Gloucester City Council

Meeting:	**Audit and Governance Committee**	**:**	**8 September 2014**
	Cabinet		**17 September 2014**
Subject:	**Treasury Management Update – Quarter 1 Report 2014/15**		
Report Of:	**Head of Finance**		
Wards Affected:	**All**		
Key Decision:	**No**	**Budget/Policy Framework:**	**Yes**
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Appendices:	**1. Prudential and Treasury Indicators** **2. Treasury Management Investments** **3. Economic Outlook** **4. Detailed interest rate forecasts**		

1.0 Purpose of Report

1.1 One of the requirements of the revised Code of Practice for Treasury Management in November 2011 recommends that members should be updated on treasury management activities at least twice a year, but preferably quarterly. This report covers Quarter 1, 1st April 2014 to 30th June 2014.

1.2 This report will highlight issues specific to the Council and also highlight the overall economic outlook as provided by the Councils treasury advisors Capita Asset Services.

1.3 The body of the report provides an overview of the Councils performance in Quarter 1 ;

- **Appendix 1** highlights the key performance indicators in line with the Councils Treasury Management Strategy.
- **Appendix 2** is the investments held at the end of quarter 1.
- **Appendix 3** is an economic summary provided by the Councils treasury advisors.
- **Appendix 4** is a detailed commentary on interest rate forecasts

2.0 Recommendations

2.1 Audit and Governance Committee is asked to **RESOLVE** that the report be noted and note that no changes are required to the prudential indicators.

3.0 Annual Investment Strategy

The Treasury Management Strategy Statement (TMSS) for 2014/15, which includes the Annual Investment Strategy, was approved by the Council on 10th April 2013. It sets out the Council's investment priorities as being:

- Security of capital;
- Liquidity; and
- Yield

3.1 The Council will also aim to achieve the optimum return (yield) on 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 cashflow 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 sovereign credit rating and Credit Default Swap (CDS) overlay information.

3.2 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 Funding for Lending Scheme. The average level of funds available for investment purposes during the quarter was £5.4m. 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.

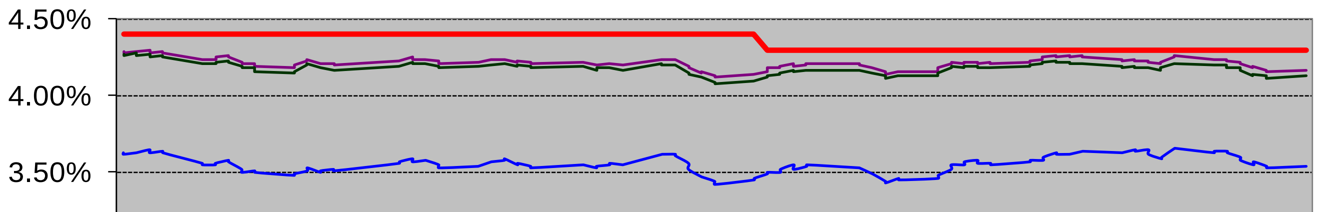
4.0 New Borrowing

4.1 The 25 year PWLB target (certainty) rate for new long term borrowing for the quarter remained at 4.40% until the 19th May when it fell to 4.30%.

4.2 No borrowing was undertaken during the quarter.

4.3 PWLB certainty rates, quarter ended 30th June 2014

	1 Year	5 Year	10 Year	25 Year	50 Year
Low	1.20%	2.50%	3.42%	4.12%	4.08%
Date	08/04/2014	14/04/2014	16/05/2014	16/05/2014	16/05/2014
High	1.47%	2.85%	3.66%	4.30%	4.28%
Date	17/06/2014	20/06/2014	20/06/2014	03/04/2014	02/04/2014
Average	1.29%	2.66%	3.56%	4.22%	4.18%



4.4 **Borrowing in advance of need.**

The Council has not borrowed in advance of need during the quarter ended 30th June 2014 and has not borrowed in advance in all of 2014/15.

5.0 Debt Rescheduling

5.1 Debt rescheduling opportunities have been limited in the current economic climate and following the increase in the margin added to gilt yields which has impacted PWLB new borrowing rates since October 2010. During the quarter ended 31st March 2014, no debt rescheduling was undertaken.

