Corporate Governance, Audit and Standards Committee
31 July 2024

EXECUTIVE HEAD OF FINANCE
REPORT NO: FIN2409

TREASURY MANAGEMENT AND NON-TREASURY INVESTMENT OPERATIONS 2023/24

SUMMARY:
This report sets out the activities of the Treasury Management and non-Treasury Investment Operations for the full financial year 2023/24, and reports on compliance with Prudential Indicators.

RECOMMENDATIONS:
Members are requested to:

(i) Pass comment to the Cabinet on the contents of this report in relation to the treasury management and non-treasury investment operations carried out during 2023/24.

1. INTRODUCTION

1.1 This report sets out the Treasury Management and Non-Treasury Investment operations for 2022/23. This report is a statutory requirement under the CIPFA Code of Practice on Treasury Management.

1.2 Full Council approved the Annual Treasury Management Strategy and Non-Treasury Investment Strategy for the financial year 2023/24 in February 2023. The Council's treasury management activity is underpinned by CIPFA's Code of Practice on Treasury Management 2021 ("the Code") and is fully incorporated into the Council's adopted strategy.

2. PURPOSE

2.1 This report sets out compliance with the strategy and performance against Prudential Indicators to the end of 2023/24 within appendices (A to D):

<u>**Appendix A**</u>

- The **Treasury Management operations** which sets out how the Council's treasury service operated during the period to March 2024;
- The **Treasury Management Borrowing** which sets out the Council's borrowing during the period to March 2024, and;
- The **Treasury Management Investments** which sets out the Council's Treasury Management investment operations for the period to March 2024.

Appendix B

- The **Non-Treasury Investment** sets out the Council's Non-Treasury investment performance for the period to March 2024.

Appendix C

- the **Prudential indicators** performance is compared to the indicators set out in the Annual Capital Strategy for the year 2023/24.

Appendix D

- The list of borrowing counterparties as at end of March 2024.

Appendix E

- Market commentary regarding from the Council's treasury management advisors Arlingclose

3 BACKGROUND

3.1 The Chartered Institute of Public Finance and Accountancy (CIPFA) have issued guidance on the aims and requirements of a Capital Strategy focusing on a whole organisation approach to prudent, sustainable, and resilient local government investment.

3.2 CIPFA have also issued two professional Codes of Practice to which the Council is required to "have regard to". These Codes provide frameworks that are designed to support local strategic planning, local asset management planning and proper option appraisal:

- The Prudential Code – developed to support local authorities in taking decisions around their capital investment programmes. The objectives of the Prudential Code are to ensure, within a clear reporting framework, that a local authority's capital expenditure plans and investment plans are affordable and proportionate; that all external borrowing and other long-term liabilities are within prudent and sustainable levels; that the risks associated with investments for commercial purposes are proportionate to their financial capacity; and that treasury management decisions are taken in accordance with good professional practice.
- The Treasury Management Code - Treasury Management is defined as 'The management of the organisation's borrowing, investments, and cash flows, including 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'.

3.3 The primary purpose of the treasury management operation is to ensure that cash flow is adequately planned, with cash being available when it is needed to deliver the Councils services. The secondary function of the treasury management operation is the funding of the Council's capital programme and manage cashflow requirements over a longer term period.

3.4 Non-treasury investment operations should ensure that all investments made primarily for service reasons. Then, second to this, the function of investment management is to generate returns.

4 CONCLUSIONS ON THE TREASURY MANAGEMENT AND NON-TREASURY INVESTMENT OPERATIONS DURING 2023/24

4.1 All treasury activity was conducted within the approved Treasury Management Practices (TMP's) for all areas apart from the interest exposure measure, please see paragraph 2.4 in Appendix C for details.

4.2 During 2023/24 there was an unprecedented number of Bank of England base rate increases from 3% in March 2023 to the current 5.25%. Whilst borrowing has remained within the approved limits (£200.8 million), interest costs have significantly increased. The majority of borrowing is currently short term and will remain so until the interest rate reduces. The rates are predicted by the financial markets to reduce circa 4% by the end of the calendar year 2025. The Council's revenue budget has capacity to pay approximately £3million interest on its borrowing, equating to £100million of borrowing in the long term. Interest costs above £3million are being funded by the Council's reserves. A full narrative on this challenge, including long term mitigation, is provided in the 2024/25 Annual Treasury Management Strategy adopted by Full Council at its meeting on 22nd February 2024.

4.3 Pooled funds are a long-term investment of surplus cash. Due to the rapid change in base rate and forecast economic climate the funds are currently valued at less than initial sums invested, full detail can be found in section 5. The mitigation is to hold these funds into the future to avoid the crystallisation of the capital loss. The current return of pooled funds is performing in line with short term treasury deposits.

