Resources and Fire & Rescue Overview and Scrutiny Committee

21 February 2024

Treasury Management Update Quarterly Report

1. Recommendation

That the Resources and Fire & Rescue Overview and Scrutiny Committee receives and comments upon the update on Treasury Management activity and performance for the third quarter of the 2023/24 financial year.

2. Executive Summary

2.1 This quarterly report has been prepared in compliance with CIPFA's Code of Practice on Treasury Management, and includes coverage of the following:

i.) a review of the Treasury Management Strategy Statement;

ii.) a review of the Council's investment portfolio for 2023/24 (Section 3);

iii.) a review of the Council's borrowing strategy for 2023/24, including comments on any debt rescheduling undertaken during 2023/24 (Section 4);

iv.) the Council's capital expenditure, as set out in the Capital Strategy, and prudential indicators (Appendix 2 of this report); and

v.) an economic update for the first half of the 2023/24 financial year (Appendix 3).

2.2 The following highlights are detailed in this report:

i.) Total treasury investments were £336m on 31 December 2023 compared to the end of the second quarter balance of £391m, a reduction of £55m.

ii.) Liquid funds (*funds that can be accessed very quickly*) decreased by £15m during the quarter. However, sufficient liquidity has been retained to more than meet the expected call on the Council's cash balances to fund spend.

iii.) Investments on fixed maturity terms decreased by £40m upon the maturities of fixed term loans to local authorities and one building society.

iv.) Investments interest rates showed some degree of stabilization and only slightly moved upwards during the quarter in response to Bank of England (BOE) base rate, which remained unchanged at 5.25% during the period. The Bank had consecutively raised the rate in the past fourteen monetary

policy meetings, they left the rate unchanged at 5.25% at the September meeting.

v.) The average interest rates earned on the Council’s treasury deposits increased to 4.68% rising from the previous quarter’s 4.50% on the back of repricing of the maturing fixed deposits that were made earlier on when interest rates were lower, and money market fund rates being higher.

vi.) Interest income on treasury investments of £13.34m was recorded during the nine months, against a budget of £3.51m. Whilst these significant additional returns are welcomed in the context of the wider Council budget, there needs to be a degree of caution around how this influences the budget setting for returns, which are influenced by the level of cash available, interest rates and need for external borrowing.

3. Annual Investment Strategy

Investment balances

3.1 The level of funds available for investment purposes during the quarter averaged £392m and totaled £336m as of 31 December 2023. These funds were available on a temporary basis, and the level of funds available was mainly dependent on the timing of precept payments, receipt of grants and progress on the capital programme.

3.2 The total investments balance reduced by £55m from the £391m at the end of the last financial quarter to £336m on 31 December 2023. About 74% (£232m) of the total treasury investments were managed in-house through fixed term lending to local authorities, housing associations and local building societies together with a bank call account, while 26% (£86m) was externally managed through money market funds and special purpose variable net asset value funds.

3.3 Total **liquid funds** (bank balances plus money market funds) averaged £98m during the quarter and reduced from £80m at the beginning of the quarter to £64m on 31 December 2023. The late national local government pay increase agreement and the subsequent backpay in November partly contributed to the downwards movement in our cash balances. The maximum level of liquid funds held was £133m held on the 29 November 2023, while the minimum total liquid funds was £64m held at the end of the quarter. This level of liquidity ensured that cash is always available when it is needed for service delivery and capital expenditure.

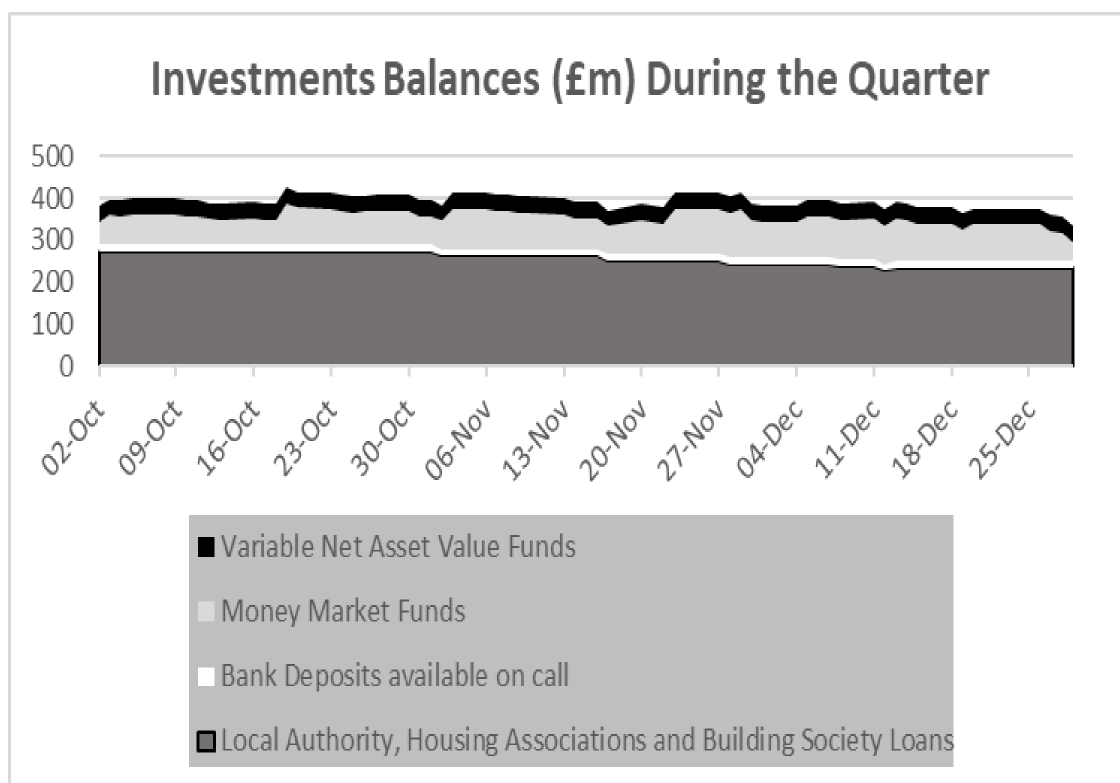
Table 1 Investment Balances movements during the half year

Investment Type in £ Millions	Balance at 30 September 2023	Movement during Q3	Balance at 31 December 2023
	£m	£m	£m
Building Society Loans	50	-20	30
Housing Association Loans	30	-	30
Local Authority Loans	192	-20	172
Bank Deposits	17	-	17
Managed In House	**289**	**-40**	**249**
Money Market Funds	63	-15	48
VNAV Funds	39	-	39
Externally Managed	**102**	**-15**	**87**
Total Funds	**391**	**-55**	**336**

3.4 Fixed deposits with local authorities, housing associations and building societies decreased from £272m at the end of last quarter to £232m while the Variable Net Asset Value (VNAV) funds remained stable, registering 1 percent growth over the three months. The variable net asset funds tend to grow in value when interest rates are low and lose value in times of high interest rates as investors sell their investments and divert them to interest-earning assets. The low growth in the value of these VNAV funds is a reflection of the high interest rates prevailing on the money market that lure investors from other non-interest earning markets.

3.5 Throughout the past three quarters of the financial year, we have maintained about £17m in a call account with the Council's main bank as a reserve instant access account in case we experience any technical issues with withdrawals from the liquid money market funds or emergency payments that need to be made after the cut off time for withdrawing from money market fund pools. This ensures the Council will always have cash to meet its statutory duties regardless of system malfunctioning or delays at the money market trading platform.

