Appendix A

Background, Economy and Outlook

1. Introduction

1.1 In February 2012 both Councils 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 Councils to approve treasury management half year and annual reports.

1.2 The Joint Treasury Management Strategy for 2022/23 was approved at both full Councils in February 2022. Both Councils have borrowed and invested substantial sums of money and are therefore exposed to financial risks including the loss of invested funds and the revenue effect of changing interest rates. The successful identification, monitoring and control of risk are therefore central to the Councils' Treasury Management Strategy.

1.3 CIPFA published its revised Treasury Management Code of Practice (the TM Code) and Prudential Code for Capital Finance in 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. The principles within the two Codes took immediate effect although local authorities could defer introducing the revised reporting requirements within the revised Codes until the 2023/24 financial year if they wish, which both Councils elected to do.)

1.4 The 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 Councils' Capital Strategy, for the financial year 2022/23, complying with CIPFA's Code requirement, was approved by both full Councils in February 2022.

1.5 The Statutory Guidance on Local Government Investments (MHCLG, 2018) requires local authorities to produce an investment strategy, covering investments that are not part of treasury management activity. The Councils' Investment Strategy, for the financial year 2022/23, was also approved by both full Councils in February 2022.

2. External Context

2.1 Economic background:

2.1.1 The ongoing conflict in Ukraine has continued to put pressure on global inflation and the economic outlook for UK and world growth remains weak. The UK political situation towards the end of the period following the 'fiscal event' increased uncertainty further.

2.1.2 The economic backdrop during the April to September period continued to be characterised by high oil, gas and commodity prices, ongoing high inflation and its impact on consumers' cost of living, no imminent end in sight to the Russia-Ukraine hostilities and its associated impact on the supply chain, and China's zero-Covid policy.

2.1.3 Central Bank rhetoric and action remained robust. The Bank of England, Federal Reserve and the European Central Bank all pushed up interest rates over the period and committed to fighting inflation, even when the consequences were in all likelihood recessions in those regions.

2.1.4 UK inflation remained extremely high. Annual headline CPI hit 10.1% in July, the highest rate for 40 years, before falling modestly to 9.9% in August. RPI registered 12.3% in both July and August. The energy regulator, Ofgem, increased the energy price cap by 54% in April, while a further increase in the cap from October, which would have seen households with average energy consumption pay over £3,500 per annum, was dampened by the UK government stepping in to provide around £150 billion of support to limit bills to £2,500 annually until 2024.

2.1.5 The latest labour market remained tight through the period but there was some evidence of easing demand and falling supply. The unemployment rate 3m/year for April fell to 3.8% and declined further to 3.6% in July. Although now back below pre-pandemic levels, the recent decline was driven by an increase in inactivity rather than demand for labour. Pay growth in July was 5.5% for total pay (including bonuses) and 5.2% for regular pay. Once adjusted for inflation, however, growth in total pay was -2.6% and –2.8% for regular pay.

2.1.6 With disposable income squeezed and higher energy bills still to come, consumer confidence fell to a record low in August. Quarterly GDP fell -0.1% in the April-June quarter driven by a decline in services output, but slightly better than the 0.3% fall expected by the Bank of England.

2.1.7 The Bank of England increased the official Bank Rate to 2.25% over the period. From 0.75% in March, the Monetary Policy Committee (MPC) pushed through rises of 0.25% in each of the following two MPC meetings, before hiking by 0.50% in August and again in September. August's rise was voted by a majority of 8-1, with one MPC member preferring a more modest rise of 0.25%. the September vote was 5-4, with five votes for an 0.5% increase, three for an 0.75% increase and one for an 0.25% increase. The Committee noted that domestic inflationary pressures are expected to remain strong and so given ongoing strong rhetoric around tackling inflation further Bank Rate rises should be expected.

2.1.8 On 23rd September the UK government, following a change of leadership, announced a raft of measures in a 'mini budget', loosening fiscal policy with a view to boosting the UK's trend growth rate to 2.5%. With little detail on how government borrowing would be returned to a sustainable path, financial markets reacted negatively. Gilt yields rose dramatically by between 0.7% - 1% for all maturities with the rise most pronounced for shorter dated gilts. The swift rise in gilt yields left pension funds vulnerable, as it led to margin calls on their interest rate swaps and risked triggering large scale redemptions of assets across their portfolios to meet these demands. It became necessary for the Bank of England to intervene to preserve market stability through the purchase of long-dated gilts, albeit as a temporary measure, which has had the desired effect with 50-year gilt yields falling over 100bps in a single day.

2.1.9 Bank of England policymakers noted that any resulting inflationary impact of increased demand would be met with monetary tightening, raising the prospect of much higher Bank Rate and consequential negative impacts on the housing market.

