TREASURY MANAGEMENT UPDATE FOR QUARTER 1, 2014

To:	**Governance and Audit Committee – 24 September 2014**
Main Portfolio Area:	**Finance**
By:	**Capital & Treasury Finance Officer**
Classification:	**Unrestricted**

Summary: **This report is to update the Governance and Audit Committee with the Treasury Management activity that has occurred for the quarter ended 30th June 2014.**

For Decision

1.0 Introduction and Background

1.1 The CIPFA (Chartered Institute of Public Finance and Accountancy) Code of Practice for Treasury Management recommends that Members be updated on treasury management activities regularly (TMSS, annual and mid year reports). This report therefore ensures this council is implementing best practice in accordance with the Code.

2.0 Economic Background for the Quarter Ended 30 June 2014 (issued by the Council's treasury advisor, Capita Asset Services (Capita), on 3 July 2014)

2.1 After strong UK Gross Domestic Product (GDP) growth of 0.7%, 0.8% and 0.7% in quarters 2, 3 and 4 respectively in 2013, and 0.8% in Q1 2014, it appears very likely that strong growth will continue into 2014 as forward surveys are very encouraging. There are also positive indications that recovery is starting to broaden away from reliance on consumer spending and the housing market into construction, manufacturing, business investment and exporting. This strong growth has resulted in unemployment falling much faster through the threshold of 7%, set by the Monetary Policy Committee (MPC) last August, before it said it would consider any increases in Bank Rate. The MPC has, therefore, now broadened its forward guidance by adopting five qualitative principles and looking at a much wider range of about eighteen indicators in order to form a view on how much slack there is in the economy and how quickly slack is being used up. Accordingly, markets are expecting a first increase around the end of 2014.

2.2 Also encouraging has been the sharp fall in the Consumer Price Index measure of inflation (CPI), reaching 1.5% in May, the lowest rate since 2009. Forward indications are that inflation is likely to fall further in 2014 to possibly 1%. The return to strong growth has also helped lower forecasts for the increase in Government debt by £73bn over the next five years, as announced in the Autumn

Statement, and by an additional £24bn, as announced in the March 2014 Budget - which also forecast a return to a significant budget surplus, (of £5bn), in 2018-19. However, monthly public sector deficit figures have disappointed in this quarter.

2.3 In June, the Federal Reserve continued with its monthly $10bn reductions in asset purchases, which started in December 2014. Monthly asset purchases have now fallen from $85bn to $35bn and are expected to stop by Q3 2014, providing strong economic growth continues this year. First quarter GDP figures were depressed by exceptionally bad winter weather, but growth rates since then look as if they are recovering well.

2.4 The Eurozone (EZ) is facing an increasing threat from deflation. In May, the inflation rate fell further, to reach 0.5%. However, this is an average for all EZ countries and includes some countries with negative rates of inflation. Accordingly, the European Central Bank (ECB) did take some rather limited action in June to loosen monetary policy in order to promote growth.

3.0 Capita's Interest Rate Forecast (issued by Capita on 3 July 2014)

3.1 The Council's treasury advisor, Capita Asset Services (Capita), has provided the following forecast:

	Sep-14	Dec-14	Mar-15	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17
Bank rate	0.50%	0.50%	0.75%	0.75%	1.00%	1.00%	1.25%	1.25%	1.50%	1.75%	2.00%	2.00%
5yr PWLB rate	2.70%	2.80%	2.90%	3.00%	3.00%	3.10%	3.20%	3.30%	3.30%	3.40%	3.50%	3.60%
10yr PWLB rate	3.70%	3.70%	3.80%	3.90%	4.00%	4.00%	4.10%	4.20%	4.20%	4.30%	4.40%	4.40%
25yr PWLB rate	4.40%	4.40%	4.50%	4.60%	4.70%	4.70%	4.80%	4.80%	4.90%	4.90%	4.90%	5.00%
50yr PWLB rate	4.40%	4.40%	4.50%	4.60%	4.70%	4.70%	4.80%	4.80%	4.90%	4.90%	4.90%	5.00%

3.2 Capita Asset Services undertook a review of its interest rate forecasts in May, after the Bank of England's Inflation Report. However, more recent developments to the Bank of England's forward guidance have necessitated a second updating in this quarter carried out on 30 June. This latest forecast now includes a first increase in Bank Rate in quarter 1 of 2015 (previously quarter 4 of 2015).

