The Public Sector Deposit Fund Advisory Board

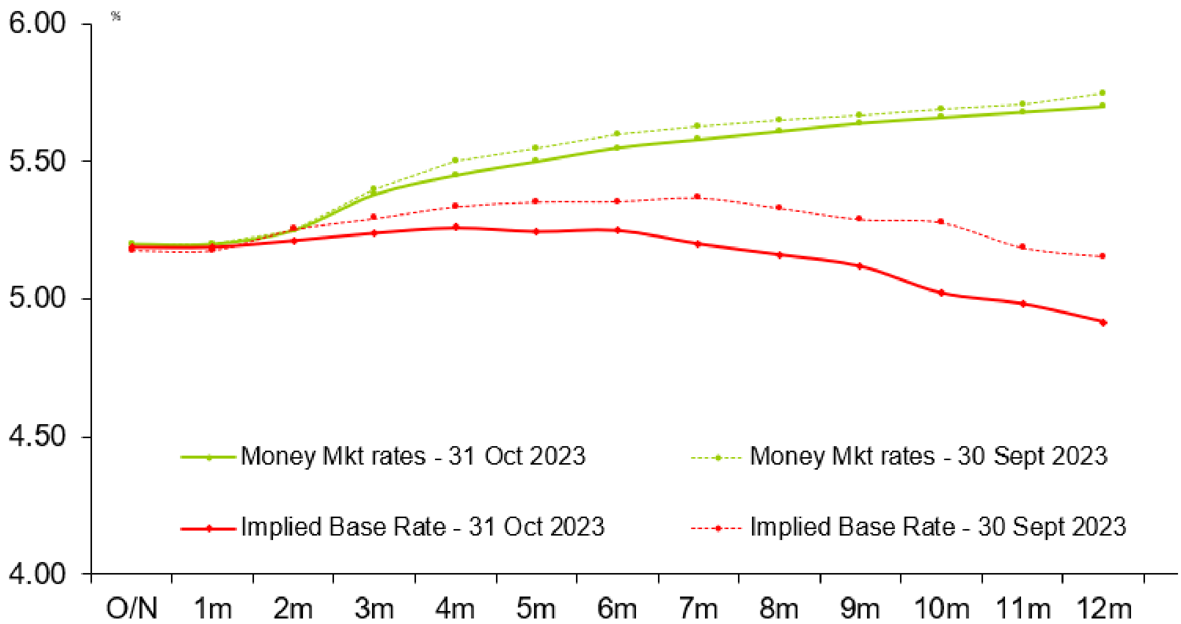
Market Overview

Summary

- **At both the September and November meetings the Bank of England's (BoE) Monetary Policy Committee (MPC) decided to hold rates at 5.25%. The decision was very close in September, Committee members voted 5-4 for the unchanged policy, this split became 6-3 in November.**
- **CPI index has dropped to 4.6% in October, down from 6.7% in September. That's the lowest rate of price increases in two years and means inflation has more than halved since late last year.**
- **Vacancies are continuing to fall as the economy struggles, while real pay is rising at the fastest rate in two years.**
- **UK growth flatlines as money supply growth turned negative for the first time since 2010.**
- **No further money market fund regulation update – though the joint HM Treasury/BoE/FCA Consultation Paper is expected imminently.**
- **Metro Bank agrees a £325mn financing deal that will give the UK challenger bank some breathing space and fill a capital hole that had prompted talks with regulators.**
- **Jes Staley, the former Barclays boss, has received the first regulatory ban for actions taken as chief executive of a major UK bank.**

