REPORT REFERENCE NO.	**RC/22/16**
MEETING	**RESOURCES COMMITTEE**
DATE OF MEETING	**23 NOVEMBER 2022**
SUBJECT OF REPORT	**TREASURY MANAGEMENT PERFORMANCE 2022-23 – QUARTER 2**
LEAD OFFICER	**TREASURER**
RECOMMENDATIONS	***That the performance in relation to the treasury management activities of the Authority for 2022-23 (to September 2022) be noted.***
EXECUTIVE SUMMARY	The Chartered Institute of Public Finance and Accountancy (CIPFA) issued a Code of Practice for Treasury Management. The Code suggests that members should be informed of Treasury Management activities at least twice a year, but preferably quarterly. This report therefore ensures this Authority is embracing Best Practice in accordance with CIPFA's Code of Practice.
RESOURCE IMPLICATIONS	As indicated within the report.
EQUALITY IMPACT ASSESSMENT	An initial assessment has not identified any equality issues emanating from this report.
APPENDICES	Appendix A – Investments held as at 30 September 2022.
LIST OF BACKGROUND PAPERS	Treasury Management Strategy (including Prudential and Treasury Indicators) as approved at the meeting of the Fire & Rescue Authority held on the 21 February 2022 – Minute DSFRA/11C refers.

1. INTRODUCTION

1.1. The Treasury Management Strategy for Devon and Somerset Fire & Rescue Authority has been underpinned by the adoption of the Chartered Institute of Public Finance and Accountancy's (CIPFA) Treasury Management in Public Services Code of Practice (the Code) and the CIPFA Prudential Code. The Code recommends that members be updated on treasury management activities regularly (TMSS, annual and midyear reports). This report, therefore, ensures this Authority is implementing best practice in accordance with the Code and includes:

- The creation and maintenance of a Treasury Management Policy Statement, which sets out the policies and objectives of the Authority's treasury management activities;
- The creation and maintenance of Treasury Management Practices, which set out the manner in which the Authority will seek to achieve those policies and objectives;
- The receipt by the full Authority of an annual Treasury Management Strategy Statement - including the Annual Investment Strategy and Minimum Revenue Provision Policy - for the year ahead, a Mid-year Review Report and an Annual Report (stewardship report) covering activities during the previous year;
- The delegation by the Authority of responsibilities for implementing and monitoring treasury management policies and practices and for the execution and administration of treasury management decisions.

1.2. Treasury management in this context is defined as:

> "The management of the local authority's borrowing, investments, 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."

1.3. The preparation of this report demonstrates that the Authority is implementing best practice in accordance with the code.

2. ECONOMICS UPDATE

2.1. The second quarter of 2022/23 saw:

- Gross Domestic Product (GDP) revised upwards in Quarter 1 of 2022/23 to +0.2% quarter on quarter (q/q) from -0.1%, which means the UK economy has avoided recession for the time being;
- Signs of economic activity losing momentum as production fell due to rising energy prices;
- Consumer Price Index (CPI) inflation ease to 9.9% Year on year (y/y) in August 2022, having been 9.0% in April 2022, but domestic price pressures showing little sign of abating in the near-term;
- The unemployment rate fall to a 48-year low of 3.6% due to a large shortfall in labour supply;

- Bank Rate rise by 100 basic points (bps) over the quarter, taking Bank Rate to 2.25% with further rises to come;
- Gilt yields surge and sterling fall following the “fiscal event” of the new Prime Minister and Chancellor on 23rd September 2022; and
- The UK economy grew by 0.2% q/q in Quarter 1 of 2022/23, though revisions to historic data left it below pre-pandemic levels.

2.2. There are signs of higher energy prices creating more persistent downward effects in economic activity. Both industrial production (-0.3% month on month {m/m}) and construction output (-0.8% m/m) fell in July 2022 for a second month in a row. Although some of this was probably due to the heat wave at the time, manufacturing output fell in some of the most energy intensive sectors (e.g., chemicals), pointing to signs of higher energy prices weighing on production. With the drag on real activity from high inflation having grown in recent months, GDP is at risk of contracting through the autumn and winter months.

