South Cambridgeshire District Council

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| **Report to:** | Audit & Corporate Governance 12 October 2023 |
| **Lead Cabinet Member:** | Councillor John Williams<br>Lead Cabinet Member for Resources |
| **Lead Officer:** | Peter Maddock, Head of Finance |

# Treasury Management – Annual Report 2022/2023

## Executive Summary

1. This report outlines the Treasury Management activities in the financial year 2022/2023 and invites the Audit and Governance Committee to note the Treasury Management performance and approve the report.

## Key Decision

2. This is not a key decision as there are no resource implications directly arising from the report at this stage.

## Recommendations

3. **That Audit and Corporate Governance Committee is requested to consider the report, to seek any clarification and, if satisfied, approve the Treasury Management Annual Report for 2022/2023.**

## Reasons for Recommendations

4. To consider a report on Treasury Management activities during the financial year 2022/2023.

## Details

Treasury Portfolio 2022/2023: Summary Position

5. The summary position as at 31 March 2023 (with comparable data for 31 March 2022) is shown below:

| | 31 March 2022 | | 31 March 2023 | |
|---|---|---|---|---|
| **Borrowing** | **£000** | **Rate %** | **£000** | **Rate %** |
| PWLB | 205,123 | 3.51 | 205,123 | 3.51 |
| LOBO - Market | Nil | | Nil | |
| Local Authority | 50,000 | 0.35 | 40,000 | 2.86 |
| Other Long-Term Liabilities | Nil | | Nil | |
| **Total Debt** | **255,123** | | **245,123** | |
| Investments | **(117,560)** | | **(138,860)** | |
| **Net Borrowing/(Investment)** | **137,563** | | **98,860** | |

Investments and the Economic Landscape

6. Investments are categorised into long and short term (i.e. less than 365 days). The sum of £26 million had less than one year to maturity as at 31 March 2023 and is, therefore, classified as short term. The remaining balance held of £107.9 million is classified as a long-term investment. The increase in Long Term Investments reflects the increased allocation to South Cambs Limited and loan to Cambourne Town Council during the year. A summary of the investments held is shown below:

| | **Balance 01/04/2022** | **New Investments** | **Maturities/ Sales** | **Interest Accrued** | **Balance 31/03/2023** |
|---|---|---|---|---|---|
| | **£000** | **£000** | **£000** | **£000** | **£000** |
| **Investment Counterparty** | | | | | |
| Short Term: | | | | | |
| Clearing Banks | Nil | 22,000 | 15,000 | 57 | 7,000 |
| Other Banks | 8,000 | 66,000 | 74,000 | 115 | Nil |
| Building Societies | 2,000 | 30,000 | 32,000 | | Nil |
| Housing Associations | 3,500 | | 3,500 | | Nil |
| Local Authorities | 2,500 | 83,000 | 66,500 | 44 | 19,000 |
| Money Market Funds | 2,155 | 295,845 | 295,635 | | 2,365 |
| Call Account | 1,885 | 44,507 | 43,797 | 5 | 2,595 |
| | | | | | |
| Long Term: | | | | | |
| Other Banks | 0 | 5000 | | | 5,000 |
| CLIC (Ice Rink Loan) | 2,400 | | | 103 | 2,400 |
| South Cambs Ltd | 94,620 | 5,380 | | 1,302 | 100,000 |
| Cambourne Town Council | 500 | | | 3 | 500 |
| **Total Investments** | **117,560** | | | | **138,860** |
| | | | | | |
| **Increase/(Decrease) in Investments** | | | | | **21,300** |

7. The economic landscape continued with a degree of uncertainty and volatility during 2022/2023, with high inflation, increasing interest rates and unstable exchange rates as recurring themes. Consumer Price Index (CPI) inflation, as a measure of price rises, increased by 10.1% in the 12 months period to March 2023 (based upon the Office for National Statistics (ONS) information). This acted as a dampener on growth during 2022/2023 and has had an impact on Council services. Whilst the prospects for economic growth and recovery are regarded as more encouraging, a cautious approach must be maintained given the level of uncertainty caused by the multi-decade high inflation, war in Europe for the first time in 75 years and necessary financial tightening by the Bank of England to control the economy.

