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TREASURY STRATEGY 2017/18 – 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 2017/18
- A review of the Treasury Strategy 2017/18 and Annual Investment Strategy
- A review of the Council's investment portfolio for 2017/18
- A review of the Council's borrowing strategy for 2017/18
- A review of any debt rescheduling undertaken
- A review of compliance with Treasury and Prudential limits for 2017/18

1.2 The key points to note are:-

- The internal treasury team achieved a return of 0.44% on the Council's cash balances outperforming the benchmark by 0.33%. This amounts to additional income of £265,650 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 changes required to the Treasury Strategy including the Annual Investment Strategy or prudential and treasury indicators as a result of decisions made by the Capital Investment Board will be reported to Council for approval.(See paragraph 10.3).

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 £265,650 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 £318m 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** – Growth in the US economy has been volatile in 2015 and 2016 and 2017 is following that path again with quarter 1 coming in at only 1.2% but quarter 2 rebounding to 3.1%, resulting in an overall annualised figure of 2.1% for the first half year. Unemployment in the US has also fallen to the lowest level for many years, reaching 4.4%, while wage inflation pressures, and inflationary pressures in general, have been building. The Federal Reserve has started on a gradual upswing in rates with three increases since December 2016 and there could be one more rate rise in 2017 which would then lift the central rate to 1.25 – 1.50%. There could then be another four more increases in 2018.

6.2 Chinese economic growth has been weakening over successive years, despite repeated rounds of central bank stimulus and medium term risks are increasing. Major progress still needs to be made to eliminate excess industrial capacity and the stock of unsold property. Japan is struggling to stimulate consistent significant growth and to get inflation up to its target of 2%, despite huge monetary and fiscal stimulus. It is also making little progress on fundamental reform of the economy.

6.3 Economic growth in the EU has been lack lustre for several years after the financial crisis despite the European Central Bank eventually cutting its main rate to minus 0.4% and embarking on a massive programme of Quantitative Easing. However, growth picked up in 2016 and now looks to have gathered ongoing substantial strength and momentum thanks to this stimulus. GDP growth was 0.5% in quarter 1 and 0.6% in quarter 2. However, despite providing massive monetary stimulus, the European Central Bank is still struggling to get inflation up to its 2% target and in August inflation was 1.5%. It is therefore unlikely that rates will start to rise until possibly 2019.

6.4 **UK Economy** – After the UK economy's strong growth in 2016, growth in 2017 has been disappointingly weak; quarter 1 came in at only 0.3% and quarter 2 was 0.3% which meant that growth in the first half of 2017 was the slowest for the first half of any year since 2012. The main reason for this has been the sharp increase in inflation, caused by the devaluation of sterling after the referendum, feeding increases in the cost of imports into the economy. This has caused, in turn, a reduction in consumer disposable income and spending power and so the services sector of the economy, accounting for around 75% of GDP, has seen weak growth as consumers cut back on their expenditure.

6.5 However, more recently there have been encouraging statistics from the manufacturing sector which is seeing strong growth, particularly as a result of increased demand for exports. It has helped that growth in the EU, our main trading partner, has improved significantly over the last year. However, this sector only accounts for around 11% of GDP so expansion in this sector will have a much more muted effect on the average total GDP growth figure for the UK economy as a whole.

6.6 The Monetary Policy Committee (MPC) meeting of 14 September 2017 surprised markets and forecasters by suddenly switching to a much more aggressive tone in terms of its words around warning that Bank Rate will need to rise. The Bank of England Inflation Reports during 2017 have clearly flagged up that they expected CPI inflation to peak at just under 3% in 2017, before falling back to near to its target rate of 2% in two years' time. Inflation actually came in at 2.9% in August, and so the Bank revised its forecast for the peak to over 3% at the 14 September MPC meeting.

6.7 This marginal revision can hardly justify why the MPC became so aggressive with its wording; rather, the focus was on an emerging view that with unemployment falling to only 4.3%, the lowest level since 1975, and improvements in productivity being so weak, the amount of spare capacity in the economy was significantly diminishing towards a point at which they now needed to take action. In addition, the MPC took a more tolerant view of low wage inflation as this now looks like a common factor in nearly all western economies as a result of increasing globalisation. However, the Bank was also concerned that the withdrawal of the UK from the EU would effectively lead to a decrease in such globalisation pressures in the UK, and so would be inflationary over the next few years.

6.8 With so much uncertainty around the Brexit negotiations, consumer confidence, and business confidence to spend on investing, it is far too early to be confident about how the next two years will pan out.

