Rother District Council **Agenda Item: 7.2**

Report to	-	Audit and Standards Committee
Date	-	25 June 2018
Report of the	-	Executive Director
Subject	-	Treasury Management Report – 2017/18 Outturn

Recommendation: It be **RESOLVED**: That the investment outturn performance for 2017/18 be noted.

Assistant Director Resources: Robin Vennard

Introduction

1. Cabinet approved the Council's 2017/18 Investment Strategy on 27 February 2017 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 2017-2018. 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).

3. The Council delegated responsibility to this Committee for the review and scrutiny of the treasury management policies and activities. During 2017/18 the minimum reporting requirements were that full Council should receive the following reports:

   - an annual treasury strategy in advance of the year (Council 27 February 2017);
   - a mid year (minimum) treasury update report (Audit and Standards Committee 27 September 2017); and
   - an annual report following the year describing the activity compared to the strategy (this report).

4. In addition, this Committee has received quarterly treasury management update reports on 11 December 2017 and 26 March 2018. In order to support Members, training on treasury management issues was undertaken on 5 July 2017. This is necessary for Members of this Committee in order to fulfil its statutory obligations. At the time of writing this report further Treasury Management training was due to take place on 18 June 2018.

5. This report provides details of the outturn position for treasury activities and officers can confirm compliance with the Council's policies previously approved by Members.

Overall Treasury Position as at 31 March 2018

6. At the beginning and the end of 2017/18 the Council's total investments were £22,466,273. There was nil borrowing at 31 March 2018 and the Capital Financing requirement of £1.091 million remained unchanged from the previous year.

The Strategy for 2017/18

7. The expectation for interest rates within the treasury management strategy for 2017/18 anticipated that Bank Rate would not start rising from 0.25% until quarter 2 2019 and then only increase once more before 31 March 2020. There would also be gradual rises in medium and longer term fixed borrowing rates during 2017/18 and the two subsequent financial years. Variable, or short-term rates, were expected to be the cheaper form of borrowing over the period. 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. Commentary on interest/investment rates and borrowing is shown at Appendix A.

The Council's Capital Expenditure and Financing 2017/18

8. 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.

9. 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 2017/18

	2016/17 Outturn £ (000)	2017/18 Budget £ (000)	2017/18 Provisional Outturn £ (000)
Capital Expenditure	2,619	5,080	2,098
Financing			
Capital Receipts	30	1,136	484
Grants and contributions	2,589	1,924	1,258
Capital Expenditure Charged to Revenue	0	2,020	356
Total Funding	2,619	5,080	2,098

10. The prudential indicators can be found in Appendix B.

Borrowing

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

Overall Investment Return 2017/18

12. The Council's temporary lending was carried out solely by Finance staff during 2017/18. A further £2.75 million was placed with the Churches, Charities, Local Authorities' (CCLA) property fund bringing the total deposited with them to £5 million.

13. Investment Policy – the Council's investment policy is governed by The Ministry of Housing, Communities and Local Government's (MHCLG) guidance, which has been implemented in the annual investment strategy approved by the Council on 27 February 2017. This policy sets out the approach for choosing investment counterparties, and is based on credit ratings provided by the three main credit rating agencies, supplemented by additional market data, (such as rating outlooks, credit default swaps, bank share prices etc.). The investment activity during the year conformed to the approved strategy, and the Council had no liquidity difficulties.

14. This temporary lending earned interest of £334,253 which equated to an average interest rate of 1.15%. This compares to a budgeted income of £235,000. All of the transactions have been reported in the Members' Bulletin throughout the year.

15. 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 2018 was £1,104,878 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

