

## **Audit Committee**

**6 December 2011**

### **Report of the Head of Finance & Property**

#### **ITEM 8 Treasury Management Update – 6 Months to 30 September 2011**

##### Purpose of Report

To report to the Committee on the Council's Treasury Management activities in the six months to 30 September 2011.

##### Action Requested

That the contents of the report be noted.

##### Policy Context

That we will deliver value for money for our citizens.

##### Background to the Report

Following Council's adoption of the Treasury Management Strategy Statement on 26 April 2010 it has since been agreed that quarterly reports on Treasury Management activities would be made to the Audit Committee.

##### I. Economic background:

- Indicators suggest that the economy has at best stagnated;
- Conditions on the high street have deteriorated further;
- Employment has fallen again;
- The public finances are expected to miss this year's fiscal forecasts;
- CPI inflation rising, heading for a peak of around 5% in the last quarter;
- The Monetary Policy Committee agrees more Quantitative Easing;
- Equities prices plummet and gilt yields fall to historic lows;
- The economic recoveries falter in the US and Europe.

Activity indicators suggest that the economic recovery has ground to a halt. Indeed, the weighted output balance of the CIPS/Markit surveys fell in August to a level that has been consistent with contraction in the past. The surveys also exclude retail activity – and the latest news from the high street suggests that the sector is in a similar position. While sales volumes rose by 0.2% month on month in July, they fell by the same amount in August.

Meanwhile, the fading of the economic recovery has impacted on the job market. The Labour Force Survey measure of employment fell by 70,000 in the three months to July, the first fall this year. And the ILO measure of unemployment rose by 80,000 over the same period – the largest rise in two years. The timelier (but narrower) claimant count measure also rose by a monthly 33,700 in July and 20,300 in August. The pace of job losses across the whole economy looks unlikely to ease off in the coming months. Job vacancies in the three months to August were 1.3% lower than a quarter ago, while the employment balances of all three of the CIPS surveys were below the 50-mark in July and August (below 50 marks a contraction in expectations).

Meanwhile, the public finances are on track to miss this year's fiscal forecasts. If the trend in borrowing seen over the first five months of the fiscal year continues, it will be around £5bn higher than the Office of Budget Responsibility expects. Admittedly, the full impact of some tax changes have yet to be felt, but the lags between developments in the economy and the public finances suggest that the recent slowdown is unlikely to have had its full effect on receipts.

Conditions in the housing market have also continued to deteriorate. Whilst the number of mortgage approvals for new house purchase rose from 48,800 in June to 52,400 in August, this has not prevented renewed falls in house prices. The Nationwide index ended the second quarter 0.2% lower than at the end of the first.

The trade in goods and services deficit was £4.5bn in July, compared to an average monthly deficit of £3.8bn in the first quarter. The survey measures of export orders also point to falls in exports ahead – the new export orders balance of the CIPS Manufacturing survey, for example, fell to its lowest level since May 2009 in September. At that level, it points to a quarterly drop in the volume of manufactured goods exports of around 5%.

Inflation continued to climb in the second quarter. CPI inflation rose from 4.2% in June to 4.4% in July and 4.5% in August. A series of rises in electricity and gas prices also took effect in late August and September which, together with a rise in food inflation reflecting past rises in agricultural commodity prices, could push inflation close to 5% in September.

Inflation may creep a little higher in the third quarter – but recent developments suggest that it should fall quite sharply next year. Measures of inflation expectations have drifted up – the Bank of England's measure of households' inflation expectations in the year ahead rose from 3.9% to 4.2% in the second quarter. However with conditions in the labour market continuing to deteriorate, these expectations seem unlikely to become ingrained. The annual rate of average earnings growth including bonuses fell from 3.1% to 2.9% in July (the rate excluding bonuses fell from 2.2% to 1.7%). Real pay growth has thus remained negative.

Financial market sentiment deteriorated sharply in the second quarter, reflecting declining prospects for economic growth and renewed risk aversion as a result of the intensification of the euro-zone sovereign debt crisis. The FTSE 100 finished the quarter at 5,128 – about 14% lower than its level at the end of the first quarter. Ten year gilt yields plummeted from 3.38% to 2.43%, reflecting falling interest rate expectations and 'safe-haven flows'.

## 2. Interest rate forecast

The Council's treasury adviser, Sector, provides the following forecast:

Sector's Interest Rate View															
	Now	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12	Mar-13	Jun-13	Sep-13	Dec-13	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15
Sector's Bank Rate View	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.75%	1.00%	1.25%	1.50%	2.00%	2.25%	2.50%
5yr PWLB Rate	2.41%	2.30%	2.30%	2.30%	2.30%	2.40%	2.50%	2.60%	2.70%	2.80%	2.90%	3.10%	3.30%	3.50%	3.70%
10yr PWLB Rate	3.46%	3.30%	3.30%	3.30%	3.40%	3.40%	3.50%	3.60%	3.70%	3.80%	4.00%	4.20%	4.40%	4.60%	4.80%
25yr PWLB Rate	4.31%	4.20%	4.20%	4.20%	4.30%	4.30%	4.40%	4.50%	4.60%	4.70%	4.80%	4.90%	5.00%	5.10%	5.20%
50yr PWLB Rate	4.42%	4.30%	4.30%	4.30%	4.40%	4.40%	4.50%	4.60%	4.70%	4.80%	4.90%	5.00%	5.10%	5.20%	5.30%

The Sector central forecast is for the first increase in bank rate to be in September 2013. Sector would remind clients of just how unpredictable PWLB rates and bond yields are as we are experiencing exceptional levels of volatility which are highly correlated to political developments (or lack of them) in the sovereign debt crisis.