8. In response to the prevailing economic conditions the Bank of England Base Rate increased several times during the financial year 2022/2023. The increase from 0.5% to 0.75% from 17 March 2022 was followed by further increases during the year, culminating in an increase to 4.25% effective from 23 March 2023. The base rate influences the interest rates that lenders charge for mortgages, loans and other types of credit. The Council itself lends its cash balances externally on a short-term basis,

with a view to generating a return that can be spent on delivering Council services whilst managing both security and liquidity of the cash.

9. Whilst there is marginal benefit from prevailing interest rates in terms of investment returns, local authorities have experienced unforeseen cost pressures as a result of increased energy prices, spiralling inflation, and national living wage pressures. The cost-of-living crisis has created a perfect storm of increased public demand for services, coupled with rising fuel and other bills for Councils. Without funding to offset this crisis, Councils could have to scale back construction projects or make in-year reductions to services. This has prompted Councils to make recalculations and to look at further cuts as they battle budgetary pressures, exacerbated by rising costs.

10. Investment returns remained relatively low but improved during 2022/2023 as a consequence of increasing investment rates. Traditionally investment returns have been measured against the London Interbank Bid Rate (LIBID) for short-term lending but, following the discontinuation of published 7 Day LIBID rates from 2022/2023 onwards, the Council is now benchmarking its investment rates to the average 7 Day SONIA (Sterling Overnight Index Average) rate as an alternative. This is being used as the comparative benchmark as SONIA can be seen as the average interest rate at which a selection of financial institutions lend to one another with a maturity of 1 day (overnight), therefore, reflecting the callable nature of the majority of the Council's short-term investments. Average 7 Day Sonia increased from 0.69% as at 1 April 2022, to 4.18% as at 31 March 2023 with consequent investment benefits. The Council's actual return of 4.21% in 2022/2023 shows the effect of the portfolio's long-term duration set out in the table above.

11. In respect of investments generally, the overall structure of interest rates has for some time meant that short term rates have generally remained lower than long term interest rates. In this scenario, the strategy has continued to be to reduce investments and borrow for short periods and possibly at variable rates when required. However, this needs careful review to avoid incurring higher borrowing costs in the future when the authority may not be able to avoid new borrowing to finance capital expenditure and/or refinance maturing debt.

12. The Council's primary objective in relation to its investments is to ensure that long term capital is not put at risk but that, within acceptable risk parameters, the portfolio is managed to ensure that interest is maximised. Liquidity is managed through the use of money market funds with additional access to the liquid PWLB and Local Authority borrowing market. This objective is reinforced in the Treasury Management Strategy approved by Council on 21 February 2023. The Council has also appointed a Treasury Management Advisor, Link Asset Services, to enable independent specialist advice to be obtained on all aspects of the treasury management function, including advice on investments.

13. The Council holds £40 million of Short-term borrowing from other Local Authorities. This funded the acquisitions of Commercial Properties and partly funded the loan to the South Cambs Investment Partnership.

14. The table below lists the £31 million held in fixed term investments as at 31 March 2023. These investments are deposits with a number of Local Authority and Banks to maintain diversification:

