Decision Report - Executive Decision
Forward Plan Reference: FP/23/04/05
Decision Date – 25/01/2024
Key Decision – No

Treasury Management Strategy Statement 2024-25

Executive Member(s): Cllr Leyshon – Lead Member for Resources and Performance
Local Member(s) and Division: All
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Summary

1. This document sets out proposed Treasury Management Strategy (TMS) for Somerset Council for 2024-25. The Council recognises that effective treasury management underpins the achievement of its business and service objectives and is essential for maintaining a sound financial reputation. It is therefore committed to driving value from all of its Treasury Management activities and to employing suitable performance measurement techniques, within the context of effective risk management.

2. This report brings together the requirements of the Chartered Institute of Public Finance and Accountancy (CIPFA) Treasury Management in the Public Services Code of Practice Revised 2021 Edition (CIPFA TM Code), and the CIPFA Prudential Code for Capital Finance in Local Authorities: Revised 2021 Edition (CIPFA Prudential Code).

3. The Council's current investment portfolio comprises:

- short-term, cash based investments as set out in Table 2 below
- a Strategic Pooled Funds Portfolio, currently valued at £116.5m
- non- Treasury investments comprising commercial property and shareholdings in Council-owned companies.

4. CIPFA's Prudential Code does not require that existing non-Treasury investments, including property, should be sold, but authorities that have an expected need to borrow should review options for exiting these investments and should summarise the outcomes from such reviews in their annual Treasury Management or Investment Strategies.

5. A review of all non-Treasury investments during 2023/24 has concluded that these do not contribute to the new Council's key objectives going forward, and plans are being developed to dispose of these in an orderly manner which achieves best value for money. Detailed disposal plans are being brought forward for member approval as and when these are developed.

6. Although the value and timings of possible sales are yet to be determined, since the Council is not intending to retain these assets over the longer term and has no plans to acquire similar investments in the future, a separate non-Treasury Investments strategy is not considered necessary at the present time. This Treasury Management Strategy sets out how all cash-based resources will be used and managed during 2024-25.

7. Whilst most of the requirements of the 2018 Department of Levelling Up, Housing, and Communities (DLUHC) Investment Guidance are no longer relevant to cash-based investments (the guidance now overwhelmingly refers to non-treasury investments), it does adhere to DLUHC guidance to prioritise Security, Liquidity and Yield, in that order.

8. As at 30th November 2023, the Council held nearly £700m of debt as part of the strategy for funding previous years' capital programmes. Of this, £138m is short-term borrowing, mostly due to mature within one year, and primarily borrowed from other Local Authorities. £405.7m is Public Works Loan Board (PWLB) debt, £93m is Lender Option Borrower Option (LOBO) debt, and a further £60.5m of fixed rate bank loans.

9. The Councils investment balance as at 30th November 2023 stood at just over £211m. This includes approximately £85m held for either external bodies, or entities where the Council is the accountable or administering body.

Recommendations

10. The Executive is asked to endorse the following and recommend approval by Full Council on 20th February 2024:

    - To adopt the Treasury Borrowing Strategy and Treasury Investment Strategy for 2024-25 as set out in this report,
    - To adopt the Prudential Treasury Indicators set out in this report, and
    - To adopt Appendix A as part of the Councils Financial regulations.

Reasons for recommendations

11. As the TMS is a key element of the Budget Framework it is considered that it should be presented to Full Council for approval, following detailed review by the Audit Committee (as set out in paragraph 26) and approval by the Council's Executive.

Other options considered

12. None. The adoption of the TMS is a regulatory requirement.

Links to Council Plan and Medium-Term Financial Plan

13. Treasury Management supports the range of business and service level objectives that together help to deliver the Somerset County Plan.

Financial and Risk Implications

14. The budget for investment income in 2024-25 is £6.25m, based on an average investment portfolio of £125m at an average return of 5% (these figures are net of balances held on behalf of third parties). The General Fund budget for debt interest in 2024-25 is £35.7m, based on average borrowing of £740m at an average interest rate of 4.83% (note 5.5% for new debt).

15. There is also additional debt and interest cost charges to the HRA, which are funded mainly from housing rents. If actual levels of investments or borrowing, or actual interest rates, differ from the forecast, performance against budget will be correspondingly different.

16. The debt interest budget includes provision for interest for debt taken under the current Capitalisation Directive, assuming that this is approved. Any debt taken by the Council to finance a Capitalisation Directive must be taken from PWLB and they will charge interest at 1% above published rates.

17. The TMS is the Council's document that sets out strategy and proposed activities to conduct Treasury Management activity while mitigating risks.

Legal Implications

18. Treasury Management must operate within specified legal and regulatory parameters as set out in the summary, and in more detail in the Treasury Management Practices (TMPs).

HR Implications

19. There are no HR implications.

Equalities Implications

20. There are no equalities implications.

Community Safety Implications

21. There are no community safety implications.

Climate Change and Sustainability Implications

22. There are no climate change or sustainability implications.

Health and Safety Implications

23. There are no health and safety implications.

Health and Wellbeing Implications

24. There are no health and wellbeing implications.

Social Value

25. Not applicable

Scrutiny comments / recommendations:

26. The Audit Committee is responsible for ensuring effective scrutiny of the Treasury Management Strategy and policies. It is currently anticipated that this TMS will be presented to the Committee for review on 25 January 2024. The Audit Committee is also responsible for monitoring the implementation of Treasury Management policies and activity, once agreed.

Background papers

- Local Government Act 2003 – Guidance under section 15(1)(a) 3rd Edition, effective from 1 April 2018.
- CIPFA 'Treasury Management in the Public Services' Code of Practice 2021.
- The CIPFA Prudential Code for Capital Finance in Local Authorities 2021.

For sight of individual background papers please contact the report author.

Background and Introduction

27. Treasury Management is the administration of cash flows, borrowing and treasury investments, and the management of associated risks. The Council has significant debt and investment portfolios and is therefore exposed to financial risks including the loss of invested funds and the revenue effect of changing interest rates. Successful identification, monitoring and control of such risks is a key component of sound financial management.

28. Treasury Management at the Council is conducted within the framework of the CIPFA Treasury Management in the Public Services: Code of Practice 2021 Edition (the CIPFA TM Code) which requires the Council to approve a treasury management strategy before the start of each financial year. This

report fulfils the Council’s legal obligation under the Local Government Act 2003 to have regard to the CIPFA TM Code.

29. Within the Code, the section, ‘Prudence in borrowing and investment’ is the key update to the code. It states “legitimate examples of prudent borrowing” as:

- financing capital expenditure primarily related to the delivery of a local authority’s functions.
- temporary management of cash flow within the context of a balanced budget.
- securing affordability by removing exposure to future interest rate rises.
- refinancing current borrowing, including adjusting levels of internal borrowing, to manage risk, reduce costs or reflect changing cash flow circumstances, and
- other treasury management activity that seeks to prudently manage treasury risks without borrowing primarily to invest for financial return.