Figure 1 – Daily Investment Balances



Creditworthiness

3.6 There were no changes to credit ratings of investment counterparties and countries over the quarter under review with the exception of Deutsche Bank AG which had its Standard & Poors (S&P) rating changed from A to A- while unchanged by the other two rating agencies. The Council currently has no investment with Deutsche Bank AG However, officers continue to monitor these, and other measures of creditworthiness to ensure that only appropriate counterparties are considered for investment purposes.

3.7 The Council uses Fitch, S&P and Moodys ratings to assess the creditworthiness of Treasury investment counterparties. A creditworthiness ratings table can be found in Appendix 4.

3.8 As stipulated in the Treasury Management Strategy, investments have been made in either UK based banks, rated building societies with a minimum of A- Fitch credit rating, and UK local authorities. As at 30 November 2023 the two building societies we have investment balances with were rated A- while all the six money market funds were rated AAA.

3.9 While a number of local authorities have issued Section 114 notices and many others are reported to be facing serious financial challenges, the sector generally remains a relatively safe investment destination due to statutory protection. Where a loan is made to a UK local authority, the lender is provided with a statutory protection via the Local Government Act 2003. It means that all money borrowed by a local authority, together with any interest on the money

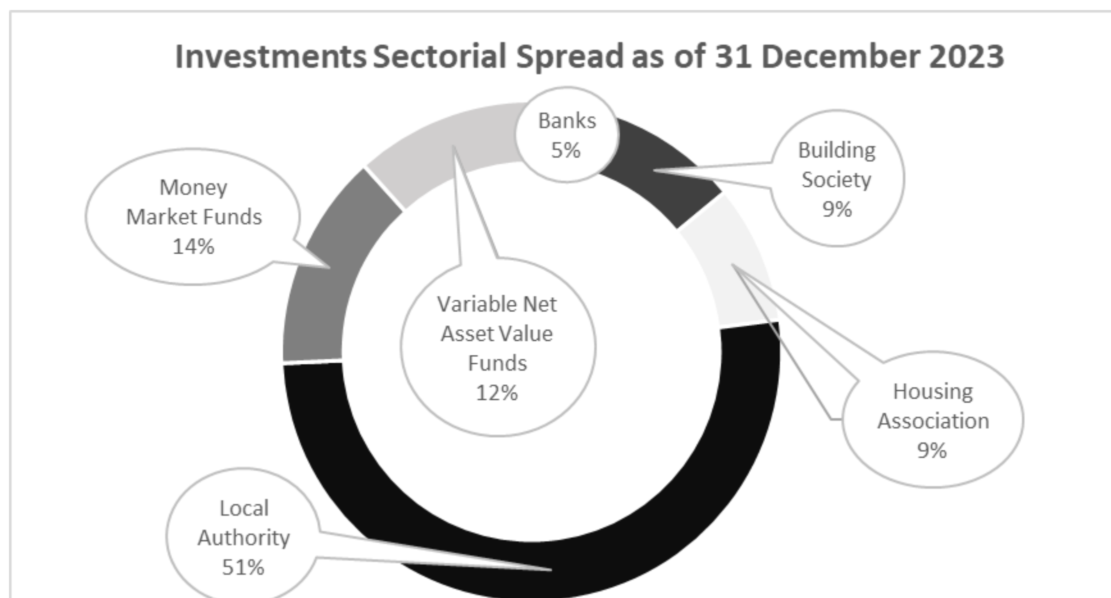
borrowed, shall be charged, on all the revenues of the authority. There are only a small number of local authorities that have a formal credit rating, so lenders will rely on this statutory protection when they arrange any loans with a UK based local authority. The CIPFA Code of Practice on Local Authority Accounting also includes wording to support this view. It says "Local authorities shall not recognise a loss allowance for expected credit losses on a financial asset where the counterparty for a financial asset is central government or a local authority for which relevant statutory provision prevents default."

3.10 Despite this cover, the Council still endeavours to invest with local authorities that have good financial standing. This also assists in the management of the reputational risk of being seen to invest Warwickshire taxpayers money in authorities in financial trouble.

Investment Counterparty Criteria

3.11 As set out in the approved 2023/24 Treasury Management Strategy, we have continued to prioritize security and liquidity with yields being considered within these two parameters. The approach resulted in the Council's treasury investments being spread across diverse sectors which exhibit strong security and liquidity features. The graph below (*Figure 2*) illustrates which sectors and in what proportions the treasury funds were invested as of 31 December 2023.

Figure 2 – Investments Sectorial Spread

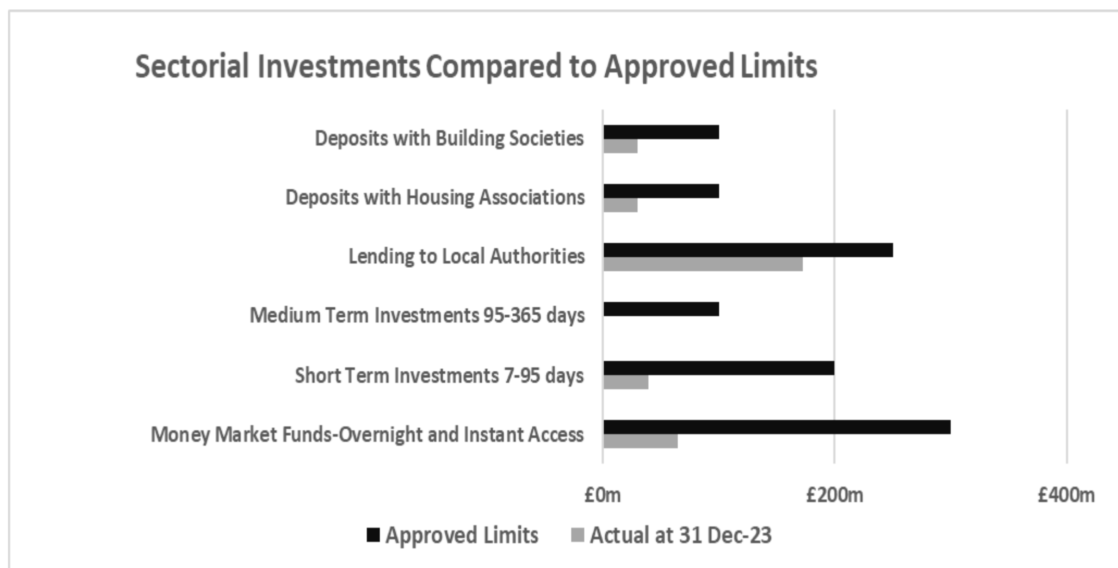


3.12 Local authorities, housing associations and building societies together held 69% of the Council's treasury funds on fixed term loans with varying durations of up to January 2026. Investments held with local authorities alone amounted to £172m equivalent to 51% of the total investment portfolio. As pointed out above, investments in local authorities remain the safest investments, regardless of the increasing financial pressures in the sector, due to the statutory protection.

3.13 While the investment counterparty criteria selection included Housing Associations, we had not invested in any housing association until the first quarter when we placed three fixed term loan investments with three different housing associations worth £30m. This expansion is increasing the range of viable investment options open to us and reduces the investment concentration risk profile.

3.14 The counterparty and sectoral total investments were all within the limits set in the Treasury Management Strategy approved by the Council. The graph below (*Figure 3*) illustrates how the sectorial exposures compared to the approved sector limits.

