Agenda Item 5

Treasury Management Outturn Report H1 2020/21

Introduction

The Authority's treasury management strategy for 2020/21 was approved on 20th March 2020. 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 remains central to the Authority's treasury management strategy.

External Context

Economic background: The spread of the coronavirus pandemic dominated during the period as countries around the world tried to manage the delicate balancing act of containing transmission of the virus while easing lockdown measures and getting their populations and economies working again. After a relatively quiet few months of Brexit news it was back in the headlines towards the end of the period as agreement between the UK and EU on a trade deal was looking difficult and the government came under fire, both at home and abroad, as it tried to pass the Internal Market Bill which could override the agreed Brexit deal, potentially breaking international law.

The Bank of England (BoE) maintained the Bank Rate at 0.1% and its Quantitative Easing programme at £745 billion. The potential use of negative interest rates was not ruled in or out by BoE policymakers, but then a comment in the September Monetary Policy Committee meeting minutes that the central bank was having a harder look at its potential impact than was previously suggested took financial markets by surprise.

Government initiatives continued to support the economy, with the furlough (Coronavirus Job Retention) scheme keeping almost 10 million workers in jobs, grants and loans to businesses and 100 million discounted meals being claimed during the 'Eat Out to Help Out' (EOHO) offer.

GDP growth contracted by a massive 19.8% (revised from first estimate -20.4%) in Q2 2020 (Apr-Jun) according to the Office for National Statistics, pushing the annual growth rate down to -21.5% (first estimate -21.7%). Construction output fell by 35% over the quarter, services output by almost 20% and production by 16%. Recent monthly estimates of GDP have shown growth recovering, with the latest rise of almost 7% in July, but even with the two previous monthly gains this still only makes up half of the lost output.

The headline rate of UK Consumer Price Inflation (CPI) fell to 0.2% year/year in August, further below the Bank of England's 2% target, with the largest downward contribution coming from restaurants and hotels influenced by the EOHO scheme. The Office for National Statistics' preferred measure of CPIH which includes owner-occupied housing was 0.5% y/y.

In the three months to July, labour market data showed the unemployment rate increased from 3.9% to 4.1% while wages fell 1% for total pay in nominal terms (0.2% regular pay) and was down 1.8% in real terms (-0.7% regular pay). Despite only a modest rise in unemployment over the period, the rate is expected to pick up sharply in the coming months as the furlough scheme ends in October. On the back of this, the BoE has forecast unemployment could hit a peak of between 8% and 9%.

The US economy contracted at an annualised rate of 31.7% in Q2 2020 (Apr-Jun). The Federal Reserve maintained the Fed Funds rate at between 0% and 0.25% but announced a change to its inflation targeting regime. The move is to a more flexible form of average targeting which will allow the central bank to maintain interest rates at low levels for an extended period to support the economy even when inflation is 'moderately' above the 2% average target, particularly given it has been below target for most of the last decade.

The European Central Bank maintained its base rate at 0% and deposit rate at -0.5%.

Financial markets: Equity markets continued their recovery, with the Dow Jones climbing to not far off its pre-crisis peak, albeit that performance being driven by a handful of technology stocks including Apple and Microsoft, with the former up 75% in 2020. The FTSE 100 and 250 have made up around half of their losses at the height of the pandemic in March. Central bank and government stimulus packages continue to support asset prices, but volatility remains.

Ultra-low interest rates and the flight to quality continued, keeping gilts yields low but volatile over the period with the yield on some short-dated UK government bonds remaining negative. The 5-year UK benchmark gilt yield started and ended the June–September period at -0.06% (with much volatility in between). The 10-year gilt yield also bounced around, starting at 0.21% and ending at 0.23% over the same period, while the 20-year rose from 0.56% to 0.74%. 1-month, 3-month and 12-month bid rates averaged 0.02%, 0.06% and 0.23% respectively over the period.

At the end of September, the yield on 2-year US treasuries was around 0.13% while that on 10-year treasuries was 0.69%. German bund yields remain negative across most maturities.

Credit review: Credit default swap spreads eased over most of the period but then started to tick up again through September. In the UK, the spreads between ringfenced and non-ringfenced entities remains, except for retail bank Santander UK whose CDS spread remained elevated and the highest of those we monitor at 85bps while Standard Chartered was the lowest at 41bps. The ringfenced banks are currently trading between 45 and 50bps.

