CAPITA

Asset Services

Treasury solutions

# Treasury Management Update

## Quarter Ended 31st December 2015

## Contents

# Treasury Management Update

## Quarter Ended 31st December 2015

The CIPFA (Chartered Institute of Public Finance and Accountancy) Code of Practice for Treasury Management recommends that members be updated on treasury management activities regularly (TMSS, annual and midyear reports). This report, therefore, ensures this Council is implementing best practice in accordance with the Code.

## 1. Economic Background

UK GDP growth rates in 2013 of 2.2% and 2.9% in 2014 were the strongest growth rates of any G7 country; the 2014 growth rate was also the strongest UK rate since 2006 and the 2015 growth rate is likely to be a leading rate in the G7 again. However, quarter 1 of 2015 was weak at +0.4% (+2.9% y/y) though there was a slight increase in quarter 2 to +0.5% (+2.3% y/y) before falling back to +0.4% (+2.1% y/y) in quarter 3. Growth is expected to improve to about +0.6% in quarter 4 but the economy faces headwinds for exporters from the appreciation of Sterling against the Euro and weak growth in the EU, China and emerging markets, plus the dampening effect of the Government's continuing austerity programme, although the pace of reductions was eased in the November autumn statement.

Despite these headwinds, the Bank of England November Inflation Report included a forecast for growth over the three years of 2015, 2016 and 2017 to be around 2.7%, 2.5% and 2.6% respectively, although statistics since then would indicate that an actual outturn for 2015 is more likely to be around 2.2%. Nevertheless, this is still moderately strong growth which is being driven mainly by strong consumer demand as the squeeze on the disposable incomes of consumers has been reversed by a recovery in wage inflation at the same time that CPI inflation has fallen to, or near to, zero over the last quarter. Investment expenditure is also expected to support growth.

The November Bank of England Inflation Report forecast was notably subdued with inflation barely getting back up to the 2% target within the 2-3 year time horizon. However, with the price of oil taking a fresh downward direction and Iran expected to soon rejoin the world oil market after the impending lifting of sanctions, there could be several more months of low inflation still to come, especially as world commodity prices have generally been depressed by the Chinese economic downturn.

There are, therefore, considerable risks around whether inflation will rise in the near future as strongly as previously expected; this will make it more difficult for the Bank of England to make a start on raising Bank Rate as soon as had been expected in early 2015, especially given the subsequent major concerns around the slowdown in Chinese growth, the knock on impact on the earnings of emerging countries from falling oil and commodity prices, and the volatility we have seen in equity and bond markets during 2015, which could potentially spill over to impact the real economies rather than just financial markets.

The American economy made a strong comeback after a weak first quarter's growth at +0.6% (annualised), to grow by no less than 3.9% in quarter 2 of 2015 before easing back to +2.0% in quarter 3. While there had been confident expectations during the summer that the Fed. could start increasing rates at its meeting on 17 September, downbeat news during the summer about Chinese and Japanese growth and the knock on impact on emerging countries that are major suppliers of commodities, was cited as the main reason for the Fed's decision to pull back from making that start. The nonfarm payrolls figures for September and revised August, issued on 2 October, were also disappointingly weak. However, since then concerns on both the domestic and international scene have abated and so the Fed made its long anticipated start in raising rates at its December meeting.

In the Eurozone, the ECB fired its big bazooka in January 2015 in unleashing a massive €1.1 trillion programme of quantitative easing to buy up high credit quality government and other debt of selected EZ countries. This programme of €60bn of monthly purchases started in March 2015 and it was intended to run initially to September 2016. At the ECB's December meeting, this programme was extended to March 2017 but was not increased in terms of the amount of monthly purchases. The ECB also cut its deposit facility rate by 10bps from -0.2% to -0.3%. This programme of monetary easing has had a limited positive effect in helping a recovery in consumer and business confidence and a start to some improvement in economic growth. GDP growth rose to 0.5% in quarter 1 2015 (1.3% y/y) but has then eased back to +0.4% (+1.6% y/y) in quarter 2 and to +0.3% (+1.6%) in quarter 3. Financial markets were disappointed by the ECB's lack of more decisive action in December and it is likely that it will need to boost its QE programme if it is to succeed in significantly improving growth in the EZ and getting inflation up from the current level of around zero to its target of 2%.

