External Factors Impacting on Treasury during 2022/23

A summary of the external factors in 2022-23 is provided by the council's treasury advisor, Arlingclose Ltd, and is detailed below.

Economic background: The war in Ukraine continued to keep global inflation above central bank targets and the UK economic outlook remained relatively weak with the chance of a mild recession. The economic backdrop during the January to March period continued to be characterised by high energy and commodity prices, high inflation, and the associated impact on household budgets and spending.

Central Bank rhetoric and actions remained consistent with combatting inflation. The Bank of England, US Federal Reserve, and European Central Bank all increased interest rates over the period, even in the face of potential economic slowdowns in those regions.

Starting the financial year at 5.5%, the annual CPI measure of UK inflation rose strongly to hit 10.1% in July and then 11.1% in October. Inflation remained high in subsequent months but appeared to be past the peak, before unexpectedly rising again in February. Annual headline CPI registered 10.4% in February, up from 10.1% in January, with the largest upward contributions coming from food and housing. RPI followed a similar pattern during the year, hitting 14.2% in October. In February RPI measured 13.8%, up from 13.4% in the previous month.

Following the decision by the UK government under Rishi Sunak and Jeremy Hunt to reverse some of the support to household energy bills announced under Liz Truss, further support in the form of a cap on what energy suppliers could charge household was announced in the March Budget to run from April until end June 2023. Before the announcement, typical household bills had been due to rise to £3,000 a year from April.

The labour market remained tight albeit with some ongoing evidence of potential loosening at the end of the period. The unemployment rate 3mth/year eased from 3.8% April-June to 3.6% in the following quarter, before picking up again to 3.7% between October-December. The most recent information for the period December-February showed an unemployment rate of 3.7%.

The inactivity rate was 21.3% in the December-February quarter, slightly down from the 21.4% in the first quarter of the financial year. Nominal earnings were robust throughout the year, with earnings growth in December-February at as 5.7% for both total pay (including bonuses) and 6.5% for regular pay. Once adjusted for inflation, however, both measures were negative for that period and have been so throughout most of the year.

Despite household budgets remaining under pressure, consumer confidence rose to -36 in March, following readings of -38 and -45 in the previous two months, and much improved compared to the record-low of -49 in September. Quarterly GDP was soft through the year, registering a 0.1% gain in the April-June period, before contracting by (an upwardly revised) -0.1% in the subsequent quarter. For the October-December period was revised upwards to 0.1% (from 0.0%), illustrating a resilient but weak economic picture. The annual growth rate in Q4 was 0.6%.

The Bank of England increased the official Bank Rate to 4.25% during the financial year. From 0.75% in March 2022, the Monetary Policy Committee (MPC) pushed through rises at every subsequent meeting over the period, with recent hikes of 50bps in December and February and then 25bps in March, taking Bank Rate to 4.25%. March's rise was voted by a majority of 7-2, with two MPC members preferring to maintain Bank Rate at 4.0%. The Committee noted that inflationary pressures remain elevated with growth stronger than was expected in the February Monetary Policy Report. The February vote was also 7-2 in favour of a hike, and again with two members preferring to keep Bank Rate on hold.

After reaching 9.1% in June, annual US inflation slowed for eight consecutive months to 6% in February. The Federal Reserve continued raising interest rates over the period with consecutive increases at each Federal Open Market Committee meetings, taking policy rates to a range of 4.75%- 5.00% at the March meeting.

From the record-high of 10.6% in October, Eurozone CPI inflation fell steadily to 6.9% in March 2023. Energy prices fell, but upward pressure came from food, alcohol, and tobacco. The European Central Bank continued increasing interest rates over the period, pushing rates up by 0.50% in March, taking the deposit facility rate to 3.0% and the main refinancing rate to 3.5%.

Financial markets: Uncertainty continued to be a key driver of financial market sentiment and bond yields remained relatively volatile due to concerns over elevated inflation and higher interest rates, as well as the likelihood of the UK entering a recession and for how long the Bank of England would continue to tighten monetary policy. Towards the end of the period, fears around the health of the banking system following the collapse of Silicon Valley Bank in the US and purchase of Credit Suisse by UBS caused further volatility.

