Rother District Council **Agenda Item: 7.5**

Report to	-	Audit and Standards Committee
Date	-	26 June 2017
Report of the	-	Executive Director of Resources
Subject	-	Treasury Management Report – 2016/17 Outturn

Recommendation: It be **RESOLVED**: That the investment outturn performance for 2016/17 be noted.

Service Manager: Robin Vennard

Introduction

1. Cabinet approved the Council's 2016/17 Investment Strategy on 15 February 2016 which requires an annual report describing the Treasury Management activity in the past year compared to the Strategy.

Background

2. This Council is required, through regulations issued under the Local Government Act 2003, to produce an Annual Treasury Report, reviewing treasury management activities and the actual prudential and treasury indicators for 2016-2017. This report meets the requirements of both the Chartered Institute of Public Finance and Accountancy (CIPFA) Code of Practice on Treasury Management (the Code) and the CIPFA Prudential Code for Capital Finance in Local Authorities (the Prudential Code).

   During 2016/17 the minimum reporting requirements were that full Council should receive the following reports:

   - an annual treasury strategy in advance of the year (Council 15 February 2016);
   - a mid year (minimum) treasury update report (Audit Committee 28 September 2016); and
   - an annual report following the year describing the activity compared to the strategy (this report).

3. The regulatory environment places responsibility on Members for the review and scrutiny of treasury management policy and activities. This report is important in that respect, as it provides details of the outturn position for treasury activities and highlights compliance with the Council's policies previously approved by Members.

4. This Council has complied with the requirement, under the Code, to give prior scrutiny to all of the above treasury management reports by the Audit and Standards Committee before they were reported to full Council. In order to support Members' scrutiny role, Member training on treasury management

issues will be undertaken on 5 July 2017 this is necessary for Members of this Committee in order to fulfil its statutory obligations.

The Council's Capital Expenditure and Financing 2016/17

5. The Council undertakes capital expenditure on long-term assets. These activities may either be:

   (a) Financed immediately through the application of capital or revenue resources (capital receipts, capital grants, revenue contributions etc.), which has no resultant impact on the Council's borrowing need; or

   (b) If insufficient financing is available, or a decision is taken not to apply resources, the capital expenditure will give rise to a borrowing need.

6. The actual capital expenditure forms one of the required prudential indicators. The table below shows the actual capital expenditure and how this was financed.

Capital Expenditure and Financing 2016/17

	2015/16 Outturn £ (000)	2016/17 Budget £ (000)	2016/17 Outturn £ (000)
Capital Expenditure	1,200	5,218	2,619
Financing			
Capital Receipts	199	1,100	30
Grants and contributions	26	3,632	2,589
Capital Expenditure Charged to Revenue	975	486	0
Total Funding	1,200	5,218	2,619

Borrowing

7. The Council has not entered into any actual new borrowing activity since becoming debt free in April 2002.

Review of Investment Performance 2016/17

Investment Strategy for 2016/17

8. The expectation for interest rates set out within the treasury management strategy for 2016/17 anticipated low but rising Bank Rate, starting in quarter 4 of 2017 and gradual rises in medium and longer term fixed borrowing rates during 2016/17. Continued uncertainty in the aftermath of the 2008 financial crisis promoted a cautious approach, whereby investments would continue to be dominated by low counterparty risk considerations, resulting in relatively low returns compared to borrowing rates. In reality the Bank of England Base Rate dropped to a historic low of 0.25% in August 2016 and has remained at this level throughout the year.

9. Our Treasury Advisors' view on the Economy and their revised interest rate forecast is shown at Appendix B.

Overall Investment Return 2016/17

10. The Council’s temporary lending was carried out solely by Finance staff during 2016/17 and no fund manager was employed during the year. Lending took the form of short term deposits up to 364 days and due to the continuation of depressed investment earnings for another year the Council invested £2.25 million in the Churches, Charities, Local Authorities’ (CCLA) Property Investment Fund in 2016/17. A further £2.75 million was invested at the end of April 2017. The current dividend yield as at April 2017 is 4.58%.

11. This temporary lending earned interest of £171,913 which equated to an average interest rate of 0.65%. This compares to a budgeted income of £135,000. All of the transactions have been reported in the Members’ Bulletin throughout the year.

12. The Council also retains the Government Gilt which will be held until maturity or traded if a significant capital gain is achieved. The Gilt is held on our behalf by our matched principal dealer King and Shaxson. The value of the Gilt at 31 March 2016 was £1,115,961 against a purchase price of £1,100,000. The gilt earned the additional interest of £13,750 in the financial year.