## 2. Interest Rate Forecast

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

| | NOW | Mar-16 | Jun-16 | Sep-16 | Dec-16 | Mar-17 | Jun-17 | Sep-17 | Dec-17 | Mar-18 | Jun-18 | Sep-18 | Dec-18 | Mar-19 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| BANK RATE | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.75 | 0.75 | 1.00 | 1.00 | 1.25 | 1.25 | 1.50 | 1.50 | 1.75 |

| | | | | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 5 yr PWLB | 1.55 | 1.70 | 1.90 | 2.00 | 2.10 | 2.20 | 2.30 | 2.40 | 2.60 | 2.70 | 2.80 | 2.90 | 3.00 | 3.10 |
| 10 yr PWLB | 2.20 | 2.30 | 2.40 | 2.50 | 2.60 | 2.70 | 2.80 | 2.90 | 3.00 | 3.10 | 3.30 | 3.40 | 3.50 | 3.60 |
| 25 yr PWLB | 3.05 | 3.20 | 3.20 | 3.30 | 3.30 | 3.50 | 3.50 | 3.60 | 3.60 | 3.70 | 3.70 | 3.70 | 3.80 | 3.80 |
| 50 yr PWLB | 2.88 | 3.00 | 3.00 | 3.10 | 3.10 | 3.30 | 3.30 | 3.40 | 3.40 | 3.50 | 3.60 | 3.60 | 3.70 | 3.70 |

Capita Asset Services undertook a review of its interest rate forecasts on 12 February and the revised forecast has pushed back the timing of the start of increases in Bank Rate from quarter 4 2016 to quarter 1 2017.

The Governor of the Bank of England, Mark Carney, has repeatedly stated that increases in Bank Rate will be slow and gradual after they do start. The MPC is concerned about the impact of increases on many heavily indebted consumers, especially when average disposable income is only just starting a significant recovery as a result of recent increases in the rate of wage inflation, though some consumers will not have seen that benefit come through for them.

# 3. Annual Investment Strategy

The Treasury Management Strategy Statement (TMSS) for 2015/16, which includes the Annual Investment Strategy, was approved by the Council on 12th February 2015. It sets out the Council's investment priorities as being:

- Security of capital;
- Liquidity; and
- Yield.

The Council will also aim to achieve the optimum return (yield) on its investments commensurate with proper levels of security and liquidity. In the current economic climate it is considered appropriate to keep investments short term to cover cash flow needs, but also to seek out value available in periods up to 24 months.

Officers can confirm that the approved limits within the Annual Investment Strategy were not breached during the quarter ended 31st December 2016.

Investment rates available in the market have been broadly stable during the quarter and have continued at historically low levels as a result of the ultra-low Bank rate. The average level of funds available for investment purposes in house during the quarter was £24.4M. These funds were available on a temporary basis, and the level of funds available was mainly dependent on the timing of precept payments, receipt of grants and progress on the Capital Programme. The Council holds £28.5M core cash balances for investment purposes (i.e. funds available for more than one year). The investment portfolio yield for the first 9 months of the year is 0.92%.

