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- CPI inflation fell from 6.7% in September to 4.6% in October, and then again to 3.9% in November. Both these falls were bigger than expected and there are clear signs of easing in domestic inflationary pressures. The fall in core CPI inflation from 5.7% to 5.1% in November was bigger than expected. That's the lowest rate since January 2022. Some of the decline in core inflation was due to the global influence of core goods inflation, which slowed from 4.3% to 3.3%. But some of it was due to services inflation falling from 6.6% to 6.3%. The Bank views the latter as a key barometer of the persistence of inflation and it came in further below the Bank's forecast of 6.9% in its November Monetary Policy Report. This will give the Bank more confidence that services inflation is now on a firmly downward path
- Our Treasury Management advisor's central assumption is that inflation will drop to the 2.0% target only if the Bank of England (the Bank) keeps interest rates at the probable peak of 5.25% until the second half of 2024.
- Moreover, it is still anticipated that the Bank of England will be keen to loosen monetary policy when the worst of the inflationary pressures are behind us – but timing on this 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. Our advisors current judgment is that rates will have to stay at their peak until the second quarter of 2024 as a minimum.
- In the upcoming months, the 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 in Israel.
- On the positive side, consumers are still estimated to be sitting on 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, most of those excess savings 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.

MPC meetings 2nd November and 14th December 2023

- On 2nd November, the Bank of England's Monetary Policy Committee (MPC) voted to keep Bank Rate on hold at 5.25%, and on 14th December reiterated that view as concerns about "sticky" inflation remained in place.

Nonetheless, with UK CPI inflation now at 3.9%, and core inflating beginning to moderate (5.1%), markets are voicing a view that rate cuts should begin in Q1 2024/25, some way ahead of the indications from MPC members.

- In addition, what happens outside of the UK is also critical to movement in gilt yields. The US has kept short-term rates in the range of 5.25%-5.50%, whilst the European Central Bank has moved its Deposit rate to a probable peak of 4%. Markets currently expect both central banks to start cutting rates in 2024.

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2. INTEREST RATES FORECAST

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 Public Works Loan Board (PWLB) rate forecasts below are based on the Certainty Rate (the standard rate minus 20 bps) which has been accessible to most authorities since 1st November 2012.

The latest forecast on 8th January sets out a view that short, medium, and long-dated interest rates will be elevated until Summer 2024, as the Bank of England seeks to squeeze inflation out of the economy.

Link Group Interest Rate View 08.01.24													
	Mar-24	Jun-24	Sep-24	Dec-24	Mar-25	Jun-25	Sep-25	Dec-25	Mar-26	Jun-26	Sep-26	Dec-26	Mar-27
BANK RATE	5.25	5.25	4.75	4.25	3.75	3.25	3.00	3.00	3.00	3.00	3.00	3.00	3.00
3 month ave earnings	5.30	5.30	4.80	4.30	3.80	3.30	3.00	3.00	3.00	3.00	3.00	3.00	3.00
6 month ave earnings	5.20	5.10	4.60	4.10	3.70	3.30	3.10	3.10	3.10	3.10	3.10	3.10	3.10
12 month ave earnings	5.00	4.90	4.40	3.90	3.60	3.20	3.10	3.10	3.10	3.10	3.10	3.20	3.20
5 yr PWLB	4.50	4.40	4.30	4.20	4.10	4.00	3.80	3.70	3.60	3.60	3.50	3.50	3.50
10 yr PWLB	4.70	4.50	4.40	4.30	4.20	4.10	4.00	3.90	3.80	3.70	3.70	3.70	3.70
25 yr PWLB	5.20	5.10	4.90	4.80	4.60	4.40	4.30	4.20	4.20	4.10	4.10	4.10	4.10
50 yr PWLB	5.00	4.90	4.70	4.60	4.40	4.20	4.10	4.00	4.00	3.90	3.90	3.90	3.90

- LIBOR and LIBID rates ceased at the end of 2021. In a continuation of previous views, money market yield forecasts are based on expected average earnings by local authorities for 3 to 12 months.
- The forecast for earnings are averages, actual rates offered by individual banks may differ significantly from these averages, reflecting their different needs for borrowing short-term cash at any one point in time.

An Overview of the Future Path of Bank Rate

Link's central forecast for interest rates was updated on 8th January 2024 and reflects a view that the MPC would be keen to underpin its anti-inflation credentials by keeping Bank Rate at 5.25% until at least the Summer of 2024. Rate cuts are expected to start when both the CPI inflation and wage/employment data are unequivocally supportive of such a move, and that there is a strong likelihood of the overall economy enduring tepid growth (at best) or a mild recession (at worst) over the coming months.

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).

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- 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 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 currently projected.
- 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.
- Projected gilt issuance, inclusive of natural maturities and Quantitative Tightening (QT), could be too much for the markets to comfortably digest without higher yields compensating.

