REPORT TO:	Executive Board Sub-Committee
DATE:	3rd November 2011
REPORTING OFFICER:	Operational Director – Finance
TITLE:	Treasury Management 2011/12 2nd Quarter: July - September

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 third quarter of 2011 saw:

- Indicators suggested that the economy has at best stagnated;
- Conditions on the high street had deteriorated further;
- Employment had fallen again;
- The public finances were expected to miss this year's fiscal forecasts;
- CPI inflation rising, heading for a peak of around 5% in Q4;
- The Monetary Policy Committee (MPC) signalled a move towards increasing Quantitative Easing (QE);
- Equities prices plummeted and gilt yields fell to historic lows;
- The economic recovery faltered in the US and Europe.

Activity indicators suggest that the economic recovery has ground to a halt. Indeed, the weighted output balance of the CIPS/Markit surveys fell in August to a level that has been consistent with contraction in the past. The surveys also exclude retail activity – and the latest news from the high street suggests that the sector is in a similar position. While sales volumes rose by 0.2% m/m in July, they fell by the same amount in August.

However, output for the first quarter was depressed by a variety of factors (including the one-off Bank Holiday for the Royal Wedding in April and the after-effects of the Japanese earthquake), so the economy might still register growth in the second quarter.

Meanwhile, the fading of the economic recovery has impacted on the job market. The Labour Force Survey measure of employment fell by 70,000 in the three months to July, the first fall this year. And the ILO measure of unemployment rose by 80,000 over the same period – the largest rise in two years. The timelier (but narrower) claimant count measure also rose by a monthly 33,700 in July and 20,300 in August. The pace of job losses across the whole economy looks unlikely to ease off in the coming months. Job vacancies in the three months to August were 1.3% lower than a quarter ago, while the employment balances of all three of the CIPS surveys were below the 50-mark in July and August (below 50 marks a contraction in expectations).

Meanwhile, the public finances are on track to miss this year's fiscal forecasts. If the trend in borrowing seen over the first five months of the fiscal year continues, it will be around £5bn higher than the OBR expects. Admittedly, the full impact of some tax changes have yet to be felt, but the lags between developments in the economy and the public finances suggest that the recent slowdown is unlikely to have had its full effect on receipts.

Conditions in the housing market have also continued to deteriorate. Whilst the number of mortgage approvals for new house purchase rose from 48,800 in June to 52,400 in August, this has not prevented renewed falls in house prices. The Nationwide index ended the second quarter 0.2% lower than at the end of the first.

The trade in goods and services deficit was £4.5bn in July, compared to an average monthly deficit of £3.8bn in Q1. The survey measures of export orders also point to falls in exports ahead – the new export orders balance of the CIPS Manufacturing survey, for example, fell to its lowest level since May 2009 in September. At that level, it points to a quarterly drop in the volume of manufactured goods exports of around 5%.

Inflation continued to climb in the second quarter. CPI inflation rose from 4.2% in June to 4.4% in July and 4.5% in August. A series of rises in electricity and gas prices also took effect in late August and September which, together with a rise in food inflation reflecting past rises in agricultural commodity prices, could push inflation close to 5% in September.

Inflation may creep a little higher in the third quarter – but recent developments suggest that it should fall quite sharply next year. Oil prices fell from $113 per barrel at the end of Q1 to $106 at the end of Q2. Agricultural prices also fell over the past quarter. Surveys of

manufacturers pricing intentions in Q2 also pointed to a fall in producer output price inflation ahead. Meanwhile, the continued weakness of the broad money supply and lending data in Q2 and the persistence of a large degree of spare capacity in the economy also suggest that inflation will fall sharply in 2012.

Measures of inflation expectations have drifted up – the Bank of England's measure of households' inflation expectations in the year ahead rose from 3.9% to 4.2% in Q2. However with conditions in the labour market continuing to deteriorate, these expectations seem unlikely to become ingrained. The annual rate of average earnings growth including bonuses fell from 3.1% to 2.9% in July (the rate excluding bonuses fell from 2.2% to 1.7%). Real pay growth has thus remained negative.

Meanwhile, the MPC became distinctly more dovish during Q2. Spencer Dale and Martin Weale both abandoned their votes for a rate hike at the meeting in August. The minutes of September's meeting also suggested that QE2 will be launched soon, although, no other members have yet joined Adam Posen in voting for more QE. Most have however accepted that the case for policy stimulus has significantly strengthened and that "a continuation of the conditions seen over the past month would probably be sufficient to justify an expansion of the asset purchase programme at a subsequent meeting."

