REPORT TO:	Executive Board Sub-Committee
DATE:	8th September 2011
REPORTING OFFICER:	Operational Director – Finance
TITLE:	Treasury Management 2011/12 1st Quarter: April - June

1.0 PURPOSE OF REPORT

1.1 The purpose of the report is to update the Sub-Committee about activities undertaken on the money market as required by the Treasury Management Policy.

2.0 RECOMMENDED: That the report be noted

3.0 SUPPORTING INFORMATION

The following has been provided by Sector, the Council's Treasury Management advisors:

3.1 Economic Background

The second quarter of 2011 saw:

- The economic recovery struggled to regain momentum;
- Conditions on the high street deteriorated;
- Mixed signals on the strength of the labour market recovery;
- Public sector borrowing come out disappointingly high;
- The near-term outlook for Consumer Prices Index (CPI) inflation deteriorated further;
- The Monetary Policy Committee (MPC) moved away from raising interest rates;
- UK equities stayed broadly flat over the quarter and gilt yields fell;
- Economic growth slowed in the US and euro-zone.

The economic recovery had been struggling to regain momentum after underlying activity more or less stagnated between October and March. The additional bank holiday for the Royal Wedding pulled down both industrial and services output in April. But the CIPS/Markit business surveys have failed to pick up by much since. An average of the surveys over the last three months pointed to quarterly GDP growth in Q2 of just 0.3% - less than half its trend rate.

The industrial recovery appears to have lost momentum quite quickly. The CIPS/Markit manufacturing survey has fallen to a level consistent with falls in manufacturing output. The output expectations balance of the CBI industrial trends survey has fallen more modestly, but has nonetheless dropped for the past three months in a row.

Meanwhile, the consumer outlook has darkened. The pick-up in the consumer sector seen during the spring appears to have been only temporary, reflecting the good weather and extra bank holiday. Retail sales volumes fell in May, more than reversing April's increase. The CBI's distributive trades survey fell in June. And a number of well-known retailers have recently fallen into administration.

Consumers appear to be reacting to the squeeze on their real incomes. Household real disposable incomes fell by 0.8% in Q1. Inflation is outpacing average earnings by about 2.5%. Consumer confidence also fell back in June and remains consistent with further falls in consumer spending.

Meanwhile, the news on the labour market had been mixed. The Workforce Jobs measure of employment rose strongly in Q1. But the timelier Labour Force Survey measure flattened off in April and May. And the number of job vacancies continued to fall throughout the quarter. The claimant count measure of unemployment also continued to rise over the last three months. This only partly reflected a rise in the number of lone parents claiming Jobseeker's Allowance due to recent benefit changes.

The housing market continued to tread water. The number of mortgage approvals for new house purchase was broadly unchanged over the quarter at a very low level of just 46,000 or so. House prices also remained broadly flat. The Nationwide index ended the second quarter at about the same level as it ended the first.

Meanwhile, net trade looked unlikely to provide as big a contribution to GDP growth in Q2 as it did in Q1. Net trade boosted quarterly Gross Domestic Product (GDP) growth by some 1.4% in Q1. However, the trade deficit was unchanged in April compared to March.

The weakness of the economy appears to be having some adverse effect on the public finances. Borrowing in the first two months of the fiscal year totalled £27.4bn, compared to last year's £25.9bn. It is early days but, at this rate, borrowing will overshoot the Office for Budget Responsibility's (OBR) Budget full-year forecast of £122bn.

Oil prices rose but then fell back during the quarter, and so ended Q2 at $113 per barrel, close to the level seen at the end of Q1. Agricultural prices fell sharply over the past quarter.

But the near-term outlook for inflation had deteriorated further. Although CPI inflation held steady at 4.5% in May, it now looks likely to rise to 5.5% or even higher within the next few months. Food price inflation is likely to rise further. And Scottish Power announced in June a 19% rise in gas prices and 10% rise in electricity prices to take effect in August. Other utility suppliers are likely to follow suit.

Households' inflation expectations rose sharply in June. But so far, there are no signs of any pick-up in pay growth. The median pay settlement was unchanged at 2.5% in May.

Most Monetary Policy Committee members still think that the rise in inflation will only be temporary and that inflation will fall back sharply next year. So despite the worsening of the near-term inflation outlook, the weakness of the activity data has pushed most members further away from an interest rate rise.

