BOROUGH COUNCIL OF WELLINGBOROUGH **AGENDA ITEM 9**

Resources Committee **30 October 2019**

Report of the Section 151 Officer

2019-20 MID YEAR REPORT ON TREASURY MANAGEMENT

1 Purpose of Report

This report aims to keep members informed of treasury management activity, in line with the Treasury Management Strategy Statement (TMSS) which was approved by this committee on 20 March 2019.

2 Executive Summary

2.1 This report combines the actual performance and investments held as at 30 September 2019 with an overall outline of expected performance for the remainder of the financial year.

2.2 It also includes as an appendix an update on the current UK economy and the forecast for interest rates going forwards. The market and economy are key factors in the level of returns that can be expected from investments and this information should help members understand the wider economic picture and its influences over the rate of return achieved.

3 Appendices

Appendix 1 - Summary of Investment transactions at 30 September 2019

Appendix 2 – Summary of economic background and interest forecast at 30 September 2019

4. **Proposed action: The resources committee is invited to RESOLVE to:**

4.1 **Note the Mid-Year Report on Treasury Management**

5. Background

The Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management and the council's treasury management policy requires periodic reports on the routine activity of the treasury management function and operations to be reported to committee, which includes a mid-year update report. This report fulfils that requirement.

6 Discussion

Annual Investment Strategy:

6.1 The Treasury Management Strategy Statement (TMSS) for 2019-20 was approved by council on 20 March 2019. The council's annual investment strategy, which is incorporated in the TMSS, outlines the council's investment priorities as follows:

- security of capital
- liquidity of investments
- yield from its investments

6.2 The council has historically invested mainly in building societies, which do not necessarily have high credit ratings as defined by the recognised credit rating agencies e.g. Fitch and Moody's. However, at the present time building societies are continuing to provide better rates of return, with a good history of credit and as such the credit risk of investing with them is considered acceptable within the parameters outlined in the TMSS. All potential investees are monitored carefully and on a regular basis.

6.3 The treasury management strategy allows for up to 25% of available funds (if we exclude our current banking provider) to be invested in individually specified domestic banks and a total of £25m in the larger domestic building societies. Wellingborough's portfolio of investments currently totals £36m, comprised of £11m with four domestic banks and £25m with eleven domestic building societies.

6.4 As illustrated in the economic background in appendix 2, investment rates are expected to continue at low levels in the medium-term, having remained at 0.75% since the beginning of August 2018. In addition, the effects of Brexit and other international political uncertainties have recently affected the rates of return from investments. This has meant that current investments are being entered into at somewhat lower rates than those previously available earlier in the year.

6.5 The level of funds available for investment purposes in the first half of 2019-20, as reported above, was £36m. Many of these funds were non-reserve backed working capital balances and as such were temporary in nature. The level of funds was dependent on the timing of precept and NNDR payments, as well as the receipt of various grants. Progress on the capital programme also influences the level of funds available for investment purposes.

2019-20 Performance to date

6.6 Appendix 1 shows a detailed list of the investments held at 30 September 2019. These totalled £36m which includes £10m in call accounts, with estimated interest receivable for the first 6 months amounting to £220k.

6.7 The profiling and the maturity of these investment are summarised in the following charts:

Chart 1:

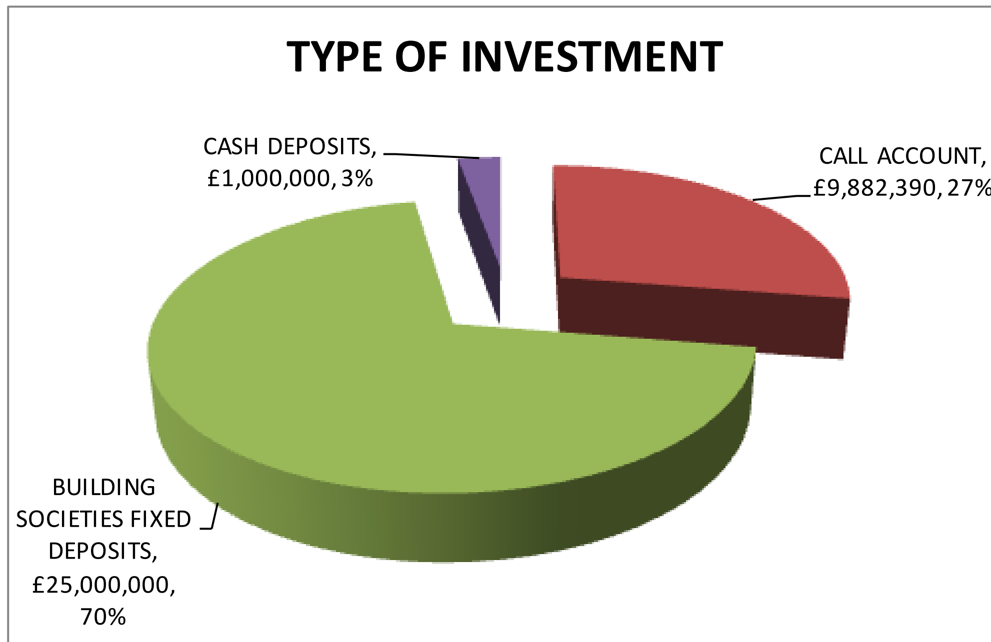
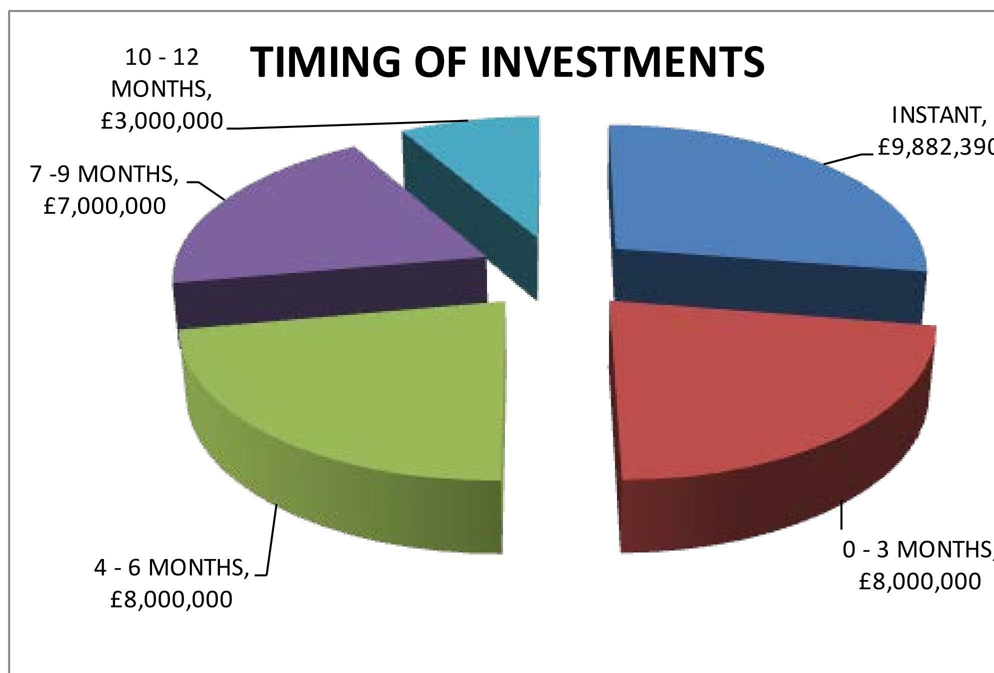


Chart 2:



6.8 The average rate of return that the council has achieved for the first six month period is 1.05%, compared to the average three months LIBID (London Interbank Bid Rate) interest rate for the same period of 0.75%.

6.9 The estimated interest receivable for the year is £352k, based on an average annual interest rate of 1%. The 2019-20 budget was set at £294k assuming an average rate of return of 1%, therefore anticipated performance for the year is approximately £62k above budget and the surplus on the budget for Investment Income will be reported as part of the revenue monitoring process for the year.

6.10 Link Asset Services, the council's treasury management advisers, have provided an overview of the current economic climate and this is set out at appendix 2, as it helps to set the scene within which the council's treasury management function operates.

