Meeting:	**Cabinet** **Audit and Governance Committee**	**11 November 2015** **23 November 2015**
Subject:	**Treasury Management Update – Quarter 2 Report 2015/16**	
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 Investment Portfolio** **3. Economic Outlook** **4. 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 2, 1st July 2015 to 30th September 2015.

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

1.3 The body of the report provides an overview of the Councils performance in Quarter 2;

- **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 Council's 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 subject to any recommendations it wishes to make to Cabinet, the contents of the report be noted.

2.2 Cabinet is asked to **RESOLVE** that the contents of the report be noted subject to any comments subsequently received by the Audit and Governance Committee.

3.0 Annual Investment Strategy

3.1 The Treasury Management Strategy Statement (TMSS) for 2015/16, which includes the Annual Investment Strategy, was approved by the Council on 18th March 2015. It sets out the Council's investment priorities as being:

- Security of capital;
- Liquidity; and
- Yield

3.2 The Council will also aim to achieve the optimum return (yield) on its 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 cash flow 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 a minimum sovereign credit rating, and Credit Default Swap (CDS) overlay information.

3.3 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 ultra-low Bank Rate. The average level of funds available for investment purposes during the quarter was £6.5m. 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

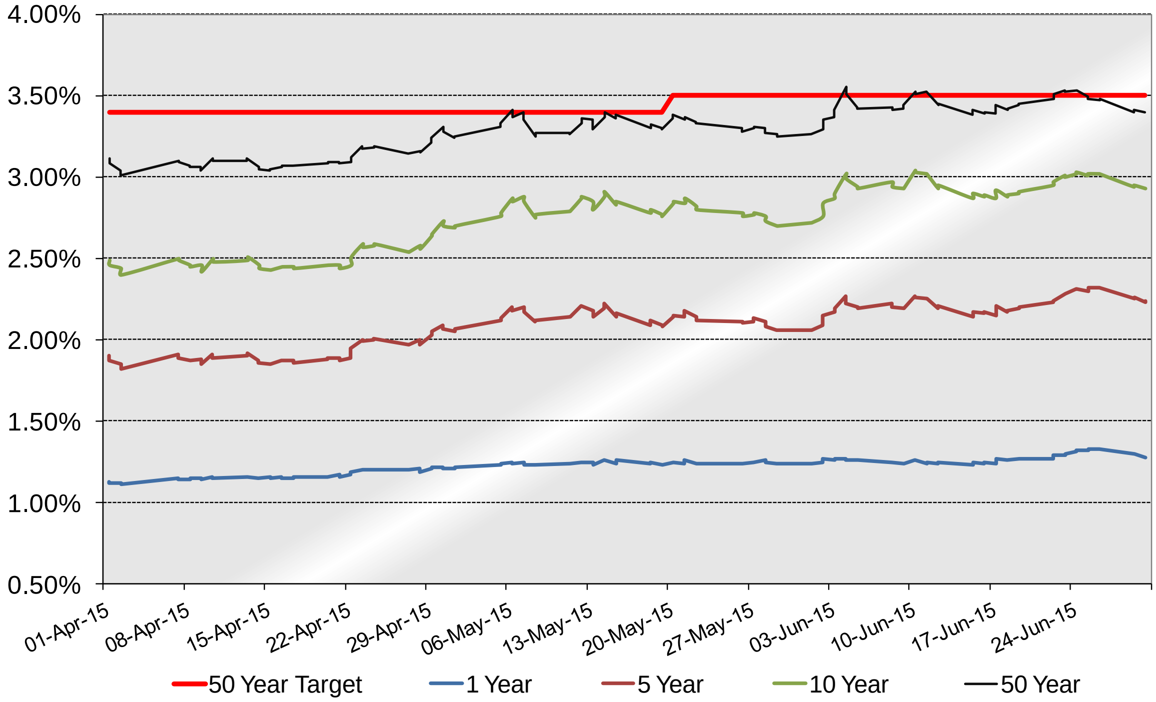
4.1 As outlined below, the general trend in PWLB rates has been an increase in interest rates during the first quarter but then a fall during the second quarter. The 50 year PWLB target (certainty) rate for new long term borrowing, for the quarter ending 30th September, fell slightly from 3.60% to 3.40% after the August Bank of England Inflation report.

4.2 No long term borrowing was undertaken during the quarter.

4.3 **PWLB certainty rates, quarter ended 30th September 2015**

	1 Year	5 Year	10 Year	25 Year	50 Year
Low	1.23%	1.96%	2.56%	3.21%	3.07%
Date	24/09/2015	24/09/2015	29/09/2015	12/08/2015	12/08/2015

High	1.35%	2.35%	3.06%	3.66%	3.58%
Date	05/08/2015	14/07/2015	14/07/2015	02/07/2015	14/07/2015
Average	1.29%	2.15%	2.78%	3.40%	3.28%



4.4 **Borrowing in advance of need.**

On the 17th March 2015 the Council completed the voluntary stock transfer to 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. Certainty returned to the markets in Quarter 1 and the Council repaid associated debt. At the end of Quarter 2, the Council is not borrowing in advance of need.

