ISLE OF ANGLESEY COUNTY COUNCIL

REPORT TO	**AUDIT COMMITTEE**
DATE	**23 FEBRUARY 2015**
SUBJECT	**TREASURY MANAGEMENT - THIRD QUARTER 2014/15**
LEAD OFFICER	**RICHARD MICKLEWRIGHT**
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Nature and reason for reporting

For scrutiny - consistent with professional guidance.

1. This report is presented to ensure that the Council is implementing best practice in accordance with the Chartered Institute of Public Finance and Accountancy (CIPFA) Code of Practice for Treasury Management. This Code recommends that Members should be updated on treasury management activities at least twice a year.

2. The Council's Treasury Advisers (Capita Asset Services) recently provided a commentary on the economic background (Appendix 1) and also a commentary on the economic outlook (Appendix 2) together with the forecast interest rates in the table below:-

	Mar-15	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18
Bank rate	0.50%	0.50%	0.50%	0.75%	0.75%	1.00%	1.00%	1.25%	1.25%	1.50%	1.75%	1.75%	2.00%
5yr PWLB rate	2.20%	2.20%	2.30%	2.50%	2.60%	2.80%	2.90%	3.00%	3.20%	3.30%	3.40%	3.50%	3.60%
10yr PWLB rate	2.80%	2.80%	3.00%	3.20%	3.30%	3.50%	3.60%	3.70%	3.80%	3.90%	4.00%	4.10%	4.20%
25yr PWLB rate	3.40%	3.50%	3.70%	3.80%	4.00%	4.20%	4.30%	4.40%	4.50%	4.60%	4.70%	4.70%	4.80%
50yr PWLB rate	3.40%	3.50%	3.70%	3.80%	4.00%	4.20%	4.30%	4.40%	4.50%	4.60%	4.70%	4.70%	4.80%

2.1 The above table represents the view of Capita Asset Services after undertaking a review of its interest rate forecasts on 5 January 2015, after a proliferation of fears in financial markets around the plunge in the price of oil had caused a flight from equities into bonds and from exposure to the debt and equities of emerging market oil producing countries to safe havens in western countries. These flows were compounded by further fears that Greece could be heading towards an exit from the Euro after the general election on January 25 and financial flows generated by the increasing likelihood that the ECB would soon be starting on full blown quantitative easing (QE) purchase of Eurozone government debt. In addition, there has been a sharp increase in confidence that the US will start increasing the Fed. rate by the middle of 2015 due to the stunning surge in GDP growth in quarters 2 and 3 of 2014. This indicated that the US is now headed towards making a full recovery from the financial crisis of 2008.

3. At the beginning of the year, the Council's borrowing portfolio was all from PWLB and was £19.2m below the Capital Financing Requirement (CFR) (i.e. part of the borrowing had been internalised). The CFR is projected to be £114.8m by the year end, and there is a borrowing requirement of £25.2m as a result. The Treasury Management Strategy Statement (Section 3.4.1) states that a flexible approach will need to be adopted with regards to the choice between internal and external borrowing. This has been, and will continue to be, the case, with consideration to all the factors listed in that section. The decision to continue to internalise has been driven mainly due to 2 factors: (1) to limit the Authority's exposure to credit risk (2) to limit the cost of carry. These are set against the backdrop of PWLB and investment rates continuing to remain at historically low levels, with only a steady increase forecast into the medium term. This current stance is in line with many other local authorities that have been asked in seminars and workshops attended by officers within the Resources Function. The appointed treasury advisors (Capita Asset Services) have also supported the decision to continue to internalise borrowing at this time. External borrowing at year end is, therefore, expected to be £89.6m. Any changes to the current approach will be reported as appropriate.

4. Borrowing and investments at the beginning and end of the quarter were as follows:-

	31 December 2014		**30 Sept 2014**	
	£m	**%**	**£m**	**%**
Borrowing – fixed rate	89.6	5.72	89.6	5.72
Borrowing – variable rate	Nil	n/a	Nil	n/a
Deposits – Call to 30 days	13.3	0.39	18.6	0.39
Deposits – Fixed Term < 1 year	Nil	n/a	Nil	n/a
Deposits – Fixed Term 1 year +	Nil	n/a	Nil	n/a
Total Deposits	13.3	0.39	18.6	0.39
Average Deposits in the Quarter	21.2	0.41	21.2	0.43

4.1 Details of the institutions holding the deposits can be found at Appendix 3.

4.2 There are two points worthy of note with regards to the investment climate:-

- The list of creditworthy counterparties continues to be highly restricted, with very few counterparties standing up to the approved credit criteria; and
- Investment rates available in the market have continued at historically low levels.

