Report to	-	Audit and Standards Committee
Date	-	26 March 2018
Report of the	-	Executive Director of Resources
Subject	-	Treasury Management Report – Quarter 3 and to the end of February 2018

Recommendation: It be **RESOLVED**: That the report be noted.

Service Manager: Robin Vennard

Introduction

1. Cabinet approved the Council's 2017/18 Investment Strategy in February 2017 (Minute CB16/76 refers). The investment strategy requires regular reports to be presented to this Committee on the Council's treasury management activities. Members are also reminded that investment activity is also reported through the Members' Bulletin. In managing its treasury management activities, the Council follows the Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management (revised 2017).

2. The primary requirements of the Code are as follows:

   i. Creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the Council's treasury management activities.

   ii. Creation and maintenance of Treasury Management Practices which set out the manner in which the Council will seek to achieve those policies and objectives.

   iii. Receipt by the full Council of an annual Treasury Management Strategy Statement (TMSS) – including the Annual Investment Strategy and Minimum Revenue Provision Policy – for the year ahead, a Mid-year Review Report and an Annual Report (stewardship report) covering activities during the previous year.

   iv. Delegation by the Council of responsibilities for implementing and monitoring treasury management policies and practices and for the execution and administration of treasury management decisions.

   v. Delegation by the Council of the role of scrutiny of treasury management strategy and policies to a specific named body. For this Council the delegated body is the Audit and Standards Committee.

3. This report has been prepared in compliance with CIPFA's Code of Practice on Treasury Management.

Economic Update

4. Appendix 1 is our treasury advisors, Link Asset Services' (LAS), view on the current economic environment and their outlook for the remainder of 2017/18, when written. It details the impact this is likely to have on the Council's investment performance. In terms of interest rate forecasts, LAS' view (as at 19 February 2018) is that the base rate will not increase until June 2018, when a rise of 0.25% may occur to 0.75%.

5. LAS say that cash rates continue to see some upside pressure, reflecting a more hawkish interest rate outlook. Markets are pricing in a circa 63% chance of a rate hike at the May Monetary Policy Committee meeting. Counterparty quality and suitable limits remain key factors when making investment decisions.

Treasury Management Strategy and Annual Investment Strategy review

6. The Council currently makes the majority of its treasury investments through the use of call and deposit accounts with the major financial UK institutions. In addition, the Council holds a Government gilt which is a legacy of the previous arrangements with the external fund managers and a £5m investment in Property Funds. The funds are managed in-house by the Finance Department.

7. The following paragraphs describe the recent investment activity and the level of investment returns currently being generated.

Investment Portfolio 2017/18

8. 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 set out in Appendix 1, 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 case of some call accounts, often below the 0.5% Bank Rate. The Council's cash levels and cash flow profiles as well as restrictions on maximum deposit duration contribute to a low risk and short-term strategy. Given this risk adverse environment, investment returns continue to remain low.

9. The Council held £29.7m of investments as at 28 February 2018 and the investment portfolio yield to date this year is £311,277 (including the gilt interest). This is set against the annual budget of £235,000. The reason for the increased income is due to the level of return on the investment in the property fund. The expected year end position is £335,000, which represents a surplus of £100,000 on the original budget.

Capital Programme

10. A major part of the Council's Treasury Management Strategy concerns the Capital Programme, how it is funded and the impact this has on our taxpayers. The following table shows the latest revised estimates for capital expenditure and the agreed Programme at the beginning of the financial year.

11. The table below summarises the capital expenditure plans and how these plans are being financed by capital or revenue resources. Any shortfall of resources results in a borrowing need.