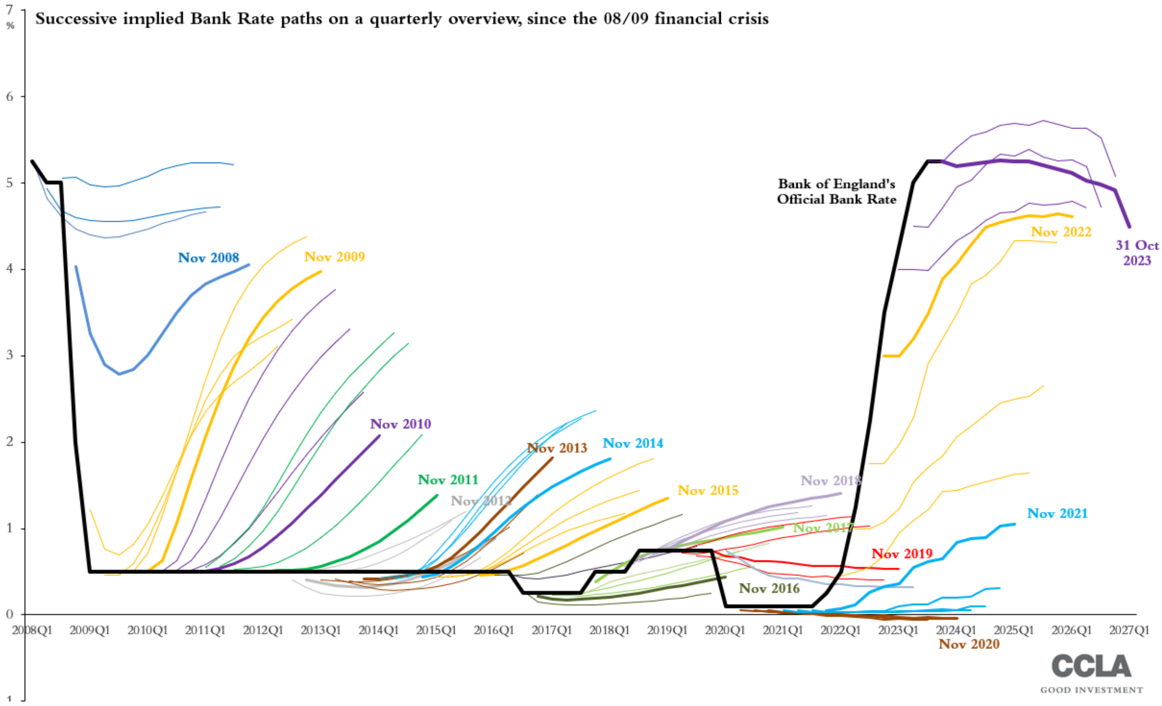
(A) Money Market Overview

Money market rates drop further, as the long end begins to price rate cuts



Source: CCLA/Bloomberg

The market has priced in the peak in the tightening monetary policy



- After introducing the "Table Mountain" profile in August, much of the focus over recent weeks has been on how much of a tabletop Table Mountain might actually have. Over recent weeks there has been mixed messages from different central bankers. BoE Governor Andrew Bailey, speaking in early November, was clear in his message that it was "too early to be talking about cutting rates", and that the MPC was "very clear" that it was not focused on potential interest rate cuts, as well as dismissing market forecasts of reductions to rates by the middle of next year. Bailey added that "Policy is going to have to be restrictive for an extended period".

  This message was perceived as a response to BoE Chief Economist Huw Pill's comments earlier in the same week, that it was "not unreasonable" for markets to expect a cut in Bank Rate (OBR) by the summer, assuming there was no significant change in trajectory for the economy.

Monetary Policy Update

- The BoE left Bank Rate at 5.25% in November, in line with City economist expectations and market pricing. We believe 5.25% marks the peak of the policy tightening cycle, though the BoE's 'Table Mountain' guidance still requires wage inflation to be under control in the new year.

  November's vote was 6-3, in line with expectations, with the hawkish dissenters backing +25bp to address persistent inflation risks. The new MPC appointee, Sarah Breeden, debuted by voting with the majority for no change.

  BoE policy guidance was little altered and continues to be framed in one-directional terms: 'Further tightening in monetary policy would be required if there were evidence of more persistent inflationary pressures'. The word 'extended' was added to the guidance on how long rates would remain restrictive, though the Governor stated in the press conference that this was not an attempt to alter market pricing around the timing of rate cuts, but merely to reinforce that the MPC is not presently discussing rate cuts.