Some members have even started to discuss the prospect of giving the economy more support. Admittedly, the hurdle for more quantitative easing will be quite high. However, it is certainly possible if the economy remains as weak as we expect.

In financial markets, the FTSE 100 finished the quarter at around 5,950 – about the same level as at the end of the first quarter. This was broadly in line with international stock markets – the S&P500 was also little changed over the period. Ten year gilt yields fell from 3.69% to 3.38% on the back of a drop in interest rate expectations. At the end of March, markets were expecting interest rates to have risen by this July. But now they expect rates to stay on hold until July next year. Meanwhile, sterling was broadly unchanged against the dollar at about $1.60, and fell only a touch against the euro.

In the US, the recovery also appears to have lost a significant amount of momentum. The ISM manufacturing index fell sharply in May and reversed only a fraction of this drop in June. Payrolls employment rose by a disappointing 54,000 in May. Meanwhile, the euro-zone economy expanded at a healthy pace in Q1, but recent falls in most leading indicators suggest that growth is slowing there too. Germany has continued to outperform the rest of the region. The risk of an imminent Greek disaster eased temporarily after an initial draft agreement on a second Greek bailout package but European policymakers' inability to deal with the crisis quickly and effectively created further uncertainty and volatility.

3.2 Economic Forecast

The following forecast has been provided by Sector:

	NOW	Sep11	Dec11	Mar12	Jun12	Sep12	Dec12	Mar13	Jun13	Sep13	Dec13	Mar14
Sectors Bank Rate View	**0.50%**	0.50%	0.50%	0.50%	0.75%	1.00%	1.25%	1.50%	2.00%	2.00%	2.25%	2.50%
5yr PWLB	**2.85%**	2.90%	3.00%	3.20%	3.40%	3.50%	3.50%	3.60%	3.80%	4.00%	4.20%	4.30%
10yr PWLB	**4.16%**	4.20%	4.30%	4.40%	4.50%	4.60%	4.70%	4.70%	4.80%	4.90%	5.00%	5.10%
25yr PWLB	**5.08%**	5.10%	5.20%	5.30%	5.30%	5.30%	5.40%	5.40%	5.40%	5.50%	5.50%	5.60%
50yr PWLB	**5.06%**	5.10%	5.20%	5.30%	5.30%	5.30%	5.40%	5.40%	5.40%	5.50%	5.50%	5.60%

- The Sector central forecast is for a June 2012 first increase in Bank Rate but with reservations that it could well slip back in time, unless there is some good news on the UK economic recovery before then.

- Sector has undertaken its normal quarterly review of interest rate forecasts after the issue of the Bank of England's (BoE) quarterly Inflation Report. The key Bank of England comments are shown below:

  - Mervyn King said after the May Inflation Report was published that Bank Rate cannot stay down indefinitely' but this does not equate to saying 'there will be a first increase in Bank Rate in November 2011'. Financial markets have over-reacted to this statement (Sector have issued a revised interest rate forecast which suggests the first rate rise will be in June 2012 as opposed to November 2011).
  - Continuing wage freezes / low pay settlements
  - BoE forecasts for the speed of recovery and of increases in GDP growth rate have consistently been over optimistic since the recession started in 2009
  - CPI will blip up in 2011 due to temporary supply side shock factors but these will drop out within 12 months - as will VAT increases
  - Unless the output gap is closed (unlikely for some considerable time) inflation will eventually fall below target
  - CPIY (CPI less the effects of increase in indirect taxation) has been at or below 2% during 2010 and under 2.9% in 2011

SUMMARY OUTLOOK

- The key question is how quickly, and strongly, will the UK economy respond to the positive stimulus from low Bank Rate, quantitative easing and the devaluation of sterling?

- Negative growth of -0.5% in Q4 2010 was a huge shock; +0.5% (quarter on quarter) in Q1 2011 meant that growth had been flat for six months. A marginal upgrading of Q1 growth figures will have only a marginal effect on the big picture for the UK but there is considerable uncertainty as to how the UK economy will evolve in the coming months.

- US Q1 growth of only 1.8% (on an annualised basis) was also a disappointment despite non-farm payroll data showing improvement.

- China and India have embarked on a major thrust to cool their over-heating economies and so may depress the rate of world economic growth.

