

APPENDIX A

Treasury Management Strategy Statement and Annual Investment Strategy

Mid-year Review Report 2017/18

1 Background

The Council operates a balanced budget, which broadly means cash raised during the year will meet its cash expenditure. Part of the treasury management operations ensure this cash flow is adequately planned, with surplus monies being invested in low risk counterparties, providing adequate liquidity initially before considering optimising investment return.

The second main function of the treasury management service is the funding of the Council's capital plans. These capital plans provide a guide to the borrowing need of the Council, essentially the longer term cash flow planning to ensure the Council can meet its capital spending operations. This management of longer term cash may involve arranging long or short term loans, or using longer term cash flow surpluses, and on occasion any debt previously drawn may be restructured to meet Council risk or cost objectives.

Accordingly, treasury management is defined as:

“The management of the local authority's investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks.”

2 Introduction

The Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management (revised 2011) primary requirements are as follows:

1. Creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the Council's treasury management activities.
2. Creation and maintenance of Treasury Management Practices which set out the manner in which the Council will seek to achieve those policies and objectives.
3. Receipt by the full council of an annual Treasury Management Strategy Statement - including the Annual Investment Strategy and Minimum Revenue Provision Policy - for the year ahead, a **Mid-year Review Report** and an Annual Report (stewardship report) covering activities during the previous year.
4. Delegation by the Council of responsibilities for implementing and monitoring treasury management policies and practices and for the execution and administration of treasury management decisions.
5. Delegation by the Council of the role of scrutiny of treasury management strategy and policies to a specific named body. For this Council the delegated body is the Budget and Strategic Planning Working Group:

This mid-year report has been prepared in compliance with CIPFA's Code of Practice on Treasury Management, and covers the following:

- An economic update for the first part of the 2017/18 financial year;
 - A review of the Treasury Management Strategy Statement and Annual Investment Strategy;
 - The Council's capital expenditure (prudential indicators);
 - A review of the Council's investment portfolio for 2017/18;
 - A review of the Council's borrowing strategy for 2017/18;
 - A review of any debt rescheduling undertaken during 2017/18;
 - A review of compliance with Treasury and Prudential Limits for 2017/18.
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3 Economics and interest rates

3.1 Economics update

UK. After the UK economy surprised on the upside with strong growth in 2016, growth in 2017 has been disappointingly weak; quarter 1 came in at only +0.3% (+1.7% y/y) and quarter 2 was +0.3% (+1.5% y/y) which meant that growth in the first half of 2017 was the slowest for the first half of any year since 2012. The main reason for this has been the sharp increase in inflation, caused by the devaluation of sterling after the referendum, feeding increases in the cost of imports into the economy. This has caused, in turn, a reduction in consumer disposable income and spending power and so the services sector of the economy, accounting for around 75% of GDP, has seen weak growth as consumers cut back on their expenditure. However, more recently there have been encouraging statistics from the manufacturing sector which is seeing strong growth, particularly as a result of increased demand for exports. It has helped that growth in the EU, our main trading partner, has improved significantly over the last year. However, this sector only accounts for around 11% of GDP so expansion in this sector will have a much more muted effect on the average total GDP growth figure for the UK economy as a whole.

The MPC increased the bank rate to 0.5% at its November meeting and also gave forward guidance that they expected to increase Bank Rate only twice more in the next three years to reach 1.0% by 2020. This is, therefore, not quite the 'one and done' scenario but is, nevertheless, a very relaxed rate of increase prediction in Bank Rate in line with previous statements that Bank Rate would only go up very gradually and to a limited extent.

The markets viewed this result as being more dovish than they had expected and sterling duly responded by falling 0.8% against the dollar and euro on the day. As this was the first increase in Bank Rate for a decade, the MPC was right to avoid alarming consumers and financial markets, and to be very reassuring about the pace of future increases.