6.0 Compliance with Treasury and Prudential Limits

6.1 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.

6.2 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 in appendix 1.

7.0 Other

7.1 During 2014/15 the Council continued to maintain an under-borrowing position.

7.2 This under-borrowing reflects that the Council resources such as reserves and provisions will have reduced debt rather than be externally invested. This strategy is sensible, at this point in time, for two reasons. Firstly, there is no differential between the marginal borrowing rate and investment rate so there is nothing to be gained by investing Council resources externally. Secondly, by using the resources to reduce debt the Council will reduce exposure to investment counterparty risk.

8. Financial Implications

8.1 Contained in the report

(Financial Services have been consulted in the preparation this report.)

9. Legal Implications

9.1 There are no legal implications from this report

(Legal Services have been consulted in the preparation this report.)

10.0 Risk & Opportunity Management Implications

10.1 There are no specific risks or opportunities as a result of this report

11. People Impact Assessment (PIA):

11.1 A PIA screening assessment has been undertaken and the impact is neutral. A full PIA is not required.

12. Other Corporate Implications

Community Safety

12.1 None

Sustainability

12.2 None

Staffing & Trade Union

12.3 None

APPENDIX 1

Prudential and Treasury Indicators as at 30th June 2014

Treasury Indicators	2014/15 Strategy	Quarter 1 Actual
Authorised limit for external debt	£86M	£66.09m
Operational boundary for external debt	£86M	£66.09M
Gross external debt	£86M	£66.09m
Investments	Nil	Nil
Net borrowing	£86m	£66.09m
Maturity structure of fixed rate borrowing - upper and lower limits		
Under 12 months	0% - 50%	0%
12 months to 2 years	0% - 50%	15.63%
2 years to 5 years	0% - 50%	23.44%
5 years to 10 years	0% - 50%	9.77%
10 years to 20 years *1	0% - 80%	12.10%
20 years to 30 years *1	0% - 80%	39.06%
30 years to 40 years *1	0% - 80%	0%
40 years to 50 years *1	0% - 80%	0%
Upper limit of fixed interest rates based on net debt *2	100%	46.04%
Upper limit of variable interest rates based on net debt *2	100%	53.96%
Upper limit for principal sums invested for over 364 days	Nil	Nil

Prudential Indicators	2014/15 Strategy	Quarter 1 Actual
Capital expenditure * • **HRA** • **GF**	£7.100m £6.882m	£0 £439k

APPENDIX 2

Investment Portfolio

There were no Investments held as at 31st March 2014

Appendix 3:

1.0 Economic Background

1.1 After strong UK GDP growth of 0.7%, 0.8% and 0.7% in quarters 2, 3 and 4 respectively in 2013, and 0.8% in Q1 2014, it appears very likely that strong growth will continue into 2014 as forward surveys are very encouraging. There are also positive indications that recovery is starting to broaden away from reliance on consumer spending and the housing market into construction, manufacturing, business investment and exporting. This strong growth has resulted in unemployment falling much faster through the threshold of 7%, set by the Monetary Policy Committee (MPC) last August, before it said it would consider any increases in Bank Rate. The MPC has, therefore, now broadened its forward guidance by adopting five qualitative principles and looking at a much wider range of about eighteen indicators in order to form a view on how much slack there is in the economy and how quickly slack is being used up. Accordingly, markets are expecting a first increase around the end of 2014.

1.2 Also encouraging has been the sharp fall in inflation (CPI), reaching 1.5% in May, the lowest rate since 2009. Forward indications are that inflation is likely to fall further in 2014 to possibly 1%. The return to strong growth has also helped lower forecasts for the increase in Government debt by £73bn over the next five years, as announced in the Autumn Statement, and by an additional £24bn, as announced in the March 2014 Budget - which also forecast a return to a significant budget surplus, (of £5bn), in 2018-19. However, monthly public sector deficit figures have disappointed in this quarter.

1.3 In June, the Federal Reserve continued with its monthly $10bn reductions in asset purchases, which started in December 2014. Asset purchases have now fallen from $85bn to $35bn and are expected to stop by Q3 201, providing strong economic growth continues this year. First quarter GDP figures were depressed by exceptionally bad winter weather, but growth rates since then look as if they are recovering well.

