ARGYLL AND BUTE COUNCIL	**PERFORMANCE REVIEW AND SCRUTINY COMMITTEE**
STRATEGIC FINANCE	**25 FEBRUARY 2016**

TREASURY MANAGEMENT MONITORING REPORT 31 DECEMBER 2015

1. EXECUTIVE SUMMARY

1.1 This report is for noting its sets out the Council's treasury management position for the period 1 November 2015 to 31 December 2015 and 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 £53.2m is currently invested.

1.3 The levels of investments have decreased slightly to £53.2m at 31 December 2015. The rate of return achieved was 0.717% which compares favourably with the target of 7 day LIBID which was 0.359%.

1.4 In December £9.5m of new borrowing was taken at 2.96% from the PWLB using the Project Rate which the Council had applied for access to in May 2015.

1.5 The net movement in external borrowing in the period was a reduction of £1.793m.

1.6 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 December 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	260,666	262,658
Net Capital Expenditure	16,371	26,707	12,776	0
Less Loans Fund Principal Repayments	(11,784)	(11,784)	(10,784)	(9,784)
Estimated CFR 31 March	**260,666**	**272,746**	**262,658**	**252,874**
Less Funded by NPDO	(78,055)	(78,055)	(76,507)	(74,961)
Estimated Net CFR 31 March	**182,611**	**194,691**	**186,151**	**177,913**
Estimated External Borrowing at 31 March	169,315	172,655	177,655	177,655
Gap	**13,296**	**22,036**	**8,496**	**258**

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 capital financing requirement at the 31 December 2015 is £182.6m. 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 £53.2m is currently invested.

	Position at 31/10/2015 £000's	Position at 31/12/2015 £000's
Loans	156,382	154,589
Internal Balances	91,668	81,229
Less Investments & Deposits	(58,370)	(53,207)
Total	**189,680**	**182,611**

Borrowing Activity

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

	Actual £000's
External Loans Repaid 1st November 2015 to 31st Decmber 2015	(11,293)
Borrowing undertaken 1st November 2015 to 31st December 2015	9,500
Net Movement in External Borrowing	**(1,793)**

4.5 New Long term Borrowing of £9.500m was taken from the PWLB at the project rate of 2.96%. Loans to the value of £1.279m were repaid to the PWLB as well as £10.014m of temporary borrowing.

4.6 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 31st October 2015	11,162	0.34%
Temp borrowing at 31st December 2015	1,148	0.30%

4.7 In May 2015 the Council applied for and received permission to borrow £9.5m from the PWLB under the Project Rate which had been made available to the Scottish Government by the UK Government. The Project Rate is set at 0.40% below the appropriate PWLB rate on the day on which the borrowing is drawn down. In December the PWLB borrowing rates had declined to a point where on the advice of our treasury advisors Capita it was felt that the Council should take the borrowing at a rate of 2.96%.

Investment Activity

4.8 The average rate of return achieved on the Council's investments to 31 December 2015 was 0.717% compared to the average LIBID rate for the same period of 0.359% which demonstrates that the Council is achieving a reasonable rate of return on its cash investments. At the 31 December 2015 the Council had £53.2m of short term investment at an average rate of 0.717%. 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**
Clydesdale Bank	Instant Access	3,697	0.50%	Short Term A-2, Long Term BBB+
Handelsbanken	35 Day Notice	5,000	0.55%	Short Term A-1+, Long Term AA-
Bank of Scotland	Instant Access	10	0.40%	Short Term A-1, Long Term A
Bank of Scotland	175 Day Notice	5,000	0.80%	Short Term A-1, Long Term A
Goldman Sachs	05/02/2015	5,000	0.775%	Short Term A-1, Long Term A
Santander	95 Day Notice	5,000	0.900%	Short Term A-1, Long Term A
Helaba Landesbank	31/08/2016	5,000	1.03%	Short Term A-1+, Long Term AA-
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+
CD - Standard Chartered	22/04/2016	5,000	0.820%	Short Term A-1, Long Term A
MMF - BNP Paribas	Instant Access	5,000	0.490%	AAA
MMF - Federated	Instant Access	4,500	0.490%	AAA
MMF - Legal & General	Instant Access	0	0.486%	AAA
MMF - Blackrock	Instant Access	0	0.438%	AAA
MMF - Standard Life (Formerly IGNIS)	Instant Access	0	0.499%	AAA
Total		**53,207**		

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 December 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 £53.2m is currently invested. The investment returns were 0.717% which is above the target of 0.359%.