- The November Monetary Policy Report (MPR) forecasts saw only modest revisions, as expected. On a constant rates projection (Bank Rate at 5.25%), the mean CPI forecast is essentially unaltered at 2 years (1.97%) and slightly lower at 3 years (1.57%). On the market rates projection – which incorporates rate cuts from Q4 2024 – the mean CPI projection is marginally above target at 2 years (2.25%) but marginally below at the 3-year horizon (1.91%).

- The BoE also decided to increase its quantitative tightening (QT) from £80 billion to £100 billion next year. QT is the opposite of quantitative easing (QE), which the BoE used to buy government bonds and other assets in order to stimulate the economy during the financial crisis and the pandemic. The BoE's decision to increase the pace of QT is a significant step, but they believe it is a necessary one in order to bring inflation back down to its target.

<u>Other Economic News</u>

- The CPI index dropped to 4.6% in October, below the consensus view of 4.7% and down from 6.7% in September. As expected, the decline follows the drop in energy bills after Ofgem lowered the cap on household bills. But, although inflation has dropped, prices are still rising compared with a year ago. On a monthly basis, CPI did not change in October. That means prices were flat compared with a rise of 2.0% in October 2022 when energy prices were surging.

  The ONS said:

  Gas costs fell by 31.0% in the year to October 2023, compared with a rise of 1.7% in September. This is the lowest annual rate since records began in January 1989.

  Electricity costs fell by 15.6% in the year to October 2023, compared with a rise of 6.7% in September. This is the lowest annual rate since records began in January 1989.

  The pace of price rises for food and non-alcoholic beverages also fell sharply in October but was still in double-digits. The annual inflation rate for food and non-alcoholic beverages dropped to 10.1% in October 2023, down from 12.2% in September. That's an improvement on the recent high of 19.2% hit in March 2023 (the highest annual rate seen for over 45 years).

  Encouragingly, core inflation in the UK has fallen, although not by as much as the headline rate of consumer prices. Core CPI, which strips out energy, food, alcohol and tobacco, rose by 5.7% in the 12 months to October, down from 6.1% in September. The ONS also reports that goods inflation dropped to just 2.9%, from 6.2%. That was mainly due to cheaper energy.

  Importantly for the BoE, services inflation dropped to 6.6% from 6.9%. The Bank had expected the gauge to remain unchanged. For context, the 2000-2019 average was 3.3%. Bloomberg estimate the BoE's measure of core services, which strips out airfares, education and package holidays, cooled to 6.6% in October, from 7% previously.

All of the big energy-related base effects are now behind us, so it is likely headline inflation will ease more gradually over the coming year. Food price inflation should continue to fall as supermarkets pass on the gains from lower commodity and energy prices to consumers. But core inflation is likely to remain sticky given the strength of wage growth. As a result, we don't see headline inflation returning to the BoE's 2% target until late-2024/early-2025.

What the inflation rate drop also means is that Bank Rate (at 5.25%) is higher than the CPI inflation rate for the first time since mid-2016.

- UK labour market figures show a largely unchanged picture, with the proportions of people who are employed, unemployed or who are neither working nor looking for a job all little changed on the previous quarter. The number of job vacancies fell for the 16th straight month. Nevertheless, vacancies still remain well above their pre-pandemic levels. With inflation easing in the latest quarter, real pay is now growing at its fastest rate for two years.

  The number of payrolled employees in the UK is estimated to have increased by 33,000 in October, to 30.2 million, well above consensus expectations for a 17,000 drop. September's figures have been revised too – to show an increase of 32,000, not the decrease of 11,000 first reported. Vacancies continued to fall, totalling 957,000 on a three-month basis in October. That compares with a peak of around 1.3 million in mid-2022 and leaves job openings closer to their 2016-19 average of 800,000.

