Shropshire Council	Committee and Date Audit Committee 24 November 2016 Cabinet 30 November 2016 Council 15 December 2016	Item Public

TREASURY STRATEGY 2016/17 – 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 2016/17
- A review of the Treasury Strategy 2016/17 and Annual Investment Strategy
- A review of the Council's investment portfolio for 2016/17
- A review of the Council's borrowing strategy for 2016/17
- A review of any debt rescheduling undertaken
- A review of compliance with Treasury and Prudential limits for 2016/17

1.2 The key points to note are:-

- The internal treasury team achieved a return of 0.60% on the Council's cash balances outperforming the benchmark by 0.32%. This amounts to additional income of £294,880 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 £294,880 which will be reflected in the Period 6 Revenue Monitor.

4.3 The Council currently has £175m held in investments as detailed in Appendix A and borrowing of £326m 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 had a patchy 2015 with sharp swings in the growth rate leaving the overall growth for the year at 2.4%. Quarter 1 of 2016 disappointed at 0.8% (annualised) while quarter 2 improved slightly to 1.4%. However, forward indicators are pointing towards a pickup in growth in the rest of 2016. The US Federal Reserve embarked on its long anticipated first increase in rates at its December 2015 meeting. At that point, confidence was high that there would then be four more increases to come in 2016.

Since then, more downbeat news on the international scene and then the Brexit vote, have caused a delay in the timing of the second increase which is now strongly expected in December this year.

6.2 Japan continues to have weak economic growth and is making little progress on fundamental reform of the economy while Chinese economic growth has been weakening and medium term risks have been increasing.

6.3 In the Eurozone, the European Central Bank (ECB) commenced in March 2015 its massive €1.1 trillion programme of quantitative easing to buy high credit quality government and other debt of selected Eurozone countries at a rate of €60bn per month. This was intended to run initially to September 2016 but was extended to March 2017. Along with other measures this has struggled to make a significant impact in boosting economic growth and in helping inflation to rise from around zero towards the target of 2%. Gross Domestic Product (GDP) growth rose by 0.6% in quarter 1 2016 but slowed to 0.3% in quarter 2. This has added to comments from many forecasters that central banks around the world are running out of ammunition to stimulate economic growth and to boost inflation. They stress that national governments will need to do more by way of structural reforms, fiscal measures and direct investment expenditure to support demand in their economies and economic growth.

6.4 UK Economy – UK GDP growth rates in 2013 of 2.2% and 2.9% in 2014 were strong but 2015 was disappointing at 1.8%, though it still remained one of the leading rates of any major advanced economy. Growth improved in quarter 4 of 2015 from 0.4% to 0.7% but fell back to 0.4% in quarter 1 of 2016 before bouncing back again to 0.7% in quarter 2. During most of 2015, the economy had faced headwinds for exporters from the appreciation during the year 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. The referendum vote for Brexit in June this year delivered an immediate shock fall in confidence indicators and business surveys, pointing to an impending sharp slowdown in the economy. However, subsequent surveys have shown a sharp recovery in confidence and business surveys, though it is generally expected that although the economy will now avoid flat lining, growth will be weak through the second half of 2016 and in 2017.

6.5 The Bank of England meeting in August addressed this expected slowdown in growth by a package of measures including a cut in Bank Rate from 0.50% to 0.25%. The Inflation Report included an unchanged forecast for growth for 2016 of 2.0% but cut the forecast for 2017 from 2.3% to just 0.8%. The Governor of the Bank of England had warned that a vote for Brexit would be likely to cause a slowing in growth, particularly from a reduction in business investment, due to the uncertainty of whether the UK would have continuing full access, (i.e. without tariffs), to the EU single market. He also suggested that the Government will need to help growth by increasing investment expenditure and possibly by using fiscal policy tools (taxation). The new Chancellor Phillip Hammond announced after the referendum result, that the target of achieving a budget surplus in 2020 will be eased.

6.6 The Inflation Report also included a sharp rise in the forecast for inflation to around 2.4% in 2018 and 2019. Consumer Price Index (CPI) inflation has started rising during 2016 as the falls in the price of oil and food twelve months ago fall out of the calculation during the year and, in addition, the post referendum 10% fall in the value of sterling is likely to result in a 3% increase in CPI over a time period of 3-4 years. However, the MPC is expected to look through a one off upward blip from this devaluation of sterling in order to support economic growth, especially if pay increases continue to remain subdued and therefore pose little danger of stoking core inflationary price pressures within the UK economy.

