



<u>Committee and Date</u>	<u>Item</u>
Audit Committee 26 November 2015	
Cabinet 9 December 2015	
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	<u>Public</u>

## TREASURY STRATEGY 2015/16 – MID YEAR REVIEW

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### 1. Summary

1.1 This mid year Treasury Strategy report has been prepared in compliance with CIPFA's Code of Practice on Treasury Management 2011 and covers the following:-

- An economic update for the first six months of 2015/16
- A review of the Treasury Strategy 2015/16 and Annual Investment Strategy
- A review of the Council's investment portfolio for 2015/16
- A review of the Council's borrowing strategy for 2015/16
- A review of any debt rescheduling undertaken
- A review of compliance with Treasury and Prudential limits for 2015/16

1.2 The key points to note are:-

- The internal treasury team achieved a return of 0.58% on the Council's cash balances outperforming the benchmark by 0.22%. This amounts to additional income of £179,480 for the first six months of the year which is included within the Council's projected outturn position.
- In the first six months all treasury management activities have been in accordance with the approved limits and prudential indicators set out in the Council's Treasury Strategy.

### 2. Recommendations

2.1 Members are asked to accept the position as set out in the report.

2.2 Members note that any capital schemes brought forward that would impact on the current strategy would need to be approved by Council.

## REPORT

### 3. Risk Assessment and Opportunities Appraisal

- 3.1 The recommendations contained in this report are compatible with the provisions of the Human Rights Act 1998.
- 3.2 There are no direct environmental, equalities or climate change consequences arising from this report.
- 3.3 Compliance with the CIPFA Code of Practice on Treasury Management, the Council's Treasury Policy Statement and Treasury Management Practices and the Prudential Code for Capital Finance together with the rigorous internal controls will enable the Council to manage the risk associated with Treasury Management activities and the potential for financial loss.

### 4. Financial Implications

- 4.1 The Council makes assumptions about the levels of borrowing and investment income over the financial year. Reduced borrowing as a result of capital receipt generation or delays in delivery of the capital programme will both have a positive impact of the council's cash position. Similarly, higher than benchmarked returns on available cash will also help the Council's financial position. For monitoring purposes, assumptions are made early in the year about borrowing and returns based on the strategies agreed by Council in the preceding February. Performance outside of these assumptions results in increased or reduced income for the Council.
- 4.2 The six monthly performance is above benchmark and has delivered additional income of £179,480 which will be reflected in the Period 6 Revenue Monitor.
- 4.3 The Council currently has £150m held in investments as detailed in Appendix A and borrowing of £332m at fixed interest rates.

### 5. Background

- 5.1 The Council defines its treasury management activities as "the management of the authority's investments and cash flows, its banking, money market and capital market transactions, the effective control of the risks associated with the activities, and the pursuit of optimum performance consistent with those risks". The report informs Members of the treasury activities of the Council for the first six months of the financial year.
- 5.2 The CIPFA Code of Practice on Treasury Management 2011 was adopted by Council in February 2012 and the primary requirements of the Code were outlined in the Treasury Strategy 2012/13.

### 6. Economic update

- 6.1 **Global Economy** – The US economy made a strong comeback after a weak first quarter's growth at 0.6% (annualised), to grow by 3.9% in quarter 2 of 2015. While there had been confident expectations during the summer that the US Federal Reserve could start increasing rates before 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 US Federal Reserve's decision to pull back from making that start. With US growth likely to weaken, expectations of a first rate increase have been pushed back from 2015 into

2016.

- 6.2 In the Eurozone, the European Central Bank (ECB) unleashed a €1.1 trillion programme of quantitative easing in January 2015 to buy up high credit quality government and other debt of selected Eurozone countries. This programme of €60 billion 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. Gross Domestic Product (GDP) growth rose to 0.5% in quarter 1 2015 but came in at 0.4% 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 Quantitative Easing programme if it is to succeed in significantly improving growth in the Eurozone and getting inflation up from the current level of around zero to its target of 2%.
- 6.3 UK Economy – UK GDP growth rates in 2013 of 2.2% and 2.9% in 2014 were the strongest growth rates of any major advanced economy. The 2014 growth rate was also the strongest UK rate since 2006 and the 2015 growth rate is likely to be a leading rate again. However, quarter 1 of 2015 was weak at 0.4% though there was a rebound in quarter 2 to 0.7%. Growth is expected to weaken 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. 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 below zero over the last quarter.
- 6.4 The August Bank of England Inflation Report forecast was notably subdued in respect of inflation which was forecast to barely get 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 re-join 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.
- 6.5 There are therefore considerable risks around whether inflation will rise in the near future as strongly as had previously been expected. This will make it more difficult for the central banks of both the US and the UK to raise rates as soon as was being forecast until recently, 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.