  Whole-economy regular wage growth, measured by Average Weekly Earnings (AWE), dropped to 7.7% in the three months to September, from 7.9% previously. Annual average regular pay growth for the public sector was 7.3% in July to September 2023 and is the highest regular annual growth rate since comparable records began in 2001; for the private sector this was 7.8% and among the largest annual growth rates seen outside of the pandemic period.

Overall, labour market conditions are loosening, but only very gradually, and wage growth is slowly easing, but the pace remains well above that consistent with the BoE's inflation target. As things stand, the labour market offers no reason for the MPC to return to hiking rates, but equally, little cause for near-term cuts. In response to these numbers, BoE Chief Economist warned that UK wages are growing too fast to be consistent with its 2% inflation target.

- The latest UK gross domestic product (GDP) data saw that the economy had flatlined in the third quarter of 2023, this defied market forecasts of a modest contraction, and ensured that a recession would be avoided for the calendar year. The ONS said that:

    - UK GDP is estimated to have shown no growth in Quarter 3 (July to Sept) 2023, following an increase of 0.2% in the previous quarter.

    - GDP is estimated to have increased by 0.6% in Quarter 3 2023 compared with the same quarter a year ago.

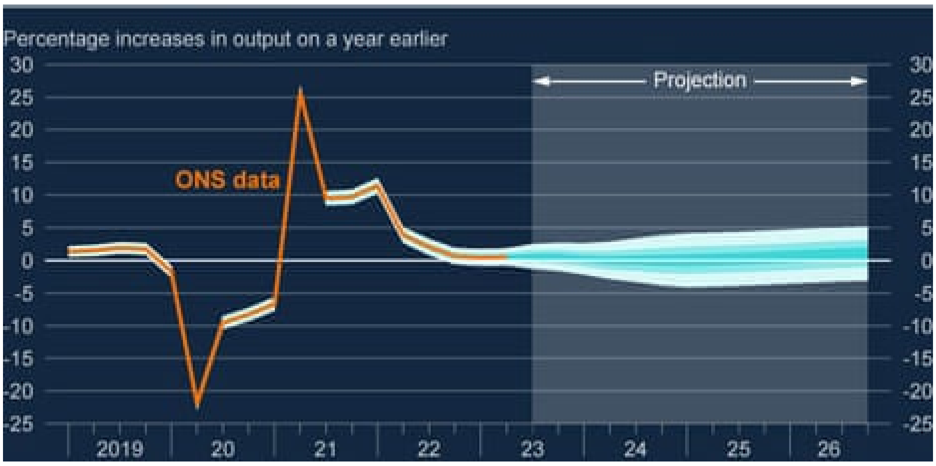
    - In output terms there was a 0.1% fall in the services sector, which offset a 0.1% increase in construction output and broadly flat output in the production sector.

    - In expenditure terms, an increase in the volume of net trade was offset by falls in business investment, household spending and government consumption.

    - In September alone, the economy grew by 0.2%, better than the 0% growth expected.

    - But August's GDP data has been revised down to show growth of just 0.1%, not the 0.2% growth previously estimated.

  The Bank of England's monetary policy report contains this depressing graph, predicting stagnation for the UK economy for more than a year:



- Shrinking real money growth could mean a recession. According to the BoE, UK money supply growth turned negative for the first time since 2010, when comparable data collection began, as higher interest rates weigh on lending. The annual growth in the amount of money in the UK economy, a measure known as M4ex, fell to minus 0.6% in August, marking the first contraction since the data series was launched. The contraction reflects the impact of higher borrowing costs to quell high inflation. August's fall in broad money growth followed a decline in the rate since late last year. The figures suggest higher interest rates are working by reducing households' and firms' demand for borrowing, which should lead to softer activity and lower inflation.

(B) <u>An update on European Money Market Fund reform</u>

No further money market fund regulation update – the joint HM Treasury/BoE/FCA Consultation Paper is expected imminently.

