Subject:	**TREASURY MANAGEMENT QUARTER ONE REPORT 2017/18**
Meeting and Date:	**GOVERNANCE – 28 SEPTEMBER 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 30th June 2017 (Q1) and an update of activity to date.
Recommendation:	That the report is received

1. Summary

The Council's investment return for the June quarter was 0.45%, which outperformed the benchmark[1] by 0.27%. Actual interest and dividends income for the quarter was £77k, which is in line with the year-to-date (YTD) budget of £76k. The Council's projected investment return for 2017/18 is £370k, which is £65k better than the original budget estimate of £305k. This improvement is due to the estimated dividend from new investments in the CCLA Property Fund, which will compensate for the general shortfall in interest rates elsewhere, as rates received on fixed term deposits and call accounts have continued to fall since the reduction of the base rate to 0.25%.

As of 1st April 2017, the Council has appointed Arlingclose Limited as its treasury advisors, and they have proposed various investment options that would help to improve returns and spread risk. These are currently being explored and evaluated, and a briefing will be given to the Investment Advisory Group (IAG) on 4th October to discuss the options as part of the Council's due diligence process. Pending this briefing, the majority of investments maturing from June 2017 onwards have not been reinvested, but have been kept in short-term call accounts and money market funds, with the exception of £6 million invested in the CCLA property fund (in £3m tranches on 30th June and 31st July), which is within the limit set in the Treasury Management Strategy Statement (TMSS) approved by members. Additionally, we have loaned £5m to Telford & Wreckin Council for 3 months from 31st August at 0.25%.

The Council remained within its Treasury Management and Prudential Code guidelines during the period, with the exception of briefly exceeding the £8m investment limit with the Bank of Scotland from 19th – 29th June 2017, when a number of deposits matured at the same time. However, the funds stood at a maximum of £8.463m for 11 days only, in an instant access call account.

[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.

2. Introduction and Background

CIPFA (the Chartered Institute of Public Finance and Accountancy) issued the revised Code of Practice for Treasury Management in November 2011; 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 2017/18 Treasury Management Strategy (TMS) on 1st March 2017 as part of the 2017/18 Budget and Medium Term Financial Plan.

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 Advisors, Arlingclose.

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

As at 30th June 2017, the Council's investment portfolio totalled £69.3m (see Appendix 2). However, some of this is shorter term, as significant funds sitting in the Dover Regeneration and Economic Development Reserve are earmarked for spending during 2017/18 and 2018/19 on the new Dover leisure centre, town hall refurbishment and other approved capital projects. After these approved commitments, there should be £20m - £25m underlying core funds available for longer term investment, while the remainder of funds will need to be kept in shorter term instruments and bank accounts for cash-flow requirements and future capital projects (subject to project appraisals).

Three fixed deposits matured in June totalling £12.4m, of which £3m was invested with the CCLA property fund on 30th June, the rest being deposited in call accounts.

The post-Brexit reduction in bank base rate, the on-going pressure on interest rates generally, and the prospect of "bail in" risk with major banks and building societies, continue to place pressure on returns and undermine the notion that such investments will remain "low risk" in the longer term. For these reasons, alternative investment instruments are being considered to diversify and spread risk while improving returns, as recommended by our new treasury advisors, Arlingclose.

3. Annual investment strategy

The investment portfolio, as at the end of June 2017, is attached at Appendix 2. Total balances held for investment and cash-flow purposes were £69.3m, rising to £72.3m at the end of August (see Appendix 4). The increase reflects normal cash-flow fluctuations 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 September 2017 of £2.35m.

Since the end of the June quarter, seven fixed term deposits have matured totalling £26.5m. The £5m deposit with Suffolk County Council matured on 10th July and was rolled over for another two months at 0.15%, and subsequently for a further month at 0.15%. A further £3m was invested in the CCLA property fund on 31st July earning 4.2% (est.), and £5m has been deposited with Telford and Wrekin Council for 3 months from 31st August 2017 at 0.25%.

