

Treasury Management Update

Quarter Ended 30 September 2019

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Treasury Management Update

Quarter Ended 30 September 2019

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 (annual, mid-year or quarterly reports). This report, therefore, ensures this Council is implementing best practice in accordance with the Code.

1. Economic Background

UK. After only tepid annual **economic growth** of 1.4% in 2018, growth in quarter 1 was unexpectedly strong at 0.5%. However, this was boosted by stock building ahead of the original March Brexit deadline so quarter 2 was expected to be slightly negative and duly came in at -0.2% q/q, +1.3% y/y.

After the Monetary Policy Committee raised **Bank Rate** from 0.5% to 0.75% in August 2018, it is little surprise that they have abstained from any further increases since then. We are unlikely to see any further action from the MPC until the uncertainties over Brexit clear. If there were a no deal exit, it is likely that Bank Rate would be cut in order to support growth. Nevertheless, the MPC does have concerns over the trend in wage inflation which peaked at a new post financial crisis high of 3.9% in June before edging back to 3.8% in July, (excluding bonuses). Growth in employment fell to only 31,000 in the three months to July, well below the 2018 average, while the unemployment rate remained at 3.8 percent, its lowest rate since 1975.

As for **CPI inflation** itself, this fell to 1.7% in August and is likely to remain close to 2% over the next two years. If there was a no deal Brexit though, it could rise towards 4%, primarily as a result of imported inflation on the back of a weakening pound.

The rise in wage inflation and fall in CPI inflation is good news for **consumers** as their spending power is improving in this scenario as the difference between the two figures is now around 2.1%, i.e. a real terms increase. Given the UK economy is very much services sector driven, an increase in household spending power is likely to feed through into providing some support to the overall rate of economic growth in the coming months.

USA. President Trump's massive easing of fiscal policy in 2018 fuelled a (temporary) boost in consumption in 2018 which generated an upturn in the rate of growth to 2.9% for 2018, just below his target of 3%. Growth in quarter 1 of 2019 was a strong 3.1% but growth fell back to 2.0% in quarter 2. The strong growth in employment numbers during 2018 has reversed into a falling trend during 2019, indicating that the economy is cooling, while inflationary pressures are also weakening. After the Fed increased rates by 0.25% in December 2018 to between 2.25% and 2.50%, it has taken decisive action to reverse monetary policy by cutting rates by 0.25% in each of July and September in order to counter the downturn in the outlook for US and world growth. There are expectations that it could cut again in December.

EUROZONE. The annual rate of growth for 2018 was 1.8% but is expected to fall to possibly around half that rate in 2019. The European Central Bank (ECB) ended its programme of quantitative easing purchases of debt in December 2018, which meant that the central banks in the US, UK and EU had all ended the phase of post financial crisis expansion of liquidity supporting world financial markets by purchases of debt. However, the downturn in EZ growth in the second half of 2018 and into 2019, together with inflation falling well under the upper limit of its target range of 0 to 2%, (but it aims to keep it near to 2%), has prompted the ECB to take new measures to stimulate growth. At its March meeting it said that it expected to leave interest rates at their present levels “at least through the end of 2019”, but that was of little help to boosting growth in the near term. Consequently, it announced a third round of TLTROs; this provides banks with cheap borrowing every three months from September 2019 until March 2021 which means that, although they will have only a two-year maturity, the Bank is making funds available until 2023, two years later than under its previous policy. As with the last round, the new TLTROs will include an incentive to encourage bank lending, and they will be capped at 30% of a bank’s eligible loans. However, since then, the downturn in EZ and world growth has gathered momentum so at its meeting on 12 September, it cut its deposit rate further into negative territory, from -0.4% to -0.5% and announced a resumption of quantitative easing purchases of debt. It also increased the maturity of the third round of TLTROs from two to three years. However, it is doubtful whether this loosening of monetary policy will have much impact on growth and unsurprisingly, the ECB stated that governments will need to help stimulate growth by fiscal policy.

CHINA. Economic growth has been weakening over successive years, despite repeated rounds of central bank stimulus; medium term risks are increasing. The trade war with the US does not currently appear to be having a significant impact on growth. Major progress still needs to be made to eliminate excess industrial capacity and to switch investment from property construction and infrastructure to consumer goods production. It also needs to address the level of non-performing loans in the banking and credit systems.