1.4 The Eurozone is facing an increasing threat from deflation. In May, the inflation rate fell further, to reach 0.5%. However, this is an average for all EZ countries and includes some countries with negative rates of inflation. Accordingly, the ECB did take some rather limited action in June to loosen monetary policy in order to promote growth.

2.0 Interest Rate Forecast

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

	Sep-14	Dec-14	Mar-15	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17
Bank rate	0.50%	0.50%	0.75%	0.75%	1.00%	1.00%	1.25%	1.25%	1.50%	1.75%	2.00%	2.00%
5yr PWLB rate	2.70%	2.80%	2.90%	3.00%	3.00%	3.10%	3.20%	3.30%	3.30%	3.40%	3.50%	3.60%
10yr PWLB rate	3.70%	3.70%	3.80%	3.90%	4.00%	4.00%	4.10%	4.20%	4.20%	4.30%	4.40%	4.40%
25yr PWLB rate	4.40%	4.40%	4.50%	4.60%	4.70%	4.70%	4.80%	4.80%	4.90%	4.90%	4.90%	5.00%
50yr PWLB rate	4.40%	4.40%	4.50%	4.60%	4.70%	4.70%	4.80%	4.80%	4.90%	4.90%	4.90%	5.00%

2.2 Capita Asset Services undertook a review of its interest rate forecasts in May, after the Bank of England's Inflation Report. However, more recent developments to the Bank of England's forward guidance have necessitated a second updating in this quarter carried out on 30 June. This latest forecast now includes a first increase in Bank Rate in quarter 1 of 2015 (previously quarter 4 of 2015).

3.0 SUMMARY OUTLOOK

3.1 Until 2013, the economic recovery in the UK since 2008 had been the worst and slowest recovery in recent history. However, growth rebounded during 2013 and the first quarter of 2014 to surpass all expectations, propelled by recovery in consumer spending and the housing market. Forward surveys are currently very positive in indicating that growth prospects are also strong for the rest of 2014, not only in the UK economy as a whole, but in all three main sectors, services, manufacturing and construction. This is very encouraging as there does need to be a significant rebalancing of the economy away from consumer spending to construction, manufacturing, business investment and exporting in order for this start to recovery to become more firmly established. One drag on the economy has been that wage inflation has been significantly below CPI inflation, so disposable income and living standards were being eroded, (although income tax cuts had ameliorated this to some extent). However, recent falls in inflation have created the potential for the narrowing of this gap and it could narrow further during this year, especially if there is also a recovery in growth in labour productivity (leading to increases in pay rates). With regard to the US, the main world economy, it faces similar debt problems to those of the UK, but thanks to reasonable growth, cuts in government expenditure and tax rises, the annual government deficit has been halved from its peak without appearing to do too much damage to growth, although labour force participation rates remain lower than ideal.

3.2 As for the Eurozone, concerns subsided considerably during 2013. However, sovereign debt difficulties have not gone away and major issues could return in respect of any countries that do not dynamically address fundamental issues of low growth, international uncompetitiveness and the need for overdue reforms of the economy, (as Ireland has done). It is, therefore, possible over the next few years that levels of government debt to GDP ratios could continue to rise. This could mean that sovereign debt concerns have not disappeared but, rather, have only been postponed.

APPENDIX 4

DETAILED COMMENTARY ON INTEREST RATES FORECAST

THE UK

May Bank of England Quarterly Inflation Report

Over the last four quarters, we have had a continuing run of strong economic news which has consolidated confidence that the UK economy is recovering strongly. However, please note that the Governor said the economy "has only just begun to head back towards normal" after the slowest ever recovery from a recession. Widespread disbelief that unemployment would take nearly three years to fall to 7%, as the Bank forecast at the time of the August Inflation Report, has indeed proved to be well founded as the rate fell to 6.8% in Q1 2014 and then to 6.6% in quarter 2. Accordingly, this latest Inflation Report has seen the Bank provide a view of the economy as moving from a recovery supported by household spending to a more broadly based expansion sustained by:-
Growth in business investment;

- A change from falling to rising real wages (average wage increases started to exceed the rate of CPI inflation over the last quarter but more recently, this situation has reversed back again);
- Increasing employment;
- Productivity growth to support those real wage increases and improve export competitiveness – expected to reach 2.5% by the end of 2014.

