

REPORT TO: Audit and Governance Committee

MEETING DATE: 1 December 2015

BY: Depute Chief Executive - Resources and Peoples Services

SUBJECT: Treasury Management Strategy Statement and Annual Investment Strategy – Mid Year Review 2015/16

1 PURPOSE

- 1.1 To update the Committee on Treasury Management activity during the first half of 2015/16.

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 2015/16 financial year to 30 September 2015;
- A review of the Treasury Management Strategy Statement and Annual Investment Strategy approved by the Council on 24th February 2015;
- A review of the Council's borrowing for 2015/16;
- A review of the Council's investment activity for 2015/16;

Economic update from Capita Asset Services

U.K.

3.5 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, possibly being equal to that of the US. However, quarter 1 of 2015 was weak at +0.4% (+2.9% y/y) though there was a rebound in quarter 2 to +0.7% (+2.4% y/y). Growth is expected to weaken to about +0.5% in quarter 3 as 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 May Budget. Despite these headwinds, the Bank of England August Inflation Report had included a forecast for growth to remain around 2.4 – 2.8% over the next three years, 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. However, since the report was issued, the Purchasing Manager's Index, (PMI), for services on 5 October would indicate a further decline in the growth rate to only +0.3% in Q4, which would be the lowest rate since the end of 2012. In addition, worldwide economic statistics and UK consumer and business confidence have distinctly weakened so it would therefore not be a surprise if the next Inflation Report in November were to cut those forecasts in August.

- 3.6 The August Bank of England Inflation Report forecast was notably subdued in respect of inflation which was forecast to barely get 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.
- 3.7 There are therefore considerable risks around whether inflation will rise in the near future as strongly as had previously been expected; this will make it more difficult for the central banks of both the US and the UK to raise rates as soon as was being forecast until recently, especially given the recent 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 in 2015 so far, which could potentially spill over to impact the real economies rather than just financial markets.
- 3.8 GDP growth in 2014 of 2.4% was followed by first quarter 2015 growth depressed by exceptionally bad winter weather at only +0.6% (annualised). However, growth rebounded very strongly in Q2 to 3.9% (annualised) and strong growth was initially expected going forward. Until the turmoil in financial markets in August caused by fears about the slowdown in Chinese growth, it had been strongly expected that the Fed. might start to increase rates in September. However, the Fed pulled back from that first increase due to global risks which might depress US growth and put downward pressure on inflation, and due to a 20% appreciation of the dollar which has caused the Fed to lower its growth forecasts. Since then the nonfarm payrolls figures for September and revised August, issued on 2 October, were disappointingly weak and confirmed concerns that US growth is likely to significantly weaken. This has pushed back expectations of the first rate increase from 2015 into 2016.

Eurozone

- 3.9 The ECB announced a massive €1.1 trillion programme of quantitative easing in January 2015 to buy up high credit quality government debt of selected EZ countries. This programme started in March and will run to September 2016. This seems to have already had a beneficial impact in improving confidence and sentiment. There has also been a continuing trend of marginal increases in the GDP growth rate which hit 0.4% in quarter 1 2015 (1.0% y/y) and +0.4%, (1.5% y/y) in Q2 GDP. The ECB has also stated it would extend its QE programme if inflation failed to return to its target of 2% within this initial time period.

Greece

- 3.10 During July, Greece finally capitulated to EU demands to implement a major programme of austerity and is now cooperating fully with EU demands. An €86bn third bailout package has since been agreed though it did nothing to address the unsupportable size of total debt compared to GDP. However, huge damage has been done to the Greek banking system and economy by the resistance of the Syriza Government, elected in January, to EU demands. The surprise general election in September gave the Syriza government a mandate to stay in power to implement austerity measures. However, there are major doubts as to whether the size of cuts and degree of reforms required can be fully implemented and so Greek exit from the euro may only have been delayed by this latest bailout.

