AGENDA ITEM NO: 5

HAMBLETON DISTRICT COUNCIL

Report To: Cabinet
29 November 2011

Subject: **TREASURY MANAGEMENT PERFORMANCE – INTERIM REPORT**

All Wards
Scrutiny Committees
Cabinet Member for Corporate Management: Councillor R Kirk

1.0 PURPOSE AND BACKGROUND:

1.1 The purpose of this report is to advise Members of the performance of the internal fund management team for the first half of the financial year. Members will recall that all fund management is now carried out in-house. Annex A contains details of performance.

1.2 As part of the Council's Treasury Management Strategy I am required to report to Members on treasury management issues at least three times per year. This report fulfils one part of that requirement.

2.0 DECISIONS SOUGHT:

2.1 Members are asked to consider the in-house investment performance for the first six months of 2011/12.

3.0 LINK TO CORPORATE PRIORITIES:

3.1 The investment of Council funds is an important aspect of good financial management which is required to sustain all Corporate Priorities.

4.0 RISK ASSESSMENT:

4.1 There are no significant risks associated with approving (or not approving) the recommendations in this report.

5.0 SUSTAINABILITY IMPLICATIONS:

5.1 None.

6.0 FINANCIAL IMPLICATIONS:

6.1 Average fund management performance over the last 6 months has seen a return of 1.50% for core investments and 0.49% for cash flow investments. This performance is above the benchmark of 0.47% and for core cash is above the target of 0.97% (benchmark plus ½%).

6.2 The investment returns (or rates) have been higher than the benchmark and target and have therefore produced a small surplus compared to the estimates. In cash terms the investment interest received (£201,665) is higher (£29,165) than what has been budgeted (£172,500) for the first six month period. In the current financial climate this is satisfactory performance.

7.0 LEGAL IMPLICATIONS:

7.1 None.

8.0 SECTION 17 CRIME AND DISORDER ACT 1998:

8.1 None.

9.0 EQUALITY/DIVERSITY ISSUES:

9.1 None for this report.

10.0 RECOMMENDATION:

10.1 It is recommended that Cabinet note the investment performance of the in-house team to date.

DAVE SIMPSON

Background papers:	None
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Annex A

FUND MANAGEMENT PERFORMANCE APRIL - SEPTEMBER 2011

1.0 BACKGROUND:

1.1 CIPFA (the Chartered Institute of Public Finance and Accountancy) issued the revised Code of Practice for Treasury Management in November 2009. It recommends that members should be updated on treasury management activities at least twice a year, but preferably quarterly. This report therefore ensures this council is implementing best practice in accordance with the Code

2.0 ECONOMIC BACKGROUND:

2.1 The quarter ended 30th September 2010 saw the following:

- Indicators suggest that the economy has at best stagnated;
- Conditions on the high street have deteriorated further;
- Employment has fallen again;
- The public finances are expected to miss this year's fiscal forecasts;
- CPI inflation rising, heading for a peak of around 5% in Q4;
- The Monetary Policy Committee signals a move towards increasing QE;
- Equities prices plummet and gilt yields fall to historic lows;
- The economic recoveries falter in the US and Europe.

2.2 Activity indicators have suggested that the 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.

2.3 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.

2.4 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. In addition the International labour Organisation (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 Chartered Institute of Purchasing and Supply (CIPS) surveys were below the 50-mark in July and August (below 50 marks a contraction in expectations).

2.5 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 Office for Budget Responsibility (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.

2.6 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.

2.7 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 Chartered Institute of Purchasing and Supply (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%.

2.8 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, pushed inflation to 5% in September.

2.9 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.

2.10 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.

2.11 Meanwhile, the Monetary Policy Committee (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 Quantitative Easing 2 will be launched soon, although, no other members have yet joined Adam Posen in voting for more Quantitative Easing. 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."

2.12 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.

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

2.14 Growth has also slowed sharply in the euro-zone. In particular, the European Central Bank (ECB) composite Purchasing Managers Index (PMI) now pointed to outright falls in Gross Domestic Product (GDP) in August. A steep drop in the European Community Economic Sentiment Indicator in August also left the index consistent with a sharp slowdown in annual GDP growth in the region.

