

Gloucester City Council

Meeting:	Cabinet	17 June 2015
	Audit and Governance Committee	01 July 2015
Subject:	Treasury Management Update – Quarter 4 Report 2014/15	
Report Of:	Cabinet Member for Performance and Resources	
Wards Affected:	All	
Key Decision:	No	Budget/Policy Framework: No
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Appendices:	1. Prudential and Treasury Indicators	
	2. Treasury Management Investments	
	3. Economic Outlook	
	4. Detailed interest rate forecasts	

FOR GENERAL RELEASE

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 4, 1st December 2014 to 31st March 2015.

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 4 ;

- **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 4.
- **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, subject to any recommendations it wishes to make to Cabinet, to **NOTE** the contents of the report.

2.2 Cabinet 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 5th March 2014. 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 £8.75m. 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 funds available for investment includes receipts from the housing stock transfer completed 17th March 2015.

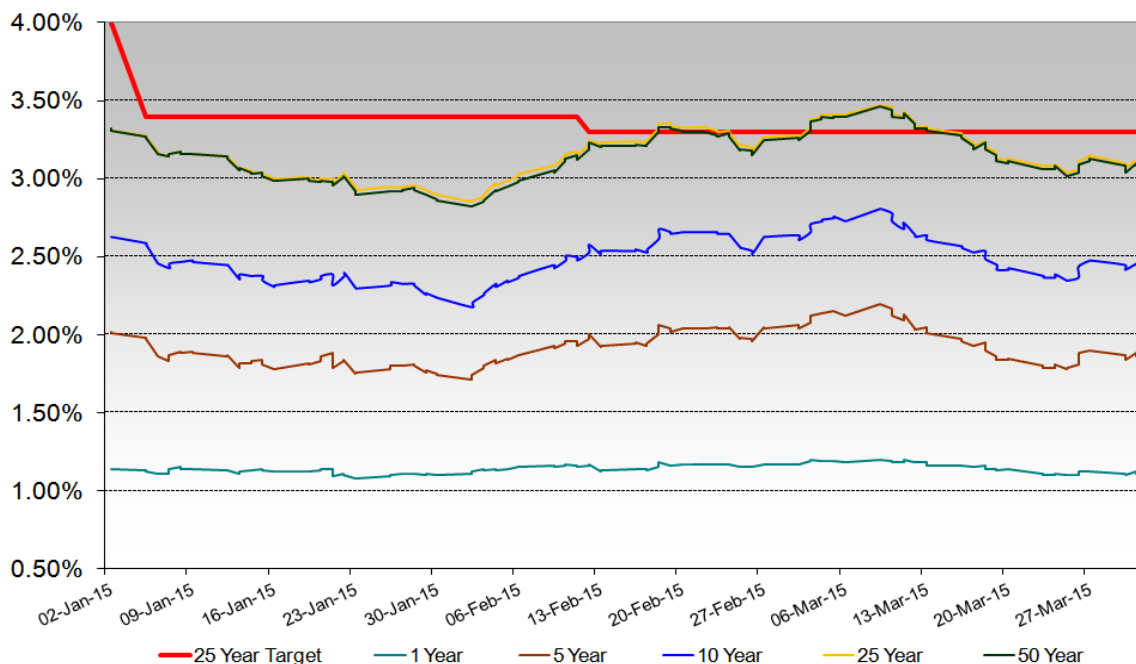
4.0 New Borrowing

4.1 The 25 year PWLB (Public Works Loan Board) target (certainty) rate for new long term borrowing for the quarter fell from 3.90% to 3.40% in early January. This was revised down further to 3.30% after the February Bank of England Inflation report.

