

**REPORT TO:** Executive Board

**DATE:** 21 November 2013

**REPORTING OFFICER:** Operational Director – Finance

**SUBJECT:** Treasury Management 2013/14  
2nd Quarter: July - September

**PORTFOLIO:** Resources

**WARDS:** All Wards

## **1.0 PURPOSE OF REPORT**

1.1 The purpose of this report is to update the Board about activities undertaken on the money market as required by the Treasury Management Policy. Commentary regarding the UK and global economic position has been provided by Capita Asset Services (formerly known as Sector) the Council's Treasury Management advisers.

**2.0 RECOMMENDED: That the report be noted.**

## **3.0 SUPPORTING INFORMATION**

3.1 During the quarter ended 30<sup>th</sup> September:-

- Indicators suggested that the economic recovery accelerated;
- Household spending growth remained robust;
- Inflation fell back towards the 2% target;
- The Bank of England introduced state-contingent forward guidance;
- 10-year gilt yields rose to 3% at their peak and the FTSE 100 fell slightly to 6460;
- The Federal Reserve decided to maintain the monthly rate of its asset purchases under Quantitative Easing 3 (QE3).

After strong growth of 0.7% in Q1, it appears that UK Gross Domestic Product (GDP) is likely to have grown at an even faster pace in Q2. On the basis of past form, the CIPS/Markit business surveys for July and August point to quarterly growth of potentially over 1.0% in the second quarter of 2013/14. Similarly, the official data have continued to improve. Admittedly, industrial production was flat in July. But even if it held steady in the rest of the quarter, it would still be 0.9% higher in Q2 than in Q1. In addition, the service sector expanded by 0.2% m/m and the construction sector grew by 2.2% m/m in July after growth of 1.8% q/q in Q1.

Consumer spending also continued to rise and may beat the increase seen in Q1. While the 1.1% monthly rise in retail sales in July was almost entirely offset by a 0.9% fall in August, the unusually warm weather in August is likely to have had a part to play in this. The retail surveys also painted a positive picture for household spending growth, with the Bank of England's Agents' Scores, BRC and CBI retail sales indicators showing stronger growth in Q3. And while growth in non-high street spending may have slowed, it probably remained robust. For example, although annual growth in new car registrations eased from the 24% rate seen in Q1, it was still a strong 15% in August.

The run of good news on the labour market continued, with the ILO unemployment rate falling to 7.7% in July from 7.8% in June. Employment rose by 80,000 in the three months to July, supported by an even bigger rise in full-time employment. This meant that the ratio of full-time to part-time workers continued to rise after it troughed last summer. The timelier claimant count measure of the unemployment rate also fell. Indeed, the cumulative fall in unemployment of 68,900 in July and August – the biggest two month fall since May and June 1997 – brought the claimant count unemployment rate down from 4.4% at the end of Q1 to 4.2% in August. Despite this, the headline (3 month average of the annual) rate of pay growth fell from 2.2% in June to just 1.1% in July. Excluding bonuses, earnings growth ticked up slightly to 1.1% y/y, but this remained well below the rate of CPI inflation at 2.7% in August, meaning real wages continued to fall.

Meanwhile, the cost of new credit has continued to fall, perhaps in response to the extension of the Bank of England's Funding for Lending Scheme (FLS) earlier this year. The quoted interest rate on a 5-year fixed mortgage at a 75% loan-to-value ratio was 3.34% in August, 7 basis points lower than in June and 77 basis points lower than when the FLS was introduced in July 2012.

Demand in the housing market continued to grow at a fast pace, supported by the FLS and the Government's Help to Buy scheme, which provide equity loans to credit-constrained borrowers. The RICS housing market survey reported that new buyer enquiries hit their highest level on record in August. Mortgage approvals for new house purchase rose to their highest level since February 2008 in August. Consequently, house prices continued to rise, with the Halifax and Nationwide measures recording 6.2% and 3.5% y/y rises in August, respectively. Office for National Statistics (ONS) data, though, shows that in real terms only London experienced y/y price rises in July. All other regions saw modest falls.