4.0 Capita's Summary Outlook (issued by Capita on 3 July 2014)

4.1 Until 2013, the economic recovery in the UK since 2008 had been the worst and slowest recovery in recent history. However, growth rebounded during 2013 and the first quarter of 2014 to surpass all expectations, propelled by recovery in consumer spending and the housing market. Forward surveys are currently very positive in indicating that growth prospects are also strong for the rest of 2014, not only in the UK economy as a whole, but in all three main sectors, services, manufacturing and construction. This is very encouraging as there does need to be a significant rebalancing of the economy away from consumer spending to construction, manufacturing, business investment and exporting in order for this start to recovery to become more firmly established. One drag on the economy has been that wage inflation has been significantly below CPI inflation, so disposable income and living standards were being eroded, (although income tax cuts had ameliorated this to some extent). However, recent falls in inflation have created the potential for the narrowing of this gap and it could narrow further during this year, especially if there is also a recovery in growth in labour productivity (leading to increases in pay rates). With regard to the US, the main world economy, it faces similar debt problems to those of the UK, but thanks to reasonable growth, cuts in government expenditure and tax rises, the annual government deficit has been halved from its peak without appearing to do too much damage to growth, although labour force participation rates remain lower than ideal.

4.2 As for the Eurozone, concerns subsided considerably during 2013. However, sovereign debt difficulties have not gone away and major issues could return in respect of any countries that do not dynamically address fundamental issues of low growth, international uncompetitiveness and the need for overdue reforms of the economy, (as Ireland has done). It is, therefore, possible over the next few years that levels of government debt to GDP ratios could continue to rise. This could mean that sovereign debt concerns have not disappeared but, rather, have only been postponed.

5.0 Capita's forward view (issued by Capita on 3 July 2014)

5.1 Capita would remind clients of the view that it expressed in its previous interest rate revision newsflashes of just how unpredictable Public Works Loan Board (PWLB) rates and bond yields are as we are experiencing volatility which is highly correlated to geo-political developments.

5.2 As there remain the threat of potential risks from a number of sources caution must be exercised in respect of all interest rate forecasts at the current time. The general expectation for an eventual trend of gently rising gilt yields and PWLB rates is predicted to remain unchanged, as market fundamentals will focus on the improved UK economic performance as well as issues such as the sheer volume of UK gilt issuance (and also US Treasury issuance) and the price of those new debt issues. Negative (or positive) developments on the geo-political front as well as any fresh issues regarding an EZ-related sovereign debt crisis could significantly impact safe-haven flows of investor money into UK, US and German bonds and produce shorter term movements away from Capita's central forecasts.

5.3 Capita's interest rate forecast is based on an initial assumption that we will not be heading into a major resurgence of the EZ debt crisis, or a break-up of the EZ, but rather that there will be a managed, albeit painful and tortuous, resolution of the debt crisis where EZ institutions and governments eventually do what is necessary - but only when all else has been tried and failed. Under this assumed scenario, growth within the EZ will be tepid for the next couple of years and, therefore, has the potential to dampen UK growth, as the EU is our biggest export market.

5.4 Capita's PWLB forecasts are based around a balance of risks. However, Capita would flag up the potential for upside risks, especially for longer term PWLB rates, as follows:-

- A further surge in investor confidence that robust world economic growth is firmly expected, causing a greater flow of funds out of bonds and into equities.
- UK inflation being significantly higher than in the wider EU and US, causing an increase in the inflation premium inherent to gilt yields.

