Treasury Management Update

Quarter Ended 31st December 2012

The CIPFA (the 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 mid year reports). This report therefore ensures this council is implementing best practice in accordance with the Code.

1. Economic background:

- During the quarter ended 31 December: -
- Indicators suggest that the economy probably contracted;
- Retail sales weakened but spending off the high street held up;
- Employment continued to rise, albeit at a slower pace;
- Inflation remained stubbornly above the MPC's 2% target;
- The MPC paused its programme of asset purchases;
- UK equity prices rose and government bond prices fell;
- The US economy continued to recover at a modest pace.
- The unwinding of the boost from the Olympic Games in August means that GDP probably contracted in the fourth quarter of 2012. The CIPS/Markit business surveys generally weakened, with the measure of services activity in December falling to its lowest level since December 2010.
- The weakness of the surveys seemed in part to reflect the washing out of the impact of the Olympics, which will have given a temporary boost to activity in the third quarter. Indeed, the official data deteriorated at the start of Q4. Following a 2.1% monthly drop in September, industrial production fell by a further 0.8% in October. In addition, the overall trade deficit widened from £2.5bn in September to £3.6bn in October.
- Meanwhile, high street spending, which is excluded from the CIPS surveys, was relatively weak. The official measure of retail sales volumes fell by 0.7% in October. With sales volumes stagnant in November, retail sales are likely to detract from overall GDP growth in Q4. For example, if sales volumes remain unchanged again in December, then sales will be 0.6% lower than in the third quarter.
- However, spending off the high street continued to show evidence of recovery. In particular, private new car registrations were 12% and 11% higher than a year ago in October and November respectively.

- All in all, the above indicate there is likely to have been a 0.4% quarterly fall in GDP in Q4 2012, which would leave growth for 2012 as a whole at about -0.1%.
- Meanwhile, although the resilience of the labour market continued, it faded a bit through the quarter. Admittedly, the claimant count measure of unemployment fell by 3,000 in November, while the Labour Force Survey measure of employment rose by 40,000 in the three months to October. However, this was the smallest increase since the start of the year.
- Pay growth remained depressed. Annual growth of overall average earnings dropped from 1.8% in June to 1.3% in October. Given the rate of inflation over this period, real pay continued to fall on an annual basis.
- Meanwhile, news on the housing market was mixed. The Halifax measure of house prices declined by 0.1% m/m in October, but then rose by 1% in November. However, the Nationwide measure was flat in November, having risen by 0.6% in October. The big picture is that prices on both measures fell slightly over the year. Elsewhere, mortgage approvals for new house purchase continued to edge up. The total of 52,982 in October was the fifth consecutive monthly rise. Although an encouraging sign, the level is still far below that seen pre-crisis.
- Banks' funding costs continued to ease over the quarter, reflecting the Bank of England's provision of low cost funding via the Funding for Lending Scheme. Rates on new fixed and floating rate mortgages both declined in October compared to their average level in Q3.
- Meanwhile, although public borrowing has continued to overshoot last year's level, the Government was helped by a number of one offs in December's Autumn Statement. Borrowing from April to November was £93bn, £9bn higher than the same period in 2011/12. However, the Office for Budget Responsibility (OBR) expects net borrowing to come in at £108bn in 2012/13, about £10bn below last year's level, largely reflecting the receipt of funds from the Bank of England's Asset Purchase Facility and the anticipated auction of 4G licences early next year.
- As far as the Autumn Statement went, there were few surprises. Austerity was extended for a further year, to 2017/18, and in light of the deterioration in the borrowing forecasts, the Chancellor chose to disregard one of his fiscal targets, to get debt as a share of GDP falling by 2015/16. While he did announce a number of growth friendly measures, including a cut in corporation tax, it was largely a case of give with one hand and take away with the other.
- Inflation remained stubbornly sticky in Q4. Indeed, CPI inflation rose from 2.2% in September to 2.7% in October, and remained at that level in November. October's jump in university tuition fees, hefty rises in utility prices at the end of

the 2012 and a pick-up in food price inflation following poor harvests, mean that inflation is likely to hover between 2.5% and 3% for the best part of 2013.