(C) <u>Sarah Breeden appointed deputy Bank of England governor</u>

Sarah Breeden, a senior Bank of England official, succeeded Sir Jon Cunliffe as the central bank's deputy governor for financial stability in November. The five-year appointment means Breeden will lead the BoE's work on financial stability, chairing its Financial Policy Committee, which recommends actions to tame risks in the financial sector, in the governor's absence. She will also sit on the Monetary Policy Committee and on the Prudential Regulation Committee.

Breeden takes the role at a time of heightened financial stability risk in the UK. The sharp rise in interest rates threatens eventually to hit the banking system with higher defaults as fixed-rate mortgages expire and as households run down their savings to cushion against the higher cost of living.

Officials are also concerned about risks for hedge funds, pension funds, private equity and other volatile corners of markets where prices have risen sharply and asset owners have borrowed heavily.

Breeden's views on monetary policy are unknown. In her role as executive director for financial stability strategy and risk, she has spearheaded the BoE's work around so-called shadow banks — institutions spanning everything from investment funds to hedge funds and crypto — including the first markets stress test, which her team is leading.

She has also headed efforts to build resilience in the pensions industry following the crisis in liability-driven investment funds following the "mini" Budget last autumn and she has led the BoE's domestic and international work on climate change.

(D) <u>Director of CAF to head UK deposit protection scheme</u>

A director of a UK charities bank, CAF Bank, is set to be named as the next boss of the institution that safeguards government guaranteed deposits in failed banks. Martyn Beauchamp, a non-executive director of CAF Bank, has been put forward as interim chief executive of the Financial Services Compensation Scheme.

CAF Bank amassed paper losses on its bond portfolio big enough to wipe out three quarters of its regulatory capital. CAF's owner, Charities Aid Foundation, offered £15mn in new debt to shore up the bank's finances in early August. Beauchamp has been a director at the bank since 2017. FSCS chair Marshall Bailey is due to step down in April 2024; the timeline allows his successor to find the permanent chief executive. He is set to take over the FSCS as the government weighs measures to increase the level of protection of bank deposits from £85,000 and introduce other changes for the UK's regime for dealing with failed banks in the aftermath of the collapse of Silicon Valley Bank's UK arm last March.

(E) Bank and Counterparty News

a. September 2023

- Norway's $1.4tn sovereign wealth fund has become the biggest shareholder in **UBS**, as the Swiss lender tries to win over international investors to the benefits of its historic takeover of **Credit Suisse**. Norges Bank Investment Management, which runs the world's biggest sovereign wealth fund, increased its stake in UBS to above 5% this month, having been a shareholder in the group for almost 20 years. UBS executives have come under pressure over the past six months to prove to investors that they can make a success of the $3.4bn state-orchestrated rescue of former rival Credit Suisse. Many big fund managers are focused on how well UBS negotiates a complex integration process and how early it restarts shareholder returns. NBIM, which was already a top-10 UBS shareholder, has overtaken US investors Dodge & Cox and BlackRock to become the largest investor, according to S&P Capital IQ. NBIM was also a top-10 investor in Credit Suisse when it collapsed in March, but had been selling down its stake.

- Banks in Singapore are stepping up scrutiny of customers from a range of countries including China and intensifying efforts to identify the sources of wealth as the city-state reels from a ballooning S$2.4bn (US$1.8bn) money-laundering scandal. Financial institutions have warned customers and their advisers that the waiting period to open a private banking account has increased from less than one month to three to four, according to wealth advisers, asset managers and private bankers. Some existing accounts are being closed. The longer processing times are not an official rule change, but a reflection of authorities tightening due diligence across the financial sector after a transnational money laundering syndicate was exposed in August. The institutions are focusing on customers from countries including China, Vanuatu, Turkey, St Kitts and Nevis, Dominica and Cyprus. "If you have a People's Republic of China passport, or possess a passport from any of the countries the suspects involved in the probe had, such as Cyprus, Vanuatu or Cambodia, you are getting red-flagged," said one adviser in private banking. Singapore police last month arrested and charged 10 people and have seized more than S$2.4bn in assets including luxury properties, gold bars, designer handbags, cash, crypto assets and cars in one of the city-state's largest-ever money-laundering probes. The suspects, who have been denied bail, all had Chinese passports. Many were also in possession of additional passports. The probe has widened to include banks, precious metals dealers, real estate agents and golf clubs.

