Report title	**Treasury Management Report – First Quarter of 2023/24**
Report author	A. Ismailov - Senior Accountant
Department	Finance
Exempt?	No
Exemption type	Not applicable
Reasons for exemption	Not applicable

Purpose of report:

For information

Synopsis of report:

This is the report on Council's treasury management activity and performance in the first quarter of the 2023/24 financial year focusing on financing and liquidity, cash management and risk management.

This report was presented to the Corporate Management Committee on 14 September and is now presented to this committee as part of its oversight role.

Recommendation(s):

None, this report is for information.

1. Background Information

1.1. The Council's treasury management activity is underpinned by CIPFA's (Chartered Institute of Public Finance and Accountancy) Code of Practice on Treasury Management ("the Code"), and the CIPFA Prudential Code for Capital Finance in Local Authorities ("the Prudential Code"). These require local authorities to produce annually Prudential Indicators and a Treasury Management Strategy Statement on the likely financing and investment activity. The Code also recommends that members are informed of treasury management activities quarterly from 2023/24.

1.2. The Council's Treasury Management Strategy for 2023/24 was approved at Full Council on 09 February 2023. This report sets out the Council's performance against the criteria in this report in first quarter of 2023/24.

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

1.4. No treasury management activity is without risk. The Council regards the successful identification, monitoring and control of risk to be the prime criteria by which the effectiveness of its treasury management activities will be measured. Accordingly, the analysis and reporting of treasury management activities focuses on their risk implications for the organisation, and any financial instruments entered into to manage these risks.

1.5. The regulatory environment places responsibility on members for the review and scrutiny of treasury management policy and activities. This report, therefore, provides details of the treasury activities and highlights compliance with the Council's policies previously approved by the members.

2. Prudential and Treasury Indicators and Compliance

2.1. In compliance with the requirements of the Code this report provides members with a summary report of the treasury management activity during first quarter of financial year of 2023/24 ("Q1 2023/24"). Officers can confirm that during the quarter, the Council complied with all its legislative and regulatory requirements and its Treasury Management Statement and Treasury Management Practices.

2.2. During the quarter the Council operated within the treasury and prudential indicators set out in the Council's Treasury Management Strategy and in compliance with the Council's Treasury Management Practices and a prudent approach was taken in relation to all investment activity with priority being given to security and liquidity over yield.

2.3. A full set of prudential and treasury indicators for Q1 2023/24 are set out in Appendix A

3. Risk management

3.1. The Council aims to achieve the optimum return (yield) on its investments commensurate with proper levels of security and liquidity. The Treasury Management Strategy Statement ("TMSS") for 2023/24, which includes the Annual Investment Strategy, sets out the Council's investment priorities as being:

Credit risk
Counterparty credit quality is assessed and monitored with reference to credit ratings including a minimum sovereign credit rating and Credit Default Swap (CDS) overlay information.

Liquidity risk
In keeping with the DLUHC Guidance on Investments, the Council maintains a sufficient level of liquidity using Money Market Funds and call accounts.

Yield
The Council seeks to optimise returns commensurate with its objectives of security and liquidity.

4. Economic update

4.1. The following section was provided by the Council's Treasury Advisors, Link Group and reflects the market position in July 2023:

4.2. The first quarter of 2023/24 saw:

- a 0.2% month on month rise in real GDP in April, partly due to fewer strikes;
- CPI inflation falling from 10.1% to 8.7% in April, before remaining at 8.7% in May. This was the highest reading in the G7;
- core CPI inflation rise in both April and May, reaching a new 31-year high of 7.1%;
- a tighter labour market in April, as the 3-month year on year growth of average earnings rose from 6.1% to 6.5%;
- interest rates rise by a further 0.75% over the quarter, taking the Bank of England's base rate from 4.25% to 5.0%;

- 10-year gilt yields nearing the "mini-Budget" peaks, as inflation surprised to the upside.

4.3. The economy has weathered the drag from higher inflation better than was widely expected. The 0.2% month on month rise in real GDP in April, following March's 0.3% month on month contraction will further raise hopes that the economy will escape a recession this year. Strikes by junior doctors and civil servants contributed to the fall in health output (0.9% month on month) and the meagre 0.1% month on month increase in public administration.