After a busy second quarter of the calendar year, the subsequent period has been relatively quiet for credit changes for the names on our counterparty list. Fitch assigned a AA- deposit rating to Netherlands lender Rabobank with a negative outlook and prior to that, while not related to our counterparty list but quite significant, revised the outlook on the US economy to Negative from Stable while also affirming its AAA rating.

There continues to remain much uncertainty around the extent of the losses banks and building societies will suffer due to the impact from the coronavirus pandemic and for the UK institutions on our list there is the added complication of the end of the Brexit transition period on 31st December and what a trade deal may or may not look like. The institutions on Arlingclose's counterparty list and recommended duration remain under constant review, but at the end of the period no changes had been made to the names on the list or the recommended maximum duration of 35 days.

Local Context

On 31st March 2020, the Authority had net investments of £6.27m with usable reserves and working capital being the underlying resources available for investment.

Borrowing Strategy during the period

At 30th September 2020 the Authority was debt free. The Authority's capital expenditure plans and treasury strategy does not imply a need to borrow during the remainder of the financial year.

Treasury Investment Activity

The Authority holds invested funds, representing income received in advance of expenditure plus balances and reserves held. During the year, the Authority's investment balances ranged between £6.2m and £6.8m due to timing differences between income and expenditure and the seasonality of the Authority's revenue generating activities. The investment position and the change over the six months to 30th September 2020 is shown in Table 1 below.

Table 1: Treasury Investment Position

Investment Portfolio	31.03.20 Balance £	Net Movement £	30.09.20 Balance £
Banks and building societies (unsecured)	179,245	1,500,055	1,679,300
Money Market Funds	750,000	0	750,000
UK Govt	950,000	(950,000)	0
Total Internal Investments	**1,879,245**	**550,055**	**2,429,300**
Investments in Pooled Funds:			
Property	3,067,341	(127,582)	2,939,759
Bonds	445,157	53,086	498,243
Multi-Asset	878,416	56,342	934,758
Total External Funds	**4,390,914**	**(18,154)**	**4,372,760**
TOTAL INVESTMENTS	**6,270,159**	**531,901**	**6,802,060**

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.

Continued downward pressure on short-dated cash rates brought net returns on sterling low volatility net asset value money market funds (LVNAV MMFs) close to zero, even after some managers temporarily lowered their fees. At this stage net negative returns are not the central case of most MMF managers over the short-term, and fee waivers should maintain positive net yields, but the possibility cannot be ruled out.

On 25th September the overnight, 1-week and 2-week deposit rates on the Debt Management Account Deposit Facility (DMADF) deposits dropped below zero percent to -0.03%, the rate was 0% for 3-week deposits and 0.01% for longer maturities.

The return on Money Market Funds net of fees also fell over the six months and for many funds net returns range between 0% and 0.1%. In many instances, the fund management companies have temporarily lowered or waived fees to maintain a positive net return.

Although the continuing risk and low returns from short-term unsecured bank investments prevails, the Authority has seen a movement back into these investments. This is due several factors, mainly a timing issue, with the redemption of UK government investments and receipt of the precept close to 30th September. Also, in light of the pandemic crisis with reduced income during Q1, the Council kept more cash available at very short notice than is normal. However, Officers will strive to diversify during the ensuing months with a particular view on local to local lending and moving away from unsecured bank deposits.

The progression of risk and return metrics are shown in the extracts from Arlingclose's quarterly investment benchmarking in Table 2 below.

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

	Credit Score	Credit Rating	Bail-in Exposure	Weighted Average Maturity (days)	Rate of Return %
31.03.2020	3.94	AA	49%	34	0.31
30.09.2020	4.68	A+	100%	1	0.04
Similar LAs	4.12	AA-	60%	55	0.17
All LAs	4.16	AA-	64%	18	0.27

Externally Managed Pooled Funds: £4.37m of the Authority's investments are held in externally managed strategic pooled bond, multi-asset and property funds where short-term security and liquidity are lesser considerations, and the objectives instead are regular revenue income and long-term price stability. In the 1 year period to 30th September 2020, these funds generated a total return of -£42.3k (-0.92%), comprising a £182.5k (3.97%) income return which is used to support services in year, and -£224.9k (-4.89%) of unrealised capital loss. A detailed breakdown of the 12-month performance of the Authority's strategic investments is shown in Appendix A.

