

**REPORT TO:** Executive Board

**DATE:** 27 February 2014

**REPORTING OFFICER:** Operational Director – Finance

**PORTFOLIO:** Resources

**TITLE:** Treasury Management 2013/14  
3rd Quarter: October – December

**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.

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

## **3.0 SUPPORTING INFORMATION**

### **Economic Background (Provided by Capita Asset Services)**

3.1 During the quarter ended 31<sup>st</sup> December 2013:

- There were signs that Gross Domestic Product (GDP) growth may have accelerated;
- Evidence pointed to a moderation of household spending growth;
- Inflation fell to its lowest level since November 2009;
- Unemployment approached the Monetary Policy Committee's (MPC) 7% forward guidance threshold;
- The MPC maintained the stance of monetary policy;
- 10-year gilt yields rose to 3% and the FTSE 100 reach 6749;
- The Federal Reserve decided to reduce the size of its monthly asset purchases by \$10bn (from \$85bn to \$75bn).

3.2 After growing at a healthy quarterly rate of 0.8% in Q3 of 2013, some of the early signs are that GDP growth was even stronger in the final quarter of 2013. On the basis of past form, the CIPS/Markit business activity surveys point to quarterly GDP growth of around 1.5% in the final quarter. The official data available for the fourth quarter so far have also been encouraging. For example, if October's 0.4% monthly expansion in industrial output was matched in the final two months of the year, quarterly growth in Q4 would have been almost 1%.

- 3.3 Household spending growth, though, may have slowed. Numerous indicators of retail sales, including the official measure and those produced by the CBI and BRC, suggest that consumer spending growth was weak in the first two months of Q4. This is not to say the consumer recovery has run its course. Indeed, the CBI survey showed a strong pick-up in sales in December. And the official measure of retail sales in the same month will be boosted by the inclusion of 'Black Friday' (despite this actually falling in the last week of November) which more timely data suggests saw a strong surge in sales, but it would take monthly growth of 1.6% in December for retail sales to flat line in Q4 as a whole.
- 3.4 Nevertheless, growth in sales off the high street may not have done so badly. For instance, although growth in new car registrations slowed in Q4, it remained fairly strong, achieving 7% annual growth in December. So it still seems likely that overall household spending rose in the fourth quarter.
- 3.5 Although it is still high, the unemployment rate has been falling quickly towards the Monetary Policy Committee's (MPC) 7% threshold for re-assessing the stance of monetary policy. Employment rose by 250,000 in the three months to October, the largest quarterly gain since mid-2010. This brought the unemployment rate down to 7.4%, compared to a rate of 7.7% in the three months to July. What's more, the Office for National Statistics' (ONS) experimental single-month estimate of unemployment reached 7% in October.
- 3.6 The decline in unemployment, which has been faster than the MPC predicted in November, has prompted overnight index swap markets to price in a rate rise as soon as Q1 2015. But Committee members have increasingly emphasised that the 7% unemployment rate is a threshold for reconsidering policy, rather than a trigger for raising rates. Indeed, the Bank's Chief Economist Spencer Dale said that interest rates would remain low not just until unemployment had dropped, but also until the economy had "seen a prolonged period of strong growth...[and] real incomes are higher".
- 3.7 The recent fall in, and improvement in the outlook for, inflation, suggests that interest rates will probably remain on hold even if the unemployment rate falls quickly to the 7% threshold. Indeed, the Consumer Prices Index (CPI) inflation rate has fallen quite sharply, reaching 2.1% in November. This was the lowest rate in four years. A number of factors contributed to this. Falling commodity prices put downward pressure on food and petrol prices, while sterling's 7% appreciation on a trade-weighted basis since its low point in July may have helped core inflation to fall. Admittedly, CPI inflation might have ticked up again in December when energy companies raised their prices, but inflation should continue to fall after that, given that commodity prices have been flat over the past year or so and sterling's

recent strength has reduced import prices, which should begin to feed into prices on the high street.