Capital Expenditure £m	2016/17 Actual £'000	2017/18 Estimate £'000	2018/19 Estimate £'000	2019/20 Estimate £'000	2020/21 Estimate £'000
Total Capital Expenditure	2,619	2,276	10,262	10,143	20,130
Financed by:					
Capital receipts	30	0	3,057	0	0
Capital grants	2589	1,376	0	0	0
Revenue	0	900	2,360	143	130
Net financing need for the year	**Nil**	**0**	**4,845**	**10,000**	**20,000**

Capital Financing Requirement and Borrowing

12. The Council's Capital Financing Requirement (CFR) denotes the Council's underlying need to borrow for capital purposes. If the CFR is positive the Council may borrow from the Public Works Loan Board (PWLB) or the market (external borrowing) or from internal balances on a temporary basis (internal borrowing). The CFR will increase each year by the amount of capital expenditure yet to be financed and is reduced by the amount that the Council sets aside for the repayment of borrowing.

13. The CFR opening balance of £1.091 million represents an "Item A" adjustment dating back to 2004: this is the agreed historic amount on which it is not necessary to provide the annual Minimum Revenue Provision (MRP) for repayment of debt. MRP would be payable for any capital expenditure financed from loan in the future.

14. The Council's CFR projections are shown in the table below:

£m	2016/17 Actual £'000	2017/18 Estimate £'000	2018/19 Estimate £'000	2019/20 Estimate £'000	2020/21 Estimate £'000
Capital Financing Requirement					
Total CFR	1,091	1,091	5,937	15,937	35,816
Movement in CFR		**0**	**4,845**	**9,879**	**19,129**

£m	2016/17 Actual £'000	2017/18 Estimate £'000	2018/19 Estimate £'000	2019/20 Estimate £'000	2020/21 Estimate £'000
Movement in CFR represented by					
Net financing need for the year (above)	Nil	0	4,845	10,000	20,000
Less MRP/VRP and other financing movements	Nil	0	0	121	871
Movement in CFR	**Nil**	**0**	**4,845**	**9,879**	**19,129**

15. MRP has been calculated on the straight line asset life basis for the purposes of this report.

Limits to Borrowing Activity

16. To ensure the Council acts reasonably when entering into borrowing, the first key control over the treasury activity is a Prudential Indicator (PI) to ensure that over the medium-term, net borrowing (borrowings less investments) will only be for a capital purpose. Net external borrowing should not, except in the short-term, exceed the total of CFR in the preceding year plus the estimates of any additional CFR for 2017/18 and next two financial years. This allows some flexibility for limited early borrowing for future years. The Council has approved a policy for borrowing in advance of need which will be adhered to if this proves prudent.

17. The Service Manager – Finance and Welfare reports that no difficulties are envisaged for the current or future years in complying with this PI.

18. A further PI controls the overall level of borrowing. This is the Authorised Limit (AL) which represents the limit beyond which borrowing is prohibited and needs to be set and revised by Members. It reflects the level of borrowing which, while not desired, could be afforded in the short-term, but is not sustainable in the longer term. It is the expected maximum borrowing need with some headroom for unexpected movements. This is the statutory limit determined under Section 3 (1) of the Local Government Act 2003.

Authorised limit	2017/18 Estimate £'000	2018/19 Estimate £'000	2019/20 Estimate £'000	2020/21 Estimate £'000
Debt	24,400	26,600	35,400	56,300
Other long term liabilities	0	0	0	0
Total	**24,400**	**26,600**	**35,400**	**56,300**

19. The Operational Boundary links directly to the Council's estimates of the CFR and estimates of other cash flow requirements. This indicator is based on the same estimates as the AL reflecting the most likely but not worst case scenario but without the additional headroom included in the AL.

Operational boundary	2017/18 Estimate £'000	2018/19 Estimate £'000	2019/20 Estimate £'000	2020/21 Estimate £'000
Debt	22,000	24,000	32,000	51,000
Other long term liabilities	0	0	0	0
Total	**22,000**	**24,000**	**32,000**	**51,000**

Conclusion

20. The Council's current treasury management and investment strategies remain robust in managing the Council's cash funds. The economic outlook remains difficult for a net investor such as the Council and supports the Council's financial strategy to continue to reduce reliance on investment returns.

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.

