ANNEX F

TREASURY MANAGEMENT UPDATE
Quarter 3 (October-December), 2012-13

Purpose:

The Chartered Institute of Public Finance and Accountancy (CIPFA) 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.

Economic climate:

Commentary from our treasury advisors Sector on the economic background is attached as Appendix A.

In summary, the fourth quarter of 2012 (calendar year) saw:

- Indicators suggest that the economy probably contracted;
- Retail sales weakened but spending off the high street held up;
- Employment continued to rise, albeit at a slower pace;
- Inflation remained stubbornly above the MPC's 2% target;
- The MPC paused its programme of asset purchases;
- UK equity prices rose and government bond prices fell;
- The US economy continued to recover at a modest pace.

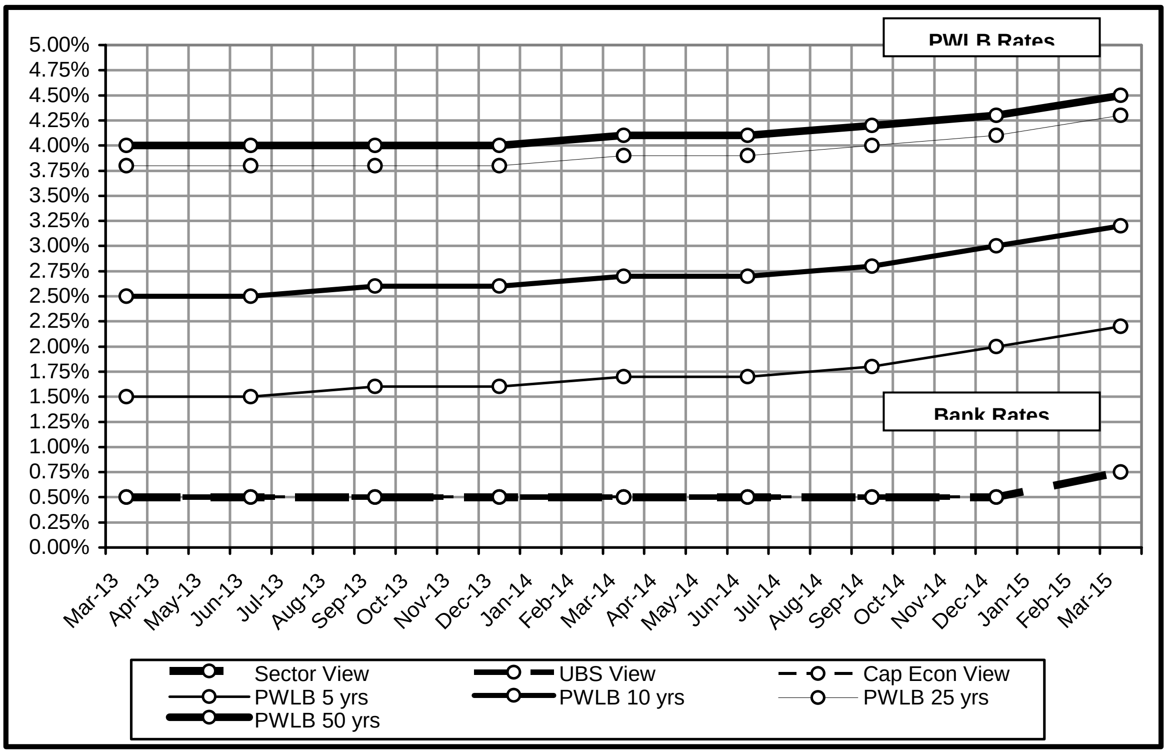
Interest rate forecast:

The forecast for interest rates over the next three years (where available) is set out below. The bank rate views of treasury advisors Sector is shown against those of economic analysts Capital Economics and UBS:

Table 1: Interest Rate Forecast

	Mar 2013	Jun 2013	Sept 2013	Dec 2013	Mar 2014	Jun 2014	Sept 2014	Dec 2014	Mar 2015
Central Bank Rate									
Sector View	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.75%
UBS View	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	-
Cap Econ View	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	-
Public Works Loan Board Rates									
5 yrs	1.50%	1.50%	1.60%	1.60%	1.70%	1.70%	1.80%	2.00%	2.20%
10 yrs	2.50%	2.50%	2.60%	2.60%	2.70%	2.70%	2.80%	3.00%	3.20%
25 yrs	3.80%	3.80%	3.80%	3.80%	3.90%	3.90%	4.00%	4.10%	4.30%
50 yrs	4.00%	4.00%	4.00%	4.00%	4.10%	4.10%	4.20%	4.30%	4.50%

Chart 1: Interest Rate Forecast



Sector undertook a review of its interest rate forecasts following the issue of the latest Bank of England Inflation Report for November 2012. In the August Inflation Report, the Bank changed its position significantly in as much as it markedly downgraded its forecasts for the strength and speed of recovery in GDP growth whereas previously it had consistently been forecasting a strong recovery to over 3% p.a. In its November Report, the Bank has continued this shift towards pessimism in the speed and strength of recovery; it is now only forecasting growth at around 1% in 2013 and 2% in 2014. These developments have pushed back expectations of the timing of the eventual start of increases in Bank Rate from Q4 2014 to Q1 2015, as well as the pace of rises in gilt yields.

