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

STRATEGIC FINANCE | **26 MAY 2016**

TREASURY MANAGEMENT MONITORING REPORT 31 MARCH 2016

1. EXECUTIVE SUMMARY

1.1 This report is for noting and sets out the Council's treasury management position for the period 1 February 2016 to 31 March 2016 and includes information on:

- Overall Borrowing Position
- Borrowing Activity
- Investment Activity
- Economic Background
- Interest Rate Forecast
- Prudential Indicators.

1.2 Borrowing is below the Capital Financing Requirement for the period to 31 March 2016, however, there are substantial internal balances, of which £46.4m is currently invested.

1.3 The levels of investments have decreased slightly to £46.4m at 31 March 2016. The rate of return achieved was 0.759% which compares favourably with the target of 7 day LIBID which was 0.363%.

1.4 Temporary borrowing was taken during the period 1 February 2016 to 31 March 2016 of £7m to ensure liquidity of funds over the year end.

1.5 The net movement in external borrowing in the period was an increase of £3.5m.

TREASURY MANAGEMENT MONITORING REPORT 31 MARCH 2016

2. INTRODUCTION

2.1 This report summarises the monitoring as at 31 March 2016 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	257,556	257,823	253,166	260,277
Net Capital Expenditure	7,723	26,707	18,282	4,166
Less Loans Fund Principal Repayments	(10,236)	(9,907)	(9,236)	(8,236)
Less: NPDO Repayment	(1,877)	(1,877)	(1,935)	(2,008)
Estimated CFR 31 March	**253,166**	**272,746**	**260,277**	**254,199**
Less Funded by NPDO	(75,944)	(78,055)	(74,058)	(72,051)
Estimated Net CFR 31 March	**177,222**	**194,691**	**186,219**	**182,148**
Estimated External Borrowing at 31 March	158,090	172,655	169,589	169,589
Gap	**19,132**	**22,036**	**16,630**	**12,559**

4.2 Borrowing is 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.

4.3 The Council's estimated net capital financing requirement at the 31 March 2016 is £177.2m. 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 £46.4m is currently invested.

	Position at 31/01/2016 £000's	Position at 31/03/2016 £000's
Loans	154,589	158,090
Internal Balances	81,200	65,570
Less Investments & Deposits	(55,442)	(46,438)
Total	**180,347**	**177,222**

Borrowing Activity

4.4 The table below summarises the borrowing and repayment transactions in the period 1 February 2016 to 31 March 2016.

	Actual £000's
External Loans Repaid 1st February 2016 to 31st March 2016	(3,500)
Borrowing undertaken 1st February 2016 to 31st March 2016	7,000
Net Movement in External Borrowing	**3,500**

4.5 The external borrowing of the Council increased by £3.5m during the period as £7m of short term borrowing was undertaken for cash flow purposes to ensure that adequate liquidity was maintained over the year end.

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 January 2016	1,148	0.30%
Temp borrowing at 31st March 2016	7,649	0.45%

Investment Activity

4.7 The average rate of return achieved on the Council's investments to 31 March 2016 was 0.759% compared to the average LIBID rate for the same period of 0.363% which demonstrates that the Council is achieving a reasonable rate of return on its cash investments. At the 31 March 2016 the Council had £46.4m of short term investment at an average rate of 0.759%. 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	678	0.50%	Short Term A-2, Long Term BBB+
Handelsbanken	35 Day Notice	0	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
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 A
Credit Inductrial et Commercial	07/07/2016	5,000	0.760%	Short Term A, Long Term A-1
CD - Totonto Dominion	12/01/2017	5,000	0.970%	Short Term A-1+, Long Term AA-
CD - Standard Chartered	22/04/2016	5,000	0.820%	Short Term A-1, Long Term A
CD - National Australia Bank	04/11/2016	5,000	0.760%	Short Term A-1+, Long Term AA-
MMF - BNP Paribas	Instant Access	5,000	0.000%	AAA
MMF - Federated	Instant Access	5,000	0.535%	AAA
MMF - Legal & General	Instant Access	0	0.000%	AAA
MMF - Blackrock	Instant Access	0	0.000%	AAA
MMF - Standard Life (Formerly IGNIS)	Instant Access	0	0.000%	AAA
MMF 0 Insight	Instant Access	750	0.464%	AAA
Total		**46,438**		

4.8 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.