4.4. The fall in the composite Purchasing Managers Index (PMI) from 54.0 in May to a three-month low of 52.8 in June (>50 points to expansion in the economy, <50 points to contraction) was worse than the consensus forecast of 53.6. Both the services and manufacturing PMIs fell. The decline in the services PMI was bigger (from 55.2 to 53.7), but it remains consistent with services activity expanding by an annualised 2%. The fall in the manufacturing PMI was smaller (from 47.1 to 46.2), but it is consistent with the annual rate of manufacturing output falling from -0.8% in April to around -5.0%. At face value, the composite PMI points to the 0.1% quarter on quarter rise in GDP in Q1 2023 being followed by a 0.2% quarter on quarter gain in Q2 2023.

4.5. Meanwhile, the 0.3% month on month rise in retail sales volumes in May was far better than the consensus forecast of a 0.2% decline and followed the robust 0.5% rise in April. Some of the rise was due to the warmer weather. Indeed, the largest move was a 2.7% month on month jump in non-store sales, due to people stocking up on outdoor-related goods. But department stores also managed to squeeze out a 0.6% rise in sales and the household goods sub-sector enjoyed a reasonable performance too. Overall, the figures were far better than analysts had expected. In addition, the GfK measure of consumer confidence rebounded from -27 to a 17-month high of -24 in June.

4.6. The recent resilience of the economy has been due to a confluence of factors including the continued rebound in activity after the pandemic, households spending some of their pandemic savings, and the tight labour market and government handouts both supporting household incomes. That said, as government support fades, real household incomes are unlikely to grow rapidly. Furthermore, higher interest rates will mean GDP is likely to contract later this year. Our central assumption is that inflation will drop to the 2.0% target only if the Bank triggers a recession by raising rates from 5.00% now to at least 5.5% and keeps rates there until at least mid-2024. Our colleagues at Capital Economics estimate that around 60% of the drag on real activity from the rise in rates has yet to bite, and the drag on the quarterly rate of real GDP growth over the next year may be about 0.2percentage points bigger than over the past year.

4.7. The labour market became tighter over the quarter and wage growth reaccelerated. Labour demand was stronger than the consensus had expected. The three-month change in employment rose from +182,000 in March to +250,000 in April. Meanwhile, labour supply continued to recover as the size of the labour force grew by 303,000 in the three months to April. That was supported by a further 140,000 decline in inactivity as people returned to work from retirement and caring responsibilities (while inactivity due to long-term sick continued to rise). But it was not enough to offset the big rise in employment, which meant the unemployment rate fell from 3.9% to 3.8%

4.8. The tighter labour market supported wage growth in April, although the 9.7% rise in the National Living Wage on 1st April (compared to the 6.6% increase in April last year) probably had a lot to do with it too. The 3-month (year on year) rate of average earnings growth reaccelerated from 6.1% to 6.5% (consensus 6.1%) and UK wage growth remains much faster than in the US and the Euro-zone. In addition, private sector wage growth increased from 7.1% to 7.6%, which left it well above the Bank of England's forecast for it to fall below 7.0%. Overall, the loosening in the labour market appears to have stalled in April and regular private sector wage growth was well above the Bank's forecast.

4.9. CPI inflation stayed at 8.7% in May (consensus 8.4%) and, perhaps more worryingly, core CPI inflation rose again, from 6.8% to a new 31-year high of 7.1%. The rise in core inflation built on the leap from 6.2% in March to 6.8% and means it is accelerating in the UK while it is slowing in the US and the Euro-zone (both fell to 5.3%). A further decline in fuel inflation, from -8.9% to -13.1%, and the second fall in food inflation in as many months, from 19.3% to 18.7%, explained why overall CPI inflation didn't rise. And the scheduled fall in the average annual utility price from £2,500 to £2,074 on 1st July means overall CPI inflation will probably ease in the coming months. But the problem is that the recent surge in core inflation and the reacceleration in wage growth shows that domestic inflationary pressures are still strengthening.

4.10. This suggests the Bank of England may have more work to do. Indeed, the Bank sounded somewhat hawkish in the June meeting. This came through most in the decision to step up the pace of hiking from the 0.25% at the previous two meetings. The 7-2 vote, with only two members voting to leave rates unchanged at 4.50%, revealed support for stepping up the fight against high inflation.