ECONOMIC COMMENTARY BASED ON CAPITAL ASSET SERVICES INTEREST RATE FORECAST / 26 February 2018

Economic Background

The Past Week

UK – It was a quiet start to the week with the first significant domestic release coming in the form of the CBI Industrial Trends Orders, measure of growth of manufacturing output, which came in at 10 in February, down from 14 last month. Unemployment rate released midweek with an unexpected rise, an increase of 46,000 out of work in the three months to December. Mark Carney pointed towards lack of business investment of 3 percent less than they were the previous year. UK GDP growth in the final quarter of 2017 has been expectedly revised down to 0.4%, less than the 0.5% in the prior quarter.

US – US Manufacturing PMI rose to 55.9 in February, a 40-month high, up from 55.5 last month. US Composite PMI, a survey measuring business activity, and US Services PMI followed suite with both coming in at 55.9, beating expectations of 54.4 and 53.8 respectively. US Initial Jobless claims came in at 222k, an improvement on 229k the previous month. The 7,000 drop with the labour market peaking near full employment.

EZ – Eurozone PMI figures came in less than expected at 57.5, down from last month’s 58.8. Overall Eurozone business activity continued to rise albeit the lower figure showing an easing in the rate of increase of new orders. Eurozone CPI came in 1.3% y/y for January, in line with expectations.

Global – Quiet overall week globally, particularly in the east with many celebrating the new lunar year.

The Week Ahead

Monday – No Key Data

Tuesday – The EC Economic Sentiment Indicator is forecast to edge lower for a 2nd month in a row, with consumer sentiment known to have weakened, possibly on the weaker equity market. Business sentiment seems set to follow suit. The US Conference Board will probably report a similar slight downturn in consumer confidence.

Wednesday – The “flash” EZ consumer price inflation is expected to see the headline rate ease to 1.2% y/y in February as the spike in food prices/ energy price inflation a year ago, added to easing fuel prices this month drag prices lower. New Fed Chair, Jerome Powell makes his first semi-annual testimony on Capitol Hill. His comments will be microscopically monitored for any potential shift in stance. He is likely to offer an upbeat appraisal of the economy and of inflation hitting target, but will probably hold back on hints of a material change in the pace of rate hikes, offering a slightly more hawkish tone from his confirmation hearing three months ago. Once his feet are more comfortably under the desk we may see a tightening of interest rate expectations.

Thursday – The UK February manufacturing PMI is expected to indicate further slowing momentum, following softer January output/new orders. A dip below 55 is suggested but this remains relatively healthy. Household borrowing figures will show that mortgage approvals remain muted and consumer growth has eased a touch. EZ unemployment is set to edge lower to 8.6% in January.

Friday – The UK construction PMI could slip below 50 and into contraction territory, with the new orders element already having done so. However, such are the fine margins that a small improvement in the housing activity indicator to boost sentiment. The more important services reading is published on Monday.

<u>Investments</u>

The Past Week - Rates

LIBOR – Once again, the LIBOR curve registered further modest steepening over the past week, as markets continued their more hawkish tone. Ultra-short rates were little changed, but the long end rose by a further c.2bps. This left the spread at c40bps between 1mth (0.498%) and 1yr (0.899%) rates.

Money Market Funds – Average Liquidity Fund yields rose by 1bps, to 51bps, while Government Fund yields were flat on the week, at 42bps. Assets Under Management registered further outflows, of c.£2.4bn, with investors perhaps switching to higher yielding, ultra-short deposits. The largest actual reductions came from BlackRock (£724m), Federated (£301), Goldman (£668m), LGIM (£661m) and Standard Life (£469m), while a small number of other funds actually saw inflows on the week. See the data report for more details on actual numbers.

Key Rating Changes

Barclays Bank Plc – Short and Long Term ratings placed on Negative Watch by Moody’s. The moves were related to ring-fencing proposals by the bank, where the non-ring fenced bank is expected to have a weaker credit profile due to its increased reliance on wholesale and capital market activities.

HSBC Bank Plc – Long Term rating placed on Negative Watch by Moody’s. As with Barclays above, move is related to ring-fencing action, with non-ring fenced bank having a weaker credit profile.

Counterparties in Monitoring

Qatar National Bank

What that means for you

Cash rates continue to see some upside pressure, reflecting a more hawkish interest rate outlook. Markets are pricing in a c.63% chance of a rate hike at the May MPC meeting.