Financial market sentiment deteriorated sharply in the second quarter, reflecting declining prospects for economic growth and renewed risk aversion as a result of the intensification of the euro-zone sovereign debt crisis. The FTSE 100 finished the quarter at 5,128 – about 14% lower than its level at the end of the first quarter. Ten year gilt yields plummeted from 3.38% to 2.43%, reflecting falling interest rate expectations, safe-haven flows as a result of a perceived rise in default risk on sovereign debt in the euro-zone and perhaps expectations that further QE might soon be on the way. Meanwhile, a global shift away from risk saw the dollar strengthen. As a result, sterling weakened against the dollar from about $1.60 to $1.56, but strengthened slightly against the euro from €1.16 to €1.10.

In the US, economic data was weak, but a little stronger than in the UK. The US ISM indices pointed to annualised quarterly GDP growth of around 1.5% in July and August. Growth in payrolls also stagnated in August. And while President Obama proposed a $450bn job creation bill, equivalent to nearly 3% of GDP, it seems unlikely to be passed by Congress in full.

Growth has also slowed sharply in the euro-zone. In particular, the ECB composite PMI now pointed to outright falls in GDP in August. A steep drop in the EC Economic Sentiment Indicator in August also left the index consistent with a sharp slowdown in annual GDP growth in the region.

3.2 Economic Forecast

The following forecast has been provided by Sector:

	NOW	Dec11	Mar12	Jun12	Sep12	Dec12	Mar13	Jun13	Sep13	Dec13	Mar14	Jun14
Sectors Bank Rate View	**0.50%**	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.75%	1.00%	1.25%	1.50%
5yr PWLB	**2.30%**	2.30%	2.30%	2.30%	2.30%	2.40%	2.50%	2.60%	2.70%	2.80%	2.90%	3.10%
10yr PWLB	**3.30%**	3.30%	3.30%	3.30%	3.40%	3.40%	3.50%	3.60%	3.70%	3.80%	4.00%	4.20%
25yr PWLB	**4.20%**	4.20%	4.20%	4.20%	4.30%	4.30%	4.40%	4.50%	4.60%	4.70%	4.80%	4.90%
50yr PWLB	**4.30%**	4.30%	4.30%	4.30%	4.40%	4.40%	4.50%	4.60%	4.70%	4.80%	4.90%	5.00%

The Sector central forecast is for the first increase in bank rate to be in September 2013. PWLB rates and bond yields are experiencing exceptional levels of volatility which are highly correlated to political developments (or lack of them) in the sovereign debt crisis.

SUMMARY OUTLOOK

Sector has undertaken a review of their interest rate forecasts as a result of two major events: -

1. The decision by the MPC to expand quantitative easing over the next four months by a further £75bn which had an immediate effect of depressing gilt yields at the long end of the curve. It also clearly underlines how concerned the MPC now is about the prospects for growth of the UK economy and that recession is now decisively a much greater concern than inflation.

2. The marked deterioration of growth prospects in the US, EU and UK, especially as concerns have further increased over Greece and the potential fall out from their debt situation. This has led in turn to a further increase in safe haven flows into UK gilts since our last interest rate forecast (16.8.11) which have depressed gilt yields and PWLB rates to even lower levels.

These developments had left short term forecasts for PWLB rates markedly out of line with actual rates. They have also substantially pushed back expectations of the timing of the eventual start of increases in Bank Rate and the expected eventual rise in gilt yields and PWLB rates.

In summary, concerns around a slow down in prospects for GDP growth in the western world are as follows: --

US

- Current weak GDP growth; jobless recovery
- Fed unlikely to increase central rate until mid 2013
- Latest Fed Twist operation unlikely to save US economy from weak growth in the shorter term
- Near exhaustion of major fiscal and monetary remedies

- Political gridlock ahead of Nov 2012 Presidential elections for major fiscal action
- New President unlikely to make significant impact on the US economy in 2013
- Housing market still fraught and banks face rising losses on mortgages which will lead in turn to restricted supply of credit to the economy; little hope of the housing market turning around in the near future

EU

- Sovereign debt crisis is morphing into an EU banking crisis where some weaker banks will need semi-nationalisation to cope with a major write down of Greek debt, resulting in an increase in government debt levels. This in turn could threaten (e.g.) the French AAA rating and lead to an increase in concerns for the size of the French debt to GDP ratio
- EU economy now heading into recession in 2012; increasing lack of supply of bank credit plus major fall in consumer and business confidence will inhibit economic growth
- High risk that 17 Euro zone nations will not agree on what to do about Greece ahead of financial markets losing patience and precipitating a crisis
- German elections in 2013 getting ever closer; German voters hostile to bailing out Greece and other weak peripherals