Investments at 31st December 2015

| | Amount £ | Average Interest Rate % |
|---|---|---|
| **Managed By NHDC** | | |
| Banks | 13,850,000 | 0.62 |
| Building Societies | 10,000,000 | 0.54 |
| Money Market Fund | 25,000 | 0.56 |
| **NHDC To Total** | **23,875,000** | **0.59** |
| **Managed by Sterling** | | |
| Banks | 0 | |
| Building Societies | 1,000,000 | 1.50 |
| **Sterling Total** | **1,000,000** | **1.50** |
| **Managed by Tradition** | | |
| Banks | 8,000,000 | 1.02 |
| Building Societies | 19,500,000 | 1.52 |
| **Tradition Total** | **27,500,000** | **1.33** |
| **TOTAL** | **52,375,000** | **1.26** |

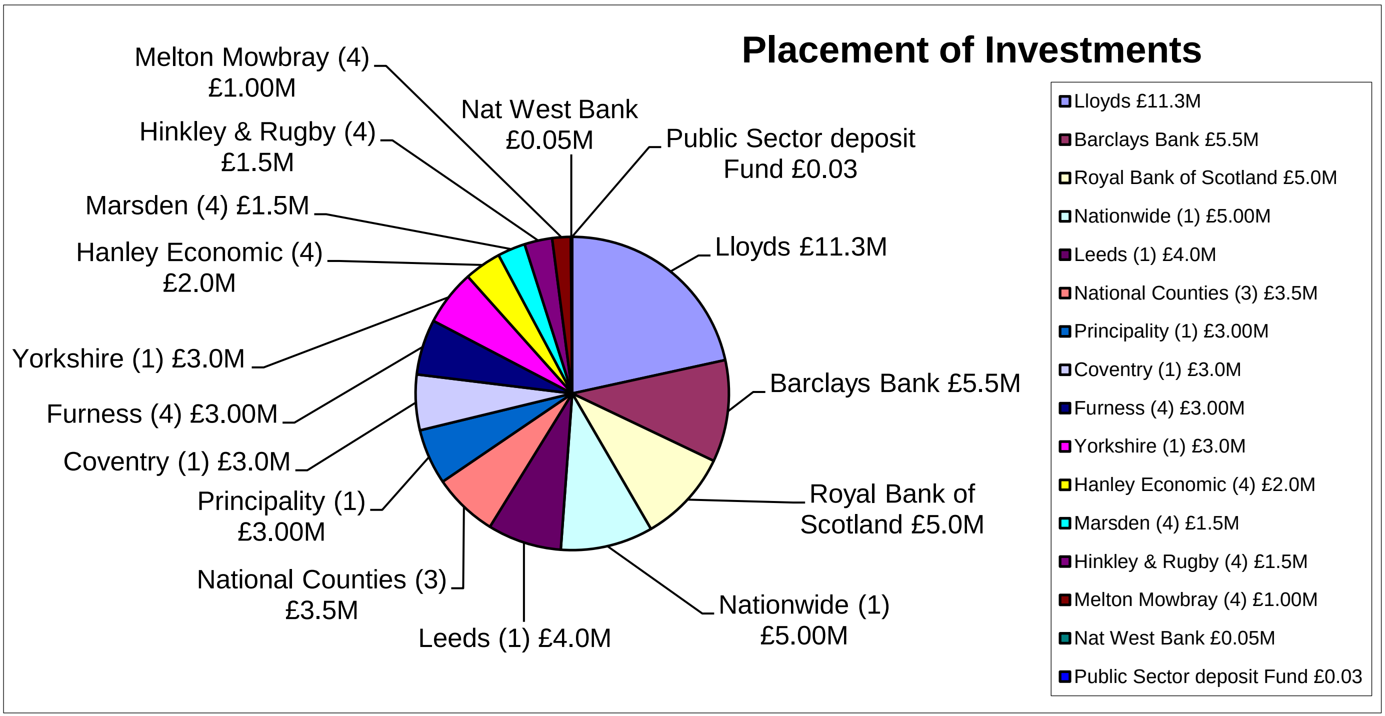
In percentage terms, this equates to:

| | Percentage |
|---|---|
| Money Market Funds | 0.05 |
| Banks | 41.72 |
| Building Societies | 58.23 |