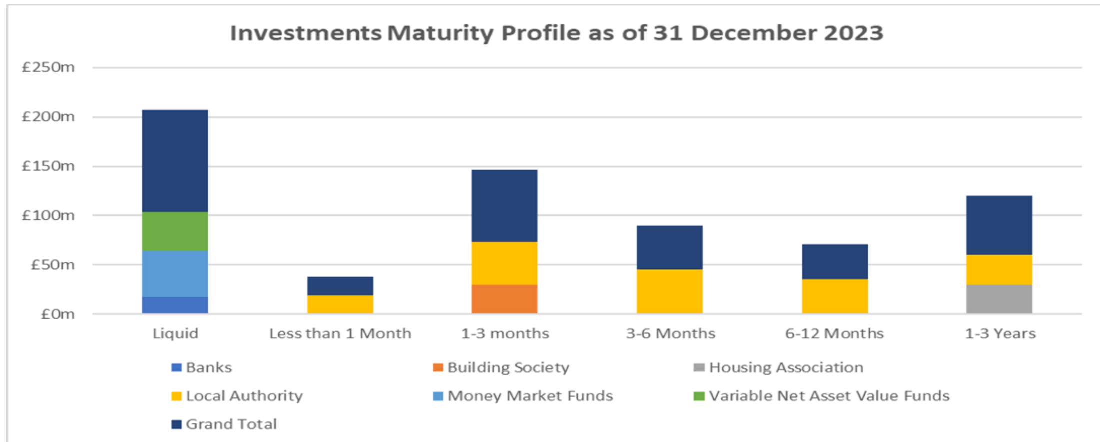
Figure 3 – Sectorial Investments Compared to Approved Limits



Investments Maturity Profile

3.15 With the bulk of the investment funds being held for financing the Council's capital programme, the maturity profile of the investments, as at 31 December 2023, depicted in the chart below tended to lean mostly to the short-term, with 82% of maturing within twelve months, 31% liquid and only 18% maturing over 12 months. Investments in the liquid money market funds continued to enjoy relatively good interest rates meeting all the Council's three investment priorities of security, liquidity and yield. This is also in line with the prevailing market where borrowers and funds are reluctant to commit to long term securities as they will be tied to expensive debt/deposits when the long-term market expectation is that interest rates will begin to fall in the medium-term as inflation declines. The chart below illustrates the maturity profile of the investments at the end of the quarter.

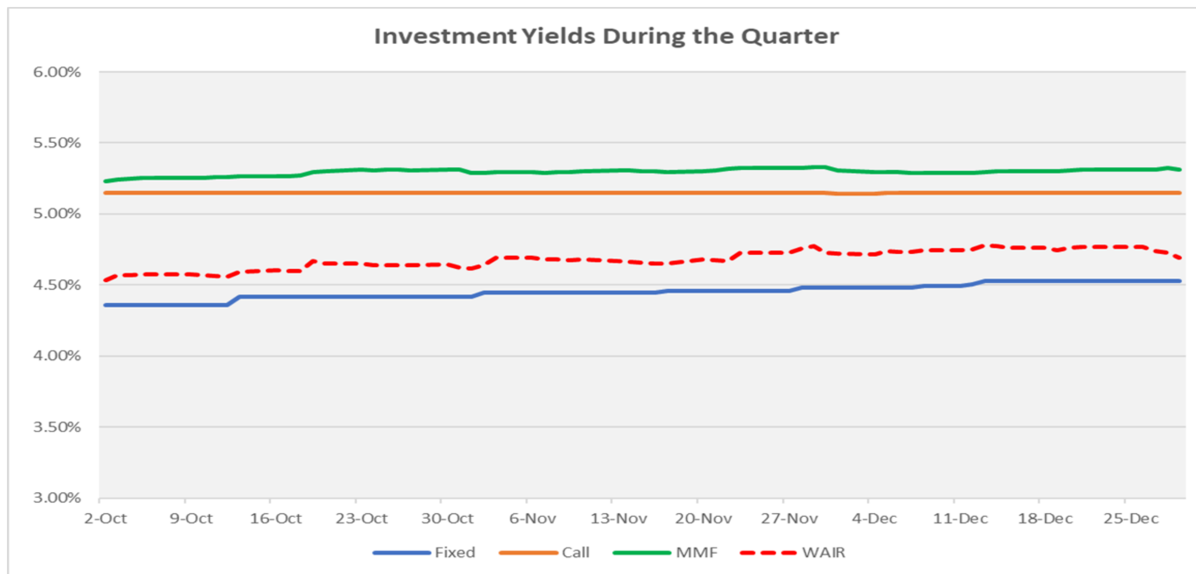
Figure 4 – Investment Maturity Profile



Investment Yield

3.16 During the first two quarters of the year, market interest rates continued with the upward trend that started during the last months of the pandemic and continued to rise further due to subsequent global and national political and economic events. However, following the Bank of England's stagnation of the bank rate, interest rate growth flattened with only marginal growth during the quarter with rates showing some level of stabilization. The Council's treasury investment yields followed this pattern with the average yield on money market funds investments rising by 9 basis points from 5.23% at the beginning of the quarter to 5.32% by the close of the quarter and average interest rate on fixed term investments also growing from 4.36% to 4.53%.

Figure 5 – Investment Yield during the Quarter



3.17 The increasing interest rates referred to above, together with adjustments to the mix of investments, resulted in treasury activities outperforming the budget after recording total income of £13.34m compared to a year-to-date budget of £3.51m. The interest income budget for the year was set up before the increase in interest rates. The additional income generated has been used to fund the

overspends in 2023/24 in the demand-led services and has been critical to supporting the financial sustainability of the Council.

3.18 The recorded £13.34m interest income represents an annualized yield of 4.54% on an average investment portfolio of £392m. The Treasury activities income was earned on investments that are managed inhouse and externally managed as shown in the table below.

Quarter 3 Investment Yields	Yield in £'000s	YTD Budget	Yield in %	Relevant Benchmark
Managed In House	**9,175**	**2,219**	**4.50%**	**3.74%**
Money Market Funds	3,236		5.32%	4.37%
Variable Net Asset Value Funds	929		3.18%	2.83%
Externally Managed	**4,165**	**1,292**	**4.62%**	
Total Funds	**13,340**	**3,511**	**4.54%**	

3.19 It is positive to highlight that all the yields surpassed the relevant benchmarks.

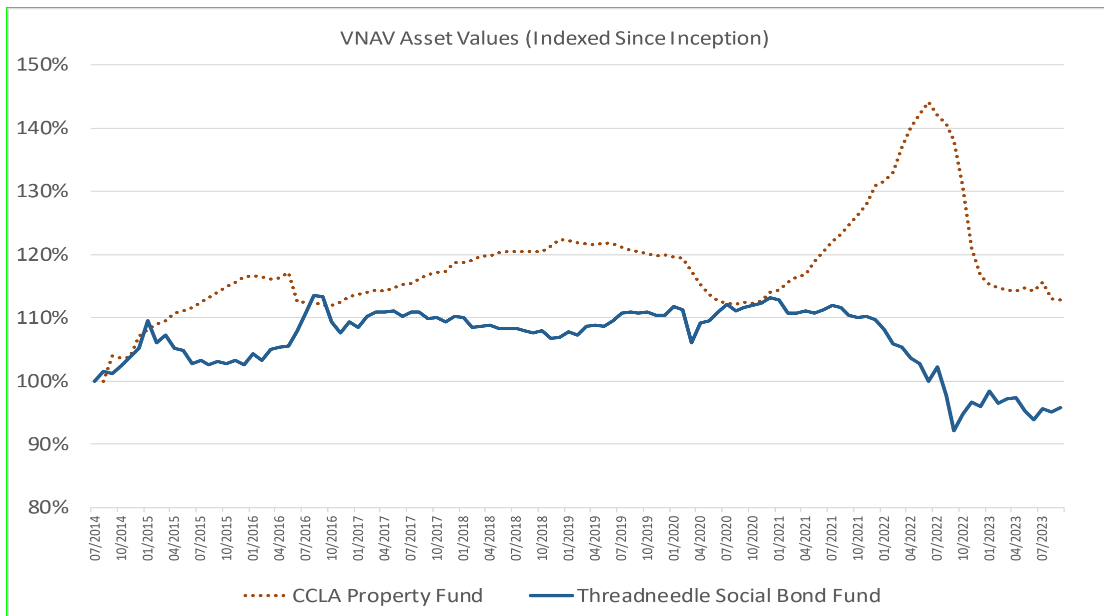
4. Variable Net Asset Value (VNAV) Investments

4.1 As noted earlier in the report, included in the treasury investments is £39m invested in variable net asset value investments as at 31 December 2023. These are investments that are traded in a similar way to listed stock, where the value of the assets held can vary up and down depending on the performance of the funds. At the beginning of the 2023/24 financial year the Council had investments in three separate funds namely, the Threadneedle Social Bond Fund, CCLA Local Authority Property Fund and the BlackRock ICS Sterling Liquid Environmentally Aware Fund. During the first quarter, a decision was made to divest from the BlackRock fund and divert funds to fixed deposits where higher returns were prevailing. The remaining two funds have consistently paid good dividends.