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 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 to date the Council has operated within the treasury limits set out in the Council's Treasury Management Strategy Statement and in compliance with the Council's Treasury Management Practices. The housing stock transfer in 14/15 changed the Council debt profile from long term to short term borrowing. The Council is able to benefit from reduced costs associated with short term borrowing compared to longer term rates while operating within the Councils borrowing requirements.

6.3 In quarter 2 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 within appendix 1.

7.0 Other

7.1 The Council continued to maintain an under-borrowed position in Quarter 2.

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.

7.3 The Council will continue to monitor its approach to under borrowing in light of market movement and future events.

8.0 Asset Based Community Development (ABCD) Considerations

8.1 This report notes the treasury management performance of the Council. There are no anticipated ABCD implications from this report.

9.0 Financial Implications

9.1 Contained in the report

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

10.0 Legal Implications

10.1 There are no legal implications from this report

(One Legal have been consulted in the preparation this report.

11.0 Risk & Opportunity Management Implications

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

12.0 People Impact Assessment (PIA):

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

13.0 Other Corporate Implications

Community Safety

13.1 None

Sustainability

13.2 None

Staffing & Trade Union

13.3 None

Press Release drafted or approved

13.4 Not applicable at this stage.

Appendix 1

Prudential and Treasury Indicators as at 30th September 2015

Treasury Indicators	2015/16 Budget £’000	Quarter 2 (Jul-Sept) Actual £’000
Authorised limit for external debt	£35M	£10M
Operational boundary for external debt	£30M	£10M
Gross external debt	£30M	£10M
Investments	N/A	£7.3M
Net borrowing	£30M	£2.7M

Maturity structure of fixed and variable rate borrowing - upper and lower limits		
Under 12 months	0% - 50%	50.00%
12 months to 2 years	0% - 50%	0%
2 years to 5 years	0% - 50%	0%
5 years to 10 years	0% - 80%	50.00%
10 years to 20 years	0% - 80%	0%
20 years to 30 years	0% - 80%	0%
30 years to 40 years	0% - 80%	0%
40 years to 50 years	0% - 80%	0%
Upper limit of fixed interest rates based on net debt	100%	50.00%
Upper limit of variable interest rates based on net debt	100%	50.00%

Appendix 2

Investment Portfolio

Investments held as at 30th September 2015 compared to our counterparty list:

Specified Investments	Outstanding Investments £'000	Date of Maturity	Interest Rate %
Banks			
Barclays Bank Plc	£2,600	N/A (call a/cs)	
Goldman Sachs	£1,700	N/A (call a/cs)	
	£4,300		
Building Societies			
Nationwide Building Society	£1,500	10/11/2015	0.46
Nationwide Building Society	£1,500	21/12/2015	0.51
	£3,000		
Total Invested	**£7,300**		

Appendix 3

1. Economic Background

UK GDP growth rates in 2013 of 2.2% and 2.9% in 2014 were the strongest growth rates of any G7 country; the 2014 growth rate was also the strongest UK rate since 2006 and the 2015 growth rate is likely to be a leading rate in the G7 again, possibly being equal to that of the US. However, quarter 1 of 2015 was weak at +0.4% (+2.9% y/y) though there was a rebound in quarter 2 to +0.7% (+2.4% y/y). Growth is expected to weaken marginally to about +0.5% in quarter 3 as the economy faces headwinds for exporters from the appreciation of Sterling against the Euro and weak growth in the EU, China and emerging markets, plus the dampening effect of the Government's continuing austerity programme, although the pace of reductions was eased in the May Budget. However, the Purchasing Manager's Index, (PMI), for services issued on 5 October would indicate an even lower growth rate of around +0.3%, in quarter 4, which would be the lowest growth rate since the end of 2012.

Despite these headwinds, the Bank of England August Inflation Report had included a forecast for growth to remain around 2.4 – 2.8% over the next three years, driven mainly by strong consumer demand as the squeeze on the disposable incomes of consumers has been reversed by a recovery in wage inflation at the same time that CPI inflation has fallen to, or near to, zero over the last quarter. Investment expenditure is also expected to support growth. Since then, worldwide economic statistics have been distinctly weak so it would not be a surprise if the next Inflation Report in November were to cut those forecasts.