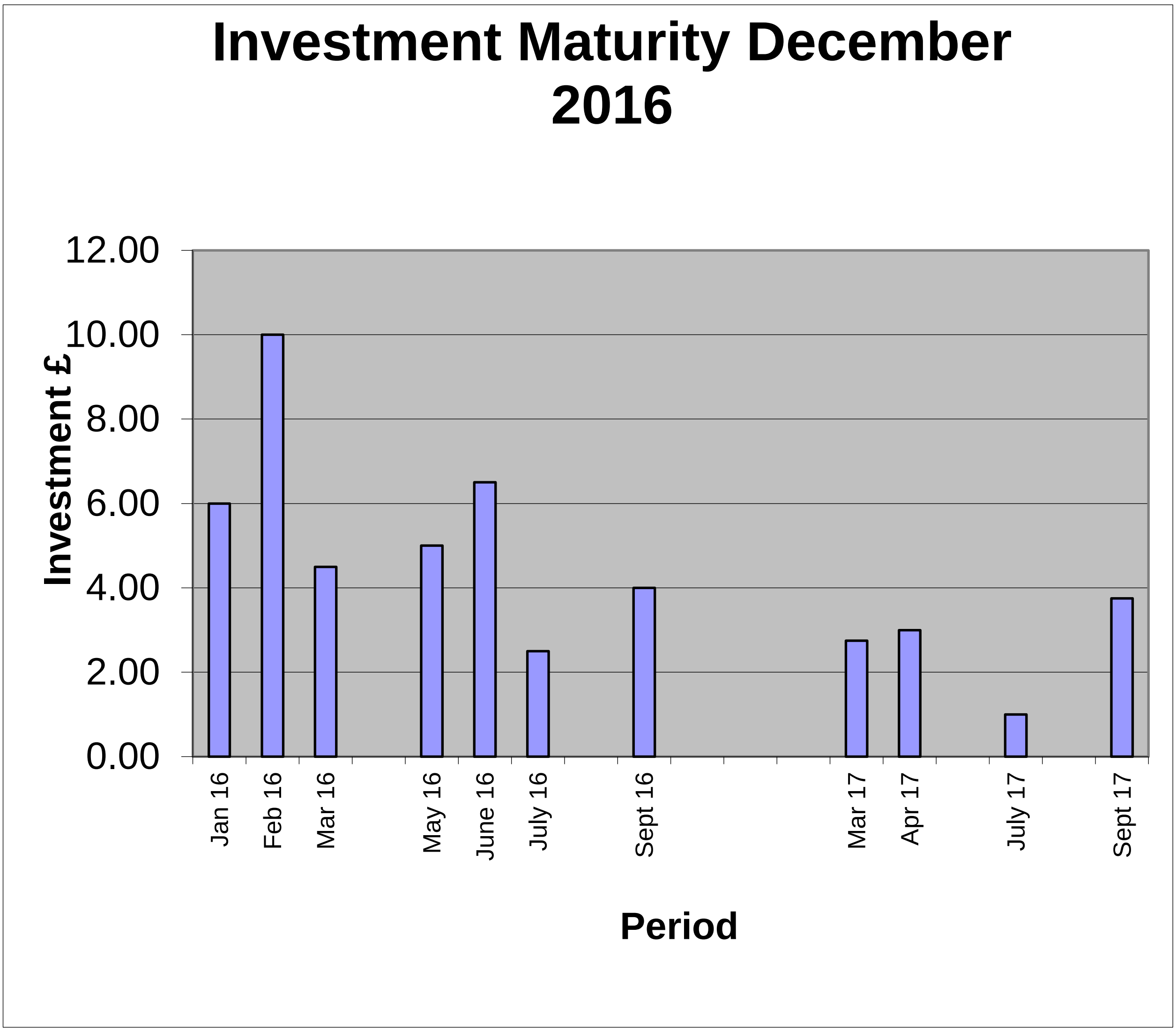
The approved 15/16 strategy is that no more than 75% of investments should be placed with Building Societies.