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 December 2015:
  - The economic recovery regain some momentum during Q4 2015 after a disappointing Q3 2015;
  - Household spending growth strengthened;
  - Wage growth slowed despite further falls in unemployment;
  - The UK came out of its brief dip into deflation;
  - The prospect of a rate hike before mid-2016 remained unlikely;
  - The Fed made a start in raising interest rates, and the ECB loosened policy;
  - The Chancellor smoothed out his fiscal austerity plans over the term of this Parliament.

- The economic recovery was shown to have slowed by more than previously thought in Q3 2015 (quarter ended 30.9.15), with real GDP growth decelerating from a downwardly-revised 0.5% in Q2 (from 0.7%) to 0.4% (from 0.5%). The annual growth rate in Q3 was also revised down from 2.3% to 2.1%. The revisions were driven largely by weaker contributions from investment expenditure.
- The latest survey evidence and official monthly data suggest that the recovery picked up pace again during the final quarter of 2015. In addition to the CBI's Composite Growth Indicator pointing to greater economic expansion in Q4 2015, the Markit/CIPS composite PMI is consistent with quarterly GDP growth strengthening to about 0.6%, which would imply 2.2% GDP growth in 2015 as a whole. Q3's unusually weak contribution of construction output to overall GDP is also likely to have been reversed in Q4.
- Consumer spending will probably have provided a significant boost, given that retail sales experienced what was almost certainly their strongest quarter this year in Q4. (In fact, it would take over a 2% monthly plunge in sales volumes in December for Q4's quarterly growth rate to not be the strongest.) Spending off the high street looks to have fared well too, in part owing to consumer confidence remaining high. Survey measures such as the CBI's consumer services business volumes balance indicate that annual growth in real household spending on consumer services could have risen in Q4 from 1.6% to as much as 3%.

- The jobs recovery pressed on in Q3, as employment rose by 176,000, and by a further 91,000 in October, pushing the employment rate up to a record-high. Consequently, the ILO unemployment rate was driven down for four successive months between July and October, from 5.6% to 5.2%

– a level not far above some estimates of its natural rate. However, by taking a wider perspective on labour market slack, we do not believe the labour market is as tight as these data alone suggest. First, impressive jobs growth reflected large increases in self-employment, as well as significant numbers of new part-time jobs, rather than conventional full-time placements. Moreover, the percentage of those in part-time work wanting to work extra hours in a full-time role saw the largest upturn for 2½ years in October, and the proportion of temporary workers wanting permanent positions has been on the rise throughout the second half of the year. Meanwhile, employer surveys have shown that recruitment difficulties have either held steady or eased recently. It is, therefore, not too surprising that pay growth has weakened so much of late. Annual growth in regular pay (ex. bonuses) softened to just 1.9% at the beginning of Q4, in contrast to 2.5% in the last quarter.

- These labour market figures will have reassured MPC doves that inflationary pressures remain muted, thereby reinforcing expectations that a rate rise is still some way off. Only recently the newest MPC member, Gertjan Vlieghe, stressed that he needs to see a decisive acceleration of wage growth before considering voting for a rate hike. And weak inflationary pressures from the labour market have been compounded by renewed falls in the energy prices in reinforcing the case to keep rates on hold for a while yet. The sterling price of Brent Crude fell below £24 per barrel in December, and wholesale gas and electricity prices fell further too. While it looks like the UK's brief flirtation with deflation in 2015 came to an end in November – CPI inflation nudged back into positive territory at 0.1% – inflation will remain below target for a long while yet. Despite these disinflationary pressures, inflation will pick up in coming months as the previous, (sharper), falls in oil prices will drop out of the calculation of the annual figure.