2.3. The fall in the composite Purchasing Manager’s Index (PMI) from 49.6 in August 2022 to a 20-month low preliminary reading of 48.4 in September 2022 points to a fall in GDP of around 0.2% q/q in Quarter 3 and consumer confidence is at a record low. Retail sales volumes fell by 1.6% m/m in August 2022, which was the ninth fall in 10 months. That left sales volumes in August 2022 just 0.5% above their pre-Covid level and 3.3% below their level at the start of the year. There are also signs that households are spending their excess savings in response to high prices. Indeed, cash in households’ bank accounts rose by £3.2bn in August 2022, which was below the £3.9bn rise in July 2022 and much smaller than the 2019 average monthly rate of £4.6bn.

2.4. The labour market remained exceptionally tight. Data for July and August 2022 provided further evidence that the weaker economy is leading to a cooling in labour demand. Labour Force Survey (LFS) employment rose by 40,000 in the three months to July 2022 (the smallest rise since February). But a renewed rise in inactivity of 154,000 over the same period meant that the unemployment rate fell from 3.8% in June 2022 to a new 48-year low of 3.6%. The single-month data showed that inactivity rose by 354,000 in July 2022 itself and there are now 904,000 more inactive people aged 16+ compared to before the pandemic in February 2020. The number of vacancies has started to level off from recent record highs but there have been few signs of a slowing in the upward momentum on wage growth. Indeed, in July 2022, the 3my/y rate of average earnings growth rose from 5.2% in June 2022 to 5.5%.

2.5. CPI inflation eased from 10.1% in July 2022 to 9.9% in August 2022, though inflation has not peaked yet. The easing in August 2022 was mainly due to a decline in fuel prices reducing fuel inflation from 43.7% to 32.1%. And with the oil price now just below $90 per barrel, we would expect to see fuel prices fall further in the coming months.

2.6. However, utility price inflation is expected to add 0.7% to CPI inflation in October 2022 when the Ofgem unit price cap increases to, typically, £2,500 per household (prior to any benefit payments). But, as the government has frozen utility prices at that level for two years, energy price inflation will fall sharply after October 2022 and have a big downward influence on CPI inflation.

2.7. Nonetheless, the rise in services CPI inflation from 5.7% y/y in July 2022 to a 30-year high of 5.9% y/y in August 2022 suggests that domestic price pressures are showing little sign of abating. A lot of that is being driven by the tight labour market and strong wage growth. CPI inflation is expected to peak close to 10.4% in November 2022 and, with the supply of workers set to remain unusually low, the tight labour market will keep underlying inflationary pressures strong until early next year.

2.8. During Quarter 2 (Q2) 2022, there has been a change of both Prime Minister and Chancellor. The new team (Liz Truss and Kwasi Kwarteng) have made a step change in government policy. The government's huge fiscal loosening from its proposed significant tax cuts will add to existing domestic inflationary pressures and will potentially leave a legacy of higher interest rates and public debt. Whilst the government's utility price freeze, which could cost up to £150bn (5.7% of GDP) over 2 years, will reduce peak inflation from 14.5% in January 2023 to 10.4% in November this year, the long list of tax measures announced at the "fiscal event" adds up to a loosening in fiscal policy relative to the previous government's plans of £44.8bn (1.8% of GDP) by 2026/27. These included the reversal of April's national insurance tax on 6th November 2022, the cut in the basic rate of income tax from 20p to 19p in April 2023, the cancellation of next April's corporation tax rise, the cut to stamp duty and the removal of the 45p tax rate, although the 45p tax rate cut announcement has already been reversed.

