ARGYLL AND BUTE COUNCIL | **PERFORMANCE REVIEW AND SCRUTINY COMMITTEE**

STRATEGIC FINANCE | **19 NOVEMBER 2015**

TREASURY MANAGEMENT MONITORING REPORT 31 AUGUST 2015

1. EXECUTIVE SUMMARY

1.1 This report is for noting and sets out the Council's treasury management position for the period 1 July 2015 to 31 August 2015. It includes information on:
- Overall Borrowing Position
- Borrowing Activity
- Investment Activity
- Economic Background
- Interest Rate Forecast
- Prudential Indicators.

1.2 Borrowing is currently estimated to be below the Capital Financing Requirement for the period to 31 March 2016, however, there are substantial internal balances, of which £58.9m is currently invested.

1.3 The levels of investments have increased slightly to £58.9m at 31 August 2015. The rate of return achieved was 0.654% which compares favourably with the target of 7 day LIBID which was 0.361%.

1.4 The net movement in external borrowing in the period is £2.929m.

1.5 There was no breaching of limits during the period.

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2. INTRODUCTION

2.1 This report summarises the monitoring as at 31 August 2015 of the Council's:
- Overall Borrowing Position
- Borrowing Activity
- Investment Activity
- Economic Background
- Interest Rate Forecast
- Prudential Indicators.

3. RECOMMENDATIONS

3.1 The treasury management monitoring report is noted.

4. DETAIL

Overall Borrowing Position

4.1 The table below details the estimated capital financing requirement (CFR) and compares this with the estimated level of external debt at the 31 March 2016. The CFR represents the underlying need for the Council to borrow to fund its fixed assets and accumulated capital expenditure.

	Forecast 2015/16 £000's	Budget 2015/16 £000's	Forecast 2016/17 £000's	Forecast 2017/18 £000's
CFR at 1 April	256,079	257,823	271,939	263,595
Net Capital Expenditure	27,644	26,707	2,440	0
Less Loans Fund Principal Repayments	(11,784)	(11,784)	(10,784)	(9,784)
Estimated CFR 31 March	**271,939**	**272,746**	**263,595**	**253,811**
Less Funded by NPDO	(78,055)	(78,055)	(76,507)	(74,961)
Estimated Net CFR 31 March	**193,884**	**194,691**	**187,088**	**178,850**
Estimated External Borrowing at 31 March	169,315	172,655	177,655	177,655
Gap	**24,569**	**22,036**	**9,433**	**1,195**

4.2 Borrowing is currently estimated to be below the CFR for the period to 31 March 2016. This reflects the approach taken to minimise surplus cash on deposit in order to avoid overdue exposure to investment / credit worthiness risks. However if it becomes clear that longer term interest rates are likely to increase significantly the position will be reviewed to ensure the Council locks in funding at low interest rates.

4.3 The Council's estimated net CFR at 31 August 2015 is £193.884m. The table below shows how this has been financed. Whilst borrowing is less than the CFR there are substantial internal balances (mainly the General Fund) of which £58.9m is currently invested.

	Position at 30/06/2015 £000's	Position at 31/08/2015 £000's
Loans	160,918	157,989
Internal Balances	85,835	94,805
Less Investments & Deposits	(56,719)	(58,910)
Total	**190,034**	**193,884**

Borrowing Activity

4.4 The table below summarises the borrowing and repayment transactions in the period 1 July 2015 to 31 August 2015.

	Actual £000's
External Borrowing Repaid 1st July 2015 to 31st August 2015	(2,929)
External Borrowing undertaken 1st July 2015 to 31st August 2015	0
Net Movement in External Borrowing	**(2,929)**

4.5 One Local Bond was repaid in the period 1 July 2015 to 31 August 2015.

4.6 No new Local Bonds were taken out in the period 1 July 2015 to 31 August 2015.

4.7 The table below summarises the movement in level and rate of temporary borrowing at the start and end of the period.

	£000s	% Rate
Temp borrowing at 30th June 2015	11,305	0.34%
Temp borrowing at 31st August 2015	11,160	0.34%

Investment Activity

4.8 The average rate of return achieved on the Council's investments to 31 August 2015 was 0.654% compared to the average LIBID rate for the same period of 0.361% which demonstrates that the Council is achieving a reasonable rate of return on its cash investments. At the 31 August 2015 the Council had £58.9m of short term investment at an average rate of 0.654%. The table below details the counterparties that the investments were placed with, the maturity date, the interest rate and the credit rating applicable for each of the counterparties.