7 Economic Forecast

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

	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19
Bank Rate	0.50%	0.50%	0.50%	0.50%	0.75%	0.75%	0.75%	0.75%	1.00%
5 Year PWLB	1.50%	1.60%	1.60%	1.70%	1.80%	1.80%	1.90%	1.90%	2.00%
10 Year PWLB	2.10%	2.20%	2.30%	2.40%	2.40%	2.50%	2.60%	2.60%	2.70%
25 Year PWLB	2.80%	2.90%	3.00%	3.00%	3.10%	3.10%	3.20%	3.20%	3.30%
50 Year PWLB	2.50%	2.60%	2.70%	2.80%	2.90%	2.90%	3.00%	3.00%	3.10%

7.2. In November there were two major developments :-

- The MPC voted 7-2 to remove the post EU referendum emergency monetary stimulus implemented in August 2016 by reversing the cut in Bank Rate at that time from 0.5% to 0.25%.
- The MPC also gave forward guidance that they expected to increase Bank Rate only twice more in the next three years to reach 1% by 2020. In effect increases are likely to be gradual and to a limited extent.

7.3. Capita Asset Services undertook its last review of interest rate forecasts on 7 November following the announcement of the Monetary Policy Committee on the 2 November to increase the Bank rate to 0.50%, the first increase since 2007. The next Bank rate increase to 0.75% is not expected until December 2018 with a further increase to 1% expected in December 2019.

7.4. Long term PWLB rates are expected to rise to 2.7% in June 2018 before steadily increasing over time to reach 3.1% by December 2019.

7.5. The overall balance of risks to economic recovery in the UK is currently to the downside but huge variables over the coming few years include just what final form Brexit will take, when finally agreed with the EU, and when.

7.6. As the threat of potential risks from a number of sources still remains, caution must be exercised in respect of all interest rate forecasts at the current time. Economic forecasting remains difficult with so many influences weighing on the UK. Capita's bank rate forecasts will be liable to further amendment in 2017/18 depending on how economic data transpires.

8. Treasury Strategy update

8.1 The Treasury Management Strategy (TMS) for 2017/18 was approved by Full Council on 23 February 2017. This Treasury Strategy does not require updating as there are no changes required at the current time to the prudential and treasury indicators previously approved. Any changes required to the Treasury Strategy including the Annual Investment Strategy or prudential and treasury indicators as a result of decisions made by the Capital Investment Board will be reported to Council for approval.

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 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 current Bank Rate. The continuing potential for a re-emergence of a Eurozone sovereign debt crisis, and its impact on banks, prompts a low risk and short term strategy. Given this risk environment and the fact that increases in Bank Rate are likely to be gradual and unlikely to return to the levels seen in previous decades, investment returns are likely to remain low. In this context it is considered that the Annual Investment Strategy approved on 23 February 2017 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.

9.3 In the first six months of 2017/18 the internal treasury team outperformed its benchmark by 0.33%. The investment return was 0.44% compared to the benchmark of 0.11%. This amounts to additional income of £265,650 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 2017, 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 2017/18 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 were at an historical low point during the first six months of 2017/18. The average level of funds available for investment purposes in the first six months of 2017/18 was £160 million.

9.6 The Council's interest receivable/payable budgets are currently projecting a surplus of £1.487 million as reported in the monthly revenue monitoring reports due to no long term borrowing being undertaken and investment returns 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 2017/18 and have not been previously breached.

10.3 The Council has put in place a Capital Investment Board, which is an officer group to oversee a revision of the Capital programme with greater focus on investment to deliver financial returns to the Council. The three key areas of focus of the Capital Investment Board and return on investment, cost reduction and social value. Proposals considered by the Capital Investment Board are formulated into reports with appropriate recommendations that then flow through to Cabinet and, where necessary, Council. No new external borrowing is currently required for future years, although discussions are currently being held at the Capital Investment Board where outline business cases are being considered. The schemes being considered are already within the current authorised borrowing limits in place. In the event the authorised borrowing limits need to be amended, this will be reported to Council for approval. The table below illustrates the low and high points across different maturity bands for borrowing rates for the first six months of the financial year.

	1 Year	5 Year	10 Year	25 Year	50 Year
Low	0.80%	1.14%	1.78%	2.52%	2.25%
Date	03/05/2017	15/06/2017	15/06/2017	08/09/2017	08/09/2017
High	1.16%	1.62%	2.22%	2.83%	2.57%
Date	15/09/2017	28/09/2017	28/09/2017	07/07/2017	07/07/2017
Average	0.94%	1.30%	1.95%	2.65%	2.39%

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, 23 February 2017, Treasury Strategy 2017/18
Cabinet Member: Peter Nutting, Leader of the Council
Local Member N/A
Appendices A. Investment Report as at 30th September 2017 B. Prudential Limits C. Prudential Borrowing Schedule