



**Committee and Date**

Cabinet

9 December 2015

## **TREASURY MANAGEMENT UPDATE – QUARTER 2 2015/16**

**Responsible Officer** James Walton

e-mail: james.walton@shropshire.gov.uk

Tel: (01743) 255011

### **1. Summary**

- 1.1. The report outlines the treasury management activities of the Council in the last quarter. It highlights the economic environment in which treasury management decisions have been made and the interest rate forecasts of the Council's Treasury Advisor, Capita Asset Services. It also updates Members on the internal treasury team's performance.
- 1.2. During the second quarter of 2015/16 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 £95,330 during the quarter which is included within the Council's projected outturn position in the monthly revenue monitor.

### **2. Recommendations**

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

## **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 year about borrowing and returns based on the strategies agreed by Council in the preceding February. Performance outside of these assumptions result in increased or reduced income for the Council.
- 4.2. The Quarter 2 performance is above benchmark and has delivered additional income of £95,330 which will be reflected in the Period 6 Revenue Monitor.
- 4.3. The Council currently has £150 million held in investments as detailed in Appendix A and borrowing of £332 million 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 those activities, and the pursuit of optimum performance consistent with those risks". The report informs Members of the treasury activities of the Council between 1 July 2015 and 30 September 2015.

## **6. Economic Background**

- 6.1. Although the economic recovery picked up pace with real UK Gross Domestic Product (GDP) growth accelerating from 0.4% in the first quarter to 0.7% in the second quarter, it looks unlikely to have maintained this strength in the third quarter. In its August quarterly inflation report, the Bank of England has included a forecast for growth to remain around 2.4% to 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 inflation has fallen over the last quarter.
- 6.2. Consumer Price Inflation (CPI) figures fell from 0.1% in July to 0% in August and -0.1% in September therefore the UK has slipped back into deflation. This was despite the fall in the price of crude oil which plummeted to as low as £27 per barrel, lowering petrol prices at the pumps. Inflation looks set to remain negative for the remainder of this year before picking up around the turn of the year as the previous, sharper falls in oil prices drop out of the annual comparison.
- 6.3. The Monetary Policy Committee (MPC) voted to keep official interest rates on hold at 0.5% during the quarter and voted not to increase its programme of asset purchases under the Bank's quantitative easing (QE) programme at its September meeting. There have been dovish noises from the Bank of England recently following the August Inflation Report which saw the Bank reduce its forecasts for CPI inflation, and not expect the 2% inflation target to

be met until mid- 2017. The MPC highlighted the downside risks to global growth given recent developments in China. It looks increasingly unlikely that the MPC will increase rates this year.

- 6.4. On the international stage, the US Federal Reserve made the decision to hold off from increasing interest rates in September mainly due to the developments in China. The recent downbeat news about Chinese growth and the knock on impact on emerging countries that are major suppliers of commodities was cited as the main reason for not increasing rates.
- 6.5. In the Eurozone, the European Central Bank (ECB) announced a massive €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 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 which rose by 0.4% in the second quarter and looks likely to maintain this pace in the third quarter.
- 6.6. The Greek Government gave into EU demands for further austerity at the last minute and 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. It is therefore possible that a Greek exit from the euro has only been delayed by the latest bailout.

## 7. Economic Forecast

- 7.1. The Council receives its treasury advice from Capita Asset Services. Their latest interest rate forecasts to 30 June 2018 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 undertook a review of its interest rate forecasts on 11 August following the issue of the latest Bank of England Inflation Report in August 2015. This latest forecast includes no change in the timing of the first increase in Bank Rate as being June 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 with inflation forecasts within the report being notably subdued with inflation barely getting back up to the 2% target within the 2-3 year time horizon.

- 7.3. 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 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.
- 7.4. Long term PWLB rates are expected to rise to 4% in September 2016 before steadily increasing over time to reach 4.6% by 31 March 2018. It is expected that there will be a high level of volatility in PWLB rates over 2015, depending on how long it takes to decide what will happen in Greece and as other factors impinge on market and investor sentiment.
- 7.5. 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 depending on how economic data transpires over 2015. 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 safe haven of bonds. Despite market turbulence in late August, and then September, causing a sharp downturn in PWLB rates, the overall longer run trend is 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 Quantitative Easing. 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.

## **8. Treasury Management Strategy**

- 8.1. The Treasury Management Strategy (TMS) for 2015/16 was approved by Full Council on 26 February 2015. 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.
- 8.2. 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 the 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.
- 8.3. In the second quarter 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 £95,330 during the quarter which is included in the Council's projected outturn position in the monthly revenue monitor.

- 8.4. 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 second quarter of 2015/16. 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.
- 8.5. 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 second quarter of 2015/16 was £173.3 million.

## 9. Borrowing

- 9.1. 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 Treasury Management Strategy. A list of the approved limits is shown in Appendix B. The Prudential Indicators were not breached during the second quarter of 2015/16 and have not been previously breached. The schedule at Appendix C details the Prudential Borrowing approved and utilised to date.
- 9.2. Capita's target rate for new long term borrowing (50 years) for the second quarter of 2015/16 fell slightly from 3.6% to 3.4% after the August Bank of England Inflation report. No new external borrowing is currently required in 2015/16 due to a review of the Capital Programme. As outlined below, borrowing rates generally fell during the quarter. The low and high points during the quarter can be seen in the table below.

	1 Year	5 Year	10 Year	25 Year	50 Year
<b>Low</b>	1.23%	1.96%	2.56%	3.21%	3.07%
<b>Date</b>	24/09/2015	24/09/2015	29/09/2015	12/08/2015	12/08/2015
<b>High</b>	1.35%	2.35%	3.06%	3.66%	3.58%
<b>Date</b>	05/08/2015	14/07/2015	14/07/2015	02/07/2015	14/07/2015
<b>Average</b>	1.29%	2.15%	2.78%	3.40%	3.28%

**List of Background Papers (This MUST be completed for all reports, but does**

**not include items containing exempt or confidential information)**

Cabinet, 29 July 2015, Treasury Management Update Quarter 1 2015/16  
Council, 26 February 2015, Treasury Strategy 2015/16.

**Cabinet Member:**

David Turner, Portfolio Holder

**Local Member**

N/A

**Appendices**

- A. Investment Report as at 30 September 2015
- B. Prudential Limits
- C. Prudential Borrowing Schedule