Sector has undertaken a review of their interest rate forecasts as a result of two major events: -

1. The decision by the MPC to expand quantitative easing over the next four months by a further £75bn which had an immediate effect of depressing gilt yields at the long end of the curve. It also clearly underlines how concerned the MPC now is about the prospects for growth of the UK economy and that recession is now decisively a much greater concern than inflation.
2. The marked deterioration of growth prospects in the US, EU and UK, especially as concerns have further increased over Greece and the potential fall out from their debt situation. This has led in turn to a further increase in safe haven flows into UK gilts which have depressed gilt yields and PWLB rates to even lower levels.

These developments had left their short term forecasts for PWLB rates markedly out of line with actual rates. They have also substantially pushed back their expectations of the timing of the eventual start of increases in Bank Rate and the expected eventual rise in gilt yields and PWLB rates.

## 3. Annual Investment Strategy

The Treasury Management Strategy Statement (TMSS) for 2011/12, which includes the Annual Investment Strategy, was approved by the Council on 11 April 2011. 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 and the heightened credit concerns it is considered appropriate to keep most investments short term with a maximum duration of 3 months.

This limit will apply to all entities on the suggested Sector Credit List with the following exceptions:

1. UK Government and related entities such as Local Authorities. Their suggested duration limit will remain at 5yrs.
2. UK semi-nationalised institutions (eg Lloyds Bank). We continue to view the current significant UK ownership of these entities as providing significant comfort to investors.
3. Money Market Funds.

Officers can confirm that the approved limits within the Annual Investment Strategy were not breached during the 6 months ended 30 September 2011.

Investment rates available in the market have continued at historically low levels. The average level of funds available for internal investment purposes during the half year was £6.25m. 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 authority holds £10.58m core cash balances for investment purposes (i.e. funds available for more than one year) and these are managed by its investment manager, Investec Asset Management Ltd.

Investment performance for 6 months ended 30 September 2011

Benchmark	Benchmark Return	Council Performance Annualised %	Investment Interest Earned In-house £	Investec Performance Annualised %	Investment Interest Earned – Investec £
7 day LIBID	0.47%	1.30%	£81k	1.01%	£105k

As illustrated, the Authority's in-house investments and the Investment managers, Investec, both outperformed the benchmark by 0.83% and 0.54% respectively. The Council's budgeted investment return for 2011/12 is £200k, and performance for the year to date is £86k above budget at the half year stage. The in-house performance is driven by one investment which is held for just under a year at 2.05%.

There have been no material changes to the Annual Investment Strategy.

#### 4. New borrowing

There has been no new borrowing so far this year. However, prior to 31 March 2012 the Council will need to borrow £79.8m (final amount still to be confirmed) to fund a payment to the government in respect of the reform of the Housing Revenue Account. The Council may borrow up to a further £8.6m to help fund its housing programme.

The actual amount to be borrowed and the full treasury implications, risks etc will be included in the 30 Year HRA Business Plan which will be tabled for approval by Cabinet and Council in February 2012. In January/February 2012 updated Treasury Management Strategy, Minimum Revenue Provision Strategy and Annual Investment Strategy for 2012/13 will be tabled for both Cabinet and Council and will include all the necessary information and treasury decisions required to implement this borrowing.

## 5. 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 limits 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 I.

## 6. Other

By November 2011 £670k had been received from the administrators of Heritable Bank Plc. The administrators are currently predicting a return to investors of between 86p and 90p in the pound.

Lead Member

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Background Papers:

Cabinet report on Treasury Management Strategy Statement etc 17 March 2011

**APPENDIX I: Prudential and Treasury Indicators as at 30 September 2011**

<b>Prudential Indicator</b>	<b>2011/12 Indicator £'000</b>	<b>At 30 September 2011 – Actual £'000</b>
Capital Financing Requirement (CFR)	-3,519	-3,519
Gross borrowing	2,620	2,000
Investments	-20,000	-24,065
Net borrowing	-17,380	-22,065
Authorised limit for external debt	8,000	8,000
Operational boundary for external debt	5,000	5,000
Limit of fixed interest rates based on net debt	100%	83%
Limit of variable interest rates based on net debt	75%	17%
Principal sums invested > 364 days	50%	2%
Maturity structure of borrowing limits:	<u>Maximum:</u>	<u>Actual:</u>
Under 12 months	30%	Nil
12 months to 2 years	30%	Nil
2 years to 5 years	50%	Nil
5 years to 10 years	70%	Nil
10 years and above	100%	100%