Subject:	**TREASURY MANAGEMENT QUARTER THREE REPORT 2016/17**
Meeting and Date:	**Governance – 6th April 2017**
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 31 December 2016 (Q3) 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 year-to-date was 0.57% (YTD), which outperformed the benchmark[1] by 0.34%. Although this return is reducing slightly as the year progresses due to interest rates on deposits coming down, the benchmark is also reducing for the same reason and the Council is performing favourably in relationship to it. The Council's budgeted investment return for 2016/17 is £329k, and performance for the full year is estimated to be £341k, which is £12k 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 the 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. Updates to the TMS were approved at Council on 28th September 2016 and 30th November 2016 to increase borrowing limits for the new Dover Leisure Centre project and the property investment strategy respectively.

[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 31st December 2016, the Council's investment portfolio totalled £52.7m (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 £3m was transferred from cash flow funds into the investment portfolio during February 2017 (increasing its value to £55.7m) to improve returns. This was lent to Eastleigh Borough Council for six months at 0.43%, reducing short term cash to mitigate the impact of low overnight deposit rates, as our operating bank, NatWest, has recently decreased the rate on its SIBA (overnight) account from 0.25% to 0.01%. A report in the "The MJ" (the management journal for local authority business) on 26th January 2017, about the growth in inter-authority lending, stated: "Borrowers get access to lending at rates that tend to be lower than those available elsewhere in the market and lenders gain through higher returns relative to a bank deposit… By 2015/16, 65% of single tier and county councils were active in the inter-authority market and the number borrowing on a long-term basis doubled since 2011." Although it has been some time since the Council has loaned money to other local authorities, it is within the terms of the TMS and a normal practice, and considered to be low risk.

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 December, is attached at Appendix 2. Core balances for investment are £52.7m. Since the end of the quarter, four deposits have matured and been reinvested for six months with the same banks and building societies, being: £1m with Nationwide on 4th January (rate decrease 0.55% to 0.42%), £2m with Lloyds on 30th January (rate decrease 0.8% to 0.6%), £3m with Nationwide on 1st February (rate decrease 0.47% to 0.37%), and £3m with Nationwide on 24th February (rate decrease 0.40% to 0.37%). Additionally, a further £3m was transferred from short term cash and lent to Eastleigh Borough Council on 24th February, as mentioned in (2) above, increasing core balances for investment to £55.7m (see Appendix 4), albeit potentially on a temporary basis depending on capital requirements.

Following the Brexit vote and the reduction in bank base rate, interest rates have dropped with all institutions. No further base rate cut is predicted to happen during the 2016/17 year but, while the "above 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 decreased from 30th September (£18.3m) to 31st December 2016 (£14.2m - see Appendix 2), partly reflecting the transfer of £8m from short-term cash-flow funds into the investment portfolio to generate better rates of return, offset by other temporary increases in cash-flow funds, but have then decreased further at the end of February 2017 to £5.9m (see Appendix 4). This is partly due to a further transfer of £3m from short-term cash flow funds into the investment portfolio on 24th February (Eastleigh), and a £2.57m payment to acquire land at Whitfield for the new leisure centre (also on 24th February). The decrease also reflects the normal reduction in cash flow funds at this time of year, arising from the timing of 'major preceptor' payments, which are made over twelve months, while the Council Tax receipts that fund them typically come in over the ten months to January and then decline. Additionally, there will be a further PWLB loan instalment to pay at the end of March 2017 of £2.35m, after which, cash balances will build again, subject to the timing of capital projects and related payments (and receipts).

4. Economic background

The report attached (Appendix 1) contains information up to the end of December 2016; since then we have received an update from Capita, included below. Please note that any of their references to quarters are based on *calendar* years:

Introduction

The UK economy grew by 0.7% in the final quarter of 2016. Data since then has suggested that the economy will continue to grow but that this may be at a slower rate than previously. The influence of US interest rate policy and geo-political developments in the Eurozone are likely to impact UK gilt yields over the course of 2017 but in what manner is not clear at present.

The Bank of England February Inflation Report stated the following:

- *There would be an increase in the forecast for GDP growth for 2017 from 1.4% to 2.0% and for 2018 from 1.5% to 1.6%, indicating the UK economy has been, and is likely to be, much more resilient to the effects of Brexit uncertainty than had been expected last August. The Bank quoted the easing of the fiscal squeeze and stronger global economic data in its latest reasoning.*

- *Inflation (Consumer Price Index measure) is expected to peak somewhere close to 2.5%, and below 3%, although there were comments around the £ strengthening in value somewhat over the last quarter and this movement could easily be reversed in the current volatile market.*

- *The equilibrium rate of unemployment was cut from 5.0% to 4.5%. This potentially means that the MPC could wait longer before taking action to combat rising inflation.*
- *Some MPC members were clearly concerned about the degree to which they could look through increases in inflation caused by the effective devaluation of the £ since the Referendum and the consequent feed through into CPI.*

In the US, there is a clear expectation that monetary policy will tighten in March and possibly several other times in 2017 as the Trump administration seek to boost economic activity through heavy infrastructure spending in order to underpin jobs growth but with possible inflationary effects. The CPI measure of US inflation is currently at 2.5%.