5 KEY RISKS

5.1 The key risks to the Councils delivery of successful treasury and non-treasury investment options include:

- Inflation levels; inflation is now reducing after a prolonged period of increased levels and reached the bank of England inflation target of 2% in June 2024.
- Bank of England Base rate is currently 5.25%. Expectations are that this will reduce during quarter 2 or quarter 3, however latest market forecast shows a slower than anticipated reduction.
- Delivery of Capital Programme: Will impact borrowing requirements and timing will impact rates achievable for both borrowing and investments during the year.

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APPENDIX A

<u>Treasury management operation for the quarter ended March 2024</u>

1 INTRODUCTION

1.1 The purpose of the treasury management operation is to ensure that cash flow is adequately planned, with cash being available when it is needed, ensuring security of surplus monies invested and minimise the Council's cost of borrowing. The Council has adopted security, liquidity and then yield (SLY) as its treasury investment model objectives.

2 TREASURY MANAGEMENT ADVICE

2.1 The Council engages the services of Arlingclose for independent treasury advice. They provide a range of treasury management services including technical advice on debt and investment management and long-term capital financing. They advise on investment trends, developments and opportunities consistent with the Council's Treasury Management Strategy.

2.2 All investment activity is carried out by the Council's own treasury team with advice from Arlingclose and having due regard to information from other sources such as the financial press and credit-rating agencies.

2.3 The Council's treasury management team maintain their knowledge of investment management. Staff attended relevant workshops provided by Arlingclose and other service providers.

3 TREASURY MANAGEMENT OPERATIONS

3.1 All treasury management activities undertaken during the year complied fully with the CIPFA Code of Practice and the Council's Approved Treasury Management Strategy, apart from the measure of interest exposure measure, please see paragraph 2.4 in Appendix C for details. Full detail of compliance against treasury indicators are given in Appendix C.

3.2 The Council measures the financial performance of its treasury management activities both in terms of its impact on the revenue budget and its relationship to benchmark interest rates to ensure value for money is achieved.

3.3 The treasury management position as at 31 March 2024 and the change during the year is shown in the table below.

	31/03/2023 Balance £m	Movement £m	31/03/2024 Balance £m	Rate %
Long-term borrowing (> 12 months)	5.0	0.0	5.0	4.65
Short-term borrowing (< 12 months)	115.0	42.0	157.0	6.03
Total Borrowing	**120.0**	**42.0**	**162.0**	
Pooled Funds	(19.3)	(0.2)	(19.5)	5.80
Short-term investments	-	(15.0)	(15.0)	5.75
Cash	(1.8)	(4.5)	(6.3)	4.96
Total Investments	**(21.1)**	**(19.7)**	**(40.8)**	
Net borrowing/(investments)	**98.9**	**22.3**	**121.2**	

4 TREASURY MANAGEMENT BORROWING OPERATIONS

4.1 As at 31 March 2024 the Council held £162m of loans, an increase of £42m from the position at 31 March 2023, as part of its strategy for funding previous and current years' capital programmes, these are summarised in the table below.

Borrowing	31/03/2023 Balance £m	Movement £m	31/03/2024 Balance £m	Rate %
Long-term borrowing	5.0	0.0	5.0	4.65
Short-term borrowing	115.0	42.0	157.0	6.03
Total Borrowing	**120.0**	**42.0**	**162.0**	

5 INVESTMENT ACTIVITY IN 2023/24

5.1 The Council lends (invests) surplus cash as part of its day-to-day cash flow management. During the year, the Council's investment position is shown in the table below. Money Market Funds are same day maturity whilst Pooled Funds have no defined maturity date, however, are available for withdrawal after a notice period of a week with the exception of CCLA fund (6 months).

Investment	31/03/2023 Balance £m	Movement £m	31/03/2024 Balance £m	Rate %
Money Market Funds	1.1	5.5	6.5	5.07
Pooled Funds	21.9	-	21.9	5.80
Deposits with other LA's	-	15.0	15.0	5.75
Total	**23.0**	**20.5**	**43.4**	

5.2 All Money Market Fund investments are with counterparties credit rated A+, this is in compliance with Treasury management Practices (TMP's) Appendix C. A full list of Money Market investments made can be found below.