The economic recovery may finally be feeding through to the public finances. Although the government registered a surprise deficit in July (a month that normally delivers a surplus), in August net borrowing was 'just' £13.2bn, compared to £14.4bn in August 2012.

The new Governor of the Bank of England, Mark Carney, took office in July. Alongside the August Quarterly Inflation Report, the Bank introduced its new policy of forward guidance in which the Monetary Policy Committee (MPC) pledged not to raise official interest rates, or reduce the size of the asset purchase facility, until the ILO unemployment rate falls to 7%. At this point, the MPC would discuss whether or not to alter official policy. This guidance was subject to three 'knockouts' which, if breached, would invalidate the guidance. These are that the MPC forecasts inflation at or above 2.5% in 18-24 months' time, inflation expectations are no longer sufficiently well anchored or financial stability is threatened by the stance of monetary policy. On the MPC's current forecasts, the unemployment rate is most likely to reach 7% in late 2016.

However, financial markets continued to price in increases in Bank Rate by mid-2015, with overnight index swap rates and gilt yields rising after the announcement of forward guidance. Members of the MPC subsequently appeared at the Treasury Select Committee and three gave further speeches to clarify the guidance, but there was little market impact. However, the Bank of England's surveys suggest the message may have got through to the public as the balance of people expecting interest rates to rise over the next 12 months fell from 29% in May to 24% in August.

Meanwhile, Consumer Prices Index (CPI) inflation fell from a 2013 peak of 2.9% in June to 2.7% in August. The fall was primarily the result of a drop in the contribution from petrol prices and a reduction in core inflation from 2.3% in June to 2% in August. CPI inflation looks likely to have edged down again in September, perhaps to about 2.5%, reflecting a further fading of both energy prices and core inflation.

The big news in financial markets was that the Federal Reserve unexpectedly decided not to taper its asset purchases in September. In announcing its decision to maintain monthly purchases at \$85bn, the Fed explained that it wanted to *"await more evidence that [the economic recovery] will be sustained before adjusting the pace of its purchases."* This came despite previous hints of tapering from the Fed and the fall in the unemployment rate in both July and August. It currently stands at 7.3%.

Across the quarter as a whole, advanced economy bond markets sold off, suggesting the rise in UK gilt yields was not solely down to markets'

scepticism about domestic forward guidance. Gilt yields tracked US Treasury yields up, with ten-year gilts rising by around 60 basis points to reach 3% in early September for the first time since mid-2011. After the Fed's decision not to taper, gilt yields fell back, although not enough to offset the previous rise. Ten-year gilts finished the quarter at 2.7%. Equity markets stayed relatively flat over the quarter. While the FTSE 100 rose from 6470 to 6620 over the first few weeks of June, the index closed the quarter at 6462.

Meanwhile, Eurozone business surveys suggested that the economy continued to expand in Q2, albeit at a moderate pace. There was also a general election in Germany in which the incumbent Chancellor, Angela Merkel, performed better than expected by winning 41.5% of the vote. She is now likely to form a coalition, but it remains to be seen what form this will take.

### 3.2 Interest Rate Forecast

The following forecast has been provided by Capita Asset Services:

	Dec-13	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15	Jun-15
<b>Bank rate</b>	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%
<b>5yr PWLB rate</b>	2.50%	2.50%	2.60%	2.70%	2.70%	2.60%	2.80%
<b>10yr PWLB rate</b>	3.70%	3.70%	3.70%	3.80%	3.80%	3.90%	4.00%
<b>25yr PWLB rate</b>	4.40%	4.40%	4.40%	4.50%	4.50%	4.60%	4.70%
<b>50yr PWLB rate</b>	4.40%	4.40%	4.40%	4.50%	4.60%	4.70%	4.80%

Capita Asset Services undertook a review of its interest rate forecasts in late September as a result of an increase in confidence in economic recovery, chiefly in the US, but more recently, also in the UK and Eurozone. The latest forecast now includes a first increase in Bank Rate in quarter 3 of 2016 (previously quarter 4).