30. The CIPFA Prudential Code determines that certain acts or practices are not prudent activity for a local authority and incur risk to the affordability of local authority investment. Therefore, in order to comply with the CIPFA Prudential Code, an authority must not borrow to invest primarily for financial return. It is also not considered prudent for local authorities to make any investment or spending decision that will increase the capital financing requirement, and so may lead to new borrowing, unless directly and primarily related to the functions of the authority. Any expected financial return should either be directly related to the financial viability of the project in question or otherwise incidental to the primary purpose of the scheme.

31. Under Section 3 of the Local Government Act 2003 (duty to determine affordable borrowing limit), a Local Council must have regard to the CIPFA Prudential Code. This code requires the setting of a number of Prudential Indicators, benchmarks within which Treasury and Investment Management, and Capital Financing are managed. The setting of Prudential Indicators for Treasury Management requires Authorities to recognise key implications of their borrowing and investment strategies. These relate to the affordability of overall borrowing limits, the maturity structure of borrowing, and longer-term investments.

32. In formulating the Treasury Management Strategy, and the setting of Prudential Indicators, the Council adopts the Treasury Management Framework and Policy recommended by CIPFA. These can be found in **Appendix A**.

External Context

33. The impact on the UK from higher interest rates and inflation, a weakening economic outlook, an uncertain political climate due to an upcoming general election, together with war in Ukraine and the Middle East, will be major influences on the Council's treasury management activity for 2024-25.

34. The Bank of England (BoE) increased Bank Rate to 5.25% in August 2023, before maintaining this through to December. At the December meeting, members of the BoE's Monetary Policy Committee voted 6-3 in favour of keeping Bank Rate at 5.25%. The three dissenters wanted to increase rates by another 0.25%.

35. Office for National Statistics (ONS) figures showed CPI inflation was 3.9% in November 2023, down 0.7% from the previous month and below expectations of 4.3%. Looking ahead, using the interest rate path implied by financial markets, the BoE expects CPI inflation to continue falling, but taking until early 2025 to reach the 2% target.

36. ONS figures showed the UK economy shrank by 0.3% between July and September 2023. The BoE forecasts GDP will likely increase modestly by 0.1% in Q4, a deterioration in the outlook compared to the August Monetary Policy Report (MPR) from the BoE. The BoE forecasts that higher interest rates will constrain GDP growth, which will remain weak over the entire forecast horizon.

37. The labour market appears to be loosening, but only very slowly. The unemployment rate rose slightly to 4.2% between June and August 2023, from 4.0% in the previous 3-month period, but the lack of consistency in the data between the two periods made comparisons difficult. Earnings growth remained strong, with regular pay (excluding bonuses) up 7.8% over the period and total pay (including bonuses) up 8.1%. Adjusted for inflation, regular pay was 1.1% and total pay 1.3%. Looking forward, the MPR showed the unemployment rate is expected to be around 4.25% in the second half of calendar 2024, but then rising steadily over the forecast horizon to around 5% in late 2025 to early 2026.

38. Having increased its key interest rate to a target range of 5.25-5.50% in August 2023, the US Federal Reserve paused in September, November, and December, maintaining the Fed Funds rate target at this level. It is likely this level represents the peak in US rates, but central bank policymakers emphasised that any additional tightening would be dependent on the cumulative impact of rate rises to date, together with inflation and developments in the economy and financial markets.

39. Eurozone inflation has declined steadily since the start of 2023, falling to an annual rate of 2.9% in October 2023. Economic growth has been weak, and GDP was shown to have contracted by 0.1% in the three months to

September 2023. In line with other central banks, the European Central Bank has been increasing rates, taking its deposit facility, fixed rate tender, and marginal lending rates to 3.75%, 4.25% and 4.50% respectively.

40. Although UK inflation and wage growth remain elevated, the Council's treasury management adviser Arlingclose forecasts that Bank Rate has peaked at 5.25%. The Bank of England's Monetary Policy Committee will cut rates in the medium term to stimulate the UK economy but will be reluctant to do so until it is sure there will be no lingering second-round effects. Arlingclose sees rate cuts from Q3 2024 to a low of around 3% by early to mid-2026.

41. Arlingclose expects long-term gilt yields to eventually fall from current levels (amid continued volatility) reflecting the lower medium-term path for Bank Rate. However, yields will remain relatively higher than in the past, due to quantitative tightening and significant bond supply. As ever, there will undoubtedly be short-term volatility due to economic and political uncertainty and events. An economic and interest rate forecast provided by Arlingclose is attached at **Appendix C**.

Local Context

42. As at 30th November 2023 the Council's external long-term debt portfolio stood at just under £700m as in **table 1** below. However, it is expected that there will be a further borrowing need of up to £110m before 31st March 2024. This is because of repaying monies owed to NHS Somerset in December (£42m) refinancing maturing loans (£49m) and reduced Council Tax income in February and March, as many households opt to pay over 10 months.

Table 1 – Debt Portfolios as at 30th November 2023

	HRA Balance £m	HRA Rate %	General Fund Balance £m	General Fund Rate %	Total Balance £m	Total Rate %
Local Authority	0.0	0.0	138.0	4.6	138.0	4.6
PWLB	145.9	2.9	259.9	3.9	405.7	3.6
Fixed rate	0.0	0.0	93.0	4.8	93.0	4.8
LOBOs	3.0	4.3	57.5	4.7	60.5	4.7

Total	**148.9**	**3.6**	**548.3**	**4.3**	**697.2**	**4.0**

43. The underlying need to borrow for capital purposes is measured by the Capital Financing Requirement (CFR), while useable reserves and working capital are the underlying resources available for investment. Statutory guidance is that debt should remain below the CFR, except in the short-term.

44. The investment portfolio set out in **Table 2** below, stood at just over £211m at 30 November 2023, although just over £85m of this total was cash held on behalf of other entities, primarily where Somerset Council is the accountable / administering body.

Table 2 – Investment Portfolios as at 30th November 2023

	Call / Notice A/cs	Money Market Funds	Time Deposits / CDs - Banks	Time Deposits - LAs	Strategic Funds	Total
Balance £m	20.0	69.5	0.0	5.0	116.5	**211.0**
Rate %	5.4	5.4	0.0	4.8	4.8	**5.0**

45. As explained in the Capital Strategy, it is currently estimated that £166.8m of new borrowing will be necessary between 1 April 2024 and 31 March 2027 to finance:

- proposed capital investment plans (£91.7m), and
- the Council's current Capitalisation Direction request to DLUHC (£70.1m).