6.11 The table in appendix 2 predicts that the Bank of England base rates are likely to remain stable into the next financial year with a small increase expected towards the latter end of 2020. This and the impact of Brexit, means that rates have recently taken a slight dip. If this trend continues it may have a significant effect on future investment interest returns. The projected impact of this will be incorporated into the 2020-21 budget and medium-term forecasts for the following years.

6.12 The chief financial officer confirms that the approved limits within the annual investment strategy were not breached during the first six months of 2019-20.

6.13 The council has complied fully with the requirements of its approved treasury management strategy during the period including use of approved counterparties and investment limits.

7 Legal Powers

Local Government Act 2003.

8 Financial and Value For Money Implications

As stated in the report.

9 Risk Analysis

Nature of risk	Consequences if realised	Likelihood of occurrence	Control measures
Fall in interest rates	Reduced income	Medium	Maintaining as high an average interest rate as possible through a mix of short and longer term fixed and variable rate investments.
Less funds available for investment	Reduced income	Medium	Regular budget monitoring, allowing for remedial action to be taken.
Loss of capital	Reduced funds available for	Low	Financial ratings of counterparties and limits

Nature of risk	Consequences if realised	Likelihood of occurrence	Control measures
	both capital and revenue purposes		on amounts invested. Review of council's lending policies.

10 Implications for Resources

No direct implications for staffing or property.

11 Implications for Stronger and Safer Communities

No direct implications.

12 Implications for Equalities

No direct implications.

13 Author and Contact Officer

Tracey Cave, Service Accountant

14 Consultees

Shaun Darcy, Director of Resources, S151 Officer

Eric Symons, Assistant Director, Deputy S151 Officer

Julie O'Connell, Finance Manager

15 Background Papers

Treasury Management Strategy Statement 2019-20

Appendix 1

Summary of Investment transactions at 30 September 2019

Summary of Investments as at 30 September 2019					
Loans Investment Number	Borrower	Interest Rate %	Period of Loan	Value of Investment £	Maturity Date
I 3443	Newcastle Building Society	1.15	365	1,000,000	01/10/2019
I 3444	Newcastle Building Society	1.15	364	1,000,000	07/10/2019
I 3445	West Bromwich Building Society	1.15	364	1,000,000	14/11/2019
I 3446	West Bromwich Building Society	1.15	364	1,000,000	06/12/2019
I 3450	National Counties Building Society	1.20	364	1,000,000	07/01/2020
I 3454	Progressive Building Society	1.25	364	1,000,000	13/03/2020
I 3457	Nottingham Building Society	1.06	183	2,000,000	04/10/2019
I 3458	Monmouthshire Building Society	1.03	183	2,000,000	04/10/2019
I 3459	Saffron Building Society	1.25	366	1,000,000	15/04/2020
I 3460	Nottingham Building Society	1.11	366	1,000,000	15/04/2020
I 3461	Santander Bank	1.25	364	1,000,000	29/05/2020
I 3462	Saffron Building Society	1.25	364	1,000,000	02/06/2020
I 3463	Furness Building Society	1.15	274	1,000,000	04/03/2020
I 3464	Principality Building Society	1.10	274	1,000,000	04/03/2020
I3465	Saffron Building Society	1.20	365	1,000,000	30/06/2020
I3466	Principality Building Society	0.90	123	2,000,000	05/11/2019
I3467	National Counties Building Society	1.25	364	2,000,000	17/07/2020
I3468	Progressive Building Society	1.05	184	1,000,000	30/01/2020
I3469	Darlington Building Society	1.10	277	1,000,000	31/03/2020
I3470	Newcastle Building Society	1.30	365	1,000,000	03/07/2020
I3471	Monmouthshire Building Society	1.05	185	1,000,000	17/02/2020
I3472	Newbury Building Society	1.15	365	1,000,000	10/09/2020
	Lloyds Call Account	0.75	CALL	3,508,580	
	Bank Of Scotland Call Account	0.65	CALL	2,361,335	
	HSBC Call Account	0.65	CALL	4,012,475	
	Total			35,882,390	