| | Amount £000 | Interest £000 | Total £000 | Term Days | Rate % | Maturity Date |
|---|---|---|---|---|---|---|
| **Counterparty** | | | | | | |
| Leeds City Council | 3,000 | 20 | 3,020 | 60 | 4.00 | 03 April 23 |
| West Yorkshire CA | 1,000 | 1 | 1,001 | 11 | 4.70 | 11 April 23 |
| Santander | 5,000 | 47 | 5,047 | 91 | 3.80 | 13 April 23 |
| Santander | 2,000 | 26 | 2,026 | 119 | 3.99 | 18 May 23 |
| Central Beds Council | 3,000 | 22 | 3,022 | 59 | 4.48 | 22 May 23 |
| Moray Council | 5,000 | 112 | 5,112 | 176 | 4.65 | 7 Sept 23 |
| Eastleigh Borough Council | 2,000 | 46 | 2,046 | 184 | 4.60 | 28 Sept 23 |
| Eastleigh Borough Council | 3,000 | 72 | 2,072 | 191 | 4.60 | 5 Oct 23 |
| Folkestone & Hythe DC | 2,000 | 71 | 2,071 | 290 | 4.45 | 14 Dec 23 |
| Close Brothers Ltd | 5,000 | 320 | 5,320 | 731 | 3.20 | 12 July 24 |
| | | | | | | |
| | | | | | | |
| | | | | | | |
| | | | | | | |
| **Total** | 31,000 | 738 | 31,738 | | | |

15. The remaining £7.9 million of short-term investment balances were held in Money Market Funds and the Council's Call account for liquidity purposes.

16. Security of capital remained the Council's main investment objective. This was maintained by following the Council's counterparty policy, as set out in its Treasury Management Strategy Statement for 2022/2023, which defined "high credit quality" organisations as those having a long-term credit rating of A- or higher that are domiciled in the UK or a foreign country with a sovereign rating of AA+ or higher.

17. All new investments are undertaken in accordance with advice from the Council's Treasury Management Adviser. A list of investment counterparties used during 2022/2023 is listed in **Appendix A**.

Borrowing

18. At 31 March 2023 the Council had external borrowing of £245.123 million:

| | Balance 01/04/2022 £000 | Maturing Debt £000 | Reclassified Debt £000 | New Debt £000 | Balance 31/03/2023 £000 |
|---|---|---|---|---|---|
| **Borrowing** | | | | | |
| Short Term Borrowing | 50,000 | 50,000 | | 40,000 | 40,000 |
| Long Term Borrowing | 205,123 | | | | 205,123 |
| **Total Borrowing** | **255,123** | | | | **245,123** |
| Other Long-Term Liabilities | - | | | | - |
| **Total External Debt** | **255,123** | | | | **245,123** |

19. £205,123 million of the total relates to borrowing from the PWLB. The PWLB loans were obtained for Housing Revenue Account (HRA) purposes as part of the HRA

Self-Financing in 2012. These loans are fixed interest maturity loans having an average term to maturity of approximately 25 years and bearing interest at an average rate of 3.51%.

Cash Management

20. In keeping with the DLUHC's Guidance on Investments, the Council maintained a sufficient level of liquidity averaging £11.6 million through the use of Money Market Funds, Notice accounts and Call accounts.

21. Internal Treasury Management includes the management of the Council's bank account balances. The aim is for all cleared funds to be deposited in interest bearing accounts or time deposits.

Outturn Budget Monitoring

22. Council, at its meeting on 22 February 2022, approved a net budget in 2022/2023 for interest payable of £0.359 million and investment income of £5.456 million. Whilst there was a lower than forecast borrowing requirement, interest rate increases particularly in the second half of the year contributed to an increase in interest payable. Capital expenditure in 2022/2023 was lower than expected and Minimum Revenue Provision (MRP) cost remained as expected as the figure is based on the opening position and not affected by in year activity. MRP is not applied to lending to South Cambs Ltd.

23. The budget is compared to the final outturn position in the table below:

| | **Budget 2022/2023** | **Provisional Outturn 2022/2023** | **Variance** |
|---|---|---|---|
| | **£000** | **£000** | **£000** |
| **Expenditure Description** | | | |
| Interest Payable - PWLB & Short-Term Loans | 359 | 591 | 232 |
| Contribution to/(from) Reserves (*Est) | (2,849) | 828 | 3,677 |
| Minimum Revenue Provision | 1,090 | 1,090 | 0 |
| Interest Receivable | (3,648) | (5,078) | (1,430) |
| **Net Expenditure** | **(5,048)** | **(2,569)** | **2,479** |

24. The significant variances against budget were the Contribution to Reserves and Interest receivable. The Reserves are estimated to increase by £0.828 million rather than the reduction forecast. This change to contribution is related to the slippage on the Greening of South Cambs Hall project and associated reduction in the contribution from the Renewable Reserve. These changes also led to lower amounts of interest being payable as borrowing balances were smaller.