46. CIPFA's Prudential Code recommends that the Council's total debt should be lower than its highest forecast CFR over the next three years. Although timings of actual cash outflows are not totally predictable, **Table 3** below demonstrates that the Council expects to comply with this recommendation in 2023/24 and in each of the following three financial years.

Table 3 - External Debt and the Capital Financing Requirement (CFR)

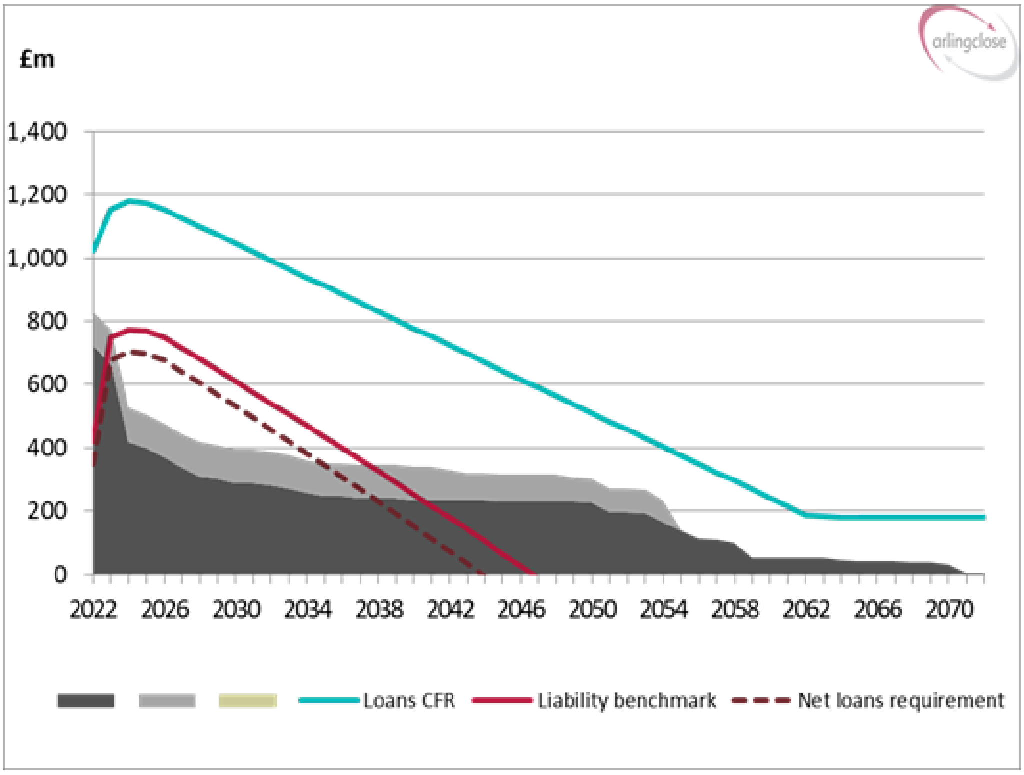
	2023/24 Forecast £m	2024/25 Estimate £m	2025/26 Estimate £m	2026/27 Estimate £m
Gross projected debt	806.9	850.8	902.0	968.7
CFR	1,143.7	1,162.8	1,187.7	1,226.4
Under/(Over) Borrowing	**336.7**	**312.0**	**285.7**	**257.7**

Liability Benchmark

47. To compare the Council's actual borrowing against an alternative strategy, a liability benchmark has been calculated showing the lowest risk level of borrowing. This assumes the same forecasts as **Table 3** above, but that cash and investment balances are kept to a minimum level of £75m to maintain sufficient liquidity but minimise credit risk.

48. Following on from the medium-term forecasts in **Table 3** above, the long-term liability benchmark is shown in the chart below together with the maturity profile of the Council's existing borrowing:

Liability Benchmark Graph



49. The liability benchmark is an important tool to help establish whether the Council is likely to be a long-term borrower or long-term investor in the future, and so shape its strategic focus and decision making. The liability benchmark itself represents an estimate of the cumulative amount of external borrowing the Council must hold to fund its current capital and revenue plans while keeping treasury investments at the minimum level required to manage day-to-day cash flow.

50. The concept is that the chart allows a comparison of current borrowing against the need to borrow, looking at both the amount (on the y axis) and the term (on the x axis). Where actual loans exceed the Liability Benchmark, the authority can make long-term investments for cash flow management or repay loans early; where the Liability Benchmark exceeds loans, the authority can take long-term borrowing or sell investments.

51. There is no requirement to borrow exactly to the Liability Benchmark, but a decision to borrow more or less, or longer or shorter, than the Liability Benchmark implies a deliberate decision to accept additional risk. This may be entirely appropriate if it is accompanied by a reduction in cost, for example through short-term borrowing at lower margins. The Liability Benchmark provides the tool for local authorities to measure this risk and make such risk/reward decisions openly and explicitly.

52. These factors represent significant cash flow, and debt and investment portfolio management for the Council's Officers. In the current financial and economic environment and taking into account potential influencing factors, it is imperative that the Council has strategies and policies in place to manage flows and balances effectively. The strategies and policies herein state the objectives of Treasury Management for the year and set out the framework to mitigate the risks to successfully achieve those objectives.

Borrowing Strategy

53. The Council's need to borrow for capital purposes is determined by the capital programme. Council Members are aware of the major projects identified by the Capital Strategy and the medium-term financial plan (MTFP). The Council currently (as at 22 December 2023) holds £727.2m of loans, as part of its strategy for funding previous years' capital programmes. The forecasts in Table 3 above shows that the Council will have a need to borrow c£166.8m over the next three years.

54. The Council's chief objective when borrowing money is to strike an appropriately low risk balance between securing low interest costs and achieving certainty of those costs over the period for which funds are required. The flexibility to renegotiate loans should the Council's long-term plans change is a secondary objective.

55. Given the significant cuts to public expenditure and in particular to local government funding, the Council's borrowing strategy continues to address the key issue of affordability without compromising the longer-term stability of the debt portfolio. The strategy would therefore be to refinance or take any required new debt whilst balancing the needs of budgets and introducing the least possible risk into the long-term debt portfolio.

56. The key drivers of borrowing strategies will be the detail of the disposal of assets within the non-treasury investment portfolio, and any disinvestment of pooled funds. Therefore, debt for the General Fund will initially be taken mainly in shorter periods, from 1 to 5 years (HRA funding may differ). This will help provide sufficient flexibility so that debt can be paid down as and when non-treasury investments are sold, or holdings in strategic pooled funds are liquidated. Secondly, as interest rates are predicted to fall over the next couple of years, it gives the opportunity to refinance maturing debt at a lower rate.

