Cabinet

29 January 2020

Title	Treasury Management Half Yearly Report 2019/20		
Purpose of the report	To note		
Report Author	Anna Russell, Deputy Chief Accountant		
Cabinet Member	Councillor Tony Harman	**Confidential**	No
Corporate Priority	Financial Sustainability		
Recommendations	**Cabinet is asked to note the treasury position achieved during the first six months of 2019/20 and the financial environment in global markets.**		
Reason for Recommendation	**Not applicable**		

1. Key issues

1.1 Treasury Management is the management of the Council's 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.

1.2 The Council has adopted the Chartered Institute of Public Finance and Accountancy's Treasury Management in the Public Services: Code of Practice (the CIPFA Code), which requires the Council to report on performance of the treasury management function at least twice yearly (mid-year and at year end).

1.3 The Council's Treasury Management Strategy for 2019/20 was reviewed and approved by Cabinet on 30 January 2019, and approved by Council on 21 February 2019, and has been consistently applied since the beginning of the financial year.

1.4 This report is an interim statement of treasury activities for the first six months of the financial year, to the end of September 2019. The Council has borrowed and invested substantial sums of money and is therefore exposed to financial risks including the loss of invested funds and the revenue effect of changing interest rates. This report covers treasury activity and the associated monitoring and control of risks.

1.5 The 2017 Prudential Code includes a requirement for local authorities to provide a Capital Strategy, a summary document approved by full Council covering capital expenditure and financing, treasury management and non-treasury investments. The Authority's Capital Strategy, complying with CIPFA's requirement, was approved by Council on 21 February 2019.

External Context – Economic background

1.6 UK Consumer Price Inflation (CPIH) fell to 1.7% year/year in August 2019 from 2.0% in July, weaker than the consensus forecast of 1.9% and below the Bank of England's target. The most recent labour market data for the three months to July 2019 showed the unemployment rate edged back down to 3.8% while the employment rate remained at 76.1%, the joint highest since records began in 1971. Nominal annual wage growth measured by the 3-month average excluding bonuses was 3.8% and 4.0% including bonuses. Adjusting for inflation, real wages were up 1.9% excluding, and 2.1% including, bonuses.

1.7 The Quarterly National Accounts for Q2 GDP confirmed the UK economy contracted by 0.2% following the 0.5% gain in Q1 which was distorted by stockpiling ahead of Brexit. Only the services sector registered an increase in growth, a very modest 0.1%, with both production and construction falling and the former registering its largest drop since Q4 2012. Business investment fell by 0.4% (revised from -0.5% in the first estimate) as Brexit uncertainties impacted on business planning and decision-making.

1.8 Politics, both home and abroad, continued to be a big driver of financial markets over the last quarter. Boris Johnson won the Conservative Party leadership contest and has committed to leaving the EU on 31st October regardless of whether a deal is reached with the EU. Mr Johnson prorogued Parliament which led some MPs to put forward a bill requiring him to seek a Brexit extension if no deal is in place by 19th October. The move was successful and, having been approved by the House of Lords, was passed into law. The Supreme Court subsequently ruled Mr Johnson's suspension of Parliament unlawful.

1.9 Tensions continued between the US and China with no trade agreement in sight and both countries imposing further tariffs on each other's goods. The US Federal Reserve cut its target Federal Funds rates by 0.25% in September to a range of 1.75% - 2%, a pre-emptive move to maintain economic growth amid escalating concerns over the trade war and a weaker economic environment leading to more pronounced global slowdown. The euro area Purchasing Manager Indices (PMIs) pointed to a deepening slowdown in the Eurozone. These elevated concerns have caused key government yield curves to invert, something seen by many commentators as a predictor of a global recession. Market expectations are for further interest rate cuts from the Fed and in September the European Central Bank reduced its deposit rate to -0.5% and announced the recommencement of quantitative easing from 1st November.

1.10 The Bank of England maintained Bank Rate at 0.75% and in its August Inflation Report noted the deterioration in global activity and sentiment and confirmed that monetary policy decisions related to Brexit could be in either direction depending on whether or not a deal is ultimately reached by 31st October.

External Context – Financial markets

1.11 After rallying early in 2019, financial markets have been adopting a more risk-off approach in the following period as equities saw greater volatility and bonds rallied (prices up, yields down) in a flight to quality and anticipation of more monetary stimulus from central banks. The Dow Jones, FTSE 100 and FTSE 250 are broadly back at the same levels seen in March/April.

1.12 Gilt yields remained volatile over the period on the back of ongoing economic and political uncertainty. From a yield of 0.63% at the end of June, the 5-year benchmark gilt yield fell to 0.32% by the end of September. There were falls in the 10-year and 20-year gilts over the same period, with the former dropping from 0.83% to 0.55% and the latter falling from 1.35% to 0.88%. 1-month, 3-month and 12-month LIBID (London Interbank Bid) rates averaged 0.65%, 0.75% and 1.00% respectively over the period.