Appendix 2

Summary of Economic Background and Outlook at 30 September 2019

UK. This first half year has been a time of upheaval on the political front as Theresa May resigned as Prime Minister to be replaced by Boris Johnson on a platform of the UK leaving the EU on or 31 October, with or without a deal. However, in September, his proroguing of Parliament was overturned by the Supreme Court and Parliament carried a bill to delay Brexit until 31 January 2020 if there is no deal by 31 October. MPs also voted down holding a general election before 31 October, though one is likely before the end of 2019. So far, there has been no majority of MPs for any one option to move forward on enabling Brexit to be implemented. At the time of writing the whole Brexit situation is highly fluid and could change radically by the day. Given these circumstances and the likelihood of an imminent general election, any interest rate forecasts are subject to material change as the situation evolves. If the UK does soon achieve a deal on Brexit agreed with the EU then it is possible that growth could recover relatively quickly. The MPC could then need to address the issue of whether to raise Bank Rate at some point in the coming year when there is little slack left in the labour market; this could cause wage inflation to accelerate which would then feed through into general inflation. On the other hand, if there was a no deal Brexit and there was a significant level of disruption to the economy, then growth could weaken even further than currently and the MPC would be likely to cut Bank Rate in order to support growth. However, with Bank Rate still only at 0.75%, it has relatively little room to make a big impact and the MPC would probably suggest that it would be up to the Chancellor to provide help to support growth by way of a fiscal boost by e.g. tax cuts, increases in the annual expenditure budgets of government departments and services and expenditure on infrastructure projects, to boost the economy.

The first half of 2019/20 has seen UK **economic growth** fall as Brexit uncertainty took a toll. In its Inflation Report of 1 August, the Bank of England was notably downbeat about the outlook for both the UK and major world economies. The MPC meeting of 19 September reemphasised their concern about the downturn in world growth and also expressed concern that prolonged Brexit uncertainty would contribute to a build-up of spare capacity in the UK economy, especially in the context of a downturn in world growth. This mirrored investor concerns around the world which are now expecting a significant downturn or possibly even a recession in some major developed economies. It was therefore no surprise that the Monetary Policy Committee (MPC) left Bank Rate unchanged at 0.75% throughout 2019, so far, and is expected to hold off on changes until there is some clarity on what is going to happen over Brexit. However, it is also worth noting that the new Prime Minister is making some significant promises on various spending commitments and a relaxation in the austerity programme. This will provide some support to the economy and, conversely, take some pressure off the MPC to cut Bank Rate to support growth.

As for **inflation** itself, CPI has been hovering around the Bank of England's target of 2% during 2019, but fell to 1.7% in August. It is likely to remain close to 2% over the next two years and so it does not pose any immediate concern to the MPC at the current time. However, if there was a no deal Brexit, inflation could rise towards 4%, primarily as a result of imported inflation on the back of a weakening pound.

With regard to the **labour market,** despite the contraction in quarterly GDP growth of -0.2% q/q, (+1.3% y/y), in quarter 2, employment continued to rise, but at only a muted rate of 31,000 in the three months to July after having risen by no less than 115,000 in quarter 2 itself: the latter figure, in particular, suggests that firms are preparing to expand output and suggests there could be a return to positive growth in quarter 3. Unemployment continued at a 44 year low of 3.8% on the Independent Labour Organisation measure in July and the participation rate of 76.1% achieved a new all-time high. Job vacancies fell for a seventh consecutive month after having previously hit record levels. However, with unemployment continuing to fall, this month by 11,000, employers will still be having difficulty filling job vacancies with suitable staff. It was therefore unsurprising that wage inflation picked up to a high point of 3.9% in June before easing back slightly to 3.8% in July, (3 month average regular pay, excluding bonuses). This meant that in real terms, (i.e. wage rates higher than CPI inflation), earnings grew by about 2.1%. As the UK economy is very much services sector driven, an increase in household spending power is likely to feed through into providing some support to the overall rate of economic growth in the coming months. The latest GDP statistics also included a revision of the savings ratio from 4.1% to 6.4% which provides reassurance that consumers' balance sheets are not over stretched and so will be able to support growth going forward.