- Meanwhile, the MPC voted in November to pause its programme of quantitative easing, leaving total asset purchases at £375bn. The announcement in November that Mark Carney, the current Governor of the Bank of Canada, will take on the Governorship of the Bank of England from June 2013, raised speculation that the MPC's current 2% inflation target may be reformulated.
- Equity prices in the UK and overseas largely continued to rise over the course of the fourth quarter, with the FTSE 100 picking up from 5,820 to 5,898. Over the period gilt prices fell, causing 10-year gilt yields to rise from about 1.55% to 1.80%. Meanwhile, the pound was unchanged against the dollar, at about $1.63, but weakened slightly against the euro from €1.25 to €1.23.
- Internationally, the US economy's recovery has remained soft. A weighted average of the manufacturing and non-manufacturing ISM indices points to annualised GDP growth of 2.0% in Q4. Total non-farm payroll employment rose by 138,000 in October and 146,000 in November, compared to an average increase of 168,000 in the third quarter. However, the agreement reached on 1st January to avert some of the "fiscal cliff" scheduled for the start of 2013 reduces the risk of a new recession.
- In the Eurozone, market sentiment continued to be steadied by the ECB's pledge to buy "unlimited" quantities of peripheral government's sovereign debt. However, activity indicators point to a deepening recession in the region. On past form, the composite Eurozone PMI points to a quarterly drop in GDP of about 0.5% in Q4.

2. Interest rate forecast

The Council's treasury advisor, Sector, provides the following forecast:

	Mar-13	Jun-13	Sep-13	Dec-13	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15
Bank rate	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.75%
5yr PWLB rate	1.50%	1.50%	1.60%	1.60%	1.70%	1.70%	1.80%	2.00%	2.20%
10yr PWLB rate	2.50%	2.50%	2.60%	2.60%	2.70%	2.70%	2.80%	3.00%	3.20%
25yr PWLB rate	3.80%	3.80%	3.80%	3.80%	3.90%	3.90%	4.00%	4.10%	4.30%
50yr PWLB rate	4.00%	4.00%	4.00%	4.00%	4.10%	4.10%	4.20%	4.30%	4.50%

Sector undertook a review of its interest rate forecasts following the issue of the latest Bank of England Inflation Report for November 2012. In the August Inflation Report, the Bank changed its position significantly in as much as it markedly downgraded its forecasts for the strength and speed of recovery in GDP growth whereas previously it had consistently been forecasting a strong recovery to over 3% p.a. In its November Report, the Bank has continued this shift towards pessimism in the speed and strength of recovery; it is now only forecasting growth at around 1% in 2013 and 2% in 2014. These developments have pushed back Sector's expectations of the timing of the eventual start of increases in Bank Rate from Q4 2014 to Q1 2015, as well as the pace of rises in gilt yields.

SUMMARY ECONOMIC OUTLOOK

UK economy

- Mervyn King was downbeat at the press conference, after the November Inflation Report was published, about the combination of stronger inflation and weaker growth facing the UK. He blamed the downturn in the global economy and viewed the recent reversal of the 25% devaluation of Sterling after the financial crash, to 20%, as being unhelpful to encouraging an export led recovery. However, some commentators are now questioning whether Sterling devaluation is a positive for an economy which is focused on producing high value added specialised goods and services which may not be as price sensitive as UK exports were in previous decades. He also commented that the banks were keeping financially weak "zombie firms" on life support systems by allowing them to breach borrowing covenants so as to avoid debt write offs hitting bank balance sheets. This may mean that more viable firms with expansion plans are being starved of credit and that the potential for a more rapid recovery is being stifled.
- The Chancellor's Autumn Statement recognised that the Government is not going to achieve its original timetable for reducing the budget deficit and total debt; the timescale has accordingly been extended. The housing market looks as if it will continue to be weak for a long time yet and the construction industry is contracting.

Eurozone

- Although market anxiety about Greece has currently subsided after the agreement to a further major financial support package amounting to nearly €50bn in December, markets are still concerned that the eventual end game could be that Greece is eventually forced to exit (dubbed "Grexit") the Eurozone and return to the drachma. There is also increasing concern that the contraction in Spain's economy and the very high level of unemployment of 25%, similar to Greece's level, could mean that both countries could get into a downward deflationary spiral which makes achieving fiscal correction increasingly difficult and unachievable.
- The ECB's pledge to provide unlimited bond buying support for countries that request an official bailout means that market anxiety about Spain and Greece is likely to be subdued in the immediate future. However, the poor economic fundamentals and outlook for both economies could well mean that a storm in financial markets has only been delayed, not cancelled. Spain has also resisted asking for an official national bailout, although it has received financial support to recapitalise its four largest banks.
- The imminent general election in Italy also creates uncertainty over which political parties will eventually create a coalition and what their eventual compromise will amount to in terms of economic policy to contain Italy's own fiscal challenges. There could therefore be volatility in Spanish and Italian bond yields in the near future, depending on political and economic developments.

- There will also be a general election in Germany in 2013 though it currently looks likely that this will lead to little change in current policy on the Euro and support for peripheral countries.