## **SUMMARY OUTLOOK**

### **UK economy**

After the previous Inflation Report included a somewhat encouraging shift towards optimism in terms of a marginal upgrading of growth forecasts, the August Inflation Report occurred in the midst of a welter of economic statistics which have left economists and forecasters speechless in terms of finding suitable words to describe a major simultaneous shift up in gear of the economy in all of the three sectors of services, manufacturing / industrial and construction! It is therefore not surprising that the Report upgraded growth

forecasts for 2013 from 1.2% to 1.4% and for 2014 from 1.7% to 2.5%. However, Bank Governor Mark Carney put this into perspective by describing this welcome increase as not yet being “escape velocity” to ensure we return to strong AND sustainable growth, after what has been the weakest recovery on record after a recession. So very encouraging - yes, but, still a long way to go! As for inflation, it was forecast to be little changed from the previous Report – falling back to 2% within two years and staying there during year three.

In addition to the stimulus provided by quantitative easing (QE), the Funding for Lending Scheme (FLS), is aimed at encouraging banks to expand lending to small and medium size enterprises. The FLS certainly seems to be having a positive effect in terms of encouraging house purchases (though levels are still far below the pre-crisis level), and causing a significant increase in house prices – but only in London and the south east. FLS is also due to be bolstered by the second phase of Help to Buy aimed to support purchasing of second hand properties, which started in October.

### **Forward guidance caveats**

The Bank of England also issued forward guidance with the Inflation Report which said that the Bank will not start to consider raising interest rates until the jobless rate (Labour Force Survey / ILO i.e. not the claimant count measure) has fallen to 7% or below. This would require the creation of about 750,000 jobs and was forecast to take three years. The UK unemployment rate currently stands at 2.5 million i.e. 7.7 % on the LFS / ILO measure. The Bank's guidance is subject to three provisos, mainly around inflation; breaching any of them would sever the link between interest rates and unemployment levels. This actually makes forecasting Bank Rate much more complex given the lack of available reliable forecasts by economists over a three year plus horizon. The Capita Asset Services view is that the recession since 2007 was notable for how unemployment did NOT rise to the levels that would normally be expected in a major recession. The latest Inflation Report noted that productivity has sunk to 2005 levels. Capita Asset Services are therefore, concerned that there has been a significant level of retention of labour, which will mean that a significant amount of GDP growth can be accommodated without a major reduction in unemployment.

In summary, Capita Asset Services current views are centred around the following: -

### **UK**

- Growth has been on an upward trend – 0.3% in Q1; 0.7% in Q2 and likely to be much stronger in Q3. The so called double dip recession at the beginning of 2012 was erased by the latest revision of statistics.
- Business surveys, consumer confidence, consumer borrowing and house prices are all on the up and may help to create a wide spread feel good factor. However, this is still a long way away from the UK getting back to sustainable strong growth.

- A fair proportion of UK GDP is dependent on overseas trade; the high correlation of UK growth to US and EU GDP growth means that the UK economy is still vulnerable to what happens in overseas markets.
- Consumer expenditure is likely to remain suppressed by inflation being higher than increases in average earnings i.e. disposable income will continue to be eroded.
- The coalition government is hampered in promoting growth by the need to tackle the budget deficit. However, the March Budget did contain measures to boost house building and the supply of mortgages, and brought forward, by one year to April 2014, the start of a £10,000 tax free allowance for incomes.
- There is little sign of a co-ordinated strategy for the private sector to finance a major expansion of infrastructure investment to boost UK growth.
- Government inspired measures to increase the supply of credit to small and medium enterprises (which are key to achieving stronger growth) by banks are not succeeding.
- Gilt yields remain vulnerable to pressures to rise, especially as they are powerfully influenced by US treasury yields and American investors have been spooked by Chairman Bernanke's comments on tapering QE. The Fed's reluctance to start tapering in September has, potentially, only delayed a trend for gilt yields to rise.