The quarterly Inflation Report itself, was notably downbeat about economic growth based on a view that the trend rate of growth for the economy has now fallen from 2.2% to only 1.5%, (whereas in the decade before the financial crash it grew at 2.9% p.a.). One of the main focuses for this was a view that productivity growth would remain very weak at about only 1% p.a. This does not augur well for increases in wage rates. This, in turn, is likely to feed through into weak domestically generated, (i.e. excluding the one off post referendum imported inflation through the fall in the value of sterling), price pressures underpinning CPI inflation. Overall, the Inflation Report was little changed from the August report and again forecast that inflation would be barely above the 2% target at the three year time horizon; it is also expected to peak very soon at 3.2%, (September was 3.0%), before falling thereafter as the devaluation effect gradually falls out of the 12 month statistics. As for forecasts for GDP growth, these also barely changed with growth falling from 1.7% to 1.6% for 2017 and being unchanged for 2018 (1.6%) and 2019 (1.8%). The MPC was also quite concerned about the situation over Brexit as there has been little significant agreement so far in terms of moving towards giving UK firms some confidence of what sort of trade terms the UK is likely to have with the EU from 2019. They felt that this uncertainty was holding back investment. The MPC's forecasts are predicated on an assumption that households and companies base their decisions on a smooth adjustment to a new trading relationship with the EU.

It has to be said that overall, this is really a quite pessimistic outlook for the UK economy. For some commentators, raising Bank Rate with such a weak outlook, did not sit easily together. However, the MPC's main justification for taking action now to raise Bank Rate was that because unemployment was at the lowest rate for 42 years at only 4.3%, there was little spare capacity left in the economy, especially when increases in productivity were expected to be so weak and taking account of Brexit caused expected falls in net immigration. They also noted that consumer confidence has remained resilient and the global economy was growing strongly which would help UK exports. In addition, financial conditions were highly accommodative through the current level of monetary policy. Accordingly, despite this weak outlook for GDP growth, they needed to take action now to ward off the potential for inflationary pressures to start building up.

3.2 Interest rate forecasts

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

	NOW	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20
BANK RATE	0.50	0.50	0.50	0.50	0.50	0.75	0.75	0.75	0.75	1.00	1.00
5 yr PWLB	1.50	1.50	1.60	1.60	1.70	1.80	1.80	1.90	1.90	2.00	2.10
10 yr PWLB	2.10	2.10	2.20	2.30	2.40	2.40	2.50	2.60	2.60	2.70	2.70
25 yr PWLB	2.70	2.80	2.90	3.00	3.00	3.10	3.10	3.20	3.20	3.30	3.40
50 yr PWLB	2.40	2.50	2.60	2.70	2.80	2.90	2.90	3.00	3.00	3.10	3.20

Economic forecasting remains difficult with so many external influences weighing on the UK. These Bank Rate forecasts, (and also MPC decisions), will be liable to further amendment depending on how economic data and developments in financial markets transpire over the next year. Forecasts for average earnings beyond the three year time horizon will be heavily dependent on economic and political developments. Volatility in bond yields is likely to endure as investor fears and confidence ebb and flow between favouring relatively more “risky” assets i.e. equities, or the “safe haven” of government bonds.

The overall longer run trend is for gilt yields and PWLB rates to rise, albeit gently. A world economic recovery will likely see investors switching from the safe haven of bonds to equities. We have pointed out consistently that the Fed. Rate is likely to go up more quickly and more strongly than Bank Rate in the UK. While there is normally a high degree of correlation between the two yields, we would expect to see a growing decoupling of yields between the two i.e. we would expect US yields to go up faster than UK yields. We will need to monitor this area closely and any resulting effect on PWLB rates.

- The overall balance of risks to economic recovery in the UK is probably to the downside, particularly with the current level of uncertainty over the final terms of Brexit.
- The balance of risks to increases in Bank Rate and shorter term PWLB rates are probably to the upside and are dependent on how strong GDP growth turns out, how quickly inflation pressures rise and how quickly the Brexit negotiations move forward positively.
- Our forecasts are predicated on an assumption that there is no break-up of the Eurozone or EU, (apart from the departure of the UK), within our forecasting time period, despite the major challenges that are looming up, and that there are no major ructions in international relations, especially between the US and China / North Korea, which have a major impact on international trade and world GDP growth.