China and Japan

- 3.11 Japan is causing considerable concern as the increase in sales tax in April 2014 has suppressed consumer expenditure and growth. In Q2 2015 growth was -1.6% (annualised) after a short burst of strong growth of 4.5% in Q1. During 2015, Japan has been hit hard by the downturn in China. This does not bode well for Japan as the Abe government has already fired its first two arrows to try to stimulate recovery and a rise in inflation from near zero, but has dithered about firing the third, deregulation of protected and inefficient areas of the economy, due to political lobbies which have traditionally been supporters of Abe's party.
- 3.12 As for China, the Government has been very active during 2015 in implementing several stimulus measures to try to ensure the economy hits the growth target of 7% for the current year and to bring some stability after the major fall in the onshore Chinese stock market. Many commentators are concerned that recent growth figures around that figure, could have been massaged to hide a downturn to a lower growth figure. 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. Overall, China is still expected to achieve a growth figure that the EU would be envious of. However, concerns about whether the Chinese cooling of the economy could be heading for a hard landing, and the volatility of the Chinese stock market, have caused major volatility in financial markets in August and September such that confidence is, at best, fragile.

Emerging countries

- 3.13 There are considerable concerns about the vulnerability of some emerging countries and their corporates which are getting caught in a perfect storm. Having borrowed massively in western currency denominated debt since the financial crisis, caused by western investors

searching for yield by channelling investment cash away from western economies with dismal growth, depressed bond yields (due to QE), and near zero interest rates, into emerging countries, there is now a strong current flowing to reverse that flow back to those western economies with strong growth and an imminent rise in interest rates and bond yields. This change in investors' strategy and the massive reverse cash flow, has depressed emerging country currencies and, together with a rise in expectations of a start to central interest rate increases in the US and UK, has helped to cause the dollar and sterling to appreciate. In turn, this has made it much more costly for emerging countries to service their western currency denominated debt at a time when their earnings from commodities are depressed. There are also going to be major issues when previously borrowed debt comes to maturity and requires refinancing at much more expensive rates, if available at all.

- 3.14 Corporates (worldwide) heavily involved in mineral extraction and / or the commodities market may also be at risk and this could also cause volatility in equities and safe haven flows to bonds. Financial markets may also be buffeted by sovereign wealth funds of countries highly exposed to falls in commodity prices which, therefore, may have to liquidate investments in order to cover national budget deficits.

Economic Outlook for the next six months of 2015/16

- 3.15 Capita Asset Services undertook its last review of interest rate forecasts on 11 August shortly after the quarterly Bank of England Inflation Report. Later in August, fears around the slowdown in China and Japan caused major volatility in equities and bonds and sparked a flight from equities into safe havens like gilts and so caused PWLB rates to fall below the above forecasts for quarter 4 2015. However, there is much volatility in rates as news ebbs and flows in negative or positive ways and news in September in respect of Volkswagen, and other corporates, has compounded downward pressure on equity prices. This latest forecast includes a first increase in Bank Rate in quarter 2 of 2016.
- 3.16 Despite market turbulence since late August causing a sharp downturn in PWLB rates, the overall trend in the longer term will be for gilt yields and PWLB rates to rise, due to the high volume of gilt issuance in the UK when economic recovery is firmly established accompanied by rising inflation and consequent increases in Bank Rate, and the eventual unwinding of QE. Increasing investor confidence in eventual world economic recovery is also likely to compound this effect as recovery will encourage investors to switch from bonds to equities.
- 3.17 The overall balance of risks to economic recovery in the UK is currently evenly balanced. Only time will tell just how long this current period of strong economic growth will last; it also remains exposed to vulnerabilities in a number of key areas.
- 3.18 The disappointing US nonfarm payrolls figures and UK PMI services figures at the beginning of October have served to reinforce a trend of increasing concerns that growth is likely to be significantly weaker than

had previously been expected. This, therefore, has markedly increased concerns, both in the US and UK, that growth is only being achieved by monetary policy being highly aggressive with central rates at near zero and huge QE in place. In turn, this is also causing an increasing debate as to how realistic it will be for central banks to start on reversing such aggressive monetary policy until such time as strong growth rates are more firmly established and confidence increases that inflation is going to get back to around 2% within a 2-3 year time horizon. Market expectations in October for the first Bank Rate increase have therefore shifted back sharply into the second half of 2016.

