Division(s): N/A

AUDIT & GOVERNANCE COMMITTEE – 23 NOVEMBER 2022

TREASURY MANAGEMENT MIDTERM REVIEW 2022/23

Report by Director of Finance

RECOMMENDATION

1. **Audit & Governance Committee is RECOMMENDED to note the report, and to RECOMMEND Council to note the council's treasury management activity the first half of 2022/23.**

Executive Summary

2. This report covers the treasury management activity for the first half of 2022/23 in compliance with the CIPFA Code of Practice on Treasury Management 2021. It provides an update on the anticipated position and prudential indicators set out in the Treasury Management Strategy Statement & Annual Investment Strategy for 2022/23 agreed as part of the council's budget and Medium Term Financial Strategy in February 2022.

3. The global economy has changed significantly since the strategy was agreed, and volatility in economic markets that began in early 2022 continued during the first six months of the financial year. Global and domestic inflationary pressures have led to central banks increasing base rates, with further rises forecast before the year end. Government announcements in September 2022 created widespread volatility in economic markets resulting in gilt yields rising by circa 1% and the value of investments in bond and equity funds temporarily dropping significantly.

4. During the first half of the year there were no maturities of external debt. The council's external debt balance remained at £313.38m on 30 September 2022.

5. The average daily balance of temporary surplus cash invested in-house in the six months to 30 September was £470.15m, compared to the £342.00m budget and reflects reprofiling in anticipated capital expenditure and higher balances of capital grants compared to the original forecast. Over that period the average in-house return was 0.91%. That was above the budgeted rate of 0.35% set in the strategy. This has produced gross interest receivable of £2.14m for the six months to 30 Sept 2022 compared to the budget of £0.77m.

6. During the first half of the year the Council maintained its holding in external funds. Gross distributions from the council's investments in pooled funds totalled £1.84m in the first half of the year, exceeding the budgeted figure of £1.56m. Forecast returns for the year are £3.81m, in line with the budget of £3.81m.

Introduction

7. The Chartered Institute of Public Finance and Accountancy's (CIPFA's) Code of Practice on Treasury Management 2021 recommends that members are informed of Treasury Management activities at least four times per year. This report, and the quarterly updates, ensures the council's reporting is consistent with best practice in accordance with CIPFA's recommendations.

8. The following annexes are attached

Annex 1	Debt Financing 2022/23
Annex 2	Public Works Loans Board (PWLB) Debt Maturing
Annex 3	Prudential Indicator Monitoring
Annex 4	Specified & Non-Specified Investments 2022/23
Annex 5	External Backdrop Provided by Link Treasury Services

Treasury Management Strategy 2022/23

9. The Treasury Management Strategy & Annual Investment Strategy for 2022/23 outlines the council's strategic objectives in terms of its debt and investment management for the financial year 2022/23.

10. The strategy sets out that the forecast average cash balance for 2022/23 is £442m. The average base rate forecast was 0.35%

11. The council intends to maintain its investment in strategic pooled funds with a purchase value of £101m (23%), with the remaining £34m (77%) being managed internally with a mixture of short, medium and long-term deposits.

12. The strategy included the continued use of pooled fund vehicles with variable net asset value.

13. The strategy for borrowing provided an option to fund new or replacement borrowing. The limit for internal borrowing was combined with the long term lending limit, and will not exceed £300m.

External Context – Summary of backdrop provided by Link Treasury Services

14. **Economic backdrop**: The UK avoided recession in the first quarter of 2022/23 with the economy growing 0.2% quarter on quarter.

15. There are signs of higher energy prices creating more persistent downward effects in economic activity. Both industrial production (-0.3% month on month) and construction output (-0.8% month on month) fell in July 2022 for a second month in a row. Although some of this was probably due to the heatwave, 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.

16. CPI inflation eased from 10.1% in July to 9.9% in August, though inflation has not peaked yet. The easing in August 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.

17. The labour market remained exceptionally tight. Data for July and August 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 (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 to a new 48-year low of 3.6%. The single-month data showed that inactivity rose by 354,000 in July 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, the 3 month year on year rate of average earnings growth rose from 5.2% in June to 5.5%.

18. The 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 Fed and 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.