This would then mean that the MPC will need to consider carefully at what point to take action to raise Bank Rate if there is an agreed Brexit deal, as the recent pick-up in wage costs is consistent with a rise in core services inflation to more than 4% in 2020.

In the **political arena**, if there is a general election soon, this could result in a potential loosening of monetary policy and therefore medium to longer dated gilt yields could rise on the expectation of a weak pound and concerns around inflation picking up although, conversely, a weak international backdrop could provide further support for low yielding government bonds and gilts.

USA. President Trump's massive easing of fiscal policy in 2018 fuelled a temporary boost in consumption in that year which generated an upturn in the rate of strong growth to 2.9% y/y. Growth in 2019 has been falling back after a strong start in quarter 1 at 3.1%, (annualised rate), to 2.0% in quarter 2. Quarter 3 is expected to fall further. The strong growth in employment numbers during 2018 has reversed into a falling trend during 2019, indicating that the economy is cooling, while inflationary pressures are also weakening The Fed finished its series of increases in rates to 2.25 – 2.50% in December 2018. In July 2019, it cut rates by 0.25% as a 'midterm adjustment' but flagged up that this was not to be seen as the start of a series of cuts to ward off a downturn in growth. It also ended its programme of quantitative tightening in August, (reducing its holdings of treasuries etc). It then cut rates again in September to 1.75% - 2.00% and is thought likely to cut another 25 bps in December. Investor confidence has been badly rattled by the progressive ramping up of increases in tariffs President Trump has made on Chinese imports and China has responded with increases in tariffs on American imports. This trade war is seen as depressing US, Chinese and world growth. In the EU, it is also particularly impacting Germany as exports of goods and services are equivalent to 46% of total GDP. It will also impact developing countries dependent on exporting commodities to China.

EUROZONE. Growth has been slowing from +1.8 % during 2018 to around half of that in 2019. Growth was +0.4% q/q (+1.2% y/y) in quarter 1 and then fell to +0.2% q/q (+1.0% y/y) in quarter 2; there appears to be little upside potential to the growth rate in the rest of 2019. German GDP growth fell to -0.1% in quarter 2; industrial production was down 4% y/y in June with car production down 10% y/y. Germany would be particularly vulnerable to a no deal Brexit depressing exports further and if President Trump imposes tariffs on EU produced cars. The European Central Bank (ECB) ended its programme of quantitative easing purchases of debt in December 2018, which meant that the central banks in the US, UK and EU had all ended the phase of post financial crisis expansion of liquidity supporting world financial markets by purchases of debt. However, the downturn in EZ growth in the second half of 2018 and into 2019, together with inflation falling well under the upper limit of its target range of 0 to 2%, (but it aims to keep it near to 2%), has prompted the ECB to take new measures to stimulate growth. At its March meeting it said that it expected to leave interest rates at their present levels "at least through the end of 2019", but that was of little help to boosting growth in the near term. Consequently, it announced a third round of TLTROs; this provides banks with cheap borrowing every three months from September 2019 until March 2021 which means that, although they will have only a two-year maturity, the Bank is making funds available until 2023, two years later than under its previous policy. As with the last round, the new TLTROs will include an incentive to encourage bank lending, and they will be capped at 30% of a bank's eligible loans. However, since then, the downturn in EZ and world growth has gathered momentum so at its meeting on 12 September, it cut its deposit rate further into negative territory, from -0.4% to -0.5%, and announced a resumption of quantitative easing purchases of debt. It also increased the maturity of the third round of TLTROs from two to three years. However, it is doubtful whether this loosening of monetary policy will have much impact on growth and unsurprisingly, the ECB stated that governments will need to help stimulate growth by fiscal policy. On the political front, Austria, Spain and Italy are in the throes of forming coalition governments with some unlikely combinations of parties i.e. this raises questions around their likely endurance. The recent results of two German state elections will put further pressure on the frail German CDU/SDP coalition government.

