

Treasury Management Update

Quarter Ended 31st December 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.

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. However, quarter 1 of 2015 was weak at +0.4% (+2.9% y/y) though there was a slight increase in quarter 2 to +0.5% (+2.3% y/y) before falling back to +0.4% (+2.1% y/y) in quarter 3. Growth is expected to improve to about +0.6% in quarter 4 but 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 November autumn statement.

Despite these headwinds, the Bank of England November Inflation Report included a forecast for growth over the three years of 2015, 2016 and 2017 to be around 2.7%, 2.5% and 2.6% respectively, although statistics since then would indicate that an actual outturn for 2015 is more likely to be around 2.2%. Nevertheless, this is still moderately strong growth which is being 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 November 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 re-join 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 Bank of England to make a start on raising Bank Rate as soon as had been expected in early 2015, especially given the subsequent 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 during 2015, which could potentially spill over to impact the real economies rather than just financial markets.

The American economy 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 before easing back to +2.0% in quarter 3. While there had been confident expectations during the summer that the Fed. could start

increasing rates at its meeting on 17 September, downbeat news during the summer 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. The nonfarm payrolls figures for September and revised August, issued on 2 October, were also disappointingly weak. However, since then concerns on both the domestic and international scene have abated and so the Fed made its long anticipated start in raising rates at its December meeting.

In the Eurozone, the ECB unleashed a massive €1.1 trillion programme of quantitative easing in January 2015 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 was intended to run initially to September 2016. At the ECB's December meeting, this programme was extended to March 2017 but was not increased in terms of the amount of monthly purchases. The ECB also cut its deposit facility rate by 10bps from -0.2% to -0.3%. This programme of monetary easing has had a limited positive effect in helping a recovery in consumer and business confidence and a start to some improvement in economic growth. GDP growth rose to 0.5% in quarter 1 2015 (1.3% y/y) but has then eased back to +0.4% (+1.6% y/y) in quarter 2 and to +0.3% (+1.6%) in quarter 3. Financial markets were disappointed by the ECB's lack of more decisive action in December and it is likely that it 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:

	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19
Bank rate	0.50%	0.75%	0.75%	1.00%	1.00%	1.25%	1.50%	1.50%	1.75%	1.75%	2.00%	2.00%	2.00%
5yr PWLB rate	2.40%	2.60%	2.70%	2.80%	2.80%	2.90%	3.00%	3.20%	3.30%	3.40%	3.50%	3.50%	3.60%
10yr PWLB rate	3.00%	3.10%	3.20%	3.30%	3.40%	3.50%	3.60%	3.70%	3.80%	3.90%	4.00%	4.10%	4.10%
25yr PWLB rate	3.70%	3.80%	3.90%	4.00%	4.10%	4.10%	4.20%	4.30%	4.30%	4.40%	4.40%	4.40%	4.50%
50yr PWLB rate	3.60%	3.70%	3.80%	3.90%	4.00%	4.00%	4.10%	4.20%	4.20%	4.30%	4.30%	4.30%	4.40%

Capita Asset Services undertook a review of its interest rate forecasts on 9 November 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 and into early 2016, it is currently very difficult for the MPC to make a start on increasing Bank Rate. In addition, 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 excluding bonuses hitting 2.5% in quarter 3, this has subsided to 1.9% and is unlikely to provide ammunition for the MPC to take action to raise Bank Rate soon as labour productivity growth would mean that net labour unit costs are still only rising by less than 1% y/y. The significant appreciation of Sterling against the Euro in 2015 has also acted to dampen UK growth while volatility in financial markets since the Inflation Report has resulted in volatility in equity and bond prices and bond yields (and therefore PWLB rates). But CPI inflation will start sharply increasing around mid-year 2016, once initial falls in fuel and commodity prices fall out of the 12 month calculation of

inflation; this will cause the MPC to take a much keener interest in the forecasts for inflation over their 2-3 year time horizon from about mid-year.

The Governor of the Bank of England, Mark Carney, has repeatedly stated that increases in Bank Rate will be slow and gradual after they do start. 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, and an update was approved at Council on 30/09/2015. The update was needed due to higher levels of in-house funds following return of monies from Investec on their withdrawal from custodianship arrangements on 30/06/2015. The TMSS 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.