Key economic statistics in the Inflation Report were as follows: -

- GDP has grown at an annual rate of 3.1% over the last four quarters;
- Bank of England GDP forecasts: 2014 unchanged at 3.4%, 2015 upped from 2.7% to 2.9%, and for 2016 unchanged at 2.8%;
- Inflation to be well behaved over the next two years: rising to 2.0% in two years' time from 1.7% in Q2 2015;
- Growth of productivity has only started to marginally improve, although it is expected to gradually rise back to its average historical rate.

We have reservations that the Bank's current forecasts for GDP growth may be over optimistic and that strong economic growth could weaken as the main impetus has come from consumer spending and an uplift in borrowing to buy property. Whilst the release of this burst of pent up demand to buy property is having a very welcome effect on the economy, this surge is likely to fade in time and will then leave a question mark over where growth is going to come from. Basically, there are four main areas of demand in the UK economy: -

Consumers – but most consumers are maxed out on borrowing and trying to pay down debt. In addition, although average wage inflation is now higher than CPI inflation, many consumers are still experiencing declining disposable income as their wage increases are continuing to be less than inflation. This will not reverse until productivity and business investment improve, so as to warrant paying higher wages than are being paid currently. It is mainly higher wages that could provide a solid stimulus to an increase in consumer expenditure which would then underpin strong growth. There are also concerns that a significant number of mortgage holders are going to find it very difficult to manage increases in Bank Rate, and so in mortgage rates, when they do start.

Government – again, maxed out on borrowing and committed to austerity programmes to reduce its expenditure. Further austerity measures are still to come.

Foreigners buying our exports – but the EU, our major export market, is likely to experience tepid growth, at best, for the next few years. Also the rise in the value of Sterling means that imports are becoming cheaper which will cause UK consumers to increase purchases of cheaper imported goods in preference to UK produced competing products, so depressing UK GDP growth.

Business investment in fixed capital formation; but this has fallen from 13.5% to 10.4% of GDP over 2008 - 2013. However, there are encouraging signs that businesses are catching the upturn in optimism and are beginning to increase investment and exports into new markets in emerging countries. However, it will take a significant length of time for this start to make a material impact on total UK GDP growth rates and to take over the baton from consumers.

The evolution of forward guidance

If you have been following the comments flying around through late June and early July, you may have ended up with the impression that Carney and other MPC members have been giving rather confused signals as to what the MPC's thoughts are when making "forward guidance" comments on what is going to happen to Bank Rate and when. Here is a quick recap of how forward guidance has evolved: -

- **August 2013.** The MPC would not consider raising Bank Rate until the unemployment rate falls to 7%; this was deemed unlikely to occur until late 2016.
- **February 2014 Quarterly Inflation Report.** Forward guidance mark 1 was abolished as the unemployment rate fell rapidly (the 7% threshold was breached in April 2014). Mark 2 'fuzzy guidance' was to be based on a range of about eighteen indicators but was still to be driven, ultimately, by the fundamental concept of how quickly the amount of slack in the economy after the recession, was used up. However, there were a wide range of views in the MPC as to how much slack there was and also around how quickly it would be used up, as there is no definitive and objective way of measuring this concept of slack. However, the Bank, and Carney, both commented that market views of likely increases in Bank Rate were in the right ball park (i.e. late 2014 / early 2015).
- **14 May: 2014 Quarterly Inflation Report.** By this time, we had hard data that the UK economic recovery was going full steam ahead in 2014, i.e. this pointed to it being more likely that Bank Rate would have to go up sooner than had been expected previously. Instead of which, Carney went out on a limb and made comments to the effect that the possibility of any Bank Rate increase in 2014 and, arguably, even as soon as Q1 2015 was minimal. No other MPC member

contradicted these comments, so the logical inference was that his comments must also have been a reflection of the view of the MPC.

