SWANAGE TOWN COUNCIL

Annual Treasury Report 2019/20

Contents

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1. Background

The Council's Treasury Management Strategy for 2019/20 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 2019/20 was approved by full Council on 25/03/2019 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: The UK's exit from the European Union and future trading arrangements, had remained one of major influences on the UK economy and sentiment during 2019/20. The 29th March 2019 Brexit deadline was extended to 12th April, then to 31st October and finally to 31st January 2020. Politics played a major role in financial markets over the period as concern over the UK's progress negotiating its exit from the European Union together with its future trading arrangements drove volatility, particularly in foreign exchange markets. The outcome of December's General Election removed a lot of the uncertainty and looked set to provide a 'bounce' to confidence and activity.

The headline rate of UK Consumer Price Inflation UK Consumer Price Inflation fell to 1.7% y/y in February, below the Bank of England's target of 2%. Labour market data remained positive. The ILO unemployment rate was 3.9% in the three months to January 2020 while the employment rate hit a record high of 76.5%. The average annual growth rate for pay excluding bonuses was 3.1% in January 2020 and the same when bonuses were included, providing some evidence that a shortage of labour had been supporting wages.

GDP growth in Q4 2019 was reported as flat by the Office for National Statistics and service sector growth slowed and production and construction activity contracted on the back of what at the time were concerns over the impact of global trade tensions on economic activity. The annual rate of GDP growth remained below-trend at 1.1%.

Then coronavirus swiftly changed everything. COVID-19, which had first appeared in China in December 2019, started spreading across the globe causing plummeting sentiment and falls in financial markets not seen since the Global Financial Crisis as part of a flight to quality into sovereign debt and other perceived 'safe' assets.

In response to the spread of the virus and sharp increase in those infected, the government enforced lockdowns, central banks and governments around the world cut interest rates and introduced massive stimulus packages in an attempt to reduce some of the negative economic impact to domestic and global growth.

The Bank of England, which had held policy rates steady at 0.75% through most of 2019/20, moved in March to cut rates to 0.25% from 0.75% and then swiftly thereafter brought them down further to the record low of 0.1%. In conjunction with these cuts, the UK government introduced a number of measures to help businesses and households impacted by a series of ever-tightening social restrictions, culminating in pretty much the entire lockdown of the UK.

The US economy grew at an annualised rate of 2.1% in Q4 2019. After escalating trade wars and a protracted standoff, the signing of Phase 1 of the trade agreement between the US and China in January was initially positive for both economies, but COVID-19 severely impacted sentiment and production in both countries. Against a slowing economic outlook, the US Federal Reserve began cutting rates in August. Following a series of five cuts, the largest of which were in March 2020, the Fed Funds rate fell from 2.5% to a range of 0% - 0.25%. The US government also unleashed a raft of COVID-19 related measures and support for its economy including a $2 trillion fiscal stimulus package. With interest rates already on (or below) the floor, the European Central Bank held its base rate at 0% and deposit rate at -0.5%.

Financial markets: Financial markets sold off sharply as the impact from the coronavirus worsened. After starting positively in 2020, the FTSE 100 fell over 30% at its worst point with stock markets in other countries seeing similar huge falls. In March sterling touched its lowest level against the dollar since 1985. The measures implemented by central banks and governments helped restore some confidence and financial markets have rebounded in recent weeks but remain extremely volatile. The flight to quality caused gilts yields to fall substantially. The 5-year benchmark falling from 0.75% in April 2019 to 0.26% on 31st March. The 10-year benchmark yield fell from 1% to 0.4%, the 20-year benchmark yield from 1.47% to 0.76% over the same period. 1-month, 3-month and 12-month bid rates averaged 0.61%, 0.72% and 0.88% respectively over the period.

Since the start of the calendar 2020, the yield on 2-year US treasuries had fallen from 1.573% to 0.20% and from 1.877% to 0.61% for 10-year treasuries. German bund yields remain negative.

Credit review: In Q4 2019 Fitch affirmed the UK's AA sovereign rating, removed it from Rating Watch Negative (RWN) and assigned a negative outlook. Fitch then affirmed UK banks' long-term ratings, removed the RWN and assigned a stable outlook. Standard & Poor's also affirmed the UK sovereign AA rating and revised the outlook to stable from negative. The Bank of England announced its latest stress tests results for the main seven UK banking groups. All seven passed on both a common equity Tier 1 (CET1) ratio and a leverage ratio basis. Under the test scenario the banks' aggregate level of

CET1 capital would remain twice their level before the 2008 financial crisis.

After remaining flat in January and February and between a range of 30-55bps, Credit Default Swap spreads rose sharply in March as the potential impact of the coronavirus on bank balance sheets gave cause for concern. Spreads declined in late March and through to mid-April but remain above their initial 2020 levels. NatWest Markets Plc (non-ringfenced) remains the highest at 128bps and National Westminster Bank Plc (ringfenced) still the lowest at 56bps. The other main UK banks are between 65bps and 123bps, with the latter being the thinly traded and volatile Santander UK CDS. While the UK and Non-UK banks on the Arlingclose counterparty list remain in a strong and well-capitalised position, the duration advice on all these banks was cut to 35 days in mid-March.

Fitch downgraded the UK sovereign rating to AA- in March which was followed by a number of actions on UK and Non-UK banks. This included revising the outlook on all banks on the counterparty list to negative, with the exception of Barclays Bank, Rabobank, Handelsbanken and Nordea Bank which were placed on Rating Watch Negative, as well as cutting Close Brothers long-term rating to A-. Having revised their outlooks to negative, Fitch upgraded the long-term ratings on Canadian and German banks but downgraded the long-term ratings for Australian banks. HSBC Bank and HSBC UK Bank, however, had their long-term ratings increased by Fitch to AA-.