Officers can confirm that the approved limits within the Annual Investment Strategy were not breached during the quarter ended 31st December 2015, with the exception of the £10m limit on deposits in the Special Interest Bearing Account (SIBA) with the Council's operating bank, NatWest. This is due to unusually high levels of cash balances including, for example, more than £3m remaining in the Council's bank account awaiting payment requests from Discovery Park, where the Council is acting as the accountable body (intermediary) for "Building Foundations for Growth" grant received from DCLG. The SIBA balance reached £16.5m during the quarter and, while reducing to £8.2m by 31st December, had spiked again since the end of the quarter, reaching £17m on 17th February 2016. Levels have normalised since, and are likely to remain within the £10m limit up to 31st March 2016, as council tax receipts dip (usually paid in ten instalments from April to January) and a further PWLB loan repayment is made in March, alongside other normal payments. SIBA balances are "instant access" and therefore lower risk.

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. These 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 **£32.5m** core cash balances for investment purposes (i.e. funds available for more than one year), as shown on Appendix 2.

Investment performance for the financial year to date as at 31st December 2015

Benchmark	Benchmark Return	Council Performance	Investment Interest Earned
7 day	0.36	0.50	£206k

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 to date is estimated to be £304k, which is **£29k** below budget.

4. New Borrowing

As outlined below, the general trend in PWLB rates has been an increase in interest rates during the first quarter followed by a fall during the second quarter: in the third quarter rates have been volatile with no overall direction. The 50 year PWLB target (certainty) rate for new long term borrowing, fell slightly during the quarter ending 31st December from 3.60% to 3.50% after the November 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 31st December 2015

	1 Year	5 Year	10 Year	25 Year	50 Year
Low	1.17%	1.90%	2.55%	3.28%	3.10%
Date	23/10/2015	15/10/2015	05/10/2015	02/10/2015	03/12/2015
High	1.33%	2.23%	2.88%	3.57%	3.43%
Date	09/11/2015	09/11/2015	09/11/2015	09/11/2015	09/11/2015
Average	1.23%	2.05%	2.69%	3.41%	3.27%

Borrowing in advance of need

This Council has not borrowed in advance of need during the quarter ended 31st December 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 and in compliance with the Council's Treasury Management Practices. The prudential and treasury Indicators are shown after point (7) below.

7. Other

Treasury Management Strategy Statement

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 have opened 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. As a result, the estimated annual shortfall reported at the end of September 2015 of £29k has not worsened, based on our revised estimate from figures to 31st December.

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. The process has been part of a wider reassessment of methodologies by each of the rating agencies. In addition to the removal of implied support, new methodologies are now taking into account additional factors, such as regulatory capital levels. In some cases, these factors have "netted" each other off, to leave underlying ratings either unchanged or little changed. A consequence of these new methodologies is that they have also lowered the importance of the (Fitch) Support and Viability ratings and have seen the (Moody's) Financial Strength rating withdrawn by the agency.

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.

It is important to stress that these rating agency changes do not reflect any changes in the underlying status or credit quality of the institution, merely a reassessment of their methodologies in light of enacted and future expected changes to the regulatory environment in which financial institutions operate. While some banks have received lower credit ratings as a result of these changes, this does not mean that they are suddenly less credit worthy than they were formerly. Rather, in the majority of cases, this mainly reflects the fact that implied sovereign government support has effectively been withdrawn from banks. They are now expected to have sufficiently strong balance sheets to be able to withstand foreseeable adverse financial circumstances without government support. In fact, in many cases, the balance sheets of banks are now much more robust than they were before the 2008 financial crisis when they had higher ratings than now. However, this is not universally applicable, leaving some entities with modestly lower ratings than they had through much of the “support” phase of the financial crisis.

Prudential and Treasury Indicators as at 31st December 2015

Treasury Indicators	2015/16 Budget £'000	Quarter 3 (Oct-Dec) 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 3 (Oct-Dec) Actual £'000
Capital expenditure	17,512	8,265
Capital Financing Requirement (CFR)	98,233	91,079