REPORT TO:	Executive Board Sub-Committee
DATE:	9 February 2012
REPORTING OFFICER:	Operational Director – Finance
PORTFOLIO:	Resources
TITLE:	Treasury Management 2011/12 3rd Quarter: October - December

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

3.1 Economic Background

- Indicators suggested that the economy was at a higher risk of recession;
- Weak demand on the high street had forced retailers to offer generous discounts;
- The labour market deteriorated, but at a slower pace than in previous months;
- Public borrowing had fallen in line with fiscal plans, but forecasts for future deficits had been revised up;
- Inflation began to fall;
- The Monetary Policy Committee (MPC) restarted quantitative easing (QE) and indicated its intention to sanction more;
- Gilt yields reached new lows, in spite of a recovery in equity prices and growing fiscal fears;
- Euro-zone policymakers failed to make progress towards a solution to the region's debt crisis.

Activity indicators suggested that the economic recovery ground to a complete halt in the third quarter and output may even have contracted. The weighted output balance of the CIPS/Markit surveys in October fell to a level that has been consistent in the past with a contraction in GDP. The output balance then broadly held at that level in November.

The CIPS surveys exclude the retail sector and the latest news from the high street has been poor, reflecting the pressures on households' finances. According to the official figures, retail sales volumes (ex. petrol) rose by 0.9% m/m in October but then fell by 0.7% in November, despite deep discounts offered by retailers. Timelier survey and anecdotal evidence suggests that, by and large, spending was weaker than usual in December.

Conditions in the labour market have also continued to deteriorate, albeit at a slower pace than in previous months. The Labour Force Survey measure of employment fell by 63,000 in the three months to October, a slower pace of deterioration than seen in the second quarter. The number of employees plummeted by 252,000 – but this was partly offset by a 166,000 rise in self-employment. Rises in the timelier claimant count measure of unemployment also became more modest – it increased by 'just' 2,500 on the previous month in October and 3,000 in November. Despite this moderating trend, employment surveys have continued to point to further job losses ahead.

The housing market has continued to recover, albeit slowly. The number of mortgage approvals for new house purchase rose from 51,200 in September to 52,900 in November. And according to the Nationwide, house prices were 0.6% higher in December than they were in September. Nonetheless, banks began the process of passing on the rise in their wholesale funding costs, reflecting the adverse effects of the euro-zone debt crisis, to consumers during the quarter.

The latest trade data tentatively suggested that net trade was on course to make a positive contribution to GDP growth in the third quarter. The trade in goods and services deficit narrowed from £4.3bn in September to £1.6bn in October (although the monthly deficit figures have been volatile recently). Some survey measures have also pointed to a recent pick-up in demand for exports as the new export orders balance of the CIPS manufacturing survey rose from 49.0 in November to 53.5 in December. At that level, it points to a quarterly rise in the volume of manufactured goods exports of around 2%.

Despite much weaker than expected GDP growth, the latest public finance figures showed that borrowing is coming in comfortably below last year's totals. Spending growth has slowed, while growth in tax receipts is still holding up reasonably well. And if the trend so far this fiscal year is sustained, borrowing will total about £122bn in 2011/12, equal to what the Office for Budget Responsibility (OBR) was forecasting until it revised its forecast to £127bn in its Economic and Fiscal Outlook that accompanied the Chancellor's Autumn Statement. The OBR also revised up its forecasts for borrowing in future years to reflect its much weaker expectations for GDP growth.

Inflation fell in the third quarter with CPI inflation falling from its recent peak of 5.2% in September to 5.0% in October and 4.8% in November. It probably fell further in December as past rises in energy prices a year ago dropped out of the annual comparison. Inflation remained on track to fall further in the coming months. Oil prices, for example, remained largely range-bound between $105pb and $115pb, while petrol prices began to fall. Meanwhile, the continued weakness of indicators of money supply growth and firms' pricing intentions, as well as the still large degree of spare capacity in the economy, suggested that underlying inflationary pressures are still very weak.

Granted, measures of inflation expectations remained quite high – the Bank of England's measure of households' inflation expectations for the year ahead only edged down from 4.2% to 4.1% in Q3. But considerable slack in the labour market should continue to prevent the translation of these expectations into stronger earnings growth. Indeed, the annual rate of average earnings growth including bonuses rose was just 2% in October (a slight rise from 1.9% in September). Real pay growth has therefore remained negative.

The MPC restarted quantitative easing (QE) in October and announced £75bn of additional gilt purchases would be completed by February. The MPC also looked primed to sanction further purchases in Q4. The November Inflation Report forecast projected CPI inflation to be well below the 2% target in two years' time, while speeches by certain members of the Committee (such as Martin Weale and Paul Fisher) suggested that they thought there was a strong case for more purchases.

Largely reflecting this dovish stance, markets expectations for official interest rates continued to fall during Q3, helping government bond yields to drop to new record lows (the 10-year gilt yield fell from 2.43% to 2% at the end of the year). The drop may also have reflected growing demand for safe-havens – while bond markets thought that default risk on UK government bonds had grown during the quarter, they viewed that risk to be lower than in many other major economies, including Germany.