2.9. Fears that the government has no fiscal anchor on the back of these announcements has meant that the pound has weakened again, adding further upward pressure to interest rates. Whilst the pound fell to a record low of $1.035 on the Monday following the government's "fiscal event", it has since recovered to around $1.12. That is due to hopes that the Bank of England will deliver a very big rise in interest rates at the policy meeting on 3rd November 2022 and the government will lay out a credible medium-term plan in the near term. This was originally expected as part of the fiscal statement on 23rd November 2022 but has subsequently been moved forward to an expected release date in October 2022. Nevertheless, with concerns over a global recession growing, there are downside risks to the pound.

2.10. The Monetary Policy Committee (MPC) has now increased interest rates seven times in as many meetings in 2022 and has raised rates to their highest level since the Global Financial Crisis. Even so, coming after the Federal Bank (Fed) and European Community Bank (ECB) raised rates by 75 basis points (bps) in their most recent meetings, the Bank of England's latest 50 basis points hike looks relatively dovish. However, the UK's status as a large importer of commodities, which have jumped in price, means that households in the UK are now facing a much larger squeeze on their real incomes.

2.11. Since the fiscal event on 23rd September 2022, it is expected the MPC will increase interest rates further and faster, from 2.25% currently to a peak of 5.00% in February 2023. The combination of the government's fiscal loosening, the tight labour market and sticky inflation expectations means we expect the MPC to raise interest rates by 100bps at the policy meetings in November 2022 (to 3.25%) and 75 bps in December 2022 (to 4%) followed by further 50 bps hikes in February 2023 and March 2023 (to 5.00%). Market expectations for what the MPC will do are volatile. If Bank Rate climbs to these levels the housing market looks very vulnerable, which is one reason why the peak in our forecast is lower than the peak of 5.50% - 5.75% priced into the financial markets at present.

2.12. Throughout 2022/23, gilt yields have been on an upward trend. They were initially caught up in the global surge in bond yields triggered by the surprisingly strong rise in CPI inflation in the US in May. 2022 The rises in two-year gilt yields (to a peak of 2.37% on 21st June 2022) and 10-year yields (to a peak of 2.62%) took them to their highest level since 2008 and 2014 respectively. However, the upward trend was exceptionally sharply at the end of September as investors demanded a higher risk premium and expected faster and higher interest rate rises to offset the government's extraordinary fiscal stimulus plans. The 30-year gilt yield rose from 3.60% to 5.10% following the "fiscal event", which threatened financial stability by forcing pension funds to sell assets into a falling market to meet cash collateral requirements. In response, the Bank did two things. First, it postponed its plans to start selling some of its quantitative easing (QE) gilt holdings until 31st October 2022. Second, it committed to buy up to £65bn of long-term gilts to "restore orderly market conditions" until 14th October 2022. In other words, the Bank is restarting Quantitative Easing (QE), although for financial stability reasons rather than monetary policy reasons.

2.13. Since the Bank's announcement on 28th September 2022, the 30-year gilt yield has fallen back from 5.10% to 3.83%. The 2-year gilt yield dropped from 4.70% to 4.30% and the 10-year yield fell back from 4.55% to 4.09%.

2.14. There is a possibility that the Bank continues with QE at the long-end beyond 14th October 2022 or it decides to delay quantitative tightening beyond 31st October 2022, even as it raises interest rates. So far at least, investors seem to have taken the Bank at its word that this is not a change in the direction of monetary policy nor a step towards monetary financing of the government's deficit. But instead, that it is a temporary intervention with financial stability in mind.

2.15. After a shaky start to the year, the Standard & Poors (S&P) 500 and FTSE 100 climbed in the first half of Q.2 of 2022/23 before falling to their lowest levels since November 2020 and July 2021 respectively. The S&P 500 is 7.2% below its level at the start of the quarter, whilst the FTSE 100 is 5.2% below it as the fall in the pound has boosted the value of overseas earnings in the index. The decline has, in part, been driven by the rise in global real yields and the resulting downward pressure on equity valuations as well as concerns over economic growth leading to a deterioration in investor risk appetite.

Interest rate forecasts

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

2.17. The latest forecast on 27th September 2022 sets out a view that both short and long-dated interest rates will be elevated for some little while, as the Bank of England seeks to squeeze inflation out of the economy, whilst the government is providing a package of fiscal loosening to try and protect households and businesses from the ravages of ultra-high wholesale gas and electricity prices.