4.9 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.

Economic and Interest Rate Forecasts

4.10 The economic background at 31 March 2016 is shown in appendix 1 with the interest rate forecast in appendix 2.

Prudential Indicators

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

5. CONCLUSION

5.1 Borrowing is below the Capital Financing Requirement for the period to 31 March 2016, however, there are substantial internal balances, of which £46.4m is currently invested. The investment returns were 0.759% which is above the target of 0.363%.

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 March 2016:
  - The economic recovery struggled for momentum;
  - Household spending remained the primary driver of growth;
  - Soft pay growth was still at odds with a tightening labour market;
  - Falling energy prices helped to keep inflation low;
  - The prospect of a rate hike before late 2016 remained unlikely;
  - The Fed held interest rates unchanged;
  - The ECB embarked on further quantitative easing;
  - The Chancellor pencilled in even more fiscal austerity in 2019/20.
- The economic recovery had a little more momentum than previously thought in Q4 2015, with real GDP growth revised upwards from 0.5% q/q to 0.6% and the annual growth rate from 2.2% to 2.3%. Quarterly growth was higher than in Q3, as the drag from net trade eased significantly. But the imbalances in the economy worsened, with the current account the largest on record at 7.0% of GDP and the savings ratio at an all-time low. Recent surveys suggest that the recovery may have lost some pace in Q1. For example, the Markit/CIPS composite PMI is consistent with quarterly GDP growth weakening to a relatively subdued 0.3%, while the CBI's composite growth indicator points to a marked slowdown in the pace of economic growth in Q1.
- The official data available for Q1 2016 so far generally corroborate the picture painted by the surveys. Construction output, which had increased in Q4, fell by 0.2% on the month in January. While industrial production and the index of services both increased at the start of the year, they both rose by only 0.2% compared to the previous month.
- However, the consumer recovery is still going strong, with household spending the main driver of economic growth. Although the pace of retail sales growth moderated a little in February's data, annual growth in sales volumes remains a respectable 3.8%. And while survey measures of spending away from the high street, such as the CBI's consumer services sales volumes balance and the Bank of England's agents' scores of consumer services turnover, have ticked down in recent months, both remain comfortably above their post-crisis averages. What's more, the GfK/NOP consumer confidence balance for major purchases remains at a level consistent with a significant pick-up in annual growth of spending on durable goods.