5.5 Downside risks currently include:

- The situation over Ukraine poses a major threat to EZ and world growth if it was to deteriorate into "economic warfare" between the West and Russia, where Russia resorted to using its control over gas supplies to Europe. Heightened political risks in the Middle East and East Asia could also trigger safe haven flows back into bonds.
- A failure to rebalance UK growth towards exporting and business investment causing a weakening of overall economic growth beyond 2014.
- A resurgence of the EZ sovereign debt crisis caused by on-going deterioration in government debt to GDP ratios.
- Recapitalising of European banks requiring more government financial support.
- Lack of support by populaces in Eurozone countries for austerity programmes, especially in countries with very high unemployment rates e.g. Greece and Spain, which still face huge challenges in engineering economic growth to correct their budget deficits on a sustainable basis.
- Monetary policy action failing to stimulate sustainable growth in western economies, especially the Eurozone and Japan.
- There are also increasing concerns about the reluctance of western economies to raise interest rates significantly for some years. This plus the huge quantitative easing (QE) measures which remain in place (and may be added to by the ECB in the near future), has created potentially unstable flows of liquidity searching for yield and therefore heightened the potential for an increase in risks in order to get higher returns. This is a return of the same environment which led to the 2008 financial crisis.

6.0 Annual Investment Strategy

6.1 The Treasury Management Strategy Statement (TMSS) for 2014/15, which includes the Annual Investment Strategy, was approved by the Council on 6 February 2014. It sets out the Council's investment priorities as being:

- Security of capital;
- Liquidity; and
- Yield.

6.2 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 it is considered appropriate to keep investments short term to cover cash flow needs, but also to seek out value available in periods up to 370 days with highly credit rated financial institutions, using Capita's suggested creditworthiness approach including sovereign credit rating and Credit Default Swap (CDS) overlay information provided by Capita.

6.3 Officers can confirm that the approved limits within the Annual Investment Strategy were not breached during the quarter ended 30th June 2014. This is on the understanding that the country restrictions on banks/investments (no more than £4m to be placed with any non-UK country which must have a minimum sovereign long term rating of AAA) do not apply to money market funds (including enhanced money market funds). The Council only invests in sterling denominated money market funds (including enhanced money market funds); there being nine such funds that the Council currently uses.

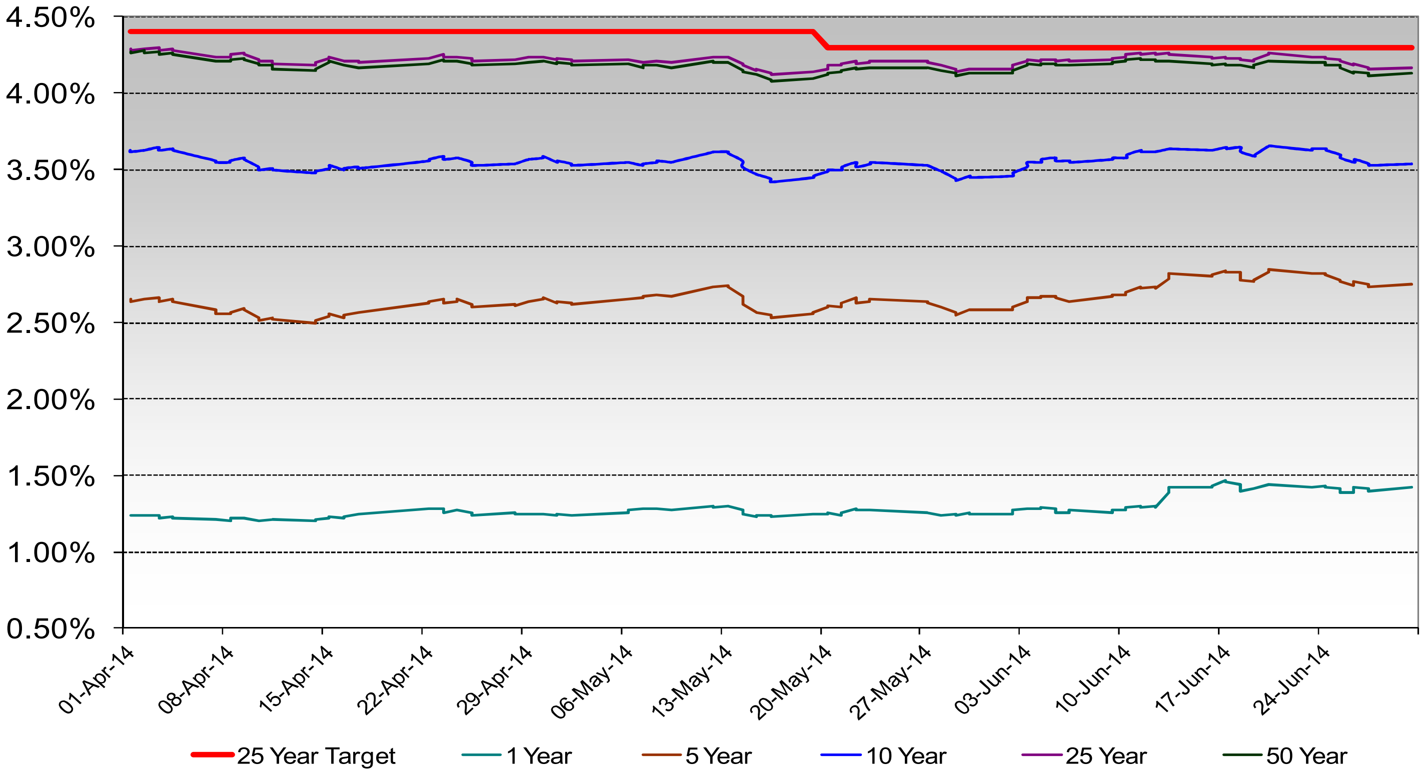
6.4 In July 2014 the Council opened an additional account with Santander UK plc (90 day notice account) to provide extra yield, subject to security and liquidity considerations as per section 6.1 above.