Benchmarking

25. Benchmarking data is also provided by the Council's Treasury Management Adviser. Investment return rates for the year to 31 March 2023 (excluding lending to South Cambs Ltd) are reported on a quarterly basis and were better than the client average and can be compared as follows:

| | Investment Returns | |
|---|---|---|
| Quarter Ending | SCDC | Client Average |
| 30 June 2022 | 1.33% | 0.92% |
| 30 September 2022 | 2.01% | 1.70% |
| 31 December 2022 | 3.36% | 2.86% |
| 31 March 2023 | 4.10% | 3.60% |

26. Benchmarking data on average weighted credit scores of the Council's counterparties (based in information held by the Council's Treasury Management Adviser) is set out in the table below and illustrates the credit risk position in relation to other Councils:

| | Weighted Average Credit Risk | |
|---|---|---|
| Quarter Ending | SCDC | Comparators |
| 31 March 2022 | 4.35 | 2.95 |
| 30 June 2022 | 4.98 | 3.21 |
| 30 September 2022 | 4.30 | 3.09 |
| 31 December 2022 | 3.84 | 2.98 |
| 31 March 2023 | 2.70 | 2.97 |

27. The benchmarking shows that the Credit Risk on the Council's portfolio has reduced during the year although it often has a higher than average Credit Risk compared to other District Authorities. The Council has maintained investment returns significantly above the client average.

Treasury Management Strategy for 2022/2023

(a) Interest Rates and Investments

28. The Treasury Management Strategy for 2022/2023 was prepared in the context of low, but increasing interest rates, with the Bank of England Base Rate responding to economic conditions by initially increasing the rate from 0.5% to 0.75% from 17 March 2022, followed by several further increases during the year, to its current level of 4.25% effective from 23 March 2023. This intervention in the financial markets has continued to affect investment returns from the Council's holdings.

29. The Council continued its policy of minimising risk by investing in Fixed Deposits only with highly rated Banks and Building Societies, Local Authority Counterparties and Registered Providers and using Money Market Funds and Bank Call Accounts to manage liquidity. This policy coupled with using pooled fund investments (suitably diversified) to maximise interest return on an element of the Council's portfolio has enabled the Council to reduce the cost of Capital Financing.

(b) Borrowing

30. The 2022/2023 borrowing strategy was based upon obtaining new loans of £30 million to fund the capital programme, in addition to £50 million of existing short term borrowing. Capital expenditure saw significant change related to the Investment

Strategy and was significantly lower than planned due to changes in PWLB lending rules. This change and careful management of cash flows and short-term borrowing enabled the Council to fund the capital programme without entering into long term borrowing. The Council had £40 million in Local Authority Loans outstanding as at 31 March 2023 with no further borrowing being required for the Capital Programme and £10 million of short term borrowing being repaid during the year.

31. During 2022/2023 there was a requirement for short term external borrowing of £40 million and this has been used to fund past capital expenditure. This is inclusive of additional loans to the value of £5.38 million made to South Cambs Limited. These loans are recognised as capital expenditure in the year increasing the Council's underlying need to borrow (the Capital Financing Requirement).

| | Actual 2021/2022 £'000 | Budget 2022/2023 £'000 | Actual 2022/2023 £'000 |
|---|---|---|---|
| **Capital Financing Requirement (CFR) as at 1st April** | | | |
| - General Fund | 127,130 | 126,017 | 126,017 |
| - HRA | 204,429 | 204,429 | 204,429 |
| **Total** | **331,559** | **330,446** | **330,446** |
| **Change in the CFR** | 28,220 | 5,500 | 0 |
| **Minimum Revenue Provision** | (1,113) | (1,090) | (1,090) |
| **Capital Financing Requirement (CFR) as at 31 March** | **330,446** | **334,856** | **329,356** |

Economy

32. The Council's Treasury Management Advisers have provided a summary of the economy during 2022/2023, and related performance, and this is included at **Appendix B**.

