SECTOR

Treasury Management Update

Quarter Ended 30 June 2013

FAR COMMITTEE (19.9.13)

Treasury Management Update

Quarter Ended 30th June 2013

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:

- During the quarter ended 30th June: -
  - Indicators suggested that the economy accelerated;
  - Stronger household spending, both on and off the high street;
  - Inflation remained stubbornly above the MPC's 2% target;
  - The MPC remained in a state of limbo ahead of Mark Carney's arrival;
  - 10-year gilt yields rose above 2.5% and the FTSE 100 fell below 6,100;
  - The Federal Reserve discussed tapering the pace of asset purchases under Quantitative Easing 3 (QE3).

- After avoiding recession in the first quarter with a 0.3% quarterly expansion, it looks likely that the economy grew even more strongly in Q2. On the basis of past form, the CIPS/Markit business surveys for April and May point to 0.5% quarterly growth in the second quarter of 2013. Official output data echoed the message from the business surveys. The 3m/3m change in industrial production reached 0.9% in April, the strongest pace since July 2010. Similarly, the service sector expanded by 0.8% on the same basis. And while output in the volatile construction sector in April was 1% lower than a year ago, it was the smallest annual fall since the end of 2011, raising the prospect that the sector supported the recovery in Q2.

- There have been signs of renewed vigour in household spending in the second quarter. May's 2.1% monthly rise in retail sales overturned April's 1.1% fall. This tallied with information from the Bank of England agents, who reported a further pick-up in retail sales values in May. Non-high street spending looks to have been robust too, with new car registrations up by 20% in the year to May.

- The pick-up in economic growth appears to have supported the labour market, with employment rising by 24,000 in the three months to April. Admittedly, this was a lot slower than the 113,000 quarterly gain in employment seen on average over the past twelve months. But the rise in employment was still strong enough to reduce the level of unemployment further. The ILO measure fell by 5,000 in the three months to April while the timelier claimant count measure reported an 8,600 fall in May. Meanwhile, pay growth rebounded strongly in April, though this was mostly driven by high earners delaying bonuses until after April's cut in the additional rate of income tax. Excluding bonuses, earnings rose by just 1.3% y/y, well below the rate of inflation at 2.7% in May.

- Meanwhile, the Bank of England extended its Funding for Lending Scheme (FLS) into 2015 and sharpened the incentives for banks to extend more business funding. To date, the mortgage market still appears to have been the biggest beneficiary from the scheme, with the quoted interest rate on a 2-year fixed rate mortgage at a 90% loan-to-value ratio now 4.6%, around 130 basis-points lower in May than when the FLS was introduced in August 2012.

- Alongside the Government's Help to Buy scheme, which provides equity loans to credit-constrained borrowers, this is helping to boost demand in the housing market. Mortgage approvals by high street banks, as measured by the BBA, rose from 33,000 to 36,100 in May. Excluding a stamp-duty holiday related spike in January 2012, this was the highest level for over three years. The rise in demand has helped to push up house prices, with both the Halifax and Nationwide measures reporting a 0.4% monthly gain in May. On an annual basis, measured prices were up by 3.7% and 1.1% respectively.