JAPAN. has been struggling to stimulate consistent significant GDP growth and to get inflation up to its target of 2%, despite huge monetary and fiscal stimulus. It is also making little progress on fundamental reform of the economy.

WORLD GROWTH. The trade war between the US and China on tariffs is a major concern to financial markets and is depressing worldwide growth, as any downturn in China will spill over into impacting countries supplying raw materials to China. Concerns are focused on the synchronised general weakening of growth in the major economies of the world compounded by fears that there could even be a recession looming up in the US, though this is probably overblown. These concerns have resulted in government bond yields in the developed world falling significantly during 2019. If there were a major worldwide downturn in growth, central banks in most of the major economies will have limited ammunition available, in terms of monetary policy measures, when rates are already very low in most countries, (apart from the US), and there are concerns about how much distortion of financial markets has already occurred with the current levels of quantitative easing purchases of debt by central banks. The latest PMI survey statistics of economic health for the US, UK, EU and China have all been sub 50 which gives a forward indication of a downturn in growth; this confirms investor sentiment that the outlook for growth during the rest of this financial year is weak.

2. Interest Rate Forecast

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

Link Asset Services Interest Rate View											
	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22
Bank Rate View	0.75	0.75	0.75	0.75	0.75	1.00	1.00	1.00	1.00	1.00	1.25
3 Month LIBID	0.70	0.70	0.70	0.70	0.80	0.90	1.00	1.00	1.00	1.10	1.20
6 Month LIBID	0.80	0.80	0.80	0.80	0.90	1.00	1.10	1.10	1.20	1.30	1.40
12 Month LIBID	1.00	1.00	1.00	1.00	1.10	1.20	1.30	1.30	1.40	1.50	1.60
5yr PWLB Rate	1.20	1.30	1.50	1.60	1.70	1.70	1.80	1.90	2.00	2.00	2.10
10yr PWLB Rate	1.50	1.60	1.80	1.90	2.00	2.00	2.10	2.20	2.30	2.30	2.40
25yr PWLB Rate	2.10	2.30	2.40	2.50	2.60	2.70	2.70	2.80	2.90	3.00	3.00
50yr PWLB Rate	2.00	2.20	2.30	2.40	2.50	2.60	2.60	2.70	2.80	2.90	2.90

After the August 2018 increase in Bank Rate to 0.75%, the first above 0.5% since the financial crash, the MPC has put any further action on hold, probably until such time as the fog of Brexit might clear and there is some degree of certainty of what the UK will be heading into. ***The above forecast, and other comments in this report, are based on a central assumption that there will be some form of muddle through agreement on a reasonable form of Brexit.*** Bank Rate forecasts will have to change if this assumption does not materialise e.g. a no deal Brexit on 31 October could well prompt the MPC to do an immediate cut of 0.5% in Bank Rate back to 0.25%. All other forecasts for investment and borrowing rates would also have to change.

The balance of risks to the UK

- The overall balance of risks to economic growth in the UK is probably to the downside due to the weight of all the uncertainties over Brexit, as well as a softening global economic picture.
- The balance of risks to increases in Bank Rate and shorter term PWLB rates are broadly similarly to the downside.

BOND YIELDS / PWLB RATES. There has been much speculation recently that we are currently in a bond market bubble. However, given the context that there are heightened expectations that the US could be heading for a recession, and a general background of a downturn in world economic growth, together with inflation generally at low levels in most countries and expected to remain subdued, conditions are ripe for low bond yields. While inflation targeting by the major central banks has been successful over the last thirty years in lowering inflation expectations, the real equilibrium rate for central rates has fallen considerably due to the high level of borrowing by consumers: this means that central banks do not need to raise rates as much now to have a major impact on consumer spending, inflation, etc. This has pulled down the overall level of interest rates and bond yields in financial markets over the last thirty years. We have therefore seen over the last year, many bond yields up to ten years in the Eurozone actually turn negative. In addition, there has, at times, been an inversion of bond yields in the US whereby ten year yields have fallen below shorter term yields. In the past, this has been a precursor of a recession. The other side of this coin is that bond prices are elevated as investors would be expected to be moving out of riskier assets i.e. shares, in anticipation of a downturn in corporate earnings and so selling out of equities. However, stock markets are also currently at high levels as some investors have focused on chasing returns in the context of dismal ultra-low interest rates on cash deposits.

