APPENDIX A

HARLOW COUNCIL
TREASURY MANAGEMENT STRATEGY
MID-YEAR REVIEW, 2015/16

Summary of the Report

1. This report provides an update on economic conditions impacting on the Council and focusses on any major issues affecting borrowing and investments.

2. A full economic commentary is provided within the report by the Council's treasury management advisors, Arlingclose Ltd. In summary interest rates are expected to increase from their historic low during 2016/17. The annual Treasury Management Strategy Statement, approved in February 2015, included the anticipation of extending the Council's investment portfolio by diversification into other products. Between April and September 2015 the Council has moved towards investing in Certificates of Deposit and opened a Property Fund account. Certificates of Deposit are tradeable instruments and may be sold before maturity, for instance if market confidence suddenly waned in a particular institution. These instruments provide enhanced levels of security for the Council's investment portfolio. Investing long-term in a Property Fund has the advantage of higher yields through quarterly dividend payments. The continued use of carefully selected Money Market Funds protects liquidity and spreads risk. In relation to borrowing for capital financing, no external loans have been taken out so far this year.

3. At all times the Council will take steps to protect its investment portfolio by placing security (the reduction of risk in order to protect the return of capital sums) and liquidity (being able to have immediate access to a reasonable amount of funds so that cashflow obligations may be met) above yield (i.e. the interest paid on investments).

4. In setting out the Council's strategy for 2016/17, a full report will be presented to Cabinet and Full Council in January/February 2016. This will be in conjunction with the 2016/17 budget proposals. A future challenge will be the changes announced by the Chancellor of the Exchequer on 8 July 2015 in relation to future, and lower, rental streams to the Council's Housing Revenue Account which will have an impact on the amounts available for future investment and borrowing strategy. The new Treasury Management Strategy Statement will reflect these changes.

Background

5. The Treasury Management Strategy for 2015/16 has been underpinned by the adoption of the Chartered Institute of Public Finance and Accountancy's (CIPFA's) Code of Practice on Treasury Management 2011, which includes the requirement for determining a treasury strategy for the likely financial and investment activity for the forthcoming financial year.

6. The Code also recommends that Councillors are informed of Treasury Management activities at least twice a year (mid-year and at year end). This report therefore ensures this Council is embracing best practice in accordance with CIPFA's recommendations.

7. Treasury management is defined as: "The management of the local Council'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".

8. In addition to reporting on risk management related to treasury activities, the Treasury Management Code also requires the Council to report on any financial instruments entered into to manage treasury risks.

External Context: A commentary provided by the Council's Treasury Management advisors, Arlingclose Ltd. (October 2015)

9. As the year began, economic data was largely overshadowed by events in Greece. Markets' attention centered on the never-ending Greek issue stumbled from turmoil to crisis, running the serious risk of a disorderly exit from the Euro. The country's politicians and the representatives of the 'Troika' of its creditors - the European Commission (EC), the European Central Bank (ECB) and the International Monetary Fund (IMF) – barely saw eye to eye. Greece failed to make a scheduled repayment to the IMF on 30 June, in itself not a default until the IMF's Managing Director declares it so. Prime Minister Tsipras blindsided Greece's creditors by calling a referendum on 5th July on reform proposals which by then were off the table anyway. The European Central Bank froze liquidity assistance provided to Greek banks and capital controls within the country severely restricted individuals' and corporates' access to cash.

10. On 12 July, following a weekend European Union Summit, it was announced that the terms for a third bailout of Greece had been reached. The deal amounting to €86 billion was agreed under the terms that Greece would see tax increases, pension reforms and privatisations; the very reforms Tsipras

had vowed to resist. This U-turn saw a revolt within the ruling Syriza party and on 27 August, Alexis Tsipras resigned from his post as Prime Minster of Greece after just eight months in office by calling a snap election, held on 20 September. This gamble paid off as Tsipras led his party to victory once again, although a coalition with the Independent Greeks was needed for a slim parliamentary majority. That government must now continue with the unenviable task of guiding Greece through the continuing economic crisis – the Greek saga is far from over.