1.13 Recent activity in the bond markets and PWLB interest rates highlight that weaker economic growth remains a global risk. The US yield curve remains inverted with 10-year Treasury yields lower than US 3-month bills. History has shown that a recession hasn't been far behind a yield curve inversion. Following the sale of 10-year Bunds at -0.24% in June, yields on German government securities continue to remain negative in the secondary market with 2 and 5-year securities currently both trading around -0.77%.

External Context – Credit background

1.14 Credit Default Swap (CDS) spreads rose and then fell again during the quarter, continuing to remain low in historical terms. After rising to almost 120bps in May, the spread on non-ring-fenced bank NatWest Markets plc fell back to around 80bps by the end of September, while for the ring-fenced entity, National Westminster Bank plc, the spread remained around 40bps. The other main UK banks, as yet not separated into ring-fenced and non-ring-fenced from a CDS perspective, traded between 34 and 76bps at the end of the period.

1.15 There were minimal credit rating changes during the period. Moody's upgraded The Co-operative Bank's long-term rating to B3 and Fitch upgraded Clydesdale Bank and Virgin Money to A-.

Local Context

1.16 With the purchase of properties starting with the BP international campus site in Sunbury during 2016/17, the Council now has significant levels of long-term borrowing, secured to fund the property acquisitions.

1.17 The Council's current strategy when making strategic asset acquisitions is to take advantage of the cheap borrowing rates available, whilst maintaining and supplementing when possible the investment portfolio that has been built up.

1.18 For the year ended 31 March 2019, the Council had capital expenditure of £382m including £361m (94%) on investment properties. The underlying need to borrow for capital purposes is measured by the Capital Financing Requirement (CFR); usable reserves and working capital are the underlying resources available for investment. This is summarised in Table 1 next.

Table 1: Capital Expenditure Summary as at 31 March 2019

	2018/19 £'000
Opening Capital Financing Requirement	**678,998**
Capital investment	
Property, Plant and Equipment	19,823
Investment Properties	360,590
Intangible Assets	132
Revenue Spend Funded from Capital under Statute	1,250
Total Capital Investment	**381,795**
Sources of Finance	
Capital Receipts	(381)
Government Grants and Contributions	(1,100)
Revenue contributions	(747)
Repayment of debt	(7,845)
Total Sources of Finance	(10,073)
Closing Capital Financing Requirement	**1,050,720**

1.19 The Council's current strategy is to maintain borrowing and investments below their underlying levels, sometimes known as internal borrowing, in order to reduce risk and keep interest costs low. The treasury management position as at 30 September 2019 and the change over the period is shown in Table 2 next.

Table 2: Treasury Management Summary

	31/03/2019 Balance £m	Movement £m	30/09/2019 Balance £m
Long-term borrowing	(1,043)	(1)	(1,044)
Short-term borrowing	(10)	4	(6)
Total borrowing	**(1,053)**	**3**	**(1,050)**
Long-term investments	37	(1)	36
Short-term investments	30	(5)	25
Cash and cash equivalents	26	2	28
Total investments	**93**	**(4)**	**89**
Net borrowing	**(960)**	**(1)**	**(961)**

1.20 Cash balances total £28m and short-term investments £25m, reflecting the increases in income generation. These cash funds are being kept liquid to ensure that funding is readily available in the context of development project and potential acquisition costs expected over the coming months.

2. Borrowing Strategy to 30 September 2019

2.1 At 30 September 2019, the Council held £1,050m of loans, a small decrease of £3m from 31 March 2019, including £1,033m long-term PWLB borrowing as part of its strategy for funding major acquisitions and developments. The 30 September 2019 borrowing position is show in Table 3 next.

Table 3: Borrowing Position

	31/03/2019 Balance £m	Movement £m	30/09/2019 Balance £m
Public Works Loan Board	1,027	6	1,033
Local authorities - long-term	16	- 5	11
Local authorities - short-term	10	(4)	6
Total Borrowing	**1,053**	**(3)**	**1,050**

2.2 At 30 September 2019, the Council also had short-term borrowing totalling £6m. This reflected the cash-flow impact of some of the costs associated with acquisitions. These funds were borrowed from other local authorities because of the short-term nature of the requirement and the affordable rates on offer.

2.3 The Council will also consider borrowing additional funds on both a long- and short-term basis for further strategic acquisition purchases that occur in the future. Work is ongoing with Arlingclose and the portfolio holder to ensure that the cheapest and most appropriate duration and source are secured.

