REPORT TO:	Executive Board Sub-Committee
DATE:	26th May 2011
REPORTING OFFICER:	Operational Director – Finance
TITLE:	Treasury Management 2010/11 4th Quarter: January-March

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 information is provided by Sector, the Council's treasury management advisors.

3.1 Economic Background

The first quarter of 2011 saw:

- A fairly modest bounce-back in activity following the snow-related disruption in Q4 of 2010;
- Indicators of consumer spending weakened;
- Little improvement in conditions in the labour market;
- Public sector borrowing remained on track to slightly undershoot the fiscal plans;
- CPI inflation continued to rise and pipeline price pressures had increased;
- The Monetary Policy Committee moved closer to raising interest rates;
- UK equities underperformed and gilt yields increased;
- Economic growth picked up in the euro-zone, albeit from sluggish rates.

Output in the services sector rose by 1.3% month on month (m/m) in January. But given that output fell by 1.1% in December, the level of output was only a little above November's level, suggesting that the underlying growth rate in the sector is close to zero. Official construction data revealed that output in the sector fell by 7.7% m/m in January, following December's large 16.6% fall. However, the recovery in manufacturing had gathered further pace. Industrial production rose by 0.5% m/m in January.

There are signs that the recovery in consumer spending has run out of steam. The official measure of retail sales volumes rose by 1.5% m/m in January. Sales volumes fell by 0.8% in February, leaving the level of sales essentially unchanged on its level of six months ago. The GfK composite measure of consumer confidence was consistent with quarterly falls in overall household spending in all three months of the quarter. Meanwhile, data on the labour market have painted a mixed picture. On the one hand, employment rose by 36,000 in the three months to January. The weighted average of the employment balance of the CIPS surveys also rose in January and February, pointing to faster employment growth ahead. However, ILO unemployment rose by 37,000 in the three months to January.

Data on the housing market have perhaps suggested that house prices have found a floor. The Halifax measure rose by 0.8% m/m in January, although it then fell by 0.9% in February. The Nationwide measure has been stronger – it fell by 0.1% in January, but then rose by 0.7% in February and 0.5% in March.

The fiscal tightening intensified at the start of the year, with the hike in VAT in early January. The latest public finance figures have suggested that borrowing is still on track to undershoot the OBR's full-year forecast of £148.5bn in 2010/11, perhaps by £5bn. The Budget on 23rd March left the scale of the fiscal squeeze largely unchanged. Elsewhere, there are still few signs that the net trade boost to growth is coming through. However, the trade in goods and services deficit narrowed from £5.5bn to £3.0bn in January, but this was largely driven by temporary factors, such as a bounce-back in exports following December's snow and the imposition of a new tax on aircraft imports.

Meanwhile, inflation has continued to rise. CPI inflation rose from 3.7% to 4.0% in January and then to 4.4% in February. The rise in inflation did not just reflect higher food and energy costs – core inflation also rose from 2.9% to 3.4%. This probably reflected January's VAT rise, given anecdotal evidence suggesting that retailers passed on a larger proportion of this year's VAT rise onto consumers than last year's. Pipeline price pressures have also continued to build – in particular, oil prices have surged from around $95pb at the end of December to $115pb at the end of March. But high inflation still looks set to be temporary. Households' inflation expectations have not risen further – indeed, the YouGov/Citigroup measure of long term inflation expectations has fallen from 3.8% in December to 3.5% in March. And the annual rate of average earnings growth (exc. bonuses) was only 2.2% in January.

Nonetheless, the rise in inflation persuaded two more members of the Monetary Policy Committee (MPC) to start voting for rate hikes (Andrew Sentance was first joined by Martin Weale in January and then Spencer Dale in February). What's more, the Bank of England's February Inflation Report forecasts suggested that interest rates would need to rise broadly in line with the markets' expectations (then, for a 150bp rise in interest rates by the end of 2012) in order for inflation to hit the 2% CPI inflation target at the two year horizon. However, continued uncertainty about the underlying strength of the recovery persuaded the majority of MPC members to keep rates on hold at 0.5%. In financial markets, UK equities underperformed.