- **12 June: Carney Mansion House speech.** Carney expressed surprise that financial markets had not factored in a higher probability that Bank Rate could go up in 2014. To say that the financial markets were flabbergasted by this dramatic change of tack since a month ago was a bit of an understatement!
- **18 June: MPC minutes.** The MPC said, (for a second time), that the decision on rates was becoming more balanced. It also said that the low probability (15%) attached in the markets to a rise in 2014 was "somewhat surprising". So Carney's comments at the Mansion House were not a Suarez moment of madness but rather comments that the whole MPC agreed with. So the financial markets now had to go back to where they started from; that they WERE right that a Bank Rate increase was likely in 2014, probably towards the end of the year (November 2014 would be the quarterly Inflation Report month when the MPC would be most likely to take action in Q4). However, to be fair to Carney and the MPC, saying that 15% was too low leaves wide open just how too low this was, i.e. should it have been a 30% risk; or 70%? Do those comments really mean the financial markets are now right to pencil in a first increase in Q4 2014?
- **24 June: Select Committee Carney comments.** An MP accused Carney of being an 'unreliable boyfriend' i.e. blowing hot one day and cold the next day. Overall, MPs felt that Carney's attempts at communicating forward guidance had been muddled and left the financial markets, and others, confused in as much as the various attempts at forward guidance had pointed in different directions. Carney attempted to dig himself out of this onslaught by emphasising that the timing for the FIRST increase in Bank Rate would be data driven i.e. no one could say for certain when that would occur. However, what he placed the most emphasis on was the medium term, i.e. the timing of the first increase was of a lesser degree of importance. So, in the medium term, increases would be **"limited and gradual".** Also, rates would not get back to around 5% as before the financial crisis. He also criticised the financial markets for not responding to the strength of recent economic data and commented that the MPC would change its views according to how data evolved. This evoked a response from one MP to say that in that case, forward guidance was redundant and we had returned to the days of "old fashioned smoke and mirrors"!

So where are we now?

- Let's make an attempt at trying to blow away the smoke of battle to see clearly where we are now: -
- Since our previous interest rate forecast on 19 May, short Sterling rates (a good indicator for when financial markets expect the first increase in Bank Rate), have shifted significantly from indicating an early 2015 first increase to Q4 2014.
- The one piece of guidance which appears to have emerged from the fray of battle unscathed is that in the medium term increases in Bank Rate will be **"LIMITED AND GRADUAL".** Also, rates would not get back to around 5% as before the financial crisis.
- The MPC have also indicated their concerns that an earlier increase in Bank Rate could help them later with implementing a slower pace of increases in Bank Rate

and keeping Bank Rate lower, than if there was a later timing for the first increase. It, therefore, becomes a matter of debate as to how rigidly they will be driven by actual data and what their 2 to 3 year forecasts for inflation (and on the other side of the same coin - slack), indicate, and instead how much weight they will put on their judgement to decide on the optimum time to vote for the first increase given their medium term concerns. Another way of putting this is ‘should forecasters now be placing more weight on what they think the MPC will do, rather than what they think inflation, and other data, would warrant on their own in terms of the timing of the first increase in Bank Rate?’

- Many forecasters have, therefore, brought forward their forecast for the first increase in Bank Rate to take account of the various comments that have been made by the MPC and Carney and the fact that economic recovery in 2014 is likely to be very robust. (27.6.14 June Q1 GDP figure came in at an annual rate of 3.0%. Surveys and other economic data are now pointing to Q2 building further momentum to around an annual rate of 3.4%.) We agree with this movement and have moved forward our first increase in Bank Rate from Q4 2015 to Q1 2015.
- But…and this little word BUT can have such a powerful effect! What would happen in the medium term if economic data were to take a nasty turn? Suppose the MPC over estimate the amount of slack in the economy and under estimate the speed with which it is used up? Or, to put it another way, suppose they get their forecasts for inflation over the next 2-3 years too low and inflation builds up quickly and threatens to become a significant risk. Could the commitment to “limited and gradual” increases in Bank Rate melt and disappear like snow on a balmy spring day? One wonders.
- Accordingly, in our revised interest rate forecast, this earlier start to the timing of the first increase in Bank Rate has resulted in slight increases in Bank Rate in the two subsequent years compared to our previous forecast. However, we have slowed down the pace at which increases occur in line with the ‘slow and gradual’ forward guidance which has been emphasised recently.