19. The full external context provided by link can be found in Annex 5.

20. **Interest Rate Forecasts** Link Group provided the following forecasts on 27 September 2022:

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

Treasury Management Activity

Debt Financing

21. The Treasury Management Strategy for 2022/23 assumed the level of external borrowing would increase by £46m during the financial year. As a result of slippage in the capital programme noted in the Capital Monitoring Report to Cabinet in July and October 2022 and the forecast for cash balances over the medium term being higher than anticipated this external borrowing does not need to be arranged in 2022/23.

22. The Council's cumulative total external debt remained at from £313.38m from 1 April 2022 to 30 Sept 2022. No new debt financing has been arranged during the year. The total forecast external debt as at 31 March 2023 is £306.38m. The forecast debt financing position for 31 March 2023 is shown in Annex 1.

23. At 30 Sept 2022, the authority had 50 PWLB[1] loans totalling £263.38m, nine LOBO[2] loans totalling £45m and one long-term fixed Money Market loan totalling £5m[3]. The combined weighted average interest rate for external debt as at 30 June 2022 was 4.44%.

Maturing Debt

24. No debt matured during the quarter of the year. The Council is forecast to repay £7m of PWLB debt by 31 March 2023. The details are set out in Annex 2.

Debt Restructuring

25. The premium charge for early repayment of PWLB debt remained relatively expensive for the loans in the Authority's portfolio and therefore unattractive for debt restructuring activity. No PWLB debt restructuring activity was undertaken during the first half of the year. However, given the forecast for bond rates, debt restructuring opportunities are being actively sought with our advisors, Link Treasury Services.

LOBOs

26. At the beginning of the financial year the Council held £45m of LOBO (Lender's Option Borrower's Option) loans where the lender has the option to propose an increase in the interest rate at set dates, following which the Authority has the option to either accept the new rate or to repay the loan at no additional cost. £15m of these LOBOs had options during 2022/23. To the 30 September 2022 none had been exercised by the lender.

27. Increased gilt yields have raised the likelihood of lenders exercising their option to increase the rates on LOBOs. Given the level of cash balances and forecasts for gilt yields to lower over the medium term, the Treasury Management Strategy Team (TMST) have agreed that the council will repay any called LOBOs with internal borrowing over the medium term to avoid additional costs of servicing these instruments. The council is also exploring early repayment opportunities of LOBOs with Link Treasury Services.

Investment Strategy

28. The Council holds deposits and invested funds representing income received in advance of expenditure plus balances and reserves. The guidance on Local Government Investments in England gives priority to security and liquidity and the Council's aim is to achieve a yield commensurate with these principles. The Council continued to adopt a cautious approach to lending to financial institutions and continuously monitored credit quality information relating to counterparties.

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[1] PWLB (Public Works Loans Board) is a Government agency operating within the United Kingdom Debt Management Office and is responsible for lending money to Local Authorities.

[2] LOBO (Lender's Option/Borrower's Option) Loans are long-term loans which include a re-pricing option for the bank at predetermined intervals.

[3] In June 2016, the Council's LOBO with Barclays PLC was converted to a fixed rate loan at its current interest rate of 3.95% to mature on the 29th May 2065 with Barclays waiving their right to change the interest rate on the loan in the future.

29. During the first half of the financial year term fixed deposits have been placed with other Local Authorities as per the approved lending list, whilst Money Market Funds have been utilised for short-term liquidity. Inter Local Authority lending remains an attractive market to deposit funds with from a security perspective, whilst the Government's Debt Management Deposit Facility (DMADF) has also provided a competitive and secure counterparty. With rapidly increasing interest rates, the Council has taken a position of laddering investments, taking advantage of increased market rates and ensuring a continuous cycle of maturities to be invested at higher rates.

30. The Treasury Management Strategy Statement and Annual Investment Strategy for 2022/23 included the use of external fund managers and pooled funds to diversify the investment portfolio through the use of different investment instruments, investment in different markets, and exposure to a range of counterparties. It is expected that these funds should outperform the Council's in-house investment performance over a rolling three-year period. The strategy permitted up to 50% of the total portfolio to be invested with external fund managers and pooled funds (excluding Money Market Funds). The performance of the pooled funds will continue to be monitored by the TMST throughout the year against respective benchmarks and the in-house portfolio.

