TREASURY MANAGEMENT MID-YEAR UPDATE 2017/18

Cabinet – 7 December 2017

Report of the: Chief Finance Officer

Status: For Consideration

Also considered by: Finance Advisory Committee – 14 November 2017

Key Decision: No

Executive Summary: This report gives details of treasury activity in the first half of the current financial year, recent developments in the financial markets and fulfils the reporting requirements of the Chartered Institute of Public Finance and Accountancy (CIPFA) Code of Practice on Treasury Management.

This report supports the Key Aim of Effective Management of Council Resources.

Portfolio Holder Cllr. John Scholey

Contact Officer Roy Parsons, Principal Accountant, Ext 7204

Recommendation to Finance Advisory Committee: That Cabinet be asked to approve the Treasury Management Mid-Year Update for 2017/18.

Recommendation to Cabinet: It be RESOLVED that the Treasury Management Mid-Year Update for 2017/18 be approved.

Reason for recommendation: As required by both the Council's Financial Procedure Rules and the CIPFA Code, a mid-year report of treasury management activity is to be presented to Members for approval.

Background

1 The Council is required through regulations issued under the Local Government Act 2003 to produce an annual Treasury Management Strategy Statement, which includes the Annual Investment Strategy and Minimum Revenue Provision Policy, for the year ahead, a mid-year review report and an annual report covering activities during the previous year.

2 During 2017/18 the minimum reporting requirements are that the Council should receive the following reports:

- an annual treasury strategy in advance of the year (Council 21/2/2017).

- a mid year treasury update report (this report).
- an annual report following the year describing the activity compared to the strategy.

3 In addition, monthly reports from our treasury management advisors, Capita Asset Services, are emailed to Members of the Finance Advisory Committee.

Introduction

4 The Council operates a balanced budget, which broadly means cash raised during the year will meet its cash expenditure. Part of the treasury management operations ensure this cash flow is adequately planned, with surplus monies being invested in low risk counterparties, providing adequate liquidity initially before considering optimising investment return.

5 The second main function of the treasury management service is the funding of the Council's capital plans. These capital plans provide a guide to the borrowing need of the Council, essentially the longer term cash flow planning to ensure the Council can meet its capital spending operations. This management of longer term cash may involve arranging long or short term loans, or using longer term cash flow surpluses, and on occasion any debt previously drawn may be restructured to meet Council risk or cost objectives.

6 Accordingly, treasury management is defined as:

"The management of the local 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."

7 This mid-year update report, prepared in compliance with CIPFA's Code of Practice on Treasury Management, covers:

(a) an economic update for the 2017/18 financial year to 30 September 2017;

(b) interest rate forecasts;

(c) a review of the Treasury Management Strategy Statement and Annual Investment Strategy;

(d) a review of the Council's investment portfolio for 2017/18; and

(e) other recent treasury management developments.

Economic update

8 **UK.** After the UK economy surprised on the upside with strong growth in 2016, growth in 2017 has been disappointingly weak; quarter 1 came in at

only +0.3% (+1.7% y/y) and quarter 2 was +0.3% (+1.5% y/y) 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. 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.

9 The Bank of England's 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, (this data was released on 12 September), and so the Bank revised its forecast for the peak to over 3% at the 14 September MPC meeting.

10 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, that 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. This effectively means that the UK labour faces competition from overseas labour e.g. in outsourcing work to third world countries, and this therefore depresses the negotiating power of UK labour. 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.

11 At the time of writing this report, the November MPC meeting had not taken place, but its outcome will be known by the time of the Finance Advisory Committee and Cabinet meetings. It looks very likely that the MPC will increase Bank Rate to 0.5% in November or, if not, in February 2018. The big question after that will be whether this will be a one off increase or the start of a slow, but regular, increase in Bank Rate. As at the start of October, short sterling rates are indicating that financial markets do not expect a second increase until May 2018 with a third increase in November 2019. However, some forecasters are flagging up that they expect growth to

improve significantly in 2017 and into 2018, as the fall in inflation will bring to an end the negative impact on consumer spending power while a strong export performance will compensate for weak services sector growth. If this scenario were to materialise, then the MPC would have added reason to embark on a series of slow but gradual increases in Bank Rate during 2018. While there is 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.