2.1.10 After hitting 9.1% in June, annual US inflation eased in July and August to 8.5% and 8.3% respectively. The Federal Reserve continued its fight against inflation over the period with a 0.5% hike in May followed by three increases of 0.75% in June, July and September, taking policy rates to a range of 3% - 3.25%.

2.1.11 Eurozone CPI inflation reached 9.1% y/y in August, with energy prices the main contributor but also strong upward pressure from food prices. Inflation has increased steadily since April from 7.4%. In July the European Central Bank increased interest rates for the first time since 2011, pushing its deposit rate from –0.5% to 0% and its main refinancing rate from 0.0% to 0.5%. This was followed in September by further hikes of 0.75% to both policy rates, taking the deposit rate to 0.75% and refinancing rate to 1.25%.

2.2 Financial markets:

2.2.1 Uncertainty remained in control of financial market sentiment and bond yields remained volatile, continuing their general upward trend as concern over higher inflation and higher interest rates continued to dominate. Towards the end of September, volatility in financial markets was significantly exacerbated by the UK government's fiscal plans, leading to an acceleration in the rate of the rise in gilt yields and decline in the value of sterling.

2.2.2 Due to pressure on pension funds, the Bank of England announced a direct intervention in the gilt market to increase liquidity and reduce yields.

2.2.3 Over the period the 5-year UK benchmark gilt yield rose from 1.41% to 4.40%, the 10-year gilt yield rose from 1.61% to 4.15%, the 20-year yield from 1.82% to 4.13% and the 50-year yield from 1.56% to 3.25%. The Sterling Overnight Rate (SONIA) averaged 1.22% over the period.

2.3 Credit background:

2.3.1 In July Fitch revised the outlook on Standard Chartered from negative to stable as it expected profitability to improve thanks to the higher interest rate environment. Fitch also revised the outlook for Bank of Nova Scotia from negative to stable due to its robust business profile.

2.3.2 Also in July, Moody's revised the outlook on Bayerische Landesbank to positive and then in September S&P revised the GLA outlook to stable from negative as it expects the authority to remain resilient despite pressures from a weaker macroeconomic outlook coupled with higher inflation and interest rates.

2.3.3 Having completed its full review of its credit advice on unsecured deposits at UK and non-UK banks, in May Arlingclose extended the maximum duration limit for five UK banks, four Canadian banks and four German banks to six months. The maximum duration for unsecured deposits with other UK and non-UK banks on the Arlingclose recommended list is 100 days. These recommendations were unchanged at the end of the period.

2.3.4 Arlingclose continued to monitor and assess credit default swap levels for signs of credit stress but made no changes to the counterparty list or recommended durations. Nevertheless, increased market volatility is expected to remain a feature, at least in the near term and, as ever, the institutions and durations on the Councils' counterparty list recommended by Arlingclose remains under constant review.

3 Outlook for the remainder of 2022/23: (based on data of 7th November)

3.1 The MPC remains concerned about inflation but sees the path for Bank Rate to be below that priced into markets.

3.2 Following the exceptional 75bp rise in November, the Councils' treasury advisor, Arlingclose, believes the MPC will slow the rate of increase at the next few meetings. Arlingclose now expects Bank Rate to peak at 4.25%, with a further 50bp rise in December and smaller rises in 2023.

3.3 The UK economy likely entered recession in Q3, which will continue for some time. Once inflation has fallen from the peak, the MPC will cut Bank Rate.

3.4 Arlingclose expects gilt yields to remain broadly steady despite the MPC's attempt to push down on interest rate expectations. Without a weakening in the inflation outlook, investors will price in higher inflation expectations given signs of a softer monetary policy stance.

3.5 Gilt yields face pressures to both sides from hawkish US/European Zone central bank policy on one hand to the weak global economic outlook on the other. Bank of England bond sales will maintain yields at a higher level than would otherwise be the case.

3.6 **Background:**

3.7 UK interest rate expectations have eased following the explosive mini budget, with a growing expectation that UK fiscal policy will now be tightened to restore investor confidence, adding to the pressure on household finances. The peak for UK interest rates will therefore be lower, although the path for interest rates and gilt yields remains highly uncertain.

3.8 Globally, economic growth is slowing as inflation and tighter monetary policy depress activity. Inflation, however, continues to run hot, raising expectations that policymakers, particularly in the US, will err on the side of caution, continue to increase rates and tighten economies into recession.

3.9 The new Chancellor dismantled the mini-budget, calming bond markets and broadly removing the premium evident since the first Tory leadership election. Support for retail energy bills will be less generous, causing a lower but more prolonged peak in inflation. This will have ramifications for both growth and inflation expectations.

3.10 The UK economy is already experiencing recessionary conditions, with business activity and household spending falling. Tighter monetary and fiscal policy, alongside high inflation will bear down on household disposable income. The short- to medium term outlook for the UK economy is bleak, with the Bank of England projecting a protracted recession.