FTSE100 finished the quarter at around 5,950 – approximately the same level as at the end of 2010. 10-year gilt yields rose from 3.58% to 3.67% on the back of higher interest rate and inflation expectations. Meanwhile, sterling rose against the dollar from around $1.55 to $1.60, but fell from €1.16 to €1.13 against the euro. In the US, recent data has been mixed. On the one hand, the rise in both the US ISM manufacturing and non-manufacturing indices for February suggested that growth is picking up in the US economy. The unemployment rate has also fallen from 9.4% in December to 8.9% in February. But on the other hand, the rise in global food and energy prices appears to have weakened real consumer spending growth. Economic growth appears to have picked up in the euro-zone, albeit from sluggish rates. February's rise in the euro-zone composite PMI to its highest level since July 2006 left the index pointing to quarterly GDP growth of around 1%. Data on consumer spending in the region has also improved.

3.2 Economic Forecast

The following forecast has been provided by Sector:

Sector's Interest Rate View	Jun-11	Sep-11	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12	Mar-13	Jun-13	Sep-13	Dec-13	Mar-14
Sector's Bank Rate View	0.50%	0.75%	1.00%	1.00%	1.25%	1.50%	2.00%	2.25%	2.50%	3.00%	3.25%	3.25%
5yr PWLB Rate	3.70%	3.70%	3.80%	3.90%	4.00%	4.10%	4.20%	4.30%	4.50%	4.60%	4.70%	4.80%
10yr PWLB View	4.90%	4.90%	4.90%	4.90%	5.00%	5.10%	5.20%	5.20%	5.30%	5.40%	5.40%	5.50%
25yr PWLB View	5.40%	5.40%	5.40%	5.40%	5.50%	5.50%	5.50%	5.50%	5.60%	5.60%	5.70%	5.70%
50yr PWLB Rate	5.40%	5.40%	5.40%	5.40%	5.50%	5.50%	5.50%	5.50%	5.60%	5.60%	5.70%	5.70%

Sectors view is that an increase in Bank Rate as soon as May 2011 (or August 2011) is unlikely to be in line with what we know about the Governor of the Bank of England own views. He has commented that:

- Increases in Bank Rate can have no effect on limiting the inflation increase caused by the VAT hike in January.
- Increases in Bank Rate can also have no effect on limiting the inflation increase caused by increases in oil prices and other commodities imported from abroad.
- CPIY (CPIY excludes the effect of increases in indirect taxation) was only 2.8% in February i.e. is CPI the wrong target for the MPC as 'is an increase in indirect taxation inflation at all - rather than an increase in taxation?
- The UK growth forecast for 2011 was downgraded from 2.6% to 2.0% in the latest Inflation Report.
- It is illogical that employees will put their current jobs at risk (when there are already 2.5m unemployed) by asking employers for significant pay rises (but with a few possible exceptions where select small groups of employees have significant strike power to damage the economy).
- Increases in Bank Rate could rebound badly in damaging consumer confidence, economic recovery and growth after the hugely disappointing fall in growth in Q4 2010.

The MPC have TWO targets: inflation is the primary one but there is a secondary target of supporting the Government's policy on economic growth and employment.

The counter arguments of the hawks are:

- The forecast for inflation two to three years ahead has been upped (despite the growth forecast being lowered!).

- Those inflation forecasts are based on market expectations of timings of Bank Rate increases i.e. three increase in 2011 of 0.25% starting in May, without which the Bank's inflation forecasts would have been higher and above the 2% target two to three years ahead.

However, the counter arguments of the doves are:

- Economic statistics in the next few months could disappoint e.g. GDP growth down; unemployment rises significantly; bank lending growth is poor; the already weak consumer confidence and housing market weaken even further.

- We have a major programme of tax rises, benefit cuts and expenditure reductions which have barely begun to bite.

- We have no idea how much or how quickly rebalancing of the economy to exporting will happen; it could disappoint (though world growth is picking up at a very encouraging pace and the Fed, in January, revised upwards its growth forecast for 2011 from a band of 3.0% to 3.4% to 3.4% to 3.9%, [2012 3.5 – 4.4%, 2013 3.7 – 4.6%]).