11. The summer also saw attention shift towards China as the Shanghai composite index (representing China's main stock market), which had risen a staggering 50%+ since the beginning of 2015, dropped by 43% in less than three months with a reported $3.2 trillion loss to investors, on the back of concerns over growth and after regulators clamped down on margin lending activity in an effort to stop investors borrowing to invest and feeding the stock market bubble. Chinese authorities intensified their intervention in the markets by halting trading in many stocks in an attempt to maintain market confidence. They surprised global markets in August as the People's Bank of China changed the way the yuan is fixed each day against the US dollar and allowed an aggressive devaluation of the currency. This sent jitters through Asian, European and US markets impacting currencies, equities, commodities, oil and metals. On 24 August, Chinese stocks suffered their steepest one-day fall on record, driving down other equity markets around the world and soon becoming known as another 'Black Monday'. Chinese stocks have recovered marginally since and are trading around the same level as the start of the year. Concerns remain about slowing growth and potential deflationary effects.

12. **UK Economy:** The economy has remained resilient over the last six months. Although economic growth slowed in Q1 (Jan – Mar) 2015 to 0.4%, year on year growth to March 2015 was a relatively healthy 2.7%. Q2 (Apr – Jun) 2015 GDP growth bounced back and was confirmed at 0.7%, with year on year growth showing slight signs of slowing, decreasing to 2.4%. GDP has now increased for ten consecutive quarters, breaking a pattern of slow and erratic growth from 2009. The annual rate for consumer price inflation (CPI) briefly turned negative in April, falling to -0.1%, before fluctuating between 0.0% and 0.1% over the next few months. In the August Quarterly Inflation Report, the Bank of England projected that GDP growth will continue around its average rate since 2013. The Bank of England's projections for inflation remained largely unchanged from the May report with them expecting inflation to gradually increase to around 2% over the next 18 months and then remain there in the near future. Further improvement in the labour market saw the

ILO unemployment rate for the three months to July fall to 5.5%. In the September report, average earnings excluding bonuses for the three months to July rose 2.9% year on year.

13. The outcome of the UK general election, largely fought over the parties' approach to dealing with the consequences of the structural deficit and the pace of its removal, saw some very big shifts in the political landscape and put the key issue of the UK's relationship with the EU at the heart of future politics.

14. The US economy slowed to 0.6% in Q1 2015 due to bad weather, spending cuts by energy firms and the effects of a strong dollar. However, Q2 GDP showed a large improvement at a twice-revised 3.9% (annualised). This was largely due to a broad recovery in corporate investment alongside a stronger performance from consumer and government spending and construction and exports. With the Fed's decision on US interest rate dependent upon data, GDP is clearly supportive. However it is not as simple as that and the Fed are keen to see inflation rise alongside its headline economic growth and also its labour markets. The Committee decided not to act at its September meeting as many had been anticipating but have signalled rates rising before the end of the year.

15. **Market reaction:** Equity markets initially reacted positively to the pickup in the expectations of global economic conditions, but were tempered by the breakdown of creditor negotiations in Greece. China led stock market turmoil around the globe in August, with the FTSE 100 falling by around 8% overnight on 'Black Monday'. Indices have not recovered to their previous levels but some improvement has been seen. Government bond markets were quite volatile with yields rising (i.e. prices falling) initially as the risks of deflation seemingly abated. Thereafter yields fell on the outcome of the UK general election and assisted by reappraisal of deflationary factors, before rising again. Concerns around China saw bond yields dropping again through August and September. Bond markets were also distorted by the size of the European Central Bank's QE programme, so large that it created illiquidity in the very markets in which it needed to acquire these bonds, notably German government bonds (bunds) where yields were in negative territory.

Local Context

16. At 31 March 2015 the Council's underlying need to borrow for capital purposes as measured by the Capital Financing Requirement (CFR) was £226.420m, while usable reserves and working capital which are the underlying resources available for investment were £49.851m.

17. At 31 March 2015, the Council had £211.947m of borrowing and £44.916m of investments. The Council's current strategy is to maintain borrowing and investments below their underlying levels, referred to as internal borrowing.

Borrowing Strategy

18. At 30 September 2015 the Council held £211.837m of PWLB loans. It does not expect to borrow any additional sums in 2015/16.