3.0 <u>INTEREST RATE FORECAST:</u>

3.1 The Council's treasury adviser, Sector, provides the following forecast

Sector's Interest Rate View

	Now	Dec-11	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%	0.50%	0.75%	1.00%	1.25%	1.50%	2.00%	2.25%	2.50%
5yr PWLB Rate	**2.41%**	2.30%	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 Rate	**3.46%**	3.30%	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 Rate	**4.31%**	4.20%	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	**4.42%**	4.30%	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%

3.2 The Sector central forecast is for the first increase in bank rate to be in September 2013. We would remind clients of the view we expressed in our two previous interest rate revision newsflashes of just how unpredictable PWLB rates and bond yields are as we are experiencing exceptional levels of volatility which are highly correlated to political developments (or lack of them) in the sovereign debt crisis.

SUMMARY OUTLOOK

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

1. The decision by the Monetary Policy Committee (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 Monetary Policy Committee (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.

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

3.5 In summary, our concerns around a slow down in prospects for Gross Domestic Product (GDP) growth in the western world are as follows: --

United States

- Current weak GDP growth; jobless recovery
- Federal Bank unlikely to increase central rate until mid 2013
- Latest Federal Bank 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

European Union

- 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

United Kingdom

- 40% of UK Gross Domestic Product (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%. The Office for Budget Responsibility (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 Standard Variable Rate (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
- Quantitative Easing (QE)2 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.

4.0 ANNUAL INVESTMENT STRATEGY:

4.1 The Treasury Management Strategy Statement (TMSS) for 2011/12, which includes the Annual Investment Strategy, was approved by Cabinet on 22 March 2011 and by the full Council on 12 April 2011. It sets out the Council's investment priorities as being:

- The **security** of capital, and
- The **liquidity** of its investments

4.2 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 of 3 months.

4.3 This limit is a change to the original Strategy and 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 1 year.
2. UK semi-nationalised institutions (Lloyds / RBS). Sector continues to view the current significant UK ownership of these entities as providing significant comfort to investors.
3. Money Market Funds.

4.4 A full list of investments held as at 1 April 2011 and made up to 30 September 2011 is contained at Annex B. It is confirmed that the approved limits within the Annual Investment Strategy were not breached during the half year to 30 September 2011, other than on one occasion relating to Loan 3461A. This loan was placed for one year but would have been due to be repaid on a Saturday. I therefore authorised the loan to be repaid on the following Monday.

4.5 Investment rates available in the market have continued at historically low levels. The average level of funds available for investment purposes during the last half year was **£25.339m.** The level of funds available was mainly dependent on the timing of precept payments, receipt of grants, the timing of major payments (for example Housing Benefits) and progress on the Capital Programme. At 30 September 2011 the authority held **£27.000m** core cash balances for investment purposes (i.e. funds available for more than one year).

5.0 PERFORMANCE APRIL – SEPTEMBER:

5.1 Fund management at the Council is performed entirely by an in-house team and conducted in accordance with the Council's Treasury Management Strategy which includes the Annual Investment Strategy. The in-house performance measure is to exceed the 7 day benchmark by 0.5%.

5.2 The first 6 months of the financial year has seen strong performance in the two quarters in relation to core cash investments but cash flow performance has only just exceed the benchmark.

1st Quarter (April to June)

5.3 For core cash investments performance in the first quarter was strong **with returns of 1.41% against the 7 day LIBID benchmark of 0.45%**. This performance, which was achieved purely by investing in fixed term deposits, not only exceeded the benchmark but also exceeded the target of 0.97% (benchmark plus 0.5%).

5.4 For cash flow investments performance in the first quarter was still good **with returns of 0.49% against the 7 day LIBID benchmark of 0.45%**. Although this performance did not exceed the target interest rate, in times when interest rates are as low as they currently are, this was a target that was not expected to be achieved.

2nd Quarter (July to September)

5.5 For core cash investments performance in the second quarter was again strong **with returns of 1.59% against the 7 day LIBID benchmark of 0.47%**. This performance also exceeded the target of 0.97% (benchmark plus 0.5%) and was higher than the first quarter.

5.6 For cash flow investments performance in the second quarter was steady **with returns of 0.49% against the 7 day LIBID benchmark of 0.47%**. Again, this performance did not exceed the target interest rate for the reason stated above.