3. Local Context

At 31st March 2019 the Authority held investments valued at £6.3m, with usable reserves and working capital being the underlying resources available for investment. At 31st March 2020, the Authority held investments valued at £6.27m. These year-end values include unrealised gains from the Council's strategic investments, being £0.63m in 2019 and £0.39m in 2020.

4. Borrowing Strategy and Debt Management

The Authority is debt free. The 2019/20 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 £2.7m by March 2023, as capital receipts and earmarked reserves are used to finance the Council's extensive capital programme.

5. Treasury 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: Treasury Investment Position

Investment Portfolio	31.03.19 Balance £	Net Movement £	31.03.20 Balance £	31.03.20 Income Return %
Banks and building societies (unsecured)	1,172,873	(993,628)	179,245	
Money Market Funds	500,000	250,000	750,000	
UK Govt - DMO	0	950,000	950,000	
Total Internal Investments	**1,672,873**	**206,372**	**1,879,245**	**0.31%**

*Investments in Pooled Funds:				
Property	3,181,122	(113,781)	3,067,341	
Multi-Asset	969,365	(90,949)	878,416	
Bonds	479,150	(33,993)	445,157	
Total External Funds	**4,629,637**	**(238,723)**	**4,390,914**	**4.15%**
TOTAL INVESTMENTS	**6,302,510**	**(32,351)**	**6,270,159**	**3.29%**

*Funds stated at Fair Value-Issued by Arlingclose

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 and moved away from short-term investments 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**
31.03.2019	4.57	A+	100%	5	0.50%
31.03.2020	3.94	AA-	49%	34	0.31%
Similar LAs	3.98	AA-	46%	44	0.64%
All LAs	4.03	AA-	56%	20	0.64%

Pooled Funds

£4.39m 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. In terms of measuring the performance of these funds, the current value is used.

For the 2019/20 financial year these funds generated an income return of £0.19m (4.15%) which is used to support services in year, and -£0.23m (-5.15%) of unrealised capital losses during the year, with a total return of -1.00%.

In a relatively short period since the onset of the COVID-19 pandemic, the global economic fallout was 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, businesses and individuals. Volatility measured by the VIX index was almost as high as during the global financial crisis of 2008/9 and evidenced in plummeting equity prices and the widening of corporate bond spreads, very close to rivalling those twelve years ago. Gilt yields fell but credit spreads widened markedly reflecting the sharp deterioration in economic and credit conditions associated with a sudden stagnation in economies, so corporate bonds yields (comprised of the gilt yield plus the credit spread) rose and prices therefore fell.

The Authority is invested in bond, multi-asset and property funds. The falls in the capital values of the underlying assets were reflected in the 31st March fund valuations with every fund registering negative capital returns over 12 months to March. Despite decent income returns in 2019-20, two of these funds have posted a negative total return over the one-year period due to the capital component of total returns, with the CCLA LAMIT fund posting a marginal positive return for the same period. These are shown in table 3 below.

Table 3: Strategic Investment Returns – 12 months to 31st March 2020

Fund Name	Book Value £m	Current Value £	Capital Growth £	Dividends Earned £	Capital Return %	Income Return %	Total Return %
CCLA-LAMIT Property Fund	2.50	3,067,341	(113,781)	134,901	(3.58)	4.24	0.66
Investec Diversified Income Fund	1.00	878,416	(90,949)	40,000	(9.38)	4.13	(5.26)
Ninety-One Strategic Corporate Bond Fund	0.50	445,157	(33,993)	17,540	(7.09)	3.66	(3.43)
Total	4.00	4,390,913	(238,723)	192,441	(5.15)	4.15	(1.00)

The unrealised capital losses (the 'drawdown' referred to by fund managers) in equity income funds were especially large, with the Council's diversified income fund being particularly affected with a 9.38% decrease in the capital value for the year.

Due to accounting practices, these funds are currently stated at cost price in the Council's Annual Return, £4m in total, and as such these funds have an overall unrealised gain of £0.39m at 31st March 2020. However, individually two funds are showing significant unrealised losses. Unrealised capital losses, or gains, will not have an impact on the General Fund until such a time as the Council redeems all or part of the units held in the funds.

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 long-term and the Authority's latest cash flow forecasts, investment in these funds has been maintained.

Treasury Performance

The budget for investment income in 2019/20 was £150,000, based on an average investment portfolio with a fair value of £5.5million at an interest rate of 2.7%. The actual income derived from investments was £207,931, with average investment balances of £6.5m, at an average interest rate of 3.1%

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 & Treasury Management Indicators

This report provides members with a summary report of the treasury management activity during 2019/20, 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 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.

	31.3.20 Actual	**2019/20 Target**	**Complied?**
Portfolio average credit rating	AA-	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 additional borrowing.

	31.3.20 Actual	**2019/20 Target**	**Complied?**
Total cash available within 3 months	£1.88m	£1m	Yes

Principal Sums Invested for Periods Longer than a year: The purpose of this indicator is to control the Authority's exposure to the risk of incurring losses by seeking early repayment of its investments. The limits on the long-term principal sum invested to final maturities beyond the period end were:

	2019/20	2020/21	2021/22
Limit on principal invested beyond year end	£5m	5M	£4.5m
Complied?	Yes	Yes	Yes

The Authority can confirm that during 2019/20 it complied with its **Treasury Management Policy Statement** and **Treasury Management Practices**.