Borrowing Activity in 2015/16

	Balance on 1 April 2015 £000	Maturing Debt £000	Debt Prematurely Repaid £000	New Borrowing £000	Balance on 30 Sep. 2015 £000	Avg Rate % and Avg Life (yrs)
CFR	226,420				226,420	
Short Term Borrowing	0	0	0	0	0	
Long Term Borrowing	211,837	0	0	0	211,837	Ave Rate: 3.309%. Ave life 19.8yrs
TOTAL BORROWING	211,837	0	0	0	211,837	
Other Long Term Liabilities	110	0	0	0	110	
TOTAL EXTERNAL DEBT	211,947	0	0	0	211,947	

19. **PWLB Certainty Rate and Project Rate Update:** The Council qualifies for borrowing at the 'Certainty Rate' (0.20% below the PWLB standard rate) for a 12 month period from 1 November 2014. In April the Council submitted its application to the CLG along with the 2015/16 Capital Estimates Return to access this reduced rate for a further 12 month period from 1 November 2015.

Investment Activity

20. The Council holds invested funds, representing income received in advance of expenditure plus balances and reserves held. Cashflow forecasts indicated that during 2015/16 the Council's investment balances would range between £22.7m and £52.4 million.

21. The Guidance on Local Government Investments in England gives priority to security and liquidity and the Council's aim is to achieve a yield commensurate with these principles.

Investment Activity in 2015/16

Investments	Balance on 1 April 2015 £000	Balance on 30 Sep. 2015 £000	Avg Rate/Yield (%)
Short term Investments Banks and Building Societies with credit ratings Local Authorities Banks – overnight deposits	 11,000 3,000 7,915	 25,000 3,000 1,905	 0.60% 0.45% 0.40%
UK Government: DMADF	 5,400	 0	-
Money Market Funds	16,600	12,630	0.42%
Other Pooled Funds: Property fund	 0	 2,000	Potential 4%
Building Societies without credit ratings	1,000	0	-
TOTAL INVESTMENTS	**44,915**	**44,535**	
Increase/ (Decrease) in Investments £000		(-)380	

22. 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 2015/16.

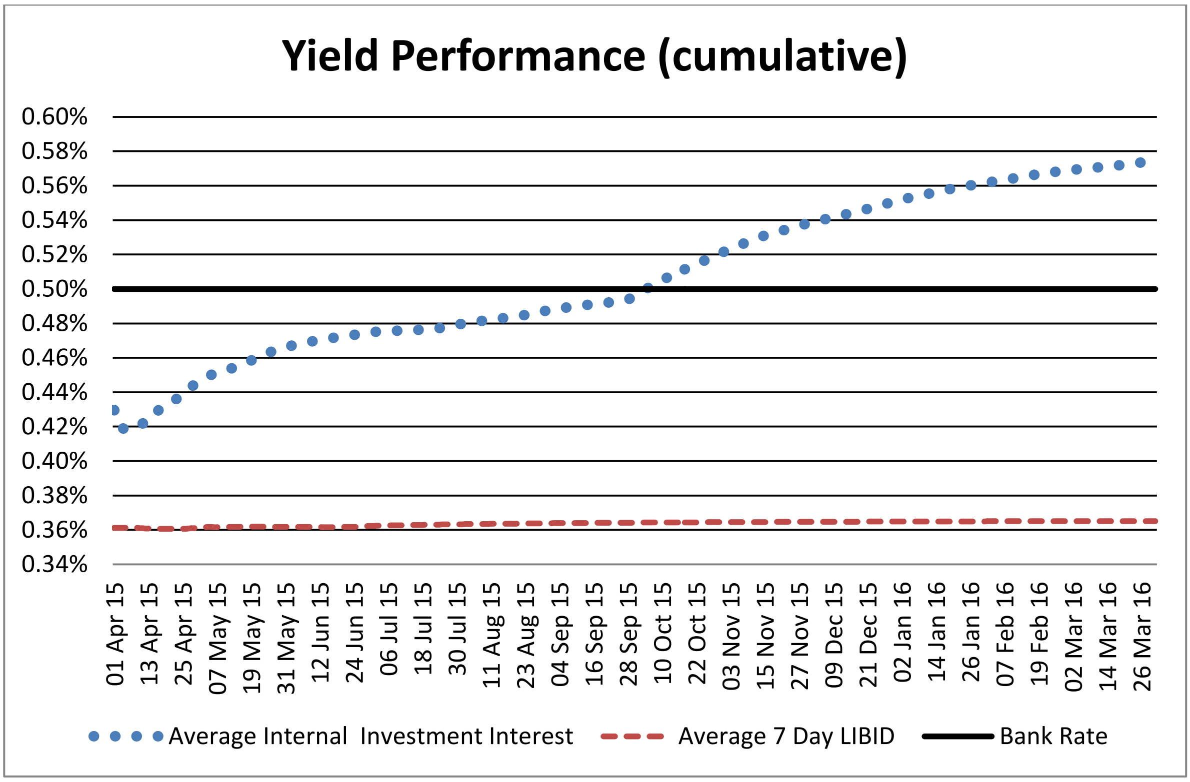
23. Counterparty credit quality was assessed and monitored with reference to credit ratings (the Council's minimum long-term counterparty rating is BBB+ across rating agencies Fitch, S&P and Moody's); credit default swap prices, financial statements, information on potential government support and reports in the quality financial press.