4.3 As referred to in Section 3, no external borrowing was taken up during the quarter. Additionally, debt rescheduling opportunities have continued to be limited in the current economic climate and following the increase in the margin added to gilt yields which has impacted PWLB new borrowing rates since October 2010. No debt rescheduling was undertaken during the quarter.

5. During the quarter, the Council remained within its Prudential and Treasury Limits.

6. There has not been any activity since the end of the quarter to note.

7. The plans for the rest of the year are:-

- To continue to invest surplus balances in a way that ensures, in order of priority, security as well as liquidity and yield;
- To continue to internalise borrowing whilst regularly monitoring market conditions; and
- To monitor the market so that rescheduling can be undertaken at an appropriate time if opportunities are available.

8. LOOKING BEYOND 2014/15

On the 2 April 2015, the Isle of Anglesey County Council is due to exit the HRA subsidy system through buying itself out and becoming self-financed. The buyout has to be financed through the PWLB, but the settlement amount and rate of interest on the borrowing are under consultation at the time of preparing this report. This has been reflected in the budget setting papers presented to Members for 2015/16 (including the 2015/16 Treasury Management Strategy Statement presented to this Committee on 9th February 2015). The outcome will be reported at the earliest appropriate opportunity.

9. RECOMMENDATION

To consider the content of the report.

RICHARD MICKLEWRIGHT
INTERIM HEAD OF FUNCTION (RESOURCES)
& S151 OFFICER **16 FEBRUARY 2015**

ATODIAD / APPENDIX 1

Cefndir Economaidd / Economic background

- After strong UK GDP growth in 2013 at an annual rate 2.7%, and then in 2014 0.7% in Q1, 0.9% in Q2 2014 (annual rate 3.2% in Q2), Q3 has seen growth fall back to 0.7% in the quarter and to an annual rate of 2.6%. It therefore appears that growth has eased since the surge in the first half of 2014 leading to a downward revision of forecasts for 2015 and 2016, albeit that growth will still remain strong by UK standards. For this recovery to become more balanced and sustainable in the longer term, the recovery needs to move away from dependence on consumer expenditure and the housing market to exporting, and particularly of manufactured goods, both of which need to substantially improve on their recent lacklustre performance. This overall strong growth has resulted in unemployment falling much faster than expected. The MPC is now focusing on how quickly slack in the economy is being used up. It is also particularly concerned that the squeeze on the disposable incomes of consumers should be reversed by wage inflation rising back significantly above the level of inflation in order to ensure that the recovery will be sustainable. There also needs to be a major improvement in labour productivity, which has languished at dismal levels since 2008, to support increases in pay rates. Unemployment is expected to keep on its downward trend and this is likely to eventually feed through into a return to significant increases in wage growth at some point during the next three years. However, just how much those future increases in pay rates will counteract the depressive effect of increases in Bank Rate on consumer confidence, the rate of growth in consumer expenditure and the buoyancy of the housing market, are areas that will need to be kept under regular review.

- Also encouraging has been the sharp fall in inflation (CPI), reaching 1.0% in November, the lowest rate since September 2002. Forward indications are that inflation is likely to remain around or under 1% for the best part of a year. The return to strong growth has helped lower forecasts for the increase in Government debt over the last year but monthly public sector deficit figures during 2014 have disappointed until November. The autumn statement, therefore, had to revise the speed with which the deficit is forecast to be eliminated.

- The U.S. Federal Reserve ended its monthly asset purchases in October 2014. GDP growth rates (annualised) for Q2 and Q3 of 4.6% and 5.0% have been stunning and hold great promise for strong growth going forward. It is therefore confidently predicted that the first increase in the Fed. rate will occur by the middle of 2015.

- The Eurozone is facing an increasing threat from deflation. In November the inflation rate fell to 0.3%. However, this is an average for all EZ countries and includes some countries with negative rates of inflation. Accordingly, the ECB did take some rather limited action in June and September to loosen monetary policy in order to promote growth and is currently expected to embark on quantitative easing early in 2015 to counter this threat of deflation and to stimulate growth.

Allan gan / From: CAPITA ASSET SERVICES – TREASURY SOLUTIONS

ATODIAD / APPENDIX 2

Rhagolygon Economaidd / Economic Outlook

Change in market sentiment and outlook

- The plunge in the price of oil has been the major surprise of the last three months. This will reduce inflation and stimulate the economies of oil importing countries.