57. Borrowing rates are expected to remain reasonably level (aside from volatility) in the coming months, before reducing from late 2024 (see forecasts in **appendix C**). It may be most cost effective in the short-term to either use internal resources or to borrow short (1-3 years) via the local authority market. These options will be pursued but might not be too fruitful as capacity for internal borrowing has reduced as investment balances are already

significantly reduced, and many local authorities are cautious about others they lend to because of news of financial issues.

58. The Council has previously raised most of its long-term borrowing from the PWLB or via LOBOs with banks. Current policy is not to take further LOBO loans. The Council will continue to assess alternatives to borrowing long-term loans from other sources including banks, pension funds and local authorities, and may wish to investigate the possibility of issuing bonds and similar instruments, in order to lower interest costs and reduce over-reliance on one source of funding in line with the CIPFA TM Code.

59. The Council may also arrange forward starting loans, where the interest rate is fixed in advance, but the cash is received in later years. This would enable certainty of cost to be achieved without suffering a cost of carry in the intervening period.

60. The use of Call Accounts and Money Market Funds (MMFs) will continue for short-term liquidity; however, it may be appropriate and/or necessary to borrow short-term (1 week to 3 months) to cover cash flow fluctuations. Where this is deemed advantageous, short-term funds will be obtained from the money market using the services of a panel of money market brokers.

Sources of borrowing

61. Approved sources of borrowing are cited in the TMPs. Since PWLB rates were reduced in December 2020, commercial lenders' offerings are less attractive than previously, but this option will still be sought and considered.

62. Variable rate loans currently mitigate the cost of carry. Shorter-dated Equal Instalment of Principal (EIP) loans can be cheaper than loans paid on maturity and are repaid systematically in equal instalments over their life. Both will be actively considered, as will shorter dated loans (1-3 years) from other Local Authorities.

63. No new borrowing will be in the form of LOBOs. Interest rates having risen and there remains a possibility that lenders will exercise their options. The Council will continue with the current policy not to accept any option to pay a higher rate of interest on its LOBO loans and will exercise its own option to repay the loan should a lender exercise an option. This would reduce refinancing risk in later years.

64. The Council will also investigate opportunities to repay where a lender is looking to exit the LOBO by selling the loan. This would be undertaken in conjunction with our treasury advisors. The Council may utilise cash resources for repayment or may consider replacing any loan(s) by borrowing from other sources. Depending on prevailing rates and the amount to be repaid, new loans might be taken over a number of maturities. The 'Maturity Structure of Borrowing' indicators have been set to allow for this contingency strategy.

Debt rescheduling

65. The PWLB allows authorities to repay loans before maturity and either pay a premium or receive a discount according to a set formula based on current interest rates relative to the rate of the loan. Other lenders may also be prepared to negotiate premature redemption terms. The Council may take advantage of this and replace some loans with new loans, or repay loans without replacement, where this is expected to lead to an overall cost saving or a reduction in risk.

66. The rise in interest rates means that more favourable debt rescheduling opportunities may arise than in previous years, however no specific debt rescheduling opportunities are being considered at the present time.

Treasury Investment Strategy

67. There has been a review of all Pooled Funds, and whilst it has been decided to substantially reduce the amalgamated portfolio, it has not yet been definitively decided what, if any holdings it may be appropriate to retain, both in size, and diversification.

68. As minimising debt has been a Council priority during 2023, and the fact that to 1st December about £90m of money held on behalf of the Somerset NHS has been repaid, investment balances have reduced significantly. Total investment balances as at 30th November were just over £211m, of which £116.5 was pooled funds. Cash balances of nearly £95m included just over £85m of cash held on behalf of other entities, £42m of which was repaid in early December.

69. There is little further capacity for passive borrowing, i.e. internal borrowing to fund capital expenditure, and balances are being minimised to provide monthly working capital. It is envisaged that balances will be kept minimal throughout 2024-25 in order to minimise debt.

Objectives

70. The CIPFA Code requires the Council to invest its funds prudently, and to have regard to the security and liquidity of its investments before seeking the highest 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.

71. Where balances are expected to be invested for more than one year, the Council will aim to achieve a total return that is equal or higher than the prevailing rate of inflation, in order to maintain the spending power of the sum invested. The Council aims to be a responsible investor and will consider environmental, social, and governance (ESG) issues when investing.

Strategy

72. As demonstrated by the liability benchmark above, the Council expects to be a long-term borrower and new treasury investments will therefore be made primarily to manage day-to-day cash flows using short-term low risk instruments. As a result of the review of strategic pooled funds, there will be disinvestment from this portfolio. The scale, timing, and identification of individual funds to be sold will depend on market conditions, potential gains or losses, and diversification.

ESG policy

73. ESG (Environmental, Social, and Governance) considerations are increasingly a factor in global investors' decision making, but the framework for evaluating investment opportunities is still developing and therefore the Council's ESG policy does not currently include ESG scoring or other real-time ESG criteria at an individual investment level. The Council will look to develop a more effective ESG policy as this area develops.

Business models

74. Under the new IFRS 9 standard, the accounting for certain investments depends on the Council's "business model" for managing them. The Council aims to achieve value from its internally managed treasury investments by a business model of collecting the contractual cash flows and therefore, where other criteria are also met, these investments will continue to be accounted for at amortised cost.

Implementation

75. The Executive Director Resources and Corporate Services (Section 151 Officer) under delegated powers set out in the Council's Constitution will undertake the most appropriate form of investment management in keeping with the contents of this Strategy following its approval by elected members and in particular with its investment objectives, income and risk management requirements and Prudential Indicators.

76. The Executive Director Resources and Corporate Services (Section 151 Officer) in turn delegates responsibility for implementing this agreed policy to Treasury Management Officers. This is done by using only the agreed investment instruments, and credit criteria below and as set out in **Appendix B**. As is current procedure, the use of a new instrument or counterparty would be proposed in conjunction with the Council's Treasury Advisors, Arlingclose and specifically authorised by the Executive Director Resources and Corporate Services (Section 151 Officer).

Approved Investments

77. The list below shows currently approved instruments, with a brief description of current and potential investment instrument characteristics underneath.

- Business Reserve Accounts and term deposits.
- Deposits with other Local Authorities.
- Low Volatility Net Asset Value (LVNAV) Money Market Funds
- The Debt Management Office (DMO)
- Variable Net Asset Value (VNAV) Money Market Funds.
- Gilts and Treasury Bills.
- Certificates of Deposit with Banks and Building Societies
- Building Societies – Including unrated Societies with better creditworthiness than their credit rated peers.
- Covered Bonds and Reverse Repurchase Agreements (Repos) present an opportunity to invest short-term with banks on a secured basis and hence be exempt from bail-in
- Pooled Funds. As stated previously, holdings in these investments will be reduced rather than added to, but nonetheless are approved for use during the year.

