FINANCE ADVISORY GROUP - 27 JULY 2011

INVESTMENT STRATEGY UPDATE

Report of the:	Deputy Chief Executive & Director of Corporate Resources
Also considered by:	Performance and Governance Committee – 27 September 2011
Status:	For consideration

Executive Summary: Members approved the Investment Strategy as part of the budget-setting process in December 2010. In considering that Strategy Members were advised that, given the current economic climate, the Strategy would need to be monitored and reviewed, where necessary, during the year.

This report follows up on recent developments in the markets and changes to credit ratings. It also gives an update on treasury activity in the first quarter of the current financial year and the latest position with regard to the Council's investment with Landsbanki Islands hf.

This report supports the Key Aim of effective management of Council resources.

Portfolio Holder Cllr. B. Ramsay

Head of Service Head of Finance and Human Resources – Mrs. Tricia Marshall

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Recommendation: That the update on treasury activity in the first quarter of 2011/12 be noted

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General Background

1 The Council aims to achieve the optimum return on its investments commensurate with proper levels of security and liquidity. The Council approved the current Investment Strategy for 2011/12 at the Council meeting on 16 December 2010.

2 Credit ratings form the basis of investment decisions and the matrix supplied by the Council's treasury advisers, Sector Treasury Services Ltd (Sector), encapsulates credit rating data to provide suggested counterparties and maturity limits.

3 Changes to the treasury management reporting regime brought about by the revised CIPFA Code of Practice on Treasury Management in the Public Services mean that regular reports should be presented to Members to enable them to have an informed view of the Council's treasury operation.

4 The annual report of performance in the previous financial year will be presented to the meeting of the Performance and Governance Committee on 27 September 2011.

Economic Background

5 The second quarter of 2011 saw:

- The economic recovery struggle to regain momentum;
- Conditions on the high street deteriorate;
- Mixed signals on the strength of the labour market recovery;
- Public sector borrowing come out disappointingly high;
- The near-term outlook for CPI inflation deteriorate further;
- The Bank of England's Monetary Policy Committee (MPC) move away from raising interest rates;
- UK equities stay broadly flat over the quarter and gilt yields fall;
- Economic growth slow in the US and euro-zone.

6 The economic recovery has been struggling to regain momentum after underlying activity more or less stagnated between October and March. The additional bank holiday for the Royal Wedding pulled down both industrial and services output in April. But the CIPS/Markit business surveys have failed to pick up by much since. An average of the surveys over the last three months point to quarterly GDP growth in Q2 of just 0.3% - less than half its trend rate.

7 The industrial recovery appears to have lost momentum quite quickly. The CIPS/Markit manufacturing survey has fallen to a level consistent with falls in manufacturing output. The output expectations balance of the CBI industrial trends survey has fallen more modestly, but has nonetheless dropped for the past three months in a row.

8 Meanwhile, the consumer outlook has darkened. The pick-up in the consumer sector seen during the spring appears to have been only temporary, reflecting the good weather and extra bank holiday. Retail sales volumes fell in May, more than reversing April's increase. The CBI's distributive trades survey fell in June. And a number of well-known retailers have recently fallen into administration.

9 Consumers appear to be reacting to the squeeze on their real incomes. Household real disposable incomes fell by 0.8% in Q1. Inflation is outpacing average earnings by about 2.5%. Consumer confidence also fell back in June and remains consistent with further falls in consumer spending.

10 Meanwhile, the news on the labour market has been mixed. The Workforce Jobs measure of employment rose strongly in Q1. But the timelier Labour Force Survey measure flattened off in April and May. And the number of job vacancies continued to fall throughout the quarter. The claimant count

measure of unemployment also continued to rise over the last three months. This only partly reflected a rise in the number of lone parents claiming Jobseeker's Allowance due to recent benefit changes.

11 The housing market has continued to tread water. The number of mortgage approvals for new house purchase was broadly unchanged over the quarter at a very low level of just 46,000 or so. House prices have also remained broadly flat. The Nationwide index ended the second quarter at about the same level as it ended the first.

12 Meanwhile, net trade looks unlikely to provide as big a contribution to GDP growth in Q2 as it did in Q1. Net trade boosted quarterly GDP growth by some 1.4% in Q1. However, the trade deficit was unchanged in April compared to March.

13 The weakness of the economy appears to be having some adverse effect on the public finances. Borrowing in the first two months of the fiscal year totalled £27.4bn, compared to last year's £25.9bn. It is early days but, at this rate, borrowing will overshoot the Office of Budget Responsibility's (OBR) full-year forecast of £122bn.

14 Oil prices rose but then fell back during the quarter, and so ended Q2 at $113 per barrel, close to the level seen at the end of Q1. Agricultural prices fell sharply over the past quarter.