Malcolm Johnston
Executive Director of Resources

Risk Assessment Statement
There are no direct risks arising from this report. Failure to follow the Council’s investment strategy could increase the risk of financial loss

The Economy and Interest Rates

The two major landmark events that had a significant influence on financial markets in the 2016-17 financial year were the UK EU referendum on 23 June and the election of President Trump in the USA on 9 November. The first event had an immediate impact in terms of market expectations of when the first increase in Bank Rate would happen, pushing it back from quarter 3 2018 to quarter 4 2019. At its 4 August meeting, the Monetary Policy Committee (MPC) cut Bank Rate from 0.5% to 0.25% and the Bank of England's Inflation Report produced forecasts warning of a major shock to economic activity in the UK, which would cause economic growth to fall almost to zero in the second half of 2016. The MPC also warned that it would be considering cutting Bank Rate again towards the end of 2016 in order to support growth. In addition, it restarted quantitative easing with purchases of £60bn of gilts and £10bn of corporate bonds, and also introduced the Term Funding Scheme whereby potentially £100bn of cheap financing was made available to banks.

In the second half of 2016, the UK economy confounded the Bank's pessimistic forecasts of August. After a disappointing quarter 1 of only +0.2% GDP growth, the three subsequent quarters of 2016 came in at +0.6%, +0.5% and +0.7% to produce an annual growth for 2016 overall, compared to 2015, of no less than 1.8%, which was very nearly the fastest rate of growth of any of the G7 countries. Needless to say, this meant that the MPC did not cut Bank Rate again after August but, since then, inflation has risen rapidly due to the effects of the sharp devaluation of sterling after the referendum. By the end of March 2017, sterling was 17% down against the dollar but had not fallen as far against the euro. In February 2017, the latest CPI inflation figure had risen to 2.3%, above the MPC's inflation target of 2%. However, the MPC's view was that it would look through near term supply side driven inflation, (i.e. not raise Bank Rate), caused by sterling's devaluation, despite forecasting that inflation would reach nearly 3% during 2017 and 2018. This outlook, however, is dependent on domestically generated inflation, (i.e. wage inflation), continuing to remain subdued despite the fact that unemployment is at historically very low levels and is on a downward trend. Market expectations for the first increase in Bank Rate moved forward to quarter 3 2018 by the end of March 2017 in response to increasing concerns around inflation.

USA. Quarterly growth in the US has been very volatile during 2016 but a strong performance since mid-2016, and strongly rising inflation, prompted the Fed into raising rates in December 2016 and March 2017. The US is the first major western country to start on a progressive upswing in rates. Overall growth in 2016 was 1.6%.

EU. The EU is furthest away from an upswing in rates; the European Central Bank (ECB) has cut rates into negative territory, provided huge tranches of cheap financing and been doing major quantitative easing purchases of debt during 2016-17 in order to boost growth from consistently weak levels, and to get inflation up from near zero towards its target of 2%. These purchases have resulted in depressed bond yields in the EU, but, towards the end of 2016, yields rose, probably due at least in part to rising political concerns around the positive prospects for populist parties and impending general elections in 2017 in the Netherlands, France and Germany. The action taken by the ECB has resulted in economic growth improving significantly in the eurozone to an overall figure of 1.7% for 2016, with Germany achieving a rate of 1.9% as the fastest growing G7 country.

On the other hand, President Trump's election and promise of fiscal stimulus, which are likely to increase growth and inflationary pressures in the US, have resulted in Treasury yields rising sharply since his election. Gilt yields in the UK have been caught between these two influences and the result is that the gap in yield between US treasuries and UK gilts has widened sharply during 2016/17 due to market perceptions that the UK is still likely to be two years behind the US in starting on an upswing in rates despite a track record of four years of strong growth.

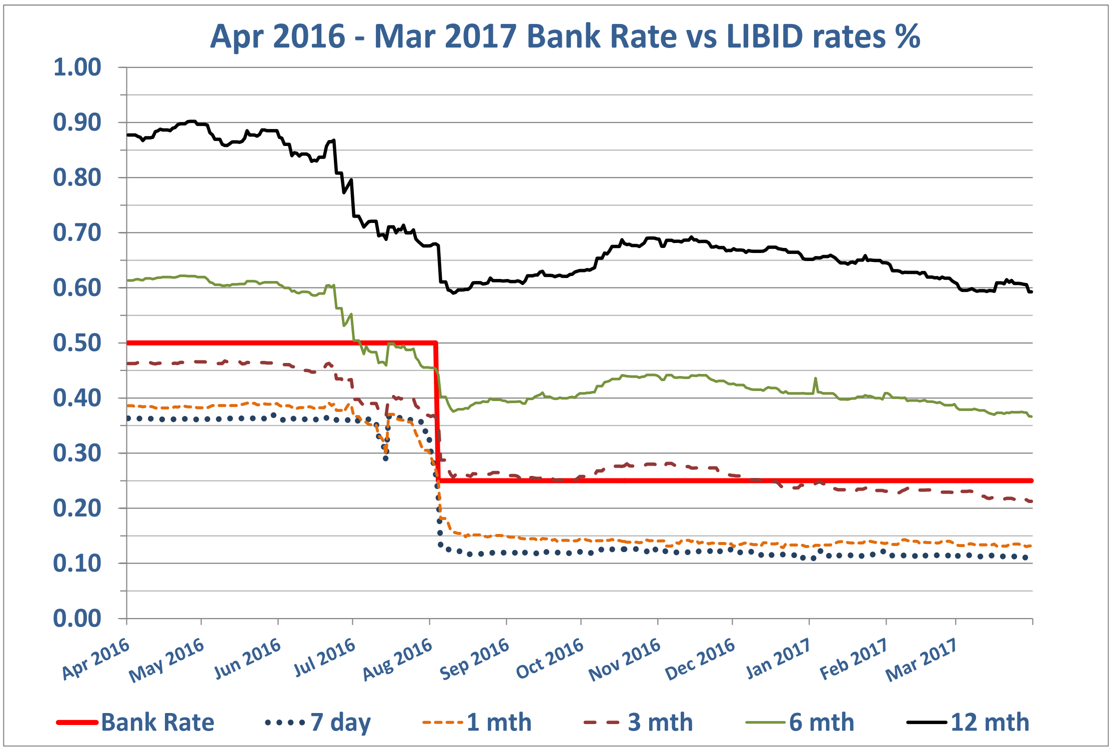
Japan struggled to stimulate consistent significant growth with GDP averaging only 1.0% in 2016 with current indications pointing to a similar figure for 2017. It is also struggling to get inflation up to its target of 2%, only achieving an average of -0.1% in 2016, despite huge monetary and fiscal stimulus, though this is currently expected to increase to around 1% in 2017. It is also making little progress on fundamental reform of the economy.