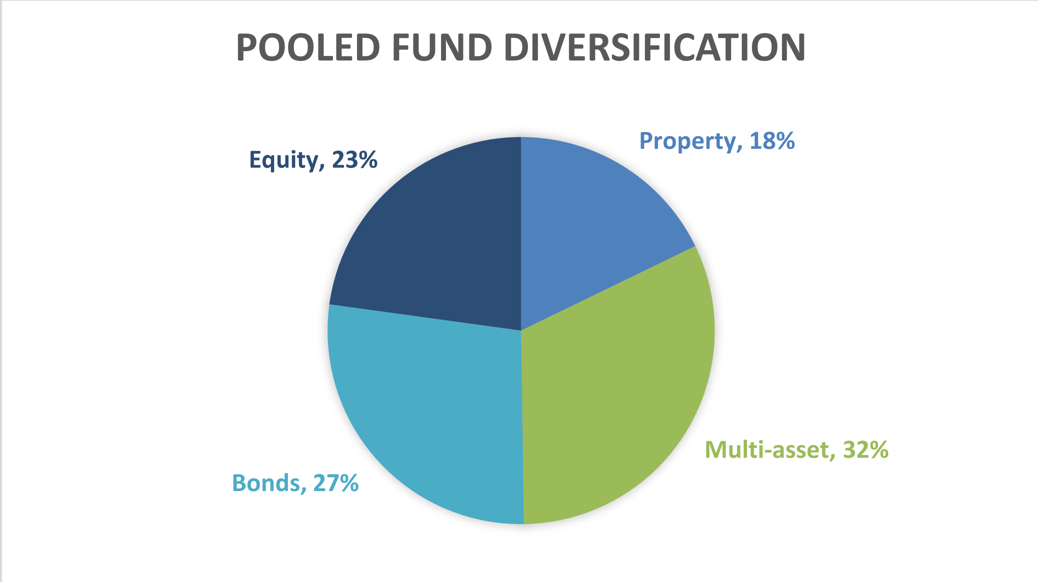
Money Market Funds	£
Aberdeen Standard Investments	200,000
Deutsche Bank	100,000
Insight	350,000
CCLA Public Sector Deposit Fund	800,000
Federated Short-Term Sterling Prime Fund	5,000,000
Total	6,450,000

Current deposits with other Local Authorities are as follows:

Deposits with other Local Authorities	£
City of Kingston Upon Hull	5,000,000
PCC Lancashire	5,000,000
City of Stoke on Trent	5,000,000
Total	15,000,000

5.3 £21.9m of the Council's investments are held in externally managed strategic pooled funds spread (diversified) across equity, multi-asset, bond and property funds where short-term security and liquidity are lesser considerations, and objectives are regular revenue income and long-term price stability. The value of the pooled fund portfolio had decreased to £19.49m as reported at the end of Quarter 3 (December 2023), this has improved to £19.51m in March 2024.

Diversification of Pooled Fund	Amount invested £m	% of Total Investments
Property	3.9	18%
Multi-asset	7.0	32%
Bonds	6.0	27%
Equity	5.0	23%
Total	**21.9**	**100%**