Counterparty	Maturity	Amount £000s	Interest Rate	Rating
Bank of Scotland	Instant Access	50	0.40%	Short Term A-1, Long Term A
Bank of Scotland	31/10/2015	5,000	1.00%	
Royal Bank of Scotland	Instant Access	50	0.25%	Short Term A-2, Long Term BBB+
Clydesdale Bank	Instant Access	810	0.50%	Short Term A-2, Long Term BBB+
Goldman Sachs	05/02/2015	5,000	0.775%	Short Term A-1, Long Term A
Handelsbanken	35 Day Notice	5,000	0.55%	Short Term A-1+, Long Term AA-
DZ Bank	14/09/2015	5,000	0.92%	Short Term A-1+, Long Term AA-
Deutsche Bank	65 Day Notice	5,000	0.522%	Short Term A-2, Long Term BBB+
Santander	95 Day Notice	5,000	0.900%	Short Term A-1, Long Term A
Nationwide Building Society	07/07/2015	5,000	0.660%	Short Term A, Long Term A-1
CD - RBS	06/01/2016	5,000	0.880%	Short Term A-2, Long Term BBB+
MMF - BNP Paribas	Instant Access	5,000	0.490%	AAA
MMF - Federated	Instant Access	3,000	0.490%	AAA
MMF - Legal & General	Instant Access	5,000	0.486%	AAA
MMF - Blackrock	Instant Access	0	0.438%	AAA
MMF - Standard Life (Formerly IGNIS)	Instant Access	5,000	0.499%	AAA
Total		**58,910**		

4.9 All investments and deposits are in accordance with the Council's approved list of counterparties and within the limits and parameters defined in the Treasury Management Practices. The counterparty list is constructed based on assessments by leading credit reference agencies adjusted for additional market information available in respect of counterparties.

4.10 The current market conditions have made investment decisions more difficult as the number of counterparties which meet the Council's parameters has reduced making it harder to achieve reasonable returns while limiting the exposure to any one institution.

4.11 No limits were breached during the period.

Economic and Interest Rate Forecasts

4.12 The economic background at 31 August 2015 is shown in appendix 1 with the interest rate forecast in appendix 2.

Prudential Indicators

4.13 The prudential indicators for 2015-16 are attached in appendix 3.

5. CONCLUSION

5.1 Borrowing is currently estimated to be below the Capital Financing Requirement for the period to 31 March 2016, however, there are substantial internal balances, of which £58.9m is currently invested. The investment returns were 0.654% which is above the target of 0.361%.

6. IMPLICATIONS

6.1	Policy –	None.
6.2	Financial -	None
6.3	Legal -	None.
6.4	HR -	None.
6.5	Equalities -	None.
6.6	Risk -	None.
6.7	Customer Service -	None.

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Appendix 1 – Economic Background
Appendix 2 – Interest Rate Forecast
Appendix 3 – Prudential Indicators

Appendix 1

Economic background:

- During the quarter ended 31st August 2015:
  - The economic recovery slowed in the first quarter;
  - Survey measures pointed to renewed vigour in Q2;
  - Wage growth picked up as the labour market tightens;
  - Deflation lasted only one month, but the outlook remain subdued;
  - Another split vote on the MPC drew nearer, but a rate hike this year remained unlikely;
  - The general election confirmed that the fiscal squeeze will re-intensify next year;
  - The possibility of a “Grexit” became greater.
- The latest economic data showed that the recovery slowed in the first quarter. However, the latest National Accounts painted the recovery in a better light than previously thought. Indeed, Q1’s quarterly GDP growth estimate was nudged up from 0.3% to 0.4% on the back of some stronger construction data. What’s more, given the strength of the business surveys, we wouldn’t be surprised if Q1’s growth figure was revised even higher in time.
- In any case, the surveys suggest that the recovery got swiftly back on track in Q2. On the basis of past form, the average level of the Markit/CIPS composite PMI is consistent with quarterly GDP growth of around 0.8%. And the Bank of England’s Agents’ scores point to a similarly-strong pick-up. Granted, only limited official data has been published so far for Q2, but April’s industrial production and trade figures paint an encouraging picture for the economic recovery at the start of the quarter.
- Early indicators suggest that the recovery in household spending has maintained plenty of momentum in Q2. Although retail sales volumes rose by just 0.2% on the previous month in May, this followed a 0.9% rise in April. Accordingly, even if sales volumes were unchanged in June, they would still have risen by 0.9% over Q2 as a whole, matching Q1’s rise. What’s more, spending off the high street looks to have remained robust as well. The Bank of England’s Agents’ Score of turnover in the services sector points to a further acceleration in nominal spending on services in the near term. In addition, the latest