15 But the near-term outlook for inflation has deteriorated further. Although CPI inflation held steady at 4.5% in May, it now looks likely to rise to 5.5% or even higher within the next few months. Food price inflation is likely to rise further. And Scottish Power announced in June a 19% rise in gas prices and 10% rise in electricity prices to take effect in August. Other utility suppliers are likely to follow suit.

16 Households' inflation expectations rose sharply in June. But so far, there are no signs of any pick-up in pay growth. The median pay settlement was unchanged at 2.5% in May.

17 Most MPC members still think that the rise in inflation will be only temporary and that inflation will fall back sharply next year. So despite the worsening of the near-term inflation outlook, the weakness of the activity data has pushed most members further away from an interest rate rise.

18 Some members of the MPC have even started to discuss the prospect of giving the economy more support. Admittedly, the hurdle for more quantitative easing will be quite high. However, it is certainly possible if the economy remains as weak as expected.

19 In financial markets, the FTSE 100 finished the quarter at around 5,950 – about the same level as at the end of the first quarter. This was broadly in line with international stock markets – the S&P500 was also little changed over the period. Ten year gilt yields fell from 3.69% to 3.38% on the back of a drop in interest rate expectations. At the end of March, markets were expecting

interest rates to have risen by this July. But now they expect rates to stay on hold until July next year. Meanwhile, sterling was broadly unchanged against the dollar at about $1.60, and fell only a touch against the euro.

20 In the US, the recovery also appears to have lost a significant amount of momentum. The ISM manufacturing index fell sharply in May and reversed only a fraction of this drop in June. Payrolls employment rose by a disappointing 54,000 in May. Meanwhile, the euro-zone economy expanded at a healthy pace in Q1, but recent falls in most leading indicators suggest that growth is slowing there too. Germany has continued to outperform the rest of the region. The risk of an imminent Greek disaster appears to have eased, but European policymakers' inability to deal with the crisis quickly and effectively is hitting the rest of the periphery.

Interest Rate Forecast

21 The Council's treasury adviser, Sector, provides the following forecast:

Sector's Interest Rate View	NOW	Sep-11	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12	Mar-13	Jun-13	Sep-13	Dec-13	Mar-14
Sector's Bank Rate View	0.50%	0.50%	0.75%	1.00%	1.25%	1.50%	1.75%	2.00%	2.25%	2.50%	2.75%	3.00%
5yr PWLB Rate	3.12%	3.55%	3.65%	3.75%	3.90%	4.00%	4.15%	4.25%	4.45%	4.60%	4.65%	4.75%
10yr PWLB View	4.45%	4.75%	4.75%	4.80%	4.95%	4.95%	5.00%	5.05%	5.15%	5.20%	5.25%	5.25%
25yr PWLB View	5.24%	5.40%	5.40%	5.40%	5.40%	5.40%	5.45%	5.50%	5.50%	5.50%	5.60%	5.65%
50yr PWLB Rate	5.20%	5.40%	5.40%	5.40%	5.40%	5.40%	5.45%	5.50%	5.50%	5.50%	5.60%	5.65%

22 The Sector central forecast is for a November 2011 first increase in Bank Rate but with reservations that it could well slip back in time, unless there is some good news on the UK economic recovery before then.

23 Sector has undertaken its normal quarterly review of interest rate forecasts after the issue of the Bank of England's quarterly Inflation Report. The key Bank of England comments are shown below:

- Mervyn King said after the May Inflation Report was published that 'Bank Rate cannot stay down indefinitely' but this does not equate to saying 'there will be a first increase in Bank Rate in November 2011'. Financial markets have over-reacted to this statement.
- Continuing wage freezes / low pay settlements
- BoE forecasts for the speed of recovery and of increases in GDP growth rate have consistently been over optimistic since the recession started in 2009
- CPI will blip up in 2011 due to temporary supply side shock factors but these will drop out within 12 months - as will VAT increases
- Unless the output gap is closed (unlikely for some considerable time) inflation will eventually fall below target
- CPIY (CPI less the effects of increase in indirect taxation) has been at or below 2% during 2010 and under 2.9% in 2011

<u>Summary Outlook</u>

24 The key question is how quickly, and strongly, will the UK economy respond to the positive stimulus from low Bank Rate, quantitative easing and the devaluation of sterling?

25 Negative growth of -0.5% in Q4 2010 was a huge shock; +0.5% (quarter on quarter) in Q1 2011 meant that growth had been flat for six months. A marginal upgrading of Q1 growth figures will have only a marginal effect on the big picture for the UK but there is considerable uncertainty as to how the UK economy will evolve in the coming months.

26 US Q1 growth of only 1.8% (on an annualised basis) was also a disappointment despite non-farm payroll data showing improvement.