What we have seen during the last half year is a near halving of longer term PWLB rates to completely unprecedented historic low levels. There is though, an expectation that financial markets have gone too far in their fears about the degree of the downturn in US and world growth. If, as expected, the US only suffers a mild downturn in growth, bond markets in the US are likely to sell off and that would be expected to put upward pressure on bond yields, not only in the US, but due to a correlation between US treasuries and UK gilts, which at various times has been strong but at other times weaker, in the UK. However, forecasting the timing of this and how strong the correlation is likely to be, is very difficult to forecast with any degree of confidence.

One potential danger that may be lurking in investor minds is that Japan has become mired in a twenty year bog of failing to get economic growth and inflation up off the floor, despite a combination of massive monetary and fiscal stimulus by both the central bank and government. Investors could be fretting that this condition might become contagious.

Another danger is that unconventional monetary policy post 2008, (ultra-low interest rates plus quantitative easing), may end up doing more harm than good through prolonged use. Low interest rates have encouraged a debt fuelled boom which now makes it harder for economies to raise interest rates. Negative interest rates could damage the profitability of commercial banks and so impair their ability to lend and / or push them into riskier lending. Banks could also end up holding large amounts of their government's bonds and so create a potential doom loop, (see appendix 4 Eurozone downside risk). In addition, the financial viability of pension funds could be damaged by low yields on holdings of bonds.

3. Annual Investment Strategy

The Treasury Management Strategy Statement (TMSS) for 2019/20, which includes the Annual Investment Strategy, was approved by the Council on 7 February. It sets out the Council's investment priorities as being:

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

The Council will 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 higher rates in periods up to 24 months.

Officers can confirm that the approved investment limits within the Annual Investment Strategy were not breached during the quarter ended 30 September 2019. However, the Council's current account did exceed the £5M maximum limit on 17 July by £74K for one day only. On 17 July the Council had the maximum invested with Building Societies (£18M) and its Money Market fund (£3M) and was not yet set up to deal with foreign banks. £6.7M was needed on 19 July to fund expenditure so it was not possible to lend longer term to a bank that the Council had capacity to invest with. With the Council now being able to invest with a foreign bank, this should not happen again.

The average level of funds available for investment purposes during the quarter was £37.9M. The Council holds £20.5M core cash balances for investment purposes (i.e. funds available for more than one year). The investment portfolio yield for the first six months of the year was 1.02%. This is the weighted average rate of interest earned on investments held by the Council between 1 April and 30 September. The 1.13% average interest rate shown in the table below is the weighted average rate of interest on outstanding investments on 30 September.