consumer confidence figures suggest that households still think now is a good time to undertake major purchases.

- Household spending should continue to be supported by developments in the labour market. The ILO unemployment rate has now fallen to 5.5%, not far above pre-crisis levels. And the employment rate is the highest since records began. The significant tightening in the labour market over the past eighteen months or so has begun to feed through into pay, with annual growth in headline average weekly earnings (excluding bonuses) picking up to 2.7% in April, its strongest since February 2009. We expect nominal wage growth to strengthen a bit further over the coming months as the unemployment rate continues to nudge down. The subdued outlook for inflation should underpin real wage growth.

- The latest consumer prices figures showed that deflation lasted just one month. CPI inflation rose from -0.1% in April to +0.1% in May, reflecting the slower pace of falls in food prices and a rebound in petrol prices. We had stressed for a long while that deflation was likely to be fleeting, as it primarily reflected temporary external factors such as the fall in energy prices and food prices, as well as an appreciation in sterling, rather than weakness in domestic demand. Meanwhile, there have not been any signs that very low inflation has had any adverse second round effects on inflation expectations or spending decisions. Nonetheless, inflation looks set to hover just above zero for the next six months, and it wouldn't take much during that period, perhaps a renewed 10% fall in the oil price, for the UK to be tipped back into deflation.

- Unsurprisingly, then, the Monetary Policy Committee do not appear to be in any rush to raise interest rates. Granted, the minutes of June's MPC meeting showed that for two members, the decision to leave rates on hold was "finely balanced". And a recent interview with the Financial Times, resident MPC hawk Martin Weale suggested that he is not too far off restoring his vote to raise rates again. But with inflation close to zero, the first budget of the next parliament due to be published in July, and the situation in Greece becoming increasingly troubling, it looks that they will wait at least another few months before turning against the grain again. And with the rest of the committee likely to stand pat for even longer, it looks unlikely that there will be an increase in interest rates this year. Indeed, we still think that the first hike in Bank Rate will occur in Q2 next year, broadly in line with market expectations.

- Meanwhile, with the Conservatives winning an outright majority in May's general election, the fiscal squeeze is set to re-intensify next year. We will know more detail about the Chancellor's plans at the

Budget on the 8th July, but we already know that in order to meet their manifesto pledge, the Conservatives will have to implement a fiscal consolidation worth around 5% of GDP over the next four years. And given that they have pledged to not increase VAT, income tax or national insurance in the next parliament, more of the planned squeeze will have to come through cuts to spending than in the last parliament. Admittedly, these plans may be watered down, but it is clear that fiscal policy will be a hindrance, not a help, to the economic recovery over the next few years, and underlines that monetary policy will have to remain extremely accommodative. Meanwhile, the general election brought with it another cloud to the economic recovery – namely a referendum on the UK's membership of the European Union which could happen during 2016, though a May date now appears unlikely.

- Internationally, the major development over the past quarter has been the deterioration of the situation in Greece. At the time of writing, the country is still a member of the euro-zone, but its future as part of the single currency has become increasingly uncertain. Greece urgently needs financial assistance in order to meet its debt repayments, but is unwilling to accept the reforms which creditors demand in exchange for funds. The situation is so severe that emergency capital controls have been imposed in order to stop the Greek banking system from collapsing. It is still possible that Greece and its creditors are able to strike a last-minute deal, but it is clear that this is likely to only offer a short-term solution, and Greece will need to undertake substantial debt restructuring or outright default if it is to return its public finances to a sustainable position in the long run. Whilst the UK's direct economic and financial exposures to Greece are small, there could be an adverse impact on the UK's economy from a wider fallout and period of general financial market instability that would be likely to prevail if a "Grexit" were to occur.