All other funds are currently being held in call accounts, pending a briefing to the IAG on 4th October. As a result, cash-flow funds increased from £10.6m at 31st March 2017 to £18.5m at 30th June 2017 (see Appendix 2), and then increased further to £31.6m by the end of August 2017 (see Appendix 4), although this will reduce due to approved capital spend in the coming weeks.

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.

Economic background

The report attached (Appendix 1) contains information up to the end of June 2017; since then we have received an update from Arlingclose, included below. Please note that any of their references to quarters are based on *calendar* years:

Introduction

Commodity prices slid back over the past six months with oil falling below $45 a barrel before inching back up to $53.8 a barrel (data as at 11/9). The primary factor in the oil price fall was oversupply and a lack of belief in OPEC's (Organisation of Petroleum Exporting Countries) ability to deliver on agreed production caps of members.

UK Data

UK Consumer Price Inflation (CPI) index rose with the data print for May showing CPI at 2.9%, its highest since June 2013 as the fall in the value of sterling following the June 2016 referendum result continued to feed through into higher import prices. Thereafter, however, CPI has fallen back to 2.6% in July which is in line with the Bank of England's estimate published in its August Inflation Report. The new inflation measure CPIH, which includes owner occupiers housing costs, was also 2.6%. The most recent labour market data for June 2017 showed that the unemployment rate had fallen further to 4.4%, its lowest since July 1975 but that the squeeze on real wages (i.e. after inflation) is intensifying with average earnings growing at 2.1%. Q1 and Q2 GDP data showed economic activity growing at a much slower pace of 0.2% and 0.3% respectively, the services sector providing the main boost to growth. With the dominant services sector accounting for 79% of GDP, the strength of consumer spending remains vital to growth, but with household savings falling and real wage growth negative, there are concerns that these constraints will limit growth in the second half of calendar year 2017.

Understandably, the Bank of England made no change to monetary policy at its meetings this year, although the vote to keep Bank Rate at 0.25% narrowed to 5-3 in

June highlighting that some MPC members were more concerned about rising inflation than the risks to growth.

US Data

Having raised rates in March, the US Federal Reserve made no change to monetary policy at the conclusion of its meeting in May. The weakness witnessed in first quarter US GDP of 1.2% annualised was overhauled by a more decent 2.6% annualised growth rate in the second quarter. The US Federal Reserve increased its target range of official interest rates in June for the second time in 2017 by 25bps (basis points) to between 1% and 1.25% and, despite US inflation hitting a soft patch with core CPI at 1.7%, a further similar increase is expected during the second half of 2017. There is also expectation that the Fed will announce at its September meeting its intention on unwinding the size of its balance sheet.

Global

Geopolitical tensions escalated in August as the US and North Korea exchanged verbal threats over reports about enhancements in North Korea's missile programme. The provocation from both sides helped wipe off nearly $1 trillion from global equity markets but safe-haven assets such as gold, the US dollar and the Japanese yen benefit. (As we write, tensions remain high, with North Korea's threat to fire missiles towards Guam [which is a US naval base], their recent missile test over Japan and an apparent successful nuclear bomb test.)

Brexit

Prime Minister Theresa May called an unscheduled General Election in June, to resolve uncertainty and in the hope of gaining an enhanced mandate to enter the forthcoming Brexit negotiations. The surprise result has led to a minority Conservative government in a confidence and supply arrangement with the Democratic Unionist Party. This political impasse clearly results in an enhanced level of political uncertainty. Although the potential for a so-called hard Brexit is now diminished, lack of clarity over future trading partnerships, in particular future customs agreements with the rest of the EU block, is denting business sentiment and investment.

The reaction from the markets on the UK election's outcome has been fairly muted, business confidence now hinges on the progress (or not) on Brexit negotiations, the ultimate 'divorce bill' for the exit and whether new trade treaties and customs arrangements are successfully concluded to the UK's benefit.

Interest Rates & Financial Indicators

In the face of a struggling economy and Brexit-related uncertainty, Arlingclose expects the Bank of England will look through periods of high inflation and maintain its low-for-longer stance on policy interest rates for an extended period.