Compliance with Performance Indicators

33. During the financial year the Council operated within the treasury limits and prudential indicators approved by Full Council on 22 February 2022.

34. Performance against prudential indicators in 2022/2023 was as follows:

**(1) Acceptance of the CIPFA Treasury Management Code of Practice (National Indicator)**

This indicator demonstrates that the Council adopted the principles of best practice. The Council adopted the Chartered Institute of Public Finance and Accountancy's *Treasury Management in the Public Services: Code of Practice 2011 Edition* in January 2012. The Council adopted the CIPFA Treasury Management Code & Guidance Notes as part of its Treasury Management Policy and Strategy which was considered and approved at its meeting on 22 February 2022.

### (2) Fixed Interest Rate Exposure and Variable Interest Rate Exposure

This indicator is set to control the Council's exposure to interest rate risk. The upper limits on fixed and variable interest rate exposures is expressed as the proportion of net principal borrowed.

| Maturity structure of borrowing | Under 12 months | More than 12 months | Under 12 months - Actual | More than 12 months - Actual |
|---|---|---|---|---|
| Upper limit for fixed interest rate exposure | 100% | 100% | 100% | 100% |
| Upper limit for variable rate exposure | 100% | 0% | 0% | 0% |

### (3) Maturity Structure of Fixed Rate Borrowing

35. This indicator is to limit large concentrations of fixed rate debt needing to be replaced at times of uncertainty over interest rates.

| Fixed Rate Borrowing | | |
|---|---|---|
| Lender | Repayable within | Amount £,000 |
| Local Authorities | <12 Months | 40,000 |
| PWLB | 10 – 15 years | 25,000 |
| PWLB | 15 – 20 years | 50,000 |
| PWLB | 20 – 25 years | 50,000 |
| PWLB | 25 – 30 years | 50,000 |
| PWLB | 30 – 35 years | 30,123 |

The 2011 revision to the CIPFA Treasury Management Code now requires the prudential indicator relating to Maturity of Fixed Rate Borrowing to reference the maturity of LOBO loans to the earliest date on which the lender can require payment.

### (4) Upper Limit for Total Principal Sums Invested Over 364 Days

The purpose of this limit is to contain exposure to the possibility of loss that may arise as a result of the Council having to seek early repayment of the sums invested.

The only loans exceeding 364 days are loans made to South Cambs Ltd, a wholly owned subsidiary of the Council, and Cambridge Ice and Leisure Centre (CLIC). Lending to CLIC formed 2% of the investment portfolio as at 31 March 2023.

The limit relates to the maximum amount that can be invested in year. With regard to liquidity, no more than 50% of the total average portfolio held will be invested in instruments over 364 days, excluding South Cambs Ltd.

### (5) Credit Risk

The Council considers security, liquidity, and yield, in that order, when making investment decisions. Credit ratings remain an important element of assessing credit risk, but they are not a sole feature in the assessment of counterparty credit risk.

The Council also considers alternative assessments of credit strength and information on corporate developments and market sentiment towards counterparties. The following key tools are used, either by the Council or the appointed Treasury Advisers to assess credit risk:

- Published credit ratings of the financial institution (minimum A- or equivalent) and its sovereign (minimum AA+ or equivalent for non-UK sovereigns).
- Sovereign support mechanisms.
- Credit default swaps (where quoted).
- Share prices (where available).
- Economic fundamentals (such as a country's net debt as a percentage of its GDP).
- Corporate developments, news, articles, markets sentiment and momentum.