The pie chart below shows the spread of investment balances as at 31 December 2015. The figures shown are in millions whilst the figure in brackets denotes the value of the building societies total assets:

(1) Building Societies with Assets over £4.5bn
(2) Building Societies with Assets between £2.5bn - £4.5bn
(3) Building Societies with Assets between £1.0bn - £2.5bn
(4) Building Societies with Assets between £0.3bn - £1.0bn



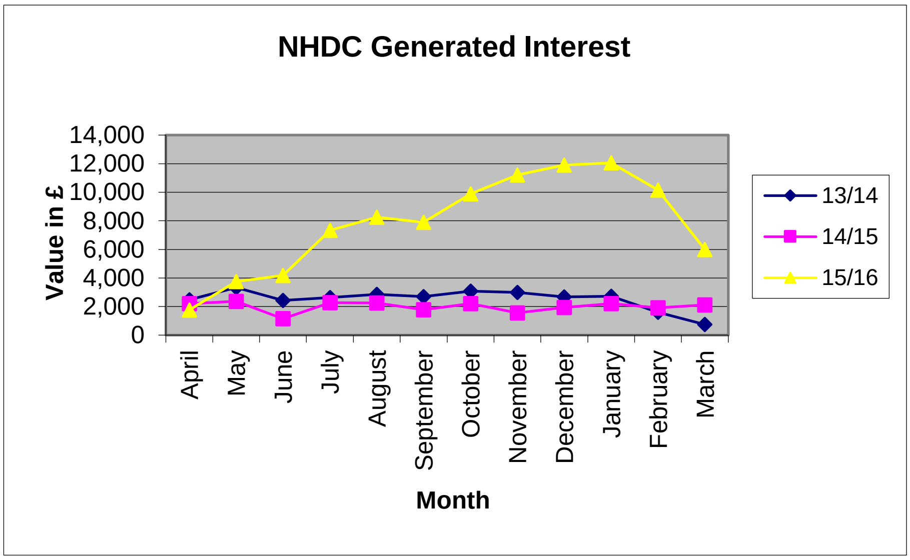

The chart below shows the Council's investment maturity profile. (This does not include the £0.025M held in the Public Sector Deposit Fund Money Market account, £0.050M held in the Nat West Liquidity account or £3.3M held in the Lloyds current account which can be called back on any day). No new deals in the third quarter were placed for longer than a year.




£4.5M of investments placed by Sterling matured in October and were retained in house to fund Capital expenditure. This leaves Sterling with a balance of £1.0M which matures in June 2016 and will be reinvested by Tradition.

The Council's Original budgeted investment return for 2015/16 was £0.364M. The projection at the first quarter increased the budget to £0.413M. The projection at the second quarter increased the budget to £0.431M an increase of £0.018M and the projection at the third quarter is £0.451 an increase of £0.020M.The increase is mainly due to in house investments being placed for longer periods. This was possible as the level of balances increased in June when asset disposal income was received, and in October when the Sterling deals were retained in house.

The graph below shows the level of interest expected to be generated from the cash available in-house over the year which is maintained to ensure adequate cash flow. Cash balances have historically reduced over January to March each year as there were no Council tax receipts in February and March.  Receipts are now spread more evenly as many residents are choosing to pay council tax over 12 months.