### **Eurozone**

- Most Eurozone countries are now starting to see a return to growth after a prolonged recession. The prospects for growth, at least in the short term, have also improved. However, for some countries, austerity programmes could prove to be a self-defeating spiral of falling demand, tax receipts, and GDP, leading to a rise, not fall, in debt to GDP ratios. Debt ratios in excess of 90% will cause market concern as beyond this level, the costs of servicing such debt becomes oppressive and growth inhibiting. This could, therefore, lead to an inevitable end game during the next few years of withdrawal from the Eurozone bloc in order to regain national control of a currency, government debt, monetary policy and, therefore, of setting national interest rates. The European Central Bank's pledge to provide unlimited bond buying support for countries that request an official bailout means that market anxiety about these countries is likely to be subdued in the near term. However, the poor economic fundamentals and outlook for some economies could well mean that an eventual storm in financial markets has only been delayed, not cancelled.
- The European Central Bank maintained its central policy rate at 0.5% in this quarter.
- The Eurozone remains particularly vulnerable to investor fears of contagion if one country gets into major difficulty.

### **US**

- There has been a marked improvement in consumer, investor and business confidence this year.

- Unemployment has continued on a steady, but unspectacular decline to 7.3%, but is still a long way from the target rate of 6.5% for an increase in the Fed policy rate.
- The housing market has turned a corner, both in terms of rising prices and in increases in the volume of house sales. More householders are, therefore, escaping from negative equity.
- US equities have reached all-time highs.
- The package of tax increases and cuts in Government expenditure starting in 2013 does not appear to be having a major impact on depressing growth.
- GDP in Q1 was disappointingly downgraded from +2.4% to a sub-par +1.8% before rising to 2.5% in Q2.

### **Capita's forward view**

Economic forecasting remains difficult with so many external influences weighing on the UK. Major volatility in bond yields is likely during the remainder of 2013/14 as investor fears and confidence ebb and flow between favouring more risky assets i.e., equities, and safer bonds.

Near-term, there is some residual risk of further QE - if there is a dip in strong growth or if the MPC takes action to do more QE in order to reverse the rapid increase in market rates, especially in gilt yields and interest rates up to 10 years. This could cause shorter-dated gilt yields and PWLB rates over the next year or two to significantly undershoot the forecasts in the table below. The failure in the US, over passing a Federal budget for the new financial year starting on 1 October, and the tension over raising the debt ceiling in mid-October, could also see bond yields temporarily dip until any binding agreement is reached between the opposing Republican and Democrat sides. Conversely, the eventual start of tapering by the Fed could cause bond yields to rise.

The longer run trend is for gilt yields and PWLB rates to rise, due to the high volume of gilt issuance in the UK, and of bond issuance in other major western countries. Increasing investor confidence in economic recovery is also likely to compound this effect as a continuation of recovery will further encourage investors to switch back from bonds to equities.

The overall balance of risks to economic recovery in the UK is currently weighted to the upside after five months of robust good news on the economy. However, only time will tell just how long this period of strong economic growth will last; it also remains exposed to vulnerabilities in a number of key areas.

Downside risks currently include:

- The conflict in the UK between market expectations of how quickly unemployment will fall as opposed to the Bank of England's forecasts

- Prolonged political disagreement over the US Federal Budget and raising the debt ceiling
- A return to weak economic growth in the US, UK and China causing major disappointment to investor and market expectations.
- The potential for a significant increase in negative reactions of populaces in Eurozone countries against austerity programmes, especially in countries with very high unemployment rates e.g. Greece and Spain, which face huge challenges in engineering economic growth to correct their budget deficits on a sustainable basis.
- The Italian political situation is frail and unstable.
- Problems in other Eurozone heavily indebted countries (e.g. Cyprus and Portugal) which could also generate safe haven flows into UK gilts.
- Monetary policy action failing to stimulate sustainable growth in western economies, especially the Eurozone and Japan.
- Weak growth or recession in the UK's main trading partners - the EU and US, depressing economic recovery in the UK.
- Geopolitical risks e.g. Syria, Iran, North Korea, which could trigger safe haven flows back into bonds

