MEETING:	**PENSIONS COMMITTEE**
DATE:	**21 NOVEMBER 2022**
TITLE:	**TREASURY MANAGEMENT 2022 –2023 MID YEAR REVIEW**
PURPOSE:	**CIPFA's Code of Practice recommends that a report on the Council's actual Treasury Management during the current financial year is produced.**
RECOMMENDATION:	**RECEIVE THE REPORT FOR INFORMATION**
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EXECUTIVE SUMMARY

During the six month period between 1 April and 30 September 2022, the Council's investment of the Pension Fund's surplus funds, pooled and co-invested with the Council's cash flow, remained well within the limits originally set. There were no defaults by the banks in which money was deposited. Furthermore, it is estimated that the actual investment income will be significantly higher than the expected income in the 2022/23 budget.

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1. INTRODUCTION

The Chartered Institute of Public Finance and Accountancy's Treasury Management Code (CIPFA's TM Code) requires that Authorities report on the performance of the treasury management function at least twice yearly (mid-year and at year end). This report provides a mid-year update.

The Council's treasury management strategy for 2022/23 was approved by full Council on 3rd March 2022. The Council has invested substantial sums of money and is therefore exposed to financial risks including the loss of invested funds and the revenue effect of changing interest rates. The successful identification, monitoring and control of risk are therefore central to the Council's treasury management strategy.

CIPFA published its revised Treasury Management Code of Practice and Prudential Code for Capital Finance in December 2021. The key changes in the two codes are around permitted reasons to borrow, knowledge and skills, and the management of non- treasury investments. The principles within the two codes took immediate effect although local authorities could defer introducing the revised reporting requirements within the revised Codes until the 2023/24 financial year if they wish which the Council has elected to do.

It was decided at the Pensions Committee, 17 March 2022 to allow the surplus funds of the Pension Fund to be pooled and co-invested with the Council's overall cash flow for the financial year 2022/23.

2. EXTERNAL CONTEXT

Economic background: The ongoing conflict in Ukraine has continued to put pressure on global inflation and the economic outlook for UK and world growth remains weak. The UK political situation towards the end of the period following the 'fiscal event' increased uncertainty further.

The economic backdrop during the April to September period continued to be characterised by high oil, gas and commodity prices, ongoing high inflation and its impact on consumers' cost of living, no imminent end in sight to the Russia-Ukraine hostilities and its associated impact on the supply chain, and China's zero-Covid policy.

Central Bank rhetoric and action remained robust. The Bank of England, Federal Reserve and the European Central Bank all pushed up interest rates over the period and committed to fighting inflation, even when the consequences were in all likelihood recessions in those regions.

UK inflation remained extremely high. Annual headline CPI hit 10.1% in July, the highest rate for 40 years, before falling modestly to 9.9% in August. RPI registered 12.3% in both July and August. The energy regulator, Ofgem, increased the energy price cap by 54% in April, while a further increase in the cap from October, which would have seen households with average energy consumption pay over £3,500 per annum, was dampened by the UK government stepping in to provide around £150 billion of support to limit bills to £2,500 annually until 2024.

The labour market remained tight through the period but there was some evidence of easing demand and falling supply. The unemployment rate 3m/year for April fell to 3.8% and declined further to 3.6% in July. Although now back below pre-pandemic levels, the recent decline was driven by an increase in inactivity rather than demand for labour. Pay growth in July was 5.5% for total pay (including bonuses) and 5.2% for regular pay. Once adjusted for inflation, however, growth in total pay was -2.6% and –2.8% for regular pay.

With disposable income squeezed and higher energy bills still to come, consumer confidence fell to a record low of –44 in August, down –41 in the previous month. Quarterly GDP fell -0.1% in the April-June quarter driven by a decline in services output, but slightly better than the 0.3% fall expected by the Bank of England.

The Bank of England increased the official Bank Rate to 2.25% over the period. From 0.75% in March, the Monetary Policy Committee (MPC) pushed through rises of 0.25% in each of the following two MPC meetings, before hiking by 0.50% in August and again in September. August's rise was voted by a majority of 8-1, with one MPC member preferring a more modest rise of 0.25%. The September vote was 5-4, with five votes for an 0.5% increase, three for an 0.75% increase and one for an 0.25% increase. The Committee noted that domestic inflationary pressures are expected to remain strong and so given ongoing strong rhetoric around tackling inflation further Bank Rate rises should be expected.