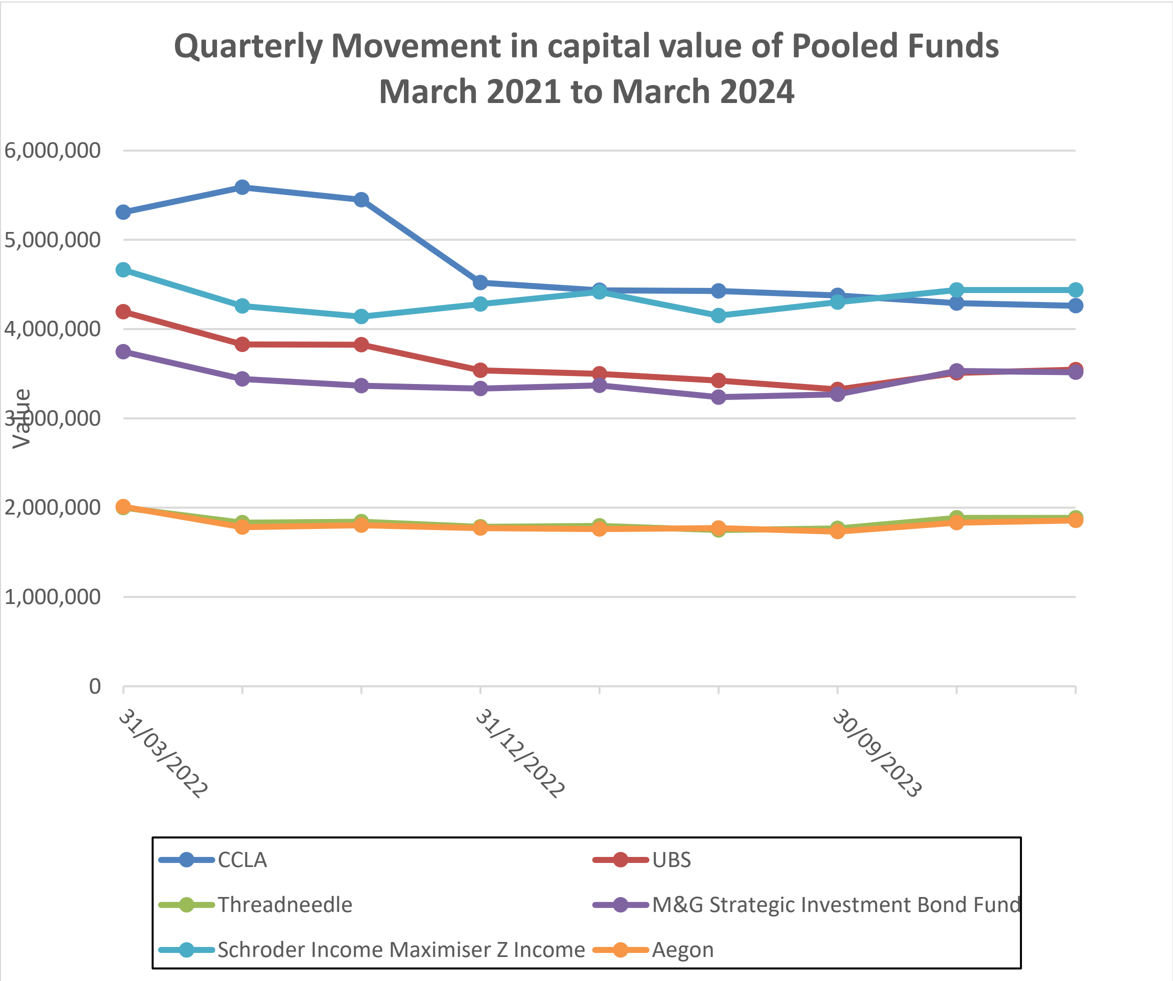
Pooled Funds performance				Capital Growth/ (Loss)	Dividends Earned
Fund Name	Cost	Valuation 31/03/23	Valuation 31/03/24	March 2023- March 2024	
Aegon (Kames)	2,000,000	1,761,757	1,856,814	95,057	115,021
CCLA – Lamit Property Fund	3,882,127	4,435,090	4,262,094	(172,996)	223,281
M&G Strategic Corporate Bond Fund	4,000,000	3,370,666	3,518,177	147,511	164,005
Schroder Income Maximiser Fund	5,000,000	4,417,453	4,440,218	22,765	312,593
Threadneedle Strategic Bond Fund	2,000,000	1,796,674	1,887,682	91,008	77,484
UBS Multi Asset Income Fund	5,000,000	3,498,761	3,547,223	48,462	225,205
	21,882,127	19,280,402	19,512,207	231,805	1,117,591

5.4 As these funds have no defined maturity date, but are available for withdrawal after a notice period, their performance and continued suitability in meeting the Council’s long term investment objectives is being reviewed.

5.5 **Accounting Standard IFRS9 impact April 2025** – The statutory override for pooled funds in England – requires change in value of the original capital invested (i.e., current market price resulting in gains and losses) to be held as a value on the Balance Sheet until the fund is sold (i.e., when the gain or loss becomes real) – is set to end in 2025/26, i.e., the last year it will be in place will be 2024/25. Pooled funds are currently valued below their purchase price because of rising interest rates and the economic downturn, resulting in a loss that will be an unbudgeted cost to the General Fund (rather than held as a notional value on the balance sheet) in **2025/26**.

5.6 Currently the override ending is a risk. If the override does end, Pooled Funds will introduce significant volatility on the Councils revenue budget because the revenue account will be subject to movements in Pooled fund valuation each year. Immediate divestment will result in a real cost to the revenue account, the values are improving, and the best mitigation strategy will be to set aside a revenue reserve to cover a reasonable worst-case scenario of the cost that reflects the current unrealised loss and expected improvement through to March 2026.

5.8 There is variation in performance across the portfolio over the last two years as shown below.



5.9 **Income Returns**_– The income returned by fund for the period to 31 March 2024 is analysed below:

- CCLA's Local Authorities' Mutual Investment Trust - £3.9 million investment at commencement of the year. The Property Fund is designed to achieve long-term capital growth and income from investments in the commercial property sector. The fund has returned 5.03% annualised income during 2023/24.

- UBS Multi-Asset Income Fund - £5 million investment. This fund follows a strategy of reducing volatility exposure levels by spreading investments across a diversified range of asset classes. This fund has returned 6.44% annualised income during 2023/24.

- Threadneedle Strategic Bond Fund - £2 million investment. The fund aims to provide income and capital appreciation through investment grade and high yield bonds. This fund has returned 4.31% annualised income during 2023/24

- M & G Corporate Bond Fund - £4m investment. This fund aims for a target total return of 3-5% from a combination of investment income or capital appreciation. This fund has returned 4.87% annualised income during 2023/24.

