Agenda Item 6

SWANAGE TOWN COUNCIL

Annual Treasury Report 2018/19

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1. Background

The Council's Treasury Management Strategy for 2018/19 is underpinned by having due regard to the Chartered Institute of Public Finance and Accountancy's Guidance for Smaller Public Organisations on the Application of the CIPFA Code of Practice for Treasury Management *in the Public Services: Code of Practice (2014 Edition) and Cross-Sectoral Guidance Notes 2017 Edition* (the CIPFA Code) and the Ministry for Housing, Communities and Local Government (MHCLG) *Guidance on Local Authority Investments,* updated February 2018. The Code recommends that members approve a treasury management annual report after the end of each financial year. This report fulfils the Authority's obligation to have regard to the CIPFA Code and any other appropriate guidance.

The Authority's Treasury Management Strategy for 2018/19 was approved by full Council on 22/01/2018 which can be accessed on https://www.swanage.gov.uk/Publications-Finance.aspx

The Authority has 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. The successful identification, monitoring and control of risk are therefore central to the Authority's treasury management strategy.

2. External Context

Economic background: After spiking at over $85/barrel in October 2018, oil prices fell back sharply by the end of the year, declining to just over $50 in late December before steadily climbing toward $70 in April 2019. UK Consumer Price Inflation (CPI) for February 2019 was up 1.9% year/year, just above the consensus forecast but broadly in line with the Bank of England's February Inflation Report. The most recent labour market data for the three months to January 2019 showed the unemployment rate fell to a new low 3.9% while the employment rate of 76.1% was the highest on record. The 3-month average annual growth rate for pay excluding bonuses was 3.4% as wages continue to rise steadily and provide some upward pressure on general inflation. Once adjusted for inflation, real wages were up 1.4%.

After rising to 0.6% in the third calendar quarter from 0.4% in the second, fourth quarter economic growth slowed to 0.2% as weaker expansion in production, construction and services dragged on overall activity. Annual GDP growth at 1.4% continues to remain below trend. Following the Bank of England's decision to increase Bank Rate to 0.75% in August, no changes to monetary policy have been made since.

The US Federal Reserve continued its tightening bias throughout 2018, pushing rates to the 2.25%-2.50% range in December. However, a recent softening in US data caused the Fed to signal a pause in hiking interest rates at the last Federal Open Market Committee (FOMC) meeting in March.

With the 29th March 2019, the original EU 'exit day,' now having been and gone, and Parliament having failed to pass a number of meaningful votes, MPs voted by a majority of one to seek an extension to the Brexit process in order to avoid a no-deal scenario. The deadline is now set for 31st October 2019, unless agreement can be reached earlier. Recent talks between the Conservative and

Labour parties to try to reach common ground on a deal have failed to do so. The ongoing uncertainty continues to weigh on sterling and UK markets.

While the domestic focus has been on Brexit's potential impact on the UK economy, globally the first quarter of 2019 has been overshadowed by a gathering level of broader based economic uncertainty. The US continues to be set on a path of protectionist trade policies and tensions with China in particular, but with the potential for this to spill over into wider trade relationships, most notably with EU. The EU itself appeared to be showing signs of a rapid slowdown in economic growth with the major engines of its economy, Germany and France, both suffering misfires from downturns in manufacturing alongside continued domestic/populist unrest in France. The International Monetary Fund downgraded its forecasts for global economic growth in 2019 and beyond as a consequence.

Financial markets: December was a month to forget in terms of performance of riskier asset classes, most notably equities. The FTSE 100 (a good indicator of global corporate sentiment) returned -8.8% assuming dividends were reinvested; in pure price terms it fell around 13%. However, since the beginning of 2019 markets have rallied, and the FTSE 100 and FTSE All share indices were both around 10% higher than at the end of 2018.

Gilt yields continued to display significant volatility over the period on the back of ongoing economic and political uncertainty in the UK and Europe. After rising in October, gilts regained their safe-haven status throughout December and into the new year - the 5-year benchmark gilt yield fell as low as 0.80% and there were similar falls in the 10-year and 20-year gilts over the same period dropping from 1.73% to 1.08% and from 1.90% to 1.55%. The increase in Bank Rate pushed up money markets rates over the year and 1-month, 3-month and 12-month LIBID (London Interbank Bid) rates averaged 0.53%, 0.67% and 0.94% respectively over the period.

Recent activity in the bond markets and PWLB interest rates highlight that weaker economic growth is not just a UK phenomenon but a global risk. During March the US yield curve inverted (10-year Treasury yields were lower than US 3 month money market rates) and German 10-year Bund yields turned negative. The drivers are a significant shift in global economic growth prospects and subsequent official interest rate expectations given its impact on inflation expectations. Further to this is world trade growth which collapsed at the end of 2018 falling by 1.8% year-on-year. A large proportion of this downturn in trade can be ascribed to the ongoing trade tensions between the US and China which despite some moderation in January does suggest that the International Monetary Fund's (IMF) and Organisation for Economic Co-Operation & Development's (OECD) forecasts for global growth in 2019 of 3.5% might need to be revised downwards.

