Appendix 2

Treasury Management Update

Quarter Ended 30th September 2010 and Mid Year Report

1 Introduction

1.1 The Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management (revised November 2009) was adopted by this Council in March 2002.

The primary requirements of the Code are as follows:

- Creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the Council's treasury management activities.
- Creation and maintenance of Treasury Management Practices which set out the manner in which the Council will seek to achieve those policies and objectives.
- Receipt by the full council of an annual Treasury Management Strategy Statement - including the Annual Investment Strategy for the year ahead, a **Mid-year Review Report** and an Annual Report (stewardship report) covering activities during the previous year.
- 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.
- 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 Accounts, Audit and Risk Committee.

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

- An economic update for the first six months of 2010/11
- A review of the Treasury Management Strategy Statement and Annual Investment Strategy
- A review of the Council's investment portfolio for 2010/11
- A review of compliance with Treasury for 2010/11

2 Economic background

2.1 Global economy - the sovereign debt crisis peaked in May 2010 prompted, in the first place, by major concerns over the size of the Greek government's total debt and annual deficit. However, any default or write down of Greek debt would have substantial impact on other countries, in particular, Portugal, Spain and Ireland. This crisis culminated in the EU and IMF putting together a €750bn support package in mid May.

2.1.1 Growth in the US, UK and the Euro zone in quarter 2 of 2010 was particularly driven by strong growth in the construction sector catching up from inclement weather earlier in the year and is unlikely to be repeated; general expectations are for much more subdued figures for the remainder of 2010. Market expectations for all three sectors of the economy is that these have all peaked and are pointing downwards, though not necessarily in to negative territory.

2.2 UK economy - following the general election in May 2010, the coalition government has put in place an austerity plan to carry out correction of the public sector deficit over the next five years. The inevitable result of fiscal contraction will be major job losses during this period, in particular in public sector services. This will have a knock on effect on consumer and business confidence. House prices have started a negative trend during the summer and mortgage approvals are at very weak levels and also declining.

2.3 Economic Growth - GDP growth is likely to have peaked at 1.2% in quarter 2 of 2010.

2.4 Unemployment - the trend of falling unemployment (on the benefit claimant count) has now been replaced since July with small increases which are likely to be the start of a new trend of rising unemployment.

2.5 Inflation and Bank Rate - CPI has remained high so far during 2010. It peaked at 3.7% in April and has fallen back to 3.1% in August. RPI remains high, at 4.7% in August. Although inflation has remained stubbornly above the MPC's 2% target, the MPC is confident that inflation will fall back under the target over the next two years. The last quarterly Inflation Report in August showed a significant undershoot after the end of 2011.

2.6 The Bank of England finished its programme of quantitative easing with a total of £200bn in November 2009 (although there is currently some increase in expectations that there might be a second round of quantitative easing).

Sector's view is that there is unlikely to be any increase in Bank Rate until the middle of 2011.

2.7 AAA rating – prior to the general election, credit rating agencies had been issuing repeated warnings that unless there was a major fiscal contraction, then the AAA sovereign rating was at significant risk of being downgraded. Sterling was also under major pressure during the first half of the year. However, after the Chancellor's budget on 22 June, Sterling has strengthened against the US dollar and confidence has returned that the UK will retain its AAA rating. In addition, international investors now view UK government gilts as being a safe haven from EU government debt. The consequent increase in demand for gilts has helped to add downward pressure on gilt yields and PWLB rates.

2.8 Quarter 2 Update - the quarter ended 30th September 2010 saw the following:

- Activity indicators suggest that the recovery has faded sharply since the second quarter (1st April to 30th June);
- The pace of recovery in retail spending is slowing, but the recovery in spending off the high street gather pace;
- Further doubt cast on the sustainability of the recovery in the labour market;
- The recovery in the housing market falter;
- Disappointment that the public finances are not on a clearly improving trend;

- The UK's trade deficit widen further, despite the continued weakness of sterling;
- CPI inflation fall at a slower pace than in the second quarter;
- The doves on the Monetary Policy Committee gain the upper hand;
- Equity and bond markets respond in different ways to the news that the recovery is faltering;
- The recoveries in the US and euro-zone lose further pace.

2.8.2 Activity indicators have suggested that the recovery has lost considerable pace since real GDP (Gross Domestic Product) expanded by 1.2% q/q in the second quarter of 2010. The weighted average of the output balances of the CIPS/Markit surveys fell from an average of 55.5 in Q1 to 52.6 in Q2. As the surveys tend to lead the official GDP data, the surveys are consistent with quarterly growth in GDP slowing to around only 0.2% by the end of the year (well below the long term average of about 0.5%)

2.8.3 The recovery off the high street may have picked up at a faster pace in Q2 but the recovery in retail spending through shops seems to have deteriorated over the quarter as retail sales volumes fell by 0.5% on the previous month in August. An average fall of -18 in Q1 to -20 in Q2 in consumer confidence (reported by GfK) may have also played a role in the fall in retail spending.

