Gloucester City Council

Meeting:	**Audit & Governance Committee** **Cabinet Briefing** **Cabinet**	**Date:**	**13 November 2014** **19 November 2014** **10 December 2014**
Subject:	**Treasury Management Update – Quarter 2 Report 2014/15**		
Report Of:	**Cabinet Member for Performance and Resources**		
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 2, 1st July 2014 to 30th September 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 2.
- **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.

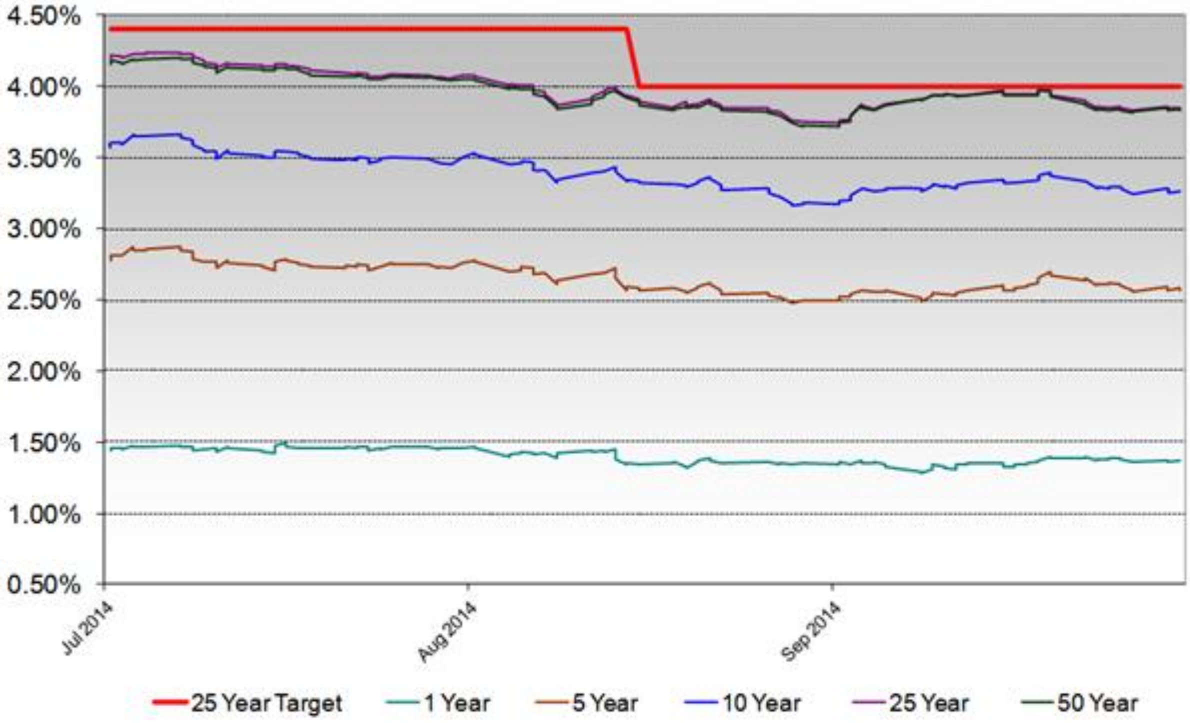
3.2 Investment rates available in the market have been broadly stable during the quarter and have continued at historically low levels as a result of the Funding for Lending Scheme. The average level of funds available for investment purposes during the quarter was £8.1m. These funds were available on 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 fell from 4.40% to 4.0% in mid August.). During Quarter 2 new external borrowing of £11.35m was undertaken in September 2014 from the PWLB / Market at a rate of 1.34%, this was to ensure greater certainty of funding and was used to repay short term borrowings of £11m.

4.2 PWLB certainty rates, quarter ended 30th September 2014

	1 Year	5 Year	10 Year	25 Year	50 Year
Low	1.28%	2.48%	3.16%	3.74%	3.72%
Date	08/09/2014	28/08/2014	28/08/2014	01/09/2014	29/08/2014
High	1.49%	2.87%	3.66%	4.24%	4.20%
Date	16/07/2014	03/07/2014	03/07/2014	04/07/2014	07/07/2014
Average	1.40%	2.66%	3.39%	3.98%	3.96%



4.3 **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 30th September 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 2 Actual
Authorised limit for external debt	£86M	£66.94m
Operational boundary for external debt	£86M	£66.94M
Gross external debt	£86M	£66.94m
Investments	Nil	Nil
Net borrowing	£86m	£66.94m
Maturity structure of fixed rate borrowing - upper and lower limits		
Under 12 months	0% - 50%	30.72%
12 months to 2 years	0% - 50%	10.83%
2 years to 5 years	0% - 50%	16.24%
5 years to 10 years	0% - 50%	6.77%
10 years to 20 years *1	0% - 80%	8.39%
20 years to 30 years *1	0% - 80%	27.06%
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%	55.19%
Upper limit of variable interest rates based on net debt *2	100%	44.81%
Upper limit for principal sums invested for over 364 days	Nil	Nil