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

- Bank of England monetary policy takes action too quickly 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.
- Geopolitical risks, especially North Korea, but also in Europe and the Middle East, which could lead to increasing safe haven flows.
- 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.
- Weak capitalisation of some European banks.

- The result of the October 2017 Austrian general election is likely to result in a strongly anti-immigrant coalition government. In addition, the new Czech prime minister is expected to be Andrej Babis who is strongly against EU migrant quotas and refugee policies. Both developments could provide major impetus to other, particularly former Communist bloc countries, to coalesce to create a major block to progress on EU integration and centralisation of EU policy. This, in turn, could spill over into impacting the Euro, EU financial policy and financial markets.
- Rising protectionism under President Trump
- A sharp Chinese downturn and its impact on emerging market countries

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

- The Bank of England is too slow in its pace and strength of increases in Bank Rate and, therefore, allows inflation 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 returning to sustained significantly higher levels causing an increase in the inflation premium inherent to gilt yields.
- The Fed causing a sudden shock in financial markets through misjudging the pace and strength of increases in its Fed. Funds Rate and in the pace and strength of reversal of QE, which then leads to a fundamental reassessment by investors of the relative risks of holding bonds, as opposed to equities. This could lead to a major flight from bonds to equities and a sharp increase in bond yields in the US, which could then spill over into impacting bond yields around the world.

4 Treasury Management Strategy Statement and Annual Investment Strategy update

The Treasury Management Strategy Statement (TMSS) for 2017/18 was approved by this Council on 8th February 2017.

There are no policy changes to the TMSS; the details in this report update the position in the light of the updated economic position and budgetary changes already approved.

5 The Council's Capital Position (Prudential Indicators)

This part of the report is structured to update:

- The Council's capital expenditure plans;
- How these plans are being financed;
- The impact of the changes in the capital expenditure plans on the prudential indicators and the underlying need to borrow; and
- Compliance with the limits in place for borrowing activity.

5.1 Prudential Indicator for Capital Expenditure

This table shows the revised estimates for capital expenditure and the changes since the capital programme was agreed at the Budget. The figures shown are the latest estimates and will be approved at the relevant policy committee during November 2017.

Capital Expenditure by Service	2017/18 Original Estimate £m	2017/18 Revised Estimate £m
Non HRA	0.846	1.858
HRA	6.164	4.127
Total capital expenditure	7.010	5.985

The increase in the non HRA capital expenditure from £0.846m to £1.858m is as a result of carry forwards £0.99m from 2017/18 and an increase to the number of the budgets including DFGs, Cattle Market and Public Conveniences £0.087m. These movements have been partially offset by reprofiling £0.065m to later years

In terms of the HRA the movement from the original estimate of £6.164m to the revised estimate of £4.127m as a result of carry forwards from 2016-17 being included into the 2017-18 capital programme of £1.687m and reprofiling of £3.724m to later years.

5.2 Changes to the Financing of the Capital Programme

The table below draws together the main strategy elements of the capital expenditure plans (above), highlighting the original supported and unsupported elements of the capital programme, and the expected financing arrangements of this capital expenditure.

Capital Expenditure	2017/18 Original Estimate £m	2017/18 Revised Estimate £m
Total capital expenditure	7.010	5.985
Financed by:		
Capital receipts	0.583	1.556
Capital grants	0.237	0.259
Reserves	6.164	4.117
Renewals and Repairs fund	0.015	0.018
Third party contribution	0.011	0.035
Total financing	7.010	5.985
Borrowing requirement	0	0

Due to changes outlined in para 5.1 there have been associated changes in the financing requirements and sources of funding which are highlighted above.

5.3 Changes to the Prudential Indicators for the Capital Financing Requirement (CFR), External Debt and the Operational Boundary

The table below shows the CFR, which is the underlying external need to incur borrowing for a capital purpose. It also shows the expected debt position over the period, which is termed the Operational Boundary.

