Appendix C

Introduction

Background for TM report as at 30th September 2023

1.0 Spelthorne Borough Council's Context

1.1 Treasury Management is the management of the Council's 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.

1.2 The Council adopted the Chartered Institute of Public Finance and Accountancy's Treasury Management in the Public Services: Code of Practice (the CIPFA Code), which requires the Council to report on performance of the treasury management function at least twice yearly (mid-year and at year end).

The following sections are based on advice from Spelthorne's treasury adviser Arlingclose.

External Context

2. Economic background:

2.1 The MPC maintained Bank Rate at 5.25% as expected. The vote was 6-3, supporting the view that this represents the peak. The minutes and the Monetary Policy Report were used to send the signal that Bank Rate would remain high for the foreseeable future, in order to bring inflation back to target. The Bank envisages that inflation will take longer to return to target, declining only gradually once the supportive base effects arising from supply/energy issues wane.
Maintaining monetary policy at restrictive levels for a long period due to caution over possible second round inflationary effects will bear down on economic growth to a greater extent, and therefore require more substantial monetary easing in the future.

2.2 The Global Economy & Financial Conditions

Consumer price inflation in advanced economies had been easing but remained high, with potential upward pressure from Middle East events affecting energy prices. Global growth in 2023 largely aligned with expectations, though the United States and China showed stronger growth in Q3, while the euro area saw weaker growth. The United States was believed to be operating above its potential output, though the role of increased supply was uncertain. In contrast, the euro area was expected to experience a period of excess supply, partly due to the impact of global energy price shocks.
Since the last MPC meeting in September, there has been a notable rise in long-term government bond yields in advanced economies, especially in the United States, driven by expectations of prolonged higher policy rates and a potential increase in the equilibrium real interest rate. Models used by the bank's staff suggested that term premia had contributed to this rise, possibly due to increased uncertainty and evolving market dynamics. However, term premia accounted for only a small portion of the overall increase in long-term bond yields in the past two years compared to the rise in expected policy rates.
It is suggested that the recent slowdown in UK GDP growth is attributed to tighter monetary policy, sluggish potential supply growth, and the phasing out of fiscal support. While some

business surveys indicated a potential GDP decline in Q4, other forward-looking indicators were less pessimistic about future growth prospects.

2.3 UK Demand & Output

In Q3 2023, UK GDP remained stagnant, falling short of August Report projections. Some business surveys indicate a potential Q4 output contraction, while others are more optimistic, forecasting a modest 0.1% growth in Q4, lower than previous projections. The Committee discussed the recent slowdown in UK GDP growth due to significant monetary policy tightening since late 2021, ongoing supply weaknesses, and the phasing out of fiscal support. They noted clear signs of tighter monetary policy affecting the real economy, especially in reduced housing investment, driven by higher financing costs. The Bank's Agents reported that elevated financing costs and economic uncertainty were also restraining business investment, though cash-rich companies continued to invest. The impact of the policy tightening on consumer spending was expected to take time, occurring alongside a broader recovery in real incomes. Nevertheless, recent declines were observed in retail sales, consumer services output, and consumer confidence.

2.4 Labour Market

The slowdown in GDP growth has led to a decrease in labour demand. Due to a drop in response rates, the ONS temporarily halted the publication of Labor Force Survey (LFS) estimates regarding employment, unemployment, and inactivity starting from the June data. Nevertheless, a wide range of indicators, which had previously tracked the underlying trends in official labour market estimates, indicated that employment remained relatively stable in the latter part of 2023. Monitoring the division between unemployment and inactivity was limited to a narrower set of indicators. Vacancies continued to decline, and signs of recruitment challenges eased, reflecting a further relaxation in the labour market. Despite these changes, the labour market had maintained a relatively tight condition.

In the context of a sluggish economy, it's anticipated that employment growth in the latter part of 2023 has softened more than previously forecasted in the August Report. The decline in job vacancies and indications of reduced recruitment difficulties also indicate a loosening labour market. Reports from the Bank's Agents echo this trend, with eased hiring constraints, although certain sectors still face persistent skills shortages. While pay growth remains elevated across various indicators, the recent surge in the annual growth rate of private sector regular average weekly earnings isn't reflected in other datasets. There's some uncertainty about the near-term trajectory of wages, but wage growth is expected to decrease in the coming quarters from these elevated levels.

2.5 Inflation

Twelve-month CPI inflation, both in September and 2023 Q3, stood at 6.7%, falling below the expectations outlined in the August Report. This decline is primarily due to lower-than-anticipated core goods price inflation. Services inflation, hovering around 7%, only slightly deviated from the August projections. Despite remaining significantly above the 2% target, CPI inflation is projected to decrease significantly, reaching 4.75% in 2023 Q4, 4.5% in 2024 Q1, and 3.75% in 2024 Q2. This reduction is expected to be driven by lower energy, core goods, and food price inflation, with some decline in services inflation after January. In the MPC's latest most likely projection, based on the market-implied path for the Bank Rate, CPI inflation returns to the 2% target by the end of 2025 and falls below it thereafter, as increasing economic slack diminishes domestic inflationary pressures.