In summary, our views on the prospects for GDP growth in the major global economies are as follows: --

UK

- The Bank of England November 2012 Inflation Report has again pushed back the timing of a return to trend growth and the rate at which inflation will fall back towards the target rate of 2%.
- It now looks likely that Q4 2012 will see a return to negative growth. If this negativity continues into the first quarter of 2013 it would be the first triple dip recession since records began in 1955.
- A fair proportion of UK GDP is dependent on overseas trade; the high correlation of UK growth to US and Eurozone GDP growth means that the UK economy is likely to register weak growth over 2013 and 2014.
- Consumers are likely to remain focused on paying down debt. Weak consumer sentiment and job fears will all act to keep consumer expenditure suppressed; this will be compounded by inflation being higher than increases in average earnings i.e. disposable income will still be eroded.
- The Coalition government is hampered in promoting growth by the need to tackle the budget deficit.
- Little sign of a coordinated strategy for the private sector to finance a major expansion of infrastructure investment to boost UK growth.
- There is potential for more QE in 2013 which will help to keep gilt yields lower than they would be otherwise.
- On the other hand, recent discussion around reformulating how RPI is calculated could adversely affect demand for inflation indexed gilts in particular, but also gilts generally, if this proposal is taken forward and was perceived to be a softening of the stand against inflation in the UK.
- The main rating agencies have all made it clear they are reviewing the UK's "AAA" status in early 2013. There is a material chance of the current ratings being downgraded. Although the UK will retain its "safe haven" status, a change in rating may place some upside pressure on gilt yields.

US

- GDP growth is likely to remain weak at around 2% - but that is a lot better than the prospects for the UK and Eurozone.
- The Fed has indicated that is unlikely to increase the central rate until 2015. It changed its policy targets to focus specifically on the employment sector. The new target is for unemployment to fall to 6.5% before official policy rates are raised.
- The "fiscal cliff" has only been partially dealt with at the beginning of January 2013. Increasing the debt ceiling and agreeing the cuts in expenditure part of the "fiscal cliff" will need to be resolved within the next two months.

- The housing market is showing some sustainable signs of having turned a corner.

Eurozone

- Austerity programmes in the various "peripheral" countries are starting to show signs of having an effect in reducing growth rates in "core" countries. The Eurozone looks as if it is heading for another quarter of negative growth in Q4 2012 and prolong the recession which began in Q3.

China

- Efforts to stimulate the economy appear to be succeeding towards the end of 2012. However, there are still concerns around the unbalanced nature of the economy which is heavily dependent on new investment expenditure. The potential for the bubble in the property sector to burst, as it did in Japan in the 1990s, could have a material impact on the economy as a whole.

Sector's forward view

Economic forecasting remains difficult with so many external influences weighing on the UK. Major volatility in bond yields is likely during 2013 as investor fears and confidence ebb and flow between favouring more risky assets i.e. equities, and safer bonds. Equity prices staged a significant rise during the second half of 2012 and the start of January, accompanied by a fall in bond prices and a rise in bond yields. 2013 is likely to see a tug of war between bond and equity prices as ebbs and flows in investor confidence and fears cause recurring spikes and falls in their prices.

The overall balance of risks to economic recovery in the UK remains weighted to the downside. Sector believes that the longer run trend is for gilt yields and PWLB rates to rise due to the high volume of gilt issuance in the UK, and the high volume of debt issuance in other major western countries. Although the prospect of further QE is likely to keep gilt yields lower than they would otherwise be in the near term, this programme is not everlasting. At some stage, the expectation of a conclusion to QE will add to the upside pressure on gilt yields

3. Annual Investment Strategy

The Treasury Management Strategy Statement (TMSS) for 2012/13, which includes the Annual Investment Strategy, was approved by the Council on 7th March 2012. 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 investments commensurate with proper levels of security and liquidity. During the period under review, the unsettled economic climate and heightened credit concerns made it appropriate to keep investments short term with a maximum duration of three months.

This limit applied to all entities on the suggested Sector Credit List with the following exceptions:

1. UK Government and related entities such as Local Authorities. Their suggested duration limit will remain at five years.
2. UK semi-nationalised institutions (Lloyds / RBS). We continue to view the current significant UK ownership of these entities as providing significant comfort to investors.
3. Money Market Funds.

A full list of investments held as at 31st December 2012, compared to Sector's counterparty list, and changes to Fitch, Moody's and S&P's credit ratings during quarter ended 31st December 2012 are shown in Appendix 2.

Investment rates available in the market have continued at historically low levels and have fallen further during the quarter as a result of a number of UK and overseas factors. Key among these were the UK Funding for Lending Scheme and the ECB's pledge to support the Eurozone. £4m of in-house funds were available for investment purposes during the quarter. These funds were available on a temporary basis, and were invested for two months (£2m) and three months (£2m). The level of funds available was mainly dependent on the timing of precept payments, receipt of grants and the changes due to Housing Finance Reform. The Council holds **£19m** core cash balances for investment purposes (i.e. funds available for more than one year).

Investment performance for quarter ended 31st December 2012

Benchmark	Benchmark Return	Council Performance	Investment Interest Earned
7 day	0.36%	1.25%	£290,000

As illustrated, the Council outperformed the benchmark by 0.89%. The Council's budgeted investment return for 2012/13 is £287,000, and performance for the year to date is approximately £75k above budget.