Credit background: Credit Default Swap (CDS) spreads drifted up towards the end of 2018 on the back of Brexit uncertainty before declining again in 2019 and continuing to remain low in historical terms. After hitting around 129 basis points in December 2018, the spread on non-ringfenced bank NatWest Markets plc fell back to around 96bps at the end of March, while for the ringfenced entity, National Westminster Bank plc, the CDS spread held relatively steady around 40bps. The other main

UK banks, as yet not separated into ringfenced and non-ringfenced from a CDS perspective, traded between 33 and 79bps at the end of the period.

The ringfencing of the big four UK banks (Barclays, Bank of Scotland/Lloyds, HSBC and RBS/Natwest Bank plc) transferred their business lines into retail (ringfenced) and investment banking (non-ringfenced) entities.

In February, Fitch put the UK AA sovereign long-term rating on Rating Watch Negative as a result of Brexit uncertainty, following this move with the same treatment for UK banks and a number of government-related entities.

There were minimal other credit rating changes during the period. Moody's revised the outlook on Santander UK to positive from stable to reflect the bank's expected issuance plans which will provide additional protection for the its senior unsecured debt and deposits.

3. Local Context

At 31st March 2018 the Authority's held investments valued at £6.5m, with usable reserves and working capital being the underlying resources available for investment. At 31st March 2019, the Authority held investments valued at £6.3m. These year-end values include unrealised gains from the Council's strategic investments, being £0.6m in 2018 and £0.63m in 2019.

4. Borrowing Strategy and Debt Management

The Authority is debt free. The 2018/19 capital expenditure plans and treasury strategy did not imply a need to borrow over the 3-year forecast period. Usable reserves are forecast to fall to £2.6m by March 2022, as capital receipts and earmarked reserves are used to finance the Council's extensive capital programme.

5. Investment Activity

The Authority holds significant invested funds, representing balances and reserves held. During the year the Authority's investment balances remained relatively stable. The investment position is shown in table 1 below.

Table 1: Investment Position – (Current Value)

Investment Portfolio	**31.03.18 Balance £**	**Net Movement £**	**31.03.19 Balance £**	**31.03.19 Income Return %**
Banks and building societies (unsecured)	1,219,605	(46,732)	1,172,873	0.37%
Money Market Funds	403,851	96,149	500,000	0.79%
Covered Bonds (secured)	364,240	(364,240)	0	n/a
Investments in Pooled Funds:				
Property	3,132,449	48,673	3,181,122	4.40%
Multi-Asset	977,695	(8,330)	969,365	4.29%

Bonds	487,665	(8,515)	479,150	3.62%
TOTAL INVESTMENTS	**6,585,505**	**(282,995)**	**6,302,510**	**3.29%**

Both the CIPFA Code and government guidance require the Authority 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.

Given the increasing risk and low returns from short-term unsecured bank investments, the Authority has continued to use higher yielding asset classes, as shown in table 1 above. Investment risk has been diversified as much as possible given the Council's overall balances, although it is recognised that the Council's short-term investment portfolio is heavily weighted with unsecured banks.

The progression of risk and return metrics are shown in the extracts from Arlingclose's quarterly investment benchmarking in table 2 below, which only includes the Council's short-term investments.

Table 2: Investment Benchmarking – Treasury investments managed in-house

	Credit Score	Credit Rating	Bail-in Exposure	Weighted Average Maturity (days)	Rate of Return %
31.03.2018	3.12	AA	53%	10	0.48%
31.03.2019	4.57	A+	100%	5	0.50%
Similar LAs	4.32	AA-	58%	44	0.78%
All LAs	4.20	AA-	55%	29	0.85%

£4.6m of the Authority's investments are held in externally managed strategic pooled funds where short-term security and liquidity are lesser considerations, and the objectives instead are regular revenue income and long-term price stability. These funds generated an average total return of £0.23m (4.99%), comprising a £0.2m (4.29%) income return which is used to support services in year, and £0.03m (0.69%) of unrealised capital growth.

Because these funds have no defined maturity date, but are available for withdrawal after a notice period, their performance and continued suitability in meeting the Authority's investment objectives is regularly reviewed. Strategic fund investments are made in the knowledge that capital values will move both up and down on months, quarters and even years; but with the confidence that over a three to five-year period total returns will exceed cash interest rates. In light of their performance over the medium- / long-term and the Authority's latest cash flow forecasts, investment in these funds has been maintained.

Readiness for Brexit: With little by way of political clarity as to the exact date on whether there would be an agreed deal prior to leaving the EU and to be prepared for the outside chance of a particularly disruptive Brexit (such as last-minute no-deal) on 29th March, the Authority ensured there were enough accounts open at UK-domiciled banks and Money Market Funds to hold sufficient liquidity over the year end and that its account with the Debt Management Account Deposit Facility (DMADF) remained available for use in an emergency.

Non-Treasury Investments

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.

The Council did not invest in non-treasury investments during the year.

6. Compliance

This report provides members with a summary report of the treasury management activity during 2018/19, having due regard to both the CIPFA Code of Practice and MHCLG Guidance. A prudent approach has been taken in relation to investment activity with priority being given to security and liquidity over yield.

The Authority can confirm that during 2018/19 it complied with its **Treasury Management Policy Statement** and **Treasury Management Practices**.