5.7 Quarterly performance is summarised in the table below.

	Annualised Returns 2011/12		
	April – June	July-Sept	Year to Date
	%	%	%
Core Cash	1.41	1.59	1.50
Cash Flow	0.49	0.49	0.49
Benchmark	0.45	0.47	0.47
Target	0.95	0.97	0.97

5.8 From the table it can be seen that for the full half year the in-house team has exceeded both the benchmark and its performance target for core cash investments, whilst cash flow performance only exceeded the benchmark.

5.9 In cash terms the returns in 2011/12 compared to the benchmark are shown :-

	Returns in Excess of 7 Day Benchmark		
	Actual Return £	Benchmark Return £	Excess Over Benchmark £
In-house Team	201,665	68,114	133,551

6.0 **FINANCIAL IMPLICATIONS:**

6.1 Performance in terms of the budget for the first half of the year is shown in the table below:

	Total £
Budget for half year	172,500
Investment Returns	201,665
Surplus/(Deficit) returns	29,165

6.2 Compared to the income provided in the revenue budgets for 2011/12, a small surplus of £29,165 has been made in the first half of the year. The effect will be to marginally increase the expected amount transferred to the Council Taxpayers Reserve.

7.0 COMPLIANCE WITH TREASURY AND PRUDENTIAL LIMITS:

7.1 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 (affordability limits) are included in the approved Treasury Management Strategy Statement TMSS.

7.2 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.

Annex B

INTERNAL TEAM INVESTMENTS

Comparison to Benchmark

1. Investments Existing at 1 April 2011

Loan No.	Institution	Date of Loan	Loan Period (Days)	Loan Amount £	Interest Rate %	Benchmark Rate %	Excess %
3325	Bank of Scotland	05/07/10	365	2,300,000	1.85	0.35	1.50
3334	Bank of Scotland	15/07/10	365	2,800,000	2.10	0.35	1.75
3351	Lloyds	19/08/10	365	2,400,000	2.10	0.40	1.7
3354	Royal Bank of Scotland	01/09/10	365	1,000,000	1.33	0.40	0.93
3394	Cater Allen	23/12/10	182	2,600,000	1.35	0.40	0.95
3395	Barclays	24/12/10	182	1,500,000	1.10	0.40	0.70
3400	Cater Allen	12/01/11	90	2,000,000	0.84	0.45	0.39
3401	Ulster Bank Ltd	17/01/11	182	1,000,000	1.15	0.45	0.70
3415	Ulster Bank Ltd	17/03/11	47	3,000,000	0.60	0.45	0.15

2. New Investments Made Between 1 April 2011 and 30 September 2011

Loan No.	Institution	Date of Loan	Loan Period (Days)	Loan Amount £	Interest Rate %	Benchmark Rate %	Excess %
3416	Nationwide B S	01/04/11	185	2,000,000	1.06	0.45	0.61
3422A	Nationwide B S	07/04/11	91	1,500,000	0.73	0.45	0.28
3424	Nationwide B S	12/04/11	91	1,000,000	0.74	0.45	0.29
3427	Cater Allen	12/04/11	91	2,000,000	1.07	0.45	0.62
3418A	Nat West	20/04/11	91	2,000,000	1.25	0.45	0.80
3432	Newcastle City Council	03/05/11	365	3,000,000	1.70	0.45	1.25
3449	Cater Allen	23/06/11	92	2,600,000	1.07	0.45	0.62
3450	Ulster Bank Ltd	24/06/11	236	1,500,000	1.34	0.45	0.89
3453	Bank of Scotland	05/07/11	366	2,300,000	2.05	0.45	1.60
3455	Ulster Bank Ltd	07/07/11	223	1,500,000	1.30	0.45	0.85
3457	Santander	12/07/11	184	1,000,000	1.40	0.45	0.95
3458	Cater Allen	12/07/11	184	2,000,000	1.30	0.45	0.85
3461A	Bank of Scotland	15/07/11	367	3,000,000	2.10	0.45	1.65
3461	Ulster Bank Ltd	18/07/11	212	1,000,000	1.30	0.45	0.85
3462	Nat West	20/07/11	92	2,000,000	1.25	0.45	0.80
3471	Lloyds	19/08/11	367	5,100,000	2.20	0.50	1.70
3449R	Cater Allen	23/09/11	90	2,600,000	1.17	0.50	0.67