CHINA. Economic growth has been weakening over successive years, despite repeated rounds of central bank stimulus; medium term risks are increasing. Major progress still needs to be made to eliminate excess industrial capacity and the stock of unsold property, and to address the level of non-performing loans in the banking and credit systems. Progress also still needs to be made to eliminate excess industrial capacity and to switch investment from property construction and infrastructure to consumer goods production. The trade war with the US does not appear currently to have had a significant effect on GDP growth as some of the impact of tariffs has been offset by falls in the exchange rate and by transhipping exports through other countries, rather than directly to the US.

JAPAN - has been struggling to stimulate consistent significant GDP growth and to get inflation up to its target of 2%, despite huge monetary and fiscal stimulus. It is also making little progress on fundamental reform of the economy.

WORLD GROWTH. The trade war between the US and China is a major concern to financial markets and is depressing worldwide growth, as any downturn in China will spill over into impacting countries supplying raw materials to China. Concerns are focused on the synchronised general weakening of growth in the major economies of the world compounded by fears that there could even be a recession looming up in the US, though this is probably overblown. These concerns have resulted in government bond yields in the developed world falling significantly during 2019. If there were a major worldwide downturn in growth, central banks in most of the major economies will have limited ammunition available, in terms of monetary policy measures, when rates are already very low in most countries, (apart from the US), and there are concerns about how much distortion of financial markets has already occurred with the current levels of quantitative easing purchases of debt by central banks. The latest PMI survey statistics of economic health for the US, UK, EU and China have all been sub 50 which gives a forward indication of a downturn in growth; this confirms investor sentiment that the outlook for growth during the rest of this financial year is weak.

3.2 Interest rate forecasts

The Council's treasury advisor, Link Asset Services, has provided the following forecast:

Link Asset Services Interest Rate View											
	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22
Bank Rate View	0.75	0.75	0.75	0.75	0.75	1.00	1.00	1.00	1.00	1.00	1.25
3 Month LIBID	0.70	0.70	0.70	0.70	0.80	0.90	1.00	1.00	1.00	1.10	1.20
6 Month LIBID	0.80	0.80	0.80	0.80	0.90	1.00	1.10	1.10	1.20	1.30	1.40
12 Month LIBID	1.00	1.00	1.00	1.00	1.10	1.20	1.30	1.30	1.40	1.50	1.60
5yr PWLB Rate	1.20	1.30	1.50	1.60	1.70	1.70	1.80	1.90	2.00	2.00	2.10
10yr PWLB Rate	1.50	1.60	1.80	1.90	2.00	2.00	2.10	2.20	2.30	2.30	2.40
25yr PWLB Rate	2.10	2.30	2.40	2.50	2.60	2.70	2.70	2.80	2.90	3.00	3.00
50yr PWLB Rate	2.00	2.20	2.30	2.40	2.50	2.60	2.60	2.70	2.80	2.90	2.90

It has been little surprise that the Monetary Policy Committee (MPC) has left Bank Rate unchanged at 0.75% so far in 2019 due to the ongoing uncertainty over Brexit. In its last meeting on 1 August, the MPC became more dovish as it was more concerned about the outlook for both the global and domestic economies. That's shown in the policy statement, based on an assumption that there is an agreed deal on Brexit, where the suggestion that rates would need to rise at a "gradual pace and to a limited extent" is now also conditional on "some recovery in global growth". Brexit uncertainty has had a dampening effect on UK GDP growth in 2019, especially around mid-year. If there were a no deal Brexit, then it is likely that there will be a cut or cuts in Bank Rate to help support economic growth.

The above forecasts have been based on an assumption that there is an agreed deal on Brexit. Given the current level of uncertainties, this is a huge assumption and so forecasts may need to be materially reassessed in the light of events over the next few weeks or months.

The balance of risks to the UK

- The overall balance of risks to economic growth in the UK is probably to the downside due to the weight of all the uncertainties over Brexit, as well as a softening global economic picture.
- The balance of risks to increases in Bank Rate and shorter term PWLB rates are currently a little below those to the downside.

Downside risks to current forecasts for UK gilt yields and PWLB rates currently include:

- **Brexit** – if it were to cause significant economic disruption and a major downturn in the rate of growth.

- **Bank of England** takes action too quickly, or too far, over the next three years to raise Bank Rate and causes UK economic growth, and increases in inflation, to be weaker than we currently anticipate.