Budget planning scenarios will continue to include a sensitivity analysis of the impact that a delayed economic recovery would have on the Council.

Annual Investment Strategy

The Treasury Management Strategy Statement (TMSS) for 2012/13, which includes the Annual Investment Strategy, was approved by the Council on 21st February 2012. It sets out the Council's investment priorities as being:

1. **S**ecurity of Capital;
2. **L**iquidity; and
3. **Y**ield

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 it is considered appropriate to hold the majority of investments short term to cover short term cash flow needs but also to seek out value available in significantly higher rates in periods up to 12 months with highly credit rated financial institutions.

The table below summarises the investment maturity position at 31st December 2012:

Table 2: Investment Maturity Position at 31st December 2012

Period	Product type / Maturity	Amount	
		£	%
Instant Access	Banks	£6,680,427	5.4
	Money Market Funds	£49,000,000	39.6
		£55,680,427	**45.0**
Fixed Term – Banks	0-3 months	£38,200,000	30.8
	3-6 months	£5,000,000	4.0
	6-12 months	£25,000,000	20.2
		£68,200,000	**55.0**
Total Investment Portfolio		**£123,880,427**	**100.0**

Investment rates available in the market have continued at historically low levels and have fallen further during the quarter as a result of a number of UK and overseas factors. The UK Funding for Lending Scheme and the ECB's pledge to support the Eurozone has directly impacted on rates available to local authorities, as institutions are able to fund cash requirements cheaper through the use of these schemes. The structure of the investment portfolio has effectively cushioned the impact to the Council.

Investment balances bought forward at 31st March 2012 were £101.6m. Due to the front-loaded nature of various government funding streams the average level of funds available for investment purposes during the quarter was £133.9m.

Balances were previously forecast to fall to circa £85.0m by 31st March 2013 as internal resources are applied to fund capital expenditure demands in lieu of further borrowing, effectively reducing the cost of carrying debt at higher cost than income generated through investment of balances and reducing exposure to counterparty risk. To further contribute to this objective, the purchase of assets from the Homes and Communities Agency will be initially funded from investment balances. Balances are now estimated to fall to circa £42.5m by 31st March 2013. The impact of this action has been taken into consideration in the Medium Term Financial Plan.

The Council's investment return for 2012/13 is currently above target. Latest projections for the financial year are reported through the Budget Monitoring process. Performance against benchmark return is shown below:

Table 3: Benchmark Performance

Benchmark	Benchmark Return	Council Performance
3 month	0.40%	1.47%

As illustrated the authority outperformed the benchmark by 107 basis points. Latest projections for the financial year are reported through the Budget Monitoring process.

New Borrowing

No new borrowing was undertaken during the quarter. Below is a table setting out the profile of existing borrowing.

Table 4: Borrowing Profile

	No of loans	Borrowing *	
		£m	**%**
Under 12 months	3	23.000	5.19
1-2 years	1	20.000	4.51
2-5 years	4	21.150	4.77
5-10 years	7	20.904	4.71
Over 10 years *	43	358.510	80.82
		443.564	**100**

Debt Restructuring

Debt rescheduling opportunities have been limited due to the current economic climate and consequent structure of interest rates. Officers continue to monitor the position.

No debt rescheduling was undertaken during the quarter.

Compliance with Treasury and Prudential Limits

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) were approved alongside the TMSS on 22nd February 2012.

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.

As reported in Quarter 1, on one occasion the maximum exposure limit the Council internally applies to separate counterparties was exceeded (by 0.07%). The amount on deposit has since been reduced in line with limits and measures to strengthen procedures have been implemented.

The Prudential and Treasury Indicators are shown in Appendix C.

Appendix A
Economic Commentary – Sector Treasury Services
Fourth quarter of 2012 (calendar year)

The unwinding of the boost from the Olympic Games in August means that GDP probably contracted in the fourth quarter of 2012. Following a 2.1% monthly drop in September, industrial production fell by a further 0.8% in October. In addition, the overall trade deficit widened from £2.5bn in September to £3.6bn in October. The official measure of retail sales volumes fell by 0.7% in October. With sales volumes stagnant in November, retail sales are likely to detract from overall GDP growth in Q4. However, spending off the high street continued to show evidence of recovery.

The claimant count measure of unemployment fell by 3,000 in November, while the Labour Force Survey measure of employment rose by 40,000 in the three months to October. Pay growth remained depressed. Annual growth of overall average earnings dropped from 1.8% in June to 1.3% in October.

On the housing market the big picture is that prices fell slightly over the year. Mortgage approvals for new house purchase continued to edge up. The total of 52,982 in October was the fifth consecutive monthly rise. Although an encouraging sign, the level is still far below that seen pre-crisis.