Prudential Indicator – Capital Financing Requirement

We are on target to achieve the original forecast Capital Financing Requirement

Prudential Indicator – the Operational Boundary for external debt

	2017/18 Original Estimate £m	2017/18 Revised Estimate £m
CFR – non housing	0.113	0.113
CFR – housing	31.484	31.484
Total CFR	31.597	31.597
Net movement in CFR	0	0
Borrowing	31.413	31.413
Other long term liabilities*	0.113	0.113
Total debt (year end position)	31.526	31.526

**on balance sheet finance leases, PFI schemes etc*

5.4 Limits to Borrowing Activity

The first key control over the treasury activity is a prudential indicator to ensure that over the medium term, net borrowing (borrowings less investments) will only be for a capital purpose. Gross external borrowing should not, except in the short term, exceed the total of CFR in the preceding year plus the estimates of any additional CFR for 2017/18 and next two financial years. This allows some flexibility for limited early borrowing for future years.

	2017/18 Original Estimate £m	2017/18 Revised Estimate £m
Borrowing	31.413	31.413
Other long term liabilities*	0.113	0.113
Total debt	31.526	31.526
CFR* (year end position)	31.597	31.597

The Corporate Director reports that no difficulties are envisaged for the current or future years in complying with this prudential indicator.

A further prudential indicator controls the overall level of borrowing. This is the Authorised Limit which represents the limit beyond which borrowing is prohibited, and needs to be set and revised by Members. It reflects the level of borrowing which, while not desired, could be afforded in the short term, but is not sustainable in the longer term. It is the expected maximum borrowing need with some headroom for unexpected movements. This is the statutory limit determined under section 3 (1) of the Local Government Act 2003.

Authorised limit for external debt	2017/18 Original Indicator £m	2017/18 Revised Indicator £m
Borrowing	45.880	45.880
Other long term liabilities	0.120	0.120
Total	46.000	46.000

6 Investment Portfolio 2017/18

In accordance with the Code, it is the Council's priority to ensure security of capital and liquidity, and to obtain an appropriate level of return which is consistent with the Council's risk appetite. As shown by forecasts in section 3.2, it is a very difficult investment market in terms of earning the level of interest rates commonly seen in previous decades as rates are very low and in line with the current 0.25% Bank Rate. The continuing potential for a re-emergence of a Eurozone sovereign debt crisis, and its impact on banks, prompts a low risk and short term strategy. Given this risk environment and the fact that increases in Bank Rate are likely to be gradual and unlikely to return to the levels seen in previous decades, investment returns are likely to remain low.

The Council held £21.5m of investments as at 30 September 2017 (£20.5m at 31 March 2017) and the investment portfolio yield for the first six months of the year is 1.10% against the seven day money market rate of 0.13%.

The Corporate Director confirms that the approved limits within the Annual Investment Strategy were not breached during the first six months of 2017/18.

The Council's budgeted investment return for 2017/18 is £67,122, and performance for the year is currently anticipated to be £72k above budget. This is due to both level of balances held and interest rate achieved being higher than budgeted.

Investment Counterparty criteria

The current investment counterparty criteria selection approved in the TMSS is meeting the requirement of the treasury management function.