4.2 No long term borrowing was undertaken during the quarter.

4.3 PWLB certainty rates, quarter ended 31st March 2015

	1 Year	5 Year	10 Year	25 Year	50 Year
Low	1.08%	1.71%	2.18%	2.85%	2.82%
Date	23/01/2015	02/02/2015	02/02/2015	02/02/2015	02/02/2015
High	1.20%	2.20%	2.81%	3.47%	3.46%
Date	03/03/2015	09/03/2015	09/03/2015	09/03/2015	09/03/2015
Average	1.14%	1.92%	2.49%	3.16%	3.14%



4.4 Borrowing in advance of need.

On the 17th March 2015 The Council completed the voluntary stock transfer to Gloucester City Homes (GCH), the Council received funding from the Government and GCH to repay debt associated with the Council housing stock. Due to uncertainty in the market around debt premia at the time of the transfer, the Council did not repay all of the market debt at that time. Funds were invested in the short term until certainty returned to the markets at which point the Council rescheduled the market debt relating to the stock transfer. This approach was set out as part of the 15/16 Treasury Strategy, as approved by Council.

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 2015, 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 the Council operated in accordance with 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. From the 17th March 2015 to 1st April 2015 the s151 Officer in consultation with the Cabinet Member for Performance and Resources was given delegated authority to make decisions on Treasury Management outside of the 14/15 Treasury Strategy as a result of the housing stock transfer. This authority covered the change to the maturity profile of Council borrowing which was outside the 14/15 strategy. The prudential and treasury Indicators are shown within appendix 1.

7.0 Other

7.1 The final quarter of 2014/15 saw the Council moved from an under-borrowing position to an over borrowing position, this was as a result of the housing stock transfer to Gloucester City Homes.

7.2 The stock transfer agreement included government funding to write off Council debt assigned to the housing stock. Market conditions at the time of the transfer were not favourable for the repayment and would have resulted in significant additional debt premia costs. The decision was taken to hold on to the debt and invest funds until market conditions improved.

8.0 Financial Implications

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

9.0 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

11.0 People Impact Assessment (PIA):

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

12.0 Other Corporate Implications

Community Safety

12.1 None

Sustainability

12.2 None

Staffing & Trade Union

12.3 None

Prudential and Treasury Indicators as at 31st March 2015

Treasury Indicators	2014/15 Strategy	Quarter 4 Actual
Authorised limit for external debt	£86M	£43.5m
Operational boundary for external debt	£85M	£43.5m
Gross external debt	£86M	£43.5m
Net borrowing	£86m	£9.9m
Maturity structure of fixed rate borrowing - upper and lower limits		
Under 12 months	0% - 50%	100%
12 months to 2 years	0% - 50%	%
2 years to 5 years	0% - 50%	%
5 years to 10 years	0% - 50%	%
10 years to 20 years *1	0% - 80%	%
20 years to 30 years *1	0% - 80%	%
30 years to 40 years *1	0% - 80%	%
40 years to 50 years *1	0% - 80%	%
Upper limit of fixed interest rates based on net debt *2		
Upper limit of fixed interest rates based on net debt *2	100%	31.03%
Upper limit of variable interest rates based on net debt *2		
Upper limit of variable interest rates based on net debt *2	100%	68.97%
Upper limit for principal sums invested for over 364 days		
Upper limit for principal sums invested for over 364 days	Nil	Nil

Prudential Indicators	2014/15 Strategy	Quarter 4 Actual
Capital expenditure * <ul style="list-style-type: none"><li data-bbox="264 327 368 356">• HRA<li data-bbox="264 358 347 387">• GF	£7.100m £6.882m	7.126m 8.264m

APPENDIX 2

Investment Portfolio

Investments held as at 31st March 2015 compared to our counterparty list:

Specified Investments	Outstanding Investments £'000	Date of Maturity	Interest Rate %
UK Local Authority			
Leeds City Council	£5,000	01/04/2015	0.3
Waltham Forest Council	£3,000	01/05/2015	0.3
	£8,000		
Banks			
Barclays Bank Plc	£1,500	N/A (call a/cs)	
Natwest Bank Plc	£3,800	N/A (call a/cs)	
Glodman Sachs	£1,300	N/A (call a/cs)	
	£6,600		
Building Societies			
Yorkshire Building Society	£4,000	20/04/2015	0.3
Coventry Building Society	£5,000	27/04/2015	0.42
Leeds Building Society	£5,000	27/04/2015	0.3
Nationwide Building Society	£5,000	20/04/2015	0.43
	£19,000		
Total Invested	£33,600		