On 23rd September the UK government, following a change of leadership, announced a raft of measures in a 'mini budget', loosening fiscal policy with a view to boosting the UK's trend growth rate to 2.5%. With little detail on how government borrowing would be returned to a sustainable path, financial markets reacted negatively. Gilt yields rose dramatically by between 0.7% - 1% for all maturities with the rise most pronounced for shorter dated gilts. The swift rise in gilt yields left pension funds vulnerable, as it led to margin calls on their interest rate swaps and risked triggering large scale redemptions of assets across their portfolios to meet these demands. It became necessary for the Bank of England to intervene to preserve market stability through the purchase of long-dated gilts, albeit as a temporary measure, which has had the desired effect with 50-year gilt yields falling over 100bps in a single day.
Bank of England policymakers noted that any resulting inflationary impact of increased demand

would be met with monetary tightening, raising the prospect of much higher Bank Rate and consequential negative impacts on the housing market.

After hitting 9.1% in June, annual US inflation eased in July and August to 8.5% and 8.3% respectively. The Federal Reserve continued its fight against inflation over the period with a 0.5% hike in May followed by three increases of 0.75% in June, July and September, taking policy rates to a range of 3% - 3.25%.

Eurozone CPI inflation reached 9.1% y/y in August, with energy prices the main contributor but also strong upward pressure from food prices. Inflation has increased steadily since April from 7.4%. In July the European Central Bank increased interest rates for the first time since 2011, pushing its deposit rate from –0.5% to 0% and its main refinancing rate from 0.0% to 0.5%. This was followed in September by further hikes of 0.75% to both policy rates, taking the deposit rate to 0.75% and refinancing rate to 1.25%.

Financial markets: Uncertainty remained in control of financial market sentiment and bond yields remained volatile, continuing their general upward trend as concern over higher inflation and higher interest rates continued to dominate. Towards the end of September, volatility in financial markets was significantly exacerbated by the UK government's fiscal plans, leading to an acceleration in the rate of the rise in gilt yields and decline in the value of sterling.

Due to pressure on pension funds, the Bank of England announced a direct intervention in the gilt market to increase liquidity and reduce yields.

Over the period the 5-year UK benchmark gilt yield rose from 1.41% to 4.40%, the 10-year gilt yield rose from 1.61% to 4.15%, the 20-year yield from 1.82% to 4.13% and the 50-year yield from 1.56% to 3.25%. The Sterling Overnight Rate (SONIA) averaged 1.22% over the period.

Credit review: In July Fitch revised the outlook on Standard Chartered from negative to stable as it expected profitability to improve thanks to the higher interest rate environment. Fitch also revised the outlook for Bank of Nova Scotia from negative to stable due to its robust business profile.

Also in July, Moody's revised the outlook on Bayerische Landesbank to positive and then in September S&P revised the GLA outlook to stable from negative as it expects the authority to remain resilient despite pressures from a weaker macroeconomic outlook coupled with higher inflation and interest rates.

Having completed its full review of its credit advice on unsecured deposits at UK and non-UK banks, in May Arlingclose extended the maximum duration limit for five UK banks, four Canadian banks and four German banks to six months. The maximum duration for unsecured deposits with other UK and non-UK banks on Arlingclose's recommended list is 100 days. These recommendations were unchanged at the end of the period.

Arlingclose continued to monitor and assess credit default swap levels for signs of credit stress but made no changes to the counterparty list or recommended durations. Nevertheless, increased market volatility is expected to remain a feature, at least in the near term and, as ever, the institutions and durations on the Council's counterparty list recommended by Arlingclose remain under constant review.

3. TREASURY INVESTMENT ACTIVITY

CIPFA revised TM Code defines treasury management investments as those which arise from the Council's cash flows or treasury risk management activity that ultimately represents balances which need to be invested until the cash is required for use in the course of business.

The Council holds invested funds, representing income received in advance of expenditure plus balances and reserves held. During the 6 months, the Council's investment balance ranged between £82.3 and £170.8 million due to timing differences between income and expenditure. The investment position during the period is shown in the table below.

Treasury Investment Position

	31.3.22 Balance £m	**6 month Movement £m**	**30.9.22 Balance £m**	**30.9.22 Income Returns %**
Banks & building societies (unsecured)	23.1	10.2	33.3	1.64
Local authorities	30.0	(15.0)	15.0	1.97
Money Market Funds	17.0	36.0	53.0	2.07
Pooled Funds	9.8	(0.6)	9.2	4.76
Debt Management Office	18.0	(18.0)	0.0	n/a
Total investments	**97.9**	**12.6**	**110.5**	

Both the CIPFA Code and government guidance require the Council to invest its funds prudently, and to have regard to the security and liquidity of its treasury investments before seeking the optimum rate of return, or yield. The Council's objective when investing money is to strike an appropriate balance between risk and return, minimising the risk of incurring losses from defaults and the risk of receiving unsuitably low investment income.