- Schroder Income Maximiser Fund - £5m investment made in December 2018. The fund aims to provide both income and capital growth, delivering a target income of 7.77% per annum. The fund has returned 7.08% annualised during 2023/24.

- Aegon Diversified Monthly Income Fund - £2m investment made in February 2019. The fund aims to provide income with the potential for capital growth over the medium term. The fund has returned 6.53% annualised during 2023/24.

6 TREASURY MANGEMENT COMPLIANCE PERFORMANCE

6.1 Detailed compliance with TMP's approved in February 2023 for 2023/24 financial year is provided in Appendix C.

APPENDIX B

NON-TREASURY INVESTMENT OPERATIONS FOR 2023/24

1 INTRODUCTION

1.1 The purpose of non-treasury investment management operations is to ensure that all investment decisions are made with a suitable level of security and liquidity. Ensuring risks and rewards are monitored regularly.

1.2 The Council holds £143.8m of such investments at as 31 March 2024 in:

- directly owned property £135.8m
- loans to local businesses and landlords £6.5m
- loans to subsidiaries and partnerships £1.4m

2 PROPORTIONALITY

2.1 The Council is dependent on profit generating investment activity to achieve a balanced revenue budget. The table below shows the forecast proportion of gross service expenditure funded by investment activity. This table includes Housing Benefits, to give consistency on prior reporting in year.

	2022/23	2023/24	
	Actual £m	Budget £m	Outturn £m
Gross Service Expenditure	58.0	57.5	67.7
Investment Income	8.1	8.3	8.2
Proportion	14.0%	14.4%	12.2%

The below table excludes the impact of Housing Benefits flowing through the income and expenditure to give a truer representation of

	2022/23	2023/24	
	Actual £m	Budget £m	Outturn £m
Gross Service Expenditure excluding Housing Benefit	33.9	34.5	42.3
Investment Income	8.1	8.3	8.2
Proportion	23.9%	24.1%	19.5%

3 SERVICE IMPROVEMENT LOANS

3.1 The Council lends money to its subsidiaries, local businesses, and its employees to support local public services and stimulate local economic growth. The Council is a funding partner of Farnborough International Limited (FIL), enabling FIL to develop the Farnborough International exhibition and conference centre. Expanding the exhibition and conferencing capabilities in Farnborough brings increased economic capacity to the Borough and is a investment in local business.

3.2 The Council's performance and upper limits on the outstanding loans to each category of borrower have been set as follows:

Category of Borrower	2023/24 Approved Limit £m	March 2024 Actual £m
Local businesses	6.7	6.5
Subsidiaries & Partnerships	3.5	1.4
Employees	0.1	0.0
Total	**10.3**	**8.0**

4 SERVICE INVESTMENTS: SHAREHOLDING IN SUBSIDIARIES

4.1 The Council invests in the shares of its subsidiary and holds a financial share in a development partnership and Rushmoor Homes to support local public services and stimulate local economic growth.

5 COMMERCIAL INVESTMENT: PROPERTY

5.1 The Council invests in local and regional commercial and residential property with the intention of making a net surplus that will be spent on local public services.

During the year the Council purchased The Meads as part of its regeneration masterplan.

Property by Type	2023 Carry Forward	2023/24 transactions Purchase Cost	Sales	Total

Mixed Use	5.2	-	-	4.5
Industrial Units	26.9	-	-	23.7
Retail	50.8	6.4	-	57.2
Offices	43.0	1.2	-	44.2
Total	**125.9**	**7.6**	**-**	**133.5**

6 NON-TREASURY INVESTMENT INDICATORS

6.1 The Council measures and manages its exposures to non-treasury investment risks using the following indicators.

6.2 **Total risk exposure:** This indicator shows the Council's total exposure to potential investment losses. This includes amounts the Council is contractually committed to lend but have yet to be drawn.

Total Investment Exposure	31-Mar-2024	
	Estimate £m	Outturn £m
Treasury Management Investments	35.9	43.4
Service Investments: Loans	8.1	8.0
Service Investments: Shares	-	-
Commercial Investments: Property	133.5	135.8
Total Investment	**177.5**	**187.2**
Commitment to lend	2.9	-
Total Exposure	**180.4**	**187.2**

6.3 **How investments are funded:** Government guidance is that these indicators should include how investments are funded. Since the Council does not normally associate particular assets with particular liabilities, this guidance is difficult to comply with. However, the following investments could be described as being funded by borrowing. The remainder of the Council's investments are funded by usable reserves and income received in advance of expenditure (internal borrowing).