Over the period the 5-year UK benchmark gilt yield rose from 1.41% to peak at 4.70% in September before ending the financial year at 3.36%. Over the same timeframe the 10-year gilt yield rose from 1.61% to peak at 4.51% before falling back to 3.49%, while the 20-year yield rose from 1.82% to 4.96% and then declined to 3.82%. The Sterling Overnight Rate (SONIA) averaged 2.24% over the period.

Credit review: Early in the period, Moody’s affirmed the long-term rating of Guildford BC but revised the outlook to negative. The agency also downgraded Warrington BC and Transport for London.

In July Fitch revised the outlook on Standard Chartered and Bank of Nova Scotia from negative to stable and in the same month Moody’s revised the outlook on Bayerische Landesbank to positive. In September S&P revised the outlook on the Greater London Authority to stable from negative and Fitch revised the outlook on HSBC to stable from negative.

The following month Fitch revised the outlook on the UK sovereign to negative from stable. Moody’s made the same revision to the UK sovereign, following swiftly after with a similar move for a number of local authorities and UK banks including Barclays Bank, National Westminster Bank (and related entities) and Santander.

During the last few months of the reporting period there were only a handful of credit changes by the rating agencies, then in March the collapse of Silicon Valley Bank (SVB) in the US quickly spilled over into worries of a wider banking crisis as Credit Suisse encountered further problems and was bought by UBS.

Credit Default Prices had been rising since the start of the period on the back of the invasion of Ukraine, and in the UK rose further in September/October at the time of the then-government’s mini budget. After this, CDS prices had been falling, but the fallout from SVB caused a spike on the back of the heightened uncertainty. However, they had moderated somewhat by the end of the period as fears of contagion subsided, but many are still above their pre-March levels reflecting that some uncertainty remains.

On the back of this, Arlingclose reduced its recommended maximum duration limit for unsecured deposits for all UK and Non-UK banks/institutions on its counterparty list to 35 days as a precautionary measure. No changes were made to the names on the list.

As market volatility is expected to remain a feature, at least in the near term and, as ever, the institutions and durations on the Authority's counterparty list recommended by Arlingclose remains under constant review.

Local authorities remain under financial pressure, but Arlingclose continues to take a positive view of the sector, considering its credit strength to be high. Section 114 notices have been issued by only a handful of authorities with specific issues. While Arlingclose's advice for local authorities on its counterparty list remains unchanged, a degree caution is merited with certain authorities.

Forecast interest Rates (May 2023)

The following forecast interest forecast are set against a background of:

- Stubborn inflation and tight labour markets have refocused attention on inflation, even as the economic risks increase. The Federal Reserve raised its policy rate to 5.25% despite the rising risk of a US recession. Similarly, as Germany teeters on the edge of recession, the ECB raised its main policy rate to 3.75% and signalled further rises ahead.

- In the UK, with upward revisions to growth and persistent inflation, sticky amid continued solid wage growth, investors are betting on further Bank Rate hikes beyond 4.5%.

- The UK economy has surprised with its strength in the first half of 2023. Government support for the cost of living, stronger wage growth and household savings have partly offset the dual headwinds of high inflation and interest rates. Households will also benefit from a likely decline in retail energy bills in H2 2023.

- However, the lagged effect of aggressive monetary tightening will increasingly pressure economic activity. Household spending will be affected by increases in mortgage payments, while business investment/spending will fall back due to higher borrowing costs. Diminished spending will inevitably increase unemployment.

- The labour market remains tight. Recent signs suggest some loosening, although wage growth has remained solid. As unemployment rises, market imbalances and thus wage growth should ease, but recent data indicates this may take some time.

- Inflation will fall sharply from April, as changes in base effects become the driver of the headline rate. Food price inflation should also decelerate soon. However, the MPC will increasingly target core inflation and wage growth, being especially wary about declining inflation rates creating strong real wage growth, thus supporting on-going consumer-led inflation. Rates will therefore remain higher for longer.

- Global bond yields remain volatile. Resilience in some economic data has supported central bank hawkishness, but also increased the chance of over-tightening. The Federal Reserve and other central banks see persistently higher policy rates through 2023 as key to dampening domestic inflationary pressure.