4.2 Since the beginning of the financial year, these funds have earned £0.632m in income, equivalent to 2.86% yield on the average investment balance of £44m held during the period.

4.3 The two remaining funds gained in value during the period of prevailing low interest rates, as shown in the graph below. However, both funds have experienced volatility driven by Covid followed by a period of stabilization.

4.4 The balances held in these funds are being reviewed in light of prevailing market conditions.



5. Borrowing

5.1 Total borrowing stood at £272.98m on 31 December 2023, compared to £321m at the start of the financial year on 1 April 2023. The reduction was due to the early repayment of six loans during the first quarter as reported in the last two reports. The next scheduled debt repayment is during the 2029 financial year. No new borrowing was undertaken during the three quarters of the year ended 31 December 2023. It is anticipated that no new borrowing will be undertaken during the remainder of this fiscal year.

Debt Maturity Profile

5.2 The table below together with a chart Annex 1 illustrate the maturity profile of the Council's borrowings. There is no scheduled repayment in the next four years. The next scheduled repayment will be due in the 2029 financial year with the last repayment in 2060.

Tenor Bucket	Amount £M
Liquid	0
< 1 Year	0
1 - 2 Years	0
2 - 5 years	8
5 - 10 years	25
10 - 20 years	29
20 - 30 years	75
30 - 40 years	137
Total Debt	**273**

Debt Rescheduling

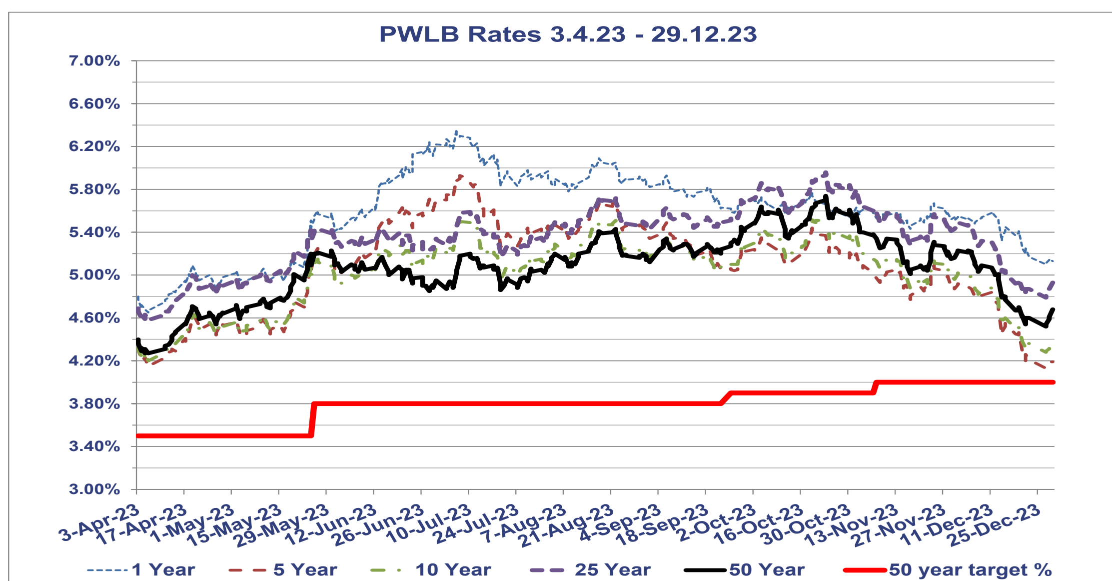
5.3 Debt rescheduling opportunities have increased significantly in the period where gilt yields, which underpin PWLB rates and market loans, have risen materially. However, during the half year under review, no viable opportunity was identified to reschedule the Council's PWLB debt. Treasury Officers continue to closely monitor the debt market developments and review any potential opportunities for debt rescheduling.

PWLB maturity Certainty Rates 3rd April to 29th December 2023

5.4 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, the advice from our Treasury Advisers is not to borrow long-term unless the Council wants certainty of rate and judges the cost to be affordable.

The following graphs and table are optional; choose whether to include and use the data for Q1 to Q3 (3rd April 2023 to 29th December 2023).

PWLB RATES 3.4.23 - 29.12.23 (note: the 1st/2nd April was a weekend)



HIGH/LOW/AVERAGE PWLB RATES FOR 3.4.23 – 29.12.23

	1 Year	5 Year	10 Year	25 Year	50 Year
Low	4.65%	4.13%	4.20%	4.58%	4.27%
Date	06/04/2023	27/12/2023	06/04/2023	06/04/2023	05/04/2023
High	6.36%	5.93%	5.53%	5.96%	5.74%
Date	06/07/2023	07/07/2023	23/10/2023	23/10/2023	23/10/2023
Average	5.60%	5.09%	5.03%	5.35%	5.08%
Spread	1.71%	1.80%	1.33%	1.38%	1.47%

6. Liability Benchmark

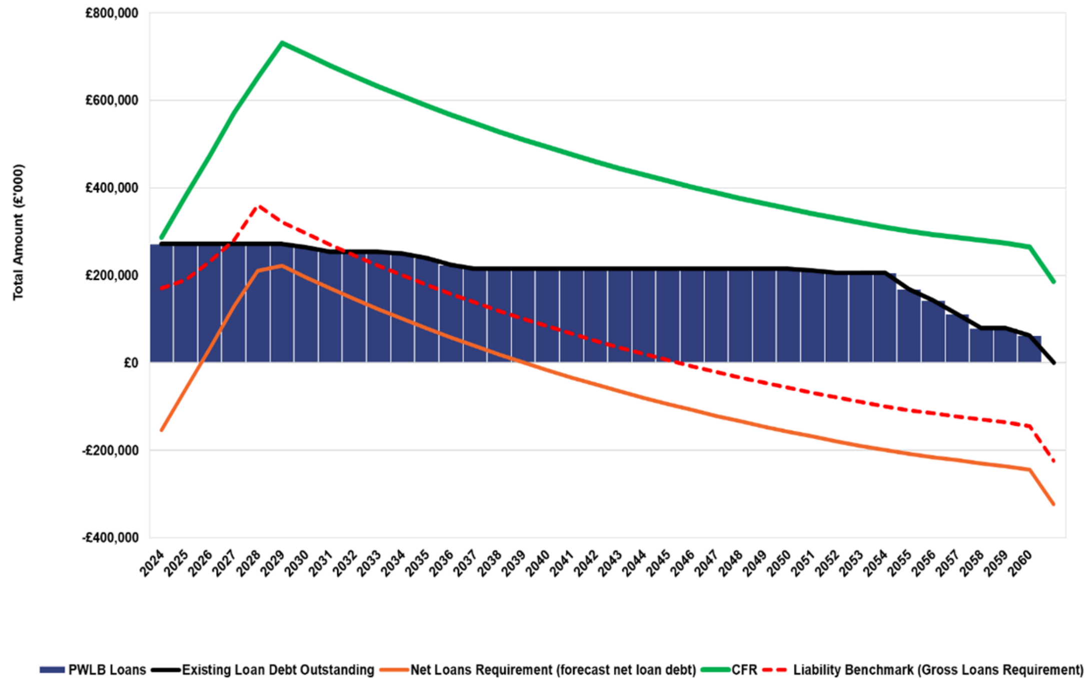
6.1 The purpose of this prudential indicator is to compare the Authority's existing loans outstanding against a standardised assessment of need for external loan debt, called the liability benchmark. The benchmark reflects the borrowing required to finance capital spending but taking into account any ability to make use of cash balances instead of borrowing externally and taking account of the need to hold a certain amount of cash liquidity. If the existing external loans outstanding are below the debt required, the authority will potentially need to borrow to meet the shortfall. If the existing external loans outstanding are more than it needs, the resulting excess cash may need to be invested. The chart therefore provides insight to an authority on how much it needs to borrow, when, and to what maturities to match its planned borrowing needs.

