East Lothian Council

REPORT TO: Audit and Governance Committee

MEETING DATE: 18 November 2014

BY: Depute Chief Executive (Resources & People Services)

SUBJECT: Treasury Management Strategy Statement & Annual Investment Strategy – Mid-year Review 2014/15

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1 PURPOSE

1.1 To update the Committee on Treasury Management activity during the first half of 2014/15.

2 RECOMMENDATIONS

2.1 The Committee are asked to note the content of the report

3 BACKGROUND

3.1 The Council operates a balanced budget, which broadly means cash raised during the year will meet its cash expenditure. Part of the treasury management operations ensure this cash flow is adequately planned, with surplus monies being invested in a way which takes account of risk and return.

3.2 The second main function of the treasury management service is the funding of the Council's capital plans. These capital plans provide a guide to the borrowing need of the Council, essentially the longer term cash flow planning to ensure the Council can meet its capital spending operations. This management of longer term cash may involve arranging long or short term loans, or using longer term cash flow surpluses, and on occasion any debt previously drawn may be restructured to meet Council risk or cost objectives.

3.3 Specialist Treasury Management advice is provided to the Council on a contractual basis by Capita Asset Services. This service includes daily market updates and regular review meetings. Operational decisions are made by the Service Manager - Corporate Finance in accordance with the approved Treasury Management Strategy, in consultation with the Head of Council Resources and after considering the advice provided by Capita Asset Services.

3.4 This mid-year report has been prepared in compliance with CIPFA's Code of Practice on Treasury Management, and covers the following:

- An economic update for the 2014/15 financial year to 30 September 2014;
- A review of the Treasury Management Strategy Statement and Annual Investment Strategy approved by the Council on 25th February 2014;
- A review of the Council's borrowing strategy for 2014/15;
- A review of the Council's investment activity for 2014/15.

Economic update from Capita Asset Services

3.5 After strong UK GDP quarterly growth of 0.7%, 0.8% and 0.7% in quarters 2, 3 and 4 respectively in 2013, (2013 annual rate 2.7%), and 0.7% in Q1, 0.9% in Q2 and a first estimate of 0.7% in Q3 2014 (annual rate 3.1% in Q3), it appears very likely that strong growth will continue through 2014 and into 2015 as forward surveys for the services and construction sectors, are very encouraging and business investment is also strongly recovering. This overall strong growth has resulted in unemployment falling much faster through the initial threshold of 7%, set by the Monetary Policy Committee (MPC) last August, before it said it would consider any increases in Bank Rate. The MPC has, therefore, subsequently broadened its forward guidance by adopting five qualitative principles and looking at a much wider range of about eighteen indicators in order to form a view on how much slack there is in the economy and how quickly slack is being used up. Most economic forecasters are expecting growth to peak in 2014 and then to ease off a little, though still remaining strong, in 2015 and 2016. Unemployment is therefore expected to keep on its downward trend and this is likely to eventually feed through into a return to significant increases in pay rates at some point during the next three years. However, just how much those future increases in pay rates will counteract the depressive effect of increases in Bank Rate on consumer confidence, the rate of growth in consumer expenditure and the buoyancy of the housing market, are areas that will need to be kept under regular review.

3.6 Also encouraging has been the sharp fall in inflation (CPI), reaching 1.2% in September, the lowest rate since 2009. Forward indications are that inflation is likely to fall further in 2014 to possibly 1%. Overall, markets are expecting that the MPC will be cautious in raising Bank Rate as it will want to protect heavily indebted consumers from too early an increase in Bank Rate at a time when inflationary pressures are also weak. A first increase in Bank Rate is therefore expected in Q2 2015 and they expect increases after that to be at a slow pace to lower levels than prevailed before 2008 as increases in Bank Rate will have a much bigger effect on heavily indebted consumers than they did before 2008.

3.7 The return to strong growth has also helped lower forecasts for the increase in Government debt by £73bn over the next five years, as announced in the 2013 Autumn Statement, and by an additional £24bn, as announced in the March 2014 Budget - which also forecast a return to a significant budget surplus, (of £5bn), in 2018-19. However, monthly public sector deficit figures have disappointed so far in 2014/15.

U.S.

3.8 The U.S. faces similar debt problems to those of the UK, but thanks to reasonable growth, cuts in government expenditure and tax rises, the annual government deficit has been halved from its peak without appearing to do too much damage to growth, although the weak labour force participation rate remains a matter of key concern for the Federal Reserve when considering the amount of slack in the economy and monetary policy decisions.