Banks unsecured: Accounts, deposits, certificates of deposit and senior unsecured bonds with banks and building societies, other than multilateral development banks. These investments are subject to the risk of credit loss via a bail-in should the regulator determine that the bank is failing or likely to fail.

Banks secured: Covered bonds, reverse repurchase agreements and other collateralised arrangements with banks and building societies. These investments are secured on the bank’s assets, which limits the potential losses in the unlikely event of insolvency, and means that they are exempt from bail-in.

Government: Loans, bonds and bills issued or guaranteed by national governments, regional and local authorities and multilateral development banks. These investments are not subject to bail-in, and there is generally a lower risk of insolvency, although they are not zero risk. Investments with the UK Central Government may be made in unlimited amounts for up to 50 years.

Pooled Funds: Shares or units in diversified investment vehicles. These funds have the advantage of providing wide diversification of investment risks, coupled with the services of a professional fund manager in return for a fee. Short-term Money Market Funds that offer same-day liquidity and very low or no volatility will be used as an alternative to instant access bank accounts, while pooled funds whose value changes with market prices and/or have a notice period will be used for longer investment periods.

Credit outlook

78. Credit Default Swap (CDS) prices were volatile during 2023, spiking in March on the back of banking sector contagion concerns following the major events of Silicon Valley Bank becoming insolvent, and the takeover of Credit Suisse by UBS. After then falling back in Q2 of calendar 2023, in the second half of the year, higher interest rates and inflation, the ongoing war in Ukraine, and now the Middle East, have led to CDS prices increasing steadily.

79. Moody's revised its outlook on the UK sovereign to stable from negative to reflect its view of restored political predictability following the volatility after the 2022 mini budget. Moody's also affirmed the Aa3 rating in recognition of the UK's economic resilience and strong institutional framework.

80. Following its rating action on the UK sovereign, Moody's revised the outlook on five UK banks to stable from negative and then followed this by the same action on five rated local authorities. However, within the same update the long-term ratings of those five local authorities were downgraded.

81. There remain competing tensions in the banking sector, on one side from higher interest rates boosting net income and profitability against another of a weakening economic outlook and likely recessions that increase the possibility of a deterioration in the quality of banks' assets. However, the institutions on our adviser Arlingclose's counterparty list remain well-capitalised and their counterparty advice on both recommended institutions and maximum duration remain under constant review and will continue to reflect economic conditions and the credit outlook.

Approved counterparties – Credit Rated

82. The Council maintains a restricted list of financial institutions to be used as counterparties, and in accordance with the credit criteria set out in **appendix B**. Any proposed additions to the list must be approved by the Executive Director Resources and Corporate Services (Section 151 Officer).

Approved counterparties – Non-Credit Rated

83. As investment decisions are never made solely based on credit ratings, and some institutions may not have ratings at all, account will be taken of any relevant credit criteria in **appendix B**, and any other relevant factors including advice from our treasury advisors for the approval of individual institutions. Again, this will be specifically authorised by the Executive Director Resources and Corporate Services (Section 151 Officer).

Credit rating

84. The Council has constructed and will maintain a counterparty list based on the criteria set out in **appendix B**. The minimum credit quality is proposed to be set at A- or equivalent. The credit standing of institutions (and issues if used) will be monitored and updated on a regular basis.

85. The Council will continuously monitor counterparties creditworthiness. All three credit rating agencies' websites will be visited frequently, and all ratings of proposed counterparties will be subject to verification on the day of investment (DLUHC guidance states that a credit rating agency is one of Standard & Poor's, Moody's Investor Services Ltd, and Fitch Ratings Ltd). All ratings of currently used counterparties will be reported to the regular treasury management meeting, where proposals for any new counterparties will be discussed.

86. New counterparties must be approved by the Executive Director Resources and Corporate Services (Section 151 Officer) before they are used. Any changes to ratings that put the counterparty below the minimum acceptable credit quality whilst we have a deposit, or a marketable instrument will be brought to the attention of the Executive Director Resources and Corporate Services (Section 151 Officer) immediately, and an appropriate response decided on a case-by-case basis. Sovereign credit ratings will be monitored and acted on as for financial institution ratings. Investment limits are set by reference to the lowest published long-term credit rating from the three rating agencies mentioned above. Where available, the credit rating relevant to the specific investment or class of investment is used, otherwise the counterparty credit rating is used.

Other information on the security of investments

87. The Council understands that credit ratings are good, but not perfect predictors of investment default. Full regard will therefore be given to other available information on the credit quality of the organisations in which it invests, including those outlined below.

- Credit Default Swaps and Government Bond Spreads.
- GDP and Net Debt as a Percentage of GDP for sovereign countries.
- Likelihood and strength of Parental Support.
- Banking resolution mechanisms for the restructure of failing financial institutions, i.e. bail-in.
- Market information on corporate developments and market sentiment towards the counterparties and sovereigns.
- Underlying securities or collateral for 'covered instruments'
- Other macroeconomic factors

88. It remains the Council's policy to suspend or remove institutions that still meet criteria, but where any of the factors above give rise to concern. Also, when it is deemed prudent, the duration of deposits placed is shortened or lengthened, depending on counterparty specific metrics, or general investment factors.

89. The extent of these restrictions will be in line with prevailing financial market conditions. If these restrictions mean that insufficient commercial

organisations of high credit quality are available to invest the Council's cash balances, then the surplus will be deposited with the UK Government via the Debt Management Office or invested in government treasury bills for example, or with other local authorities. This may cause a reduction in the level of investment income earned but will protect the principal sum invested.

Investment limits

90. Investment limits are set out in **appendix B**. In setting criteria in appendix B, account is taken of both expected and possible balances, the availability and accessibility of the various instruments to be used, and their security, liquidity, and yield characteristics.

Liquidity management

91. The Council uses purpose-built cash flow forecasting software to determine the maximum period for which funds may prudently be committed. The forecast is compiled on a prudent basis to minimise the risk of the Council being forced to borrow on unfavourable terms to meet its financial commitments. Limits on long-term investments are set by reference to the Council's medium-term financial plan and cash flow forecast.

Treasury Management Prudential Indicators

92. The Council measures and manages its exposures to Treasury Management risks using specific Prudential Indicators which are set out below and should be adopted as per the recommendations set out in this report:

- The Authorised Limit and Operational Boundary,
- The Maturity Structure of Borrowing,
- Principal sums invested for periods longer than a year, and
- Credit Risk Indicators

93. Other Prudential Indicators which relate primarily to capital investment and capital funding are set out in the Capital Strategy.