The only indicators with prescriptive values are credit ratings. Other indicators of creditworthiness are considered in relative rather than absolute terms.

**(6) Liquidity Risk**

The Council has adopted a voluntary measure of its exposure to liquidity risk by monitoring the amount of cash available to meet unexpected payments within a rolling three-month period, without additional borrowing.

## Implications

36. In the writing of this report, taking into account the financial, legal, staffing, risk management, equality and diversity, climate change, community safety and any other key issues, the following implications have been considered:

**Legal**

37. The Council is required to have regard to the CIPFA Code of Practice for Treasury Management in the Public Services. The Code recommends that an annual post year report on Treasury Management activities is prepared for consideration after each year end.

**Policy**

38. Full Council, at its meeting on 22 February 2022, approved the Council's Treasury Management Policy and Strategy Statements for 2022/2023 and the Strategy was reaffirmed by Audit and Governance Committee, at its meeting on 1 December 2022, following a mid-year review.

**Finance**

39. In 2022/2023 the Council managed a turnover in investments of £565 million (£419 million in 2021/2022) in-house within the Finance Team in the Finance Directorate. As at 31 March 2023, the Council had funds to the market value of £139 million (£117.6 million at 31 March 2022), all managed in-house. These funds include capital balances, reserves, and provisions, collection fund monies and monies held on behalf of third parties. The increase was due primarily to retained business rates.

40. At 31 March 2023 the Council had external borrowing of £245.123 million plus £Nil million of leasing liabilities.

**Risk/Opportunities**

41. There are clearly inherent risks in placing investments both in terms of the security of the capital invested and the level of return from the investment. The approved Treasury Management Strategy 2022/2023 identified the Councils investment priorities as:

    (i) The security of the capital;
    (ii) The liquidity of its investments.

42. Compliance with the Treasury Management Strategy and associated Treasury Management Practices seeks to mitigate the risks inherent with the treasury management function. The consideration of Security, Liquidity and Yield, in that order, is critical when assessing potential treasury investments.

43. The Treasury Management Strategy states that the Authority'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 low investment income.

44. The Council engages an external Treasury Management Adviser to provide appropriate and timely advice on the Council's treasury portfolio (and, in particular, to provide advice on counter-party creditworthiness and investment limits). This appointment is regarded as critical given the investment risks.

**Climate Change**

45. There are no direct environmental implications arising from the report.

**Consultation Responses**

46. Consultations have been undertaken with the Lead Cabinet Member for Resources and the Council's treasury management adviser.

**Alignment with Council Priority Areas**

47. Timely and robust consideration of the Council's treasury management activities is vital to ensure that financial performance is in line with expectations.

## Background Papers

Where the Local Authorities (Executive Arrangements) (Meetings and Access to Information) (England) Regulations 2012 require documents to be open to inspection by members of the public, they must be available for inspection:

(a) at all reasonable hours at the offices of South Cambridgeshire District Council;

(b) on the Council's website; and

(c) in the case of documents to be available for inspection pursuant to regulation 15, on payment of a reasonable fee required by the Council by the person seeking to inspect the documents at the offices of South Cambridgeshire District Council.

The following documents are relevant to this report:

- Budget Setting Report – Report to Council: 22 February 2022
- Capital Strategy – Report to Council: 22 February 2022
- Treasury Management Strategy – Report to Council: 22 February 2022
- Mid-Year 2021/2022 Treasury Management Report – Report to Audit & Corporate Governance Committee: 1 December 2022
- Treasury Management Strategy – Report to Council: 21 February 2023