- 3.8 The housing market continued to recover in Q4, supported by the earlier implementation of the mortgage guarantee element of the Government's Help to Buy Scheme. Prices rose at an annual rate of 8.4% and 6.4% in November according to the Halifax and Nationwide measures, respectively. Would-be buyers continue to enter the market more quickly than sellers, with the RICS survey pointing to further price rises. The cost of new mortgages remains low, too, with the quoted interest rate on a 5-year fixed mortgage at a 75% loan-to-value ratio at 3.36% in November, 2 basis points lower than the average in Q3 and 81 basis points lower than when the Funding for Lending Scheme (FLS) was introduced in July 2012. Talk of a housing bubble on the national level still seems to be wide of the mark, with prices well below their pre-crisis peak in real terms. Moreover, the FLS was adjusted so that it no longer provides cheap finance for mortgages.
- 3.9 There were few surprises in the Autumn Statement. The Chancellor announced a fiscally neutral package of policies, with measures to ease the cost of households' utility bills offset by further spending cuts. More bullish forecasts from the Office for Budget Responsibility (OBR) left expected public borrowing over the next five years £73 billion lower than projected in the March Budget. All this left Mr Osborne expected to meet his primary fiscal mandate to balance the cyclically adjusted current budget in five years, a year early, though he still misses the supplementary target for the debt to GDP ratio to be falling in 2015/16.
- 3.10 Internationally, the biggest news was the Federal Reserve's decision at its December meeting to begin tapering its asset purchases. Although the announcement that the Fed's monthly purchases would be reduced by \$10bn was not the consensus view, which saw tapering beginning in the early part of 2014, it was not a big surprise. The decision reflected the relative strength of the US labour market, which on average added over 200,000 jobs per month in the four months up to November.
- 3.11 Markets took the Fed's move in their stride, with equities and bond yields up slightly on the day. Over the quarter, equities performed well domestically and overseas as economic prospects improved. The FTSE 100 was up by 4.4% to 6749, while the S&P 500 rose by almost 10%. Gilt yields also rose, with the ten-year rate ending Q4 28 basis points higher at 3%, having closely tracked US Treasury yields. Sterling rose by 2.3% against the dollar to finish the year at 1.66, while it rose by 0.5% against the euro to 1.20.
- 3.12 Activity indicators in the Eurozone point towards continued weak, albeit positive, economic growth in the fourth quarter of 2013 after a mere 0.1% quarterly expansion in Q3 and disinflationary pressures are

intense. Although CPI inflation rose from 0.7% to 0.9% in November, it remains well below the European Central Bank's (ECB) target of below but close to 2%. This is despite the ECB cutting its main refinancing rate by 25 basis points to 0.25% in November.

### Interest Rate Forecast

3.13 The following forecast has been provided by Capita Asset Services:

	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17
Bank rate	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.75%	1.00%	1.00%	1.25%
5yr PWLB rate	2.50%	2.60%	2.70%	2.70%	2.80%	2.80%	2.90%	3.00%	3.10%	3.20%	3.30%	3.40%	3.40%
10yr PWLB rate	3.60%	3.70%	3.80%	3.80%	3.90%	3.90%	4.00%	4.10%	4.20%	4.30%	4.30%	4.40%	4.50%
25yr PWLB rate	4.40%	4.50%	4.50%	4.60%	4.60%	4.70%	4.80%	4.90%	5.00%	5.10%	5.10%	5.10%	5.10%
50yr PWLB rate	4.40%	4.50%	4.50%	4.60%	4.70%	4.80%	4.90%	5.00%	5.10%	5.20%	5.20%	5.20%	5.20%

Capita Asset Services undertook a review of its interest rate forecasts in late November, after the Bank of England's latest quarterly Inflation Report. This latest forecast now includes a first increase in Bank Rate in quarter 2 of 2016 (previously quarter 3) and reflects greater caution as to the speed with which the MPC will start increasing Bank Rate than the current expectations of financial markets.

## **SUMMARY OUTLOOK**

### **UK economy**

3.14 Until 2013, the economic recovery in the UK since 2008 had been the worst and slowest recovery in recent history. However, growth strongly rebounded in 2013 - quarter 1 (+0.3%), 2 (+0.7%) and 3 (+0.8%), to surpass all expectations as all three main sectors, services, manufacturing and construction contributed to this strong upturn. The Bank of England has, therefore, upgraded growth forecasts in the August and November quarterly Inflation Reports for 2013 from 1.2% to 1.6% and for 2014 from 1.7% to 2.8%, (2015 unchanged at 2.3%).

3.15 Forward surveys are currently very positive in indicating that growth prospects are also strong for 2014, not only in the UK economy as a whole, but in all three main sectors, services, manufacturing and construction. This is very encouraging as there does need to be a significant rebalancing of the economy away from consumer spending to construction, manufacturing, business investment and exporting in order for this start to recovery to become more firmly established. One drag on the economy is that wage inflation continues to remain

significantly below CPI inflation so disposable income and living standards are under pressure, although income tax cuts have improved this to some extent. This therefore means that labour productivity must improve significantly for this situation to be corrected by the warranting of increases in pay rates.

- 3.16 While Bank Rate has remained unchanged at 0.5% and quantitative easing has remained unchanged at £375bn in 2013, the Funding for Lending Scheme (FLS) was extended to encourage banks to expand lending to small and medium size enterprises.
- 3.17 Inflation has fallen from a peak of 3.1% in June 2013 to 2.1% in November. It is expected to remain near to the 2% target level over the MPC's two year time horizon.
- 3.18 The UK has lost its AAA rating from Fitch and Moody's but that caused little market reaction.

