

# Treasury Management Update

## Quarter Ended 30th September 2015

The CIPFA (Chartered Institute of Public Finance and Accountancy) Code of Practice for Treasury Management recommends that members be updated on treasury management activities regularly (TMSS, annual and midyear reports). This report, therefore, ensures this Council is implementing best practice in accordance with the Code. (Please note that the references to Q1, Q2, Q3 and Q4 in Appendix 1 are based on the *calendar* year, whereas the covering report is based on the *financial* year so that Q2 is the period ended 30<sup>th</sup> September 2015).

### 1. Economic Background

UK GDP growth rates in 2013 of 2.2% and 2.9% in 2014 were the strongest growth rates of any G7 country; the 2014 growth rate was also the strongest UK rate since 2006, and the 2015 growth rate is likely to be a leading rate in the G7 again, possibly being equal to that of the US. However, quarter 1 of 2015 was weak at +0.4% (+2.9% y/y) though there was a rebound in quarter 2 to +0.7% (+2.4% y/y). Growth is expected to weaken marginally to about +0.5% in quarter 3 as the economy faces headwinds for exporters from the appreciation of Sterling against the Euro and weak growth in the EU, China and emerging markets, plus the dampening effect of the Government's continuing austerity programme, although the pace of reductions was eased in the May Budget.

Despite these headwinds, the Bank of England is forecasting growth to remain around 2.4 – 2.8% over the next three years, driven mainly by strong consumer demand as the squeeze on the disposable incomes of consumers has been reversed by a recovery in wage inflation at the same time that CPI inflation has fallen to, or near to, zero over the last quarter. Investment expenditure is also expected to support growth.

The August Bank of England Inflation Report forecast was notably subdued with inflation barely getting back up to the 2% target within the 2-3 year time horizon. However, with the price of oil taking a fresh downward direction and Iran expected to soon rejoin the world oil market after the impending lifting of sanctions, there could be several more months of low inflation still to come, especially as world commodity prices have generally been depressed by the Chinese economic downturn.

There are therefore considerable risks around whether inflation will rise in the near future as strongly as previously expected; this will make it more difficult for the central banks of both the US and the UK to raise rates as soon as had previously been expected, especially given the recent major concerns around the slowdown in Chinese growth, the knock on impact on the earnings of emerging countries from falling oil and commodity prices, and the volatility we have seen in equity and bond markets in 2015 so far, which could potentially spill over to impact the real economies rather than just financial markets.

The American economy has made a strong comeback after a weak first quarter's growth at +0.6% (annualised), to grow by no less than 3.9% in quarter 2 of 2015. While there had been confident expectations during the summer that the Fed. could start increasing rates at its meeting on 17 September, or if not by the end of 2015, the recent downbeat news about Chinese and Japanese growth and the knock-on impact on emerging countries that are major suppliers of commodities, was

cited as the main reason for the Fed's decision to pull back from making that start. This has led to a reappraisal of the likelihood of any increase occurring in 2015 with early 2016 now being widely regarded as being more likely.

In the Eurozone, the ECB, in January 2015, unleashed a massive €1.1 trillion programme of quantitative easing to buy up high credit quality government and other debt of selected EZ countries. This programme of €60bn of monthly purchases started in March 2015 and it is intended to run initially to September 2016. This already appears to have had a positive effect in helping a recovery in consumer and business confidence and a start to a significant improvement in economic growth. GDP growth rose to 0.5% in quarter 1 2015 (1.0% y/y) but came in at +0.4% (+1.5% y/y) in quarter 2 and looks as if it may maintain this pace in quarter 3. However, the recent downbeat Chinese and Japanese news has raised questions as to whether the ECB will need to boost its QE programme if it is to succeed in significantly improving growth in the EZ and getting inflation up from the current level of around zero to its target of 2%.