Eurozone

3.9 Concern in financial markets for the Eurozone subsided considerably during 2013. However, sovereign debt difficulties have not gone away and major issues could return in respect of any countries that do not dynamically address fundamental issues of low growth, international uncompetitiveness and the need for overdue reforms of the economy, (as Ireland has done). It is, therefore, possible over the next few years that levels of government debt to GDP ratios could continue to rise for some countries. This could mean that sovereign debt concerns have not disappeared but, rather, have only been postponed.

China and Japan

3.10 Japan is causing considerable concern as the increase in sales tax in April has suppressed consumer expenditure and growth. In Q2 growth was -1.8% q/q and -7.1% over the previous year. The Government is hoping that this is a temporary blip. As for China, Government action in 2014 to stimulate the economy appeared to be putting the target of 7.5% growth within achievable reach but recent data has raised fresh concerns. There are also major concerns as to the creditworthiness of much bank lending to corporates and local government during the post 2008 credit expansion period and whether the bursting of a bubble in housing prices is drawing nearer.

Economic Outlook for the next six months of 2014/15

3.11 Capita Asset Services undertook a review of its interest rate forecasts on 24 October. During September and October, a further rise in geopolitical concerns, principally over Ukraine but also over the Middle East, plus fears around Ebola and an accumulation of dismal growth news in most of the ten largest economies of the world and also on the growing risk of deflation in the Eurozone, had sparked a flight from equities into safe havens like gilts and depressed PWLB rates. However, there is much volatility in rates as news ebbs and flows in negative or positive ways. This latest forecast includes a first increase in Bank Rate in quarter 2 of 2015.

3.12 Our PWLB forecasts are based around a balance of risks. However, there are potential upside risks, especially for longer term PWLB rates, as follows:-

- A further surge in investor confidence that robust world economic growth is firmly expected, causing a flow of funds out of bonds and into equities.
- UK inflation being significantly higher than in the wider EU and US, causing an increase in the inflation premium inherent to gilt yields

3.13 Downside risks currently include:

- The situation over Ukraine poses a major threat to EZ and world growth if it was to deteriorate into economic warfare between the West and Russia where Russia resorted to using its control over gas supplies to Europe.
- Fears generated by the potential impact of Ebola around the world
- UK strong economic growth is currently mainly dependent on consumer spending and the potentially unsustainable boom in the housing market. The boost from these sources is likely to fade after 2014.
- A weak rebalancing of UK growth to exporting and business investment causing a weakening of overall economic growth beyond 2014.
- Weak growth or recession in the UK's main trading partner - the EU, inhibiting economic recovery in the UK.
- A return to weak economic growth in the US, UK and China causing major disappointment in investor and market expectations.
- A resurgence of the Eurozone sovereign debt crisis caused by ongoing deterioration in government debt to GDP ratios to the point where financial markets lose confidence in the financial viability of one or more countries and in the ability of the ECB and Eurozone governments to deal with the potential size of the crisis.
- Recapitalisation of European banks requiring more government financial support.
- Lack of support by populaces in Eurozone countries for 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.

- Italy: the political situation has improved but it remains to be seen whether the new government is able to deliver the austerity programme required and a programme of overdue reforms. Italy has the third highest government debt mountain in the world.
- France: after being elected on an anti austerity platform, President Hollande has embraced a €50bn programme of public sector cuts over the next three years. However, there could be major obstacles in implementing this programme. Major overdue reforms of employment practices and an increase in competiveness are also urgently required to lift the economy out of stagnation.
- Monetary policy action failing to stimulate sustainable growth in western economies, especially the Eurozone and Japan.
- Heightened political risks in the Middle East and East Asia could trigger safe haven flows back into bonds.
- There are also increasing concerns at the reluctance of western central banks to raise interest rates significantly for some years, plus the huge QE measures which remain in place (and may be added to by the ECB in the near future). This has created potentially unstable flows of liquidity searching for yield and, therefore, heightened the potential for an increase in risks in order to get higher returns. This is a return to a similar environment to the one which led to the 2008 financial crisis.