31. At the start of the year the UK Bank Rate was 0.75%, which was above the forecast of 0.25%. Official rates rose to 1.25% by June 2023 and again to 2.25% by September 2022. With ongoing inflationary pressures impacting on the UK economy, the current forecast is for interest rates to increase to a high of 5.00% by March 2023, then reduce to 2.50% by 2025.

32. The long term lending limit for 2022/23 is £205m. During the first six months of the year the average available cash headroom within that limit was £10m.

The Council's Lending List

33. The Council's in-house cash balances were deposited with institutions that meet the Council's approved credit rating criteria. The approved Lending List is updated to reflect changes in counterparty credit quality with changes reported to Cabinet on a bi-monthly basis. There were no changes to the lending list in the first half of 2022.

34. In the six months to 30 September 2022 there were no instances of breaches in policy in relation to the council's Lending List. Any breaches in policy will be reported to Cabinet as part of the monthly Business Management & Monitoring report.

Investment Performance

35. Security of capital has remained the Authority's main investment objective. This has been maintained by following the Authority's counterparty policy as set out in its Treasury Management Strategy Statement and Annual Investment Strategy for 2022/23 and by maintaining a limited exposure to "bail in" banks and favouring deposits with other Local Authorities and the DMADF. As at 30 September 2022, the Council had £344.0m deposited with 40 other Local Authorities with an average deposit total of £8.60m per authority., The maximum deposit with any single local authority was £21m. This was below the limit of £30m. The Council also had £80m deposited with the DMADF and £10m with banking institutions as at 30 September 2022.

36. The average daily balance of temporary surplus cash invested in-house in the quarter to 30 September 2022 was £470.15m, compared to the budget of £342.00m. The Council achieved an average in-house return for that period of 0.91%, above the budgeted rate of 0.35% set in the strategy. This has produced gross interest receivable of £2.14m for the quarter to 30 September compared to budget of £0.77m.

37. Cash balances for the year are estimated to be £42.3m lower as they otherwise would have been as a result of negative DSG balances. The impact of this is an estimated opportunity cost of £0.47m in unearned interest during 2022/23.

38. As the negative DSG balance is forecast to increase over the medium term, coupled with forecast increasing interest rates, the estimated opportunity costs of the negative balance is £2.45m in 2023/24, £2.60m in 2024/25 and £2.68m in 2025/26.

39. Temporary surplus cash includes; developer contributions; council reserves and balances; trust fund balances; and various other funds to which the Council pays interest at each financial year end, based on a margin below the Sterling Overnight Interest Average.

External Fund Managers and Pooled Funds

40. During the first quarter of 2022/23 the Council maintained its holding in external funds. The value of the funds was £95.90m as at 30 September 2022 compared to £101.08m at 30 June 2022. The original purchase cost of the portfolio in March 2019 was £101.0m. Weighted by original purchase value, pooled fund investments produced an annualised income return of 3.67% for the period. These investments are held with a long-term view and performance is assessed accordingly.

41. Gross distributions from pooled funds have totalled £1.84m in the first half of the year, exceeding the budgeted figure of £1.56m.

Prudential Indicators for Treasury Management

42. The Authority confirms compliance with its Prudential Indicators for 2022/23, which were set as part of the Authority's Treasury Management Strategy Statement. The position as at 30 June 2022 for the Prudential Indicators is shown in Annex 3.

Training

43. The Treasury Management Team continue to keep up to date with the latest developments and attend external workshops and conferences to maintain their knowledge and awareness of current issues where relevant

Financial Implications

44. Interest payable and receivable in relation to Treasury Management activities are included within the overall Strategic Measures budget. In house interest receivable for 2022/23 is currently forecast to be £4.80m, which is £3.26m above the £1.54m budget. An estimated £2.2m of this will be applied to Developer Contributions. As at 30 September 2022, £2.14m of the £4.80 interest receivable has been realised.

45. Dividends payable from external funds in 2022/23 are forecast as £3.81m, which is in line with budget.

46. Interest payable is currently forecast to be £13.81m, which is £0.58m below the budgeted figure of £14.39m, due to £46m of new external borrowing not required during the year.