## 2. Interest Rate Forecast

The Council's treasury advisor, Capita Asset Services, has provided the following forecast:

	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18
<b>Bank rate</b>	0.50%	0.50%	0.75%	0.75%	1.00%	1.00%	1.25%	1.50%	1.50%	1.75%	1.75%
<b>5yr PWLB rate</b>	2.40%	2.50%	2.60%	2.80%	2.90%	3.00%	3.10%	3.20%	3.30%	3.40%	3.50%
<b>10yr PWLB rate</b>	3.00%	3.20%	3.30%	3.40%	3.50%	3.70%	3.80%	3.90%	4.00%	4.10%	4.20%
<b>25yr PWLB rate</b>	3.60%	3.80%	3.90%	4.00%	4.10%	4.20%	4.30%	4.40%	4.50%	4.60%	4.60%
<b>50yr PWLB rate</b>	3.60%	3.80%	3.90%	4.00%	4.10%	4.20%	4.30%	4.40%	4.50%	4.60%	4.60%

Capita Asset Services undertook a review of its interest rate forecasts on 11 August after the August Bank of England Inflation Report. This latest forecast includes no change in the timing of the first increase in Bank Rate as being quarter 2 of 2016. With CPI inflation now likely to be at or near zero for most of 2015, it is difficult for the MPC to make a start on increasing Bank Rate when the Inflation Report forecast was also notably subdued with inflation barely getting back up to the 2% target within the 2-3 year time horizon. Despite average weekly earnings ticking up to 2.9% y/y in the three months ending in July, (as announced in mid-September), this is unlikely to provide ammunition for

the MPC to take action to raise Bank Rate soon as labour productivity growth meant that net labour unit costs are still only rising by about 1% y/y. The significant appreciation of Sterling against the Euro in 2015 has also acted as a dampening to UK growth while sharp volatility in financial markets since the Inflation Report has depressed equity prices, raised bond prices and lowered bond yields (and PWLB rates).

The Governor of the Bank of England, Mark Carney, has repeatedly stated that increases in Bank Rate will be slow and gradual. The MPC is concerned about the impact of increases on many heavily indebted consumers, especially when average disposable income is only just starting a significant recovery as a result of recent increases in the rate of wage inflation, though some consumers will not have seen that benefit come through for them.

### 3. Annual Investment Strategy

The Treasury Management Strategy Statement (TMSS) for 2015/16, which includes the Annual Investment Strategy, was approved by the Council on 04/03/2015. It sets out the Council's investment priorities as being:

- Security of capital;
- Liquidity; and
- Yield.

The Council will also aim to achieve the optimum return (yield) on its investments commensurate with proper levels of security and liquidity. In the current economic climate it is considered appropriate to keep investments short term to cover cash flow needs, but also to seek out value available in periods up to 12 months with highly credit-rated financial institutions, using our suggested creditworthiness approach, including a minimum sovereign credit rating, and Credit Default Swap (CDS) overlay information.

Investment rates available in the market have been broadly stable during the quarter and have continued at historically low levels as a result of the ultra-low Bank Rate and other extraordinary measures such as the Funding for Lending Scheme. Funds were available on a temporary basis, and the level of funds available was mainly dependent on the timing of precept payments, receipt of grants and progress on the Capital Programme. The Council holds over **£30m** core cash balances for investment purposes (i.e. funds available for more than one year). However, only £17m are shown as portfolio/core balances on Appendix 2 at 30<sup>th</sup> September, as the majority of funds returned by Investec are being held in short-term call accounts pending the opening of new longer term accounts at better rates following update of the TMSS, subject to suitable credit criteria (e.g. £5m has been placed with Barclays for six months on 2<sup>nd</sup> October 2015).

#### Investment performance for period ended 30th September 2015

Benchmark	Benchmark Return	Council Performance	Investment Interest Earned
<b>7 day</b>	0.36	0.50	£130k year-to-date

As illustrated, the Council outperformed the benchmark by 14 **bps**. The Council's budgeted investment return for 2015/16 is **£333k**, and performance for the year is estimated to be **£304k**, which is **£29k** below budget. However, this is an improvement on the £41k shortfall forecast at the end of the previous quarter.