- The jobs recovery has continued, with employment rising by 116,000 in the three months to January on the previous three months. Admittedly, this represents a slowdown from 206,000 in December, but it was enough to keep the ILO unemployment rate at 5.1%. This is a post-crisis low and only a touch above the Bank of England's 5.0% estimate of the natural rate (i.e. the rate at which further falls become incompatible with the inflation target). The timelier claimant count measure showed unemployment falling further in February. While annual growth in regular pay (ex. bonuses) ticked up to 2.2% at the start of the year, wage growth is still subdued by past standards. This is rather at odds with the tightening labour market.
- However, it still appears that the labour market is probably not as tight as the unemployment rate alone suggests. The recent strength of jobs growth has partly relied on rises in self-employment. Indeed, self-employment accounted for almost a quarter of the new jobs created in the three months to January. Also, the proportion of part-time workers who would prefer a full-time role remained elevated in January, while the Bank of England's agents' scores for recruitment difficulties eased.
- Given the recent weakness in productivity growth, unit labour costs are now growing at around 2%. But MPC members have previously suggested that they may need to see growth above 2% to offset weaker import prices. What's more, Governor Carney has suggested that he would also like to see quarterly GDP growth above trend rates (of about 0.6%) and higher core inflation before voting for a rate rise. So with little progress on these fronts either, a rate hike in the near term remains unlikely.
- Indeed, the lack of inflationary pressures from outside the labour market only serves to reinforce this view. Despite rising to 0.3% so far this year from an average of 0.1% in Q4, CPI inflation is still far below the Bank of England's 2% target. The price of Brent crude has weakened further this year, dipping below £23pb, which has helped to keep inflation low. And price cuts announced by four major gas suppliers will start to weigh on inflation in March and April. While we do expect inflation to pick up this year as last year's sharp falls in oil and food prices drop out of the annual comparison, and the effect of sterling's appreciation between mid-2013 and mid-2015 fades, the bigger picture is that it is likely to return to target only very slowly. Accordingly, we don't expect the MPC to vote to raise interest rates until around November this year.
- Like the Bank of England, the Fed kept interest rates unchanged in Q1, citing risks associated with recent "global economic and financial developments". Also, FOMC members now expect only two rate hikes in the US this year, compared to four back in December, despite the fact that their inflation projections are largely unchanged.

- After disappointing markets with limited stimulus measures late last year, the ECB Governing Council announced a bumper package in March. It expanded monthly asset purchases from €60bn to €80bn, cut the deposit rate to -0.4% and created new targeted measures for lending to eurozone banks. Nonetheless, the euro actually strengthened shortly afterwards, as markets reacted adversely to comments by President Draghi suggesting that interest rates might not fall any further.

- Turning to the public finances, the Chancellor delivered his Budget in March against the backdrop of downwardly revised OBR forecasts for economic growth. In order to repair the damage to his chances of achieving his fiscal target of a budget surplus in 2019/20, Mr Osborne shifted the timing of corporation tax payments, brought forward investment spending to earlier in the parliament and pencilled in £3.5bn of unspecified departmental spending cuts in 2019/20.

- Timing issues aside, the measures announced in the Budget confirmed that the fiscal tightening is set to intensify this year. The government's consolidation package was already far more austere than those faced in other advanced economies and the new measures included in the Budget add a further net fiscal takeaway of £6.1bn over the next five years as a whole. Admittedly, our GDP forecasts are rather more optimistic than the OBR's, and if realised would suggest that the Chancellor won't have to implement quite as much austerity as his current plans imply in order to hit his target. However, this probably won't become clear for a while and in the meantime the fiscal stance is set to tighten markedly, increasing to 0.9% of GDP in 2016/17.

- Finally, after steep falls in January and February, the FTSE 100 rebounded and ended Q1 just 2% below its level at the start of the year. By comparison, global equities were down by around 1% over the course of Q1. Meanwhile, on a trade-weighted basis, sterling weakened by around 6% in Q1, with worries over the possible impact of a Brexit in particular appearing to weigh on the pound.

Appendix 2

Interest Rate Forecast:

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

Market Volatility Likely to be an On-going Feature in the Near-Term

- Since the start of 2016, the global economic data releases have been disappointing in the main. This has been fuelled by a weaker economic performance by China, a continuation of price pressures on commodities and oil in particular, and a re-pricing of credit risk in respect of major financial institutions.

- Forecasting in such a volatile environment of course means that further adjustments may be necessary in the short-term, but for now our revised forecast has pushed back the timing of the start of increases in Bank Rate to quarter 1 2017. The pace of increases thereafter has remained slow and gradual. Our PWLB forecasts similarly now reflect a slower pace of increase, reflecting not only the market unease but also the prospect of inflation remaining in the zero to 1% range for longer than previously anticipated. This view is in keeping with the inflation forecasts contained within the Bank of England's February Inflation Report.