3.19 Downside risks to current forecasts for UK gilt yields and PWLB rates currently include:

- Geopolitical risks in Eastern Europe, the Middle East and Asia, increasing safe haven flows.
- UK economic growth turns significantly weaker than we currently anticipate.
- Weak growth or recession in the UK's main trading partners - the EU, US and China.
- A resurgence of the Eurozone sovereign debt crisis.
- Recapitalisation of European banks requiring more government financial support.
- Emerging country economies, currencies and corporates destabilised by falling commodity prices and / or the start of Fed. rate increases, causing a flight to safe havens

3.20 The potential for upside risks to current forecasts for UK gilt yields and PWLB rates, especially for longer term PWLB rates include: -

- Uncertainty around the risk of a UK exit from the EU.
- The ECB severely disappointing financial markets with a programme of asset purchases which proves insufficient to significantly stimulate growth in the EZ.
- The commencement by the US Federal Reserve of increases in the Fed. funds rate causing a fundamental reassessment by investors of the relative risks of holding bonds as opposed to equities and leading to a major flight from bonds to equities.

- UK inflation returning to significantly higher levels than in the wider EU and US, causing an increase in the inflation premium inherent to gilt yields.

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

	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18
Bank rate	0.50%	0.50%	0.75%	0.75%	1.00%	1.00%	1.25%	1.50%	1.50%	1.75%	1.75%
5yr PWLB rate	2.40%	2.50%	2.60%	2.80%	2.90%	3.00%	3.10%	3.20%	3.30%	3.40%	3.50%
10yr PWLB rate	3.00%	3.20%	3.30%	3.40%	3.50%	3.70%	3.80%	3.90%	4.00%	4.10%	4.20%
25yr PWLB rate	3.60%	3.80%	3.90%	4.00%	4.10%	4.20%	4.30%	4.40%	4.50%	4.60%	4.60%
50yr PWLB rate	3.60%	3.80%	3.90%	4.00%	4.10%	4.20%	4.30%	4.40%	4.50%	4.60%	4.60%

Review of the Treasury Management Strategy Statement and Annual Investment Strategy.

3.22 There are no policy changes to the Treasury Management Strategy Statement (TMSS) approved by the Council on 24th February 2015. 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 2015/16.

BORROWING UPDATE

3.23 The Council's capital financing requirement (CFR) for 2015/16 is £448m. 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). This is a prudent and cost effective approach in the current economic climate but will require ongoing monitoring in the event that upside risk to gilt yields prevails.

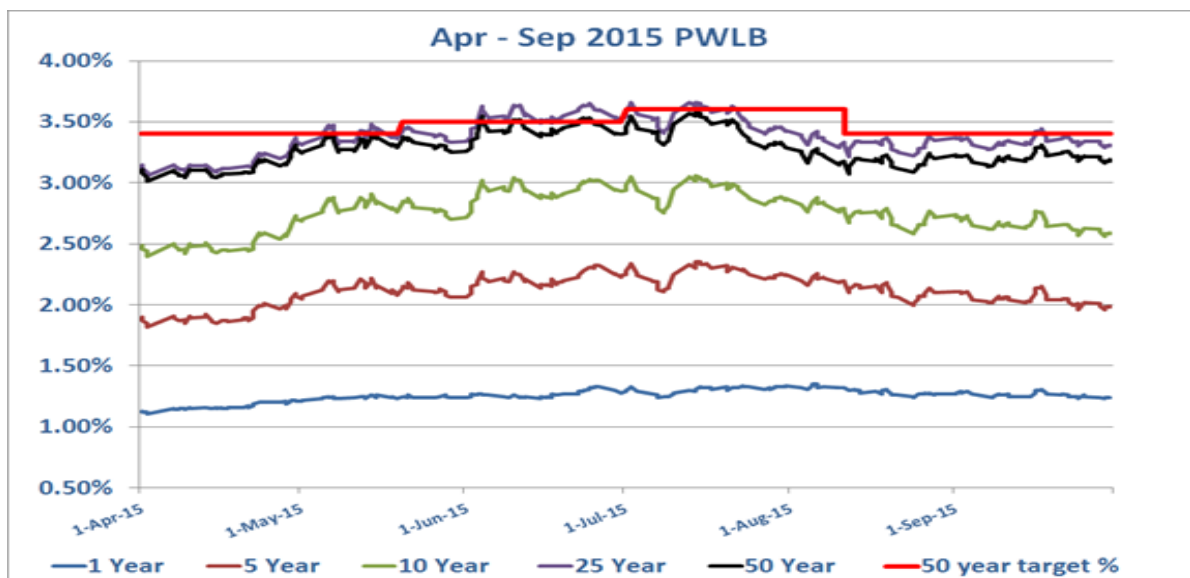
3.24 Due to the overall financial position and the underlying need to borrow for capital purposes (the capital financing requirement - CFR), new external borrowing of £9.896m was undertaken from the PWLB