3.11 Demand for labour remains strong, although there are some signs of easing. The decline in the active workforce has fed through into higher wage growth, which could prolong higher inflation. The development of the UK labour market will be a key influence on MPC decisions. It is difficult to see labour market strength remaining given the current economic outlook.

3.12 Global bond yields have steadied somewhat as attention turns towards a possible turning point in US monetary policy. Stubborn US inflation and strong labour markets mean that the Federal Reserve remains hawkish, creating inflationary risks for other central banks breaking ranks.

3.13 However, in a departure from Federal Reserve and European Central Bank policy, in November the Bank of England attempted to explicitly talk down interest rate expectations, underlining the damage current market expectations will do to the UK economy, and the probable resulting inflation undershoot in the medium term. This did not stop the Governor affirming that there will be further rises in Bank Rate.

3.14 There has been a material tightening in financial conditions, including the elevated path of market interest rates. In addition, high energy prices continue to weigh on spending, despite an assumption of some fiscal support for household energy bills beyond the current six-month period of the Energy Price Guarantee. As a result, the UK economy is expected to remain in recession throughout 2023 and the first half of 2024, and GDP is expected to recover only gradually thereafter.

3.15 Although there is judged to be a greater margin of excess demand currently, continued weakness in spending leads to an increasing degree of economic slack emerging from the first half of 2023, including a rising unemployment rate.

3.16 Despite a decline in global price pressures and a significant fall in the contribution of household energy prices to CPI inflation, domestic inflationary pressures remain strong over the next year. But an increasing degree of economic slack depresses domestic pressures further out. Conditioned on the elevated path of market interest rates, CPI inflation declines to below the 2% target in the medium term, although the Committee judges that the risks to the inflation projections are skewed to the upside.

3.17 Arlingclose – Forecast rates (based on data of 7th November**)**

	Current	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24	Jun-24	Sep-24	Dec-24	Mar-25	Jun-25	Sep-25
Official Bank Rate													
Upside risk	0.00	0.25	0.50	0.75	1.00	1.00	1.00	1.25	1.50	1.75	1.50	1.25	1.25
Arlingclose Central Case	3.00	3.50	4.00	4.25	4.25	4.25	4.25	4.00	3.75	3.50	3.50	3.50	3.50
Downside risk	0.00	0.25	0.50	0.75	0.75	0.75	0.75	0.75	1.00	1.00	1.00	1.00	1.00

4 Local Context

4.1 On 31 March 2022, Babergh had a net borrowing requirement of £132m and Mid Suffolk had a net borrowing requirement of £112m arising from revenue and capital income and expenditure.

4.2 The underlying need to borrow for capital purposes is measured by the Capital Financing Requirement (CFR), while usable reserves and working capital are the underlying resources available for investment. These factors are summarised in Table 1 that follows.

4.3 **Table 1: Balance Sheet Summary**

Balance Sheet Summary	31.03.22 Babergh £m	31.03.22 Mid Suffolk £m
General Fund CFR	71.555	101.275
HRA CFR	94.031	94.241
Total CFR	**165.586**	**195.516**
(Less): Usable reserves	(49.460)	(67.070)
(Less) / Add: Working capital	15.424	(16.869)
Net borrowing requirement	**131.550**	**111.577**

4.4 Higher official interest rates have increased the cost of short-term, temporary loans and investment returns from cash assets that can be used in lieu of borrowing. The current strategy is to maintain borrowing and investments below their underlying levels, sometimes known as internal borrowing, in order to reduce risk and keep interest costs low.

4.5 The treasury management position on 30 September 2022 and the change during the half year is shown in Table 2 that follows.

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4.6 **Table 2: Treasury Management Summary**

Babergh	31.03.22 Balance £m	Movement £m	30.09.22 Balance £m	30.09.22 Rate %
Long-term borrowing	94.396	(0.275)	94.121	3.20%
Short-term borrowing	26.000	(7.000)	19.000	1.07%
Total borrowing	**120.396**	**(7.275)**	**113.121**	
Long-term investments	11.105	0.000	11.105	4.56%
Short-term investments	8.000	(6.000)	2.000	0.98%
Cash and Cash equivalents	1.714	0.119	1.833	1.03%
Total Investments	**20.819**	**(5.881)**	**14.938**	
Net borrowing	**99.577**		**98.183**	

Mid Suffolk	31.03.22 Balance £m	Movement £m	30.09.22 Balance £m	30.09.22 Rate %
Medium / Long-term borrowing	97.335	6.949	104.285	2.68%
Short-term borrowing	29.000	1.500	30.500	1.04%
Total borrowing	**126.335**	**8.449**	**134.785**	
Long-term investments	11.101	0.000	11.101	4.58%
Short-term investments	8.000	(8.000)	0.000	0.93%
Cash and Cash equivalents	2.317	(0.984)	1.333	1.00%
Total Investments	**21.418**	**(8.984)**	**12.434**	
Net borrowing	**104.917**		**122.350**	