- Turning to the fiscal situation, the public borrowing figures continued to be distorted by a number of one-off factors. On an underlying basis, borrowing in Q2 looked to be broadly in line with last year's figures, highlighting the government's difficulty in reducing borrowing while economic growth is relatively lacklustre.
- Meanwhile, the 2013 Spending Review, covering only 2015/16, made no changes to the headline Government spending plan. Total expenditure was still forecast to be broadly flat in real terms in 2015/16 and the £50bn planned capital expenditure announced for that fiscal year was identical to the amount already outlined in March's Budget.
- On the monetary policy front, June's MPC meeting, the last chaired by the outgoing Governor Mervyn King, showed that the Committee remained in limbo ahead of the arrival of his replacement, Mark Carney. The Committee voted 6-3 to keep the level of asset purchases unchanged at £375bn, with the majority judging that the current stimulus and Funding for Lending Scheme would be sufficient to support growth in the context of price stability.
- Having fallen from 2.8% to 2.4% in April, CPI inflation rose to 2.7% in May. May's rise mostly reflected price changes due to the earlier timing of Easter, which depressed inflation in April. Even so, inflation is still likely to have risen further in June due to base effects, with last year's fuel price falls providing an unfavourable annual comparison. That said, underlying price pressures do seem to be easing, with wages and producer prices both growing at subdued rates. Indeed, if anything, the inflation outlook brightened over the second quarter, with the price of oil falling from $108pb to $103pb while sterling appreciated by around 1.5% on a trade-weighted basis.
- Having continued to rally over April and May, financial markets sold off in June following a Federal Reserve statement that suggested the central bank may 'taper' its asset purchases earlier than anticipated. The resulting rise in US Treasury yields was replicated in the UK, with 10 year gilt yields rising to 2.5% from 1.8% at the start of the quarter. Equities were hit too, with the FTSE 100 falling from 6,411 at the start of the quarter to below 6,100 before ending the quarter a bit higher at 6,240.
- In the US, the statement from the Fed took the limelight. The Fed's comments sparked a sharp sell-off in the Treasury market, with 10-year Treasury yields hitting 2.54%. The Fed move was a response to the improving economic outlook in the US. Indeed, payroll figures showed that the US added 175,000 new jobs in May, helping to pull the unemployment rate down to 7.6%, from 8.2% a year ago. In the housing market, house prices rose by 12% in the year to April, which helped to bring more households out of negative equity.
- Meanwhile, tensions in the Eurozone eased over the second quarter, but there remained a number of triggers for a potential flare-up. For example, the Democratic Left party left the Greek governing coalition in June, causing 10 year Greek government bond yields to surge to 11.5% from around 8% a month ago. And while the economic survey data improved consistently over the first half of the year, the composite Eurozone PMI is still pointing to a further contraction in output in Q2. If this materialises, it would be the seventh quarter of Eurozone recession, the longest on record.

2. Interest rate forecast

The Council's treasury advisor, Sector, has provided the following forecast:

	Sep-13	Dec-13	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15
Bank rate	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.75%
5yr PWLB rate	1.80%	1.80%	1.90%	2.00%	2.10%	2.20%	2.40%
10yr PWLB rate	2.90%	2.90%	3.00%	3.10%	3.20%	3.30%	3.50%
25yr PWLB rate	4.10%	4.10%	4.20%	4.20%	4.30%	4.40%	4.60%
50yr PWLB rate	4.20%	4.20%	4.40%	4.40%	4.50%	4.60%	4.70%

Sector undertook a review of its interest rate forecasts following the issue of the latest Bank of England Inflation Report in May 2013. Sector has left unchanged its forecast for the first increase in Bank Rate to be in March 2015. However, forecasts for PWLB rates have been increased as a result of the marked recovery in confidence in equity markets, anticipating stronger economic recovery in America, supported by growth in the Far East. The rise in equity prices was dented towards the end of the quarter by comments from Ben Bernanke, chairman of the Federal Reserve, that QE3 would be tapered off in the not too distant future. This seemed to catch financial markets by surprise and generated a bit of a stampede out of bonds and equities. This sharp selloff in bonds caused ten year bond yields to jump up nearly 90 bps between the low and high for the quarter.

SUMMARY OUTLOOK

UK economy

In Mervyn King's last Inflation Report as Governor of the Bank of England, there was a distinct shift towards optimism in terms of a marginal upgrading of growth forecasts so that the wording changed for the recovery from "remain weak by historical standards" to "modest and sustained recovery over the next three years". In addition, there was a lowering of the inflation forecast to now hit the 2% target within two years. However, this is still a long way away from strong recovery though the chances of there being more quantitative easing (QE) have receded due to business surveys indicating that the economy is on the up. QE has not increased from a total of £375bn since October 2012 and other measures have been implemented in preference to further QE. Thus the Funding for Lending Scheme (FLS), (started in August 2012), was expanded in April to provide further incentive to banks to expand lending to small and medium size enterprises. The FLS certainly seems to be having a positive effect in terms of stimulating house purchases (though levels are still far below the pre crisis level), and a marginal increase in house prices. However, concerns are increasing that QE and FLS are also in danger of causing asset price bubbles. Investors may seek higher returns by switching investment of cash from deposit accounts (yielding very low rates) and from government and corporate bonds - ahead of the eventual end of QE - to equities, whilst FLS may have the side effect of inflating house prices, creating the potential for prices in each of these markets to be pushed at some point in time to potentially unsustainable levels.

Sector's forward view

Economic forecasting remains difficult with so many external influences weighing on the UK. Major volatility in bond yields is likely during 2013/14 as investor fears and confidence ebb and flow between favouring more risky assets i.e., equities, and safer bonds. Key areas of uncertainty include:

- The potential for a significant increase in negative reactions of populaces in Eurozone countries against austerity programmes, especially in countries with very high unemployment rates e.g. Greece and Spain, which face huge challenges in engineering economic growth to correct their budget deficits on a sustainable basis.