47. The Business Management & Monitoring Report to Cabinet in November 2022 notes that the net impact of the additional interest, after taking account of increases to interest payable on developer contributions is forecast to be £1.6m in 2022/23.

Comments checked by:

Lorna Baxter, Section 151 Officer, lorna.baxter@oxfordshire.gov.uk

Legal Implications

48. There are no direct legal implications arising from this report save for the need for ongoing collaborative working between the S.151 Officer and the Monitoring Office. CIPFA guidance promotes the need for consultative working and collaboration between these respective roles to promote good organisational governance.

Comments checked by:

Kate Charlton, Interim Head of Legal, kate.charlton@oxfordshire.gov.uk

Sustainability Implications

49. This report is not expected to have any negative impact with regards to the Council's zero carbon emissions commitment by 2030.

Contact officer: Tim Chapple – Treasury Manager
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October 2022

Annex 1

OXFORDSHIRE COUNTY COUNCIL DEBT FINANCING 2022/23

Debt Profile		£m
1. PWLB	85%	263.38
2. Other Long Term Loans	15%	50.00
3. Sub-total External Debt		313.38
4. Internal Balances		0.00
5. Actual Debt at 31 March 2022	**100%**	**313.38**
6. Prudential Borrowing		42.62
7. Borrowing in Advance		0.00
8. Minimum Revenue Provision		-10.17
9. Forecast Debt at 31 March 2023		**345.84**
Maturing Debt		
10. PWLB loans maturing during the year		-7.00
11. PWLB loans repaid prematurely in the course of debt restructuring		0.00
12. Total Maturing Debt		**-7.00**
New External Borrowing		
13. PWLB Normal		0.00
14. PWLB loans raised in the course of debt restructuring		0.00
15. Money Market LOBO loans		0.00
16. Total New External Borrowing		**0.00**
Debt Profile Year End		
17. PWLB	74%	256.38
18. Money Market loans (incl £45m LOBOs)	14%	50.00
19. Forecast Sub-total External Debt		306.38
20. Forecast Internal Balances	12%	39.46
21. Forecast Debt at 31 March 2023	**100%**	**345.84**

Line

1 – 5 This is a breakdown of the Council’s debt at the beginning of the financial year (1 April 2020). The PWLB is a government agency operating within the Debt Management Office. LOBO (Lender’s Option/ Borrower’s Option) loans are long-term loans, with a maturity of up to 60 years, which includes a re-pricing option for the bank at predetermined time intervals. Internal balances include provisions, reserves, revenue balances, capital receipts unapplied, and excess of creditors over debtors.

6 ‘Prudential Borrowing’ reflects Prudential Borrowing taken by the authority whereby the associated borrowing costs are met by savings in the revenue budget.

7 ‘Borrowing in Advance’ is the amount the Council borrowed in advance to fund future capital finance costs.

8 The amount of debt to be repaid from revenue. The sum to be repaid annually is laid down in the Local Government and Housing Act 1989, which stipulates that the repayments must equate to at least 4% of the debt outstanding at 1 April each year.

9 The Council’s forecast total debt by the end of the financial year, after taking into account new borrowing, debt repayment and movement in funding by internal balances.

10 The Council’s normal maturing PWLB debt.

11 PWLB debt repaid early during the year.

12 Total debt repayable during the year.

13 The normal PWLB borrowing undertaken by the Council during 2022/23.

14 New PWLB loans to replace debt repaid early.

15 The Money Market borrowing undertaken by the Council during 2022/23

16 The total external borrowing undertaken.

18-22 The Council’s forecast debt profile at the end of the year.

Annex 2

Long-Term Debt Maturing 2022/23

Public Works Loan Board: Loans maturing during 2022/23

Date	Amount £m	Rate %
31/10/2022	4.000	5.050%
31/12/2022	1.000	6.250%
26/03/2023	0.316	6.625%
26/03/2023	1.684	6.625%
Total	**7.000**	

Annex 3

Prudential Indicators Monitoring at 30 September 2022

The Local Government Act 2003 requires the Authority to have regard to CIPFA's Prudential Code for Capital Finance in Local Authorities (the Prudential Code) when determining how much money it can afford to borrow. To demonstrate that the Authority has fulfilled the requirements of the Prudential Code the following indicators must be set and monitored each year.