The potential for upside risks to UK gilt yields and PWLB rates, especially for longer term PWLB rates include: -

- A sharp upturn in investor confidence that sustainable robust world economic growth is firmly expected, causing a surge in the flow of funds out of bonds into equities.
- A reversal of Sterling's safe-haven status on a sustainable improvement in financial stresses in the Eurozone.
- Further downgrading by credit rating agencies of the creditworthiness and credit rating of UK Government debt, consequent upon repeated failure to achieve fiscal correction targets and sustained recovery of economic growth which could result in the ratio of total government debt to GDP to rise to levels that undermine investor confidence in the UK and UK debt.
- UK inflation being significantly higher than in the wider EU and US, causing an increase in the inflation premium inherent to gilt yields.
- In the longer term – an earlier than currently expected reversal of QE in the UK; this could initially be implemented by allowing gilts held by the Bank to mature without reinvesting in new purchases, followed later by outright sale of gilts currently held.

### 3.3 Short Term Borrowing 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)	0.49	0.48	0.49	0.48	0.48	0.48	0.48
1 Month (Market)	0.49	0.49	0.49	0.49	0.49	0.49	0.49
3 Month (Market)	0.51	0.51	0.51	0.51	0.52	0.52	0.52

### 3.4 Longer Term Borrowing Rates

	Start	July		Aug		Sept	
		Mid	End	Mid	End	Mid	End
	%	%	%	%	%	%	%
1 Year (Market)	0.90	0.88	0.86	0.88	0.88	0.89	0.87
10 Year (PWLB)	3.57	3.49	3.51	3.88	3.81	3.98	3.73
25 Year (PWLB)	4.45	4.42	4.44	4.63	4.51	4.63	4.46

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 Borrowing/Investments

Turnover during period

	No. Of Deals Struck	Turnover £m
New Borrowing	8	19.5
New Investments	3	9.0

Note that New Investments excludes investment in National Westminster call account which is re-invested on a daily basis.

Position at Month End

	July £m	August £m	September £m
Total Borrowing	75.00	73.00	74.50
Total Investments	53.45	55.00	52.65

Investment Income Forecast

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

	Cumulative	Cumulative	Cumulative	Cumulative
--	------------	------------	------------	------------

	Budget £'000	Actual £'000	Target Rate %	Actual Rate %
Quarter 1	107	170	0.26	1.12
Quarter 2	190	302	0.36	1.04
Quarter 3	235			
Quarter 4	257			

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 0.36%, 3 month rate was 0.39% and the 6 month rate was 0.47%.

### 3.6 New Long Term Borrowing

No new long term borrowing was taken during the quarter.

### 3.7 Policy Guidelines

The Treasury Management Strategy Statement (TMSS) for 2013/14, which includes the Annual Investment Strategy, was approved by the Council on 6<sup>th</sup> March 2013. 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 12 months in accordance with Capita's credit rating methodology.

### 3.8 Treasury Management Indicators

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 are included in the approved Treasury Management Strategy Statement.

## 4.0 **DEBT RESCHEDULING**

4.1 No debt rescheduling was undertaken during the quarter.

## 5.0 **POLICY IMPLICATIONS**

5.1 None

## **6.0 OTHER/FINANCIAL IMPLICATIONS**

- 6.1 Funding for the capital programme is dependent on the activities undertaken to support the programme being affordable and within the approved prudential indicators set out in the Treasury Management Strategy Statement

## **7.0 IMPLICATIONS FOR THE COUNCIL'S PRIORITIES**

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

## **8.0 RISK ANALYSIS**

- 8.1 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

## **9.0 EQUALITY AND DIVERSITY ISSUES**

- 9.1 There are no issues under this heading.

## **10.0 LIST OF BACKGROUND PAPERS UNDER SECTION 100D OF THE LOCAL GOVERNMENT ACT 1972**

- 10.1 There are no background papers under the meaning of the Act.