## 4. New Borrowing

The 50 year PWLB target (certainty) rate for new long term borrowing, for the quarter ending 30<sup>th</sup> September, fell slightly from 3.60% to 3.40% after the August Bank of England Inflation report.

No borrowing was undertaken during the quarter.

It is anticipated that no further borrowing will be undertaken during this financial year.

### PWLB certainty rates quarter ended 30th September 2015

	1 Year	5 Year	10 Year	25 Year	50 Year
<b>Low</b>	1.23%	1.96%	2.56%	3.21%	3.07%
<b>Date</b>	24/09/2015	24/09/2015	29/09/2015	12/08/2015	12/08/2015
<b>High</b>	1.35%	2.35%	3.06%	3.66%	3.58%
<b>Date</b>	05/08/2015	14/07/2015	14/07/2015	02/07/2015	14/07/2015
<b>Average</b>	1.29%	2.15%	2.78%	3.40%	3.28%

### Borrowing in advance of need

This Council has not borrowed in advance of need during the quarter ended 30th September 2015 and has not borrowed in advance in all of 2015/16.

## 5. Debt Rescheduling

No debt rescheduling was undertaken during the quarter.

## 6. Compliance with Treasury and Prudential Limits

It is a statutory duty for the Council to determine and keep under review the affordable borrowing limits. The Council's approved Treasury and Prudential Indicators (affordability limits) are included in the approved TMSS.

During the financial year to date the Council has operated within the treasury and prudential indicators set out in the Council's Treasury Management Strategy Statement (TMSS) and in compliance with the Council's Treasury Management Practices, with the exception of the funds in overnight accounts with the Council's operating bank, which exceed the £10m limit. This is low risk and temporary while the Council opens new accounts with other highly credit-rated banks to spread risk and improve returns, following revision of the TMSS (approved by Council on 30<sup>th</sup> September 2015). The prudential and treasury Indicators are shown after point (7) below.

## 7. Other

### **Treasury Management Strategy Statement**

Investec withdrew from the segregated investment fund market and, on 30 June 2015, returned the Council's investment of £11m approx. A further £1.9m in Gilts was separately transferred to King and Shaxson to be held until maturity in 2018.

The treasury management strategy statement (TMSS) has been revised to take account of the higher level of in-house funds being managed by DDC. We are in the process of opening further accounts with highly credit-rated institutions, at low risk, to enable higher returns with a view to minimising any further shortfall of investment income against budget in 2015/16.

### **Changes in credit rating methodology.**

The main rating agencies (Fitch, Moody's and Standard & Poor's) have, through much of the financial crisis, provided some institutions with a ratings "uplift" due to implied levels of sovereign support. Commencing in 2015, in response to the evolving regulatory regime, all three agencies have begun removing these "uplifts" with the timing of the process determined by regulatory progress at the national level. In some cases, these factors have "netted" each other off, to leave underlying ratings either unchanged or little changed.

In keeping with the agencies' new methodologies, the credit element of our own credit assessment process now focuses solely on the Short and Long Term ratings of an institution. While this is the same process that has always been used by Standard & Poor's, this has been a change to the use of Fitch and Moody's ratings. It is important to stress that the other key elements to our process, namely the assessment of Rating Watch and Outlook information as well as the Credit Default Swap (CDS) overlay have not been changed.

## Prudential and Treasury Indicators as at 30<sup>th</sup> September 2015

Treasury Indicators	2015/16 Budget £'000	Quarter 2 (Jul-Sep) Actual £'000
Authorised limit for external debt	113,500	113,500
Operational boundary for external debt	108,000	108,000
Maturity structure of fixed rate borrowing - upper and lower limits		
Under 12 months	2,086	2,086
12 months to 2 years	3,256	3,256
2 years to 5 years	6,993	6,993
5 years to 10 years	13,232	13,232
10 years and above	64,188	64,188
Prudential Indicators	2015/16 Budget £'000	Quarter 2 YTD (Apr-Sep) Actual £'000
Capital expenditure	19,856	5,099
Capital Financing Requirement (CFR)	98,233	91,079