3. ANNUAL INVESTMENT STRATEGY

The Treasury Management Strategy Statement (TMSS) for 2023/24, which includes the Annual Investment Strategy, was approved by the Council on 30 March 2023. In accordance with the CIPFA Treasury Management Code of Practice, it sets out the Council's investment priorities as being:

- Security of capital
- Liquidity
- Yield

The Council will aim to achieve the optimum return (yield) on its investments commensurate with proper levels of security and liquidity, aligned with the Council's risk appetite. In the current economic climate, over and above keeping investments short-term to cover cash flow needs, there is a benefit to seek out value available in periods up to 12 months with high credit rated financial institutions, using the Link suggested creditworthiness approach, including a minimum sovereign credit rating and Credit Default Swap (CDS) overlay information.

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As shown by the charts below and the interest rate forecasts in section 2, investment rates have remained elevated during 2023/24 but are now expected to have peaked.

The following table displays a selection of interest rates prevailing as of 1 April 2023 and 31 December 2023.

	01/04/2023	31/12/2023
Bank Base Rate	4.25%	5.25%
1 Month SONIA	4.17%	4.96%
PWLB 10-year Maturity	4.50%	4.57%
PWLB 15-year maturity	4.74%	4.92%
PWLB 25-year maturity	4.86%	5.13%

Creditworthiness

There have been few changes to credit ratings over the quarter under review. However, officers continue to closely monitor these, and other measures of creditworthiness to ensure that only appropriate counterparties are considered for investment purposes.

Investment counterparty criteria

The current investment counterparty criteria selection approved in the TMSS is meeting the requirement of the treasury management function.

CDS prices

For UK banks, there are no underlying negative themes. Prices are not misaligned with other creditworthiness indicators, such as credit ratings. Nevertheless, it remains important to undertake continual monitoring of all aspects of risk and return in the current circumstances.

Investment balances

The Council has been able to invest a total of £296.5m during the first three quarters of 2023/24, with an average investment value of £3.9m. These funds were available on a temporary basis, and the level of funds available was mainly dependent on the timing of the Council's payments, receipt of grants and progress on the capital programme.

Appendix A gives details of the investments made during the year, and the following table gives a summary, which shows the Council's average rate of return was below the benchmark. This is in line with the Authority's risk averse policy whereby the security of the capital sum is the number one priority at the expense of more competitive investment returns.

	Total Value of Investments	Average Investment	Investment Returns	Average Rate of Return	Benchmark Return *
Internally Managed	£296.5m	£3.9m	£1.5m	4.78%	4.96%

* Benchmark = 1 month SONIA uncompounded

4.96%

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The above investment returns include £651,544 of interest received in relation to the ongoing investment of the funds received from the Welsh Government in respect of the Rail Infrastructure Loan. There is a condition of the funding approval that states any interest earned from holding the loan must be added to the works programme. Therefore, this income will be placed into a reserve until such time it is used to fund works or can be transferred to the Authority. The remaining £847,399 investment returns relates to interest due from the investment of the Council's own funds.

As illustrated, the Council underperformed the benchmark by 18 bps, however the Council's budgeted investment return for 2023/24 is £320,500 and due to the availability of funds to invest and the continued increases in bank rates above previous forecasts, the Council has significantly exceeded this estimate.

Approved limits

Officers can confirm that the approved limits within the Annual Investment Strategy were not breached during the quarter ended 31st December 2023.

4. BORROWING

In mid-December the Lender of a Market (LOBO) loan gave notice of proposed rate increase from 4.50% to 5.94%. The Authority has opted to repay £4m of Market (LOBO) loans during the first week of quarter four.

Due to the current elevated level of interest rates, the Council is not planning to undertake long-term borrowing but will instead borrow in the short-term for re-financing of long-term debt or for cash flow purposes, due to the expectation that interest rates will begin to fall during 2024.

This situation will be monitored closely by the Treasury Management team, who will plan the future borrowing requirement of the Council in line with forecast interest rates.