- The Italian political situation is frail and unstable.

- Problems in other Eurozone heavily indebted countries could also generate safe haven flows into UK gilts.
- Monetary policy action failing to stimulate growth in western economies, especially the Eurozone and Japan.
- The potential for weak growth or recession in the UK's main trading partners - the EU and US.
- The impact of the UK Government's austerity plan in dampening confidence and growth.
- Geopolitical risks e.g. Syria, Iran, North Korea

However, there is particular potential for upside risks to UK gilt yields and PWLB rates, especially for longer term PWLB rates, as follows: -

- UK inflation being significantly higher than in the wider EU and US, causing an increase in the inflation premium inherent to gilt yields.
- A renewed increase in investor confidence that robust world economic growth is firmly expected, together with a reduction or end of QE operations in the US, causing a flow of funds out of bonds into equities.
- A reversal of Sterling's safe-haven status on an improvement in financial stresses in the Eurozone.
- In the longer term - a reversal of QE; this could initially be implemented by allowing gilts held by the Bank to mature without reinvesting in new purchases, followed later by outright sale of gilts currently held.
- Further downgrading by credit rating agencies of the creditworthiness and credit rating of UK Government debt, consequent upon repeated failure to achieve fiscal correction targets and recovery of economic growth.

The overall balance of risks to economic recovery in the UK is now evenly weighted. Sector believes that the longer run trend is for gilt yields and PWLB rates to rise, due to the high volume of gilt issuance in the UK, and of bond issuance in other major western countries. Near-term, the prospect of further QE has diminished but measures other than QE may be more favoured by Governor Carney if additional support is viewed as being required.

Given the generally weak outlook for economic growth, Sector sees the prospects for any increase in Bank Rate before 2015 as limited. Indeed, the first increase could be even further delayed if the tentative signs of growth failed to be maintained.

3. NHDC Annual Investment Strategy

The Treasury Management Strategy Statement (TMSS) for 2013/14, which includes the Annual Investment Strategy, was approved by the Council on 13th February 2013. It sets out the Council's investment priorities as being:

- Security of capital;
- Liquidity; and
- Yield

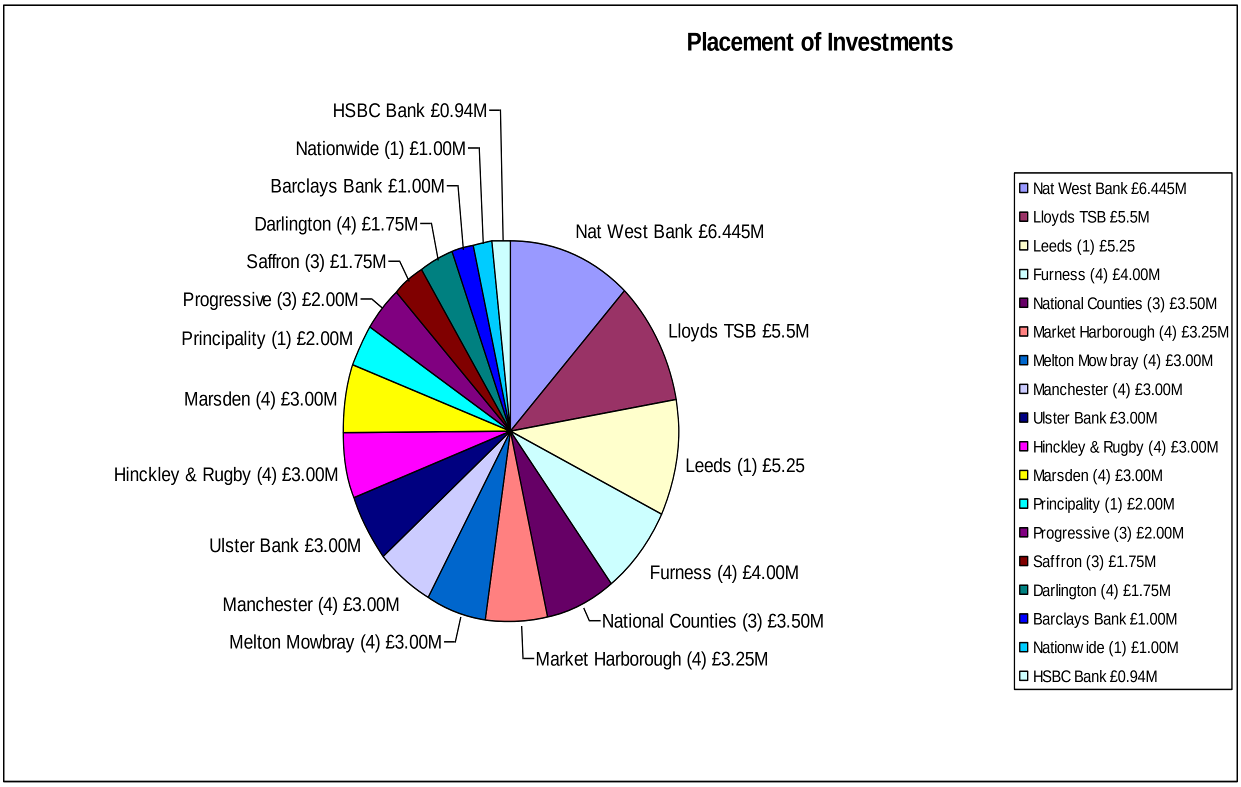
The Council will also aim to achieve the optimum return (yield) on investments commensurate with proper levels of security and liquidity. In the current economic climate it is considered appropriate to keep investments short term to cover cash flow needs but also to seek out value available in higher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