7 Economic Forecast

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

	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19
Bank rate	0.10%	0.10%	0.10%	0.10%	0.10%	0.10%	0.25%	0.25%	0.25%	0.25%	0.50%
5yr PWLB rate	1.00%	1.00%	1.10%	1.10%	1.10%	1.10%	1.20%	1.20%	1.20%	1.20%	1.30%
10yr PWLB rate	1.50%	1.50%	1.60%	1.60%	1.60%	1.60%	1.70%	1.70%	1.70%	1.70%	1.80%
25yr PWLB rate	2.30%	2.30%	2.40%	2.40%	2.40%	2.40%	2.50%	2.50%	2.50%	2.50%	2.60%
50yr PWLB rate	2.10%	2.10%	2.20%	2.20%	2.20%	2.20%	2.30%	2.30%	2.30%	2.30%	2.40%

7.2 The Bank of England's Monetary Policy Committee (MPC) agreed to reduce the Bank Rate from 0.50% to 0.25% in August 2016. The MPC gave forward guidance that it expected the Bank Rate to be cut further before the end of the year and therefore Capita believes the rate will be reduced to 0.10% in December 2016. The Bank Rate is expected to remain at this historically low level until June 2018 when it is expected to rise to 0.25% before eventually rising to 0.50% in June 2019.

7.3 Long term PWLB rates are expected to rise slightly to 2.20% in June 2017 before gently increasing over time to reach 2.40% by June 2019.

7.4 An eventual world economic recovery may see investors switching from the safe haven of bonds to equities. However, there have exceptional levels of volatility in financial markets which have caused significant swings in PWLB rates.

7.5 The overall balance of risks to economic recovery in the UK remains to the downside. Downside risks to current forecasts for UK gilt yields and PWLB rates include monetary policy action reaching its limit of effectiveness and failing to stimulate sustainable growth, combat the threat of deflation and reduce high levels of debt in some major developed economies, combined with a lack of adequate action from national governments to promote growth through structural reforms, fiscal policy and investment expenditure, weak capitalisation of some European banks, a resurgence of the Eurozone sovereign debt crisis, geopolitical risks in Europe, the Middle East and Asia, and weak growth or recession in the UK's main trading partners, the EU and US.

7.6 The potential for upside risks to current forecasts for UK gilt yields and PWLB rates, particularly longer term PWLB rates include the pace and timing of increases in the Federal Funds rate, agreed by the US Federal Reserve, 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 equites, 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 2016/17 was approved by Full Council on 25 February 2016. 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

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 0.25% Bank Rate. In this context it is considered that the Annual Investment Strategy approved on 25 February 2016 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 2016/17 the internal treasury team outperformed its benchmark by 0.32%. The investment return was 0.60% compared to the benchmark of 0.28%. This amounts to additional income of £294,880 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 2016, 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 2016/17 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 2016/17 was £184 million.

9.6 The Council's interest receivable/payable budgets are currently projecting a surplus of £1.448 million as reported in the monthly revenue monitoring reports due to no long term borrowing being undertaken and investment balances 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 2016/17 and have not been previously breached.

10.3 No new external borrowing is currently required for future years, although work to develop a new capital programme and the introduction of an Investment Board is continuing. Outline Business Case applications have been requested for a number of proposed schemes which are still in development and will be presented to the Investment Board for consideration prior to full Business Case submission. Once the 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 a sharp fall 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	0.81%	0.95%	1.42%	2.08%	1.87%
Date	07/09/2016	10/08/2016	10/08/2016	12/08/2016	30/08/2016
High	1.20%	1.80%	2.51%	3.28%	3.08%
Date	27/04/2016	27/04/2016	27/04/2016	27/04/2016	27/04/2016
Average	0.99%	1.33%	1.92%	2.69%	2.46%

10.4 During the first six months of the financial year there has been volatility in the financial markets, particularly following the vote in favour of the UK to leave the European Union, and this has had an impact on the PWLB rates. The overall longer run trend is for gilt yields and PWLB rates to rise, albeit gently. An eventual world recovery may also see investors switching from the safe haven of 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, 25 February 2016, Treasury Strategy 2016/17
Cabinet Member: Malcolm Pate, Leader of the Council
Local Member N/A
Appendices A. Investment Report as at 30th September 2016 B. Prudential Limits C. Prudential Borrowing Schedule