- An anaemic economic recovery is probably the most likely outcome in the UK and US, after the initial rebound in 2010, for the next three to four years; recovery is likely to be slower and more protracted than normal business cycle recoveries as this is a financial crisis recovery where lack of credit is still stifling growth.

- The Bank of England is likely to determine that further increases in CPI in 2011, towards 5%, as being due to one off factors that will drop out of the index within 12 months, so underpinning the view that inflation will be back to near target within a two to three year time horizon.

- This does assume that raised inflation expectations do not feed through into a significant increase in the general level of wage settlements.

- There has been a significant erosion of the confidence of financial markets in the EU handling of the peripheral debt crisis. There is now a major and escalating risk that the Greek, Irish, Portuguese debt crisis may not be contained and could lead to debt restructurings that could do significant damage to banks which already have weakened balance sheets. It is worth noting that many western governments have already exhausted their capacity to increase government debt to again bail out banks further damaged by any such future events and to counter the dampening of economic growth that would follow.

UPSIDE RISKS TO CENTRAL FORECAST

- Bank Rate cuts do finally succeed in feeding through to stimulate a strong economic recovery.

- A major increase in UK exports due to the circa 20% depreciation of Sterling over the last two years and import substitution by UK produced goods and services - assuming a reasonably strong economic recovery in US, EU and emerging markets.

- Corporate profitability has improved considerably since the recession due to cost cutting; many larger corporate balance sheets are now awash with cash. This could fuel an increase in investment expenditure and also M&A (merger and acquisitions) activity i.e. drive share prices higher and give investors a feel good factor (to spend more?)

DOWNSIDE RISKS TO CENTRAL FORECAST

- Chinese and Indian economies are now over-heating; Chinese authorities spooked by inflation over 5%. The Chinese central bank has raised the central rate four times and increased bank reserve requirements six times since October 2010 to curtail bank credit creation capacity. This could lead to increased volatility or an outright fall in commodity prices.

- UK emerging market funds are finding it difficult to place the huge investment cash flows they are receiving; Chinese investors with surplus cash are investing it in property and shares as if it is a one way bet! Ideally, there needs to be a rebalancing of Chinese spending on retail sales as opposed to the creation of asset price bubbles in property and shares.

- US economy has disappointed in Q1 2011 limping along at 1.8% annual growth rate after a strong Q4 2010 at 3.1%.

- US (and UK) have exhausted their capacity for any further fiscal stimulus for their economies.

- US is still not even on the starting line for dealing with cutting back a massive annual fiscal deficit; cut backs to come are likely to dampen the economy further.

- US: banks have major risk exposure to a fraught housing market where house prices have gone down 8.2% in the 12 months to April 2011, have fallen 29.5% since the peak in June 2006, where 29.5% of mortgages are now in negative equity and there is no imminent turn around in sight for the housing market.

- Peripheral European economies' crisis requires the European Central Bank to adopt a more pragmatic stance to debt restructuring: the longer the delay, the bigger the potential fallout.

- UK consumer confidence at very low levels whilst major cuts in Government expenditure and public sector jobs still to feed through fully into the economy and to dampen growth over the next few years.

- Despite the private sector creating more jobs than the public sector is cutting, the high current total level of unemployment of around 2.5m means that it will take several years to reduce total unemployment down to pre recession levels.

- No significant growth in personal disposable income likely for a couple of years due to:

    - Continuing wage freezes / low pay settlements;
    - Inflation exceeding wage increases so disposable income is being eroded;
    - Increases in taxation;
    - Mortgagors coming off cheap fixed rate mortgage deals onto standard variable rates.

- House prices have fallen to their lowest level since July 2009 and no turn around is in sight in the current economic climate.

- Consumers are focused on reducing over-borrowing by repaying debt rather than spending and are fearful of eventual increases in Bank Rate sending mortgage standard variable rates (SVRs) up in parallel; rebuilding of consumer balance sheets will increase the savings ratio and depress consumer expenditure.

- Banks are still heavily focused on rebuilding their balance sheets – RBS and Lloyds still have massive maturing wholesale borrowing to refinance; the Bank of England Special Liquidity Scheme (SLS) ends in Jan 2012; the BoE has lent £185bn to banks and building societies which must be repaid. The BoE has indicated there will be no extension of this timeframe for the SLS.