2.8.4 Further doubt has been cast on the sustainability of the recovery in the labour market. The ILO measure of unemployment was around 8,000 lower in the 3 months to July although employment actually rose by 286,000 over the same period.

2.8.5 The recovery in the housing market has also begun to falter. Only 47,400 mortgages for new house purchase were approved in August on the Bank of England's official measure; this is nearly 20% lower than at the end of 2010. Furthermore, the Nationwide house price index fell by 0.5% and 0.8% in July and August respectively before rising by 0.1% in September.

2.8.6 August's public finances figures severely dented hopes that the fiscal position is on a clearly improving trend. The public borrowing figure (on the PSNB ex. measure) of £15.9bn in August was nearly £2bn larger than at the same time a year ago. However, this figure still left a cumulative borrowing total in the first five months of the fiscal year of £58.1bn, around £4bn below last year's equivalent figure of £61.9bn. The UK's trade deficit widened further in the third quarter, despite the continued weakness of sterling. The trade in goods deficit rose from £7.5bn to £8.7bn in July which was the largest deficit on record.

2.8.7 CPI (consumer price inflation) inflation fell from 3.2% to 3.1% in July, and remained unchanged in August. Inflation therefore fell in this quarter but at a slower pace than in the previous quarter. While oil price inflation has begun to ease, an easing in clothes deflation and a pick-up in food and drink inflation were responsible for preventing CPI inflation from falling further in August. The Bank of England's quarterly Inflation Report in August once again projected inflation to fall to below the 2% target and remain there at the two year policy horizon. The MPC (Monetary Policy Committee) voted to maintain the outstanding stock of asset purchases under quantitative easing (QE) at £200bn at each meeting in the quarter. The minutes to September's MPC meeting revealed that for most members "the probability that further action would become necessary to stimulate the economy and keep inflation on track to hit the target in the medium term had increased." Also, the majority of members on the MPC voted in each meeting to keep official interest rates on hold, apart from Andrew Sentence who voted for a 25bp rise.

2.9 Sector's view for the next six months of 2010/11 - it is currently difficult to have confidence as to exactly how strong the UK economic recovery is likely to be, and there are a range of views in the market. Sector has adopted a moderate view. There are huge uncertainties in all forecasts due to the major difficulties of forecasting the following areas:

- the speed of economic recovery in the US and EU
- the degree to which government austerity programmes will dampen economic growth
- the speed of rebalancing of the UK economy towards exporting and substituting imports
- changes in the consumer savings ratio
- the potential for more quantitative easing, and the timing of this in both the UK and US
- the speed of recovery of banks' profitability and balance sheet imbalances
- the potential for a major EU sovereign debt crisis which could have a significant impact on financial markets and the global and UK economy

2.9.2 The overall balance of risks is weighted to the downside and there is some risk of a double dip recession and deleveraging, creating a downward spiral of falling demand, falling jobs and falling prices, although this is currently viewed as being a small risk.

2.9.3 Sector believes that the longer run trend is for gilt yields and PWLB rates to rise due to the high volume of gilt issuance in the UK, and the high volume of debt issuance in other major western countries.

3 Interest rate forecast

3.1 The Council's treasury adviser, Sector, provides the following forecast:

Sector's Interest Rate View													
	NOW	Dec-10	Mar-11	Jun-11	Sep-11	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12	Mar-13	Jun-13	Sep-13
Sector's Bank Rate View	0.50%	0.50%	0.50%	0.50%	0.75%	1.00%	1.25%	1.50%	2.00%	2.50%	3.00%	3.25%	3.25%
5yr PWLB Rate	1.88%	2.20%	2.20%	2.40%	2.60%	2.80%	3.00%	3.30%	3.60%	3.80%	4.10%	4.40%	4.40%
10yr PWLB View	3.14%	3.30%	3.30%	3.40%	3.70%	3.90%	4.00%	4.30%	4.40%	4.60%	4.60%	4.90%	4.90%
25yr PWLB View	4.04%	4.20%	4.30%	4.30%	4.40%	4.50%	4.70%	4.70%	4.80%	5.00%	5.00%	5.00%	5.00%
50yr PWLB Rate	4.10%	4.20%	4.30%	4.30%	4.40%	4.50%	4.70%	4.70%	4.80%	5.00%	5.00%	5.00%	5.00%

3.2 The forecast is based on recent events which have caused a major fall in bond yields which, in turn, have dragged down PWLB rates.