Authorised limit and Operational Boundary

94. The Council is required to set an authorised limit and an operational boundary for managing external debt. The authorised limit is the maximum external debt (net of investments) that may be incurred in the specified years. The operational boundary differs from the authorised limit in that it is based on expectations of the maximum external debt according to probable, not all possible events. The operational boundary has been set to be in line with the CFR and is therefore consistent with the maximum level of external debt projected in the Capital Strategy.

*Table 4 – Operational Debt Boundary and Authorised Debt Limit**

	2023/24 limit £m	2024/25 limit £m	2025/26 limit £m	2026/27 limit £m
Operational boundary:				
Borrowing	1,004.4	1,165	1,190	1,230
PFI	79.3	40.0	38.0	35.0
Operational boundary – total debt	1,083.8	1,205	1,228.0	1,265.0
Authorised limit:				
Borrowing	1039.4	1,195	1,220	1,250
PFI	84.3	45.0	43.0	40.0
Authorised limit– total debt	1,123.7	1,240.0	1,263.0	1,290.0

*Includes borrowing for both General Fund and HRA

Maturity Structure of Borrowing

95. The Council has set for the forthcoming year, both the upper and lower limits with respect to the maturity structure of its borrowing. The calculation is the amount of projected borrowing maturing in each period, expressed as a percentage of the total projected borrowing. CIPFA TM Code guidance for the ‘maturity structure’ indicator states that the maturity of LOBO loans should be treated as if their next option date is the maturity date.

96. The ‘maturity structure of borrowing’ indicators have been set with regard to this and having given due consideration to refinancing the significant short-term debt that will mature, possible new borrowing, current interest rate expectations, and the possibility of rescheduling or prematurely repaying loans outlined in the borrowing strategy. The bands and limits give the required flexibility to be able to deliver the borrowing strategy in any of the challenging scenarios that may evolve. The only change to last year is that the >12 months and within 24 months upper limit has been raised by 5%.

97. Proposed limits are:

	Upper Limit	Lower Limit
Under 12 months	50%	15%
>12 months and within 24 months	30%	0%
>24 months and within 5 years	25%	5%
>5 years and within 10 years	25%	0%
>10 years and within 20 years	25%	0%
>20 years and within 30 years	20%	0%
>30 years and within 40 years	30%	10%
>40 years and within 50 years	15%	0%
>50 years	5%	0%

Long-term treasury management investments

98. The purpose of this indicator is to control the Council's exposure to the risk of incurring losses by seeking early repayment of its investments.

99. The prime policy objectives of local authority investment activities are the security and liquidity of funds, and authorities should avoid exposing public funds to unnecessary or unquantified risk. Authorities should consider the return on their investments; however, this should not be at the expense of security and liquidity. It is therefore important that authorities adopt an appropriate approach to risk management with regards to their investment activities.

	2024-25 £m	2025-26 £m	2026-27 £m
Prudential Limit for principal sums invested for periods longer than 1 year	120	120	120

100. Long-term investments with no fixed maturity date include strategic pooled funds but exclude Money Market Funds and bank accounts with no fixed maturity as these are considered short-term. As the combined Council already holds a portfolio of £116.5m of pooled funds, a prudential indicator of slightly more than this amount is deemed necessary for all years, to allow for deposits slightly over 1 year's duration. This should reduce over time, due to disinvestment of this portfolio, but exact amounts and timings are not known at this time. The sums indicated in this indicator do not include any investment in non-Treasury Investments covered by a separate Investment Strategy.

Credit Risk Indicator

101. The Council has adopted a voluntary measure of its exposure to credit risk by monitoring the value-weighted average credit rating / credit score of its in-house investment portfolio. This is calculated by applying a score to each investment (AAA=1, AA+=2, etc.) and taking the arithmetic average, weighted by the size of each investment. Unrated investments are assigned a score based on their perceived risk (in conjunction with Arlingclose) and will be calculated quarterly.

Credit risk indicator	Target
Portfolio average credit rating (score)	A (6.0)

Liability Benchmark

102. A new Prudential Indicator, the Liability Benchmark was introduced in 2023-24. Whilst it gives no specific numbers as benchmarks, it is an important tool to help establish whether the Council is likely to be a long-term borrower or long-term investor in the future, and so shape its strategic focus and decision making. The liability benchmark itself represents an estimate of the cumulative amount of external borrowing the Council must hold to fund its current capital and revenue plans while keeping treasury investments at the minimum level required to manage day-to-day cash flow.

103. The liability benchmark informs both borrowing and investment decisions and is outlined in paragraphs 47-52 above.

Derivative Instruments

104. As part of its published TM strategy, the Council must explicitly state whether it plans to use derivative instruments to manage risks. The general power of competence in Section 1 of the Localism Act 2011 removes much of the uncertainty over local authorities' use of standalone financial derivatives (i.e. those that are not embedded into a loan or investment).

105. At present the Council does not intend to use derivatives. Should this position change, the Council would seek to develop a detailed and robust risk management framework governing the use of derivatives, but this change in strategy will require Full Council approval.

External Service Providers

106. The Code states that the use of external service providers should be reviewed regularly and that services provided are clearly documented, and that the quality of that service is controlled and understood.

107. The Council recognises, as per CIPFA guidance, that, "the overall responsibility for treasury management must always remain with the Council". So as not to place undue reliance on treasury advisors and other external services, the council has always sourced its own information, performed its own analysis of market and investment conditions, and the suitability of counterparties. It continues to do so through embedded practices, thereby maintaining the skills of the in-house team to ensure that services provided can be challenged, and that undue reliance is not placed on them.

Member Training

108. All public service organisations should be aware of the growing complexity of treasury management in general, and its application to the public services in particular. Modern treasury management, and particularly non-treasury investments demand appropriate skills.

109. All Council Members receive introductory training, which includes an overview of the treasury management function. Council Officers would be able and willing to provide a more detailed level of training, if Councillors thought that there would be no conflict of interest.

110. Through contacts with the CIPFA Treasury Management Forum and its independent Treasury Advisors, The Council could also facilitate training via an independent third party. Officers also have contacts within a number of money market brokers and fund managers who could provide training if required. Alternatively, information sheets could be prepared and made available to help keep members abreast of current developments.

Markets in Financial Instruments Directive II (MiFID II)

111. As a result of the second Markets in Financial Instruments Directive (MiFID II), from 3rd January 2018 local authorities were automatically treated as retail clients but could “opt up” to professional client status, providing certain criteria was met. This included having an investment balance of at least £10 million and the person(s) authorised to make investment decisions on behalf of the Council have at least a year’s relevant professional experience. In addition, the regulated financial services firms to whom this directive applies have had to assess that that person(s) have the expertise, experience and knowledge to make investment decisions and understand the risks involved. Each regulated Financial Services firm undertakes a separate assessment with ongoing compliance.