	31-Mar-2024	
Investments funded by borrowing	**Estimate £m**	**Actual £m**
Service Investments: Loans	8.1	8.0
Commercial Investments: Property	133.5	135.8
Investment in Town Centres	30.5	18.2
Total Funded by Borrowing	**172.1**	**162.0**

6.4 **Rate of return received:** This indicator shows the investment income received less the associated costs, including the cost of borrowing where appropriate, as a proportion of the sum initially invested. Note that due to the complex local government accounting framework, not all recorded gains and losses affect the revenue account in the year they are incurred.

Investments rate of return (net of all costs)	**31-Mar-2024**	
	Estimate %	**Actual %**
Treasury Management investment	4.0	5.7
Service Investments: Loans	5.5	4.9
Commercial Investments: Property	2.6	5.3

APPENDIX C

PRUDENTIAL INDICATORS

1.1 **Prudential Indicators:_**The following indications are required by the CIPFA "Prudential Code" 2017 edition.

1.2 **Estimates of Capital Expenditure:** The Council's planned capital expenditure and financing may be summarised as follows.

	2023/24	
	Budget £m	**Outturn £m**
General Fund Capital Expenditure	50.0	34.6
Total	**50.0**	**34.6**
External Sources	9.2	4.8
Own Resources	2.6	1.9
Debt	38.2	27.9
Total	**50.0**	**34.6**

1.3 Debt is only a temporary source of finance, since loans and leases must be repaid, and this is therefore replaced over time by other financing, usually from revenue, which is known as minimum revenue provision (MRP). Alternatively, proceeds from selling capital assets (known as capital receipts) may be used to replace debt finance. Planned MRP and use of capital receipts are as follows:

	2023/24	
	Budget £m	**Outturn £m**
MRP	2.17	1.57
Capital Receipts	2.63	0

1.4 **Gross Debt and the Capital Financing Requirement:** In order to ensure that over the medium-term debt will only be for a capital purpose, the Council should ensure that debt does not, except in the short term, exceed the total of capital financing requirement in the preceding year plus the estimates of any additional capital financing requirement for the current and next two financial years. This is a key indicator of prudence.

	2023/24	
	Budget £m	Outturn £m
Debt (inc. leases)	172.1	162.0
Capital Financing Requirement	177.0	167.6
Difference	4.9	5.6

1.5 **Affordable borrowing limit:** The Council is legally obliged to set an affordable borrowing limit (also termed the authorised limit for external debt) each year. In line with statutory guidance, a lower "operational boundary" is also set as a warning level should debt approach the limit.

	2023/24	
	Budget Limit £m	Outturn £m
Authorised Limit - total external debt	200.8	162.0
Operational Boundary - total external debt	195.8	162.0

1.6 Compliance with specific investment limits is demonstrated in the table below.

	31-Mar-24 Actual £m	2023/24 Limit £m	Complied?
Any group of pooled funds under the same management	21.9	25.0	Yes
Money Market Funds	6.6	25.0	Yes

2 TREASURY MANAGEMENT INDICATORS

2.1 The Council measures and manages its exposures to treasury management risks using the following indicators.

2.2 **Security:** The Council has adopted a voluntary measure of its exposure to credit risk by monitoring the value-weighted average credit rating of its investment portfolio. This is calculated by applying a score to each investment (AAA=1, AA+=2, etc.) and taking the arithmetic average, weighted by the size of each investment. Unrated investments are assigned a score based on their perceived risk.

	31-Mar-24 Actual	2023/24 Target	Complied?
Portfolio average credit rating	A+	A-	Yes

Liquidity: The Council has adopted a voluntary measure of its exposure to liquidity risk by monitoring the amount it can borrow each period without giving prior notice.

	31-Mar-24 Actual £m	2023/24 Target £m	Complied?
Total sum borrowed in past 3 months without prior notice	-	1.0	Yes

2.4 **Interest Rate Exposures**: This indicator is set to control the Council's exposure to interest rate risk on variable accounts. The upper limits on the one-year revenue impact of a 1% rise or fall in interest rates will be:

Borrowing net of Investments	31-Mar-24 Actual £m	2023/24 Limit £m	Complied?
Upper limit on one-year impact of a 1% **rise** in interest rates (on borrowing net of investments)	0.685	0.5	No
Upper limit on one-year impact of a 1% **fall** in interest rates (on borrowing net of investments)	1.197	0.5	No

Borrowing	31-Mar-24 Actual £m	2023/24 Limit £m	Complied?
Upper limit on one-year impact of a 1% **rise** in interest rates (on borrowing only)	0.873	0.5	No
Upper limit on one-year impact of a 1% **fall** in interest rates (on borrowing only)	1.984	0.5	No

Investments	31-Mar-24 Actual £m	2023/24 Limit £m	Complied?