1. Economic Background

- After strong UK GDP growth in 2013 at an annual rate of 2.7%, and then growth in 2014 of 0.6% in Q1, 0.8% Q2, 0.6% Q3 and 0.6% Q4 (annual rate for 2014 of 2.8% - the strongest rate since 2006), there are good grounds for optimism that the growth rate will increase further during 2015 as the positive effects from the fall in the price of oil feeds through to consumers and other parts of the economy. In its February quarterly Inflation Report, the Bank of England maintained its GDP forecast for 2015 at 2.9%, but revised up its forecasts for 2016 and 2017 to 2.9% and 2.7% respectively, from 2.6% in both years. The main source of upward revisions came from higher consumption growth, which is now expected to accelerate to 3.75% in 2015 due primarily to a 3.5% rise in real post-tax household income growth. Income growth is also supported by solid employment growth and a pick-up in average weekly pay growth of 3.5% in 2014 and 4.0% in 2016 and 2017. Unit labour cost growth is consequently forecast to be 2.0% in 2015 and 2.75% in 2016 which then pushes up the inflation forecast slightly in two years time to 1.96%, while in three years' time it is forecast at 2.15%.
- The American economy is well on track to making a full recovery from the financial crash. GDP quarterly growth rates (annualised) for Q2, Q3 and Q4 of 4.6%, 5.0% and 2.2%, (2.4% for 2014 as a whole), hold great promise for strong growth going forward and for further falls in unemployment. It is therefore confidently predicted that the Federal Open Market Committee will start on the first increase in the Fed funds rate during 2015 and is likely to be ahead of the UK in being the first major western country to raise rates.
- As for the Eurozone, on 21 January 2015 the ECB fired its big bazooka in unleashing a massive €1.1 trillion programme of quantitative easing 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 is currently intended to run initially to September 2016. However, it remains to be seen whether this will have a significant enough effect in terms of boosting growth and employment, though the fall in the price of oil will provide additional support.

2. Interest Rate Forecast

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

	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18
Bank rate	0.50%	0.50%	0.50%	0.75%	0.75%	1.00%	1.25%	1.25%	1.50%	1.50%	1.75%	2.00%
5yr PWLB rate	2.20%	2.30%	2.50%	2.60%	2.70%	2.80%	3.00%	3.10%	3.20%	3.30%	3.40%	3.50%
10yr PWLB rate	2.80%	3.00%	3.10%	3.20%	3.40%	3.50%	3.60%	3.70%	3.80%	3.90%	4.00%	4.10%
25yr PWLB rate	3.40%	3.60%	3.80%	3.90%	4.00%	4.20%	4.30%	4.40%	4.50%	4.60%	4.60%	4.70%
50yr PWLB rate	3.40%	3.60%	3.80%	3.90%	4.00%	4.20%	4.30%	4.40%	4.50%	4.60%	4.60%	4.70%