112. The Council continues to meet the conditions to opt up to professional status and has done so in order to maintain its erstwhile MiFID II status prior to January 2018. As a result, the Council will continue to have access to products including money market funds, pooled funds, treasury bills, bonds, shares and to financial advice.

Appendix A

Treasury Management Policy Statement

Introduction and Background

The Council adopts the key recommendations of CIPFA's Treasury Management in the Public Services: Code of Practice (the CIPFA TM Code), as described in Section 5 of the Code.

The Council will create and maintain, as the cornerstones for effective treasury and investment management:

- A treasury management policy statement stating the policies, objectives and approach to risk management of its treasury management activities.
- Suitable treasury management practices (TMPs) setting out the manner in which the organisation will seek to achieve those policies and objectives, and prescribing how it will manage and control those activities.
- Investment management practices (IMPs) for investments that are not for treasury management purposes.

The content of the policy statement, TMPs and IMPs will follow the recommendations contained in Sections 6, 7 and 8 of the CIPFA TM Code, subject only to amendment where necessary to reflect the particular circumstances of this organisation. Such amendments will not result in the organisation materially deviating from the CIPFA TM Code's key principles.

The Council (i.e. Full Council) will receive reports on its treasury and investment management policies, practices and activities, including, as a minimum, an annual strategy and plan in advance of the year, a mid-year review and an annual report after its close in the form prescribed in its TMPs and IMPs.

The Council delegates responsibility for the implementation and regular monitoring of its treasury management policies and practices to Executive and for the execution and administration of treasury management decisions to the Section 151 Officer, who will act in accordance with the organisation's policy statement, TMPs and IMPs, and if they are a CIPFA member, CIPFA's Standard of Professional Practice on treasury management.

This organisation nominates the Audit Committee to be responsible for ensuring effective scrutiny of the treasury management strategy and policies.

Policies and Objectives of Treasury Management Activities

The Council defines its treasury management activities as:

> "The management of the organisation's borrowing, investments and cash flows, including 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."

This Council regards the successful identification, monitoring and control of risk to be the prime criteria by which the effectiveness of its treasury management activities will be measured. Accordingly, the analysis and reporting of treasury management activities will focus on their risk implications for the organisation, and any financial instruments entered into to manage these risks.

This Council acknowledges that effective treasury management will provide support towards the achievement of its business and service objectives. It is therefore committed to the principles of achieving value for money in treasury management, and to employing suitable performance measurement techniques, within the context of effective risk management.

The Council's borrowing will be affordable, sustainable and prudent and consideration will be given to the management of interest rate risk and refinancing risk. The source from which the borrowing is taken, and the type of borrowing should allow the Council transparency and control over its debt.

The Council's primary objective in relation to investments remains the security of capital. The liquidity or accessibility of the Council's investments followed by the yield earned on investments remain important but are secondary considerations.

Appendix B

Somerset Council Lending Counterparty Criteria 2024-25

The following criteria will be used to manage counterparty risks to Somerset Council investments for new deposits / investments from 1st April 2024.

Please note that the limits in this appendix apply only to Treasury Management Investments, not to those detailed in the separate Investment Strategy.

Where deposits held were made under previous criteria, there will be no compulsion to terminate those deposits to meet new criteria, where a penalty would be incurred.

Deposits
Any Financial Institution that is authorised by the Prudential Regulation Authority to accept deposits in the UK or is a UK Building Society can be lent to, subject to the rating criteria below at the time of the deposit.

Unrated Building Societies
Unrated Building Societies as identified by Treasury Advisors can be used, with a maximum of £1m per Society and a maximum maturity of 1 year.

Marketable Instruments – Any bank, other organisation, or security whose credit ratings satisfy the criteria below: -

Rating of Counterparty or Security
<u>Deposits or instruments of less than 13 months duration (refer to long-term ratings)</u>

Fitch A- or above
S&P A- or above
Moody's A3 or above

The maximum deposit / investment amount for any authorised counterparty or security that has as a minimum at least two ratings of the three above will be £15m (Reduced by £5m from 2023-24). This is approximately 5.4% of average investment balances, or 9.4% of average cash balances up to 30th November. The % may be significantly less if borrowing up to the CFR is taken early in the year.

The allowed deposit amounts above are the single maximum per counterparty at any one time, and that counterparty or security must be rated as above or better by at least two of the three agencies. Short-term ratings will be monitored and considered in relative rather than absolute terms.

It remains the Council's policy to suspend or remove institutions that still meet criteria, but where any of the other factors below give rise to concern. Also, when it is deemed prudent, the duration of deposits placed is shortened or lengthened, depending on counterparty specific metrics, or general investment factors. Where deposits held were made under previous criteria, there will be no compulsion to terminate those deposits to meet new criteria, where a penalty would be incurred.

Operational Bank Accounts
As the Council's current bankers, Nat West are currently within the minimum criteria. If they should fall below criteria, the instant access Call Account facility may still be used for short-term liquidity requirements and business continuity arrangements. This will generally be for smaller balances where it is not viable to send to other counterparties or in the event of unexpected receipts after the daily investment process is complete. Money will be placed in the instant access Nat West call account overnight.

Public Sector Bodies
Any UK Local Authority or Public Body will have a limit of £10m (Reduced by £5m from 2023-24) and a maximum maturity of 2 years.

The UK Government, including Gilts, T-Bills, and the Debt Management Office (DMADF) will be unlimited in amount and duration.

The table below gives a definition and approximate comparison of various ratings by the three main agencies: -

Definitions of Rating Agency Ratings

	Fitch		Moody's		S&P	
Short-Term	**F1+**	Exceptionally strong	**P-1**	Superior	**A-1+**	Extremely strong
	F1	Highest quality			**A-1**	Strong
	F2	Good quality	**P-2**	Strong	**A-2**	Satisfactory
	F3	Fair quality	**P-3**	Acceptable	**A-3**	Adequate
	B	Speculative	**NP**	Questionable	**B and below**	Significant speculative characteristics
	C	High default risk				
	(+) or (-)		**(1,2, or 3)**		**(+) or (-)**	
Long-Term	**AAA**	Highest quality	**Aaa**	Exceptional	**AAA**	Extremely strong
	AA	V High quality	**Aa**	Excellent	**AA**	Very strong
	A	High quality	**A**	Good	**A**	Strong
	BBB	Good quality	**Baa**	Adequate	**BBB**	Adequate capacity
	BB	Speculative	**Ba**	Questionable	**BB and below**	Significant speculative characteristics
	B	Highly Speculative	**B**	Poor		
	CCC	High default risk	**Caa**	Extremely poor		

Financial Groups
For Financial Groups (where two or more separate counterparties are owned by the same eventual parent company) investments can be split between entities, but an overall limit equal to the highest rated constituent counterparty within the group will be used.

