Treasury Management Financial Outlook and Quarterly Benchmarking

Financial Review and Outlook for 2017/18

Global equity markets continued to be supported by expectations of strengthening economic activity, although this was tempered towards the end of the quarter following comments from the Bank of England that interest rates could rise in the relatively near future, although the pace is expected to be gradual. Other factors that have contributed to the current interest environment are:

- Progress on Brexit has been slow with EU and UK having different priorities;
- Inflation has remained higher than expected, thereby limiting purchasing power;
- Housing market remains subdued;
- Debt being used to support spending; and
- The government has eased public sector pay cap but has indicated it remains committed to tight fiscal policy.

Our financial advisors, Arlingclose have reservations that the UK's economic outlook justifies an increase in interest rates at this stage. Their central case is for gilt yields to remain broadly stable in the across the medium term, but there may be near term volatility due to shifts in interest rate expectations.

However on 2nd November 2017 the Bank of England raised the Bank Rate by 0.25% to 0.50%.

Credit Developments and Credit Risk Management

UK bank credit default swaps continued their downward trend, reaching three-year lows by the end of June. Bank share prices have not moved in any particular pattern.

There were a few credit rating changes during the quarter. The significant change was the downgrade by Moody's to the UK sovereign rating in September from Aa1 to Aa2 which resulted in subsequent downgrades to sub-sovereign entities including local authorities. Moody's downgraded Standard Chartered Bank's long-term rating to A1 from Aa3 on the expectation that the bank's profitability will be lower following management's efforts to de-risk their balance sheet. The agency also affirmed Royal Bank of Scotland's and NatWest's long-term ratings at Baa1, placed Lloyds Bank's A1 rating on review for upgrade, revised the outlook of Santander UK plc, and Nationwide building society from negative to stable.

Ring-fencing, which requires the larger UK banks to separate their core retail banking activity from the rest of their business, is expected to be implemented within the next year. In May, we were advised to reduce the maximum duration of unsecured investments with Bank of Scotland, HSBC Bank and Lloyds Bank from 13 months to 6 months as until banks' new structures are finally determined and published, the different credit risks of the 'retail' and 'investment' banks cannot be known for certain.

The new EU regulations for Money Market Funds were finally approved and published in July and existing funds will have to be compliant by no later than 21st January 2019. The key features include Low Volatility NAV (LVNAV) Money Market Funds which will be permitted to maintain a constant dealing NAV, providing they meet strict new criteria and minimum liquidity requirements. MMFs will not be prohibited from having an external fund rating (as had been suggested in draft regulations). Arlingclose expects most of the short-term MMFs it recommends to convert to the LVNAV structure and awaits confirmation from each fund.

Investment Benchmarking as at 30 September 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 that this alongside a reduction in the base rate 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 had £2M of bonds mature and have invested a further £4M in property funds, with all other cash being placed in MMF as we run our investment balances down. As a result we had 36% (£27.2M) of our overall investment in Money Market Funds at the end of the quarter but this is expected to fall to around £10M by the end of December. Due to earlier investment decisions our income return on investments managed internally is 0.72% which is higher than the average of 0.48% whilst still maintaining a higher than unitary average credit rating of AA-. Total income return at 2.05% is also higher than the average for both unitary and across Arlingclose’s client base. This is expected to increase as the investments made in property funds recover 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 4.55% that is the driver.

Investment Benchmarking

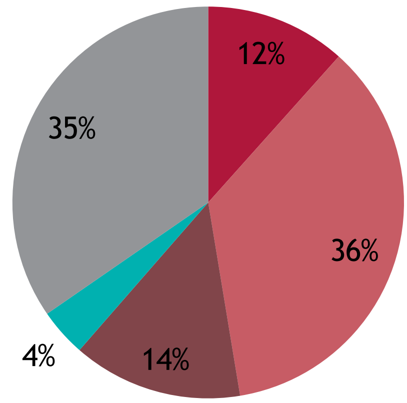
30 September 2017

	Southampton	20 English Unitaries Average	135 LAs Average
Internal Investments	£49.8m	£66.0m	£63.5m
External Funds	£26.4m	£12.2m	£10.3m
TOTAL INVESTMENTS	**£76.2m**	**£77.2m**	**£73.7m**
Security			
Average Credit Score	3.72	4.80	4.44
Average Credit Rating	AA-	A+	AA-
Average Credit Score (time-weighted)	1.38	4.53	4.32
Average Credit Rating (time-weighted)	AAA	A+	AA-
Number of Counterparties / Funds	18	14	16
Proportion Exposed to Bail-in	72%	70%	64%
Liquidity			
Proportion Available within 7 days	41%	49%	44%
Proportion Available within 100 days	41%	68%	67%
Average Days to Maturity	211	100	40
Market Risks			
Average Days to Next Rate Reset	172	115	66
External Fund Volatility	1.6%	1.2%	1.8%
Yield			
Internal Investment Return	0.72%	0.54%	0.48%
External Funds - Income Return	4.55%	4.15%	3.48%
External Funds - Capital Gains/Losses	-3.10%	1.78%	1.17%
External Funds - Total Return	1.46%	5.92%	4.65%
Total Investments - Income Return	2.05%	1.09%	0.89%

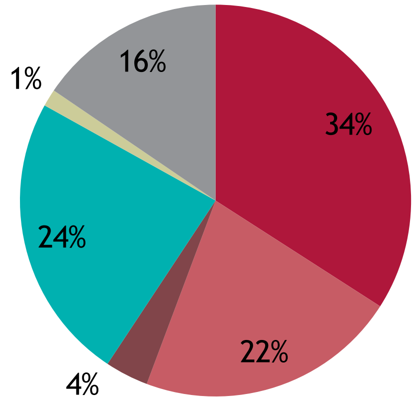
Notes

- 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.

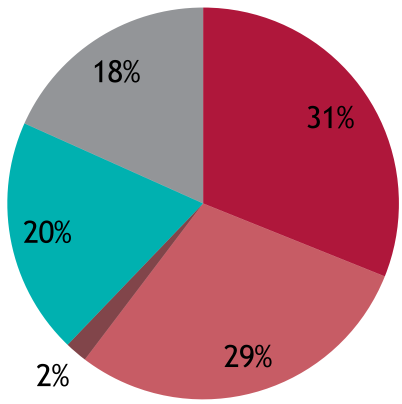
Southampton



All Arlingclose Clients



English Unitaries



- Bank Unsecured
- MMF Unsecured
- Bank Secured
- Government
- Corporate/RP
- External Funds