Investments at 30 September 2019

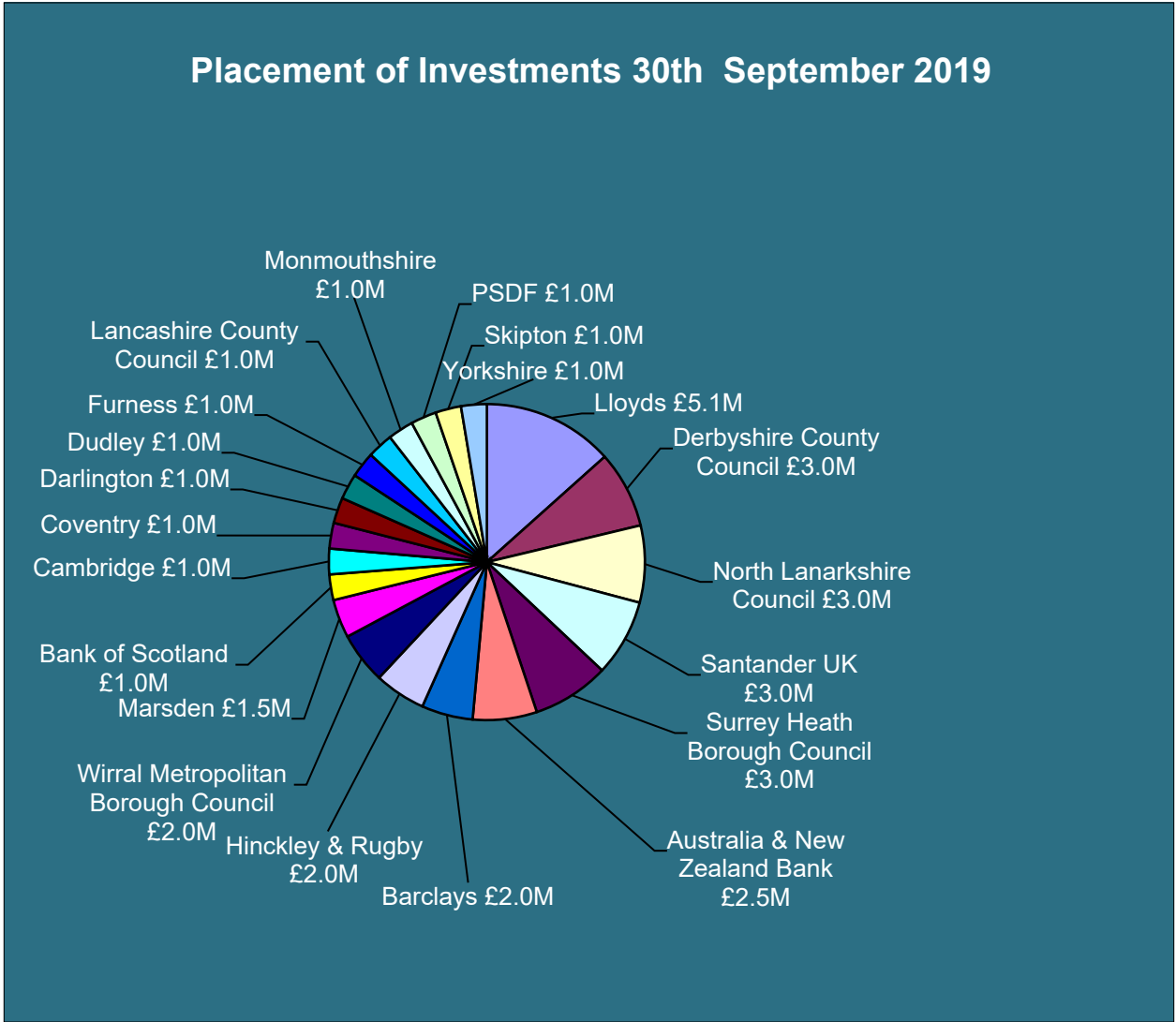
	Amount	Average
	£	Interest Rate %
Managed By NHDC		
Banks	13,600,000	1.00
Building Societies	3,000,000	0.96
Local Authorities	12,000,000	0.86
Money Market Fund	1,000,000	0.82
NHDC To Total	29,600,000	1.00
Managed by Tradition		
Building Societies	8,500,000	1.42
Tradition Total	8,500,000	1.42
TOTAL	38,100,000	1.13

In percentage terms, this equates to:

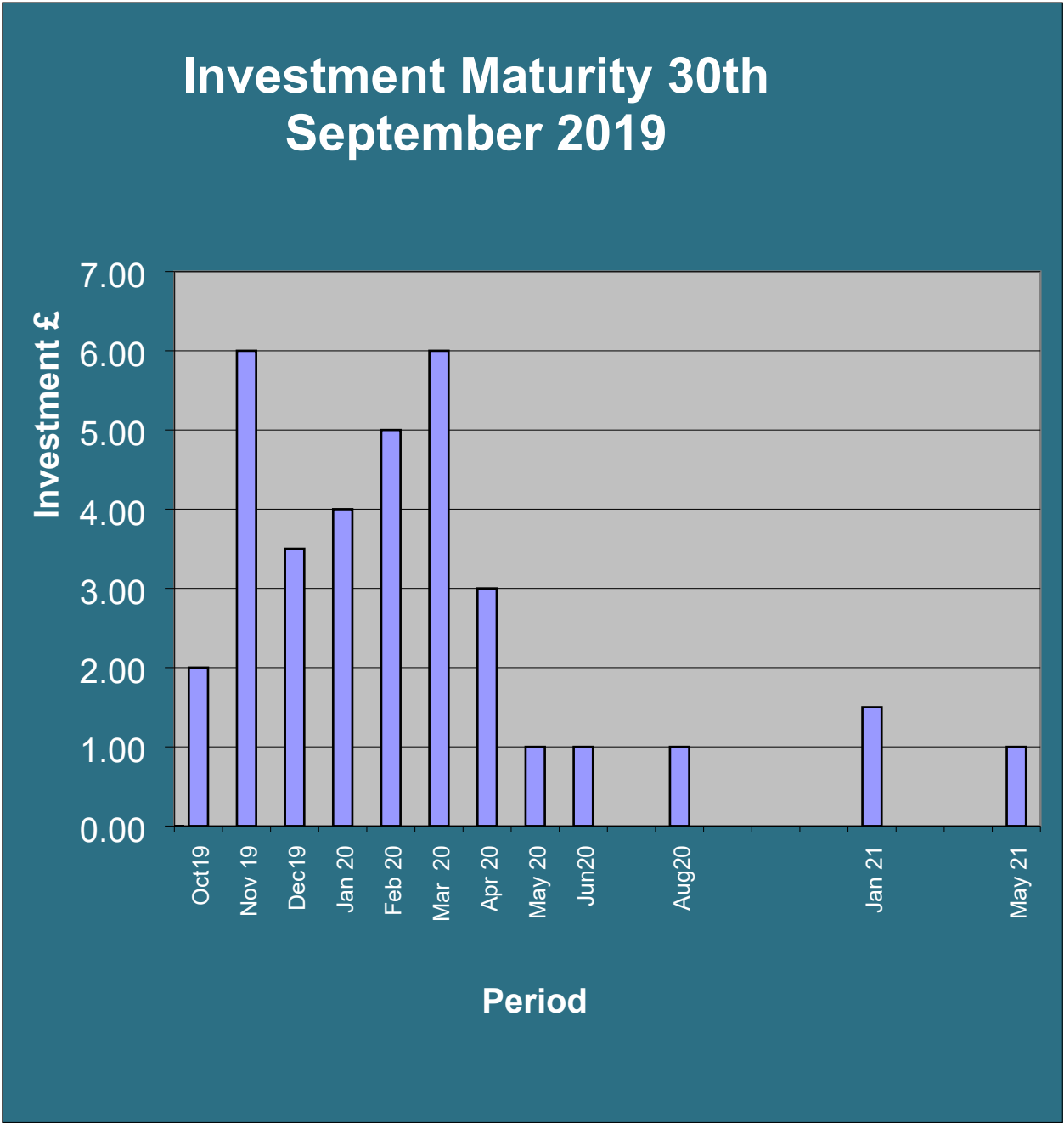
	Percentage
Money Market Funds	3
Local Authorities	31
Banks	36
Building Societies	30

The approved 19/20 strategy is that no more than 60% of investments should be placed with Building Societies with a maximum value of £18M. The value at 30 September was £11.5M

The pie chart below shows the spread of investment balances as at 30 September 2019. This is a snapshot in time that demonstrates the diversification of investments.