- Capita Asset Services undertook a review of its interest rate forecasts after the February Bank of England Inflation Report. On 21 January 2015 the ECB unleashed its €1.1 trillion programme of quantitative easing to buy up high credit quality government and other debt of selected EZ countries. This gave further impetus to the trend of a rise in bond prices and correspondingly, a fall in bond yields to phenomenally low levels. This trend had started earlier after a proliferation of fears in financial markets around the plunge in the price of oil had caused a flight from equities into bonds and from exposure to the debt and equities of emerging market oil producing countries to safe havens in western countries. These flows were compounded by further fears that Greece could be heading towards an exit from the Euro after the general election on January 25 elected a left wing anti austerity government.
- In addition, there has been a sharp increase in confidence in this quarter that the US will start increasing the Fed funds rate by the end of 2015 due to strong GDP growth in 2014 and the rapidly falling unemployment rate. This indicated that the US is now headed towards making a full recovery from the financial crisis of 2008.
- The result of the combination of the above factors is that we have seen bond yields plunging to phenomenally low levels, especially in long term yields. This plunge in bond yields was partially reversed towards the end of the quarter. However, these very low levels are unsustainable in the longer term but just how quickly these falls will unwind is hard to predict.
- In addition, positive or negative developments on the world political scene could have a major impact in either keeping yields low or prompting them to recover back up again. We also have a UK general election coming up in May 2015; it is very hard to predict what its likely result will be and the consequent impact on the UK economy, and how financial markets will react to those developments.
- This latest forecast includes a move in the timing of the first increase in Bank Rate from quarter 4 of 2015 to quarter 1 of 2016 as a result of the sharp fall in inflation due to the fall in the price of oil and the impact of that on core inflation. The Governor of the Bank of England, Mark Carney, has repeatedly stated that increases in Bank Rate will be slow and gradual. The MPC is concerned about the impact of increases on many heavily indebted consumers, especially when average disposable income is only starting to gradually increase as a result of wage inflation now running marginally above the depressed rate of CPI inflation, though some consumers will not have seen that benefit come through for them. In addition, whatever party or coalition wins power in the next general election, will be faced with having to implement further major cuts in expenditure and / or increases in taxation in order to eradicate the annual public sector net borrowing deficit.

DETAILED COMMENTARY ON INTEREST RATES FORECASTS

Our treasury management advisers, Capita Asset Services have provided us with the following update to their interest rate forecasts.

Change in market sentiment and outlook

- The plunge in the price of oil, if maintained during 2015, will increase consumer disposable income and act as a stimulus to economic growth (both in the UK and in other oil importing countries e.g. the EU as a whole). In the February Inflation Report, the Bank of England accordingly maintained its forecast for growth in 2015 at 2.9%, despite the slowdown in Q4 2014, and increased its forecast for 2016 from 2.5% to 2.9%.
- There is a real possibility that CPI inflation could turn slightly negative for a short period around midyear 2015. This is only likely to be a temporary blip until the fall in the price of oil drops out of the twelve month calculation of CPI during Q4 2015, when inflation is expected to tick up markedly from near zero. In our view, financial markets have over reacted to the prospect of temporary deflation in pushing the first increase in Bank Rate back from Q4 2015 into the second half of 2016. The latest Inflation Report clearly shows a rise in inflation to being slightly above the 2% target in the 2 to 3 year time horizon due to strengthening growth.
- The temporary blip down in inflation during 2015 might make it difficult for the MPC to raise Bank Rate as early as we expected in our previous forecast but we have only moved our forecast for the first increase in Bank Rate back from Q4 2015 to Q1 2016. However, we would certainly not rule out a November 2015 first increase if the Greek and other situations are favourable.
- Greece: the Greek government led by the anti EU and anti austerity party Syriza, is making a strong push to renegotiate the austerity programme and debt repayments. This has led to prolonged negotiations with the troika of the ECB, EU and IMF as the proposals made to date, (as at the end of March), were judged to be inadequate. There is therefore a risk that this could end with Greece leaving the euro. However, the Eurozone has put in place sufficient firewalls that a Greek exit would have little direct impact on the rest of the EZ and the euro. The indirect effect is more problematic to quantify as the Greek election result is likely to strengthen support for anti EU and anti austerity political parties in many EU countries. Of particular concern is the fact that Spain and Portugal have general elections coming up in late 2015. Italy is arguably the greatest risk as it has the third biggest debt mountain in the world and has shown little progress so far in undertaking fundamental reforms to improve the competitiveness of the economy.
- The political risks around the UK general election in May 2015 have increased with the likely result being very hard to predict. There are additional potential risks around UK EU membership which could also affect investor sentiment towards the UK and towards gilts as an investment. Any sharp adverse investor reaction on either or both scores, could lead to a corresponding jump up in gilt yields (and PWLB rates).
- We are also concerned at the level of potential risk around several of the major emerging economies government and corporate debt, from both the potential for default in some countries and also a sharp swing in investor sentiment which has previously sought out higher yields in these economies during an extended period when yields in western countries have been heavily suppressed. Russia and Brazil are already in recession.
- Local authorities should expect a high level of volatility in PWLB rates during 2015, depending on how long it takes to decide what will happen in Greece and as other factors impinge on market and investor sentiment. We would not be surprised to see PWLB rates swinging by 50 bps in a quarter, which makes any forecasts in the shorter term *subject to a much higher level of volatility than has been usual*.