3.0 The MPC's Policy Decision

With the significant increase in Bank Rate during this tightening cycle, the current monetary policy stance is seen as restrictive. The decision to maintain or increase the Bank Rate at this meeting is finely balanced between the risks of not tightening enough in the face of potentially persistent inflationary pressures and the risks of over-tightening given the yet-to-be-realised effects of previous policy actions. Six members voted in favour of maintaining the Bank Rate at 5.25% at this meeting. For most in this group, the MPC's latest projections indicated that a restrictive monetary policy stance was likely to be necessary for an extended period to achieve a sustained return to the 2% inflation target. However, the possibility of a further rate increase remained on the table for some.

3.1 Three members favoured a 0.25 percentage point rate increase to 5.5% at this meeting, as they observed ongoing growth in real household incomes and positive forward-looking output indicators. They believed that more persistent inflationary pressures required this action to achieve the medium-term target sustainably.

3.2 The MPC will continue to closely monitor indicators of persistent inflationary pressures and the overall resilience of the economy, including labour market conditions, wage growth, and services price inflation. Monetary policy must remain sufficiently restrictive for a considerable period to bring inflation sustainably back to the 2% target. The MPC's latest projections suggest that a protracted period of restrictive policy may be needed, with the possibility of further tightening if evidence of sustained inflationary pressures emerges.
4.0 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.

4.1 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.4.2 Local authorities remain under financial pressure, but Arlingclose continues to take a positive view of the sector, considering its credit strength to be high. authorities on its counterparty list remains unchanged, a degree of caution is merited with certain authorities.
with more detail and twelve examples of permitted and prohibited use of PWLB loans. Authorities that are purchasing or intending to purchase investment assets primarily for yield will not be able to access the PWLB except to refinance existing loans or externalise internal borrowing. Acceptable use of PWLB borrowing includes service delivery, housing, regeneration, preventative action, refinancing and treasury management.

4.3 CIPFA published its revised Prudential Code for Capital Finance and Treasury Management Code on 20 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.

4.4 The principles of the Prudential Code took immediate effect although local authorities to comply with the Prudential Code, authorities must not borrow to invest primarily for financial return. This Code also states that it is not prudent for local authorities to make investment or spending decision that will increase the CFR unless directly and primarily related to the functions of the authority. Existing commercial investments are not required to be sold; however, authorities with existing commercial investments who expect to need to borrow should review the options for exiting these investments.

4.5 Borrowing is permitted for cashflow management, interest rate risk management, to refinance current borrowing and to adjust levels of internal borrowing. Borrowing to refinance capital expenditure primarily related to the delivery of a local authority's function but where a financial return is also expected is allowed, provided that financial return is not the primary reason for the expenditure. The changes align the CIPFA Prudential Code with the PWLB lending rules.

4.6 Unlike the Prudential Code, there is no mention of the date of initial application in the Treasury Management Code. The TM Code now includes extensive additional requirements for service and commercial investments, far beyond those in the 2017 version.

5.0 Treasury Investment

CIPFA published a revised Treasury Management in the Public Services Code of Practice and Cross-Sectoral Guidance Notes on 20 December 2021. These define treasury management investments as investments that arise from the organisation's cash flows or treasury risk management activity that ultimately represents balances that need to be invested until the cash is required for use in the course of business.

5.1 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 optimal 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. Ultra-low short-dated cash rates, which were a feature since March 2020 when Bank Rate was cut to 0.1%, prevailed for much of the 12-month reporting period resulting in the return on sterling low volatility net asset value (LVNAV) Money Market Funds being close to zero even after some managers had temporarily waived or lowered their fees. However, higher returns on cash instruments followed the increases in Bank Rate in December, February and March. At 31 March, the 1-day return on the Council's MMFs was 0.06% and 0.09%.

5.2 Externally Managed Pooled Funds: In the 6 months to September improved market sentiment was reflected in equity, property and multi-asset fund valuations and, in turn, the capital values of the property, equity and multi-asset income funds in the Council's portfolio. The prospect of higher inflation and rising bond yields did however result in muted bond fund performance. In the January- March quarter, the two dominant themes were tighter UK and US monetary policy and higher interest rates, and the military invasion of Ukraine by Russia in February, the latter triggering significant volatility and uncertainty in financial markets.

5.3 Current Market Condition: 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.

5.4 Treasury Management Indicators: The Council measures and manages its exposures to treasury management risks using the indicators shown at Appendices A. Appendix B shows benchmarking details that Arlingclose provides shortly after year end. The indicators are slightly different from the detail in the Council's own results which are produced later after the year end, including for example accruing adjustment.

5.5 The Council's Treasury Management Strategy for 2023/24 was reviewed and approved by CP&RC on the 19th of October 2023, and approved to which reduced the Authorised Limit, Operational Boundary and Capital Finance Requirement by £283m.

5.6 The 2022 Prudential Code includes a requirement for local authorities to provide a Capital Strategy, a summary document approved by full Council covering capital expenditure and financing, treasury management and non-treasury investments. The Council's Capital Strategy for 2023/24, complying with CIPFA's requirement, was approved by Council on 23 February 2023.