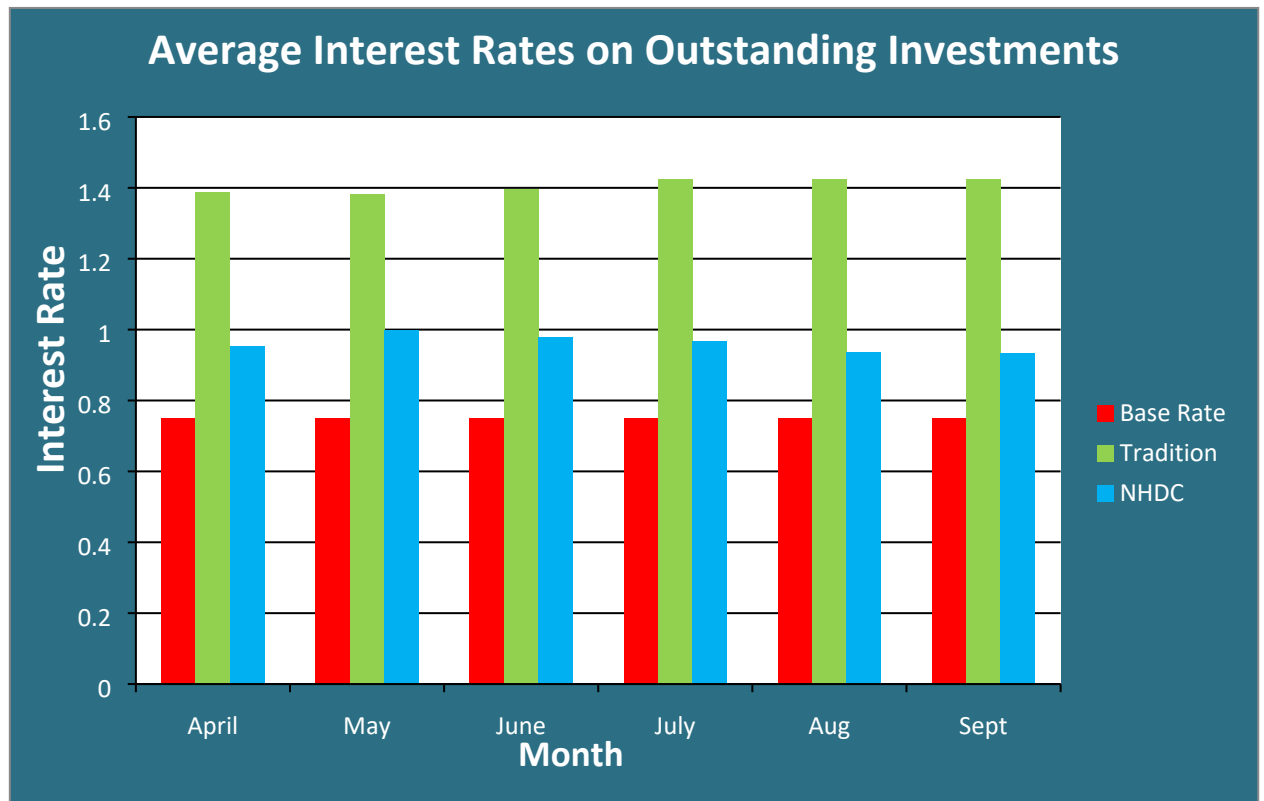


The chart below shows the Council's investment maturity profile. (This does not include the £1.0M held in the Public Sector Deposit Fund Money Market account or £2.1M held in the Lloyds current account which can be called back on any day).



The Council's Original budgeted investment return for 2019/20 was £0.300M. The projection reported in the 1st quarter report was £0.372M and remains unchanged.

The graph below shows the average rate of interest on outstanding investments at 30 September.



The higher rates achieved through Tradition reflect that these are longer-term investments. In general, the Council can currently achieve similar rates for the same length of investment. The Council only undertakes new investments through Tradition where the rate achieved (after fees) are greater than what the Council could achieve for a similar investment.

Treasury indicator below shows the capital value and expected income from Capital Investment assets, alongside any borrowing that is attached to those assets and the expected cost of that borrowing.

Year	Capital value of investment assets £m	Original Expected annual income from investment assets £m	Revised Expected annual income from investment assets £m	Loans linked to investment assets £m	Expected annual borrowing costs for loans linked to investment assets £m
2019/20	18.899	1.089	1.156	0	0
2020/21	18.899	1.139	1.209	0	0
2021/22	18.899	1.189	1.259	0	0
2022/23	18.899	1.189	1.259	0	0
2023/24	18.899	1.189	1.259	0	0

4. New Borrowing

No long term borrowing was undertaken during the quarter / half year ended 30 September 2019.

However, £2.0M was borrowed for cash flow on the 20 June until the 1 July at a rate of 0.7%

Based on 2nd quarter estimate for capital expenditure, the Council's capital financing requirement (CFR) for 2019/20 is expected to be -£2.43M (-£5.91M at the end of 18/19). 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 (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.

Loans Outstanding at 30 September 2019:

	Amount	Average Interest Rate
	£	%
Public Works Loans Board	£431k	9.70

Forecast outstanding debt:

Year	Forecast Borrowing £m	Forecast other long-term liabilities £m *	Forecast External £m	Total Debt	Operational Boundary £m	Authorised Limit £m
31 st March 2019 (Actual)	0.440	2.724	3.164		4.1	10
31 st March 2020 (Forecast)	0.423	2.270	2.693		3.6	9
31 st March 2021 (Forecast)	0.405	1.816	2.221		3.1	9
31 st March 2022 (Forecast)	0.387	1.362	1.749		2.6	8
31 st March 2023 (Forecast)	0.367	0.908	1.275		2.0	7
31 st March 2024 (Forecast)	0.347	0.454	0.801		1.5	7

* Comprises the finance lease relating to Letchworth Multi-storey car park and the forecast impact of the finance lease for waste vehicles.