- The balance of the above views is very delicate but Sector has moved the forecast for the first Bank Rate increase forward from Q4 2011 (November) to Q3 (August) on the basis that this reflects what the MPC is LIKELY to do rather than what the MPC OUGHT to do. The Sector view though, is that the MPC ought to hold off from increasing Bank Rate as long as possible in order to protect economic growth and that current inflation pressures are temporary and will fade.

What will be absolutely crucial during 2011 is what actually happens to UK growth and how much the economy succeeds in expanding exports and reducing imports. No one can be very confident as to how that will actually turn out. Also, many over stretched consumers may be increasingly fearful of impending increases in interest rates pushing the cost of servicing their debts up and so may focus their cash resources on saving or reducing their debt levels. This could also be a significant negative impact on UK economic growth.

Sector still maintain that the general trend beyond the next twelve months of gently rising gilt yields and PWLB rates is expected to remain unchanged as market fundamentals focus on the sheer volume of UK gilt issuance (and also US Treasury issuance) and the price of those new debt issues. Negative (or positive) developments in the EU sovereign debt crisis could significantly impact current safe haven flows of investor money into UK and US bonds and produce shorter term movements away from our central forecasts. However, Sector's revised forecasts are now building in the major shift in market sentiment that has occurred over the last three months whereby most of the gradual increase in gilt yields and PWLB rates Sector expected over the next few years back last August time, has now already occurred, i.e. increases have been much quicker than originally forecast.

As there are significant potential downside risks to these forecasts and to the pace of both UK and world recovery, Sector would suggest that authorities err on the side of caution when setting their investment budgets.

Any forecasts beyond a one year time horizon will be increasingly subject to being significantly amended as and when world events and financial markets change.

3.3 Short Term Rates

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

		January		February		March	
	Start	Mid	End	Mid	End	Mid	End
	%	%	%	%	%	%	%
Call Money (Market)	0.57	0.57	0.57	0.58	0.58	0.58	0.58
1 Month (Market)	0.59	0.60	0.60	0.61	0.61	0.61	0.62
3 Month (Market)	0.76	0.77	0.78	0.80	0.80	0.81	0.82

3.4 Longer Term Rates

		January		February		March	
	Start	Mid	End	Mid	End	Mid	End
	%	%	%	%	%	%	%
1 Year (Market)	1.51	1.52	1.53	1.57	1.58	1.58	1.60
10 Year (PWLB)	4.65	4.83	4.87	5.06	4.82	4.65	4.78
25 Year (PWLB)	5.23	5.41	5.45	5.50	5.38	5.27	5.31

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	5	11.00
Short Term Investments	32	54.20

Position at Month End

	January £m	February £m	March £m
Short Term Borrowing	0.00	0.00	0.00
Short Term Investments	21.30	20.30	9.55

Expenditure on the capital programme which included land acquisitions for the Mersey Gateway had the result of reducing investments held in March.

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	175	192	0.42	3.01
Quarter 2	251	344	0.42	2.46
Quarter 3	273	426	0.43	2.17
Quarter 4	275	466	0.45	1.91

The Actual rate exceeds the benchmark rate reflecting previous actions taken, to lock in a large proportion of the investment portfolio into longer dated fixed rate investments. When these investments unwind, the Council will not generate the same amount of income it has experienced in previous years.

The target rate is based on the 7-day LIBID rate. For comparison purposes the 1 month average rate was 0.48%, 3 month rate was 0.67% and the 6 month rate was 0.97%.

3.6 Policy Guidelines

Interest Rate Exposure – complied with.
Borrowing Instruments – complied with.

Prudential Indicators – complied with:
- Operational Boundary for external debt;
- Upper limit on interest rate exposure on fixed rate debt;
- Upper limit on interest rate exposure on variable rate debt;

- Maturity structure of borrowing as a percentage of fixed rate borrowing;
- Total principal sums invested for periods longer than 364 days;
- Maturity structure of new fixed rate borrowing

4.0 POLICY IMPLICATIONS

5.0 OTHER IMPLICATIONS

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.