2.18. The increase in PWLB rates reflects a broad sell-off in sovereign bonds internationally but more so the disaffection investors have with the position of the UK public finances after September's "fiscal event". To that end, the MPC has tightened short-term interest rates with a view to trying to slow the economy sufficiently to keep the secondary effects of inflation – as measured by wage rises – under control, but its job is that much harder now.

2.19. The PWLB rate forecasts below are based on the Certainty Rate (the standard rate minus 20 bps, calculated as gilts plus 80bps) which has been accessible to most authorities since 1st November 2012.

Link Group Interest Rate View 27.09.22												
	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24	Jun-24	Sep-24	Dec-24	Mar-25	Jun-25	Sep-25
BANK RATE	4.00	5.00	5.00	5.00	4.50	4.00	3.75	3.25	3.00	2.75	2.75	2.50
3 month ave earnings	4.50	5.00	5.00	5.00	4.50	4.00	3.80	3.30	3.00	2.80	2.80	2.50
6 month ave earnings	4.70	5.20	5.10	5.00	4.60	4.10	3.90	3.40	3.10	3.00	2.90	2.60
12 month ave earnings	5.30	5.30	5.20	5.00	4.70	4.20	4.00	3.50	3.20	3.10	3.00	2.70
5 yr PWLB	5.00	4.90	4.70	4.50	4.20	3.90	3.70	3.50	3.40	3.30	3.20	3.20
10 yr PWLB	4.90	4.70	4.60	4.30	4.10	3.80	3.60	3.50	3.40	3.30	3.20	3.20
25 yr PWLB	5.10	4.90	4.80	4.50	4.30	4.10	3.90	3.70	3.60	3.60	3.50	3.40
50 yr PWLB	4.80	4.60	4.50	4.20	4.00	3.80	3.60	3.40	3.30	3.30	3.20	3.10

3. TREASURY MANAGEMENT STRATEGY STATEMENT

Annual Investment Strategy

3.1. The Authority’s Annual Investment Strategy, which is incorporated in the Treasury Management Strategy Statement (TMSS) was approved by the Authority on the 21 February 2022. It outlines the Authority’s investment priorities as follows:

- Security of Capital
- Liquidity
- Yield

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

3.3. As shown by the interest rate forecasts in section 2, rates have improved dramatically during Q1 and Q2 2022 and are expected to improve further as Bank Rate continues to increase over the next year or so.

Creditworthiness.

3.4. Significant levels of downgrades to Short and Long Term credit ratings have not materialised since the crisis in March 2020. In the main, where they did change, any alterations were limited to Outlooks. However, as economies have reopened, there have been some instances of previous lowering of Outlooks being reversed.

3.5. A full list of investments held as at 30 September 2022 are shown in Appendix A.

3.6. The average level of funds available for investment purposes during the quarter was £40.441m (£36.201m at the end of Quarter 1). These funds were available on a temporary basis and the level of funds was dependent on the level of reserves, timing of precept payments, receipt of grants and progress on the Capital Programme.

Benchmark	Benchmark Return	Authority Performance	Investment interest to Quarter 2
3 Month SONIA	1.56%	2.35%	£0.086m.

3.7. As illustrated above, the Authority out-performed the 3-month Sterling Overnight Index Average (SONIA) benchmark by 0.79bp. SONIA replaced LIBID at the end of December and has traded at a higher average rate than the LIBID benchmarks. Based on current market deposit rates on offer, it is currently anticipated that the actual investment return for the whole of 2022-23 will over recover the Authority's budgeted investment target of £0.100m by £0.449m. However, there is much volatility with interest rates at the moment, so this forecast is likely to be revised.

Borrowing Strategy

Prudential Indicators:

3.8. It is a statutory duty for the Authority to determine and keep under review the "Affordable Borrowing Limits". The Authority's approved Prudential Indicators (affordability limits) are outlined in the approved TMSS.