The August Bank of England Inflation Report forecast was notably subdued with inflation barely getting back up to the 2% target within the 2-3 year time horizon. However, with the price of oil taking a fresh downward direction and Iran expected to soon rejoin the world oil market after the impending lifting of sanctions, there could be several more months of low inflation still to come, especially as world commodity prices have generally been depressed by the Chinese economic downturn.

There are therefore considerable risks around whether inflation will rise in the near future as strongly as previously expected; this will make it more difficult for the central banks of both the US and the UK to raise rates as soon as had previously been expected, especially given the recent major concerns around the slowdown in Chinese growth, the knock on impact on the earnings of emerging countries from falling oil and commodity prices, and the volatility we have seen in equity and bond markets in 2015 so far, which could potentially spill over to impact the real economies rather than just financial markets.

The American economy made a strong comeback after a weak first quarter's growth at +0.6% (annualised), to grow by no less than 3.9% in quarter 2 of 2015. While there had been confident expectations during the summer that the Fed. could start increasing rates at its meeting on 17 September, or if not by the end of 2015, the recent downbeat news about Chinese and Japanese growth and the knock on impact on emerging countries that are major suppliers of commodities, was cited as the main reason for the Fed's decision to pull back from making that start. The nonfarm payrolls figures for September and revised August, issued on 2 October, were disappointingly weak and confirmed concerns that US growth is likely to weaken. This has pushed back expectations of a first rate increase from 2015 to 2016. However, there are increasing concerns, both in the US and UK, that the growth rates currently being achieved are only being achieved with monetary policy being highly aggressive with central rates at near zero and huge QE in place. This is causing an increasing debate as to how realistic it will be for central banks to start on reversing such aggressive monetary policy until such time as strong growth rates are more firmly established and confidence increases that inflation is going to get back to around 2% within a 2-3 year time horizon. In the Eurozone, the ECB fired its big bazooka in January 2015 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 intended to run initially to September 2016. This already appears to have had a positive effect in helping a recovery in consumer and business confidence and a start to a significant improvement in economic growth. GDP growth rose to 0.5% in quarter 1 2015 (1.0% y/y) but came in at +0.4% (+1.5% y/y) in quarter 2 and looks as if it may maintain this pace in quarter 3. However, the recent downbeat Chinese and Japanese news has raised questions as to whether the ECB will need to boost its QE programme if it is to succeed in significantly improving growth in the EZ and getting inflation up from the current level of around zero to its target of 2%.

2. Interest Rate Forecast

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

	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18
Bank rate	0.50%	0.50%	0.75%	0.75%	1.00%	1.00%	1.25%	1.50%	1.50%	1.75%	1.75%
5yr PWLB rate	2.40%	2.50%	2.60%	2.80%	2.90%	3.00%	3.10%	3.20%	3.30%	3.40%	3.50%
10yr PWLB rate	3.00%	3.20%	3.30%	3.40%	3.50%	3.70%	3.80%	3.90%	4.00%	4.10%	4.20%
25yr PWLB rate	3.60%	3.80%	3.90%	4.00%	4.10%	4.20%	4.30%	4.40%	4.50%	4.60%	4.60%
50yr PWLB rate	3.60%	3.80%	3.90%	4.00%	4.10%	4.20%	4.30%	4.40%	4.50%	4.60%	4.60%

Capita Asset Services undertook a review of its interest rate forecasts on 11 August after the August Bank of England Inflation Report. This latest forecast includes no change in the timing of the first increase in Bank Rate as being quarter 2 of 2016. With CPI inflation now likely to be at or near zero for most of 2015, it is difficult for the MPC to make a start on increasing Bank Rate when the Inflation Report forecast was also notably subdued with inflation barely getting back up to the 2% target within the 2-3 year time horizon. Despite average weekly earnings ticking up to 2.9% y/y in the three months ending in July, (as announced in mid-September), this is unlikely to provide ammunition for the MPC to take action to raise Bank Rate soon as labour productivity growth meant that net labour unit costs are still only rising by about 1% y/y. The significant appreciation of Sterling against the Euro in 2015 has also acted as a dampening to UK growth while sharp volatility in financial markets since the Inflation Report has depressed equity prices, raised bond prices and lowered bond yields (and PWLB rates).

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 just starting a significant recovery as a result of recent increases in the rate of wage inflation, though some consumers will not have seen that benefit come through for them.

Appendix 4

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.

Post Bank of England Inflation Report August 2015 interest rate review

- There has been very little change in our forecasts since our previous forecasts in February and May. This time, we have left unchanged the start of the increases in Bank Rate at quarter 2 of 2016; this is in line with comments from the Bank of England.