3.3 Recent UK and US statistics indicate that recovery is likely to be anaemic. The Bank of England Inflation Report in August downgraded the forecast for GDP growth for 2011 from 3.4% to 2.8% but even 2.8% is widely viewed as being optimistic.

3.4 The increase in the risk of further quantitative easing in the UK and US (i.e. a further loosening of monetary policy) implied that the forecasts for the first increase in Bank Rate needed to be put back from Q1 2011 to Q3.

3.5 Long term PWLB rates are expected to remain at historically low levels during 2011 but then to be on a rising trend to reach 5.00% in December 2012 due to the high volume of gilt issuance in the UK, and the high volume of debt issuance in other major western countries. Gilt yields and PWLB rates – especially in the medium to long maturity periods, have fallen considerably due to the sovereign debt crisis in the EU which peaked in May. This, together with the coalition government's emergency budget to accelerate the speed of reduction in the public sector deficit, has meant that UK gilts have taken on safe haven status for international investors.

3.6 It is currently difficult to have confidence as to exactly how strong the UK economic recovery is likely to be, and there are a range of views in the market. Sector has adopted a moderate view. There are huge uncertainties in all forecasts due to the major difficulties of forecasting the following areas:

- the speed of economic recovery in the US and EU;
- the degree to which government austerity programmes will dampen economic growth;
- the speed of rebalancing of the UK economy towards exporting and substituting imports;
- changes in the consumer savings ratio;
- the potential for more quantitative easing, and the timing of this in both the UK and US;
- the speed of recovery of banks' profitability and balance sheet imbalances;
- the potential for a major EU sovereign debt crisis which could have a significant impact on financial markets and the global and UK economy.

3.7 The overall balance of risks is weighted to the downside and there is some risk of a double dip recession and deleveraging, creating a downward spiral of falling demand, falling jobs and falling prices, although this is currently viewed as being a small risk.

4 Annual Investment Strategy

4.1 The Treasury Management Strategy Statement (TMSS) for 2010/11, which includes the Annual Investment Strategy, was approved by the Council on 22.02.2010. It sets out the Council's investment priorities as being:

- Security of Capital
- Liquidity

4.2 The Council will also aim to achieve the optimum return (yield) on investments commensurate with proper levels of security and liquidity. In the current economic climate it is considered appropriate to keep investments short term to cover short term cash flow needs but also to seek out value available in significantly higher rates in periods up to 12 months with highly credit rated financial institutions, using Sector's suggested creditworthiness approach, including sovereign credit rating and Credit Default Swap (CDS) overlay information provided by Sector: this applies in particular to nationalised and semi nationalised UK banks.

4.3 Officers can confirm that the approved limits within the Annual Investment Strategy were not breached during the quarter ended 30.9.2010. Investments held as at 30 September 2010 across the 3 funds are detailed in Appendix 2a. Investment performance for quarter ended 30.9.2010

Fund	**Amount at 30 Sept 210**	**Q2 Interest Budget**	**Q2 Actual Interest**	**Variance**	**Annual Rate of return %**
TUK	25,000,000	413,257	427,521	14,264	
Investec	20,344,343	200,000	106,916	-93,084	
In House	25,997,095	61,120	140,852	79,732	
Total	**71,341,438**	**674,377**	**675,289**	**912**	**1.87**

4.4 The 12month benchmark for investment returns according to Sector is 1.34% and as illustrated, the authority outperformed the benchmark by **53 bps** primarily as a result of the longer term investments which are achieving >5% - these however are nearing maturity.

4.5 The Council's budgeted investment return for 2010/11 is **£1.348m** and performance for the year to date is in line with the budget.

5 Compliance with Treasury Limits

5.1 During the financial year to date the Council has operated within the treasury limits and Prudential Indicators set out in the Council's Treasury Management Strategy Statement and in compliance with the Council's Treasury Management Practices.

6 Icelandic Investments

6.1 The Council currently has a total of £6.5 million in short term investments (i.e. those with maturity periods of up to one year) with one of the affected banks Glitner. The latest position is that, the Council currently does not have preferential credit status and as such would only recover 31% of this balance. Local Authorities have objected to this creditor status and legal action is being taken.

6.2 Local authorities' objections will now be considered under the processes followed under Icelandic insolvency law, and court action will be taken as necessary. 14 test cases which contain legal arguments to support preferential creditor status and 100% recovery have been presented to the Icelandic Courts in September 2010. Cherwell represent 3 of these cases (each deposit is a separate test case).

6.3 The defendants including the winding up board now have until mid October 2010 to file their submissions in response.

6.4 The LGA is confident that local authorities' priority status as depositors will in due course be secured and 100% recovered and we will keep this committee informed of progress.