## **7 Economic Forecast**

- 7.1 The Council receives its treasury advice from Capita Asset Services. Their latest interest rate forecasts are shown below:

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

- 7.2 Capita believes the Bank Rate will remain at its current low level of 0.50% until June 2016 when it is expected to rise to 0.75% before rising to 1.00% in December 2016. This means investment returns will continue to be at historically low levels during this period. The Bank Rate is then expected to reach 1.75% by 31 March 2018.
- 7.3 Long term PWLB rates are expected to rise to 4.20% in March 2017 before steadily increasing over time to reach 4.60% by 31 March 2018 when economic recovery is firmly established accompanied by rising inflation and consequent increases in Bank rate, and the eventual unwinding of Quantitative Easing.
- 7.4 Economic forecasting remains difficult with so many external influences weighing on the UK. Despite market turbulence since late August 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.
- 7.5 Downside risks to current forecasts for UK gilt yields and PWLB rates include geopolitical risks in Eastern Europe, the Middle East and Asia, weak growth or recession in the UK's main trading partners the EU, US and China, a resurgence of the Eurozone sovereign debt crisis and recapitalisation of European banks requiring more government financial support.
- 7.6 The potential for upside risks to current forecasts for UK gilt yields and PWLB rates, particularly longer term PWLB rates include uncertainty around the risk of a UK exit from the European Union, the European Central Bank severely disappointing financial markets with a programme of asset purchases which proves insufficient to significantly stimulate Eurozone growth, the commencement by the US Federal Reserve of increases in the Federal 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 and UK inflation returning to significantly higher levels than in the wider EU and US.

## 8. Treasury Strategy update

- 8.1 The Treasury Management Strategy (TMS) for 2015/16 was approved by Full Council on 26 February 2015. This Treasury Strategy does not require updating as there are no policy changes or any changes required to the prudential and treasury indicators previously approved.

## 9. Annual Investment Strategy update

- 9.1 The Council's Annual Investment Strategy, which is incorporated in the TMS, outlines the Council's investment priorities as the security and liquidity of its capital. As outlined in paragraph 6 & 7 above there is still considerable uncertainty and volatility in the financial and banking market, both globally and in the UK. It is a very difficult investment market in terms of earning the level of interest rates commonly seen in previous decades as rates are very low and in line with the 0.5% Bank Rate. In this context it is considered that the Annual Investment Strategy approved on 26 February 2015 is still fit for purpose in the current economic climate.
- 9.2 The Council aims to achieve the optimum return on investments commensurate with the proper levels of security and liquidity. In the current economic climate it is considered appropriate to keep investments short term (up to 1 year), and only invest with highly credit rated financial institutions using Capita's suggested creditworthiness approach, including sovereign credit rating and Credit Default Swap (CDS) overlay information provided by Capita. The Treasury Team continue to take a prudent approach keeping investments short term and with the most highly credit rated organisations. This approach has been endorsed by our external advisors, Capita Asset Services.
- 9.3 In the first six months of 2015/16 the internal treasury team outperformed its benchmark by 0.22%. The investment return was 0.58% compared to the benchmark of 0.36%. This amounts to additional income of £179,480 during the first six months which is included within the Council's projected outturn position.
- 9.4 A full list of investments held as at 30 September 2015, compared to Capita's counterparty list, and changes to Fitch, Moody's and Standard & Poor's credit ratings are shown in **Appendix A**. None of the approved limits within the Annual Investment Strategy were breached during the first six months of 2015/16 and have not been previously breached. Officers continue to monitor the credit ratings of institutions on a daily basis. Delegated authority has been put in place to make any amendments to the approved lending list.
- 9.5 As illustrated in the economic background section above, investment rates available in the market are at an historical low point. The average level of funds available for investment purposes in the first six months of 2015/16 was £163 million.
- 9.6 The Council's interest receivable/payable budgets are currently projecting a surplus of £1.210 million as reported in the monthly revenue monitoring reports due to no long term borrowing being undertaken and investment balances and interest rates achieved being higher than anticipated.

## 10. Borrowing

- 10.1 It is a statutory duty for the Council to determine and keep under review the "Affordable Borrowing Limits". Council's approved Prudential Indicators (affordability limits) are outlined in the TMS. A list of the approved limits is shown in **Appendix B**. The

schedule at **Appendix C** details the Prudential Borrowing approved and utilised to date.

- 10.2 Officers can confirm that the Prudential Indicators were not breached during the first six months of 2015/16 and have not been previously breached.
- 10.3 The 2015/16 Capital Programme includes borrowing for the refurbishment of Mardol House for Student accommodation. This has been financed via internal borrowing against Council balances, avoiding the requirement for new external borrowing and the ongoing revenue costs of the borrowing will be financed from the additional income generated by the scheme. No new external borrowing is currently required for future years, although work to develop a new capital programme is continuing, but the business cases for a number of proposed schemes are still in development and dependant on external decisions before the Council can make a commitment to them. Once this programme is finalised it will be presented to Council for consideration and the prudential borrowing implications updated in the Treasury Strategy. The schemes being considered are already within the current authorised borrowing limits in place. As outlined in the table below, the general trend has been an increase in interest rates during the first six months of the year across all maturity bands. The dates of the low points and high points across different maturity bands are shown in the table below.

	1 Year	5 Year	10 Year	25 Year	50 Year
Low	1.11%	1.82%	2.40%	3.06%	3.01%
Date	02/04/2015	02/04/2015	02/04/2015	02/04/2015	02/04/2015
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	1.26%	2.12%	2.76%	3.39%	3.29%

- 10.4 During the first six months of the financial year there has been a lot of volatility in the financial markets and this has had an impact on the PWLB rates. 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.

## 11. Debt Rescheduling

- 11.1 Debt rescheduling opportunities have been limited in the current economic climate and consequent structure of interest rates. During the first six months of the year no debt rescheduling was undertaken.

**List of Background Papers (This MUST be completed for all reports, but does not include items containing exempt or confidential information)**

Council, 26 February 2015, Treasury Strategy 2015/16

**Cabinet Member:**

Keith Barrow, Leader of the Council

**Local Member**

N/A

**Appendices**

A. Investment Report as at 30th September 2015

B. Prudential Limits

C. Prudential Borrowing Schedule