3.14 The following table shows Capita Asset Services' forecast for interest rates:

	Dec-14	Mar-15	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18
Bank rate	0.50%	0.50%	0.75%	0.75%	1.00%	1.00%	1.25%	1.25%	1.50%	1.50%	1.75%	2.00%	2.25%	2.50%
5yr PWLB rate	2.50%	2.70%	2.70%	2.80%	2.90%	3.00%	3.10%	3.20%	3.30%	3.40%	3.50%	3.50%	3.50%	3.50%
10yr PWLB rate	3.20%	3.40%	3.50%	3.60%	3.70%	3.80%	3.90%	4.00%	4.10%	4.10%	4.20%	4.20%	4.30%	4.30%
25yr PWLB rate	3.90%	4.00%	4.10%	4.30%	4.40%	4.50%	4.60%	4.70%	4.70%	4.80%	4.80%	4.90%	4.90%	5.00%
50yr PWLB rate	3.90%	4.00%	4.10%	4.30%	4.40%	4.50%	4.60%	4.70%	4.70%	4.80%	4.80%	4.90%	4.90%	5.00%

Review of the Treasury Management Strategy Statement and Annual Investment Strategy

3.15 There are no policy changes to the Treasury Management Strategy Statement (TMSS) approved by the Council on 25th February 2014 No changes are required to the prudential indicators approved in the TMSS and approved prudential indicators have been complied with during the first six months of 2014/15.

Borrowing Update

3.16 During the first 6 months of 2014/15 borrowing decisions were taken in accordance with the approved strategy. The Council continued to take advantage of short term borrowing from other public sector bodies at rates below bank base rate which provided a pragmatic solution to managing cash flow. At the same time the need to safeguard against rising PWLB rates resulted in some longer term borrowing. No debt restructuring was undertaken during the period covered by this report.

During the first 6 months of 2014, one new PWLB loan was taken out:

Date of Borrowing	Principal	Maturity	Interest Rate
26/9/2014	£5m	49 years	3.82%

One PWLB loan matured during the period and was repaid:

Date repaid	Principal	Maturity	Interest rate
24/9/14	£5m	5 years	2.84%

The following short term loans were taken from other public sector bodies:

Date of borrowing	Lender	Amount	Interest rate	Repayment Date
17/4/2014	Leicestershire CC	£10m	0.4%	17/10/14
29/4/2014	Derbyshire CC	£5m	0.4%	24/10/14
10/9/14	Derbyshire CC Superannuation Fund	£5m	0.5%	10/3/15
24/9/14	Leicester City Council	£10m	0.5%	19/12/2014
30/9/14	Northamptonshire Council	£3m	0.7%	30/9/2015
	Total	£33m		

The following short term loans matured and were repaid:

Date of borrowing	Lender	Amount	Interest rate	Date repaid
9/10/13	Leicestershire CC	£2m	0.47%	9/4/14
15/10/13	Derbyshire CC	£5m	0.47%	15/4/14
20/12/13	Devon & Cornwall Police	£3m	0.48%	30/4/14
16/12/13	Kensington & Chelsea Council	£5m	0.47%	30/4/14
22/1/14	Hackney Council	£3m	0.45%	22/4/14
28/2/14	Kensington & Chelsea Council	£5m	0.41%	30/6/14
24/2/14	Redcar & Cleveland Borough Council	£1m	0.42%	24/6/14
5/2/14	Merseyside ITA	£5m	0.45%	5/8/14
10/3/14	Derbyshire CC	£5m	0.45%	10/9/14
31/3/14	Hertfordshire Police & Crime Commission	£5m	0.45%	30/9/14
	Total	£39m		

Investment Update

3.17 Investment decisions during the first 6 months of 2014/15 were taken in accordance with the approved strategy. There were no new investments during the period and surplus cash balances were held in the Council's bank account.

3.18 East Lothian Council Common Good funds and Charitable Trust funds are managed in two separate portfolios by an external investment management company, Investec. At 30th September 2014, the East Lothian Charitable Trust portfolio was valued at £2.806m, which represents an increase of £0.039m over the 6 month period. The Common Good portfolio was valued at £2.867m which also represents an increase of £0.039m over the 6 month period.

4 POLICY IMPLICATIONS

4.1 There are no direct policy implications associated with this report however the Council's treasury management activity is determined by the policy framework set out in the approved Treasury Management Strategy.

5 EQUALITIES IMPACT ASSESSMENT

5.1 This report is not applicable to the well being of equalities groups and an Equalities Impact Assessment is not required.

6 RESOURCE IMPLICATIONS

6.1 Financial – There are no direct financial implications associated with this report however the Council's Treasury Management activity clearly has a significant impact on the management of the Council's financial resources.

6.2 Personnel - None

6.3 Other - None

7 BACKGROUND PAPERS

7.1 Treasury Management Strategy 2014/15 to 2016/17 – East Lothian Council 25 February 2014

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