THE GLOBAL ECONOMY

- We can only repeat our previous warnings that we are in times when events can precipitate major volatility in markets. During this year we have seen a flight to safe havens resulting from investment flows out of emerging countries back to western economies as the prospects for higher growth in these economies has improved. This has been triggered by the Fed’s start to tapering and successive months of reducing QE purchases by $10bn per month.
- As for the EZ, while Ireland and Portugal have made very good progress and have been able to exit from their bail out programmes, there remains the prospect that Greece could require a third bailout package, though not one on the same scale as the first two.
- A further concern over the EZ is the potential “Japanification” of the economy as some countries are now experiencing, or are very near to, deflation. Deflation causes a real increase in the value of debt. This is dangerous in itself for already heavily indebted countries but even more so where countries are still running up annual deficits of 3% or more. We are, therefore, concerned that some EZ countries experiencing low growth, will, over the next few years, see a significant

increase in total government debt to GDP ratios. There is a potential danger for these ratios to rise to the point where markets lose confidence in the financial viability of one, or more, countries. However, it is impossible to forecast whether any individual country will lose such confidence, or when, and so precipitate a resurgence of the EZ debt crisis. While the ECB has adequate resources to manage a debt crisis in a small EZ country, if one, or more, of the larger countries were to experience a major crisis of market confidence, this would present a serious challenge to the ECB and to EZ politicians. All eyes are currently on the ECB in terms of whether they will provide further policy support, having resorted to negative interest rates in June in an effort to encourage financial institutions to lend into the "real economy".

CAPITA ASSET SERVICES FORWARD VIEW

We would remind clients of the view that we expressed in our previous interest rate revision newsflashes of just how unpredictable PWLB rates and bond yields are as we are experiencing volatility which is highly correlated to geo-political developments.

As there remain the threat of potential risks from a number of sources caution must be exercised in respect of all interest rate forecasts at the current time. The general expectation for an eventual trend of gently rising gilt yields and PWLB rates is predicted to remain unchanged, as market fundamentals will focus on the improved UK economic performance as well as issues such as the sheer volume of UK gilt issuance (and also US Treasury issuance) and the price of those new debt issues. Negative (or positive) developments on the geo-political front as well as any fresh issues regarding an EZ-related sovereign debt crisis could significantly impact safe-haven flows of investor money into UK, US and German bonds and produce shorter term movements away from our central forecasts.

Our interest rate forecast is based on an initial assumption that we will not be heading into a major resurgence of the EZ debt crisis, or a break-up of the EZ, but rather that there will be a managed, albeit painful and tortuous, resolution of the debt crisis where EZ institutions and governments eventually do what is necessary - but only when all else has been tried and failed. Under this assumed scenario, growth within the EZ will be tepid for the next couple of years and, therefore, has the potential to dampen UK growth, as the EU is our biggest export market.

Our PWLB forecasts are based around a balance of risks. However, we would flag up the potential for upside risks, especially for longer term PWLB rates, as follows:-

- A further surge in investor confidence that robust world economic growth is firmly expected, causing a greater flow of funds out of bonds and into equities.
- UK inflation being significantly higher than in the wider EU and US, causing an increase in the inflation premium inherent to gilt yields.

Downside risks currently include:

- The situation over Ukraine poses a major threat to EZ and world growth if it was to deteriorate into "economic warfare" between the West and Russia, where Russia resorted to using its control over gas supplies to Europe. Heightened political risks in the Middle East and East Asia could also trigger safe haven flows back into bonds.
- A failure to rebalance UK growth towards exporting and business investment causing a weakening of overall economic growth beyond 2014.

- A resurgence of the EZ sovereign debt crisis caused by ongoing deterioration in government debt to GDP ratios.
- Recapitalising of European banks requiring more government financial support.
- Lack of support by populaces in Eurozone countries for austerity programmes, especially in countries with very high unemployment rates e.g. Greece and Spain, which still face huge challenges in engineering economic growth to correct their budget deficits on a sustainable basis.
- Monetary policy action failing to stimulate sustainable growth in western economies, especially the Eurozone and Japan.
- There are also increasing concerns that the reluctance of western economies to raise interest rates significantly for some years. This plus the huge QE measures which remain in place (and may be added to by the ECB in the near future), has created potentially unstable flows of liquidity searching for yield and therefore heightened the potential for an increase in risks in order to get higher returns. This is a return of the same environment which led to the 2008 financial crisis.