- There is a downside to the plunge in oil prices in terms of a sharp increase in the risk of emerging country debt default and emerging country oil producing corporate defaults. This could have a knock on effect on western banks who have lent to these areas and to hedge, pension and investment funds which have been wrong footed by holding debt or equities in these areas.

- Greece: the anti EU and anti austerity party Syriza is likely to be the strongest party in the January 25 general election. However, the Eurozone has put in place sufficient firewalls that a Greek exit would have little direct impact on the rest of the EZ and the Euro. The indirect effect is more problematic to quantify as such an election result would be likely to strengthen support for anti EU and anti austerity political parties in many EU countries. Italy is the greatest risk as it has the third biggest debt mountain in the world and has shown little progress so far in undertaking fundamental reforms to improve the competitiveness of the economy.

- UK GDP growth forecasts have recently been more subdued although growth will still remain strong, but not as strong as previously expected.

- The political risks around the UK general election in May 2015 have increased with the likely result now being very hard to predict.

- A combination of the above factors has caused us to put back the start of increases in Bank Rate from Q2 2015 to Q4 with knock on delays on increases in following years.
- We have also had to bring our short term PWLB forecasts down to reflect current abnormally low levels which are unsustainably low. However, how quickly or slowly they will unwind is very hard to predict.

The one area of resoundingly good news over the last three months has been that the American economy is well on track to making a full recovery from the financial crash. GDP growth rates (annualised) for Q2 and Q3 of 4.6% and 5.0% have been stunning and hold great promise for strong growth going forward and further falls in unemployment. It is therefore confidently predicted that the Fed. will start on the first increase in the Fed. rate by the middle of 2015. In contrast, the surge in UK growth during 2014 appears to have diminished (Q1 0.7%, Q2 0.9%, Q3 0.7%) and the year on year rate has subsided from 3.2% in Q2 to 2.6% in Q3. Forward indicators are also revealing some cooling of prospects going forward, though lets still keep hold of the fact that this remains strong growth by UK standards, but not as strong as previously forecast.

In consequence, it is now the US which is most likely to be putting central rates up before the UK. The prospects for the UK are somewhat mixed. The hoped for rebalancing of the economy towards greater reliance on exports is not happening and the UK faces an uphill struggle with its main trading partner, the EU now expected to resort to full blown quantitative easing (QE) early in 2015 in order to stimulate the economy to rise above near stagnation. However, UK consumer confidence is still buoyant although the housing market looks as if it is also cooling with house price rises and new mortgage approvals both subsiding. UK consumers are obviously benefiting from the fall in the oil price with overall inflation falling to 1.0% in November, the lowest rate since September 2002. It is also forecast to stay around the same level for the best part of a year.

Nevertheless, the beneficial effect of the fall in oil prices will fall out after twelve months, so inflation will rise as a result after then, although it is still expected to remain at or near 2%. What this does mean, however, is that average wage increases are likely to exceed inflation for the coming year and so increase the disposable income of consumers. This, in turn, will underpin domestic demand and support GDP growth. Looking further forward, whichever political party or coalition comes to power after the general election in May 2015 will still have to decide what balance of government spending cuts and / or tax increases will be needed to bring the public sector net borrowing deficit down. This will likely mean an erosion of overall consumer disposable income although further falls in unemployment will counteract some of this effect. The Bank of England therefore faces an incredibly delicate task of balancing the pros and cons of when to start on increasing Bank Rate, especially knowing that many consumers are still heavily indebted and very vulnerable to increases in borrowing rates.

A further factor affecting financial markets and the confidence of UK producers is the increase in political risk. The UK faces a general election where the outcome looks very hard to predict as to the knock on effects on the UK economy.

As for the MPC, their last minutes appeared to show a consolidation of support for holding off on increasing Bank Rate due to the fall in inflation caused by the fall in oil prices. They will also be focusing in 2015 on how quickly wage inflation increases and said it needed to pick up further in order to meet the 2% inflation target. This resulted in financial market investors pushing back their bets on the timing of the next interest rate hike to late 2015 / early 2016. Our view has also shifted in this forecast to a first increase in Q4 2015 rather than Q2 2015.

CAPITA ASSET SERVICES FORWARD VIEW

Economic forecasting remains difficult with so many external influences weighing on the UK. Our Bank Rate forecasts, (and also MPC decisions), will be liable to further amendment depending on how economic data transpires over 2015. Forecasts for average earnings beyond the three year time horizon will be heavily dependent on economic and political developments. Major volatility in bond yields is likely to endure as investor fears and confidence ebb and flow between favouring more risky assets i.e. equities, or the safe haven of bonds.