- However, it is difficult to perceive non-negative growth outcomes from synchronised monetary tightening and slower, perhaps negative, money growth across developed economies. This suggests more significant reductions in policy rates in the future.

	Current	Jun-23	Sep-23	Dec-23	Mar-24	Jun-24	Sep-24	Dec-24	Mar-25	Jun-25	Sep-25	Dec-25	Mar-26
Official Bank Rate													
Upside risk	0.00	0.50	0.50	0.50	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75
Central Case	4.50	4.75	4.75	4.75	4.25	3.75	3.50	3.25	3.00	3.00	3.00	3.00	3.00
Downside risk	0.00	0.25	0.50	0.50	0.50	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
3-month money market rate													
Upside risk	0.00	0.50	0.50	0.50	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75
Central Case	4.70	4.80	4.80	4.75	4.25	3.70	3.50	3.20	3.10	3.10	3.10	3.10	3.10
Downside risk	0.00	0.25	0.50	0.50	0.50	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
5yr gilt yield													
Upside risk	0.00	0.70	0.80	0.90	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Central Case	3.55	3.80	3.60	3.50	3.50	3.50	3.50	3.50	3.50	3.50	3.50	3.50	3.50
Downside risk	0.00	0.70	0.90	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
10yr gilt yield													
Upside risk	0.00	0.70	0.80	0.90	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Central Case	3.73	4.00	3.75	3.60	3.60	3.60	3.60	3.60	3.60	3.60	3.60	3.60	3.60
Downside risk	0.00	0.70	0.90	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
20yr gilt yield													
Upside risk	0.00	0.70	0.80	0.90	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Central Case	4.12	4.00	4.00	4.00	4.00	4.00	4.00	4.00	4.00	4.00	4.00	4.00	4.00
Downside risk	0.00	0.70	0.90	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
50yr gilt yield													
Upside risk	0.00	0.70	0.80	0.90	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Central Case	3.78	3.70	3.70	3.70	3.70	3.70	3.70	3.70	3.70	3.70	3.70	3.70	3.70
Downside risk	0.00	0.70	0.90	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00

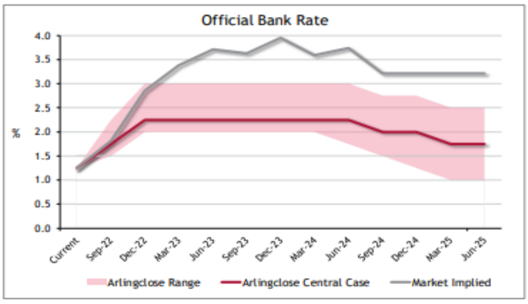
PWLB Standard Rate (Maturity Loans) = Gilt yield + 1.00%; PWLB Certainty Rate (Maturity Loans) = Gilt yield + 0.80%
PWLB HRA Rate (Maturity Loans) = Gilt yield + 0.40% (from June 2023); UKIB Rate (Maturity Loans) = Gilt yield + 0.60%

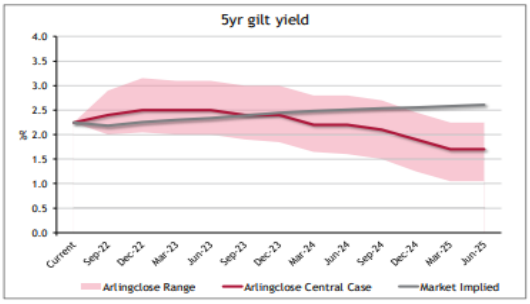
- **The MPC raised Bank Rate by 25bps to 4.5% in May. Due to the current policy of reacting to lagging data, we believe it is more likely than not that Bank Rate rises to 4.75% in June, although we consider further hikes to be unnecessary.**
- **The MPC will cut rates in the medium term to stimulate a stuttering UK economy but will be reluctant to do so until services inflation and wage growth ease. We see rate cuts from the first quarter of 2024 to a low of around 3% by 2025, although the timing and extent of rate cuts remains highly uncertain.**
- **Arlingclose expects gilt yields to fall from current levels reflecting a lower medium term path for Bank Rate. However, yields will remain relatively higher than in the past, with continued elevated volatility.**
- **Gilt yields face pressures to both sides. While there are fears of a global decline in economic activity and an expectation of falling inflation rates, these downward effects on gilt yields will be partly offset by hawkish-leaning central bankers, BoE bond sales, and high government borrowing.**