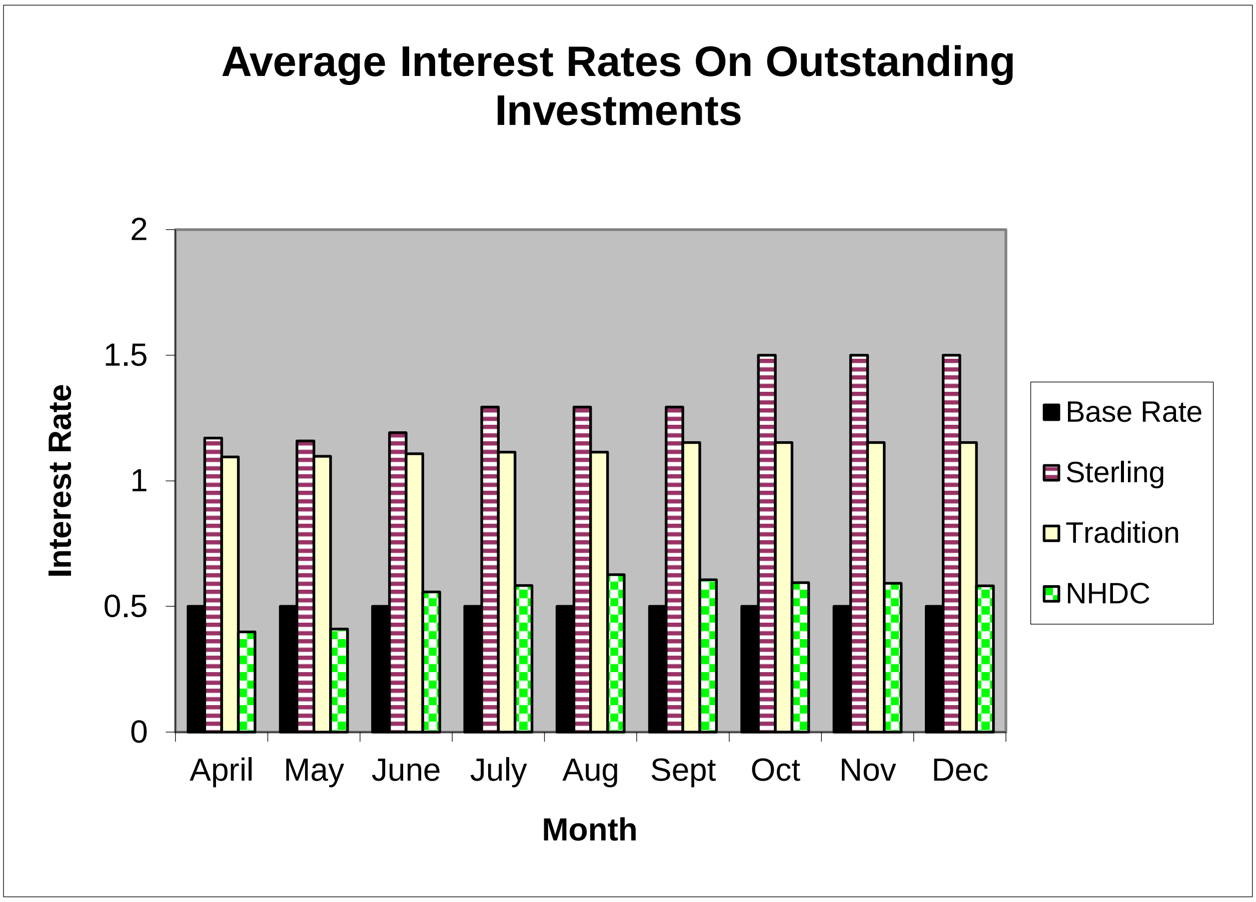

The spike in June / July resulted when income was received from an asset disposal. The level of in house balance increased in October when funds mature that were placed by Sterling. These will remain in house to be invested short term to fund capital expenditure.

The table below shows the average rates achieved on investments made during the third quarter.

| | Ave Interest Rate on Deals made in the 3rd Qrt |
|---|---|
| | % |
| NHDC | 0.51 |
| Tradition | 0 |

There were no Tradition deals maturing in the third quarter.

Base rate started the year at 0.5% and remained constant through out the first nine months. The graph below shows the average rate of interest on outstanding investments at $31^{st}$ December.




As can be seen from the graph, the average rate of interest on outstanding investments for NHDC (cash managed internally) is consistently lower than that of the Cash Managers. This is because the investments made by NHDC during the year are to meet cash flow requirements and are therefore made for short periods. At present, rates in the shorter periods are lower than the longer periods. The Cash Managers have more long term investments and the turnover of investments is small in comparison to NHDC.