- **JPMorgan's** UK bank will stop customers buying cryptocurrencies from next month to combat rising numbers of criminals using digital assets to target victims. The ban by **Chase UK** marks a step up as British lenders try to stop their networks being used for scams and frauds. While several banks, including **HSBC** and **NatWest**, have set restrictions on their customers' purchases for crypto, outright bans are rare. Chase said its UK block, which will come into effect from 16 October, had been informed by data showing the high rate of crypto scams and fraud in the UK, including fake investments and false celebrity endorsements. Crypto-related fraud losses increased more than 40% in the year to March 2023, surpassing £300mn for the first time, according to data from fraud reporting agency Action Fraud. One senior banker estimated that between 20 and 25% of transactions sent from their customers' accounts to cryptocurrency firms were related to fraud. "We've seen an increase in the number of crypto scams targeting UK consumers, so we have taken the decision to prevent the purchase of crypto assets on a Chase debit card or by transferring money to a crypto site from a Chase account," the bank said. Although Chase UK's move is not part of a group-wide policy, JPMorgan said in 2018 that it would prohibit customers from purchasing cryptocurrencies with credit cards.

- **HSBC's** head of public affairs is stepping down, weeks after making a public apology for saying the UK government had been "weak" by curtailing its dealings with China because of pressure from the US. Sherard Cowper-Coles, an outspoken former British ambassador to Saudi Arabia, will leave the bank this month. He apologised in September for saying at a private event in London that the UK should follow its own interests when it comes to China, rather than simply accept the US's position. Bloomberg first reported his departure. Cowper-Coles, who also chairs lobby group the China-Britain Business Council, said last month that he made the comments in a personal capacity. The CBBC did not immediately respond to questions about whether he would remain in the role. After his speech came to light, HSBC chair Mark Tucker raised questions about Cowper-Coles's behaviour and the bank insisted that chief executive Noel Quinn's office approve all subsequent travel and speaking engagements. The comments from one of its most senior figures - who advises the chair and chief executive - put HSBC in an embarrassing position at a time when its network straddling twin bases in London and Hong Kong is becoming tougher to navigate as geopolitical tensions rise.

<u>October 2023</u>

- **UBS** has settled with the government of Mozambique over Credit Suisse's involvement in a £2bn alleged "tuna bond" fraud that wrecked the country's finances, just before a trial was due to start in London. Credit Suisse and Mozambique "have mutually released each other from any liabilities and claims" related to loans and bond issues arranged for the country in 2013, UBS said. The loans were ostensibly to fund projects including a state tuna fishery but later collapsed into default over the alleged looting of hundreds of millions of dollars. The borrowing had been partly concealed from the IMF and other donors, who cut support to the country after the loans were discovered. UBS, which has been working to clear a mountain of legacy legal issues at Credit Suisse, will not pay any cash under the settlement, according to people familiar with the details. Mozambique had claimed ahead of a three-month trial that Credit Suisse and other defendants ignored the looting of hundreds of millions of dollars from the "tuna bond" loans in bribes and kickbacks. The country was seeking $1.5bn in damages, including for economic losses after the IMF and international donors pulled their funding. "The parties are pleased to have resolved this long-running dispute stemming from events occurring a decade ago," UBS said. Credit Suisse has already paid $475mn in fines and forgave $200mn of Mozambican debts in a 2021 settlement with four regulators in three countries over the scandal.