## Appendices

A Investment Counterparties 2022/2023

B Treasury Management Adviser – Economic Review 2022/2023

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**Appendix A**

# Investment Counterparties 2022/2023

The Council's investment counterparties used during 2022/2023 are listed below:

| Category | Counterparty |
|---|---|
| Building Society | Coventry BS |
| Building Society | Nationwide BS |
| Building Society | Yorkshire BS |
| Clearing Bank | Barclays Bank |
| Clearing Bank | Santander UK |
| Other Bank | Close Brothers |
| Other Bank | Goldman Sachs International Bank |
| Other Bank | Lloyds Bank Commercial Markets |
| Other Bank | Standard Chartered |
| Other Bank | SMBC Bank International PLC |
| Housing Association | Places for People |
| Local Authority | Ashford BC |
| Local Authority | Calderdale MBC |
| Local Authority | Babergh DC |
| Local Authority | Cornwall Council |
| Local Authority | Central Bedfordshire Council |
| Local Authority | Eastleigh BC |
| Local Authority | Folkestone & Hythe DC |
| Local Authority | Hertfordshire CC |
| Local Authority | Knowsley MBC |
| Local Authority | Leeds City Council |
| Local Authority | Moray Council |
| Local Authority | Merthyr Tydfil CBC |
| Local Authority | Surrey CC |
| Local Authority | Trafford Council |
| Local Authority | Wakefield Council |
| Local Authority | West Yorkshire CA |
| Local Authority | Wirral BC |
| Police Authority | West Mercia Police |
| Police Authority | West Yorkshire Police |
| Money Market Fund | Aberdeen Standard Life |
| Money Market Fund | Deutsche Bank |
| Money Market Fund | Aviva |
| Money Market Fund | Federated |
| Call account | Barclays Bank plc |
| South Cambs Ltd | Ermine Street Housing |
| Other investments/Loans | Cambourne Town Council |

**Appendix B**

# Treasury Management Adviser – Economic Review 2022/2023

**UK. Economy.**

Against a backdrop of stubborn inflationary pressures, the easing of Covid restrictions in most developed economies, the Russian invasion of Ukraine, and a range of different UK Government policies, it is no surprise that UK interest rates have been volatile right across the curve, from Bank Rate through to 50-year gilt yields, for all of 2022/23.

Market commentators' misplaced optimism around inflation has been the root cause of the rout in the bond markets with, for example, UK, EZ and US 10-year yields all rising by over 200bps in 2022. The table below provides a snapshot of the conundrum facing central banks: inflation is elevated but labour markets are extra-ordinarily tight, making it an issue of fine judgment as to how far monetary policy needs to tighten.

| | UK | Eurozone | US |
|---|---|---|---|
| **Bank Rate** | 4.25% | 3% | 4.75%-5% |
| **GDP** | 0.1%q/q Q4 (4.1%y/y) | +0.1%q/q Q4 (1.9%y/y) | 2.6% Q4 Annualised |
| **Inflation** | 10.4%y/y (Feb) | 6.9%y/y (Mar) | 6.0%y/y (Feb) |
| **Unemployment Rate** | 3.7% (Jan) | 6.6% (Feb) | 3.6% (Feb) |

Q2 of 2022 saw UK GDP deliver growth of +0.1% q/q, but this was quickly reversed in the third quarter, albeit some of the fall in GDP can be placed at the foot of the extra Bank Holiday in the wake of the Queen's passing. Q4 GDP was positive at 0.1% q/q. Most recently, January saw a 0.3% m/m increase in GDP as the number of strikes reduced compared to December. In addition, the resilience in activity at the end of 2022 was, in part, due to a 1.3% q/q rise in real household disposable incomes. A big part of that reflected the £5.7bn payments received by households from the government under the Energy Bills Support Scheme.

Nevertheless, CPI inflation picked up to what should be a peak reading of 11.1% in October, although hopes for significant falls from this level will very much rest on the movements in the gas and electricity markets, as well as the supply-side factors impacting food prices. On balance, most commentators expect the CPI measure of inflation to drop back towards 4% by the end of 2023. As of February 2023, CPI was 10.4%.