The Chief Financial Officer confirms that the approved limits within the Annual Investment Strategy were not breached during the third quarter of 2015/16.

# 4. New Borrowing

No borrowing was undertaken during the quarter.

The Council's capital financing requirement (CFR) for 2015/16 is -£20.2m. The CFR denotes the Council's underlying need to borrow for capital purposes. If the CFR is positive the Council may borrow from the PWLB or the market (external borrowing) or from internal balances on a temporary basis (internal borrowing). The CFR is negative as the Council has more cash investments than borrowing. The balance of external and internal borrowing is generally driven by market conditions.

It is anticipated that long term borrowing will not be undertaken during this financial year.

**PWLB certainty rates quarter ended 31st December 2015**

| | 1 Year | 5 Year | 10 Year | 25 Year | 50 Year |
|---|---|---|---|---|---|
| **Low** | 1.17% | 1.90% | 2.55% | 3.28% | 3.10% |
| **Date** | 23/10/2015 | 15/10/2015 | 05/10/2015 | 02/10/2015 | 03/12/2015 |
| **High** | 1.33% | 2.23% | 2.88% | 3.57% | 3.43% |
| **Date** | 09/11/2015 | 09/11/2015 | 09/11/2015 | 09/11/2015 | 09/11/2015 |
| **Average** | 1.23% | 2.05% | 2.69% | 3.41% | 3.27% |

**Loans Outstanding at 31 December 2015**

| | **Amount** | **Average Interest Rate** | **Cumulative Rate** |
|---|---|---|---|
| | **£** | **%** | **%** |
| Public Works Loans Board | 540,539 | 9.0595 | 8.85 |
| Lender Option Borrower Option | 1,000,000 | 10.125 | 10.10 |
| | 1,540,539 | 9.7511 | 8.5485 |

# 5. Debt Rescheduling

No debt rescheduling was undertaken during the quarter.

# 6. Compliance with Treasury and Prudential Limits

It is a statutory duty for the Council to determine and keep under review the affordable borrowing limits. The Council's approved Treasury and Prudential Indicators (affordability limits) are included in the approved TMSS.

During the financial year to date the Council has operated within the treasury and prudential indicators set out in the Council's Treasury Management Strategy Statement and in compliance with the Council's Treasury Management Practices. The prudential and treasury Indicators are shown in Appendix 1.

# APPENDIX 1: Prudential and Treasury Indicators as at 31st December 2015

| Treasury Indicators | 2015/16 Budget £'000 | Quarter 3 (Oct-Dec) Actual £'000 |
|---|---|---|
| **Authorised limit for external debt** | 8,000 | 1,541 |
| **Operational boundary for external debt** | 6,000 | 1,541 |
| **Gross external debt** | 4,572 | 1,541 |
| **Investments** | (36,250) | (52,375) |
| **Net borrowing** | (31,678) | (50,834) |

| | | |
|---|---|---|
| **Maturity structure of fixed rate borrowing - upper and lower limits** | | |
| **Under 12 months** | 57 | 57 |
| **12 months to 2 years** | 1,035 | 1,035 |
| **2 years to 5 years** | 58 | 58 |
| **5 years to 10 years** | 97 | 97 |
| **10 years and above** | 325 | 325 |

| | | |
|---|---|---|
| **Upper limit of fixed interest rates based on net debt *2** | 70% - 100% | 97.09 |
| **Upper limit of variable interest rates based on net debt *2** | 0% - 30% | 2.91% |

| | | |
|---|---|---|
| **Upper limit for principal sums invested over 364 days** | Max 40% | 20% |

| Prudential Indicators | 2015/16 Budget<br>£'000 | Quarter 3 (Oct-Dec)<br>Actual<br>£'000 |
|---|---|---|
| **Capital expenditure *** | 10,798 | 2,485 |
| **Capital Financing Requirement (CFR) *** | (20,194) | (20,194) |
| **In year borrowing requirement** | 0 | 0 |