The external borrowing forecast can be used to give an indication of the borrowing that may be required, which is combined with outstanding existing borrowing. The Council will also borrow for short-term cash-flow needs if required. The actual borrowing that is taken out will depend on the latest forecasts and the offers that are available at the time that it is required. There will also be a consideration of when any other borrowing becomes due, with the aim of achieving a spread of these dates. This is to try and avoid refinancing risk. The Council is required to set indicators for the maturity structure of its borrowing. Given the low level of borrowing that the Council currently has and is forecast to have, it is considered appropriate to maintain full flexibility as to the exact duration of any borrowing undertaken.

To manage refinancing risk, the Council sets limits on the maturity structure of its borrowing. However these indicators are set relatively high to provide sufficient flexibility to respond to opportunities to repay or take out new debt (if it was required), while remaining within the parameters set by the indicators. Due to the low level of existing borrowing, the under 12 months limits have a broad range to allow for cash-flow borrowing (if it was required).

Maturity Period	Lower %	Upper %
Under 12 months	0	100
12 months to 2 years	0	50
2 years to 5 years	0	60
5 years to 10 years	0	70
10 years to 20 years	0	80
20 years and above	0	100

The Council does not have a need to borrow, so therefore does not currently need to apply a Minimum Revenue Provision (MRP).

There is a prudential indicator that compares the net cost of financing (i.e. borrowing costs less income generated from investments) with the net revenue budget of the Council. However the indicator below considers the cost of borrowing as a % of the net revenue budget of the Council.

Year	Estimated cost of borrowing £m	Forecast net revenue budget	Estimated cost of borrowing as a % of net revenue budget
2019/20	0.042	15.450	0.27
2020/21	0.041	14.808	0.28
2021/22	0.040	14.911	0.27
2022/23	0.039	15.021	0.26
2023/24	0.037	15.021	0.25

The Council is required to set a prudential indicator that estimates financing costs (cost of borrowing less income from investments) as a percentage of its net revenue budget.

Year	Estimated cost of borrowing £m	Less: Forecast of interest earned £m	Net Financing Costs £m	Forecast net revenue budget	Estimated cost of borrowing as a % of net revenue budget
2019/20	0.042	0.372	-0.330	15.45	-2.136
2020/21	0.041	0.417	-0.376	14.808	-2.539
2021/22	0.040	0.516	-0.476	14.911	-3.192
2022/23	0.039	0.526	-0.487	15.021	-3.242
2023/24	0.037	0.584	-0.547	15.021	-3.642

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.

7. Other

A tender was undertaken in September to award a 3 year contract to provide the Council with Treasury advice. The contract was awarded to Link, our current adviser.

APPENDIX 1: Prudential and Treasury Indicators for 2019-20 as at 30 September 2019

Treasury Indicators	2019/20 Budget £'000	30.9.19 Actual £'000
Authorised limit for external debt	9,000	431
Operational boundary for external debt	3,600	431
Gross external debt	2,548	431

Maturity structure of fixed rate borrowing - upper and lower limits		
Under 12 months	17	17
12 months to 2 years	18	18
2 years to 5 years	58	58
5 years to 10 years	82	82
10 years to 20 years	15	15
20 years to 30 years	20	20

Prudential Indicators	2019/20 Budget £'000	30.09.19 Actual £'000
Capital expenditure The budget is the expected capital expenditure during the year. The actual total is spend to date. Only at the end of the year will actuals get close to the budget.	7,822	597
Capital Financing Requirement (CFR) The total historic outstanding capital expenditure which has not yet been paid for from either revenue or capital resources. It is essentially a measure of the Council's underlying borrowing need. The year end position reflects the budgeted capital spend during the year. A negative total means that there is no borrowing requirement.	-0,063	-5,903
In year borrowing requirement	0	0
Ratio of financing costs to net revenue stream Net expenditure/ (income) from borrowing and investments, as a % of the Council's net revenue. This is negative as the Council is currently receiving a net income from investments.	-1,969	-2,06