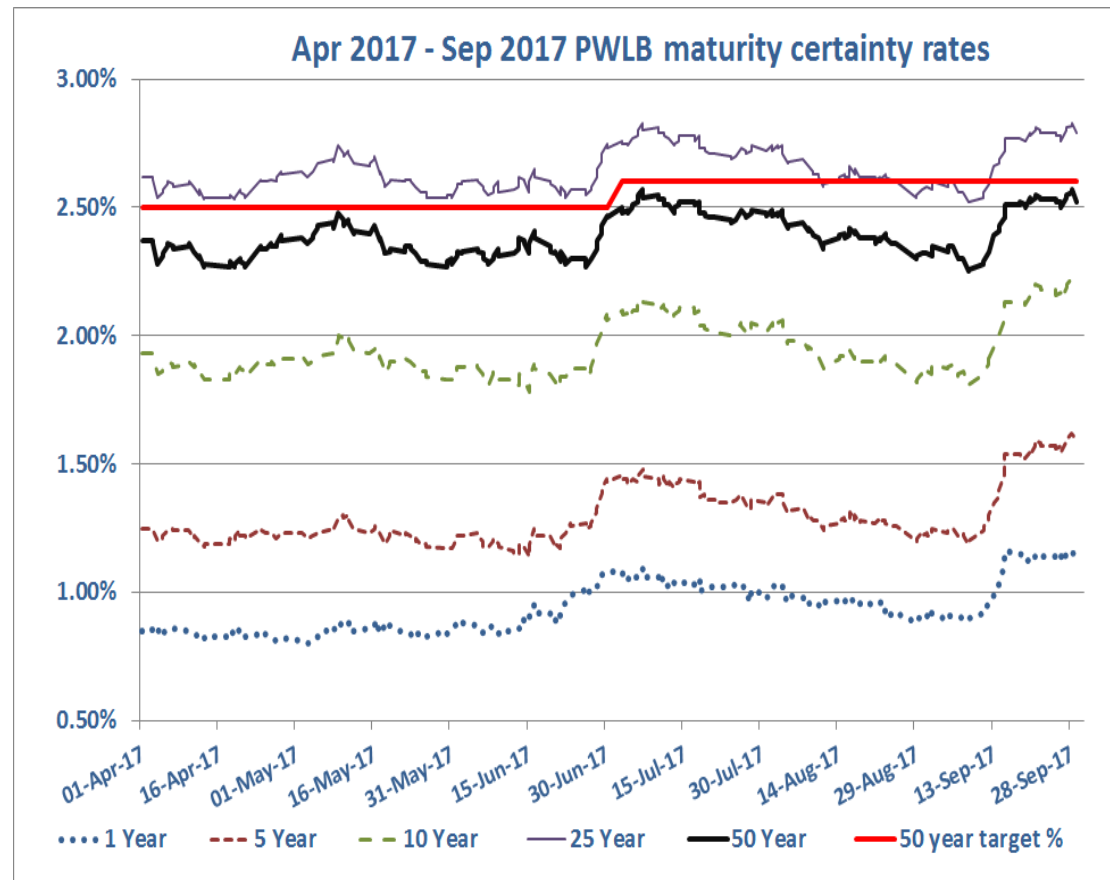
7 Borrowing

The Council's capital financing requirement (CFR) for 2017/18 is £31.597m. The CFR denotes the Council's underlying need to borrow for capital purposes. If the CFR is positive the Council may borrow from the PWLB or the market (external borrowing) or from internal balances on a temporary basis (internal borrowing). The balance of external and internal borrowing is generally driven by market conditions. Table 5.4 shows the Council has borrowings of £31.413m. This is a prudent and cost effective approach in the current economic climate but will require ongoing monitoring in the event that upside risk to gilt yields prevails.

It is anticipated that further borrowing will not be undertaken during this financial year.

The graph and table below show the movement in PWLB certainty rates for the first six months of the year to date:

PWLB certainty rates 1 April 2017 to 30 September 2017



	1 Year	5 Year	10 Year	25 Year	50 Year
Low	0.8	1.14	1.78	2.52	2.25
Date	03/05/2017	15/06/2017	15/06/2017	08/09/2017	08/09/2017
High	1.16	1.62	2.22	2.83	2.57
Date	15/09/2017	28/09/2017	28/09/2017	07/07/2017	07/07/2017
Average	0.9408	1.2981	1.9470	2.6475	2.3917

8 Debt Rescheduling

Debt rescheduling opportunities have been very limited in the current economic climate given the consequent structure of interest rates, and following the increase in the margin added to gilt yields which has impacted PWLB new borrowing rates since October 2010. No debt rescheduling has therefore been undertaken to date in the current financial year.