Authorised and Operational Limit for External Debt

Actual debt levels are monitored against the Operational Boundary and Authorised Limit for External Debt below. The Operational Boundary is based on the Authority's estimate of most likely, i.e. prudent, but not worst case scenario for external debt. The council confirms that the Operational Boundary has not been breached during 2022/23.

The Authorised Limit is the affordable borrowing limit determined in compliance with the Local Government Act 2003. It is the maximum debt that the Authority can legally owe. The authorised limit provides headroom over and above the operational boundary for unusual cash movements. The Authority confirms that the Authorised limit was not breached in the first half of 2022/23.

Authorised limit for External Debt	£495,000,000
Operational Limit for External Debt	£610,000,000
Capital Financing Requirement for year	£437,546,949

	Actual 30/09/2022	**Forecast 31/03/2023**
Borrowing	£313,382,618	£306,382,618
Other Long-Term Liabilities	£ 17,000,000	£ 17,000,000
Total	**£330,382,619**	**£323,382,618**

Interest Rate Exposures

These indicators are set to control the Authority's exposure to interest rate risk. The upper limits on fixed and variable rate interest exposures. Fixed rate investments are borrowings are those where the rate of interest is fixed for the whole financial year. Instruments that mature during the financial year are classed as variable rate.

Fixed Interest Rate Exposure	
Fixed Interest Net Borrowing limit	£350,000,000
Actual at 30 September 2022	-£124,117,382
Variable Interest Rate Exposure	
Variable Interest Net Borrowing limit	£0
Actual at 30 September 2022	-£30,040,174

Principal Sums Invested over 365 days

Total sums invested for more than 364 days limit	£215,000,000
Actual sums invested for more than 364 days	£ 96,500,000

Maturity Structure of Borrowing

This indicator is set to control the Authority's exposure to refinancing risk. The upper and lower limits on the maturity structure of fixed rate borrowing and the actual structure at 30 September 2022, are shown below. Time periods start on the first day of each financial year. The maturity date of borrowing is the earliest date on which the lender can demand repayment.

	Limit %	**Actual %**
Under 12 months	0 - 20	11.81
12 – 24 months	0 - 25	3.83
24 months – 5 years	0 - 35	16.59
5 years to 10 years	5 - 40	24.37
10 years +	40 - 95	43.40

Annex 4

Specified and Non Specified Investments 2022/23

Specified Investments

Investment Instrument	Minimum Credit Criteria	Use
Debt Management Agency Deposit Facility	N/A	In-house and Fund Managers
Term Deposits – UK Government	N/A	In-house
Term Deposits – other Local Authorities	N/A	In-house
Term Deposits – Banks and Building Societies	Short-term F1, Long-term BBB+, Minimum Sovereign Rating AA+	In-house and Fund Managers
Certificates of Deposit issued by Banks and Building Societies	A1 or P1	In-house on a buy and hold basis and Fund Managers
Money Market Funds	AAA	In-house and Fund Managers
Other Money Market Funds and Collective Investment Schemes[4]	Minimum equivalent credit rating of A+. These funds do not have short-term or support ratings.	In-house and Fund Managers
UK Government Gilts	N/A	In-house on a buy and hold basis and Fund Managers
Treasury Bills	N/A	In-house and Fund Managers
Reverse Repurchase Agreements - maturity under 1 year from arrangement and counterparty is of high credit quality (not collateral)	Long Term Counterparty Rating A-	In-house and Fund Managers
Covered Bonds – maturity under 1 year from arrangement	Minimum issue rating of A-	In-house and Fund Managers

[4] I.e., credit rated funds which meet the definition of a collective investment scheme as defined in SI 2004 No 534 and SI 2007 No 573.