UK

- 40% of UK GDP dependent on overseas trade; high correlation of UK growth to US and EU GDP growth means that the UK economy may only barely escape recession in the next two years
- Consumers have paid down total debt to income ratio from 180% in 2008 to 160%. OBR forecasts March 2011 for GDP growth of 2.5% in 2012 and 3.0% in the following three years are predicated on an increase in consumer spending and borrowing taking that ratio back to 175% by 2015 i.e. an increase of £570bn in debt. This is highly unlikely given current consumer sentiment, job fears, high inflation eroding disposable incomes, small or no pay increases, mortgagors coming off initial cheap fixed rate deals onto higher SVR rates etc.
- Little sign of a coordinated strategy for the private sector to finance a major expansion of infrastructure investment to boost UK growth
- Little sign of a major increase in exports to boost UK growth
- QE2 likely to be too little too late to boost UK growth significantly in the near term

CHINA

- Increasing concerns that efforts to gently slowdown the economy to cool inflation could lead into a hard landing.

3.3 Short Term Rates

The bank base rate remained at 0.50% throughout the quarter.

	Start	July		Aug		Sept	
		Mid	End	Mid	End	Mid	End
	%	%	%	%	%	%	%
Call Money (Market)	0.60	0.59	0.60	0.60	0.61	0.61	0.62
1 Month (Market)	0.63	0.63	0.63	0.65	0.66	0.67	0.69
3 Month (Market)	0.83	0.83	0.83	0.86	0.89	0.92	0.95

3.4 Longer Term Rates

	Start	July		Aug		Sept	
		Mid	End	Mid	End	Mid	End
	%	%	%	%	%	%	%
1 Year (Market)	1.58	1.59	1.59	1.61	1.65	1.68	1.72
10 Year (PWLB)	4.50	4.31	4.16	3.81	3.80	3.59	3.55
25 Year (PWLB)	5.22	5.13	5.06	4.94	4.80	4.64	4.53

Market rates are based on LIBOR rates published at the middle and end of each month. PWLB rates are for new loans based on principal repayable at maturity.

3.5 Temporary Borrowing/Investments

Turnover during period

	No. Of Deals Struck	Turnover £m
Short Term Borrowing	5	13.00
Short Term Investments	34	61.74

Position at Month End

	July £m	Aug £m	Sept £m
Short Term Borrowing	18.00	20.00	18.00
Short Term Investments	47.61	52.32	52.80

Investments increased during the quarter as a result of delays in the capital programme with borrowing to finance the capital programme remaining fairly constant.

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	218	0.47	1.16
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 0.52%, 3 month rate was 0.70% and the 6 month rate was 1.02%.

3.6 New Borrowing

Sector's 25 year PWLB target rate for new long term borrowing for the quarter started at 5.40% and ended at 5.10%. The average PWLB rate for 5 year borrowing during the quarter was 2.59%. Due to the overall financial position and the underlying need to borrow for capital purposes (the Capital Financing Requirement - CFR), new external borrowing of £13.0m was undertaken from the Market as follows

Source	Value (£m)	Rate (%)
Market	8.00	0.85
Market	5.00	1.35

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 and the heightened credit concerns it is considered appropriate to keep investments short term with a maximum duration of 3 months.

This limit will apply to all entities on the suggested Sector Credit List with the following exceptions:

1. UK Government and related entities such as Local Authorities. Their suggested duration limit will remain at 5yrs.

2. UK semi-nationalised institutions (Lloyds / RBS). We continue to view the current significant UK ownership of these entities as providing significant comfort to investors.

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 September 2011.

4.0 DEBT RESCHEDULING

4.1 No debt rescheduling was undertaken during the quarter.

5.0 OTHER

5.1 Counterparties

Following continued euro zone concerns renewed fears of low growth projections in the UK, the long term credit ratings of all the banks (except Barclays) held on the Council's counterparty list were downgraded.

None of the counterparties fell below the Council's minimum requirements as set out in the Treasury Management Strategy 2011/12 or are reporting any expected difficulties in returning any current or future deposits to the Council.

The level of uncertainty in the current economic climate means that it is very difficult to place deposits with counterparties who are unaffected by world economic events. The Council continues to manage its treasury management function in accordance with its Treasury Management Strategy prioritising in order security, liquidity and yield.

6.0 POLICY IMPLICATIONS

6.1 None

7.0 OTHER IMPLICATIONS

7.1 None

8.0 IMPLICATIONS FOR THE COUNCIL'S PRIORITIES

8.1 **Children and Young People in Halton**

None

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

None

8.3 **A Healthy Halton**

None

8.4 **A Safer Halton**

None

8.5 **Halton's Urban Renewal**

None

9.0 RISK ANALYSIS

9.1 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

10.0 EQUALITY AND DIVERSITY ISSUES

10.1 There are no issues under this heading.

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

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