The UK unemployment rate fell through 2022 to a 48-year low of 3.6%, and this despite a net migration increase of c500k. The fact remains, however, that with many economic participants registered as long-term sick, the UK labour force shrunk by c500k in the year to June. Without an increase in the labour force participation rate, it is hard to see how the UK economy will be able to grow its way to prosperity, and with average wage increases running at over 6% the MPC will be concerned that wage inflation will prove just as sticky as major supply-side shocks to food (up 18.3% y/y in February 2023) and energy that have endured since Russia's invasion of Ukraine on 22 February 2022.

Bank Rate increased steadily throughout 2022/23, starting at 0.75% and finishing at 4.25%.

In the interim, following a Conservative Party leadership contest, Liz Truss became Prime Minister for a tumultuous seven weeks that ran through September and October. Put simply, the markets did not like the unfunded tax-cutting and heavy spending policies put forward by her Chancellor, Kwasi Kwarteng, and their reign lasted barely seven weeks before being replaced by Prime Minister Rishi Sunak and Chancellor Jeremy Hunt. Their Autumn Statement of the 17th of November gave rise to a net £55bn fiscal tightening, although much of the "heavy lifting" has been left for the next Parliament to deliver. However, the markets liked what they heard, and UK gilt yields have reversed the increases seen under the previous tenants of No10/11 Downing Street, although they remain elevated in line with developed economies generally.

As noted above, GDP has been tepid throughout 2022/23, although the most recent composite Purchasing Manager Indices for the UK, US, EZ and China have all surprised to the upside, registering survey scores just above 50 (below suggests economies are contracting, and above suggests expansion). Whether that means a shallow recession, or worse, will be avoided is still unclear. Ultimately, the MPC will want to see material evidence of a reduction in inflationary pressures and a loosening in labour markets. Realistically, that is an unlikely outcome without unemployment rising and wage settlements falling from their current levels. At present, the bigger rise in employment kept the ILO unemployment rate unchanged at 3.7% in January. Also, while the number of job vacancies fell for the ninth consecutive month in February, they remained around 40% above pre-pandemic levels.

Our economic analysts, Capital Economics, expect real GDP to contract by around 0.2% q/q in Q1 and forecast a recession this year involving a 1.0% peak-to-trough fall in real GDP.

The £ has remained resilient of late, recovering from a record low of $1.035, on the Monday following the Truss government's "fiscal event", to $1.23. Notwithstanding the £'s better run of late, 2023 is likely to see a housing correction of some magnitude as fixed-rate mortgages have moved above 4.5% and affordability has been squeezed despite proposed Stamp Duty cuts remaining in place.

As for equity markets, the FTSE 100 started 2023 strongly, rising to a record high of 8,014 on 20th February, as resilient data and falling inflation boosted earnings. But global equities fell sharply after concerns over the health of the global banking system emerged early in March. The fall in the FTSE 100 was bigger than the drop in the US S&P 500. Indeed, at around 7,600 now, the FTSE is 5.2% below its record high on 20th February, while the S&P 500 is only 1.9% lower over the same period. That's despite UK banks having been less exposed and equity prices in the UK's financial sector not falling as far. It may be due to the smaller decline in UK interest rate expectations and bond yields, which raise the discounted value of future earnings, compared to the US.

**USA.** The flurry of comments from Fed officials over recent months suggest there is still an underlying hawkish theme to their outlook for interest rates. Markets are pricing in a further interest rate increases of 25-50bps, on top of the current interest rate range of 4.75% - 5%.

In addition, the Fed is expected to continue to run down its balance sheet once the on-going concerns about some elements of niche banking provision are in the rear-view mirror.

As for inflation, it is currently at c6% but with the economy expected to weaken during 2023, and wage data already falling back, there is the prospect that should the economy slide into a recession of any kind there will be scope for rates to be cut at the backend of 2023 or shortly after.

**EU.** Although the Euro-zone inflation rate has fallen below 7%, the ECB will still be mindful that it has further work to do to dampen inflation expectations and it seems destined to raise rates to 4% in order to do so. Like the UK, growth has remained more robust than anticipated but a recession in 2023 is still seen as likely by most commentators.