Prudential Indicators	2014/15 Strategy	Quarter 2 Actual
Capital expenditure * • **HRA** • **GF**	£7.100m £6.882m	£2.739m £1.266m

APPENDIX 2

Investment Portfolio

There were no Investments held as at 30th September 2014

Appendix 3:

1.0 Economic Background

1.1 After strong UK GDP quarterly growth of 0.7%, 0.8% and 0.7% in quarters 2, 3 and 4 respectively in 2013, (2013 annual rate 2.7%), and 0.7% in Q1 and 0.9% in Q2 2014 (annual rate 3.2% in Q2), it appears very likely that strong growth will continue through 2014 and into 2015 as forward surveys for the services and construction sectors, are very encouraging and business investment is also strongly recovering. The manufacturing sector has also been encouraging though the latest figures indicate a weakening in the future trend rate of growth. However, for this recovery to become more balanced and sustainable in the longer term, the recovery needs to move away from dependence on consumer expenditure and the housing market to exporting, and particularly of manufactured goods, both of which need to substantially improve on their recent lacklustre performance. This overall strong growth has resulted in unemployment falling much faster through the initial 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, subsequently 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. The MPC is particularly concerned that the current squeeze on the disposable incomes of consumers should be reversed by wage inflation rising back above the level of inflation in order to ensure that the recovery will be sustainable. There also needs to be a major improvement in labour productivity, which has languished at dismal levels since 2008, to support increases in pay rates. Most economic forecasters are expecting growth to peak in 2014 and then to ease off a little, though still remaining strong, in 2015 and 2016. Unemployment is therefore expected to keep on its downward trend and this is likely to eventually feed through into a return to significant increases in pay rates at some point during the next three years. However, just how much those future increases in pay rates will counteract the depressive effect of increases in Bank Rate on consumer confidence, the rate of growth in consumer expenditure and the buoyancy of the housing market, are areas that will need to be kept under regular review.

1.2 Also encouraging has been the sharp fall in inflation (CPI), reaching 1.5% in July, 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 so far this year.

1.3 In September, the U.S. Federal Reserve continued with its monthly $10bn reductions in asset purchases, which started in December 2014. Asset purchases have now fallen from $85bn to $15bn and are expected to stop in October 2014, providing strong economic growth continues. First quarter GDP figures were depressed by exceptionally bad winter weather, but quarter 2 rebounded strongly to 4.6%.

1.4 The Eurozone is facing an increasing threat from deflation. In September, the inflation rate fell further, to reach 0.3%. 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 and September 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:

	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%	0.75%	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%	3.40%	3.50%	3.50%
10yr PWLB rate	3.50%	3.60%	3.70%	3.80%	3.90%	4.00%	4.10%	4.10%	4.20%	4.30%	4.30%
25yr PWLB rate	4.10%	4.20%	4.30%	4.40%	4.50%	4.60%	4.70%	4.80%	4.80%	4.90%	4.90%
50yr PWLB rate	4.10%	4.20%	4.30%	4.40%	4.50%	4.60%	4.70%	4.80%	4.80%	4.90%	4.90%

2.2 Capita Asset Services undertook a review of its interest rate forecasts in mid August, after the Bank of England's Inflation Report. By the beginning of September, a further rise in geopolitical concerns, principally over Ukraine but also over the Middle East, had caused a further flight into safe havens like gilts and depressed PWLB rates further. However, there is much volatility in rates as news ebbs and flows in negative or positive ways.

2.3 This latest forecast includes a move in the timing of the first increase in Bank Rate from quarter 3 of 2015 to quarter 1 of 2015 as a result of the building momentum of strong GDP growth over the last eighteen months. Confidence has also substantially increased that strong growth will continue into 2015 and 2016. However, the Governor of the Bank of England, Mark Carney, has repeatedly stated that increases in Bank Rate will be slow and gradual as the MPC is concerned about the impact of increases on many heavily indebted consumers, especially when disposable income is currently being squeezed by wage inflation running significantly under the rate of CPI inflation.

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 FORECASTS

- Financial markets have pushed back their first increase in Bank Rate from November 2014 to February 2015

- During this quarter, we have moved our first increase in Bank Rate from Q3 2015 to Q1 2015. However, we feel there are downside risks to this central forecast i.e. the first rise could be delayed further if inflation comes in lower than the Bank of England's forecast, growth in labour productivity disappoints and wage inflation fails to rise as fast as the Bank's August Inflation Report new lowered forecast for 2014 of 1.25% (half their previous forecast!).