The overall longer run trend is for gilt yields and PWLB rates to rise, due to the high volume of gilt issuance in the UK, and of bond issuance in other major western countries. Increasing investor confidence in eventual world economic recovery is also likely to compound this effect as recovery will encourage investors to switch from bonds to equities.

The overall balance of risks to economic recovery in the UK is currently evenly balanced. Only time will tell just how long this current period of strong economic growth will last; it also remains exposed to vulnerabilities in a number of key areas.

The interest rate forecasts in this report are based on an initial assumption that there will not be a major resurgence of the EZ debt crisis. There is an increased risk that Greece could end up leaving the Euro but if this happens, the EZ now has sufficient fire walls in place that a Greek exit would have little immediate direct impact on the rest of the EZ and the Euro. It is therefore expected that there will be an overall managed, albeit painful and tortuous, resolution of any EZ debt crisis that may occur where EZ institutions and governments eventually do what is necessary - but only when all else has been tried and failed. Under this assumed scenario, growth within the EZ will be weak at best for the next couple of years with some EZ countries experiencing low or negative growth, which will, over that time period, see an increase in total government debt to GDP ratios. There is a significant danger that these ratios could rise to the point where markets lose confidence in the financial viability of one, or more, countries, especially if growth disappoints and / or efforts to reduce government deficits fail to deliver the necessary reductions. However, it is impossible to forecast whether any individual country will lose such confidence, or when, and so precipitate a sharp resurgence of the EZ debt crisis. While the ECB has adequate resources to manage a debt crisis in a small EZ country, if one, or more, of the larger countries were to experience a major crisis of market confidence, this would present a serious challenge to the ECB and to EZ politicians.

Downside risks currently include:-

- The situation over Ukraine poses a major threat to EZ and world growth if it was to deteriorate into economic warfare between the West and Russia where Russia resorted to using its control over gas supplies to Europe;
- Fears generated by the potential impact of Ebola around the world;
- UK strong economic growth is currently mainly dependent on consumer spending and the potentially unsustainable boom in the housing market. The boost from these sources is likely to fade after the strong surge in growth in the first half of 2014;
- A weak rebalancing of UK growth to exporting and business investment causing a weakening of overall economic growth beyond 2014;
- Weak growth or recession in the UK's main trading partner - the EU, inhibiting economic recovery in the UK;
- A return to weak economic growth in the US, UK and China causing major disappointment in investor and market expectations;
- A resurgence of the Eurozone sovereign debt crisis caused by ongoing deterioration in government debt to GDP ratios to the point where financial markets lose confidence in the financial viability of one or more countries and in the ability of the ECB and Eurozone governments to deal with the potential size of the crisis;
- Recapitalisation of European banks requiring more government financial support;
- Lack of support by populaces in Eurozone countries for austerity programmes, especially in countries with very high unemployment rates e.g. Greece and Spain, which face major challenges in engineering economic growth to correct their budget deficits on a sustainable basis;
- Italy: the political situation has improved but it remains to be seen whether the new government is able to deliver the austerity programme required and a programme of overdue reforms. Italy has the third highest government debt mountain in the world;
- France: after being elected on an anti austerity platform, President Hollande has embraced a €50bn programme of public sector cuts over the next three years. However, there could be major obstacles in implementing this programme. Major overdue reforms of employment practices and an increase in competiveness are also urgently required to lift the economy out of stagnation;
- Monetary policy action failing to stimulate sustainable growth and to combat the threat of deflation in western economies, especially the Eurozone and Japan;
- Heightened political risks in the Middle East and East Asia could trigger safe haven flows into bonds;
- There are also increasing concerns at the reluctance of western central banks to raise interest rates significantly for some years, plus the huge QE measures which remain in place (and likely to be added to by the ECB in the near future). This has created potentially unstable flows of liquidity searching for yield and, therefore, heightened the potential for an increase in risks in order to get higher returns. This is a return to a similar environment to the one which led to the 2008 financial crisis.

The potential for upside risks to UK gilt yields and PWLB rates, especially for longer term PWLB rates include: -

- An adverse reaction by financial markets to the result of the UK general election in May 2015 and the economic and debt management policies adopted by the new government;

- ECB either failing to carry through on recent statements that it will soon start quantitative easing (purchase of government debt) or severely disappointing financial markets with embarking on only a token programme of minimal purchases which are unlikely to have much impact, if any, on stimulating growth in the EZ. (It should be noted that the Bundesbank and most German politicians have been very opposed to the concept of QE).