6.2 The liability benchmark makes no assumptions about the level of future prudential borrowing beyond the horizon of the 5-year Medium Term Financial Strategy and so the Capital Financing Requirement (CFR) and the liability benchmark tail off in the chart below, when in reality a rolling programme of new capital expenditure will be approved over time and the CFR will not reduce.

6.3 The liability benchmark is the lowest level of borrowing compared to the CFR borrowing requirement – borrowing only when reserves reach a set minimum level. This assumes that internal resources such as reserves and working capital are utilised and that cash and investment balances are reduced gradually over time.

6.4 As capital spending increases over the next few years and the Council utilises its reserves rather than borrowing more, and the gap between external debt (the black line) and the liability benchmark (the dotted red line) reduces until the Council does start borrowing externally again.

6.5 The cash liquidity buffer is reflected in the gap between the dotted red line (the liability benchmark) and the solid orange line (the net loans requirement). This buffer is planned to be brought down to £100m over time, representing a more efficient use of balance sheet resources, and this shows as a reduced gap between these two lines.



7. Non-Treasury Investments

7.1 In addition to managing the Council's treasury investments and borrowings, the Treasury Management Team are also responsible for managing other non-treasury investments, undertaken in pursuit of achieving the Council's economic, commercial, and social objectives. Among the ongoing non-treasury investments that the team is involved in are: loans through the Warwickshire Investment Fund, and loans to the Warwickshire Property and Development Group, and Educaterers, the schools catering local authority trading company.

7.2 The non-treasury investments activities are reported and monitored at other Council governance forums and are not included in this report.

8. Financial Implications

8.1 The financial implications of the treasury management performance and activity are set out in the body of the report.

9. Environmental Implications

9.1 As stated in the Council approved Treasury Management Strategy Statement (TMSS), the Council is committed to considering environmental, social, and governance (ESG) issues, and has a particular interest in terms of climate

change and pursuing activities that have a positive social impact.

9.2 In the TMSS, the Council undertook to ensure an understanding of the degree to which investments may contribute towards climate change and where appropriate, move cash balances to funds that have ESG driven targets, or “green funds”, to ensure our investment is contributing towards tackling ESG issues, among other undertakings, with security and liquidity of investments taking precedence.

9.3 **Environmental**: The majority (69%) of the treasury investments outstanding at the end of this third quarter of the financial year (31st December 2023) were fixed-term deposits with other local authorities, housing associations and building societies. Of these deposits, 66% by value were with local authorities, housing associations or building societies with a climate action plan. However, as security and liquidity take priority over ESG impact, the Council divested from the Blackrock Liquid Environmentally Aware Fund. This was because the fund was deemed a Variable Net Asset Value fund (VNAV) which means that there was capital at higher risk.

9.4 **Governance**: Officers rely on credit ratings for assessing governance alignment. Governance considerations are included as part of the credit rating process, such as whether the money market fund asset manager is suitably qualified, competent, and capable, and whether there is an experienced and credible senior management team and sufficient resources. Therefore, the high credit ratings suggest that there are robust governance procedures within the banks, building societies and money market funds in which the Council invested in the quarter.

9.5 **Social alignment**: It is assumed that other local authorities will largely align with the Council’s objectives. They are likely to provide similar services to the communities within their area, and have similar objectives, such as promoting a thriving economy and supporting people to live their best lives. Similarly, the primary objective of most housing associations is to provide affordable housing, which aligns with the Council Plan objectives.

10. Timescales Associated with Next Steps

10.1 This report will be presented to Resources and Fire & Rescue Overview and Scrutiny Committee on 21 February 2024.

10.2 A Treasury Management Outturn report and Investment Outturn report will be presented to Cabinet after the year-end.

Appendix

Appendix 1 – Investment and Borrowing Portfolio
Appendix 2 – Prudential Indicators
Appendix 3 – Economic Update
Appendix 4 – Creditworthiness ratings table

Background Papers
February 2024 Council paper, Treasury Management Strategy and Investment Strategy.

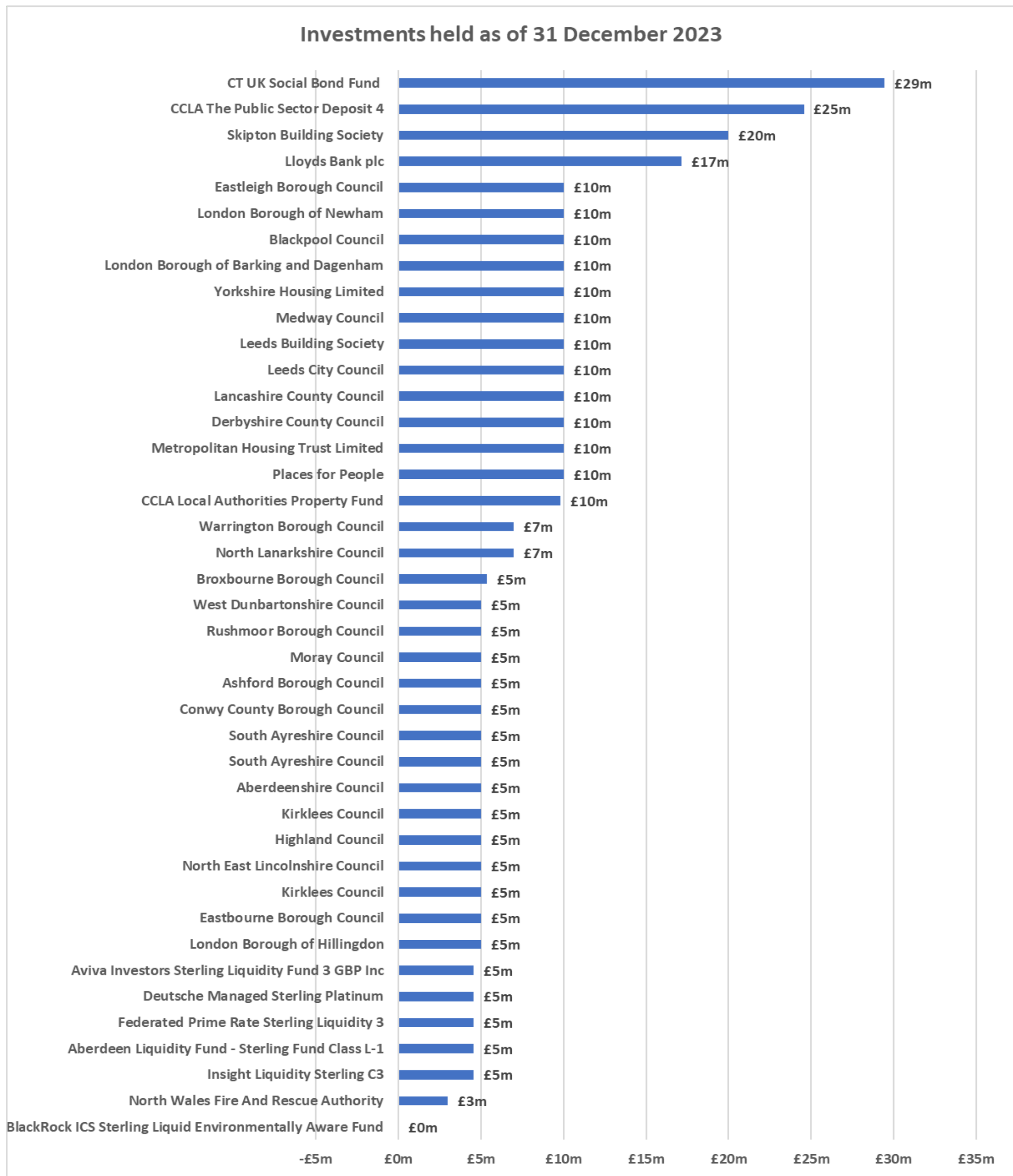
	Name	Contact Information
Report Author	Makion Chiwade Senior Accountant-Treasury and Investments	makionchiwade@warwickshire.gov.uk
Director	Virginia Rennie Director of Finance	vrennie@warwickshire.gov.uk
Executive Director	Rob Powell Executive Director for Resources	robpowell@warwickshire.gov.uk
Portfolio Holder	Peter Butlin Portfolio Holder for Finance and Property	cllrbutlin@warwickshire.gov.uk