- Given this, as well as the monetary policy actions of the Fed and the ECB at the end of the fourth quarter, the Bank of England is now playing 'piggy in the middle' between tightening in the US and further loosening in the euro-zone. The US FOMC commenced its rate "lift off" in December in response to a "considerable improvement" in labour market conditions. In contrast, the ECB Governing Council cut its deposit facility rate by 10bps to -0.3%, and extended (not expanded) its QE programme to March 2017 from September 2016. However, the Council failed to live up to its own hype by failing to follow through on its own dovish signals with a more extensive policy loosening. But as the temporary boosts from the substantial falls in the oil price and the strength of the euro fade in 2016, we expect the ECB will have to expand its QE programme by Q2 2016.

- Turning to the public finances, the Chancellor delivered his Spending Review and Autumn Statement in November. Due to the OBR "finding" another £27bn of savings over the forecast period, from changing various forecasts and modelling assumptions, Mr Osborne was allowed to reverse his tax credits cuts, and to pursue a more balanced path of consolidation over the parliament. But while the profile and pace of cuts have eased a little, the intensity of the consolidation package as a whole is not that different to the one presented in July's Budget, and remains far more austere than those faced in other advanced economies. The OBR forecasts that Mr Osborne will achieve a £10bn budget surplus in 2019-20 and that net debt as a percentage of GDP will fall in every year of the Parliament.

- However, November's public finance figures now indicate that an overshoot of the borrowing target for this fiscal year is likely. On the other hand, since we think the OBR is too cautious about the scope for productivity and GDP growth to bounce back, it is quite possible that the Chancellor actually ends up reaching his £10bn budget surplus earlier than the current OBR forecast. The big picture is still that austerity will be renewed in 2016, although we think that the economic recovery should be able to weather this relatively well.
- Finally, the FTSE 100 rose by 3% between end-Q3 and end-Q4. However, UK equity prices were still down by 5% over the year as a whole. By comparison, global equities rose over 4% in Q4, and fell by 4.5% over 2015 as a whole. Meanwhile, on a trade-weighted basis, sterling weakened by around 0.4% over Q4. This left it around 3% higher than the start of the year.

Appendix 2

Interest Rate Forecast:

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

Post Bank of England Inflation Report November 2015

- There has been little change in our forecasts since our previous forecasts in May and August. We have left unchanged the start of the increases in Bank Rate at quarter 2 of 2016 despite all the media interpretation that the Bank of England Inflation Report means that Bank Rate is not now expected to go up for eighteen months until quarter 2 2017. We have, however, reduced our forecasts for average investment earnings beyond 2018/19 to reflect a slower expected rate of rise in Bank Rate over a longer timeframe.
- The so called ‘super Thursday’ in the first week of November dumbfounded forecasters’ expectations with what was seen to be a very dovish view of inflation risks. This effectively meant that the MPC could go on holiday for all of 2016 as there would be no decision making to do to change Bank Rate! This was met with disbelief by most forecasters, the majority of whom have left their forecasts for quarter 2 2016 unchanged as the first increase in Bank Rate. This begs the question as to whether the Inflation Report has been correctly interpreted.
- In his press conference, Mark Carney focused on the need to balance two fundamental forces – domestic UK strength and foreign weakness. In terms of domestic strength, shaving one hair’s breadth of 0.1% off growth rate forecasts for 2015, 2016 and 2017 to 2.7%, 2.5% and 2.6% respectively would struggle to provide any justification for a huge shift in Bank Rate forecasts. Rather, these forecasts indicate a continuation of a trend of almost equally strong growth from that in 2013-2015 which has been dependent on strong domestic demand in the face of weak exporting. It should be borne in mind that despite the austerity programme over the last Parliament, a deficit reduction of 5% of GDP was achieved at the same time as strong growth over the last three years. A further reduction of the deficit of 5% of GDP is also planned for the next five years.
- So this leaves the Bank’s warning over its concerns for emerging market countries as the main change since the previous Inflation Report; this may in part reflect the concerns of the Bank’s chief economist, Andy Haldane, who recently warned that China's sharp stock market falls could prove the start of a third act of the global financial crisis which started in 2008. Although such concerns did cause the Fed to pull back from making a start