27 China and India have embarked on a major thrust to cool their over-heating economies and so may depress the rate of world economic growth.

28 An anaemic economic recovery is probably the most likely outcome in the UK and US, after the initial rebound in 2010, for the next three to four years; recovery is likely to be slower and more protracted than normal business cycle recoveries as this is a financial crisis recovery where lack of credit is still stifling growth.

29 The Bank of England is likely to determine that further increases in CPI in 2011, towards 5%, as being due to one off factors that will drop out of the index within 12 months, so underpinning the view that inflation will be back to near target within a two to three year time horizon.

30 This does assume that raised inflation expectations do not feed through into a significant increase in the general level of wage settlements.

31 There has been a significant erosion of the confidence of financial markets in the EU handling of the peripheral debt crisis. There is now a major and escalating risk that the Greek, Irish, Portuguese debt crisis may not be contained and could lead to debt restructurings that could do significant damage to banks which already have weakened balance sheets. It is worth noting that many western governments have already exhausted their capacity to increase government debt to again bail out banks further damaged by any such future events and to counter the dampening of economic growth that would follow.

Annual Investment Strategy

32 Part of the service offered by Sector is to produce a monthly analysis of the Council's investment portfolio together with the latest amendments to credit ratings. These are emailed to Members of the Group each month and the one for June 2011 appears at Appendix A for information. A graphical representation of investment returns, which is used in the monthly financial results submitted to the Group appears at Appendix B.

33 Members will note that investment returns currently exceed target and that the benchmark percentage investment returns are also being exceeded.

34 This has been achieved against a background of a highly cautious investment policy which has been developed to address global concerns about the credit quality of financial institutions.

35 Over the last year, Officers expressed concern about the availability of suitable counterparties meeting the requirements of the strategy particularly as the lending criteria had been tightened in response to the credit crunch and worsening financial markets. The result of changes to the lending criteria is summarised in Appendix C along with the latest version of the lending list.

36 For the sake of completeness, the UK banks and building societies currently meeting the investment criteria specified in Appendix C are as follows:-

- Bank of Scotland plc (part of the Lloyds group)
- Barclays Bank plc
- Cater Allen Ltd (part of the Santander group)
- Clydesdale Bank plc
- HSBC Bank plc
- Lloyds TSB Bank plc
- National Westminster Bank plc (part of the RBS group)
- Nationwide Building Society
- Royal Bank of Scotland plc
- Santander UK plc
- Ulster Bank Ltd (part of the RBS group)

Icelandic Investment

37 The Landsbanki test case claims were heard by the Icelandic District Court on 14-18 February 2011.

38 On 1 April 2011, the Icelandic District Court found in UK wholesale depositors' favour and ruled that deposits placed by UK wholesale depositors have priority status in the winding up of both Landsbanki and Glitnir (the other failed Icelandic bank).

39 The Icelandic District Court awarded UK wholesale depositors interest on their deposits from the date of maturity up to 22 April 2009 at a rate of 8% (i.e. in accordance with the English Judgments Act). Claims for the costs of filing the claims were rejected and each party was ordered to pay their own costs of the litigation.

40 The other parties in the claim have appealed the decision to the Supreme Court. If the Icelandic Supreme Court upholds the decision of the Icelandic District Court, it is anticipated that UK wholesale depositors of Landsbanki and Glitnir will recover 95% and 100% of the value of their deposits respectively. Distributions will not be made to creditors until after any appeals to the Icelandic Supreme Court have taken place, which is expected to be later this year.

Key Implications

Financial implications

41 The management of the Council's investment portfolio and cash-flow generated balances plays an important part in the financial planning of the authority with interest receipts in the order of £186k supporting the revenue budget for 2011/12. The security of its capital and liquidity of its investments is of paramount importance. Restricting the number of counterparties for deposits increases the risk of not achieving the interest receipts budget for 2011/12.

Legal, Human Rights etc.

42 None.

Impact on and Outcomes for the Community

43 Investment income is used to support the revenue budget, providing funding for Council services that would otherwise have to be met from higher fees and charges or by service reductions.

Risk Assessment Statement

44 Treasury management has two main risks:-

- Fluctuations in interest rates can result in a reduction in income from investments; and
- a counterparty to which the Council has lent money fails to repay the loan at the required time.

45 Consideration of risk is integral in the Council's approach to treasury management. However, this particular report has no specific risk implications as it merely gives details of performance over the first quarter of the current financial year.

Sources of Information:

Annual Investment Strategy report (Council 16 December 2010, Cabinet 13 December 2010, Performance and Governance Committee 16 November 2010)

CIPFA Code of Practice on Treasury Management in the Public Services (2009)

Sector Treasury Services Ltd. - economic updates, monthly investment reports and credit rating lists

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