2.4 The Council's chief objective when borrowing has been to strike an appropriately low risk balance between securing low interest costs and achieving cost certainty over the period for which funds are required, with flexibility to renegotiate loans should the Council's long-term plans change being a secondary objective.

2.5 Affordability and the "cost of carry" remained important influences on the Council's borrowing strategy alongside the consideration that, for any borrowing undertaken ahead of need, the proceeds would have to be invested in the money markets at rates of interest significantly lower than the cost of borrowing.

Treasury Investment Activity

2.6 Both the CIPFA Code and government guidance require the Council to invest its funds prudently, and to have regard to the security and liquidity of its treasury investments before seeking the optimum rate of return, or yield. The Authority's objective when investing money is to strike an appropriate balance between risk and return, minimising the risk of incurring losses from defaults and the risk of receiving unsuitably low investment income.

2.7 As at 30 September 2019, the Council's investment portfolio totalled £89m, with £53m of this being short-term and cash funds. A breakdown of the investments is given in **Appendix A**.

2.8 The pooled fund investments form a key part of the portfolio and a full list of these and their current performance is detailed in **Appendix B**. Pooled investments for period to end of September was £817k, with an annualised revenue return (dividend yield) of £1.54m (4.8%).

Investment Performance Monitoring

2.9 Security of capital has remained the Council's main investment objective. This has been maintained by following the Council's counterparty policy as set out in its Treasury Management Strategy Statement for 2019/20.

2.10 The Council seeks professional advice from Arlingclose and closely adheres to the advice set out in the Ministry of Housing, Communities and Local Government (MHCLG) guidance. Given Spelthorne's dependency on investment returns to balance the budget, the Council's investment strategy is also kept under constant review and quarterly review meetings are held with Arlingclose, the Council's treasury advisor.

2.11 Counterparty credit quality was assessed and monitored with reference to credit ratings (the Council's minimum long-term counterparty rating for institutions defined as having "high credit quality" is A- across rating agencies Fitch, S&P and Moody's); credit default swap prices, financial statements, information on potential government support and reports in the quality financial press.

Readiness for Brexit

2.12 Given the continuing uncertainty around the UK's departure from the EU, the Council will ensure there are enough accounts open at UK domiciled banks and Money Market Funds to hold sufficient liquidity required in the near term and that its account with the Debt Management Account Deposit Facility (DMADF) remains available for use in an emergency.

Non-Treasury Investments

2.13 The definition of investments in CIPFA's revised Treasury Management Code now covers all the financial assets of the Authority as well as other non-financial assets which the Authority holds primarily for financial return. This is replicated in MHCLG's Investment Guidance, in which the definition of investments is further broadened to also include all such assets held partially for financial return.

2.14 The Council held such investments in directly owned property valued at £985m at the end of March 2019, as well as shareholding in Knowle Green Estates Limited, with investment property of £7m.

Outlook for the remainder of 2019/20 as at end September 2019

2.15 The global economy is entering a period of slower growth in response to political issues, primarily the trade policy stance of the US. The UK economy has displayed a marked slowdown in growth due to both Brexit uncertainty and the downturn in global activity. In response, global and UK interest rate expectations have eased dramatically.

2.16 There appears no near-term resolution to the trade dispute between China and the US, a dispute that the US appears comfortable exacerbating further. With the 2020 presidential election a year away, Donald Trump is unlikely to change his stance.

2.17 Central bank actions and geopolitical risks will continue to produce significant volatility in financial markets, including bond markets.

2.18 Our treasury advisor Arlingclose expects Bank Rate to remain at 0.75% for the foreseeable future but there remain substantial risks to this forecast, dependant on Brexit outcomes and the evolution of the global economy. Arlingclose also expects gilt yields to remain at low levels for the foreseeable future and judge the risks to be weighted to the downside and that volatility will continue to offer longer-term borrowing opportunities

3. Financial implications

3.1 The financial implications are as set out in this report. The ability to maximise interest returns is paramount to generate sufficient funds to support the General Fund and even a small decline in interest rates can mean a significant reduction in cash returns. Therefore, it is our aim to continue to maintain flexibility commensurate with the high level of security and liquidity and minimal risk when making investment decisions.

4. Other considerations

4.1 The Council fully complies with best practice as set out in CIPFA's 2019 Treasury Management and Prudential Codes and in MHCLG's Guidance on Investments effective from April 2018.

4.2 Nothing in the Council's current strategy is intended to preclude or inhibit capital investment in local projects deemed beneficial to the local community and which have been approved by the Council.

5. Timetable for implementation

5.1 Treasury management is an ongoing activity and normally there is no specific timetable for implementation.

Background papers: None.

Appendices: Appendix A - Details of Investments
Appendix B - Pooled Funds