4.11. That said, the Bank has not committed to raising rates again or suggested that 0.5% rises are now the norm. What it did say was that "the scale of the recent upside surprises in official estimates of wage growth and services CPI inflation suggested a 0.5 percentage point increase in interest rates was required at this particular meeting". Moreover, the Committee did not strengthen its forward guidance that any further rate hikes would be conditional on the data. However, it looks highly probable, given the on-going strength of inflation and employment data, that the Bank will need to raise rates to at least 5.5% and to keep rates at their peak until the mid-point of 2024. We still think it is only a matter of time before the rise in rates weakens the economy sufficiently to push it into recession. That is why instead of rising to between 6.00%-6.25%, as is currently priced in by markets, we think rates are more likely to peak between 5.50-6.00%. Our forecast is also for rates to be cut in the second half of 2024, and we expect rates to then fall further than markets are pricing in.

4.12. Growing evidence that UK price pressures are becoming increasingly domestically generated has driven up market interest rate expectations and at one point pushed the 10-year gilt yield up to 4.49% in late June, very close to its peak seen after the "mini-budget". Yields have since fallen slightly back to 4.38%. But growing expectations that rates in the UK will remain higher for longer than say in the US. While higher interest rates are priced into the markets, the likely dent to the real economy from the high level of interest rates is not. That's why we think there is scope for market rate expectations to fall back in 2024 and why we expect the 10-year PWLB Certainty Rate to drop back from ca.5.20% to 5.00% by the end of 2023 and to 4.20% by the end of 2024.

4.13. The pound sterling strengthened from $1.24 at the start of April to a one-year high at $1.26 in early May, which was partly due to the risks from the global banking issues being seen as a bigger problem for the US than the UK. The pound then fell back to $1.23 at the end of May, before rising again to $1.28 in the middle of June as the strong core CPI inflation data released in June suggested the Bank of England was going to have to raise rates more than the US Federal Reserve or European Central Bank in order to tame domestic inflation. However, sterling's strong run may falter because more hikes in the near term to combat high inflation are likely to weaken growth (and, hopefully, at some point inflation too) to such a degree that the policy rate will probably be brought back down, potentially quite quickly, as the economic cycle trends downwards decisively. This suggests that additional rate hikes are unlikely to do much to boost the pound.

4.14. In early April, investors turned more optimistic about global GDP growth, pushing up UK equity prices. But this period of optimism appears to have been short-lived. The FTSE 100 has fallen by 4.8% since 21st April, from around 7,914 to 7,553, reversing part of the 7.9% rise since 17th March. Despite the recent resilience of economic activity, expectations for equity earnings have become a bit more downbeat. Nonetheless, further down the track, more rate cuts than markets anticipate should help the FTSE 100 rally.

5. Borrowing Activity in Q1 2023/24

5.1. The Council's underlying need to borrow for capital expenditure is termed the Capital Financing Requirement ("CFR"). This figure is a gauge of the Council's indebtedness. The CFR results from the capital activity of the Council and resources used to pay for the capital spend. It represents the Q1 2023/24 unfinanced capital expenditure, and prior years' net or unfinanced capital expenditure which has not yet been paid for by revenue or other resources.

5.2. Part of the Council's treasury activities is to monitor cash position and organise financing against the borrowing needs. Financing sourced through combination of external borrowing from external bodies, such as the Government, through the Public Works Loan Board ("PWLB"), or the money markets, or utilising temporary cash resources within the Council.

5.3. During Q1 2023/24, the Council continued to maintain an under-borrowed position. This meant that the capital borrowing need, the CFR, was not fully funded with loan debt, as cash supporting the Council's reserves, balances and cash flow was used as an interim measure in the sharply rising interest rates environment and the period of relatively low capital spend.