Country Limits
Excluding the UK, there will be a limit of £20m collectively to all organisations domiciled in one Sovereign Country (Reduced by £10m from 2023-24). This is approximately 7.2% of average investment balances, or 12.6% of average cash balances up to 30th November. The % may be significantly less if borrowing up to the CFR is taken early in the year.

Money Market Funds
Any LVNAV Money Market Fund used must be rated by at least two of the main three ratings agencies and must have the following ratings.

Fitch AAAmmf	Moody's Aaa-mf	Standard & Poor's AAAm

Subject to the above, deposits can be made with the following limits: -
The lower of £15m or 0.5% of the total value for individual Funds.

VNAV and other Pooled Funds
As a result of the review of strategic pooled funds, there will be disinvestment from this portfolio. The scale, timing, and identification of individual funds to be sold will depend on market conditions, potential gains or losses, and diversification.

It may be decided that a percentage of pooled funds are retained to provide diversification should cash interest rates fall significantly again. Whilst it is difficult to state absolute or percentage limits at present, amounts would be in relation to core balances and reserves and will be significantly below levels currently held.

Other Indicators
The Council will continue to use a range of indicators, not just credit ratings. Among other indicators to be taken into account will be:

- Credit Default Swaps and Government Bond Spreads.
- GDP, and Net Debt as a Percentage of GDP for sovereign countries.
- Likelihood and strength of Parental Support.
- Banking resolution mechanisms for the restructure of failing financial institutions, i.e. bail-in.
- Share Price.
- Market information on corporate developments and market sentiment towards the counterparties and sovereigns.
- Underlying securities or collateral for covered instruments.
- Other macroeconomic factors

Appendix C

Arlingclose Economic Outlook & Interest Rate Forecast

Interest rate forecast

The MPC held Bank Rate at 5.25% in December. We believe this is the peak for Bank Rate.

The MPC will cut rates in the medium term to stimulate the UK economy but will be reluctant to do so until it is sure there will be no lingering second round effects. We see rate cuts from Q3 2024 to a low of around 3% by early to mid-2026.

The immediate risks around Bank Rate have become more balanced, due to the weakening UK economy and dampening effects on inflation. This shifts to the downside in the short term as the economy weakens.

Long-term gilt yields are now substantially lower. Arlingclose expects yields to be flat from here over the short-term reflecting medium term Bank Rate forecasts. Periodic volatility is likely.

	Current	Dec-23	Mar-24	Jun-24	Sep-24	Dec-24	Mar-25	Jun-25	Sep-25	Dec-25	Mar-26	Jun-26	Sep-26
Official Bank Rate													
Upside risk	0.00	0.25	0.50	0.50	0.75	0.75	0.75	0.75	0.75	0.75	0.75	1.00	1.00
Central Case	5.25	5.25	5.25	5.25	5.00	4.75	4.25	4.00	3.75	3.50	3.25	3.00	3.00
Downside risk	0.00	0.00	-0.25	-0.50	-0.75	-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	0.25	0.50	0.50	0.75	0.75	0.75	0.75	0.75	0.75	0.75	1.00	1.00
Central Case	5.40	5.40	5.40	5.30	5.15	4.80	4.30	4.10	3.80	3.50	3.25	3.05	3.05
Downside risk	0.00	0.00	-0.25	-0.50	-0.75	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00
5yr gilt yield													
Upside risk	0.00	0.50	0.70	0.70	0.85	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Central Case	4.28	4.35	4.30	4.25	4.10	4.00	3.75	3.50	3.40	3.30	3.30	3.30	3.35
Downside risk	0.00	-0.55	-0.75	-0.85	-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	0.50	0.70	0.70	0.80	0.90	1.00	1.10	1.20	1.20	1.20	1.20	1.20
Central Case	4.32	4.40	4.35	4.30	4.25	4.15	4.00	3.80	3.75	3.65	3.60	3.65	3.70
Downside risk	0.00	-0.55	-0.75	-0.85	-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	0.50	0.70	0.70	0.80	0.90	1.00	1.10	1.20	1.20	1.20	1.20	1.20
Central Case	4.78	4.70	4.65	4.55	4.45	4.35	4.25	4.25	4.25	4.25	4.25	4.25	4.25
Downside risk	0.00	-0.55	-0.75	-0.85	-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	0.50	0.70	0.70	0.80	0.90	1.00	1.10	1.20	1.20	1.20	1.20	1.20
Central Case	4.38	4.30	4.25	4.20	4.15	4.15	4.10	4.10	4.10	4.10	4.10	4.10	4.10
Downside risk	0.00	-0.55	-0.75	-0.85	-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%
UKIB Rate (Maturity Loans) = Gilt yield + 0.60%

Underlying assumptions

UK inflation and wage growth remain elevated but have eased over the past two months fuelling rate cuts expectations. Near-term rate cuts remain unlikely, although downside risks will increase as the UK economy likely slides into recession.

The MPC's message remains unchanged as the Committee seeks to maintain tighter financial conditions. Monetary policy will remain tight as inflation is expected to moderate to target slowly, although some wage and inflation measures are below the Bank's last forecasts.

Despite some deterioration in activity data, the UK economy remains resilient in the face of tighter monetary policy. Recent data has been soft but mixed; the more timely PMI figures suggest that the services sector is recovering from a weak Q3. Tighter policy will however bear down on domestic and external activity as interest rates bite.

Employment demand is easing. Anecdotal evidence suggests slowing recruitment and pay growth, and we expect unemployment to rise further. As unemployment rises and interest rates remain high, consumer sentiment will deteriorate. Household and business spending will therefore be weak.

Inflation will fall over the next 12 months. The path to the target will not be smooth, with higher energy prices and base effects interrupting the downtrend at times. The MPC's attention will remain on underlying inflation measures and wage data. We believe policy rates will remain at the peak for another 10 months, or until the MPC is comfortable that the risk of further 'second round' effects has diminished.

Maintaining monetary policy in restrictive territory for so long when the economy is already struggling, will require significant loosening in the future to boost activity.

Global bond yields will remain volatile. Markets are currently running with expectations of near-term US rate cuts, fuelled somewhat unexpectedly by US policymakers themselves. Term premia and bond yields have experienced a marked decline. It would not be a surprise to see a reversal if data points do not support the narrative, but the current 10-year yield appears broadly reflective of a lower medium-term level for Bank Rate.

There is a heightened risk of fiscal policy and/or geo-political events causing substantial volatility in yields.