- Finally, UK equity prices have significantly underperformed their US counterparts since the beginning of Q2, with the FTSE 100 falling by 2.3%, whilst the S&P 500 has fallen by only 0.5%. That said, UK equity prices have performed better than those in Europe, which have been hit by renewed fears of a Grexit. Meanwhile, sterling has remained strong against the euro, due to these fears as well as the ECB's ongoing programme of Quantitative Easing. UK 10-year government bond yields have also increased by about 50 basis points since the beginning of Q2. This probably reflects a confluence of factors, such as easing fears of a prolonged bout of deflation, and growing concerns about the impact of a deterioration in the situation in the euro-zone. In any case, gilt yields had looked too low early this year given the fundamental strength of the economic recovery.

Appendix 2

Interest Rate Forecast:

Our treasury management advisers, Capita Asset Services have provided us with the following update to their interest rate forecasts.

Change in market sentiment and outlook

- There has been very little change in our forecasts since our previous forecast in February. We have moved back the start of the increases in Bank Rate by one quarter, to quarter 2 of 2016, to reflect a lowering of forecasts for growth, and in line with comments from the Bank of England.
- In its May Inflation Report, the Bank of England reduced its forecasts for annual growth from 2.9% to 2.5% in 2015 and 2.7% in 2016. 2017 growth was forecast at 2.4% from 2.7%. There were a number of contributing factors to these downward revisions.
- UK quarterly growth in quarter 1 2015 was disappointing and slowed to 0.4% (2.9% y/y), from 0.8% (3.4% y/y), in the previous quarter.
- The Bank also took a more pessimistic view on the rate of, and timing of, the keenly hoped for recovery of growth in labour productivity and of increases in wages; it cut its forecast for wages growth in 2015 from 3.5% to 2.5%. This is despite strong growth in employment and continuing reductions in the rate of unemployment; employment increased by 202,000 in the three months January to March and by 1.25m over the last two years. Unemployment has dropped by 386,000 over the last year and the unemployment rate has fallen to 5.5%. On the other hand, job vacancies stood at 736,000 in the last quarter, close to their highest level since records began in 2001. Despite all this positive news, annual wage increases (excluding bonuses) in the last three months were only 1.9%. For this recovery to become sustainable over the longer term, there must be a recovery in the growth of productivity and real wages in excess of the rate of inflation.
- The election of a majority Conservative Government which is going to implement significant cuts in government expenditure, in order to reduce the size of the annual budget deficit, will slow GDP growth marginally.
- CPI inflation dipped into deflation territory, falling to -0.1%. This dip into deflation will only last for a short period until the fall in the prices of oil and food drop out of the twelve month calculation of CPI, especially during Q4 2015, when inflation is expected to tick up markedly. The latest Inflation Report clearly shows an anticipated rise in inflation to being slightly above the 2% target in the two to three year time horizon.

- Greece: the Greek government led by the anti EU and anti-austerity party Syriza, is making a strong push to renegotiate the austerity programme and debt repayments. This has been met with a robust rejection by the ECB, EU and IMF. There is, therefore, a risk that this could end with Greece leaving the Euro. However, the Eurozone has put in place sufficient firewalls that a Greek exit would have little direct impact on the rest of the EZ and the Euro. The Spanish local elections this quarter surprised analysts due to a strong showing by the anti-austerity party. However, there is considerable debate as to whether this level of support will transfer from a protest vote at local level into the general election at a national level which is coming up soon.

- We remain concerned at the level of potential risk surrounding the government and corporate debt of several of the major emerging economies, from the perspective of both the potential for default in some countries and also a sharp swing in investor sentiment: investors have previously sought out higher yields in these economies during an extended period when yields in western countries have been heavily suppressed.

- Clients should expect a high level of volatility in PWLB rates over 2015, depending on how long it takes to decide what will happen in Greece and as other factors impinge on market and investor sentiment. We would not be surprised to see PWLB rates swinging by 50 bps in a quarter, which makes any forecasts in the shorter term subject to a much higher level of volatility than has been usual.