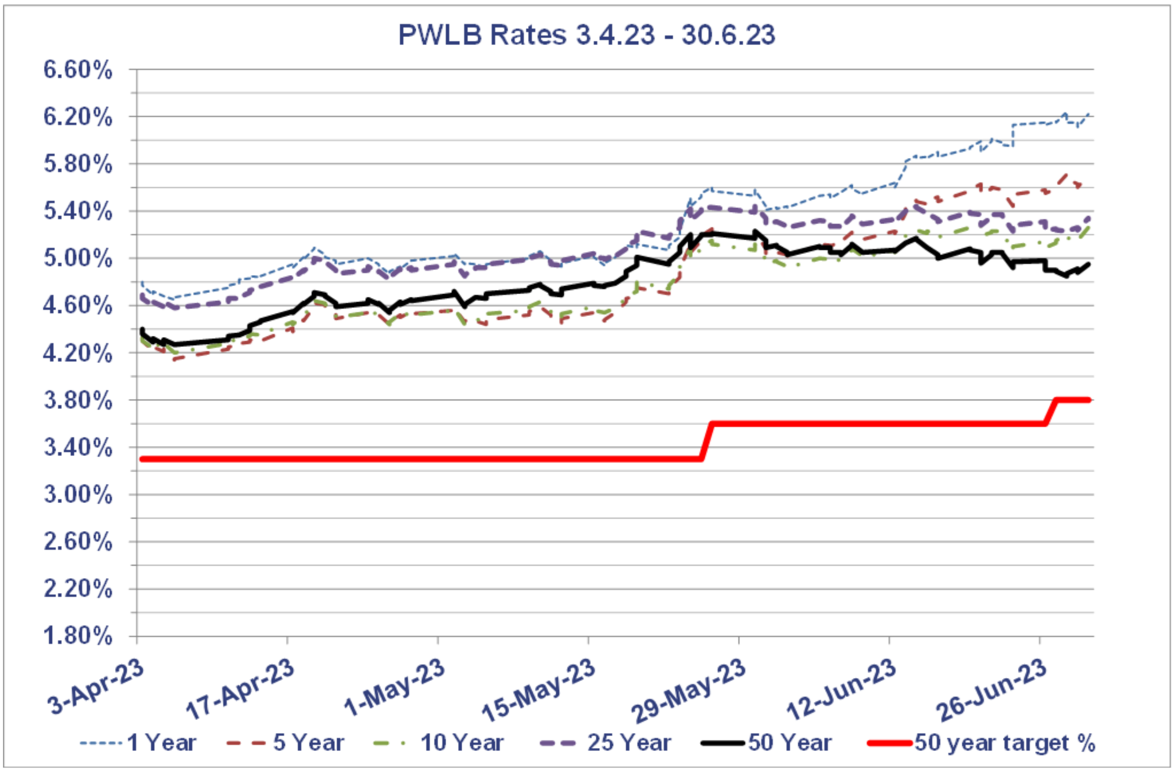
5.4. Table 1 sets out the borrowing activity in Q1 2023/24.

Table 1 – Borrowing activity in Q1 2023/24

	Opening Balance £'000	New borrowing £'000	Borrowings repaid £'000	Closing balance £'000
HRA – PWLB	100,000	0	0	100,000
General Fund - PWLB	499,000	0	0	499,000
General Fund – Other	44,181	0	281	43,900
	643,181	**0**	**281**	**642,900**

5.5. PWLB rates are based on gilt (UK Government bonds) yields through HM Treasury determining a specified margin to add to gilt yields. The main influences on gilt yields are Bank Rate, inflation expectations and movements in US treasury yields. Hence, gilt yields and PWLB rates were on a rising trend between 1st April and 30th June.

5.6. The 50-year PWLB Certainty Rate target for new long-term borrowing started 2023/24 at 3.30% before increasing to a peak of 3.80% in June. As can be seen, 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. (Please also note that from 15th June, HRA borrowing is 0.4% lower than the Certainty Rate). The actual PWLB rates during the year were as follows:



6. Interest rates in Q1 2023/24

6.1. Bank rates continued to increase during Q1 2023/24. On 11th May, the Bank of England's Monetary Policy Committee (MPC) increased Bank Rate by 25 basis points to 4.50%, and on 22nd June moved rates up a further 50 basis points to 5.00%.

6.2. Nonetheless, the Bank of England will have a difficult task in convincing investors that they will be able to dampen inflation pressures anytime soon. Talk of the Bank's inflation models being "broken" is perhaps another reason why gilt investors are demanding a premium relative to US and Euro-zone bonds, for example.