3.9. A full list of the approved limits (as amended) are included in the Financial Performance Report 2022-23, considered elsewhere on the agenda, which confirms that no breaches of the Prudential Indicators were made in the period to September 2022 and that there are no concerns that they will be breached during the financial year.

Current external borrowing

3.10. The Authority has not taken any external loans since June 2012 and has been using cash resources to meet any capital expenditure. The amount of outstanding external borrowing as at 30 September 2022 was £24.711m, forecast to reduce to £24.264m by the end of the financial year as a result of standard loan repayments. All of this debt is at fixed rate with the remaining principal having an average rate of 4.25% and average life of 23.5 years.

Loan Rescheduling

3.11. No debt rescheduling was undertaken during the quarter. As per previous updates, the Authority will continue to work closely with our treasury advisors to explore any opportunities to repay existing loans, however the differential between current Public Works Loan Board early repayment rates and new loan rates, mean there is no financial benefit in undertaking premature loan repayment at this time. A number of options were run during Q2 2022 and will be kept under review, especially as bank rates are increasing.

New Borrowing

3.12. Gilt yields and PWLB rates were on a generally rising trend throughout Q2 2022, the exception being a short rally in gilts in July/August. However, they rose exceptionally sharply towards the end of September.

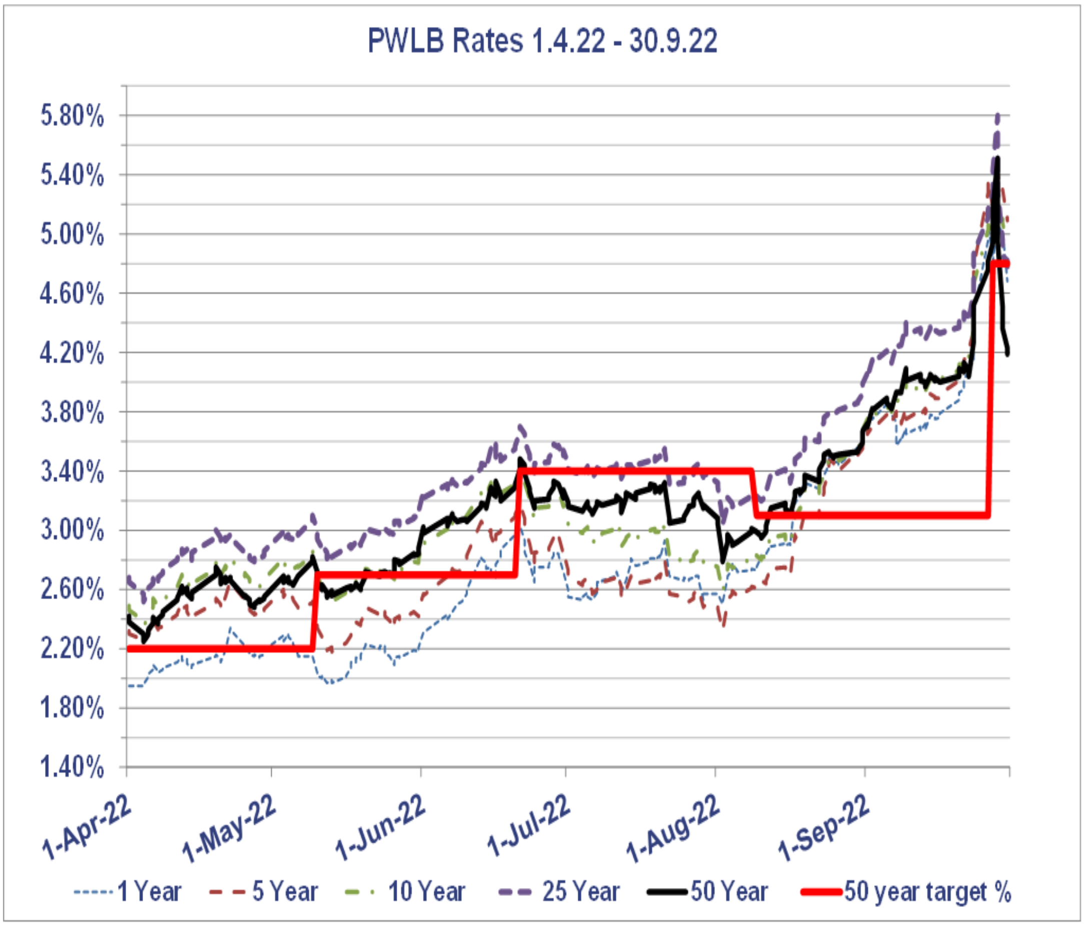
3.13. The 50-year PWLB target certainty rate for new long-term borrowing started 2022/23 at 2.20% before finishing Q2 at 4.80%, albeit we forecast rates to fall-back to 3.10% by the end of September 2025.