Financial markets: Gilt yields displayed significant volatility over the period (data to 11/9) with the push-pull from expectations of tapering of Quantitative Easing (QE) in the US and Europe and from geopolitical tensions, which also had an impact on gilts.

The yield on the 5 year gilts rose from 0.35% in mid-June to 0.71% in early July, before falling back to 0.39% in September. The 10-year gilts rose from 0.93% to 1.31%, then falling to 0.97% over the same period and the yield on 20-year gilts rising from 1.62% to 1.94% then falling back to 1.61%.

The FTSE 100 nevertheless powered away reaching a record high of 7548 in May but dropping off marginally to 7415 at the time of writing (9th Sep). Money markets rates have remained low: 1-month, 3-month and 12-month LIBID rates have averaged 0.25%, 0.30% and 0.65% over the period from January to 9th September.

Credit Ratings

Credit background: UK bank credit default swaps have continued their downward trend, reaching three year lows by the end of June. Bank share prices have not moved in any particular pattern.

There were a few credit rating changes during the quarter. Moody's downgraded Standard Chartered Bank's long-term rating to A1 from Aa3 on the expectation that the bank's profitability will be lower following management's efforts to de-risk their balance sheet. The agency also affirmed Royal Bank of Scotland's and NatWest's long-term ratings at Baa1, placed Lloyds Bank's A1 rating on review for upgrade, revised the outlook of Santander UK plc, and Nationwide and Coventry building societies from negative to stable following improvement to their asset quality, but downgraded the long-term rating of Leeds BS from A2 to A3. [If applicable to your portfolio] Moody's downgraded the major Canadian banks' long-term ratings on the agency's expectation of a more challenging operating environment for the banks for the remainder of 2017 and beyond that could lead to a deterioration in the banks' asset quality and increase their sensitivity to external shocks. Moody's downgraded the ratings of the large Australian banks to Aa3 from Aa2 reflecting the agency's view of the rising risks from the banks' exposure to the Australian housing market and the elevated proportion of lending to residential property investors.

S&P also revised Nordea Banks outlook to stable from negative, whilst affirming their long-term rating at AA-. The outlook revision reflects Nordea's geographic diversification and strong financials. The agency also upgraded the long-term rating of ING Bank from A to A+.

Regulatory

Ring-fencing, which requires the larger UK banks to separate their core retail banking activity from the rest of their business, is expected to be implemented within the next year. In May, following Arlingclose's advice, the Authority reduced the maximum duration of its deposits at Bank of Scotland, HSBC Bank and Lloyds Bank from 13 months to 6 months as there is some uncertainty surrounding which banking entities the Authority will be dealing with once ring-fencing is implemented. Even where there has been a level of clarity provided regarding where local authority customers will sit within the proposed new legal structures of the banks, it is not yet known what the balance sheet structures of those banks will be.

The new EU regulations for Money Market Funds were finally approved and published in July and existing funds will have to be compliant by no later than 21st January 2019. The key features include Low Volatility NAV (LVNAV) Money Market Funds which will be permitted to maintain a constant dealing NAV, providing that the fund's market NAV does not deviate from the dealing NAV by more than 20 basis points, alongside other criteria including minimum liquidity requirements. MMFs will not be prohibited from having an external fund rating (as had been suggested in draft regulations). Arlingclose expects most of the short-term MMFs it recommends to convert to the LVNAV structure but it remains to be seen how each fund manager reacts to the final regulation.

4. **Net Borrowing**

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

5. **Debt Rescheduling**

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

6. **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, subject to the note in (1) above.

Appendices

Appendix 1 – Arlingclose Treasury Management Report for Quarter One

Appendix 2 – Investment portfolio as at 30 June 2017

Appendix 3 – Borrowing portfolio as at 30 June 2017

Appendix 4 – Investment portfolio as at 31 August 2017

Background Papers

Medium Term Financial Plan 2017/18 – 2020/21

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