Investments as at 30 June 2013

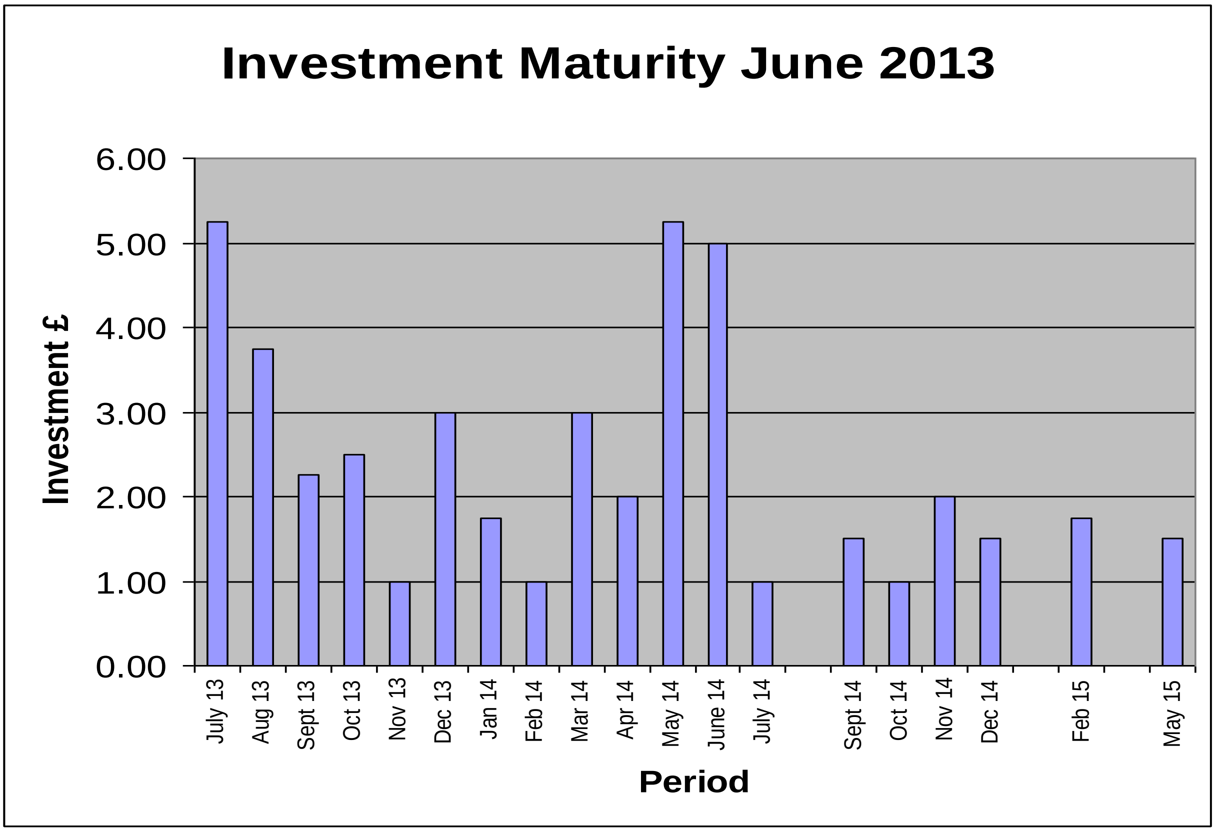
	Amount £	Average Interest Rate %
Managed by NHDC		
Banks	7,385,000	0.49
NHDC Total	**7,385,000**	**0.49**
Managed by Sterling		
Banks	1,500,000	2.2
Building Societies	21,500,000	1.70
Sterling Total	**23,000,000**	**1.71**
Managed by Tradition		
Banks	8,000,000	1.79
Building Societies	15,000,000	1.23
Tradition Total	**23,000,000**	**1.41**
TOTAL	**53,385,000**	**1.56**

