Subject:	**TREASURY MANAGEMENT QUARTER TWO REPORT 2016/17**
Meeting and Date:	**Governance – 1st December 2016**
Report of:	**Mike Davis – Director of Finance, Housing & Community**
Portfolio Holder:	**Councillor Mike Connolly – Portfolio Holder for Corporate Resources and Performance**
Decision Type:	**Non-Key Decision**
Classification:	**Unrestricted**
Purpose of the report:	To provide details of the Council's treasury management for the quarter ended 30 September 2016 (Q2) and an update of activity to date.
Recommendation:	That the report is received

1. Summary

The Council has remained within its Treasury Management and Prudential Code guidelines during the period.

The Council's investment return for the quarter was 0.60% (YTD), which outperformed the benchmark[1] by 0.32% although this return is expected to reduce slightly by the year-end as interest rates on new and rolled over deposits come down. However, the Council's budgeted investment return for 2016/17 is £329k, and performance for the full year is estimated to be £335k, which is slightly ahead of budget. This takes into account expected reductions in interest rates on assumed rollover of term deposits on maturity, but not any further reduction in the bank base rate which could impact performance by the end of year.

2. Introduction and Background

CIPFA (the Chartered Institute of Public Finance and Accountancy) issued the revised Code of Practice for Treasury Management in November 2009; it recommends that members should be updated on treasury management activities at least twice a year, but preferably quarterly. This report therefore ensures this council is implementing best practice in accordance with the Code.

Council adopted the 2016/17 Treasury Management Strategy (TMS) on 2nd March 2016 as part of the 2016/17 Budget and Medium Term Financial Plan. The Treasury Management Strategy (TMS) for 2016/17 was approved by Council as part of its MTFP on 2nd March 2016. An update of the TMS was approved at Council on 28th September 2016, with a further version being considered by Cabinet and Council on 21st and 30th November respectively to increase borrowing limits for the purpose of property investment.

[1] The "benchmark" is the interest rate against which performance is assessed. DDC use the London Inter-Bank Bid Rate or LIBID, as its benchmark.

In order to comply with the CIPFA code referred to above a brief summary is provided below and Appendix 1 contains a full report from the Council's Treasury Management Advisers, Capita.

Members are asked to note that in order to minimise the resource requirements in producing this report, Capita's report has been taken verbatim. Capita generally use a more journalistic style than is used by our officers, but in order to avoid changing the meaning or sense of Capita's work, this has not been edited out.

As at 30th September 2016, the Council's investment portfolio totalled £44.6m (see Appendix 2). However, some of this may be shorter term, as significant funds sitting in the Dover Regeneration and Economic Development Reserve are earmarked for spending during 2016/17 and 2017/18 on the new Dover leisure centre and town hall refurbishment (subject to project approvals).

An additional £8m was transferred from cash flow funds into the investment portfolio during October (increasing its value to £52.6m), by adding £3m to a Barclays term deposit (now £8m) when it rolled over on 4th October (taken from NatWest SIBA monies) and by depositing £5m with Leeds Building Society on 6th October for six months by reducing the size of the Council's stake in the Goldman Sachs Money Market Fund (MMF). This has resulted in an improved rate of 0.46% being secured with Leeds compared to the 0.26% from the MMF. Similarly, the Barclays deposit achieves 0.451% compared to the NatWest SIBA rate of 0.25%.

The post-Brexit reduction in bank base rate, the on-going pressure on interest rates generally, and the reduction in deposit durations permissible for part nationalised banks following reductions in the Government's stakes in them, continue to place pressure on returns from banks and building societies. However, keeping funds with such highly credit-rated institutions for the currently recommended maximum six-month deposit durations remains a low risk strategy that maintains security of capital as far as possible in the uncertain post-Brexit economic climate.

3. **Annual investment strategy**

The investment portfolio, as at the end of September, is attached at Appendix 2. Core balances for investment are £44.6m. Since the end of the quarter, two deposits have matured and been reinvested for six months with the same banks, being: £5m with Barclays on 4th October (rate decrease 0.64% to 0.451%), and £1m with Lloyds on 9th November (rate decrease 0.8% to 0.6%). Additionally, a further £8m was transferred from short term cash and placed with Barclays (£3m) and Leeds Building Society (£5m) as mentioned in (2) above, increasing core balances for investment to £52.6m, albeit potentially on a temporary basis depending on capital requirements.

Additionally, following the Brexit vote and the reduction in bank base rate, interest rates have dropped with all institutions. A further expected base rate cut is no longer predicted to happen and, while the "on budget" forecast for the year includes allowance for deposits rolling over at the new lower rates, if there are further interest rate cuts with individual institutions these could put pressure on investment income for 2016/17 and beyond.

The Gilt holding of £1.9 million transferred to King and Shaxson following Investec's withdrawal from the segregated funds market will be held until its maturity date of July 2018.