- A resurgence of the **Eurozone sovereign debt crisis**, possibly **Italy**, due to its high level of government debt, low rate of economic growth and vulnerable banking system, and due to the election in March 2018 of a government which has made a lot of anti-austerity noise. The EU has had sharp disagreements in successive years with Italy over setting a budget within the limits of EU rules. (Early September – a new coalition government may be formed which would be less anti-EU.) The rating agencies have already downgraded Italian debt to one notch above junk level. If Italian debt were to fall below investment grade, many investors would be unable to hold Italian debt. Unsurprisingly, investors are becoming increasingly concerned by the actions of the Italian government and consequently, Italian bond yields have risen – at a time when the government faces having to refinance over €200bn of debt maturing in 2019. However, the biggest concern is the major holdings of Italian government debt held by Italian banks and insurers.

Any downgrading of such debt would cause Italian bond prices to fall, causing losses on their portfolios, so reducing their capital and forcing them to sell bonds – which, in turn, would cause further falls in their prices etc. This is the so called **'doom loop'**. Due to the Italian government's already high level of debt, it would not be able to afford to bail out the banking system. **Portugal** faces the same problem as its debt is also only one notch above junk level.

- Weak capitalisation of some **European banks**, particularly Italian banks.

- **German minority government.** In the German general election of September 2017, Angela Merkel's CDU party was left in a vulnerable minority position dependent on the fractious support of the SPD party, as a result of the rise in popularity of the anti-immigration AfD party. Then in October 2018, the results of the Bavarian and Hesse state elections radically undermined the SPD party and showed a sharp fall in support for the CDU. As a result, the SPD had a major internal debate as to whether it could continue to support a coalition that is so damaging to its electoral popularity. After the result of the Hesse state election, Angela Merkel announced that she would not stand for re-election as CDU party leader at her party's convention in December 2018. However, this makes little practical difference as she has continued as Chancellor, though more recently concerns have arisen over her health. Early September 2019 – the results of the Saxony and Brandenburg regional elections were again very disappointing for the CDU and SPD; this will rejuvenate the tensions of October 2018 between these two parties that form the current coalition government.

- **Other minority EU governments.** Sweden, Spain, Portugal, Netherlands and Belgium all have vulnerable minority governments dependent on coalitions which could prove fragile.

- **Italy, Austria, the Czech Republic and Hungary** now form a strongly anti-immigration bloc within the EU. There has also been rising anti-immigration sentiment in Germany and France.

- The increases in interest rates in the US during 2018, combined with a trade war between the USA and China, sparked major volatility in equity markets during the final quarter of 2018 and into 2019. In mid-2019, investor fears of a looming recession have again sparked moves by investors out of riskier assets i.e. equities, into safe havens of government bonds of major western countries. Some **emerging market countries** which have borrowed heavily in dollar denominated debt could be particularly exposed to investor flight from equities to safe havens, typically US treasuries, German bunds and UK gilts.

- There are concerns around the level of **US corporate debt** which has swollen massively during the period of low borrowing rates in order to finance mergers and acquisitions. This has resulted in the debt of many large corporations being downgraded to a BBB credit rating, close to junk status. Indeed, 48% of total investment grade corporate debt is rated at BBB. If such corporations fail to generate profits and cash flow to reduce their debt levels as expected, this could tip their debt into junk ratings which will increase their cost of financing and further negatively impact profits and cash flow.

- **Geopolitical risks,** for example in North Korea, but also in Europe and the Middle East, which could lead to increasing safe haven flows.

Upside risks to current forecasts for UK gilt yields and PWLB rates

- **Brexit** – if agreement was reached all round that removed all threats of economic and political disruption between the EU and the UK.

- The **Bank of England is too slow** in its pace and strength of increases in Bank Rate and, therefore, allows inflationary pressures to build up too strongly within the UK economy, which then necessitates a later rapid series of increases in Bank Rate faster than we currently expect.

- **UK inflation,** whether domestically generated or imported, returning to sustained significantly higher levels causing an increase in the inflation premium inherent to gilt yields