6.3. Of course, what happens outside of the UK is also critical to movement in gilt yields. The US Federal Reserve has already hiked short-term rates to a range of 5.00%-5.25% (with more to come), whilst the European Central Bank looks likely to raise its Deposit rate at least once more to 3.75%, with upside risk of higher to come.

6.4. While the Council continues to take a cautious approach to investing, it is also fully appreciative of changes to regulatory requirements for financial institutions in terms of additional capital and liquidity that came about in the aftermath of the financial crisis. These requirements have provided a far stronger basis for financial institutions, with annual stress tests by regulators evidencing how institutions are now far more able to cope with extreme stressed market and economic conditions.

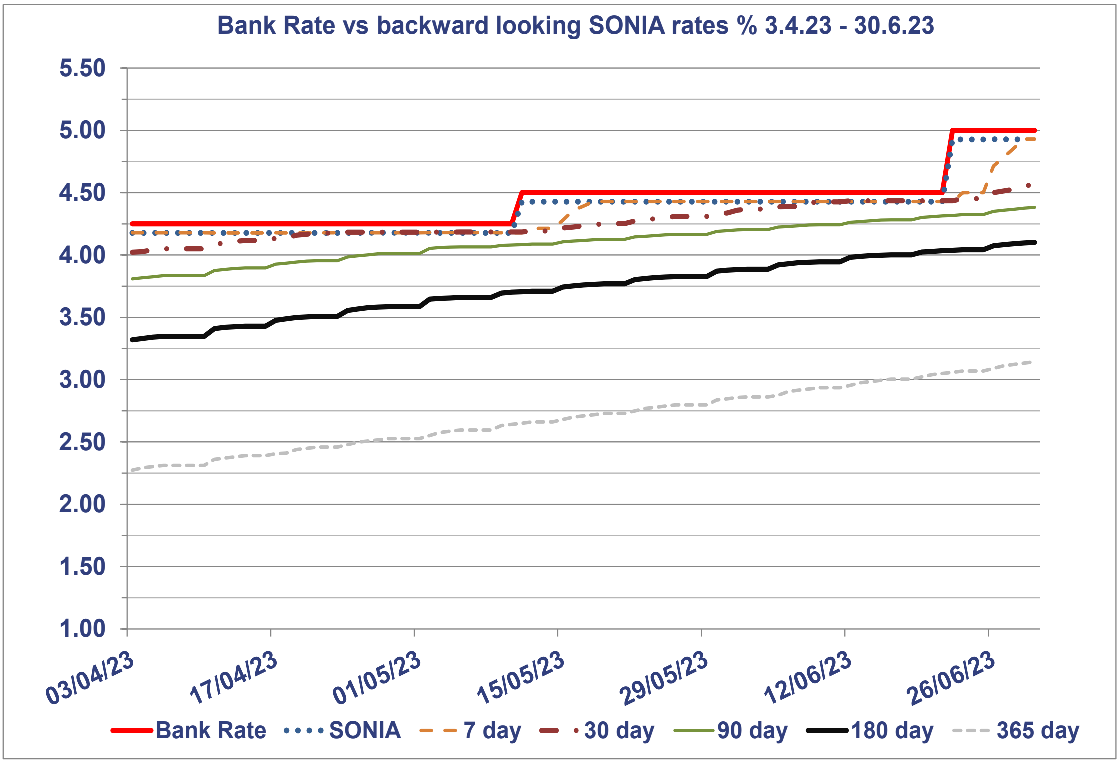
6.5. Investment balances have been kept to a minimum through the agreed strategy of using reserves and balances to support internal borrowing, rather than borrowing externally from the financial markets. External borrowing would have incurred an additional cost, due to the differential between borrowing and investment rates. This also provides benefits of reducing counterparty risk exposure, by fewer investments in the financial markets.

<u>Interest rate benchmark</u>

6.6. LIBOR (the London Inter-bank Offered Rate) a benchmark interest rate was replaced by the reformed Sterling Overnight Index Average ("SONIA") from 31 December 2021.

SONIA is published daily and measures the cost of overnight borrowing on a backward-looking basis.