7.0 New Borrowing and Debt Rescheduling

7.1 Capita's target rate for the 25 year PWLB certainty rate for new long term borrowing for the quarter remained at 4.40% until 19 May when it fell to 4.30%. No new borrowing was undertaken during the quarter by the Council.

PWLB certainty rates, quarter ended 30th June 2014

	1 Year	5 Year	10 Year	25 Year	50 Year
Low	1.20%	2.50%	3.42%	4.12%	4.08%
Date	08/04/2014	14/04/2014	16/05/2014	16/05/2014	16/05/2014
High	1.47%	2.85%	3.66%	4.30%	4.28%
Date	17/06/2014	20/06/2014	20/06/2014	03/04/2014	02/04/2014
Average	1.29%	2.66%	3.56%	4.22%	4.18%



7.2 To minimise investment risk, the Council has reduced the overall debt liability by repaying £196k of external debt. This relates to loans which are repayable by equal instalments of principal (EIP) over the lives of these loans.

7.3 This Council has not borrowed in advance of need during the quarter ended 30th June 2014 and has not borrowed in advance in all of 2013/14.

7.4 Debt rescheduling opportunities have been limited in the current economic climate and following the increase in the margin added to gilt yields which has impacted PWLB new borrowing rates since October 2010. During the quarter ended 30th June 2014, no debt rescheduling was undertaken by the Council.

8.0 Compliance with Treasury and Prudential Limits

8.1 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.

8.2 During the financial year to date the Council has operated within the treasury and prudential indicators set out in the Council's Treasury Management Strategy Statement and in compliance with the Council's Treasury Management Practices.

9.0 Options

9.1 That the Governance and Audit Committee approves this report.

10.0 Corporate Implications

10.1 Financial and VAT

10.1.1 There are no financial or VAT implications arising directly from this report.

10.2 Legal

10.2.1 There are no legal implications arising directly from this report.

10.3 Corporate

10.3.1 This report is being brought before Members of the Governance and Audit Committee as recommended by the CIPFA Code of Practice as being best practice.

10.4 Equity and Equalities

10.4.1 There are no equality or equity issues arising directly from this report.

11.0 Recommendation

11.1 That the Governance and Audit Committee approves this report.

12.0 Decision Making Process

12.1 As per section 11.1 above.

13.0 Disclaimer

13.1 This report is a technical document focussing on public sector investments and borrowings and, as such, readers should not use the information contained within the report to inform personal investment or borrowing decisions. Neither Thanet District Council nor any of its officers or employees makes any representation or warranty, express or implied, as to the accuracy or completeness of the information contained herein (such information being subject to change without notice) and shall not be in any way responsible or liable for the contents hereof and no reliance should be placed on the accuracy, fairness or completeness of the information contained in this document.

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Annex List

None	N/A

Corporate Consultation Undertaken

Finance	N/A
Legal	N/A