- Recent safe-haven flows into gilts have depressed gilt yields and PWLB rates. We have previously warned that geopolitical events make forecasting PWLB rates highly unpredictable in the shorter term with any degree of confidence and reliability. We have made a major assumption that these fears will subside i.e. that these safe-haven flows will unwind and rates will rise back again over the next few quarters.

Over the last year, we have had many twists and turns in forward guidance since Mark Carney, was appointed as the Governor of the Bank of England. With the August Inflation Report, and further comments from Carney, we have yet another twist which has caught the markets out again. Indeed, some commentators have now upgraded Carney from being the 'unreliable boyfriend' blowing hot one day and cold the next, to being the 'fearful fiancée' i.e. he has popped the question but can't bring himself to name the day! However, to be fair to Carney, he HAS emphasised consistently that the MPC's decisions will be driven by data and the further twist that we now have is that the latest data (available at the time of the August Inflation Report), for June showed that wage inflation was running at close to zero. Indeed, the Report slashed its forecast for wage inflation in 2014 by half to only 1.25% - a figure which is significantly under their forecast for CPI inflation running at around 1.7 – 1.9% for much of 2014 and 2015 (although Capital Economics think the Bank has over estimated inflation and that it is likely to fall to about 1% around the end of this year). This subdued wage inflation is even more remarkable considering how quickly unemployment is falling and employment is strongly rising, (these two do not necessarily go together!), and so has given rise to comments in the Report that there is considerable hidden slack in the economy in terms of people having jobs, but only part time and wanting to work longer hours, and self employed people struggling to establish financially viable businesses. Throw in also that increases in labour productivity are still weak and you can see the MPC's logic that until this hidden slack is used up, and wage inflation exceeds inflation, they will be cautious about increasing Bank Rate in order to ensure we get sustainable economic growth.

The long standing unanimity in MPC voting patterns broke down in the August meeting when a 7-2 split vote occurred as two members wanted to start the increase in Bank Rate to 0.75%. This reflects a view by some MPC members that an earlier increase in Bank Rate is more beneficial in the medium term than delaying an increase until statistics make an increase imperative.

We have also slightly lowered some forecasts through to June 2017 to reflect our lowered expectations for inflation and the speed of increase in labour productivity and wage inflation.

We are also concerned that the Eurozone situation appears to be deteriorating further, so this may weaken UK growth as the EZ is our largest export market. EZ GDP figures for Q2 showed growth flat lining after a mere +0.2% in Q1. Germany actually had negative growth of -0.2% in Q2, France 0.0%, and Italy fell into a technical recession (two quarters of negative growth). The tit for tat sanctions between the EU and Russia cast a shadow over future growth prospects so there is a real risk the EZ could be heading towards a triple dip recession since 2008.

However, there is also an increasing risk of the Japanisation of the EZ economy, that is it could fall into a deflationary spiral, as inflation continued falling in September to only +0.3%, the lowest rate since October 2009. This will increase pressure even further on the ECB to pull out all the stops and perhaps embark on quantitative easing (QE), something it has been very reluctant to do. It is a moot point as to whether the ECB will do too little too late. However, several EZ countries are already in the grip of deflation and face little hope of escaping in the near future. Admittedly, Spain, Portugal and Greece are improving on the growth side as reforms bring positive benefits. But again, the downside is that their total government debt is still increasing faster than economic growth; Spain's debt has now reached 98.4% of GDP yet its borrowing rates have plummeted! Greece's debt is now at an unsustainably high level but it is highly unlikely that creditors will agree to yet another hair-cut to reduce that level.

A further area of increased concern is Japan. The Q2 GDP figure came in at -1.7% (-6.8% on an annual basis) as fears that the increase in sales tax from 5% to 8% in April would depress sales after April were confirmed as being well founded as consumers rushed to spend before the tax increase came in. The government and the Bank of Japan are forecasting that GDP will grow sharply in Q3 but the last time sales tax was increased in 1997, the economy fell into a prolonged recession.

As for China, Government action in 2014 to stimulate the economy appeared to be putting the target of 7.5% growth within achievable reach but recent data has raised fresh concerns. There are also major concerns as to the creditworthiness of much bank lending to corporates and local government during the post 2008 credit expansion period and whether the bursting of a bubble in housing prices is drawing nearer.

There are also increasing concerns that the reluctance of western economies to raise interest rates significantly for several years, 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 consequently an increase in investor risk exposures in order to get higher returns. This is a return of the same environment which led to the 2008 financial crisis.