Counterparty quality and suitable limits remain key factors when making investment decisions.

Risk Analysis

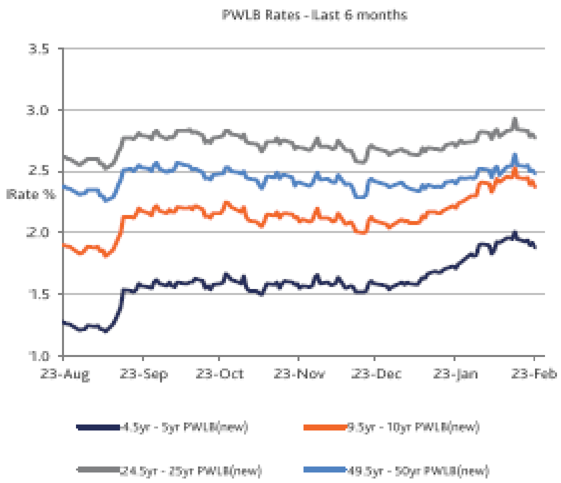
A reversal in market sentiment saw CDS prices bounce higher over the past week, with those in Europe heading higher than their US counterparts. Index levels are now in the mid-50s in both regions. At the individual level, all of the top 10 changes for the week and the month were European Banks.

Major equity markets struggled for any clear direction on the week. The FTSE dropped by 0.69%, while other major indices only just kept in positive territory. Bank sub-indices were similarly mixed, with the UK variant falling by near 2%, as HSBC dropped by c.5% and RBC by c.2.5%. These offset a c.5% gain for Barclays. Despite the fall in the index, the VFTSE volatility measure dropped by 13.8%.

Debt Markets

The Past Week
Gilt yields fell across the week on the back of weaker unemployment figures as investors' optimism in financial markets fall.

PWLB rates remain in line with our trigger levels at the short end of the curve whilst medium to longer end of the curve are currently below.



The Week Ahead
Limited UK data is likely to reflect a softening of activity in the economy which could further ease interest rate expectations. Markets remain focussed on a May rate hike but if the economy continues to evidence a slowing economy, there could be a rethink.

US interest rate expectations will be monitored following Fed Chair Powell's comments. If he is more hawkish than expected then there could be a shift from 3 to 4 expected hikes this year.

PWLB	Current	Trigger	Spread
4.5-5yr	1.90	1.90	0.00
9.5-10yr	2.38	2.50	-0.12
24.5-25yr	2.77	2.80	-0.03
49.5-50yr	2.48	2.60	-0.12

Interest Rate Forecasts								
Bank Rate	**Jun-18**	**Sep-18**	**Dec-18**	**Mar-19**	**Jun-19**	**Sep-19**	**Dec-19**	**Mar-20**
Link	0.75%	0.75%	1.00%	1.00%	1.00%	1.00%	1.25%	1.25%
Capital Eco.	0.75%	1.00%	1.25%	1.25%	1.50%	1.50%	1.75%	2.00%
5yr PWLB Rate								
Link	2.00%	2.10%	2.10%	2.20%	2.30%	2.30%	2.40%	2.40%
Capital Eco.	1.90%	2.10%	2.40%	2.40%	2.40%	2.40%	2.40%	2.40%
10yr PWLB Rate								
Link	2.50%	2.60%	2.70%	2.70%	2.80%	2.80%	2.90%	3.00%
Capital Eco.	2.40%	2.60%	2.80%	2.80%	2.80%	2.80%	2.80%	2.80%
25yr PWLB Rate								
Link	2.90%	3.00%	3.10%	3.20%	3.20%	3.30%	3.30%	3.40%
Capital Eco.	2.90%	3.10%	3.30%	3.30%	3.30%	3.35%	3.35%	3.35%
50yr PWLB Rate								
Link	2.70%	2.80%	2.90%	3.00%	3.00%	3.10%	3.10%	3.20%
Capital Eco.	2.70%	2.90%	2.90%	2.90%	3.05%	3.05%	3.15%	3.15%