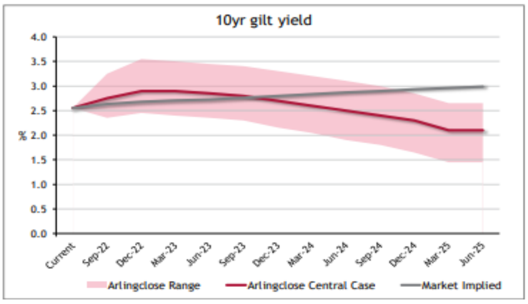
Arlingclose and Market Projections June 2022

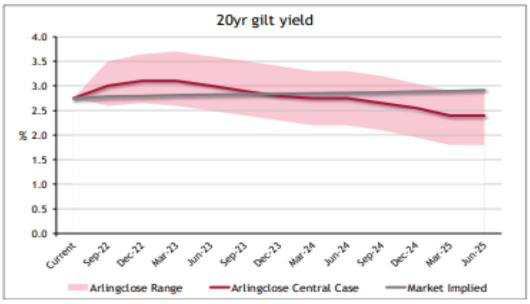
Charts show the Arlingclose central case along with upside and downside risks: Arlingclose judges that the risks around its forecasts are initially to the upside before becoming more balanced over time.

PWLB Standard Rate (Maturity Loans) = Gilt yield + 1.00
PWLB Certainty Rate (Maturity Loans) = Gilt yield + 0.8
UKIB Rate (Maturity Loans) = Gilt yield + 0.60%



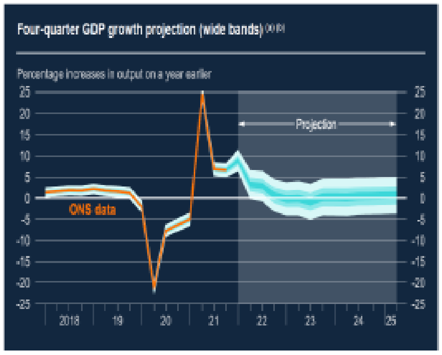




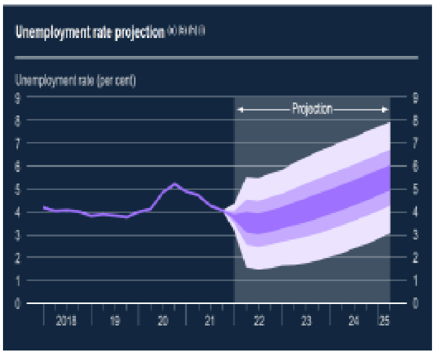


Bank of England Monetary Policy Report - May 2022

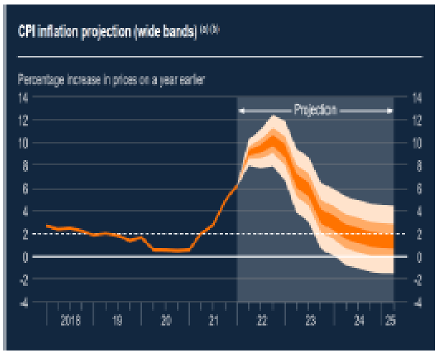
Outlook for UK GDP



Outlook for UK Unemployment



Outlook for UK CPI inflation



- Persistently higher global commodity prices and tradable goods prices from supply chain constraints, both accentuated by the invasion of Ukraine, lead to a sharp slowdown in world activity and push global consumer price inflation up further before their effects eventually dissipate.
- Demand growth in the UK slows sharply over the first half of the projection, predominantly reflecting the adverse impact of higher global commodity and tradable goods prices.
- The labour market tightens further in the near term before the slowdown in demand leads to a rise in unemployment and excess supply over the rest of the projection.
- The vast majority of the increase and subsequent fall in CPI inflation reflects the impact of external factors. Domestic price pressures rise further this year, as wage growth strengthens, and companies rebuild their margins. The increase in excess supply moderates these forces such that inflation is close to the 2% target in two years' time and well below it in three years.