- Eventual reversal of Quantitative Easing by selling gilts etc will take cash out of the economy and restrict credit growth; gilt sales will need to be sensitively timed considering the huge level of gilt sales already planned just to fund each year's deficit.

3.3 <u>Short Term Rates</u>

The bank base rate remained at 0.5% throughout the quarter.

		April		May		June	
	Start	Mid	End	Mid	End	Mid	End
	%	%	%	%	%	%	%
Call Money (Market)	0.58	0.58	0.59	0.59	0.59	0.59	0.60
1 Month (Market)	0.62	0.62	0.62	0.62	0.63	0.62	0.63
3 Month (Market)	0.82	0.82	0.82	0.82	0.83	0.82	0.83

3.4 Longer Term Rates

		April		May		June	
	Start	Mid	End	Mid	End	Mid	End
	%	%	%	%	%	%	%
1 Year (Market)	1.60	1.60	1.59	1.59	1.58	1.58	1.58
10 Year (PWLB)	4.78	4.80	4.67	4.54	4.50	4.47	4.50
25 Year (PWLB)	5.31	5.32	5.22	5.19	5.13	5.17	5.22

Market rates are based on LIBOR rates published at the middle and end of each month. PWLB rates are for new loans in the “lower quota” entitlements.

3.5 Temporary Borrowing/Investments

Turnover during period

	No. Of Deals Struck	Turnover £m
Short Term Borrowing	10	26.00
Short Term Investments	37	76.69

Position at Month End

	April £m	May £m	June £m
Short Term Borrowing	14.00	14.00	10.00
Short Term Investments	33.85	40.80	40.11

Investments increased during the quarter as a result of delays in the capital programme.

Investment Income Forecast

The forecast income and outturn for the quarter is as follows:

	Cumulative Budget £’000	Cumulative Actual £’000	Cumulative Target Rate %	Cumulative Actual Rate %
Quarter 1	19	34	0.46	1.09
Quarter 2	37			
Quarter 3	64			

Quarter 4	90			

The actual rate exceeds the benchmark rate. This is due to the management of cash deposits around the planned delivery of the capital programme and most notably the acquisition of land for the Mersey Gateway project.

The target rate is based on the 7-day LIBID rate. For comparison purposes the 1 month average rate was 0.50%, 3 month rate was 0.70% and the 6 month rate was 0.99%.

3.6 New Borrowing

Due to the underlying need to borrow for capital purposes, new external borrowing of £20.0m was undertaken from the PWLB and the market.

The borrowing consisted of:

Source	Value (£m)	Rate (%)
PWLB	10,000	2.21
Market	10,000	1.50

It is anticipated that further borrowing will be undertaken during this financial year.

3.7 Policy Guidelines

The Treasury Management Strategy Statement (TMSS) for 2011/12, which includes the Annual Investment Strategy, was approved by the Council on 2nd March 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 it is considered appropriate to keep investments short term to cover short term cash flow needs but also to seek out value available in significantly higher rates in periods up to 12 months with highly credit rated financial institutions, using Sector's suggested creditworthiness approach, including sovereign credit rating and Credit Default Swap (CDS) overlay information provided by Sector: this applies in particular to nationalised and semi nationalised UK banks.

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.

There approved limits within the Annual Investment Strategy were not breached during the quarter ended 30th June 2011.

4.0 POLICY IMPLICATIONS

4.1 None

5.0 OTHER IMPLICATIONS

5.1 None

6.0 IMPLICATIONS FOR THE COUNCIL'S PRIORITIES

6.1 **Children and Young People in Halton**

None

6.2 **Employment, Learning and Skills in Halton**

None

6.3 **A Healthy Halton**

None

6.4 **A Safer Halton**

None

6.5 **Halton's Urban Renewal**

None

7.0 RISK ANALYSIS

7.1 The main risks with Treasury Management are security of investment and volatility of return. To combat this, the Authority operates within a clearly defined Treasury Management Policy and annual borrowing and investment strategy, which sets out the control framework

8.0 EQUALITY AND DIVERSITY ISSUES

8.1 There are no issues under this heading.

9.0 LIST OF BACKGROUND PAPERS UNDER SECTION 100D OF THE LOCAL GOVERNMENT ACT 1972

9.1 There are no background papers under the meaning of the Act.