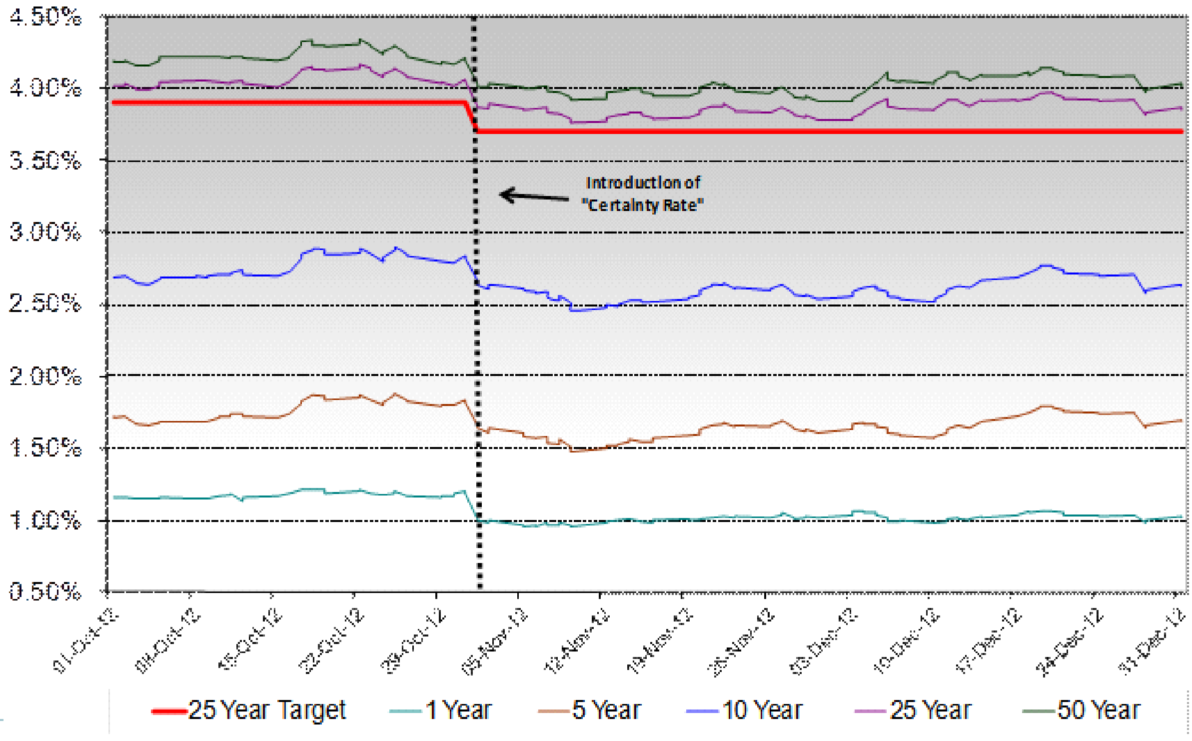
4. New borrowing:

No borrowing was undertaken during the quarter.

Sector's 25 year PWLB target rate for new long term borrowing for the quarter was lowered to 3.70% from 3.90% following the introduction of the "Certainty Rate" on 1st November 2012. The table below has been complicated by the introduction of this. However, gilt yields (on which PWLB rates are based), generally rose during the quarter.

PWLB rates quarter ended 31.12.2012

	1 Year	5 Year	10 Year	25 Year	50 Year
Low	0.96%	1.48%	2.46%	3.76%	3.91%
Date	05/11/12	09/11/12	09/11/12	09/11/12	30/11/12
High	1.21%	1.88%	2.90%	4.17%	4.34%
Date	17/10/12	25/10/12	25/10/12	22/10/12	22/10/12
Average	1.07%	1.68%	2.66%	3.93%	4.09%



Borrowing in advance of need

This Council has not borrowed in advance of need during the quarter ended 31st December 2012 and has no intention to borrow in advance in 2012/13.

5. Debt rescheduling

Debt rescheduling opportunities have been limited in the current economic climate and structure of interest rates following increases in PWLB new borrowing rates in October 2010. 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 below:

Prudential and Treasury Indicators as at 31st December 2012

Prudential Indicator	2012/13 Budget £000	Quarter 3 Actual £000
Authorised limit for external debt	111,000	111,000
Operational boundary for external debt	105,473	105,473
Net borrowing	91,266	91,266
Capital Financing Requirement (CFR)	98,233	98,233
Maturity structure of borrowing limits:		
Under 12 months	10,186	10,186
12 months to 2 years	2,837	2,837
2 years to 5 years	6,095	6,095

5 years to 10 years	11,526	11,526
10 years and above	76,226	76,226