6.7. The SONIA (backward-looking) rates during the Q1 2023/24 were as follows:



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	Bank Rate	SONIA	7 day	30 day	90 day	180 day	365 day
High	5.00	4.93	4.93	4.57	4.38	4.10	3.14
High Date	22/06/2023	30/06/2023	30/06/2023	30/06/2023	30/06/2023	30/06/2023	30/06/2023
Low	4.25	4.18	4.18	4.02	3.81	3.32	2.27
Low Date	03/04/2023	04/04/2023	11/04/2023	03/04/2023	03/04/2023	03/04/2023	03/04/2023
Average	4.44	4.37	4.34	4.27	4.11	3.74	2.70
Spread	0.75	0.75	0.75	0.55	0.57	0.78	0.87

6.8. The Council's actual interest rate performance during Q1 2023/24 was 4.31%. The Council's overall performance compares favourably with the new average SONIA rates (given the current environment of continuous bank rate increases) as can be seen in the above table.

6.9. The Council's Treasury Management Strategy sets out a lower rate of interest for the Housing Revenue Account based on the risk-free nature of the account. This lower rate is achieved by deducting the credit risk margin from the actual rate achieved by the Council. The resulting interest rate applicable to the HRA during Q1 2023/24 was 4.11%.

6.10. The Council invests in two Pooled Funds (operated by CCLA (Churches, Charities and Local Authorities) Investment Management Limited). These allow the Council to diversify into asset classes other than cash without the need to own and manage the underlying investments. Investments in these funds are long term in nature and over long termhorizons they provide investors with relatively strong levels of interest (in the form of dividends). However, the capital values of these assets can be subject to large fluctuations (both up and down) over relatively short time frames.

6.11. The movement of the Council's two CCLA pooled funds is as follows:

Table 2 – Pooled Funds in Q1 2023/24				
	Original Investment £	**Value 31 Mar 2023 £**	**Value 30 Jun 2023 £**	**Annualised Return %**
CCLA Property Fund	2,000,000	2,263,467	2,260,326	5.26
CCLA Diversified Income Fund	2,000,000	1,894,514	1,884,849	4.13

The differences between the Original Sums invested and the Values at 30 Jun 2023 are held on the Council's Balance Sheet in the Pooled Investments Adjustment Account.

7. Investments in Q1 2023/24

7.1. The Council's investment policy is governed by DLUHC investment guidance and is reflected in the Annual Investment Strategy approved by the Council each year. This policy sets out the approach for choosing investment counterparties and is based on credit ratings provided by the three main credit rating agencies, supplemented by additional market data, (such as rating outlooks, credit default swaps, bank share prices etc.). The investment activity during the first quarter of financial year of 2023/24 conformed to the approved strategy, and the Council had no liquidity difficulties.

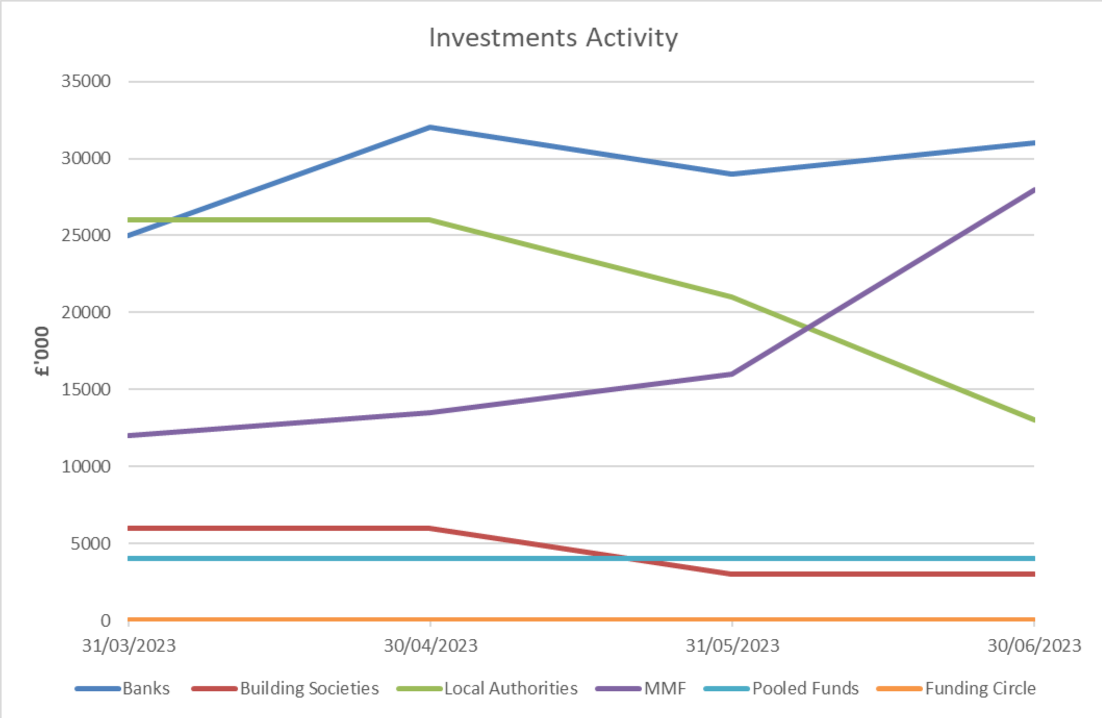
7.2. Investments of £79.0million were held by the Council as of 30 June 2023 with investment turnover principally driven by the availability of counterparties that meet the criteria set out in the Annual Investment Strategy. Table 3 below summarises investment activity during this quarter, split between the sectors of the counterparties that the funds were invested with.