3.14. No new borrowing was undertaken during the quarter and none is planned during 2022-23 as a result of the Authority's adopted financial strategy to utilise revenue funds (revenue budget and reserves) to finance capital investment needs for the medium term.

PWLB rates quarter ended 30 September 2022

	1 Year	5 Year	10 Year	25 Year	50 Year
Low	1.95%	2.18%	2.36%	2.52%	2.25%
Date	01/04/2022	13/05/2022	04/04/2022	04/04/2022	04/04/2022
High	5.11%	5.44%	5.35%	5.80%	5.51%
Date	28/09/2022	28/09/2022	28/09/2022	28/09/2022	28/09/2022
Average	2.81%	2.92%	3.13%	3.44%	3.17%
Spread	3.16%	3.26%	2.99%	3.28%	3.26%

3.15. Borrowing rates for this quarter are shown overleaf.



<u>Borrowing in Advance of Need</u>

3.16. The Authority has not borrowed in advance of need during this quarter.

4. SUMMARY AND RECOMMENDATION

4.1. In compliance with the requirements of the Chartered Institute of Public Finance and Accountancy Code of Practice of Treasury Management, this report provides the Committee with the first quarter report on treasury management activities for 2022-23 to September 2022. As is indicated in this report, none of the Prudential Indicators have been breached, and a prudent approach has been taken in relation to investment decisions taken so far, with priority being given to liquidity and security over yield. Whilst investment returns are recovering as a result of the increase in interest rates, the Authority is still anticipating that investment returns will meet the budgeted target, as rates were forecast to rise when the budget was set.

SHAYNE SCOTT
Treasurer

APPENDIX A TO REPORT RC/22/16

Investments as at 30 September 2022						
Counterparty	**Maximum to be invested**	**Amount Invested**	**Maturity Date**	**Call or Term**	**Period invested**	**Interest rate(s)**
	£m	£m				
First Abu Dhabi Bank	7.000	-4.000	23/03/2023	T	6 mths	2.01%
Standard Chartered Sustainable	7.000	-4.000	06/10/2022	T	6 mths	1.45%
Standered Chartered Sustainable	7.000	-1.000	28/10/2022	T	12 mths	1.79%
Sumitomo Mitsui Banking Corporation	7.000	-5.000	21/11/2022	T	12 mths	2.02%
Standered Chartered Sustainable	7.000	-2.000	06/01/2023	T	12 mths	2.11%
National Bank of Kuwait (International) PLC	7.000	-5.000	27/01/2023	T	6 mths	2.57%
Lloyds Bank	7.000	-2.000	27/02/2023	T	6 mths	3.00%
Heleba	7.000	-3.000	27/02/2023	T	6 mths	2.93%
Lloyds Bank	7.000	-5.000	23/12/2022	T	4 mths	2.29%
Heleba	7.000	-2.000	08/09/2023	T	12 mths	4.01%
Barclays Bank	8.000	-0.150		C	Instant Access	Variable
Aberdeen Standard	8.000	-3.000		C	Instant Access	Variable
Blackrock	8.000	-2.305		C	Instant Access	Variable
Total Amount Invested		**-38.455**				