Risk Assessment Statement

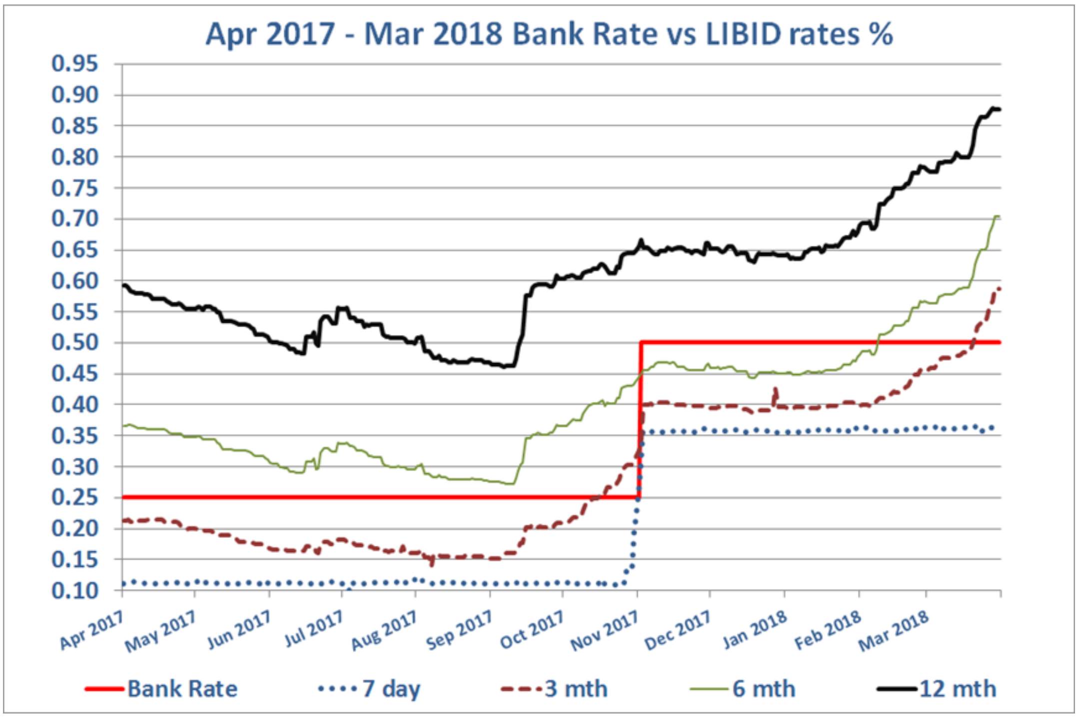
There are no direct risks arising from this report. Failure to follow the Council's investment strategy could increase the risk of financial loss

The Economy and Interest Rates

During the calendar year of 2017, there was a major shift in expectations in financial markets in terms of how soon Bank Rate would start on a rising trend. After the UK economy surprised on the upside with strong growth in the second half of 2016, growth in 2017 was disappointingly weak in the first half of the year which meant that growth was the slowest for the first half of any year since 2012. The main reason for this was the sharp increase in inflation caused by the devaluation of sterling after the EU referendum, feeding increases into the cost of imports into the economy. This caused a reduction in consumer disposable income and spending power as inflation exceeded average wage increases. Consequently, the services sector of the economy, accounting for around 75% of GDP, saw weak growth as consumers responded by cutting back on their expenditure. However, growth did pick up modestly in the second half of 2017. Consequently, market expectations during the autumn, rose significantly that the MPC would be heading in the direction of imminently raising Bank Rate. The minutes of the MPC meeting of 14 September indicated that the MPC was likely to raise Bank Rate very soon. The 2 November MPC quarterly Inflation Report meeting duly delivered by raising Bank Rate from 0.25% to 0.50%. The 8 February MPC meeting minutes then revealed another sharp hardening in MPC warnings on a more imminent and faster pace of increases in Bank Rate than had previously been expected. Market expectations for increases in Bank Rate, therefore, shifted considerably during the second half of 2017-18 and resulted in investment rates from 3 – 12 months increasing sharply during the spring quarter. The general election on 8 June had relatively little impact on financial markets.

Investment Rates in 2017/18

Investments rates for 3 months and longer have been on a rising trend during the second half of the year in the expectation of Bank Rate increasing from its floor of 0.25%, and reached a peak at the end of March. Bank Rate was duly raised from 0.25% to 0.50% on 2 November 2017 and remained at that level for the rest of the year. However, further increases are expected over the next few years. Deposit rates continued into the start of 2017/18 at previous depressed levels due, in part, to a large tranche of cheap financing being made available under the Term Funding Scheme to the banking sector by the Bank of England; this facility ended on 28 February 2018.