In a relatively short period since the onset of the COVID-19 pandemic in March and the ensuing enforced lockdown in many jurisdictions, the global economic fallout has been sharp and large. Market reaction was extreme with large falls in equities, corporate bond markets and, to some extent, real estate echoing lockdown-induced paralysis and the uncharted challenges for governments, business and individuals.

The Authority is invested in bond, multi-asset and property funds. The falls in the capital values of the underlying assets, in particular bonds and equities were reflected in the 31st March 2020 fund valuations with every fund registering negative capital returns over a 12-month period. Since March there here has been improvement in market sentiment which is reflected in an increase in capital values of the short-dated, strategic bond and multi-asset income funds in the Authority's portfolio. The capital value of the property fund is below that at 31st March. Market values at 31st March and 30th September 2020 are as shown in Table 1, above.

Similar to many other property funds, dealing (i.e. buying or selling units) in the CCLA Local Authorities Property Fund was suspended by the fund in March 2020. The relative infrequency of property transactions in March as the pandemic intensified meant that it was not possible for valuers to be confident that their valuations correctly reflected prevailing conditions. To avoid material risk of disadvantage to buyers, sellers and holders of units in the property fund, the management company was obliged to suspend transactions until the required level of certainty is re-established. The dealing suspension was lifted in September 2020. There has also been a change to redemption terms for the CCLA Local Authorities Property Fund; from September 2020 investors are required to give at least 90 calendar days' notice for redemptions.

Because the Authority's externally managed 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 are 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.

Estimates for income 2020/21

Estimated income from treasury investments was set at £185,000 for the 2020/21 financial year. This was based upon an assumed average 3.5% annualised income return. Table 3 below shows the income and budget to 30th September 2020. This shows that income is slightly below budget year to date.

Table 3: Income-Actual v Budget 30 September 2020

	Actual £k	Budget £k	Under £k	Actual %	Estimate %
Treasury Investment Income	91	92.5	1.5	2.57%	3.5%

The corporate world is still adjusting to the economic shock, with probably more to come, and it is still too early to tell which companies will withstand the economic damage in the short- to medium-term or which will choose to conserve cash in very difficult economic conditions simply to survive.

Investment income in the Authority's 2020/21 budget was set against a very different economic backdrop. The Bank Rate, which was 0.75% in February 2020, now stands at 0.1%. Interest earned from short-dated money market investments will be significantly lower. In relation to income from the Authority's externally managed strategic funds, dividends and income distributions will ultimately depend on many factors including but not limited to the duration of COVID-19 and the extent of its economic impact and the fund's sectoral asset allocation.

In 2020/21 the Authority expects to receive lower income from its cash and short-dated money market investments and from its externally managed funds than it did in 2019/20 and earlier years. It is likely that a downward adjustment may need to be made on the expectations for investment income in 2020/21. This will be reviewed during the next quarter, with little impact in the 1st half of the year from its strategic investments. However, the implications of external factors such as Covid-19 and Brexit may be for the long-term rather than just the short-term. Income received will continue to be monitored.

Compliance

The Finance Manager reports that all treasury management activities undertaken during the quarter complied fully with the CIPFA Code of Practice and the Authority's approved Treasury Management Strategy. Compliance with specific investment limits is demonstrated in table 4 below.

Table 4: Investment Limits

	Q1 Maximum	**30.9.20 Actual**	**2020/21 Limit**	**Complied?**
Any single organisation, except the UK Government	£3.19m	£3.18m	£4m	Yes
UK Central Government	£0.95m	£0m	unlimited	Yes
Any group of organisations under the same ownership	£3.19m	£3.18m	£3.5m	Yes
Any group of pooled funds under the same management	£2.95m	£2.94m	£3.5m	Yes
Negotiable instruments held in a broker's nominee account	£0m	£0m	£1.5m	Yes
Limit per non-UK country	£0m	£0m	£1m	Yes
Registered providers and registered social landlords	£0m	£0m	£1m	Yes
Unsecured investments with building societies	£0m	£0m	£1m	Yes
Loans to unrated corporates	£0m	£0m	£0.5m	Yes
Money Market Funds	£0.75m	£0.75m	£1m	Yes

Treasury Management Indicators

The Authority measures and manages its exposures to treasury management risks using the following indicators.