Table 3 - Investment activity in Q1 2023/24				
	Opening Balance £000	**New Investments** £000	**Investments Recalled** £000	**Closing Balance** £000
Specified Investments				
Banking sector	25,000	24,000	18,000	31,000
Building societies	6,000	3,000	6,000	3,000
Local Authorities	26,000	3,000	16,000	13,000
Central Government	0	0	0	0
Money Market Funds	12,000	41,500	25,500	28,000
Unspecified Investments				
Short Dated Bond Funds & Cash Funds	0	0	0	0
Pooled Funds & Investment Schemes	4,000	0	0	4,000
Funding Circle	42	0	0	42
	73,042	71,500	65,500	79,042

7.3. Aside from the parameters set in the Annual Investment Strategy, the main factors that determine the amount of investment income are the level of interest rates, cash flow and the level of reserves and balances. The impact of capital cash flows – receipts from sales and timing of capital projects – also has a significant impact on cash flows.

7.4. The monthly movement in balances between these categories during Q1 2023/24 is set out in Table 4 below and reflects the available counterparties and investment rates at that time.

Table 4 - Movement between investments during Q1 2023/24



7.5. A full list of investments held as of 30 June 2023 is set out in Appendix C.

8. Non-treasury Investments

8.1. The Prudential Code, TM Code and DLUHC regulations include guidance on what is termed "non-treasury" investments. These are predominantly investments for commercial return such as:

- commercial loans to companies and other organisations, and
- holding property for a financial return (investment property).

The Council owns a significant investment property portfolio which is now managed through its developing Asset Management Strategy and provided loans to its wholly owned companies and local community groups.

<u>Commercial Loans</u>

8.2. The Council has funded its three wholly owned companies via Loan Facilities (that have been approved by the Full Council at rates set in accordance with the competition rules) which enabled them to buy some of the properties resulting from the Council's regeneration schemes. There are no plans in the current Capital Programme to increase investments in these areas. The table below sets out the list of loan facilities and movements in their balances in Q1 2023-24.

Loan Type	31/03/2023 Investment £'000	Q1 2023/24 Movement £'000	30/06/2023 Investment £'000	Interest Rate %
Development Loans - AddlestoneOne	25,326		25,326	5.04
Development Loans – Magna Square	11,838		11,838	4.22
Development Loans - Other	1,000		1,000	4.86
Working Capital Loans	445		445	7.54
Working Capital Loans	300		300	7.36
Working Capital Loans	2,100	400	2,500	7.40

Totals	41,009	400	41,409	

8.3. The Working Capital Loan Facilities Agreement approved in October 2020 allowed a sum of £3m available to draw down as required. Of this amount £500,000 is still available to drawdown. It is anticipated that this will be required before the end of this financial year.

Property performance measurement

8.4. As part of both the Annual Asset Management Strategy and the Capital & Investment Strategy, a set of performance reporting measures were approved.