The increases in Bank Rate over the period under review, and with the prospect of more increases to come, short-dated cash rates, which had ranged between 0.7% - 1.5% at the end of March, rose by around 1.5% for overnight/7-day maturities and by nearly 3.5% for 9-12 month maturities.

By the end of September, the rates on DMADF deposits ranged between 1.85% and 3.5%. The return on the Council's sterling low volatility net asset value Money Market Funds ranged between 0.54% - 0.58% p.a. in early April and between 1.96% and 2.17% at the end of September.

£10m of the Council's investments are held in externally managed strategic pooled property, multi-asset and equity funds where short- term security and liquidity are lesser consideration, and the objectives instead are regular revenue income and long- term price stability. Because these funds have no defined maturity date, but are available for withdrawal after a notice period, their performance and continued stability in meeting the Council's investment objective are regularly reviewed.

The performance of our pooled property, multi-asset and equity funds at 30 September 2022 can be seen below:

STRATEGIC POOLED FUND PORTFOLIO	GWYNEDD	From: 30/09/2021	To: 30/09/2022

FUND NAME	ASSET CLASS	No of Units Held in Period	Current Value £	Capital Growth £	Dividends Earned £	Holding Period (yrs)	Capital Return	Income Return	Total Return	Volatility
AEGON (KAMES) DIVERSIFIED MONTHLY INCOME FUND	MULTI ASSET	1,158,480	1,052,132	-202,815	69,928	1.0	-16.16%	5.57%	-10.59%	10.5%
CCLA - LAMIT PROPERTY FUND	PROPERTY	1,524,344	5,219,354	505,472	180,086	1.0	10.72%	3.82%	14.54%	5.9%
NINETY ONE (INVESTEC) DIVERSIFIED INCOME FUND	MULTI ASSET	1,228,153	1,080,434	-126,693	43,345	1.0	-10.50%	3.59%	-6.90%	4.4%
SCHRODER INCOME MAXIMISER FUND	EQUITY - UK	5,173,994	1,824,350	-243,178	163,069	1.0	-11.76%	7.89%	-3.87%	14.9%
GRAND TOTAL			9,176,269	-67,214	456,428	1.0	-0.73%	4.94%	4.21%	6.3%
			Unrealised capital loss since purchase:	-823,731		Annualised income return:		4.94%		

It is evident that the combined capital value of £9.176m is less than the initial investment of £10m. Strategic fund investments are made in the knowledge that capital values will move both up and down on months, quarters, and even years; but with the confidence that over a three to five year period total returns will exceed cash interest rates. Investment in these funds will be maintained in the medium term.

Investment Benchmarking

The progression of risk and return metrics are shown in the extracts from Arlingclose's quarterly investment benchmarking in the table below.

	Credit Score	Credit Rating	Bail-in Exposure	Weighted Average Maturity (days)	Rate of Return %
30.06.2022	4.55	A+	60%	29	1.42
30.09.2022	4.92	A+	80%	36	2.32
Similar LAs **All LAs**	**3.93** **4.29**	**AA-** **AA-**	**39%** **55%**	**74** **18**	**2.06** **2.06**

Treasury Management Performance

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.

The Council's budgeted investment income for the year is £0.4m, however the actual expected investment income for the year 2022/23 is significantly higher, estimated at £1.8m due to the increase in the base rate and forecasted future increases.

4. COMPLIANCE

The Head of Finance can confirm that the treasury management activities undertaken during the period complied fully with CIPFA Code of Practice and the Council's approved Treasury Management Strategy.

The Council's investments remained well within the limits originally set.

Investment Limits

	Counterparty Maximum during period	Counterparty 30.9.22 Actual	Counterparty 2022/23 Limit	Complied
The UK Government	£61m	£0m	Unlimited	✓
Local authorities & other government entities	£5m	£5m	£10m	✓
Secured investments	£0m	£0m	£10m	✓
Banks (unsecured)	£5m	£5m	£5m	✓
Building societies (unsecured)	£5m	£5m	£5m	✓
Registered providers (unsecured)	£0m	£0m	£5m	✓
Money market funds	£10m	£10m	£10m	✓
Strategic pooled funds	£5m	£5m	£10m	✓
Real Estate Investment Trusts	£0m	£0m	£10m	✓
Other investments	£0m	£0m	£5m	✓

Treasury Management Indicators

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

Security: The Council has adopted a voluntary measure of its exposure to credit risk by monitoring the value-weighted average credit rating or credit score 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.