The American economy experienced disappointing growth in quarter 1 2015, contracting by 0.2% on an annualised basis, due to bad weather hitting construction and consumer spending, a ports strike and the near 20% appreciation in the value of the dollar. However, it is expected to recover strongly in quarter 2 and resume its trend of making a full recovery from the financial crash. GDP growth for 2014 as a whole of 2.4% holds great promise for strong growth going forward and for further falls in unemployment. It is therefore expected that the Fed will start on the first increase in the Fed rate during 2015 and is likely to be ahead of the UK in being the first major western country to raise rates.

As for the Eurozone, the ECB fired its big bazooka in announcing 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). Deflation has also ended with a return into positive territory with an increase from 0.0% in April to +0.3% in May. In May, ten year bond yields shot up by around 50 bps after having dipped to near zero for a brief period.

CAPITA ASSET SERVICES FORWARD VIEW

Economic forecasting remains difficult with so many external influences weighing on the UK. Our Bank Rate forecasts, (and also MPC decisions), will be liable to further amendment depending on how economic data transpires over 2015. Forecasts for average earnings beyond the three year time horizon will be heavily dependent on economic and political developments. Major volatility in bond yields is likely to endure as investor fears and confidence ebb and flow between favouring more risky assets i.e. equities, or the safe haven of bonds.

The overall 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. 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.

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.

We would, however, remind clients of the view that we have expressed in our previous interest rate revision newsflashes of just how unpredictable PWLB rates and bond yields are at present. We are experiencing exceptional levels of volatility which are highly correlated to geo-political and sovereign debt crisis developments. Our revised forecasts are based on the Certainty Rate (minus 20 bps) which has been accessible to most authorities since 1st November 2012.

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

- Geopolitical risks in Eastern Europe, the Middle East and Asia, increasing safe haven flows;
- UK strong economic growth being 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;
- Monetary policy action failing to stimulate sustainable growth and to combat the threat of deflation in western economies, especially the Eurozone and Japan

The potential for upside risks to 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 in 2015, 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.

APPENDIX 3 : PRUDENTIAL INDICATORS

PRUDENTIAL INDICATOR	2015/16	2015/16	2016/17	2017/18
(1). EXTRACT FROM BUDGET				
	Original Estimate	**Forecast Outturn**	**Forecast Outturn**	**Forecast Outturn**
Gross Capital Expenditure	**£'000**	**£'000**	**£'000**	**£'000**
Non - HRA	45,505	46,442	20,273	10,140
TOTAL	45,505	46,442	20,273	10,140
Ratio of financing costs to net revenue stream				
Non - HRA	8.24%	8.24%	7.96%	7.55%
Net borrowing requirment				
brought forward 1 April *	257,823	256,079	271,939	263,595
carried forward 31 March *	272,746	271,939	263,595	253,811
in year borrowing requirement	14,923	15,860	(8,344)	(9,784)
In year Capital Financing Requirement				
Non - HRA	14,923	15,860	(8,344)	(9,784)
TOTAL	14,923	15,860	(8,344)	(9,784)
Capital Financing Requirement as at 31 March				
Non - HRA	272,746	271,939	263,595	253,811
TOTAL	272,746	271,939	263,595	253,811
Incremental impact of capital investment decisions	£ p	£ p	£ p	£ p
Increase in Council Tax (band D) per annum	35.36	35.36	5.23	0.00

PRUDENTIAL INDICATOR	2015/16	2016/17	2017/18
(2). TREASURY MANAGEMENT PRUDENTIAL INDICATORS	**£'M**	**£'M**	**£'M**
Authorised limit for external debt -			
borrowing	203	220	215
other long term liabilities	83	83	83
TOTAL	286	303	298
Operational boundary for external debt -			
borrowing	198	215	210
other long term liabilities	80	80	80
TOTAL	278	295	290
Upper limit for fixed interest rate exposure			
Principal re fixed rate borrowing	195%	190%	190%
Upper limit for variable rate exposure			
Principal re variable rate borrowing	60%	60%	60%
Upper limit for total principal sums invested for over 364 days (per maturity date)	£20m	£20m	£20m

Maturity structure of new fixed rate borrowing during 2014/15	upper limit	lower limit
under 12 months	30%	0%
12 months and within 24 months	30%	0%
24 months and within 5 years	30%	0%
5 years and within 10 years	40%	0%
10 years and above	80%	0%