China and emerging market counties. At the start of 2016, there were considerable fears that China's economic growth could be heading towards a hard landing, which could then destabilise some emerging market countries particularly exposed to a Chinese economic slowdown and / or to the effects of a major reduction in revenue from low oil prices. These fears have largely subsided and oil prices have partially recovered so, overall, world growth prospects have improved during the year.

Equity markets. The result of the referendum, and the consequent devaluation of sterling, boosted the shares of many FTSE 100 companies which had major earnings which were not denominated in sterling. The overall trend since then has been steeply upwards and received further momentum after Donald Trump was elected President as he had promised a major fiscal stimulus to boost the US economy and growth rate.

Investment Rates in 2016/17

After the EU referendum, Bank Rate was cut from 0.5% to 0.25% on 4 August and remained at that level for the rest of the year. Market expectations as to the timing of the start of monetary tightening started the year at quarter 3 2018, but then moved back to around the end of 2019 in early August before finishing the year back at quarter 3 2018. Deposit rates continued into the start of 2016/17 at previous depressed levels but then fell during the first two quarters and fell even further after the 4 August MPC meeting resulted in a large tranche of cheap financing being made available to the banking sector by the Bank of England. Rates made a weak recovery towards the end of 2016 but then fell to fresh lows in March 2017.



Interest rate forecasts

The Council's treasury advisor, Capita Asset Services, has provided the following forecast for interest rates and borrowing as at 1 June 2017.

Interest Rate Forecasts								
Bank Rate								
	Q2 17	Q3 17	Q4 17	Q1 18	Q2 18	Q3 18	Q4 18	Q1 19
Capita	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%
Capital Eco.	0.25%	0.25%	0.25%	0.25%	0.50%	0.50%	0.75%	0.75%
5yr PWLB Rate								
Capita	1.40%	1.40%	1.50%	1.60%	1.70%	1.70%	1.80%	1.80%
Capital Eco.	1.30%	1.40%	1.60%	2.00%	2.30%	2.60%	2.90%	2.90%
10yr PWLB Rate								
Capita	2.00%	2.10%	2.20%	2.30%	2.30%	2.40%	2.40%	2.50%
Capital Eco.	2.10%	2.20%	2.30%	2.60%	2.80%	3.10%	3.30%	3.30%
25yr PWLB Rate								
Capita	2.70%	2.80%	2.90%	2.90%	3.00%	3.00%	3.10%	3.10%
Capital Eco.	2.65%	2.75%	2.95%	3.15%	3.45%	3.65%	3.90%	3.90%
50yr PWLB Rate								
Capita	2.50%	2.60%	2.70%	2.70%	2.80%	2.80%	2.90%	2.90%
Capital Eco.	2.60%	2.70%	2.80%	3.10%	3.30%	3.60%	3.80%	3.80%

Appendix B

PRUDENTIAL INDICATORS	2015/16	2016/17	2016/17
	Actual £000	Estimated outturn £000	Actual £000
Capital Expenditure	1,199	5,218	2,619
Ratio of financing costs to net revenue stream	1%	1%	2%
Net Debt Position at 31 March	0	0	0
Capital Financing Requirement as at 31 March	1,091	1,091	1,091
Annual change in Capital Financing Requirement	0	0	0
Incremental impact of capital investment decisions			
Increase in council tax (band D) per annum	£ 0.04	£ 0.22	£ -
Authorised limit for external debt			
Borrowing	17,000	17,000	17,000
Other long term liabilities (finance leases)	0	0	0
TOTAL	17,000	17,000	17,000
Operational boundary for external debt			
Borrowing	15,000	15,000	19,000
Other long term liabilities (finance leases)	0	0	0
TOTAL	15,000	15,000	19,000