	Actual	Target	Complied
Portfolio average credit score	4.9	6.0	✓

Liquidity: The Council has adopted a voluntary measure of its exposure to liquidity risk by monitoring the amount of cash available to meet unexpected payments.

	30.9.22 Actual	2022/23 Target	Complied
Total cash available within 3 months	£81.3m	£10m	✓

Interest Rate Exposures: This indicator is set to control the Council's exposure to interest rate risk. The upper limits on the one year revenue impact of a 1% rise or fall in interest were:

Interest rate risk indicator	30.9.22 Actual	2022/23 Limit	Complied
Upper limit on one-year revenue impact of a 1% <u>rise</u> in interest rates	£878,000	£643,000	x
Upper limit on one-year revenue impact of a 1% <u>fall</u> in interest rates	£878,000	£643,000	x

This indicator has not been complied with as the interest rate environment was significantly different to when setting the strategy was set. The Council's revenue budget is expected to benefit from higher interest earnings in the short term.

Principal Sums Invested for Periods Longer than 364 days: 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 total principal sum invested to final maturities beyond the period end were:

	2022/23	**2023/24**	**2024/25**
Actual principal invested beyond year end	£0m	£0m	£0m
Limit on principal invested beyond year end	£20m	£20m	£20m
Complied	✓	✓	✓

5. INVESTMENT TRAINING

During the period, officers have attended investment training with Arlingclose and CIPFA relevant to their roles.

6. OUTLOOK FOR THE REMAINDER OF 2022/23

	Current	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24	Jun-24	Sep-24	Dec-24	Mar-25	Jun-25	Sep-25
Official Bank Rate													
Upside risk	0.00	0.50	0.75	0.75	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Arlingclose Central Case	2.25	4.25	5.00	5.00	5.00	5.00	5.00	5.00	5.00	4.75	4.25	3.75	3.25
Downside risk	0.00	-1.00	-1.00	-0.75	-0.50	-0.50	-0.50	-0.75	-1.25	-1.50	-1.75	-1.75	-1.75

Arlingclose expects Bank Rate to rise further during 2022/23 to reach 5% by the end of the year.

The MPC is particularly concerned about the demand implications of fiscal loosening, the tight labour market, sterling weakness and the willingness of firms to raise prices and wages.

The MPC may therefore raise Bank Rate more quickly and to a higher level to dampen aggregate demand and reduce the risk of sustained higher inflation. Arlingclose now expects Bank Rate to peak at 5.0%, with 200bps of increases this calendar year.

This action by the MPC will slow the economy, necessitating cuts in Bank Rate later in 2024.

Gilt yields will face further upward pressure in the short term due to lower confidence in UK fiscal policy, higher inflation expectations and asset sales by the BoE. Given the recent sharp rises in gilt yields, the risks are now broadly balanced to either side. Over the longer term, gilt yields are forecast to fall slightly over the forecast period.

<u>Background:</u>

Monetary policymakers are behind the curve having only raising rates by 50bps in September. This was before the "Mini-Budget", poorly received by the markets, triggered a rout in gilts with a huge spike in yields and a further fall in sterling. In a shift from recent trends, the focus now is perceived to be on supporting sterling whilst also focusing on subduing high inflation.

There is now an increased possibility of a special Bank of England MPC meeting to raise rates to support the currency. Followed by a more forceful stance over concerns on the looser fiscal outlook. The MPC is therefore likely to raise Bank Rate higher than would otherwise have been necessary given already declining demand. A prolonged economic downturn could ensue.

Uncertainty on the path of interest rates has increased dramatically due to the possible risk from unknowns which could include for instance another Conservative leadership contest, a general election, or further tax changes including implementing windfall taxes.

The government's blank cheque approach to energy price caps, combined with international energy markets priced in dollars, presents a fiscal mismatch that has contributed to significant decline in sterling and sharp rises in gilt yields which will feed through to consumers' loans and mortgages and business funding costs.

UK government policy has mitigated some of the expected rise in energy inflation for households and businesses flattening the peak for CPI, whilst extending the duration of elevated CPI. Continued currency weakness could add inflationary pressure.

The UK economy already appears to be in recession, with business activity and household spending falling. The short- to medium-term outlook for the UK economy is relatively bleak.

Global bond yields have jumped as investors focus on higher and stickier US policy rates. The rise in UK government bond yields has been sharper, due to both an apparent decline in investor confidence and a rise in interest rate expectations, following the UK government's shift to borrow to loosen fiscal policy. Gilt yields will remain higher unless the government's plans are perceived to be fiscally responsible.

The housing market impact of increases in the Base Rate could act as a "circuit breaker" which stops rates rising much beyond 5.0%, but this remains an uncertainty.