Banks' funding costs continued to ease, reflecting the Bank of England's provision of low cost funding via the Funding for Lending Scheme. Rates on new fixed and floating rate mortgages both declined in October.

Meanwhile, although public borrowing has continued to overshoot last year's level, the Government was helped by a number of one offs in December's Autumn Statement. Borrowing from April to November was £93bn, £9bn higher than the same period in 2011/12. However, the Office for Budget Responsibility (OBR) expects net borrowing to come in at £108bn in 2012/13, about £10bn below last year's level, largely reflecting the receipt of funds from the Bank of England's Asset Purchase Facility and the anticipated auction of 4G licences early next year.

Austerity was extended in the Autumn Statement, to 2017/18, and in light of the deterioration in the borrowing forecasts, the Chancellor chose to disregard one of his fiscal targets, to get debt as a share of GDP falling by 2015/16.

CPI inflation rose from 2.2% in September to 2.7% in October, and remained at that level in November. October's jump in university tuition fees, hefty rises in utility prices at the end of the 2012 and a pick-up in food price inflation following poor harvests, mean that inflation is likely to hover between 2.5% and 3% for the best part of 2013.

The MPC voted in November to pause its programme of quantitative easing, leaving total asset purchases at £375bn, and announced in November that Mark Carney, the current Governor of the Bank of Canada, will take on the Governorship of the Bank of England from June 2013.

Equity prices in the UK and overseas largely continued to rise over the course of the fourth quarter, with the FTSE 100 picking up from 5,820 to 5,898. Over the period gilt prices fell, causing 10-year gilt yields to rise from about 1.55% to 1.80%. Meanwhile, the pound was unchanged against the dollar, at about $1.63, but weakened slightly against the euro from €1.25 to €1.23.

Appendix B
Commentary on Interest Rate Outlook – Sector Treasury Services

Summary Outlook
In summary, our view on the prospects for GDP growth in the UK economy is as follows:

UK

- The Bank of England November 2012 Inflation Report has again pushed back the timing of a return to trend growth and the rate at which inflation will fall back towards the target rate of 2%;
- It now looks likely that Q4 2012 will see a return to negative growth. If this negativity continues into the first quarter of 2013 it would be the first triple dip recession since records began in 1955;
- A fair proportion of UK GDP is dependent on overseas trade; the high correlation of UK growth to US and Eurozone GDP growth means that the UK economy is likely to register weak growth over 2013 and 2014;
- Consumers are likely to remain focused on paying down debt. Weak consumer sentiment and job fears will all act to keep consumer expenditure suppressed; this will be compounded by inflation being higher than increases in average earnings i.e. disposable income will still be eroded;
- The Coalition government is hampered in promoting growth by the need to tackle the budget deficit;
- Little sign of a coordinated strategy for the private sector to finance a major expansion of infrastructure investment to boost UK growth;
- There is potential for more QE in 2013 which will help to keep gilt yields lower than they would be otherwise;
- On the other hand, recent discussion around reformulating how RPI is calculated could adversely affect demand for inflation indexed gilts in particular, but also gilts generally, if this proposal is taken forward and was perceived to be a softening of the stand against inflation in the UK;
- The main rating agencies have all made it clear they are reviewing the UK's "AAA" status in early 2013. There is a material chance of the current ratings being downgraded. Although the UK will retain its "safe haven" status, a change in rating may place some upside pressure on gilt yields.

Appendix C
Treasury and Prudential Indicators as at 31st December 2012

Prudential Indicator	2012/13 Indicator	Quarter 3 – Actual
Authorised limit for external debt	----- £597.000m -----	
Operational boundary for external debt	----- £577.000m -----	
Gross borrowing	£453.564m	£443.564m
Investments	£95.000m	£133.907m
Net borrowing	£358.564m	£299.657m
Capital Financing Requirement (CFR)	£563.102m	£541.645m
Ratio of financing costs to net revenue streams: GF	12.22%	10.61%
HRA	44.83%	35.22%
Incremental impact of capital investment decisions:-		
a) Increase in council tax (band D) per annum.	£26.10p	£17.35p *
b) Increase in average housing rent per week	£0.08p	£0.08p
Limit of fixed interest rates based on net debt (average)	£567.000m	£377.144
Limit of variable interest rates based on net debt (average)	£30.000m	-£69.467
Principal sums invested > 364 days	£30.000m	£0.000m
Maturity structure of borrowing limits:-		
Under 12 months	Max. 15% Min. 0%	5.19%
12 months to 2 years	Max. 15% Min. 0%	4.51%
2 years to 5 years	Max. 50% Min. 0%	4.77%
5 years to 10 years	Max. 50% Min. 0%	4.71%
10 years and above	Max. 100% Min. 50%	80.82%

* Reduction in incremental impact resulting from HRA Reform borrowing reducing the overall debt pool consolidated rate