12 **EU.** Economic growth in the EU, (the UK's biggest trading partner), has been lack lustre for several years after the financial crisis despite the European Central Bank (ECB) eventually cutting its main rate to -0.4% and embarking on a massive programme of QE. 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 (2.0% y/y) and 0.6% in quarter (2.3% y/y). However, despite providing massive monetary stimulus, the ECB is still struggling to get inflation up to its 2% target and in August inflation was 1.5%. It is therefore unlikely to start on an upswing in rates until possibly 2019.

13 **USA.** Growth in the American economy has been volatile in 2015 and 2016. 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 (Fed) 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. At its June meeting, the Fed strongly hinted that it would soon begin to unwind its $4.5 trillion balance sheet holdings of bonds and mortgage backed securities by reducing its reinvestment of maturing holdings.

14 **China.** Economic growth has been weakening over successive years, despite repeated rounds of central bank stimulus; medium term risks are increasing. Major progress still needs to be made to eliminate excess industrial capacity and the stock of unsold property, and to address the level of non-performing loans in the banking and credit systems.

15 **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.

Interest rate forecasts

16 The Council's treasury advisor, Capita Asset Services, has provided the following forecast:

	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20
Bank rate	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.50%	0.50%	0.75%	0.75%
5yr PWLB rate	1.50%	1.60%	1.70%	1.70%	1.80%	1.80%	1.90%	1.90%	2.00%	2.00%
10yr PWLB rate	2.20%	2.30%	2.30%	2.40%	2.40%	2.50%	2.50%	2.60%	2.60%	2.70%
25yr PWLB rate	2.90%	2.90%	3.00%	3.00%	3.10%	3.10%	3.20%	3.20%	3.30%	3.30%
50yr PWLB rate	2.70%	2.70%	2.80%	2.80%	2.90%	2.90%	3.00%	3.00%	3.10%	3.10%

17 Capita Asset Services undertook its last review of interest rate forecasts on 9 August after the quarterly Bank of England Inflation Report. There was no change in MPC policy at that meeting. However, the MPC meeting of 14 September revealed a sharp change in sentiment whereby a majority of MPC members said they would be voting for an increase in Bank Rate "over the coming months". It is therefore possible that there will be an increase to 0.5% at the November MPC meeting. If that happens, the question will then be as to whether the MPC will stop at just withdrawing the emergency Bank Rate cut of 0.25% in August 2016, after the result of the EU withdrawal referendum, or whether they will embark on a series of further increases in Bank Rate during 2018.

18 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.

19 Downside risks to current forecasts for UK gilt yields and Public Works Loan Board (PWLB) rates currently include:

- UK economic growth and increases in inflation are weaker than we currently anticipate.
- Weak growth or recession in the UK's main trading partners - the EU and US.
- Geopolitical risks in Europe, the Middle East and Asia, which could lead to increasing safe haven flows.
- A resurgence of the Eurozone sovereign debt crisis.
- Weak capitalisation of some European banks.
- Monetary policy action failing to stimulate sustainable growth and to get inflation up consistently to around monetary policy target levels.

20 The potential for upside risks to current forecasts for UK gilt yields and PWLB rates, especially for longer term PWLB rates include: -

- The pace and timing of increases in the Fed. 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.

- UK inflation returning to significantly higher levels causing an increase in the inflation premium inherent to gilt yields.

Treasury Management Strategy and Annual Investment Strategy update

21 The Treasury Management Strategy Statement (TMSS) and Prudential Indicators for 2017/18 were approved by the Council on 21 February 2017. There are no policy changes to the TMSS thus far and the details in this report merely update the position in the light of updated economic data.