Non-Specified Investments

Investment Instrument	Minimum Credit Criteria	Use	Max % of total Investments	Max Maturity Period
Term Deposits – other Local Authorities (maturities in excess of 1 year)	N/A	In-house	50%	3 years
Term Deposits – Banks and Building Societies (maturities in excess of 1 year)	Short-term F1+, Long-term AA-	In-house and Fund Managers	50% in-house; 100% External Funds	3 years
Structured Products (e.g. Callable deposits, range accruals, snowballs, escalators etc.)	Short-term F1+, Long-term AA-	In-house and Fund Managers	50% in-house; 100% External Funds	3 years
UK Government Gilts with maturities in excess of 1 year	N/A	In-house and Fund Managers	50% in-house; 100% External Funds	5 years in-house, 10 years fund managers
Bonds issued by Multilateral Development Banks	AAA	In-house and Fund Managers	50% in-house; 100% External Fund	25 years
Bonds issued by a financial institution which is guaranteed by the UK Government	AA	In-house and Fund Managers	50% in-house; 100% External Fund	5 years in-house
Collective Investment Schemes[5] but which are not credit rated	N/A	In-house and Fund Managers	50% In-house; 100% External Funds	Pooled Funds do not have a defined maturity date

[5] Pooled funds which meet the definition of a collective investment scheme as defined in SI 2004 No 534 and SI 2007 No 573.

Sovereign Bond Issues	AAA	In-house on a buy and hold basis. Fund Managers	50% in-house; 100% External Funds	5 year in-house, 30 years fund managers
Reverse Repurchase Agreements - maturity in excess of 1 year, or/and counterparty not of high credit quality.	Minimum long term rating of A-	In-house and Fund Managers	50% in-house; 100% External Funds	3 years
Covered Bonds	AAA	In-house and Fund Managers	50% in-house; 100% External Funds	20 years
Registered Providers	As agreed by TMST in consultation with the Leader and the Cabinet Member for Finance	In-house	50% In-house	5 years

The maximum limits for in-house investments apply at the time of arrangement.

Annex 5

External Backdrop Provided by Link Treasury Services

- The second quarter of 2022/23 saw:
  - GDP revised upwards in Q1 2022/23 to +0.2% 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;
  - CPI inflation ease to 9.9% y/y in August, having been 9.0% in April, 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 100bps 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.
- The UK economy grew by 0.2% q/q in Q1 2022/23, though revisions to historic data left it below pre-pandemic levels.
- There are signs of higher energy prices creating more persistent downward effects in economic activity. Both industrial production (-0.3% 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.
- The fall in the composite PMI from 49.6 in August to a 20-month low preliminary reading of 48.4 in September points to a fall in GDP of around 0.2% q/q in Q3 and consumer confidence is at a record low. Retail sales volumes fell by 1.6% m/m in August, which was the ninth fall in 10 months. That left sales volumes in August 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, which was below the £3.9bn rise in July and much smaller than the 2019 average monthly rate of £4.6bn.
- The labour market remained exceptionally tight. Data for July and August 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 (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 to a new 48-year low of 3.6%. The single-month data showed that inactivity rose by 354,000 in July 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, the 3my/y rate of average earnings growth rose from 5.2% in June to 5.5%.
- CPI inflation eased from 10.1% in July to 9.9% in August, though inflation has not peaked yet. The easing in August 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 $90pb, we would expect to see fuel prices fall further in the coming months.

- However, utility price inflation is expected to add 0.7% to CPI inflation in October 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 and have a big downward influence on CPI inflation.
- Nonetheless, the rise in services CPI inflation from 5.7% y/y in July to a 30-year high of 5.9% y/y in August 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 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.
- During H1 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 next year 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, 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.
- 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 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 but has subsequently been moved forward to an expected release date in October. Nevertheless, with concerns over a global recession growing, there are downside risks to the pound.
- The 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 Fed and 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.
- Since the fiscal event on 23rd September, we now expect the Monetary Policy Committee (MPC) to 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 (to 3.25%) and 75 basis points in December (to 4%) followed by further 50 basis point hikes in February and March (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.
- 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. The rises in two-year gilt yields (to a peak of 2.37% on 21st June) 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. Second, it committed to buy up to £65bn of long-term gilts to "restore orderly market conditions" until 14th October. In other words, the Bank is restarting QE, although for financial stability reasons rather than monetary policy reasons.

- Since the Bank's announcement on 28th September, 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%.
- There is a possibility that the Bank continues with QE at the long-end beyond 14th October or it decides to delay quantitative tightening beyond 31st October, 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.
- After a shaky start to the year, the S&P 500 and FTSE 100 climbed in the first half of Q2 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.