Cash flow funds had increased from 30th June (£16.4m) to 30th September (£18.3m - see Appendix 2), but have decreased at the end of October to £10.4m (see Appendix 4) following the decision to transfer £8m into the investment portfolio to generate better rates of return.

4. **Economic background**

The report attached (Appendix 1) contains information up to the end of September 2016; since then we have received an update from Capita, and the abbreviated highlights are included below. Please note that their reference to quarters is based on *calendar* years. The full update from Capita can be made available on request:

Introduction

UK growth is expected to have strengthened in 2016 with the first three quarters coming in respectively at +0.4%, +0.7% and +0.5%. The latest Bank of England forecast for growth in 2016 as a whole is +2.2%. The figure for quarter 3 was a pleasant surprise which confounded the downbeat forecast by the Bank of England in August of only +0.1%, (subsequently revised up in September, but only to +0.2%).

The referendum vote for Brexit in June 2016 delivered an immediate shock fall in 'confidence indicators' and business surveys at the beginning of August, which were interpreted by the Bank of England in its August Inflation Report as pointing to an impending sharp slowdown in the economy. However, the following monthly surveys in September showed an equally sharp recovery in confidence and business surveys so that it is generally expected that the economy will post reasonably strong growth numbers through the second half of 2016 and also in 2017, albeit at a slower pace than in the first half of 2016.

Bank Rate

The Monetary Policy Committee (MPC) meeting of 3 November left Bank Rate unchanged at 0.25% and other monetary policy measures also remained unchanged. This was in line with market expectations.

The latest MPC decision included a forward view that Bank Rate could go either up or down depending on how economic data evolves in the coming months. Our central view remains that Bank Rate will remain unchanged at 0.25% until the first increase to 0.50% in quarter 2 2019 (unchanged from our previous forecast). However, we would not, as yet, discount the risk of a cut in Bank Rate if economic growth were to take a significant dip downwards, though we think this is unlikely.

The pace of Bank Rate increases in our forecasts has been slightly increased beyond the three year time horizon to reflect higher inflation expectations.

BANK RATE	**Est. now**	**Est. previously**
Q1 2017	0.25%	0.10%
Q1 2018	0.25%	0.10%
Q1 2019	0.25%	0.25%
Q1 2020	0.75%	-

Inflation

*The August quarterly Inflation Report was based on a pessimistic forecast of near to zero GDP growth in quarter 3 i.e. a sharp slowdown in growth from +0.7% in quarter 2, in reaction to the shock of the result of the referendum in June. However, **consumers** have very much stayed in a 'business as usual' mode and there has been no sharp downturn in spending; it is consumer expenditure that underpins the services sector which comprises about 75% of UK GDP. After a fairly flat three months leading up to October, retail sales in October surged at the strongest rate since September 2015. In addition, the GfK consumer confidence index has recovered quite strongly to -3 in October after an initial sharp plunge in July to -12 in reaction to the referendum result.*

Bank of England GDP forecasts in the November quarterly Inflation Report were as follows, (August forecasts in brackets) - 2016 +2.2%, (+2.0%); 2017 1.4%, (+0.8%); 2018 +1.5%, (+1.8%). There has, therefore, been a sharp increase in the forecast for 2017, a marginal increase in 2016 and a small decline in growth, now being delayed until 2018, as a result of the impact of Brexit.

Capital Economics' GDP forecasts are as follows: 2016 +2.0%; 2017 +1.5%; 2018 +2.5%. They feel that pessimism is still being overdone by the Bank and Brexit will not have as big an effect as initially feared by some commentators.

*The other key factor in forecasts for Bank Rate is **inflation** where the MPC aims for a target for CPI of 2.0%. The November Inflation Report included an increase in the peak forecast for inflation from 2.3% to 2.7% during 2017; (Capital Economics are forecasting a peak of 3.2% in 2018). This increase was largely due to the effect of the sharp fall in the value of sterling since the referendum, (16% down against the US dollar and 11% down against the Euro); this will feed through into a sharp increase in the cost of imports and materials used in production in the UK.*

*What is clear is that **consumer disposable income** will come under pressure, as the latest employers' survey is forecasting median pay rises for the year ahead of only 1.1% at a time when inflation will be rising significantly higher than this. The CPI figure for October surprised by under shooting forecasts at 0.9%. However, producer output prices rose at 2.1% and core inflation was up at 1.4%, confirming the likely future upwards path.*

Employment

Employment has been growing steadily during 2016, despite initial expectations that the referendum would cause a fall in employment. However, the latest employment data in November, (for October), showed a distinct slowdown in the rate of employment growth and an increase in the rate of growth of the unemployment claimant count. House prices have been rising during 2016 at a modest pace but the pace of increase has been slowing since the referendum; a downturn in prices could dampen consumer confidence and expenditure.