Upper limit on one-year impact of a 1% **rise** in interest rates (on investments)	0.187	0.5	Yes
Upper limit on one-year impact of a 1% **fall** in interest rates (on investments)	0.187	0.5	Yes

In prior period only the investment position has been reported. This report now shows the net and borrowing position for completeness. On each of these bases, the £0.5m target has been exceeded due to the levels of borrowing the Council currently has in place. The Council is unable to take action on this currently as the borrowing is required for treasury management cashflow and funding of committed capital expenditure. However, it can be noted that the risk to the Council is higher than approved levels.

2.5 The impact of a change in interest rates is calculated on the assumption that maturing loans and investments will be replaced at current rates.

2.6 Time periods start on the first day of each financial year. The maturity date of borrowing is the earliest date on which the lender can demand repayment.

2.7 **Principal Sums Invested for Periods Longer than a year:** The purpose of this indicator is to control the Council's exposure to the risk of incurring losses by seeking early repayment of its investments. The limits on the long-term principal sum invested to final maturities beyond the period end were:

Currently investments beyond year end are mainly made up of pooled funds. Currently, as the pooled funds are in a capital loss position, strategically the council has decided to hold on to these investments. The trend over recent months is that valuations are improving. These investments deliver dividend income for the council in the meantime.

	2023/24 £m	**2022/23 £m**	**2021/22 £m**
Actual principal invested beyond year end	36.9	21.9	21.9
Limit on principal invested beyond year end	90.0	90.0	90.0
Complied	Yes	Yes	Yes

APPENDIX D

LIST OF DEBT COUNTERPARTIES AS AT 31 MARCH 2024

	Amount £
Chichester District Council	5,000,000
Merseyside Fire and Rescue Services	3,000,000
Rushcliffe Borough Council	5,000,000
Vale of Glamorgan Council	3,000,000
North of Tyne Combined Authority	5,000,000
Bolton Metropolitan Borough Council	5,000,000
Vale of Glamorgan Council	2,000,000
Northern Ireland Housing Executive	5,000,000
Oxfordshire County Council	5,000,000
Northern Ireland Housing Executive	10,000,000
West Midlands Combined Authority	5,000,000
Somerset County Council Pension Fund	3,000,000
West Yorkshire Combined Authority	7,000,000
Oxfordshire County Council	5,000,000
West Yorkshire Combined Authority	3,000,000
Nottinghamshire Office of the PCC	6,000,000
Vale of White Horse District Council	5,000,000
North Ayrshire Council	5,000,000
West of England Combined Authority	10,000,000
Crawley Borough Council	2,000,000
South Oxfordshire County Council	5,000,000
Vale of White Horse District Council	2,500,000
West Yorkshire Combined Authority	5,000,000
Furness Building Society	7,500,000
Renfrewshire Council	5,000,000
Warwickshire County Council	5,000,000
West Midlands Combined Authority	10,000,000
Havant Borough Council	5,000,000
West Midlands Combined Authority	5,000,000
Crawley Borough Council	3,000,000
Test Valley Borough Council	5,000,000
Gloucestershire County Council	5,000,000
	162,000,000

APPENDIX E

Market commentary regarding the year 2023/24 from the Council's treasury management advisors Arlingclose – April 2024

Economic background: UK inflation continued to decline from the 8.7% rate seen at the start of 2023/24. By the last quarter of the financial year headline consumer price inflation (CPI) had fallen to 3.4% in February but was still above the Bank of England's 2% target at the end of the period. The core measure of CPI, i.e., excluding food and energy, also slowed in February to 4.5% from 5.1% in January, a rate that had stubbornly persisted for three consecutive months.

The UK economy entered a technical recession in the second half of 2023, as growth rates of -0.1% and -0.3% respectively were recorded for Q3 and Q4. Over the 2023 calendar year GDP growth only expanded by 0.1% compared to 2022. Of the recent monthly data, the Office for National Statistics reported a rebound in activity with economy expanding 0.2% in January 2024. While the economy may somewhat recover in Q1 2024, the data suggests that prior increases in interest rates and higher price levels are depressing growth, which will continue to bear down on inflation throughout 2024.

Labour market data provided a mixed message for policymakers. Employment and vacancies declined, and unemployment rose to 4.3% (3mth/year) in July 2023. The same month saw the highest annual growth rate of 8.5% for total pay (i.e., including bonuses) and 7.8% for regular pay growth (i.e. excluding bonuses). Thereafter, unemployment began to decline, falling to 3.9% (3mth/year) in January and pay growth also edged lower to 5.6% for total pay and 6.1% for regular pay, but remained above the Bank of England's forecast.