- The so called Bank of England's 'super Thursday' on 6 August turned out to be a damp squib with market expectations of the first increase in Bank Rate being pushed back to quarter 2 2016 after the flurry of excitement caused by Mark Carney's comments in July where he said that an interest rate rise would come "into sharper relief around the turn of the year". However, as he subsequently clarified, this was not intended to give rise to an inference that rates would rise in 2015!

- What did stand out in the MPC voting on 6 August was that one member started to vote for an immediate increase in Bank Rate, while the minutes showed that "some members" were concerned about upside risks to inflation, (but not to downside risks).

- CPI inflation has been between -0.1% to +0.1% between April and August and is expected to continue near to zero for some months to come. The latest Inflation Report was notably subdued in its forecast for inflation over the 2 – 3 year time horizon with inflation barely getting above the 2% target. However, there are significant downside risks to even this level of inflation as the report was also notable for downgrading its forecasts for growth in labour productivity despite robust forecasts for increases in business investment (which ought to boost productivity growth). This is key as the real cost of wages will be depressed by strong productivity growth and so would therefore cause price rises for goods and services to be subdued. In addition, the downturn in Chinese growth has depressed commodity prices but these will take time to feed through into CPI figures. We also have the potential for a further increase in oil supply depressing oil prices further if the end of sanctions on Iran occurs in the near future. A further factor is that the Fed. is likely to commence raising rates, probably in early 2016, which will cause the dollar to appreciate relative to Sterling and so cause the UK cost of imports, denominated in dollars, to fall.

- UK quarterly growth in quarter 2 2015 jumped back up to +0.7% (+2.4% y/y) from the disappointing +0.4% (2.7% y/y) in quarter one. However, growth is expected to subside to about +0.5% in quarter 3 2015 but the services Purchasing Manager's Index, (PMI), at the beginning of October was particularly weak and would indicate a lower growth rate of +0.3% in quarter 4; this would be the lowest growth rate since the end of 2012.

- The election of a majority Conservative Government which is going to implement significant cuts in government expenditure in order to reduce the size of the annual budget deficit, will slow GDP growth marginally.

- Greece: the Greek government capitulated to EU demands for further austerity at the eleventh hour and 59th minute and has now agreed a third bailout package. However, there is considerable doubt as to whether Greece will be able to implement and tolerate the level of cuts stipulated. The bailout also does nothing to address the unsupportable size of total debt relative to GDP that is now outstanding after nine months of prevarication and disaster for the economy this year. It is therefore eminently possible that Greek exit from the euro has only been delayed by this third bailout.

- We remain concerned at the level of potential risk surrounding the government and corporate debt of several of the major emerging economies, from the perspective of both the potential for default in some countries and also a sharp swing in investor sentiment: investors have previously sought out higher yields in these economies during an extended period when yields in western countries have been heavily suppressed. Corporates heavily involved in mineral extraction and / or the commodities market may also be at risk and this could also cause volatility in equities and safe haven flows to bonds. Financial markets may also be buffeted by sovereign wealth funds of countries highly exposed to falls in commodity prices which, therefore, may have to liquidate some of their investments in order to cover national budget deficits.

- Clients should therefore expect a high level of volatility in PWLB rates over 2015, depending on how long it takes to resolve the longer term future and financial viability of Greece and as various 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.

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.

Despite market turbulence in late August, and then September, causing a sharp downturn in PWLB rates, the overall trend in the longer term will be for gilt yields and PWLB rates to rise when economic recovery is firmly established accompanied by rising inflation and consequent increases in Bank Rate, and the eventual unwinding of QE. 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.

We have pointed out above that the Fed. rate is likely to go up sooner and more strongly than Bank Rate in the UK. These increases will have corresponding effects in pushing up US Treasury and UK gilt yields. While there is normally a high degree of correlation between the two yields, we would expect to see a decoupling of yields between the two i.e. we would expect US yields to go up faster than UK yields. We will need to monitor this area closely and the resulting effect on PWLB rates.

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. However, the weak US nonfarm payroll figures and weak UK PMI figures at the beginning of October have provided added weight to the view that the first increase in central rates in the US and UK is more likely to occur later in 2016 than previously expected, and then only if there is substantial evidence that stronger growth is firmly in place and that inflation is going to reach around 2% within a 2-3 year time horizon. Market expectations have shifted at the beginning of October to the second half of 2016 for the first increase in Bank Rate.

We would, however, remind clients of the view that we have expressed in our previous interest rate revision newsflashes 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 EU, US and China.
- A resurgence of the Eurozone sovereign debt crisis.
- Recapitalisation of European banks requiring more government financial support.
- Emerging country economies, currencies and corporates destabilised by falling commodity prices and / or the start of Fed. rate increases, causing a flight to safe havens.

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

- Uncertainty around the risk of a UK exit from the EU.
- 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 Reserve of increases in the Fed. funds rate 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.