The report was circulated to the following members prior to publication:

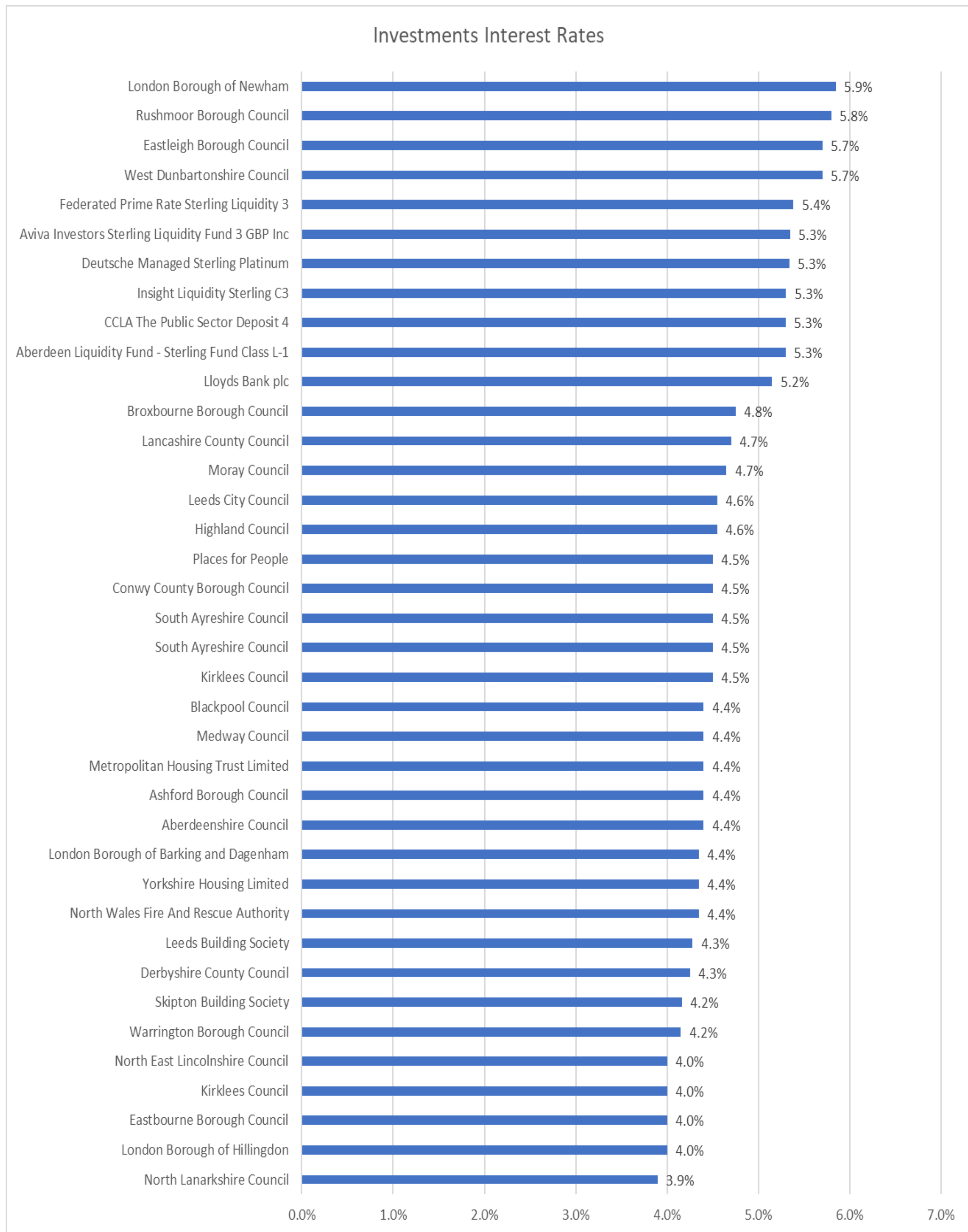
Portfolio Holder for Finance and Property
Leaders of the Labour, Liberal Democrats and Green Groups
Chair and Spokespersons of the Resources and Fire & Rescue Overview & Scrutiny Committee

APPENDIX 1: Investment and Borrowing Portfolios

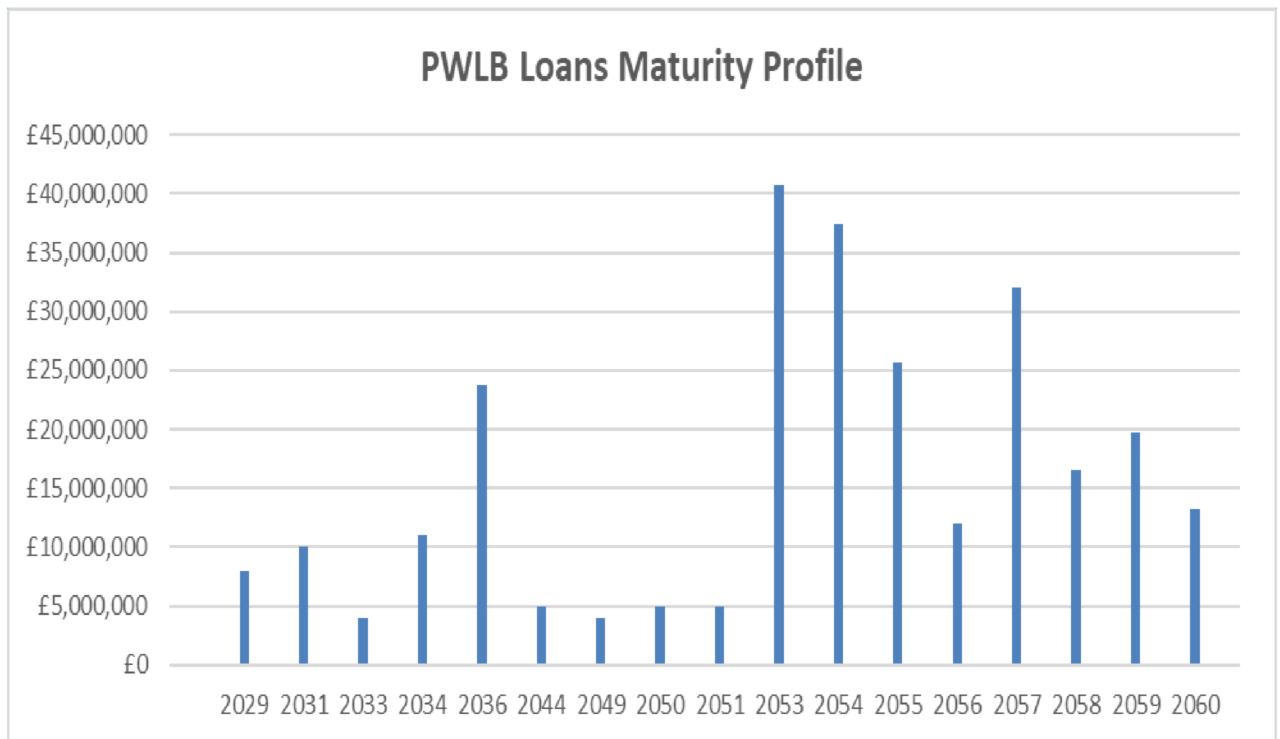
Investments held as of 31st December 2023