Date of Borrowing	Principal	Maturity	Interest Rate
03/09/15	£2.896m	47 years	3.01%
29/09/15	£3.5m	14 years	2.94%
29/09/15	£3.5m	44 years	3.21%

3.25 The graph and table below show the movement in PWLB certainty rates for the first six months of the year to date for comparison

PWLB Certainty Rates

	1 Year	5 Year	10 Year	25 Year	50 Year
Low	1.11%	1.82%	2.40%	3.06%	3.01%
Date	02/04/2015	02/04/2015	02/04/2015	02/04/2015	02/04/2015
High	1.35%	2.35%	3.06%	3.66%	3.58%
Date	05/08/2015	14/07/2015	14/07/2015	02/07/2015	14/07/2015
Average	1.26%	2.12%	2.76%	3.39%	3.29%



3.26 As shown, the general trend has been an increase in interest rates during the first quarter but then a fall during the second quarter.

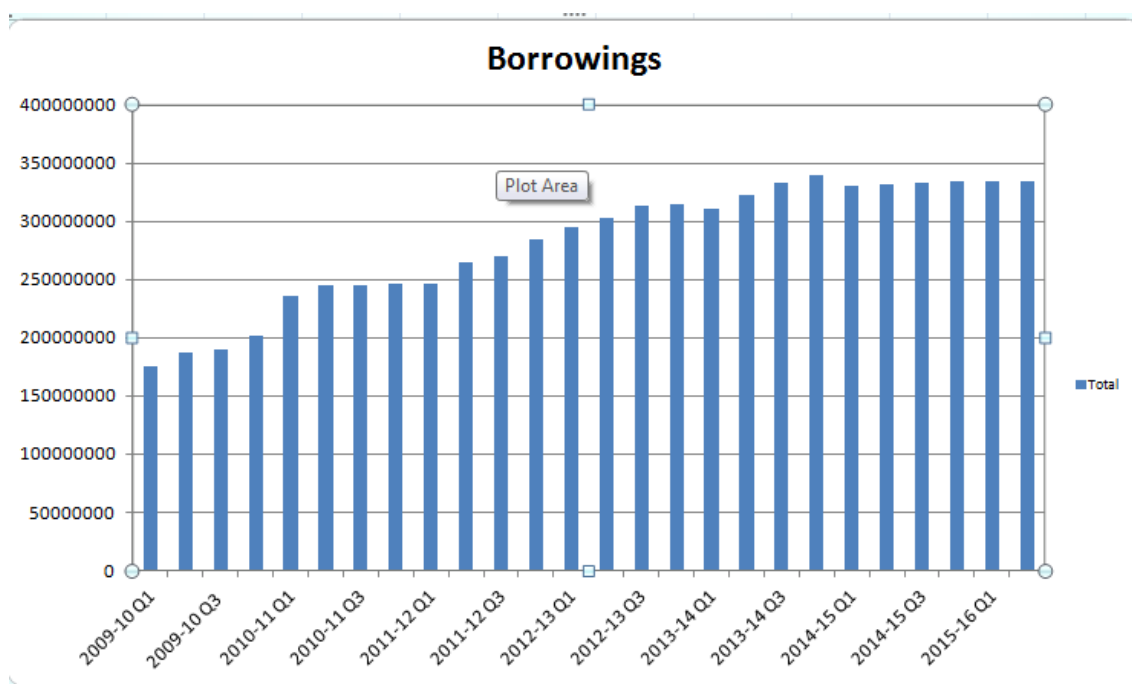
One PWLB loan matured during the first six months and was repaid:

Date repaid	Principal	Maturity	Interest rate
24/9/15	£6m	6 years	3.12%

3.27 There were no short term loans taken and the following short term loan matured and was repaid:

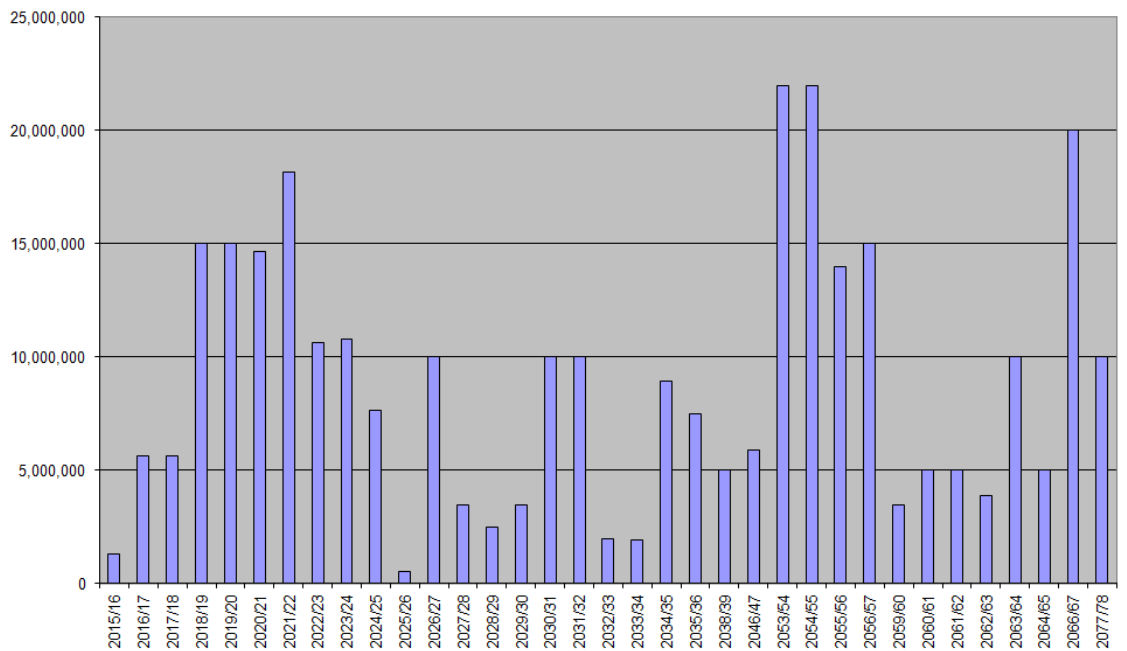
Date of borrowing	Lender	Amount	Interest rate	Date repaid
30/09/14	Northamptonshire CC	£3m	0.70%	30/09/15

3.28 Due to this the Council's overall external borrowing is relatively unchanged with external borrowings of £334.32m at 30th September.



3.29 There is a further maturity of £1.3m in October.

Current Maturity Profile



- 3.30 It is anticipated that further borrowing will be undertaken during this financial year

Debt Rescheduling

- 3.31 No debt rescheduling was undertaken during the first six months of 2015/16 as debt rescheduling opportunities have been limited in the current economic climate, with the consequent structure of interest rates, and following the increase in the margin added to gilt yields which has impacted PWLB new borrowing rates since October 2010.

Investment Update

- 3.32 Investment decisions during the first 6 months of 2015/16 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, 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 2015, the East Lothian Charitable Trust portfolio was valued at £2.736m, which represents a decrease of £0.249m over the 6 month period. The Common Good portfolio was valued at £2.786m which represents a decrease of £0.267m over the 6 month period.

4.0 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 Equality 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 2015/16 to 2017/18 – East Lothian Council 24 February 2015

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