Having begun the financial year at 4.25%, the Bank of England's Monetary Policy Committee (MPC) increased Bank Rate to 5.25% in August 2023 with a 3-way split in the Committee's voting as the UK economy appeared resilient in the face of the dual headwinds of higher inflation and interest rates. Bank Rate was maintained at 5.25% through to March 2024. The vote at the March meeting was 8-1 in favour of maintaining rates at this level, with the single dissenter preferring to cut rates immediately by 0.25%. Although financial markets shifted their interest rate expectations downwards with expectations of a cut in June, the MPC's focus remained on assessing how long interest rates would need to be restrictive in order to control inflation over the medium term.

In the Bank's quarterly Monetary Policy Report (MPR) released in August 2023 the near-term projection for services price inflation was revised upwards, goods price inflation widespread across products, indicating stronger domestic inflationary pressure with second-round effects in domestic prices and wages likely taking longer to unwind than they did to emerge. In the February 2024 MPR the Bank's expectations for the UK economy were positive for the first half of 2024, with a recovery from the mild recession in calendar H2 2023 being gradual. Headline CPI was forecast to dip below the 2% target quicker than previously thought due to declining energy prices, these effects would hold inflation slightly above target for much of the forecast horizon.

Following this MPC meeting, Arlingclose, the authority's treasury adviser, maintained its central view that 5.25% remains the peak in Bank Rate and that interest rates will most likely start to be cut later in H2 2024. The risks in the short-term are deemed to be to the downside as a rate cut may come sooner than expected, but then more broadly balanced over the medium term.

The US Federal Reserve also pushed up rates over the period, reaching a peak range of between 5.25-5.50% in August 2023, where it has stayed since. US policymakers have maintained the relatively dovish stance from the December FOMC meeting and at the meeting in March, economic projections pointed to interest rates being cut by a total of 0.75% in 2024.

Following a similarly sharp upward trajectory, the European Central Bank hiked rates to historically high levels over the period, pushing its main refinancing rate to 4.5% in September 2023, where it has remained. Economic growth in the region remains weak, with a potential recession on the cards, but inflation remains sticky and above the ECB's target, putting pressure on policymakers on how to balance these factors.

Financial markets: Sentiment in financial markets remained uncertain and bond yields continued to be volatile over the year. During the first half of the year, yields rose as interest rates continued to be pushed up in response to rising inflation. From October they started declining again before falling sharply in December as falling inflation and dovish central bank attitudes caused financial markets to expect cuts in interest rates in 2024. When it emerged in January that inflation was stickier than expected and the BoE and the Federal Reserve were data dependent and not inclined to cut rates soon, yields rose once again, ending the period some 50+ bps higher than when it started.

Over the financial year, the 10-year UK benchmark gilt yield rose from 3.44% to peak at 4.75% in August, before then dropping to 3.44% in late December 2023 and rising again to 3.92% (28 March 2024). The Sterling Overnight Rate (SONIA) averaged 4.96% over the period to 31 March.

Credit review: In response to an improving outlook for credit markets, in January 2024 Arlingclose moved away from its previous temporary stance of a 35-day maximum duration and increased its advised recommended maximum unsecured duration limit on all banks on its counterparty list to 100 days.

Earlier in the period, S&P revised the UK sovereign outlook to stable and upgraded Barclays Bank to A+. Moody's also revised the UK outlook to stable, Handelsbanken's outlook to negative, downgraded five local authorities, and affirmed HSBC's outlook at stable while upgrading its Baseline Credit Assessment. Fitch revised UOB's and BMO's outlooks to stable.

In the final quarter of the financial year, Fitch revised the outlook on the UK sovereign rating to stable from negative based on their assessment that the risks to the UK's public finances had decreased since its previous review in October 2022, the time of the mini-budget.

Moody's, meanwhile, upgraded the long-term ratings of German lenders Helaba, Bayern LB and LBBW on better solvency and capital positions, despite challenges from a slowing German economy and exposure to the commercial real estate sector. Moody's also upgraded or placed on review for an upgrade, Australian banks including ANZ, CBA NAB and Westpac on the back of the introduction of a new bank resolution regime.

Credit default swap prices began the financial year at elevated levels following the fallout from Silicon Valley Bank and collapse/takeover of other lenders. From then the general trend was one of falling prices and UK lenders' CDS ended the period at similar levels to those seen in early 2023. Earlier in the year some Canadian lenders saw their CDS prices rise due to concerns over a slowing domestic economy and housing market, while some German lenders were impacted by similar economic concerns and exposure to commercial real estate towards the end of the period, with LBBW remaining the most elevated.

Heightened market volatility is expected to remain a feature, at least in the near term and, credit default swap levels will be monitored for signs of ongoing credit stress. As ever, the institutions and durations on the Authority's counterparty list recommended by Arlingclose remain under constant review.