Investment yield as of the 31st December 2023



Borrowing profile as at the 31st December 2023



APPENDIX 2: Prudential Indicators

PRUDENTIAL INDICATOR (1). AFFORDABILITY PRUDENTIAL INDICATORS	2022/23 Actual	2023/24 Estimate	2024/25 Estimate
	£'000	**£'000**	**£'000**
Capital Expenditure	117,352	160,094	179,508
	%	**%**	**%**
Ratio of financing costs to net revenue stream	5.13%	4.33%	4.40%
Gross borrowing requirement	**£'000**	**£'000**	**£'000**
Gross Debt	321,413	272,413	272,413
Capital Financing Requirement as at 31 March	256,854	287,253	381,922
Under/(Over) Borrowing	(64,559)	14,840	109,509
	£'000	**£'000**	**£'000**
In year Capital Financing Requirement	10,503	11,083	11,299

PRUDENTIAL INDICATOR (2). TREASURY MANAGEMENT PRUDENTIAL INDICATORS	2022/23 Actual	2023/24 Estimate	2024/25 Estimate
Authorised limit for external debt -	**£'000**	**£'000**	**£'000**
Borrowing	386,000	490,000	625,000
TOTAL	**386,000**	**490,000**	**625,000**
Operational boundary for external debt -	**£'000**	**£'000**	**£'000**
Borrowing	321,413	467,851	597,155
TOTAL	**321,413**	**326,320**	**311,976**
Upper limit for fixed interest rate exposure			
Net principal re fixed rate borrowing / fixed term investments	100%	100%	100%
Upper limit for variable rate exposure			
Net principal re fixed rate borrowing / fixed term investments	25%	25%	25%
Upper limit for total principal sums invested for over 365	**£'000**	**£'000**	**£'000**
(per maturity date)	£150,000	£150,000	£150,000

Maturity structure of borrowing during year	upper limit	lower limit
under 12 months	20%	0%
12 months and within 24 months	40%	0%
24 months and within 5 years	60%	0%
5 years and within 10 years	100%	0%
10 years and above	100%	0%

Maturity structure of new variable rate borrowing during	upper limit	lower limit
under 12 months	35%	0%
12 months and within 24 months	45%	0%
24 months and within 5 years	65%	0%
5 years and within 10 years	100%	0%
10 years and above	100%	0%

APPENDIX 3: Economic Update (provided by Link Group)

1. Economic Update

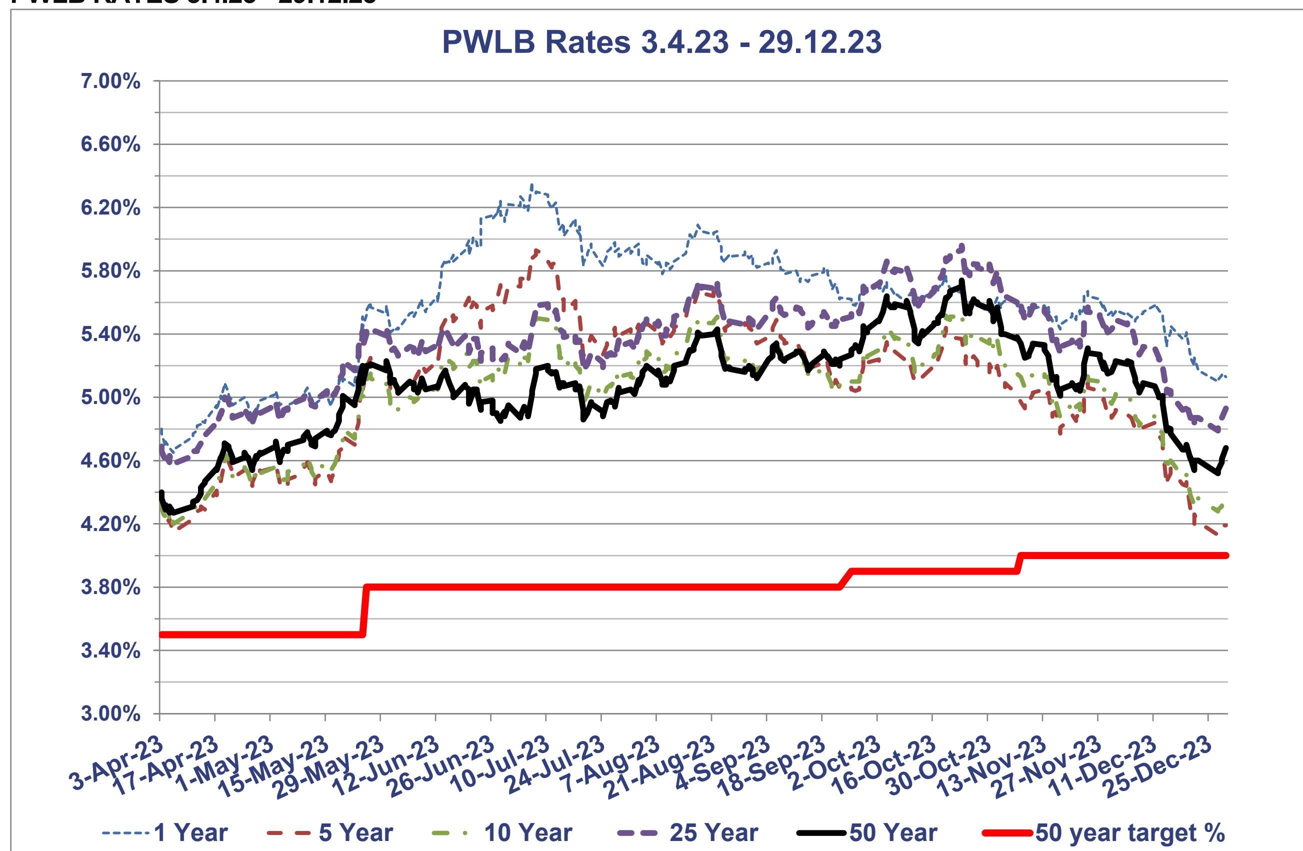
- The third quarter of 2023/24 saw:
  - A 0.3% m/m decline in real GDP in October, potentially partly due to unseasonably wet weather, but also due to the ongoing drag from higher interest rates. Growth for the second quarter, ending 30th September, was revised downwards to -0.1% and growth on an annual 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.
- The revision of GDP data in Q2 to a 0.1% q/q fall may mean the mildest of mild recessions has begun. Indeed, real GDP in October fell 0.3% m/m which does suggest that the economy may stagnate again in Q3. The weakness in October may partly be due to the unseasonably wet weather. That said, as the weakness was broad based it may also be the case that the ongoing drag from higher interest rates is more than offsetting any boost from the rise in real wages.
- However, the rise in the flash composite activity Purchasing Managers Index, from 50.7 in November to 51.7 in December, did increase the chances of the economy avoiding a contraction in Q3. The improvement was entirely driven by the increase in the services activity balance from 50.9 to 52.7. (Scores above 50 point to expansion in the economy, although only tepid in this instance.) The press release noted that this was primarily driven by a revival in consumer demand in the technological and financial services sectors. This chimes with the further improvement in the GfK measure of consumer confidence in December, from -24 to -22. The services PMI is now consistent with non-retail services output growing by 0.5% q/q in Q3, but this is in stark contrast to the manufacturing sector where the output balance slumped from 49.2 to 45.9 and, at face value, the output balance is consistent with a 1.5% q/q fall in manufacturing output in Q3.
- The 0.3% m/m fall in retail sales volumes in October means that after contracting by 1.0% q/q (which was downwardly revised from -0.8% q/q) in Q2, retail activity remained weak at the start of Q3. That suggests higher interest rates are taking a bigger toll on real consumer spending.
- Higher interest rates have filtered through the financial channels and weakened the housing market but, overall, it remains surprisingly resilient with only marginal falls showing year on year on the Halifax (-1%) and Nationwide (-1.8%) indices. However, the full weakness in real consumer spending and real business investment has yet to come as currently it is estimated that around two thirds to a half of the impact of higher interest rates on household interest payments has yet to be felt.
- 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. Indeed, the timelier three-month annualised rate of average earnings growth fell from +2.4% to -1.2%. Excluding bonuses, it fell from 5.3% to 2.0%. Furthermore, one of the Bank's key barometers of inflation persistence, regular private sector pay