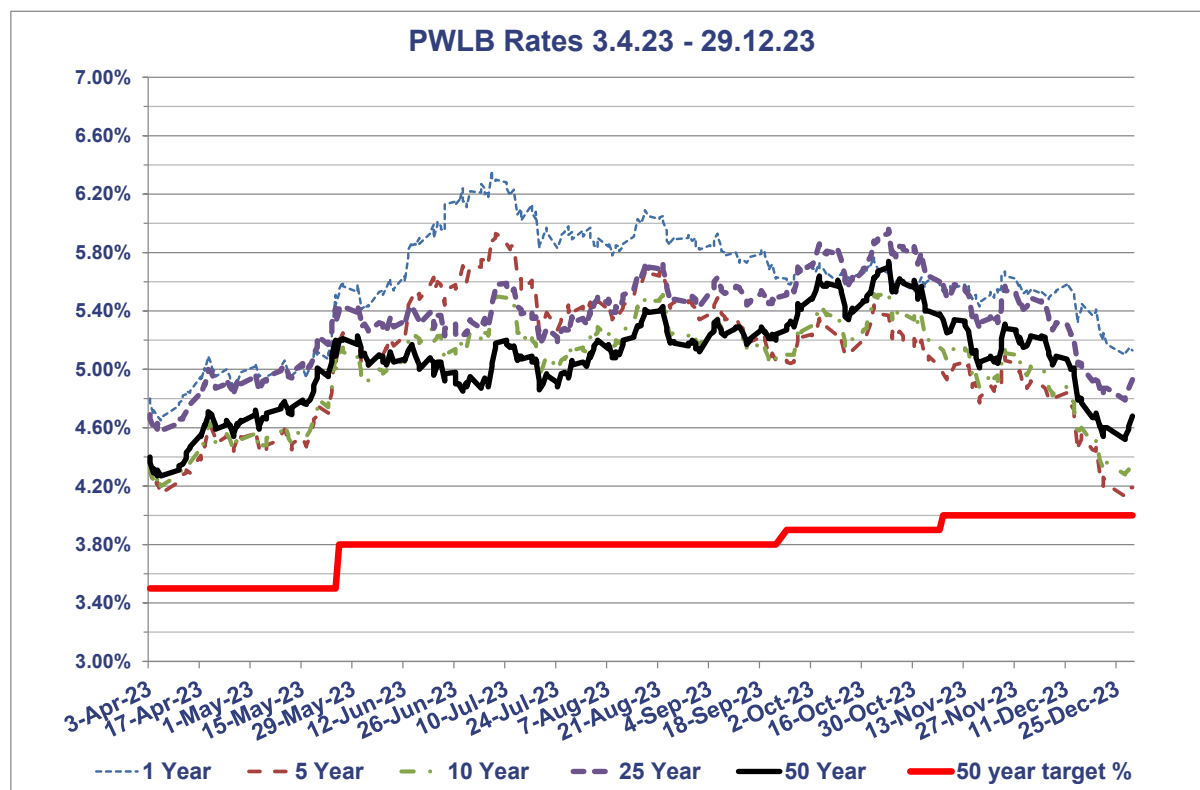
PWLB maturity Certainty Rates 1st April to 31st December 2023

Gilt yields and PWLB rates were on a rising trend from April through to October but dropped back significantly in November and December.

The 50-year PWLB Certainty Rate target for new long-term borrowing started 2023/24 at 3.50% (the lowest forecast rate within a two-year time horizon), increasing to a peak of 4.00% in November. With rates elevated across the whole of the curve, it is advised to not borrow long-term unless the Authority wants certainty of rate and judges the cost to be affordable.

PWLB RATES 3.4.23 - 29.12.23

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Temporary Loans

Appendix B lists the short-term loan activity during the year and shows that over the period a total of £48.4 million loans were brought forward from the previous year and £49.3 million of new short-term loans were raised. A total of £61.3 million of these loans have been repaid during the year (including the brought forward loans), leaving a balance outstanding as of 31 December 2023 of £36.5 million. The decrease in short-term loans can be attributed to the running down of our own investments in order to reduce the requirement of the need to borrow to fund short term cash flow deficits.

The following table gives a summary which shows that the average rate of interest paid was well within the benchmark. However, this is due to the Council entering into short-term borrowing when interest rates were low. With the current high level of interest rates, further borrowing will exceed the benchmark rate. This is still seen as the preferred option of borrowing, instead of entering into long-term borrowing now when rates are expected to fall during 2024.

	Total Value of Loans during the period	Average Loan	Interest paid during the period	Average Interest Rate	Benchmark Interest Rate *
Short Term borrowing	£97.72m	£4.29m	£0.9m	3.24%	4.50%

* Benchmark = budgeted interest rate for new borrowings 4.50%

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The Council's budgeted interest on temporary borrowing for 2023/24 is £1.98m. The Treasury Management team forecast that temporary borrowing interest will not exceed £1.5m for the financial year.

As shown in section 3, the Council has exceeded its investment returns target for the financial year. Should the interest on temporary borrowing exceed the in year budget, it is anticipated that any additional investment interest received will offset the increased cost of borrowing.

5. DEBT RESCHEDULLING

Debt rescheduling opportunities have increased significantly in the current quarter where gilt yields, which underpin PWLB rates and market loans, have risen materially. Members will be advised if there is value to be had by rescheduling or repaying a part of the debt portfolio.

No debt rescheduling has been undertaken during the financial year.

6. COMPLIANCE WITH TREASURY AND PRUDENTIAL LIMITS

The prudential and treasury Indicators are shown in Appendix 2.

It is a statutory duty for the Council to determine and keep under review the affordable borrowing limits. During the quarter ended 31st December 2023, the Council has operated within the treasury and prudential indicators set out in the Council's Treasury Management Strategy Statement for 2023/24. The Chief Officer Resources reports that no difficulties are envisaged for the current or future years in complying with these indicators.

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

Please note that the outturn figures for 2022/23 are unaudited at this stage, so may be subject to change.