24. Given the increasing risk and continued low returns from short-term unsecured bank investments, and having established that £2m is available for longer-term investment, in September 2015 the Council diversified into a Property Fund.

25. The Council has further diversified its portfolio into Certificates of Deposit. Although these remain unsecured investments – and subject to bank bail-in risk – these are tradeable unlike term deposits.

26. Further to the change to the Council's bankers, the capacity to manage large amounts of short-term cash has diminished. This has enabled officers to identify scope to invest sums for longer periods of time resulting in higher yields.

27. The graph below gives an indication of the improved yield as a consequence of managed diversification.



Counterparty Update (Arlingclose Ltd)

28. All three credit ratings agencies have reviewed their ratings in the six months to reflect the loss of government support for most financial institutions and the potential for varying loss given defaults as a result of new bail-in regimes in many countries. Despite reductions in government support many institutions have seen upgrades due to an improvement in their underlying strength and an assessment that the level of loss given default is low.

29. Fitch reviewed the credit ratings of multiple institutions in May. Most UK banks had their support rating revised from 1 (denoting an extremely high probability of support) to 5 (denoting external support cannot be relied upon). This resulted in the downgrade of the long-term ratings of Royal Bank of Scotland (RBS) to BBB+ from A, Deutsche Bank to A from A+, Bank Nederlandse Gemeeten to AA+ from AAA and ING to A from A+. JP Morgan Chase and the Lloyds Banking Group however both received one notch upgrades.

30. Moody's concluded its review in June and upgraded the long-term ratings of Close Brothers, Standard Chartered Bank, ING Bank, Goldman Sachs International, HSBC, RBS, Coventry Building Society, Leeds Building

Society, Nationwide Building Society, Svenska Handelsbanken and Landesbank Hessen-Thueringen.

31. S&P reviewed UK and German banks in June downgrading Barclays' long-term rating to A- from A, RBS to BBB+ from A- and Deutsche Bank to BBB+ from A. S&P has also revised the outlook of the UK as a whole to negative from stable, citing concerns around a planned referendum on EU membership and its effect on the economy.

32. At the end of July, the Council's treasury advisors, Arlingclose Ltd, advised an extension of recommended durations for unsecured investments in certain UK and European institutions following improvements in the global economic situation and the receding threat of another Eurozone crisis. A similar extension was advised for some non-European banks in September, with the Danish Danske Bank being added as a new recommended counterparty and certain non-rated UK building societies also being extended.

<u>Compliance with Prudential Indicators</u>

33. The Council confirms compliance with its Prudential Indicators for 2015/16, which were set in February 2015 as part of the Council's Treasury Management Strategy Statement.

<u>Outlook for Q3 and Q4 2015/16 (Arlingclose Ltd)</u>

34. Following the Bank of England's quarterly inflation forecast in November 2015, Arlingclose Ltd's expectation for the first rise in the Bank Rate (base rate) – to 0.75% - has been revised to the third calendar quarter of 2016. The pace of interest rate rises will be gradual and the extent of rises limited. The appropriate level for Bank Rate for the post-crisis UK economy is likely to be lower than the previous norm, between 2.0% and 3.0%.

35. The weak global environment and resulting low inflation expectations are likely to dampen long term interest rates. We project gilt yields will follow a shallow upward path in the medium term, with continuing concerns about the Eurozone, and other geo-political events, weighing on risk appetite, while inflation expectations remain subdued. The uncertainties surrounding the timing of UK and US interest rate rises, and the Chinese stock market-led turmoil, are likely to prompt short term volatility in gilt yields.