growth, dropped from 7.9% 3myy to 7.3%, which leaves it comfortably on track to fall to 7.2% by December, as predicted by the Bank in November.

- The fall in wage growth occurred despite labour demand being stronger in October than expected. The three-month change in employment eased only a touch from +52,000 in September to +50,000 in October. But resilient labour demand was offset by a further 63,000 rise in the supply of workers in the three months to October. That meant labour supply exceeded its pre-pandemic level for the first time, and the unemployment rate remained at 4.2% in October. In the three months to November, the number of job vacancies fell for the 17th month in a row, from around 959,000 in October to around 949,000. That has reduced the vacancy to unemployment ratio as demand for labour eases relative to supply, which may support a further easing in wage growth in the coming months.
- 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 (consensus forecast 5.6%). 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.
- The Bank of England sprung no surprises with its December monetary policy committee (MPC) meeting, leaving interest rates at 5.25% for the third time in a row and pushing back against the prospect of near-term interest rate cuts. The Bank continued to sound hawkish, with the MPC maintaining its tightening bias saying that "further tightening in monetary policy would be required if there were evidence of more persistent inflationary pressures". And it stuck to the familiar script, saying that policy will be "sufficiently restrictive for sufficiently long" and that "monetary policy is likely to need to be restrictive for an extended period of time". In other words, the message is that the MPC is not yet willing to endorse investors' expectations that rates will be cut as soon as May 2024.
- Looking ahead, our colleagues at Capital Economics forecast that the recent downward trends in CPI and core inflation will stall over the next few months before starting to decline more decisively again in February. That explains why we think the Bank of England won't feel comfortable cutting interest rates until H2 2024.
- The fall in UK market interest rate expectations in December has driven most of the decline in 10-year gilt yields, which have fallen in line with 10-year US Treasury and euro-zone yields. 10-year gilt yields have fallen from 4.68% in October 2023 to around 3.70% at the time of writing, with further declines likely if the falling inflation story is maintained.
- Investors' growing expectations that the Fed will cut interest rates soon has led to an improvement in risk sentiment, which has boosted the pound and other risky assets. In addition, the rise in the pound, from $1.21 in November to $1.27 now, has also been supported by the recent relative decline in UK wholesale gas prices.
- The further fall in 10-year real gilt yields in December has supported the recent rise in the FTSE 100. That said, the index remains 5% below its record high in February. This modest rise in equities appears to have been mostly driven by strong performances in the industrials and rate-sensitive technology sectors. But UK equities have continued to underperform US and euro-zone equities. The FTSE 100 has risen by 2.2% in December, while the S&P 500 has risen by 3.8%. This is partly due to lower energy prices, which have been a relatively bigger drag on the FTSE 100, due to the index's high concentration of energy companies.

In the chart below, the rise in gilt yields across the curve in the first half of 2023/24, and therein PWLB rates, is clear to see, prior to the end of year rally based on a mix of supportive domestic and international factors.

PWLB RATES 3.4.23 - 29.12.23



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. Both reviews reflected a split vote, the latter by 6 votes to 3, with the minority grouping voting for an increase of 0.25% 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. Of course, the data will be the ultimate determinant, so upcoming publications of employment, wages and inflation numbers will be of particular importance, and on-going volatility in Bank Rate expectations and the gilt yield curve can be expected.
- In addition, what happens outside of the UK is also critical to movement in gilt yields. The US FOMC has kept short-term rates in the range of 5.25%-5.50%, whilst the ECB has moved its Deposit rate to a probable peak of 4%. Markets currently expect both central banks to start cutting rates in 2024.

2. Interest rate forecasts

The Council has appointed Link Group as its treasury advisors and part of their service is to assist the Council to formulate a view on interest rates. The PWLB rate forecasts below are based on the Certainty Rate (the standard rate minus 20 bps) which has been accessible to most authorities since 1st November 2012.

Link Group Interest Rate View	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

A SUMMARY OVERVIEW OF THE FUTURE PATH OF BANK RATE

- Our central forecast for interest rates was previously updated on 7th November and reflected a view that the MPC would be keen to underpin its anti-inflation credentials by keeping Bank Rate at 5.25% until at least H2 2024. We expect rate cuts 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.

- 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, our 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 a little better at this stage of the economic cycle than may have been expected. Nonetheless, with approximately 400,000 households per quarter facing a mortgage interest reset at higher levels than their current rate, the economy will face on-going headwinds from that source, in addition to lower income households having to spend disproportionately on essentials such as food, energy and rent payments.

PWLB RATES

- As illustrated in the charts in section 1, gilt yields have endured a volatile nine months with yields rising significantly on the back of inflation concerns before retracing much of those increases in November and December. With the market now anticipating rate cuts by H2 2024, the short and medium parts of the curve are now close to where they started 2023/24, but the longer part of the curve is still a little higher. At the time of writing there is c50 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.

- 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.

APPENDIX 4 – Creditworthiness Ratings Table

Moodys	S&P	Fitch	Description
Aaa	AAA	AAA	Highest credit quality, minimum credit risk
Aa1, Aa2 Aa3	AA+, AA, AA-	AA+, AA, AA-	Very high credit quality, very low credit risk
A1, A2, A3	A+, A, A-	A+, A, A-	High credit quality (upper-medium grade)
Baa1, Baa2, Baa3	BBB+, BBB, BBB-	BBB+, BBB, BBB-	Good credit quality, currently low credit risk
Ba1, Ba2, Ba3	BB+, BB, BB-	BB+, BB, BB-	Speculative elements, issue faces uncertainties and adverse conditions
B1, B2, B3	B+, B, B-	B+, B, B-	High credit risk, but issue still able to meet financial commitments
Caa1, Caa2, Caa3	CCC+, CCC, CCC-	CCC	Issuer currently vulnerable, default likely
Ca	CC	CC	Issuer currently highly vulnerable, near default
C	R, SD, D	C, RD, D	Lower rating typically in fault on some or all of its financial obligations