### **The Global Economy**

- 3.19 **The Eurozone (EZ):** The sovereign debt crisis has eased considerably during 2013 which has been a year of comparative calm after the hiatus of the Cyprus bailout in the spring. In December, Ireland escaped from its three year EZ bailout programme as it had dynamically addressed the need to substantially cut the growth in government debt, reduce internal price and wage levels and promote economic growth. The EZ finally escaped from seven quarters of recession in quarter 2 of 2013 but growth is likely to remain weak and so will dampen UK growth.
- 3.20 **USA:** The economy has managed to return to robust growth in Q2 2013 of 2.5% y/y and 4.1% y/y in Q3, in spite of the fiscal cliff induced sharp cuts in federal expenditure that kicked in on 1 March, and increases in taxation. The Federal Reserve therefore decided in December to reduce its \$85bn per month asset purchases programme of quantitative easing by \$10bn. It also amended its forward guidance on its pledge not to increase the central rate until unemployment falls to 6.5% by adding that there would be no increases in the central rate until 'well past the time that the unemployment rate declines below 6.5%, especially if projected inflation continues to run below the 2% longer goal'. Consumer, investor and business confidence levels have all improved markedly in 2013. The housing market has turned a corner and house sales and increases in house prices have returned to healthy levels. Many house owners have, therefore, been helped to escape from negative equity and banks have also largely repaired their damaged balance sheets so that they can resume healthy levels of lending. All this portends well for a reasonable growth rate looking forward.

## Capita Asset Services' Forward View

- 3.21 Economic forecasting remains difficult with so many external influences weighing on the UK. Major volatility in bond yields is likely to endure as investor fears and confidence ebb and flow between favouring more risky assets i.e. equities, and safer bonds.
- 3.22 There could well be volatility in gilt yields over the next year as financial markets anticipate further tapering of asset purchases by the Fed. The timing and degree of tapering could have a significant effect on both Treasury and gilt yields. Equally, while the political deadlock and infighting between Democrats and Republicans over the budget has almost been resolved the raising of the debt limit, has only been kicked down the road. A final resolution of these issues could have a significant effect on gilt yields during 2014.
- 3.23 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.
- 3.24 The overall balance of risks to economic recovery in the UK is currently evenly weighted. 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.
- 3.25 Downside risks currently include:
- UK strong economic growth is currently very dependent on consumer spending and recovery in the housing market. This is unlikely to endure much beyond 2014 as most consumers are maxed out on borrowing and wage inflation is less than CPI inflation, so disposable income is being eroded.
  - A weak rebalancing of UK growth to exporting and business investment causing a major weakening of overall economic growth beyond 2014
  - Weak growth or recession in the UK's main trading partners - the EU and US, depressing economic recovery in the UK.
  - Prolonged political disagreement over the raising of the US debt ceiling.
  - A return to weak economic growth in the US, UK and China causing major disappointment in investor and market expectations.
  - A resurgence of the Eurozone sovereign debt crisis caused by ongoing deterioration in government debt to GDP ratios to the point where financial markets lose confidence in the financial viability of one or more countries and in the ability of the ECB and Eurozone governments to deal with the potential size of the crisis.

- 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; this will cause major difficulties in implementing austerity measures and a programme of overdue reforms. Italy has the third highest government debt mountain in the world.
- Problems in other Eurozone heavily indebted countries (e.g. Cyprus and Portugal) which could also generate safe haven flows into UK gilts, especially if it looks likely that one, or more countries, will need to leave the Eurozone.
- A lack of political will in France, (the second largest economy in the EZ), to dynamically address fundamental issues of low growth, poor international uncompetitiveness and the need for overdue reforms of the economy.
- Monetary policy action failing to stimulate sustainable growth in western economies, especially the Eurozone and Japan.
- Geopolitical risks e.g. Syria, Iran, North Korea, which could trigger safe haven flows back into bonds.

3.26 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.
- 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.

### 3.27 Short Term Borrowing 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)	0.48	0.47	0.47	0.47	0.47	0.47	0.38
1 Month (Market)	0.49	0.49	0.49	0.49	0.49	0.49	0.49
3 Month (Market)	0.52	0.52	0.52	0.52	0.52	0.52	0.53

### 3.28 Longer Term Borrowing Rates

	Start	Oct		Nov		Dec	
		Mid	End	Mid	End	Mid	End
	%	%	%	%	%	%	%
1 Year (Market)	0.87	0.89	0.87	0.88	0.88	0.87	0.91
10 Year (PWLB)	3.73	3.89	3.63	3.84	3.85	3.99	4.14
25 Year (PWLB)	4.46	4.56	4.38	4.53	4.55	4.57	4.64

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.

### 3.29 Temporary Borrowing/Investments

Turnover during period

	No. Of Deals Struck	Turnover £m
Short Term Borrowing	28	73.24
Short Term Investments	41	73.30

Position at Month End

	Oct £m	Nov £m	Dec £m
Short Term Borrowing	75.00	76.00	85.00
Short Term Investments	49.05	48.90	48.65

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	92	170	0.26	1.12
Quarter 2	163	302	0.36	1.04
Quarter 3	223	412	0.35	0.99
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 0.40% and the 6 month rate was 0.47%.

### 3.30 New Borrowing

No new long term borrowing was taken during the quarter.

### 3.31 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 Asset Services rating methodology.

### 3.32 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.

There are no breaches to report during the quarter.

## **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.