In contrast to the UK, the economic data improved in the US in Q3. The manufacturing ISM strengthened in November and December to a level consistent in the past with annual GDP growth of 2.5% to 3.0%. Non-farm payrolls also increased by 112,000 in October and 100,000 in November.

In the euro-zone, policymakers made little progress to deal with the region's debt crisis. The economic data in the euro-zone also continued to weaken – while the composite PMI rose in November in December, it remained below the theoretical "no-change" level of 50 and on past form was consistent with quarterly falls in GDP of almost 1%. A deep recession in the euro-zone remains a key risk to the outlook for the UK economy.

3.2 <u>Economic Forecast</u>

The following forecast has been provided by Sector:

Sector's Interest Rate View														
	NOW	Mar-12	Jun-12	Sep-12	Dec-12	Mar-13	Jun-13	Sep-13	Dec-13	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15
Sector's Bank Rate View	**0.50%**	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.75%	1.00%	1.25%	1.50%	2.00%	2.25%	2.50%
5yr PWLB Rate	**2.06%**	2.30%	2.30%	2.30%	2.40%	2.50%	2.60%	2.70%	2.80%	2.90%	3.10%	3.30%	3.50%	3.70%
10yr PWLB View	**3.11%**	3.30%	3.30%	3.40%	3.40%	3.50%	3.60%	3.70%	3.80%	4.00%	4.20%	4.40%	4.60%	4.80%
25yr PWLB View	**4.06%**	4.20%	4.20%	4.30%	4.30%	4.40%	4.50%	4.60%	4.70%	4.80%	4.90%	5.00%	5.10%	5.20%
50yr PWLB Rate	**4.13%**	4.30%	4.30%	4.40%	4.40%	4.50%	4.60%	4.70%	4.80%	4.90%	5.00%	5.10%	5.20%	5.30%

The Sector central forecast is for the first increase in bank rate to be in September 2013. PWLB and bond yields remain extremely unpredictable at present. We are experiencing exceptional levels of volatility which are highly correlated to political developments (or lack of them) in the Eurozone 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 by a further £75bn. This tranche is due to be completed in February 2012. This decision had an immediate effect of depressing gilt yields at the long end of the curve. It also clearly underlined how concerned the MPC is about the prospects for UK growth and that recession is now 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 pushed PWLB rates to even lower levels.

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

- Despite better than expected data releases in the latter stages of 2011, weak GDP growth and lingering threat of a jobless recovery remain
- 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. Currently all Eurozone sovereign ratings under review for possible downgrade.
- 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 of Italy and Spain being fully dragged into peripheral sovereign debt crisis. Current proposed rescue measures are insufficient to cope with such a prospect.
- The latest proposals on tighter fiscal unity have been poorly received by markets. There have been scant signs of positive impact on equities, bond yields or expectations for Eurozone growth.
- 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	Oct		Nov		Dec	
		Mid	End	Mid	End	Mid	End
	%	%	%	%	%	%	%
Call Money (Market)	0.62	0.62	0.62	0.63	0.63	0.63	0.63
1 Month (Market)	0.69	0.69	0.70	0.73	0.74	0.76	0.77
3 Month (Market)	0.95	0.96	0.99	1.01	1.04	1.06	1.08

3.4 Longer Term Rates

	Start	Oct		Nov		Dec	
		Mid	End	Mid	End	Mid	End
	%	%	%	%	%	%	%
1 Year (Market)	1.72	1.74	1.76	1.79	1.82	1.84	1.87
10 Year (PWLB)	3.55	3.70	3.63	3.26	3.28	3.22	3.11
25 Year (PWLB)	4.53	4.45	4.42	4.11	3.97	4.13	4.03

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	2	5.000
Short Term Investments	34	99.660

Position at Month End

	Oct £m	Nov £m	Dec £m
Short Term Borrowing	23.00	23.00	23.00
Short Term Investments	61.95	62.00	64.91

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	449	0.50	1.27
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 0.60%, 3 month rate was 0.89% and the 6 month rate was 1.18%.

3.6 New Borrowing

Sector's 25 year PWLB target rate for new long term borrowing for the quarter started at 5.00% and ended at 4.20%. Due to the overall financial position and the underlying need to borrow for capital purposes (the Capital Financing Requirement - CFR), new external borrowing of £20.0m was undertaken from the Market and PWLB as follows:

Source	Value (£m)	Rate (%)
Market	5.00	0.85
Market	5.00	1.40
PWLB	10.00	2.24

It is anticipated that no 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 IMPLICATIONS FOR THE COUNCIL'S PRIORITIES

5.1 There are no direct implications, however, the revenue budget and capital programme support the delivery and achievement of all the Council's priorities.

6.0 RISK ANALYSIS

6.1 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

7.0 EQUALITY AND DIVERSITY ISSUES

7.1 There are no issues under this heading.

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

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