Treasury Management Financial Outlook and Quarterly Benchmarking

Financial Review and Outlook for 2017/18

The most significant economic event was the increase in the Bank Rate in November by 0.25% to 0.50%, making it the first increase by the Bank of England's Monetary Policy Committee (MPC) to rates since July 2007. The vote to increase Bank Rate was 7-2, reflecting the MPC's growing concern that rising inflation had finally outweighed the risks to growth and largely to meet market expectations. Future increases in Bank Rate are expected to be at a gradual pace and limited in extent. Other factors that have contributed to the current interest environment are:

- Gilt yields were broadly stable during the quarter;
- Progress on Brexit has been slow;
- Inflation has remained higher than expected, thereby limiting purchasing power, the new inflation measure CPIH, which is a new additional measure of consumer price inflation including a measure of owner occupiers' housing costs, was 2.8%;
- Unemployment has continued to decrease;
- Housing market remains subdued;
- Debt being used to support spending;
- The government has eased public sector pay cap but has indicated it remains committed to tight fiscal policy: and
- Gilt yields were broadly stable during the quarter;

Credit Developments and Credit Risk Management

UK bank credit default swaps have remained broadly stable throughout the quarter. Bank share prices have not moved in any pattern. Much of the activity by credit rating agencies during the quarter has related to the upcoming UK bank ring fencing which will take effect in 2018. Ring fencing requires the larger UK banks to separate their core retail banking activity from the rest of their business, resulting in two separate banks. In general, the agencies expect to give the ringfenced "retail" bank a higher credit rating than the non-ringfenced "investment" bank. In practice, this will only affect Barclays, HSBC, Lloyds and RBS as other UK banks and building societies either only conduct retail banking activities or have less than £25 billion of deposits covered by the Financial Services Compensation Scheme.

Barclays Bank plc was upgraded to A from A- by Standard & Poor's (S&P), after the bank announced its plans for its ringfenced bank, Barclays Bank UK plc, and the non-ringfenced bank, Barclays Bank plc. S&P also assigned preliminary ratings of 'A/A-1' to Barclays Bank UK plc.

In November S&P revised upwards the outlook of various UK banks and building societies to positive or stable and simultaneously affirmed their long and short-term ratings. These reflect the agency's view that the institutions now show increased resilience, have made substantial progress in meeting regulatory capital requirements and are now better positioned to deal with uncertainties and potential turbulence in the run-up to the UK's exit from the EU in March 2019.

Investment Benchmarking as at 31 December 2017.

The Council advisors undertake quarterly investment benchmarking across its client base. The charts below show how we compare to other Unitaries and across the average. As reported previously our portfolio was more diversified and at higher interest rates than the average as a result of moving into the bond programme earlier than most clients, but there is now more competition for bonds from both government bodies and other local authorities, so opportunities to replace maturing bonds are limited and we will see a fall in suitable instruments. With this in mind and following discussions with our advisors it was decided to move more into property funds, which are a longer term investment, and to restrict temporary borrowing and therefore run our short term investments down.

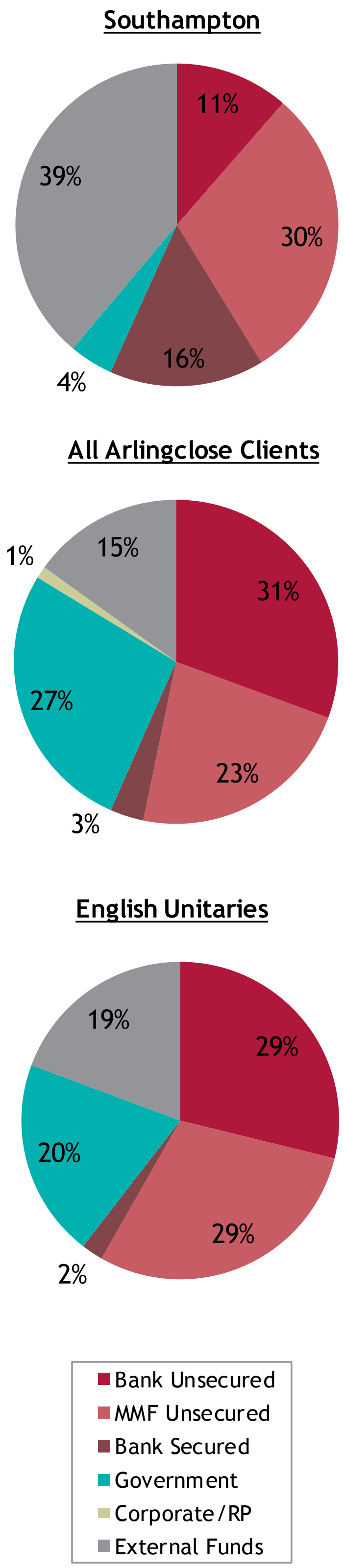
During the last quarter we maintained our investments in bonds at £13.7M and the property funds at £27M (as there were no maturities), with all other cash being placed in either MMF or instant access bank. As a result we had 30% (£20.6M) of our overall investment in Money Market Funds at the end of the quarter and although slightly higher than the average this was a reduction from the previous quarter at 36% (£27.2M) this is expected to fall to further to around £10M by the end of March.

Due to earlier investment decisions our income return on investments managed internally is 0.93% which is higher than the average of 0.54% whilst still maintaining a higher than unitary average credit rating of AA-. Total income return at 2.38% is also higher than the average for both unitary (1.14%) and LA's (0.92%). Our total investment return at 1.84% has recovered as the investments made in property funds recovered some of the initial capital loss (as previously reported the value of the funds are more volatile but less risky than buying individual properties and do not constitute capital spend and it is the income return at 4.66% that is the driver) and are again higher than both the both unitary (1.52%) and LA's (1.14%) across Arlingclose's client base.

Investment Benchmarking

31 December 2017

	Southampton	22 English Unitaries Average	150 LAs Average
Internal Investments	£42.1m	£67.2m	£63.1m
External Funds	£26.8m	£12.7m	£10.2m
TOTAL INVESTMENTS	**£68.9m**	**£78.2m**	**£73.3m**
Security			
Average Credit Score	3.73	5.02	4.51
Average Credit Rating	AA-	A+	A+
Average Credit Score (time-weighted)	1.35	4.68	4.23
Average Credit Rating (time-weighted)	AAA	A+	AA-
Number of Counterparties / Funds	18	13	16
Proportion Exposed to Bail-in	67%	67%	61%
Liquidity			
Proportion Available within 7 days	35%	48%	41%
Proportion Available within 100 days	40%	70%	68%
Average Days to Maturity	216	180	41
Market Risks			
Average Days to Next Rate Reset	176	196	71
External Fund Volatility	2.2%	1.2%	2.1%
Yield			
Internal Investment Return	0.93%	0.60%	0.54%
External Funds - Income Return	4.66%	3.81%	3.41%
External Funds - Capital Gains/Losses	-1.40%	1.39%	0.70%
External Funds - Total Return	3.26%	5.21%	4.11%
Total Investments - Income Return	2.38%	1.14%	0.92%
Total Investments - Total Return	**1.84%**	**1.52%**	**1.14%**



Notes

- Unless otherwise stated, all measures relate to internally managed investments only, i.e. excluding external pooled funds.
- Averages within a portfolio are weighted by size of investment, but averages across authorities are not weighted.
- Credit scores are calculated as AAA = 1, AA+ = 2, etc.
- Volatility is the standard deviation of weekly total returns, annualised.