Inflation

UK headline CPI increased by 1.8% year on year for January. The Retail Prices Index (RPI) measured inflation as increasing at 2.6% year on year. The Producer Prices Index (PPI) is increasing at over 20% year on year, and these costs may be passed on to consumers in part in due course.

UK Public Finances

The UK public finance release in February showed that the government is on target to achieve its £68.2bn net Public Sector Borrowing Requirement in 2017/18 and perhaps better that number by £10bn. However, any out-performance is likely to see the majority of monies "banked" in the event that there is some uncertainty in the UK's economic performance over the coming months.

Employment

Total weekly earnings increased (including bonuses) by 2.6% year on year. Meantime, unemployment has remained at sub 5%, the latest reading coming in at 4.8%.

There were fears that the Brexit vote would lead to widespread job losses in the immediate aftermath but these fears were not realised. Nevertheless, labour market indicators tend to lag behind the wider economy and thus we may have to wait some time before the post-referendum/Brexit labour market effects are translated into hard data.

Europe

Given the number and type of challenges the EU faces over the next year or so, 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. The main risks to uncertainty are set out below:

- ***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 bailout funds. A crunch point is imminent this summer when Greece needs to make major repayments it will not be able to make unless there is a new bail out which is very unlikely ahead of the general election due in Germany before late October.

- ***Spain*** *has had two 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.*

- ***4 December Italian constitutional referendum*** *on reforming the Senate and reducing its powers; this became a confidence vote on Prime Minister Renzi who duly resigned when he lost the vote. The rejection of these proposals could stop progress on fundamental political and economic reform which is urgently needed to deal with Italy's core problems, especially low growth. They were also intended to give Italy more stable government, as no western European country has had such a multiplicity of governments since the Second World War as Italy, due to the equal split of power between the two chambers of the Parliament which are both voted in by the Italian electorate but by using different voting systems. This means there is now major uncertainty about the road ahead for Italy.*

- ***Dutch general election 15 March****; a far right party is currently polling neck and neck with the incumbent ruling party. In addition, anti-big business and anti-EU activists have already collected two thirds of the 300,000 signatures required to force a referendum to be taken on approving the "EU – Canada free trade" pact. This could delay the pact until a referendum in 2018 which would require unanimous approval by all EU governments before it can be finalised. In April 2016, Dutch voters rejected by 61.1% an EU – Ukraine cooperation pact under the same referendum law. Dutch activists are concerned by the lack of democracy in the institutions of the EU. The ability of just one nation among 27 nations in the post Brexit EU to halt progress on international agreements poses an identifiable risk to the UK in negotiations with the EU on the terms of Brexit.*

- ***French presidential election****; first round 13 April; second round 7 May.*

- ***German Federal election*** *August – 22 October. 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.*

With regard to EU economic activity, GDP was 1.7% for the bloc in 2016. However, whereas Spain, and Germany to a lesser extent, has performed well – there is weakness in the French and Italian economic performance which will drag on the bloc's performance as a whole. Inflation is also on an upward trajectory although unemployment numbers have improved.

US Data

The US job market shone once again in January, and 227,000 jobs were added. Unemployment remains at a low 4.8% but inflation has picked up to 2.5% and the FOMC is expected to move short-term rates up in March to the 0.75% - 1% range.

Policy announcements from the Trump administration are likely to continue to impact on the market's expectations, but with the Dow Jones already showing at over 21,000 there appears to be a high degree of confidence that the US economy is likely to perform well, at least in the near-term.

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, and a further update on 30th November to approve a further increase in *borrowing limits* to fund the separate Property Investment Strategy, which itself was approved at the 30th November meeting. Details of any specific borrowing will be advised to Members as part of the quarterly update reports when it is undertaken. None was undertaken in the quarter to December 2016 and none is expected in the final quarter of 2016/17. However, it is likely that borrowing *will* be undertaken in 2017/18, dependent on timing of projects and progress under the property investment strategy.

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 three

Appendix 2 – Investment portfolio as at 31 December 2016

Appendix 3 – Borrowing portfolio as at 31 December 2016

Appendix 4 – Investment portfolio as at 28 February 2017

Background Papers

Medium Term Financial Plan 2016/17 – 2019/20

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