Further Commentary

UK. The outcome of the EU referendum in June 2016 resulted in a gloomy outlook and economic forecasts from the Bank of England based around an expectation of a major slowdown in UK GDP growth, particularly during the second half of 2016, which was expected to push back the first increase in Bank Rate for at least three years. Consequently, the Bank responded in August 2016 by cutting Bank Rate by 0.25% to 0.25% and making available over £100bn of cheap financing to the banking sector up to February 2018. Both measures were intended to stimulate growth in the economy. This gloom was overdone as the UK economy turned in a G7 leading growth rate of 1.8% in 2016, (actually joint equal with Germany), and followed it up with another 1.8% in 2017, (although this was a comparatively weak result compared to the US and EZ).

During the calendar year of 2017, there was a major shift in expectations in financial markets in terms of how soon Bank Rate would start on a rising trend. After the UK economy surprised on the upside with strong growth in the second half of 2016, growth in 2017 was disappointingly weak in the first half of the year; quarter 1 came in at +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 was the sharp increase in inflation caused by the devaluation of sterling after the EU referendum, feeding increases into the cost of imports into the economy. This caused a reduction in consumer disposable income and spending power as inflation exceeded average wage increases. Consequently, the services sector of the economy, accounting for around 75% of GDP, saw weak growth as consumers responded by cutting back on their expenditure. However, growth did pick up in quarter 3 to 0.5% before dipping slightly to 0.4% in quarter 4.

Consequently, market expectations during the autumn rose significantly that the MPC would be heading in the direction of imminently raising Bank Rate. The MPC meeting of 14 September provided a shock to the markets with a sharp increase in tone in the minutes where the MPC considerably hardened their wording in terms of needing to raise Bank Rate very soon. The 2 November MPC quarterly Inflation

Report meeting duly delivered on this warning by withdrawing the 0.25% emergency rate cut which had been implemented in August 2016. Market debate then moved on as to whether this would be a one and done move for maybe a year or more by the MPC, or the first of a series of increases in Bank Rate over the next 2-3 years. The MPC minutes from that meeting were viewed as being dovish, i.e. there was now little pressure to raise rates by much over that time period. In particular, the GDP growth forecasts were pessimistically weak while there was little evidence of building pressure on wage increases despite remarkably low unemployment. The MPC forecast that CPI would peak at about 3.1% and chose to look through that breaching of its 2% target as this was a one off result of the devaluation of sterling caused by the result of the EU referendum. The inflation forecast showed that the MPC expected inflation to come down to near the 2% target over the two to three year time horizon. So this all seemed to add up to cooling expectations of much further action to raise Bank Rate over the next two years.

However, GDP growth in the second half of 2017 came in stronger than expected, while in the new year there was evidence that wage increases had started to rise. The 8 February MPC meeting minutes therefore revealed another sharp hardening in MPC warnings focusing on a reduction in spare capacity in the economy, weak increases in productivity, higher GDP growth forecasts and a shift of their time horizon to focus on the 18 – 24 month period for seeing inflation come down to 2%. (CPI inflation ended the year at 2.7% but was forecast to still be just over 2% within two years.) This resulted in a marked increase in expectations that there would be another Bank Rate increase in May 2018 and a bringing forward of the timing of subsequent increases in Bank Rate. This shift in market expectations resulted in investment rates from 3 – 12 months increasing sharply during the spring quarter.

PWLB borrowing rates increased correspondingly to the above developments with the shorter term rates increasing more sharply than longer term rates. In addition, UK gilts have moved in a relatively narrow band this year, (within 25 bps for much of the year), compared to US treasuries. During the second half of the year, there was a noticeable trend in treasury yields being on a rising trend with the Fed raising rates by 0.25% in June, December and March, making six increases in all from the floor. The effect of these three increases was greater in shorter terms around 5 year, rather than longer term yields.

As for equity markets, the FTSE 100 hit a new peak near to 7,800 in early January before there was a sharp selloff in a number of stages during the spring, replicating similar developments in US equity markets.

The major UK landmark event of the year was the inconclusive result of the general election on 8 June. However, this had relatively little impact on financial markets. However, sterling did suffer a sharp devaluation against most other currencies, although it has recovered about half of that fall since then. Brexit negotiations have been a focus of much attention and concern during the year but so far, there has been little significant hold up to making progress.