The pie chart below shows the spread of investment balances as at 30 June 2013. 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 £6.45M held in the Nat West Liquidity account or £0.94M held in the HSBC call account which can be called back on any day).

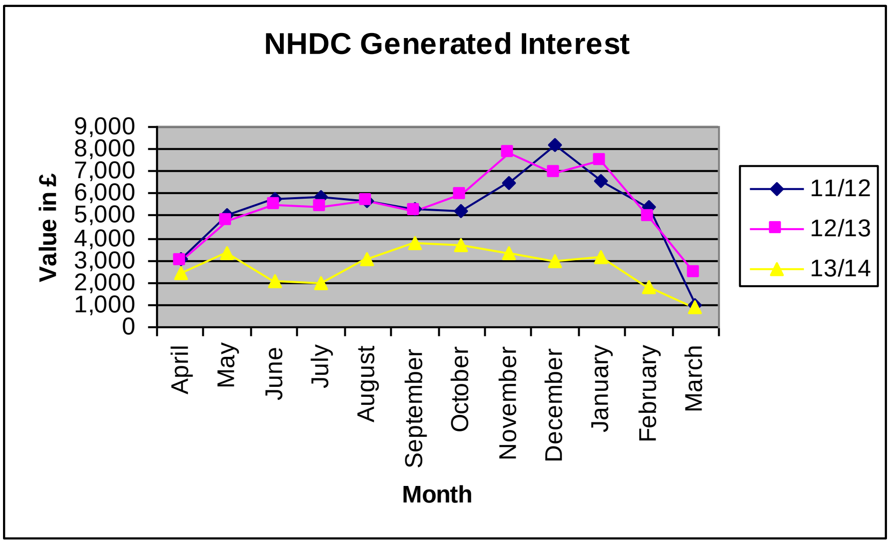


Investment rates available in the market have continued at historically low levels and have fallen further during the quarter as a result of the Funding for Lending Scheme. The average level of funds available for investment purposes during the quarter was £6.89M. These funds were available on a temporary 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. At the 30th June the Council held £46M core cash balances for investment purposes (i.e. funds available for more than one year). This will reduce to £42.25M when the Council funds the purchase of the DCO.

Investment performance for quarter ended 30 June 2013

The Council's budgeted investment return for 2013/14 is £0.679M, and performance for the year to date is £0.023M below budget, giving a new budget of £0.656M.