US Data

Despite some data setbacks, the US is still, probably, the best positioned of the major world economies to make solid progress towards a combination of strong growth, full employment and rising inflation: this is going to require the central bank to take action to raise rates so as to make progress towards normalisation of monetary policy, albeit at lower central rates than prevailed before the 2008 crisis.

The result of the presidential election in November is expected to lead to a strengthening of US growth if Trump's election promise of a major increase in expenditure on infrastructure is implemented. This policy is also likely to strengthen inflation pressures as the economy is already working at near full capacity. In addition, the unemployment rate is at a low point verging on what is normally classified as being full employment. However, the US does have a substantial amount of hidden unemployment in terms of an unusually large, (for a developed economy), percentage of the working population not actively seeking employment.

The election does not appear likely to have much impact on the Fed. in terms of holding back further on increasing the Fed. Rate. Accordingly, the next rate rise is still widely expected to occur in December 2016, followed by sharper increases thereafter, which may also cause Treasury yields to rise further. If the Trump package of policies is fully implemented, there is likely to be a significant increase in inflationary pressures which could, in turn, mean that the pace of further Fed. Rate increases will be quicker and stronger than had been previously expected.

Europe

EZ GDP growth in the first three quarters of 2016 has been 0.5%, +0.3% and +0.3%, (+1.6% y/y). Forward indications are that economic growth in the EU is likely to continue at moderate levels. This has added to comments from many forecasters that those central banks in countries around the world which are currently struggling to combat low growth, are running out of ammunition to stimulate growth and to boost inflation. Central banks have also been stressing that national governments will need to do more by way of structural reforms, fiscal measures and direct investment expenditure to support demand and economic growth in their economies.

There are also significant specific political and other risks within the EZ:

- ***Greece** continues to cause major stress in the EU due to its tardiness and reluctance in implementing key reforms required by the EU to make the country more efficient and to make significant progress towards the country being able to pay its way – and before the EU is prepared to agree to release further bail out funds.*
- ***Spain** has had two inconclusive general elections in 2015 and 2016, both of which failed to produce a workable government with a majority of the 350 seats. At the eleventh hour on 31 October, before it would have become compulsory to call a third general election, the party with the biggest bloc of seats (137), was given a majority confidence vote to form a government. This is potentially a highly unstable situation, particularly given the need to deal with an EU demand for implementation of a package of austerity cuts which will be highly unpopular.*
- *The under capitalisation of **Italian banks** poses a major risk. Some **German banks** are also undercapitalised, especially Deutsche Bank, which is under threat of major financial penalties from regulatory authorities that will further weaken its capitalisation. What is clear is that national governments are forbidden by EU rules from providing state aid to bail out those banks that are at risk, while, at the same time, those banks are unable realistically to borrow additional capital in financial markets due to their vulnerable financial state. However, they are also 'too big, and too important to their national economies, to be allowed to fail'.*

- ***German Federal election August – 22 October 2017.*** *This could be affected by significant shifts in voter intentions as a result of terrorist attacks, dealing with a huge influx of immigrants and a rise in anti EU sentiment.*
- *The core EU (note, not just the Eurozone currency area) principle of* ***free movement of people*** *within the EU is a growing issue leading to major stress and tension between EU states, especially with the Visegrad bloc of former communist states.*

Given the number and type of challenges the EU faces in the next eighteen months, there is an identifiable risk for the EU project to be called into fundamental question. The risk of an electoral revolt against the EU establishment has gained traction after the shock results of the UK referendum and the US Presidential election. But it remains to be seen whether any shift in sentiment will gain sufficient traction to produce any further shocks within the EU.

5. **Net Borrowing**

The Council's borrowing portfolio is attached at Appendix 3. No new borrowing was undertaken during the quarter.

Council approved a revised TMS on 28th September to increase borrowing limits to enable the borrowing to support the Dover Leisure Centre project to be undertaken, subject to project approval. A further update is being considered by Cabinet and Council on 21st and 30th November respectively to approve a further increase in borrowing limits to fund the separate property investment strategy, which itself will require consideration for approval at the same meetings. Details of any specific borrowing will be advised to Members as part of the quarterly update reports when it is undertaken.

6. **Debt Rescheduling**

At this time it is not of benefit to the Council to consider rescheduling of its long-term debt, as advised by Capita.

7. **Compliance with Treasury and Prudential Limits**

The Council has operated within the treasury limits and Prudential Indicators and in compliance with the Council's Treasury Management Practices.

Appendices

Appendix 1 – Capita treasury management report for quarter two

Appendix 2 – Investment portfolio as at 30 September 2016

Appendix 3 – Borrowing portfolio as at 30 September 2016

Appendix 4 – Investment portfolio as at 31 October 2016

Background Papers

Medium Term Financial Plan 2016/17 – 2019/20

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