- **Metro Bank** has struck a financing deal that will give the UK challenger bank breathing space and fill a capital hole that had prompted talks with regulators. The package announced after a weekend of negotiations includes a £325mn capital raise, split between £150mn of fresh equity from Metro's largest shareholders and £175mn of new debt from bondholders. Metro's biggest shareholder — Colombian billionaire Jaime Gilinski Bacal — is due to contribute £102mn of the new equity, giving him a 53% stake in the bank once the deal is completed. Gilinski has a record in Latin America of buying banking assets cheaply and turning them into acquisition vehicles. Chief executive Dan Frumkin said that the deal offered Metro "a bit more fuel in the tank" for growth and said the bank would stick to its branch-based approach at a time when rivals have shut thousands of branches. "There's nothing wrong with the Metro business model — it has a huge potential to deliver for all stakeholders," Frumkin told analysts. "With the capital we've just obtained, we're very confident in where we go next." Shares in Metro climbed 10% in early trading after the deal, but remain down more than 60% this year. Metro's financing package also includes £600mn of debt refinancing, which will involve holders of Metro's riskier tier 2 bonds taking a 40 to 45% haircut on their investments. The bank said it was still in discussions about selling off as much as £3bn in residential mortgages, a move that could further improve its capital position. A £3bn sale would reduce its risk-weighted assets by about £1bn, Metro said. The Financial Times reported that **NatWest**, **Santander, HSBC, JPMorgan** and **Lloyds Banking Group** were all considering bids for some of the bank's assets after the Bank of England contacted lenders to see if they were interested in buying Metro. However, in the absence of sweeteners from the UK government or regulators the banks ruled out a bid.

- Jes Staley, the former **Barclays** boss, has received the first regulatory ban for actions taken as chief executive of a major UK bank after he allegedly misled the watchdog about his past relationship with Jeffrey Epstein.

  The FCA said it would ban Staley from holding senior positions in financial services, and fine him £1.8m, for "recklessly approving . . . two misleading statements about the nature of his relationship" with deceased sex offender Epstein, with whom he had close ties during his time at **JPMorgan Chase**, before he joined the UK bank. Barclays said in light of the FCA decision, Staley would have to forfeit as much as £17.8mn in deferred bonuses that it had frozen. "A CEO needs to exercise sound judgment and set an example to staff at their firm. Mr Staley failed to do this," the FCA said in a statement. "We consider that he misled both the FCA and the Barclays board about the nature of his relationship with Mr Epstein."

  Banking supervisors concluded that "we cannot rely on him to act with integrity by disclosing uncomfortable truths about his close personal relationship with Mr Epstein". Staley said he was "disappointed" by the FCA decision and that he would appeal against it. He has referred the case to the Upper Tribunal, which is overseen by an independent judge and hears challenges to FCA penalties. "If I had known who Jeffrey Epstein really was, there is absolutely no doubt that I wouldn't be in the position I am in today," Staley said in a statement. "Prior to undertaking my former role, it was known that I had had a relationship with Epstein."

  The FCA will now have to prove its case at the Upper Tribunal, which has previously overturned regulatory bans of individuals. Sara George, a lawyer at Sidley Austin, said the FCA "has to prove Mr Staley is not fit and proper. He does not have to prove that he is." The action is the second time that Staley's fitness to run the British lender has been questioned under the UK's senior managers regime, which was introduced in 2016 to hold executives personally accountable for failings. He was criticised and fined £642,000 in 2018 after he repeatedly tried to identify a whistleblower, against the advice of colleagues and in breach of the bank's rules.

- **UniCredit** has struck its first deal since veteran banker Andrea Orcel took the helm of the Italian lender in 2021, offering to buy a 9% shareholding in Greece's **Alpha Bank** and taking a majority stake in its Romanian unit. The acquisition of the stake in Alpha Bank, which the Greek state must approve, would mark the first investment in a Greek lender by another European bank since before the financial crisis plunged the country's banking sector into turmoil. UniCredit has offered to buy the shares from the Hellenic Financial Stability Fund, the country's bank recapitalisation fund set up during the sovereign debt crisis.