Investment portfolio 2017/18

22 In accordance with the Code, it is the Council's priority to ensure security of capital and liquidity, and to obtain an appropriate level of return which is consistent with the Council's risk appetite. As described 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 0.25% Bank Rate. The continuing potential for a re-emergence of a Eurozone sovereign debt crisis, and its impact on banks, prompts a low risk 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.

23 The Council held £37.365m of investments as at 30 September 2017 (£29.320m at 31 March 2017) and the investment portfolio yield for the first six months of the year is 0.37% against 7 Day and 3 Month LIBID benchmarks of 0.16% and 0.26% respectively. A full list of investments held as at 30 September 2017 appears in the Appendix.

24 The approved limits within the Annual Investment Strategy were not breached during the first six months of 2017/18.

25 The Council's budgeted investment return for 2017/18 is £157k and performance for the year to 30 September 2017 is approximately £6k below budget. At this stage, the year-end forecast is expected to be between £10-15k below the budgeted level of £157k.

26 The current investment counterparty criteria approved in the Treasury Management Strategy Statement is currently meeting the requirements of the treasury management function. However, there is potential for increasing the number of counterparties which would help spread risk with the added benefit of improving interest returns. Some proposals for inclusion in the 2018/19 Strategy will be brought before the next meeting for consideration.

Other recent treasury management developments

Revised CIPFA Codes

27 CIPFA is currently conducting an exercise to consult local authorities on revising the Treasury Management Code and Cross Sectoral Guidance Notes, and the Prudential Code. CIPFA is aiming to issue the revised codes during November 2017.

28 A particular focus of this exercise is how to deal with local authority investments which are not treasury type investments e.g. by investing in purchasing property in order to generate income for the authority at a much higher level than can be attained by treasury investments. One recommendation is that local authorities should produce a new report to Members to give a high level summary of the overall capital strategy and to enable Members to see how the cash resources of the authority have been apportioned between treasury and non treasury investments. Officers are monitoring developments and will report to Members when the new codes have been agreed and issued and on the likely impact on this authority.

The Markets in Financial Instruments Directive (MiFID II)

29 The EU has set a deadline of 3 January 2018 for the introduction of regulations under MiFID II. These regulations will govern the relationship that financial institutions conducting lending and borrowing transactions will have with local authorities from that date. They also affect the relationship between the Council and its advisors and brokers. There will be little effect on this authority apart from us having to fill in forms sent by each institution we deal with and for each type of investment instrument we use, apart from cash deposits with banks and building societies.

Key Implications

Financial

30 The management of the Council's investment portfolio and cash-flow generated balances plays an important part in the financial planning of the authority. The security of its capital and liquidity of its investments is of paramount importance.

Legal Implications and Risk Assessment Statement

31 Under Section 151 of the Local Government Act 1972, the Section 151 Officer has statutory duties in relation to the financial administration and stewardship of the authority, including securing effective arrangements for treasury management.

32 This annual review report fulfils the requirements of The Chartered Institute of Public Finance & Accountancy's Code of Practice on Treasury Management 2009.

33 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.

34 Consideration of risk is integral in our approach to treasury management. However, this particular report has no specific risk implications as it is not proposing any new actions, but merely reporting performance over the last six months.

Equality Assessment

35 The decisions recommended through this paper have a remote or low relevance to the substance of the Equality Act. There is no perceived impact on end users.

Conclusions

36 The overall return on the Council's investments up to the end of September 2017 is slightly below budget and is forecast to remain below that level by the end of the financial year.

37 The percentage yield on the portfolio is 0.37%, which exceeds the recognised benchmarks.

38 The economic situation both globally and within the Eurozone remains volatile, and this will have consequences for the UK economy particularly as the Brexit process moves forward. Treasury management in the current and recent financial years has been conducted against this background and with a cautious investment approach.

Appendix: Investment Portfolio at 30 September 2017

Background Papers: Treasury Management Strategy for 2017/18 - Council 21 February 2017

Adrian Rowbotham
Chief Finance Officer