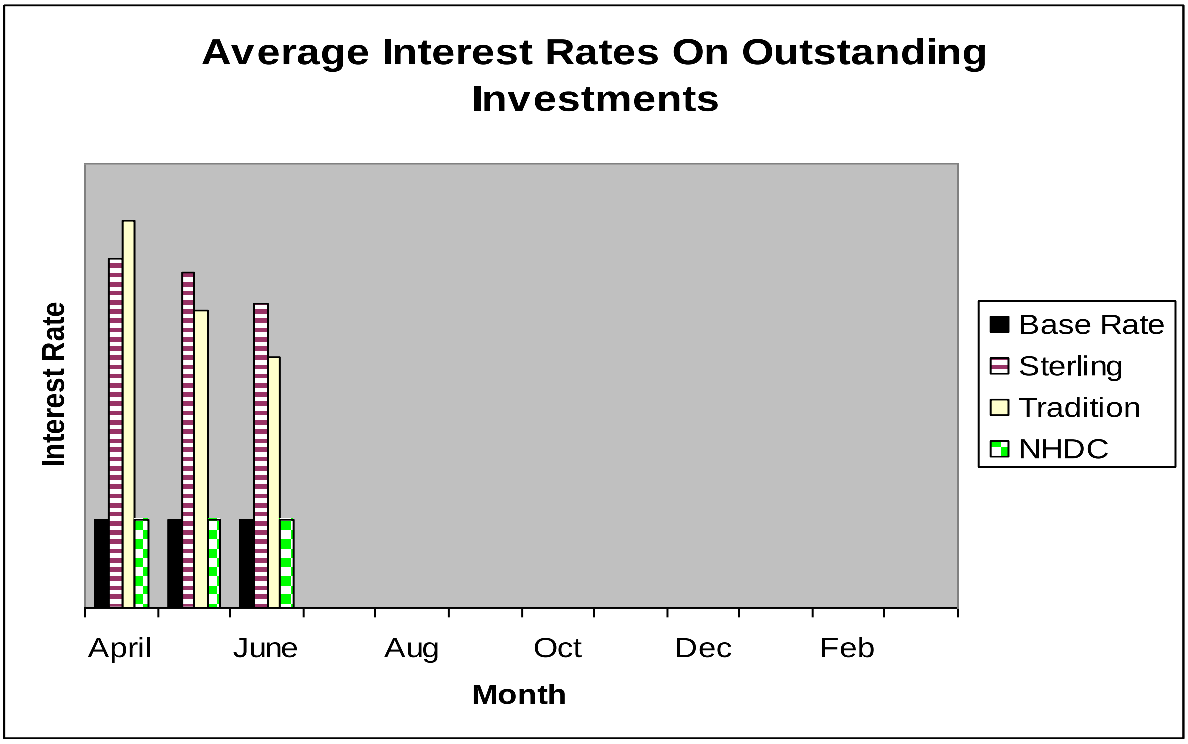
The graph below shows the level of interest expected to be generated from the cash available in-house over the year which is maintained to ensure adequate cashflow. The dip in June and July reflects an increase in Capital expenditure compared to the previous two years. Cash balances reduce over January to March each year as there are no Council tax receipts in February and March.



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

	Ave Interest Rate on Deals made in the 1st Quarter %
NHDC	0.49
Sterling	0.79
Tradition	0.72

Base rate started the year at 0.5% and remained constant through the first three months. The graph below shows the average rate of interest on outstanding Investments.



As can be seen from the graph, the average rate of interest on outstanding investments for NHDC 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.

4. New borrowing:

No borrowing was undertaken during the quarter.

The table below show the current borrowing rates available from the Public Works Loans Board.

PWLB certainty rates, quarter ended 30th June 2013

	1 Year	5 Year	10 Year	25 Year	50 Year
Low	0.91%	1.50%	2.51%	3.71%	3.84%
Date	02/04/2013	08/04/2013	23/04/2013	08/04/2013	08/04/2013
High	1.20%	2.31%	3.39%	4.30%	4.41%
Date	24/06/2013	24/06/2013	24/06/2013	24/06/2013	25/06/2013
Average	1.02%	1.75%	2.81%	3.95%	4.09%

Loans Outstanding as at 30 June 2013

	Amount £	Average Interest Rate %	Cumulative Rate %
Public Works Loans Board	1,264,881	8.49	8.85
Lender Option Borrower Option Loans	1,000,000	10.13	10.10
Temporary Loans 364 Days and under	-	-	-
	2,264,881	9.21	8.54

The Council has reduced the overall debt liability by repaying £2M of external debt in the first quarter. This was the temporary loan taken in March to cover a short fall in cashflow for 20 days. The total of loan repayments during the year will be £2,605,400. This is made up of the temporary loan of £2M and PWLB loans reaching maturity.

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 below.

Prudential Indicator	2013/14 Budget £'000	As at 30 June 2013 £'000
Capital expenditure	10,420	208
In year borrowing requirement	0	0
Authorised limit for external debt	8,000	2,265
Operational boundary for external debt	6,000	2,265
Gross borrowing	6,265	2,265
Investments	(44,235)Ave	(53,385)
Net borrowing	(37,970)	(51,120)*
Capital Financing Requirement (CFR)	(32,983)	(32,983)
Limit of fixed interest rates based on investment	70%-100%	87%
Limit of variable interest rates based on investments	0%-30%	13%
Principal sums invested > 364 days	20,000 Max	11,750
Maturity structure of borrowing limits		
Under 12 months	605	605
12 months to 2 years	87	87
2 years to 5 years	1,116	1,116
5 years to 10 years	88	88
10 years and above	367	367

* The Net borrowing (outstanding borrowing less cash investments) is a credit of £51M as at the end of June 2013 because the Council has more cash investments than borrowing. As a result the Capital Financing Requirement is negative.