on raising rates at its September meeting, by the date of its December meeting, concerns had subsided and so the Fed made that first start on increasing rates.

- However, the key to MPC decision making will always be inflation. The latest Inflation Report indicated that inflation was currently expected to struggle to get barely over 2% at the end of the 2 to 3 year time horizon assuming that Bank Rate did not go up until Q2 2017. However, once the falls in oil, gas and food prices over recent months fall out of the 12 month calculation of CPI, there will be a sharp tick up from the current zero rate to around 1% in the second half of 2016. In addition, increases at the three year horizon were the biggest in a decade and at the two year horizon were the biggest since February 2013. However, forecasting inflation two to three years out requires many subsidiary assumptions, particularly on what will happen to pay inflation as the unemployment rate continues to fall? But that then needs to be offset by the net effect on gross pay inflation of increases in productivity. Then you need to forecast which way already very low unemployment figures and already high vacancy numbers will go and the overall impact on the amount of 'spare capacity'. Add to the mix further austerity measures kicking in during the term of this Parliament and determining which way consumer confidence will go, and you will end up with a 'range of views among MPC members about the balance of risks to inflation', as stated in the Inflation Report. Accordingly there is huge room for MPC perceptions of where inflation will be 2-3 years out to vary over the next year.

- The overall view of the Interest Rate Strategy Group is that given the current trend of economic statistics, there is little justification for changing to the prevalent market view that there will not be an increase in Bank Rate for eighteen months until Q2 2017. Such a view would only be warranted by a major downturn in world or UK growth and / or if there is a significant decline in inflationary pressures e.g. from such factors as a sharp increase in the pace of replacement of workers by computers and robots automating work. At the current time, these would be major assumptions. Accordingly, we have opted to leave our central forecast for a first increase in Bank Rate unchanged at Q2 2016 but there are downside risks to our current forecast for the timing of the first increase.

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 the next year. 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.

We have pointed out consistently that the Fed. rate is likely to go up both sooner and at a sharper rate than Bank Rate in the UK. These increases will have corresponding effects in pushing up US Treasury and UK gilt yields. While there is normally a high degree of correlation between the two yields, we would expect to see a decoupling of yields between the two i.e. we would expect US yields to go up faster than UK yields. We will monitor this area and the resulting effect on PWLB rates.

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 currently include:

- Geopolitical risks in Eastern Europe, the Middle East and Asia, increasing safe haven flows.
- UK economic growth is 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 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 commencement by the US Federal Reserve of increases in the Fed. funds rate in the near future, 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				
	Forecast Outturn	**Original Estimate**	**Forecast Outturn**	**Forecast Outturn**
Capital Expenditure	**£'000**	**£'000**	**£'000**	**£'000**
Non - HRA	34,325	45,505	20,273	10,140
TOTAL	34,325	45,505	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 *	256,079	257,823	272,746	262,658
carried forward 31 March *	260,666	272,746	262,658	252,874
in year borrowing requirement	4,587	14,923	(10,088)	(9,784)
In year Capital Financing Requirement				
Non - HRA	4,587	14,923	(10,088)	(9,784)
TOTAL	4,587	14,923	(10,088)	(9,784)
Capital Financing Requirement as at 31 March				
Non - HRA	260,666	272,746	262,658	252,874
TOTAL	260,666	272,746	262,658	252,874
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%