The manufacturing sector has been the bright spot in the economy, seeing stronger 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, the manufacturing sector only accounts for around 11% of GDP so expansion in this sector has a much more muted effect on the average total GDP growth figure for the UK economy as a whole.

EU. Economic growth in the EU, (the UK's biggest trading partner), was lack lustre for several years after the financial crisis despite the ECB eventually cutting its main rate to -0.4% and embarking on a massive programme of quantitative easing to stimulate growth. However, growth eventually picked up in 2016 and subsequently gathered further momentum to produce an overall GDP figure for 2017 of 2.3%. Nevertheless, despite providing this massive monetary stimulus, the ECB is still struggling to get inflation up to its 2% target and in March, inflation was still only 1.4%. It is, therefore, unlikely to start an upswing in rates until possibly towards the end of 2019.

USA. Growth in the American economy was volatile in 2015 and 2016. 2017 followed that path again with quarter 1 at 1.2%, quarter 2 3.1%, quarter 3 3.2% and quarter 4 2.9%. The annual rate of GDP growth for 2017 was 2.3%, up from 1.6% in 2016. Unemployment in the US also fell to the lowest level for 17 years, reaching 4.1% in October to February, while wage inflation pressures, and inflationary pressures in general, have been building. The Fed has been the first major western central bank to start on an upswing in rates with six increases since the first one in December 2015 to lift the central rate to 1.50 – 1.75% in March 2018. There could be a further two or three increases in 2018 as the Fed faces a challenging situation with GDP growth trending upwards at a time when the recent Trump fiscal stimulus is likely to increase growth further, consequently increasing inflationary pressures in an economy which is already operating at near full capacity. In October 2017, the Fed also became the first major western central bank to make a start on unwinding quantitative easing by phasing in a gradual reduction in reinvesting maturing debt.

Chinese economic growth has been weakening over successive years, despite repeated rounds of central bank stimulus and 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.

Japan. GDP growth has been improving to reach an annual figure of 2.1% in quarter 4 of 2017. However, it is still struggling to get inflation up to its target rate of 2% despite huge monetary and fiscal stimulus, although inflation has risen in 2018 to reach 1.5% in February. It is also making little progress on fundamental reform of the economy.

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 2018.

Interest Rate Forecasts

Bank Rate	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20
Link	0.50%	0.50%	0.75%	0.75%	0.75%	1.00%	1.00%	1.00%
Cap Econ	0.50%	0.75%	1.00%	1.00%	1.25%	1.25%	1.50%	1.50%
5Y PWLB RATE								
Link	1.90%	2.00%	2.00%	2.10%	2.20%	2.20%	2.30%	2.30%
Cap Econ	1.80%	2.00%	2.40%	2.40%	2.40%	2.40%	2.40%	2.40%
10Y PWLB RATE								
Link	2.40%	2.40%	2.50%	2.60%	2.60%	2.70%	2.80%	2.80%
Cap Econ	2.30%	2.40%	2.80%	2.80%	2.80%	2.80%	2.80%	2.80%
25Y PWLB RATE								
Link	2.70%	2.80%	2.90%	3.00%	3.10%	3.20%	3.30%	3.30%
Cap Econ	2.85%	2.95%	3.33%	3.33%	3.33%	3.33%	3.33%	3.33%
50Y PWLB RATE								
Link	2.40%	2.50%	2.60%	2.70%	2.80%	2.90%	3.00%	3.00%
Cap Econ	2.65%	2.80%	3.15%	3.15%	3.15%	3.15%	3.15%	3.15%

Appendix B

PRUDENTIAL INDICATORS	2016/17	2017/18	2017/18
	Actual £000	Estimated outturn £000	Actual £000
Capital Expenditure	2,619	5,080	2,098
Ratio of financing costs to net revenue stream	-1.00%	-2.00%	-3.00%
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
Authorised limit for external debt			
Borrowing	20,900	24,400	24,400
Other long term liabilities (finance leases)	0	0	0
TOTAL	20,900	24,400	24,400
Operational boundary for external debt			
Borrowing	19,000	22,000	22,000
Other long term liabilities (finance leases)	0	0	0
TOTAL	19,000	22,000	22,000