- A sudden reversal of Russian policy on military intervention in eastern Ukraine caused by the likelihood of, or actual, severe damage done to the Russian economy by a prolonged depression in oil prices and by sanctions.

- A sudden reversal of Iranian policy on developing militarised nuclear capability caused by the likelihood of, or actual, severe damage done to the Iranian economy by a prolonged depression in oil prices and by sanctions.

- The commencement by the US Fed. of increases in the central rate in 2015 causing a fundamental reassessment by investors of the relative risks of holding bonds as opposed to equities, leading to a sudden flight from bonds to equities

- A surge in investor confidence that a return to robust world economic growth is imminent, causing a flow of funds out of bonds into equities.

- UK inflation returning to significantly higher levels than in the wider EU and US, causing an increase in the inflation premium inherent to gilt yields.

Allan gan / From: CAPITA ASSET SERVICES – TREASURY SOLUTIONS

ATODIAD / APPENDIX 3

Graddfeydd Credyd Gwrthbartion buddsoddi a'r adneuon a ddelir gyda phob un ar 31 Rhagfyr 2014 *
Credit ratings of investment counterparties and deposits held with each as at 31 December 2014*

Grŵp Bancio/ Banking Group	Sefydliad/ Institution	Adneuon / Deposit £'000	Hyd (Galw tymor sefydlog) / Duration (Call / Fixed Term**)	Cyfnod (O/I)/ Period (From - To)	Graddfa Dychweliad/ Rate of Return %	Graddfa Tymor Hir Fitch Long Term Rating	Graddfa Tymor Byr Fitch Short Term Rating	Graddfa Tymor Hir Moody's Long Term Rating	Graddfa Tymor Byr Moody's Short Term Rating	Graddfa Tymor Hir Standard & Poor's (S&P) Long Term Rating	Graddfa Tymor Byr Standard & Poor's (S&P) Short Term Rating	Lliw Sector/Hyd Awgrymiedig/ Sector Colour / Suggested Duration
Lloyds Banking Group plc	Bank of Scotland plc	**5,277**	**Galw/ Call**	**n/a**	**0.40**	**A**	**F1**	**A1**	**P-1**	**A**	**A-1**	**Glas - 12 mis/ Blue - 12 months**
HSBC Holdings plc	HSBC Bank plc	**501**	**Galw/ Call**	**n/a**	**0.25**	**AA-**	**F1+**	**Aa3**	**P-1**	**AA-**	**A-1+**	**Oren – 12 mis / Orange – 12months**
Santander Group plc***	Santander UK plc	**7,499**	**Galw/ Call**	**n/a**	**0.40**	**A**	**F1**	**A2**	**P-1**	**A**	**A-1**	**Coch – 6 mis/ Red - 6 months**
The Royal Bank of Scotland Group plc	The Royal Bank of Scotland plc	**0**	**Galw/ Call**	**n/a**	**0.25**	**A**	**F1**	**Baa1**	**P-2**	**A-**	**A-2**	**Glas - 12 mis / Blue - 12 months**

* Ceir y Rhestr Benthyca Cymeradwyedig yn Atodiad 6 o'r Datganiad Strategaeth Rheoli Trysorlys 2014/15/Strategaeth Buddsoddi Blynyddol/ The Approved Lending List can be found at Appendix 6 of the 2014/15 Treasury Management Strategy Statement / Annual Investment Strategy

** Sef tymor ar pwynt y buddsoddi/Being term at the point of investment.

- Yn Atodiad 4 ceir y graddfeydd credyd cyfatebol ar gyfer y 3 asiantaeth graddio y cyfeirir atynt uchod./The equivalent credit ratings for the 3 rating agencies referred to above can be found at Appendix 4.

ATODIAD / APPENDIX 4

Graddfeydd Credyd Cyfatebol/

Equivalent Credit Ratings (Fitch, Moodys, S&P)

Tymor Hir Fitch Long Term	Tymor Hir Moodys Long Term	Tymor Hir S&P Long Term
AAA	Aaa	AAA
AA+	Aa1	AA+
AA	Aa2	AA
AA-	Aa3	AA-
A+	A1	A+
A	A2	A
A-	A3	A-
BBB+	Baa1	BBB+
BBB	Baa2	BBB
BBB-	Baa3	BBB-
Tymor Byr Fitch Short Term	**Tymor Byr Moodys Short Term**	**Tymor Byr S&P Short Term**
F1+	d/b / n/a	A-1+
F1	P-1	A-1
F2	P-2	A-2
F3	P-3	A-3