- All of the above is broadly in line with Bank of England Governor Carney's Queen Mary College speech, made in January, which definitively ruled out an increase in Bank Rate until the following three criteria had been met:

    1. Quarter-on-quarter GDP growth is above 0.6% i.e. using up spare capacity. This condition was met in Q2 2015, but Q3 and Q4 came up short.
    2. Core inflation (stripping out most of the effect of decreases in oil prices), registers a concerted increase towards the MPC's 2% target. This measure has been on a steadily decreasing trend since mid-2014, reaching 1.4% in February 2016.
    3. Unit wage costs are on a significant increasing trend (and above increases in productivity). This would imply that spare capacity for increases in employment and productivity gains are being exhausted, and that further economic growth will fuel inflationary pressures.

- This downturn in world economic prospects has also led to the Fed quickly becoming much more cautious about further increases in the Fed rate after its initial increase in December 2015. Instead of four expected increases in 2016, most forecasters now expect no more than two. However, if economic statistics were to take a turn for the worse, even two could be in doubt. At the current time, though, robust increases in domestic consumer demand and employment are providing solid under pinning for a continuation of a reasonable rate of economic growth while inflationary pressures also appear to be subdued.

- Confidence is another big issue to factor into all forecasting. On-going volatility in financial markets could dampen investment decision making as corporates take a more cautious view of prospects in the coming years due to international risks. This could also impact via a slowdown in increases in employment. The upcoming Brexit referendum could also dampen investment decision making. However, consumers will be enjoying the increase in disposable incomes as a result of falling prices of fuel, food and other imports from emerging countries, so this could well feed through into an increase in consumer expenditure and demand in the UK economy. .

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 and developments in financial markets transpire 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. An eventual world economic recovery may also see investors switching from the safe haven of bonds to equities in contrast to recent market activity which saw the FTSE100 drop to 5500 during the last quarter and gilt yields again reach the lows last seen in 2013 and 2014.

We have pointed out consistently that the Fed. rate is likely to go up more quickly and more strongly than Bank Rate in the UK and recent events have not changed that view, just that the timing of such increases in the US may well have been deferred and the pace slowed until calmer waters return. While there is normally a high degree of correlation between Treasury and gilt yields, we would expect to see a decoupling of bond yields between the two countries i.e. we would expect US yields to go up faster than UK yields. We will need to monitor this area closely and the resulting effect on PWLB rates.

The overall balance of risks to economic recovery in the UK remains to the downside. Although economic growth remains relatively steady, only time will tell whether some of the global headwinds sap some of the strength from the UK's future growth.

We would, as always, remind clients of the view that we have expressed in our previous interest rate forecasts of just how unpredictable PWLB rates and bond yields are at present. We are experiencing exceptional levels of volatility which are highly correlated to emerging market, 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:

- Emerging country economies, currencies and corporates destabilised by falling commodity prices and / or Fed. rate increases, causing a further flight to safe havens (bonds).
- Geopolitical risks in Europe, the Middle East and Asia, increasing safe haven flows.
- UK economic growth and increases in inflation are weaker than we currently anticipate.
- Weak growth or recession in the UK's main trading partners - the EU and US.
- 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 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 pace and timing 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.

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	28,044	45,505	39,359	27,326
TOTAL	28,044	45,505	39,359	27,326
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 *	257,556	257,823	253,166	260,277
carried forward 31 March *	253,166	272,746	260,277	254,199
in year borrowing requirement	(4,390)	14,923	7,111	(6,078)
In year Capital Financing Requirement				
Non - HRA	(4,390)	14,923	7,111	(6,078)
TOTAL	(4,390)	14,923	7,111	(6,078)
Capital Financing Requirement as at 31 March				
Non - HRA	253,166	272,746	260,277	254,199
TOTAL	253,166	272,746	260,277	254,199
Incremental impact of capital investment decisions	£ p	£ p	£ p	£ p
Increase in Council Tax (band D) per annum	35.36	35.36	5.23	9.13

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%