8.5. To better describe the role the investment property portfolio plays in the Council's capital and revenue strategies, the following table sets out the key performance indicators in Q1 2023-24:

KPI	Metric Description	YTD 30/06/2023
Investment Property Income	Variance from target income	£0
Investment Property Rent Arrears	As a percentage of the total portfolio income – taken prior to Quarterly due dates	3.31%
Vacancy Rates	As a percentage of the total portfolio area in SQ FT	5.87%
Tenant Retention	Number of renewals completed and tenant breaks not exercised	91%
Income Return (Proportionality)	Investment income as a percentage of all general fund income (excluding Taxation)	42%
Capital Value	Difference in annual valuation figures, annually. (March 2022 – March 2023)	-£24.8m

These measures and KPIs will be further developed in 2023-24 using benchmarking analysis relative to the broader market, based on frequent data via a subscription to MSCI Analytics. Work on uploading data to MSCI is currently being undertaken.

8.6 With regard to the Capital values; the figures of -£24.8M reflects the fact that our investment property portfolio is heavily weighted in the office sector (approximately 64%), the majority of which have a shortening income profile which in turn leads to a yield swing affecting the capital return. The office sector has undergone a significant shift since October 2022 with persistent high inflation, interest rate hikes and volatility in the financial sector causing investor caution which adds to cautious valuations. In addition to the challenging market conditions particularly in the south east office sector, occupation activity remains sensitive to economic headwinds which include rising energy costs, the new rates revaluation, and ongoing build-cost inflation which have impacted the all-in occupational cost of space which has resulted in occupiers taking less space.

8.7 As with the treasury information, the provision of economic data helps to put some of the above metrics into perspective. An update on property related economic matters provided by local agents Vail Williams reflecting the market position in July 2023 is set out in Appendix D.

9. Legal Implications

9.1. The powers for a local authority to borrow and invest are governed by the Local Government Act 2003 and associated Regulations. A local authority may borrow or invest for any purpose relevant to its functions, under any enactment, or for the purpose of the prudent management of its financial affairs. The Regulations also specify that authorities should have regard to the CIPFA Treasury Management Code, the Government Investments Guidance and the CIPFA Prudential Code for Capital Finance in Local Authorities when carrying out their treasury management functions.

10. Environmental/Sustainability/Biodiversity implications

10.1. Ethical or Sustainable investing is becoming a more commonplace discussion within the wider investment community. There are currently a small, but growing number of financial institutions and fund managers promoting Environmental, Social and Governance (ESG) products however the types of products we can invest in are constrained to those set out in our Investment Strategy which is driven by investment guidance, both statutory and from CIPFA, making it clear that all investing must adopt SLY principles – security, liquidity and yield: ethical issues must play a subordinate role to those priorities.

10.2. The Council does not invest directly in any companies – other than our own – and our investments are limited to investments with the banking sector (term deposits etc) and investments in property (our investment properties). We do have £4million split between two pooled funds both managed by the CCLA and their approach to ESG can be found on their website.

11. Council Policy

11.1. This is set out in the Treasury Management Policy Statement, the Annual Investment Strategy, and associated Practices and Schedules.

11.2. The Council's treasury management policy statement states:

"The Council regards the successful identification, monitoring and control of risk to be the prime criteria by which the effectiveness of its treasury management activities will be measured. Accordingly, the analysis and reporting of treasury management activities will focus on their risk implications for the organisation, and any financial instruments entered into to manage these risks."

11.3. It is the security of investments that has always been the main emphasis of our treasury strategy. In balancing risk against return, Officers continue to place emphasis on the control of risk over yield.

12. Conclusions

12.1. The first quarter of 2023/24 continued the challenging investment environment with counterparty risk remaining our primary treasury management priority. The criteria in the Annual Investment Strategy are continuously reviewed to minimise risk as much as practicable whilst retaining the ability to invest with secure institutions.

13. Appendices

- Appendix A – Treasury and Prudential Indicators 2023/24 as of 30 June 2023
- Appendix B – Borrowings as of 30 June 2023
- Appendix C – Investments as of 30 June 2023
- Appendix D – Economic commentary for property as of 30 June 2023