Security: The Authority has adopted a voluntary measure of its exposure to credit risk by monitoring the value-weighted average credit rating of its investment portfolio. This is calculated by applying a score to each investment (AAA=1, AA+=2, etc.) and taking the arithmetic average, weighted by the size of each investment. Unrated investments are assigned a score based on their perceived risk.

	30.9.20 Actual	2020/21 Target	Complied?
Portfolio average credit rating	A+	A	Yes

Liquidity: The Authority has adopted a voluntary measure of its exposure to liquidity risk by monitoring the amount of cash available to meet unexpected payments within a rolling three-month period, without the need to borrow.

	30.9.20 Actual	2020/21 Target	Complied?
Total cash available within 3 months	£2.4m	£1m	Yes

Arlingclose's Outlook for the remainder of 2020/21

	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23
Official Bank Rate													
Upside risk	0.00	0.00	0.00	0.15	0.15	0.15	0.15	0.30	0.30	0.30	0.30	0.30	0.30
Arlingclose Central Case	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
Downside risk	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50

The medium-term global economic outlook is weak. While the strict initial lockdown restrictions have eased, coronavirus has not been supressed and second waves have prompted more restrictive measures on a regional and national basis. This ebb and flow of restrictions on normal activity will continue for the foreseeable future, at least until an effective vaccine is produced and importantly, distributed.

The global central bank and government responses have been significant and are in many cases on-going, maintaining more stable financial, economic and social conditions than otherwise. This has supported a sizeable economic recovery in Q3.

However, the scale of the economic shock to demand, on-going social distancing measures, regional lock downs and reduced fiscal support will mean that the subsequent pace of recovery is limited. Early signs of this are already evident in UK monthly GDP and PMI data, even before the latest restrictions.
This situation will result in central banks maintaining low interest rates for the medium term. In the UK, Brexit is a further complication. Bank Rate is therefore likely to remain at low levels for a very long time, with a distinct possibility of being cut to zero. Money markets have priced in a chance of negative Bank Rate.

Longer-term yields will also remain depressed, anchored by low central bank policy rates, expectations for potentially even lower rates and insipid inflation expectations. There is a chance yields may follow a slightly different path in the medium term, depending on investor perceptions of growth and inflation, or if the UK leaves the EU without a deal.

Arlingclose expects Bank Rate to remain at the current 0.10% level and additional monetary loosening in the future most likely through further financial asset purchases (QE). While

Arlingclose’s central case for Bank Rate is no change from the current level of 0.1%, further cuts to Bank Rate to zero or even into negative territory cannot be completely ruled out.

Gilt yields are expected to remain very low in the medium term. Shorter-term gilt yields are currently negative and will remain around zero or below until either the Bank of England expressly rules out negative Bank Rate or growth/inflation prospects improve.

Downside risks remain in the near term, as the government dials down its fiscal support measures, reacts to the risk of a further escalation in infection rates and the Brexit transition period comes to an end.

Appendix A

STRATEGIC POOLED FUND PORTFOLIO			SWANAGE				From	30/09/2019	To:	30/09/2020		

ASSET CLASS (All)

FUND NAME	ASSET CLASS	No of Units Held in Period	Current Value £	Capital Growth £	Dividends Earned £	Holding Period (yrs)	Capital Return	Income Return	Total Return	Volatility
CCLA - LAMIT PROPERTY FUND	PROPERTY	1,053,526	2,939,759	-211,653	130,315	1.0	-6.72%	4.14%	-2.58%	2.4%
M&G STRATEGIC CORPORATE BOND FUND	BOND	44,259	498,243	4,457	15,792	1.0	0.90%	3.20%	4.10%	12.1%
NINETY ONE (INVESTEC) DIVERSIFIED INCOME FUND	MULTI ASSET	940,645	934,758	-17,719	36,445	1.0	-1.86%	3.83%	1.97%	9.6%
GRAND TOTAL			4,372,760	-224,915	182,552	1.0	-4.89%	3.97%	-0.92%	3.1%

Unrealised capital loss: -224,915 Annualised income return: 3.97%