After strong UK GDP growth in 2013 at an annual rate of 2.7%, and then growth in 2014 of 0.6% in Q1, 0.8% Q2, 0.6% Q3 and 0.6% Q4 (annual rate for 2014 of 2.8% - the strongest rate since 2006), there are good grounds for optimism that the growth rate will increase further during 2015 as the positive effects from the fall in the price of oil feeds through to consumers and other parts of the economy. In its February quarterly Inflation Report, the Bank of England maintained its GDP forecast for 2015 at 2.9%, but revised up its forecasts for 2016 and 2017 to 2.9% and 2.7% respectively, from 2.6% in both years. The main source of upward revisions came from higher consumption growth, which is now expected to accelerate to 3.75% in 2015 due primarily to a 3.5% rise in real post-tax household income growth. Income growth is also supported by solid employment growth and a pick-up in average weekly pay growth of 3.5% in 2014 and 4.0% in 2016 and 2017. Unit labour cost growth is consequently forecast to be 2.0% in 2015 and 2.75% in 2016 which then pushes up the inflation forecast slightly in two years time to 1.96%, while in three years' time it is forecast at 2.15%.

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CAPITA ASSET SERVICES FORWARD VIEW

Economic forecasting remains difficult with so many external influences weighing on the UK. Our Bank Rate forecasts, (and also MPC decisions), will be liable to further amendment depending on how economic data transpires over 2015. Forecasts for average earnings beyond the three year time horizon will be heavily dependent on economic and political developments. Major volatility in bond yields is likely to endure as investor fears and confidence ebb and flow between favouring more risky assets i.e. equities, or the safe haven of bonds.

The overall longer run trend is for gilt yields and PWLB rates to rise, due to the high volume of gilt issuance in the UK, and of bond issuance in other major western countries. Increasing investor confidence in eventual world economic recovery is also likely to compound this effect as recovery will encourage investors to switch from bonds to equities.

The overall balance of risks to economic recovery in the UK is currently evenly balanced. Only time will tell just how long this current period of strong economic growth will last; it also remains exposed to vulnerabilities in a number of key areas.

We would, however, remind clients of the view that we have expressed in our previous interest rate revision newflashes of just how unpredictable PWLB rates and bond yields are at present. We are experiencing exceptional levels of volatility which are highly correlated to geo-political and sovereign debt crisis developments. Our revised forecasts are based on the Certainty Rate (minus 20 bps) which has been accessible to most authorities since 1st November 2012.

Downside risks to current forecasts for UK gilt yields and PWLB rates currently include:

- Geopolitical risks in Eastern Europe, the Middle East and Asia, increasing safe haven flows.

- UK strong economic growth is weaker than we currently anticipate.
- Weak growth or recession in the UK's main trading partners - the EZ, US and China.
- A resurgence of the Eurozone sovereign debt crisis.
- Recapitalisation of European banks requiring more government financial support.
- Monetary policy action failing to stimulate sustainable growth and to combat the threat of deflation in western economies, especially the Eurozone and Japan.

The potential for upside risks to current forecasts for UK gilt yields and PWLB rates, especially for longer term PWLB rates include: -

- An adverse reaction by financial markets to the result of the UK general election in May 2015 and potentially the EU, economic and debt management policies adopted by any new government.
- The ECB severely disappointing financial markets with a programme of asset purchases which proves insufficient to significantly stimulate growth in the EZ.
- The commencement by the US Federal Open Market Committee of increases in the Fed funds rate in 2015, causing a fundamental reassessment by investors of the relative risks of holding bonds as opposed to equities and leading to a major flight from bonds to equities.
- UK inflation returning to significantly higher levels than in the wider EU and US, causing an increase in the inflation premium inherent to gilt yields.