

QUARTERLY TREASURY MANAGEMENT REPORT – QTR 3

1. Borrowing Requirement and Debt Management

The Authority's chief objective when borrowing continues to be striking an appropriately low risk balance between securing low interest costs and achieving cost certainty over the period for which funds are required, with flexibility to renegotiate loans should the Authority's long-term plans change being a secondary objective

As at the 31 December 2016, the council's overall outstanding long term borrowing was £262M, at an average rate of 3.32% and an average maturity of 23 years, this has increased by £14M since the end of the year (£249M) due to taking £30M in temporary borrowing in October to fund the capital programme and to replace maturing debt. The long term debt portfolio is made up of loans from the Public Works Loan Board (PWLB) of £223M and market loans of £9M.

Included within the PWLB portfolio is £35M of variable rate loans, which are currently averaging 0.70% and are helping to keep overall borrowing costs down. Whilst in the current climate of low interest rates this remains a sound strategy, the Council need to review these regularly and if appropriate switching into fixed rate loans if interest rates start to rise rapidly.

As at the 31 March 2016 the Council used £106M of internal resources in lieu of borrowing which has been the most cost effective means of funding past capital expenditure to date. This has lowered overall treasury risk by reducing both external debt and temporary investments. However, this position will not be sustainable over the medium to long term and the Council will need to borrow to cover this amount as balances fall.

Based on the latest Capital programme update and maturing debt the Council is expected to have a borrowing need up to £183.7M between 2016/17 and 2018/19. Of this £55.2M relates to new HRA capital spend, £112M for new capital spend on the GF, including £65M that has been allocated for the purchase of property for income generation, the remainder relates to the refinancing of existing debt and externalising internal debt to cover expected fall in balances.

No new long term borrowing has been taken to date and will be assessed in conjunction with the development of the capital programme, cash balances and advice from the Council's treasury advisor.

Any further borrowing taken this year is likely to be short term in nature to take advantage of the existing low interest rate and to protect ourselves against the possibility of a fall in interest rates following the UK's vote to leave the European Union and the subsequent uncertainty. It will take some time before the full implications of 'Brexit' are known.

Budgeted Expenditure

The interest cost of financing the Authority's long term and short term loan debt is charged to the Income and Expenditure account. The interest cost in 2016/17 of financing the Authority's loan debt is currently expected to be £8.9M of which £5.2M relates to the HRA.

2. Investment Activity

The Authority holds significant invested funds, representing income received in advance of expenditure plus balances and reserves.

The Guidance on Local Government Investments in England gives priority to security and liquidity and the Council's aim is to achieve a yield commensurate with these principles. Security of capital has remained the Council's main investment objective. This has been maintained by following the Council's counterparty policy as set out in its TM Strategy Statement for 2016/17.

Counterparty credit quality is assessed and monitored with reference to: Credit Ratings; credit default swaps; financial statements, information on potential government support and reports in the quality financial press.

Internal investments

Balances initially increased at the beginning of the year rising from £89M to £106M in mid- April, but have since fallen back to £75M, £26M less than the same time last year. Current cash flow forecast indicate that this will fall further and as about £37.6M is in fixed term deals, in order to maintain our minimum working cash flow we will probably need an injection of temporary borrowing towards the end of year especially if we make further investments under Property Investment Fund.

As reported previously, following advice from our advisors Arlingclose, we have invested in bonds to optimise investment income, including corporate bonds as an alternative to fixed term deposits with banks as although the risk of insolvency remains, there is no risk of pre-emptive bail-in by the regulator and corporates are far less geared than banks. These deals will generate around £0.45M for the year. The rating for National Grid Gas plc has fallen one rating since we bought it but our advisors have no concerns for this and it is still on the list of approved counterparties.

Following Brexit and the fall in interest rates there is a lack of availability of suitable bonds so as bonds mature they are not currently being reinvested; this coupled with the decision to divert up to £20M of the money allocated to PIF investments to the CCLA (as the return is similar but with less risk as it can offer further diversification) will see a further fall in our internal investments.

The Authority has internal investments amounting to £66.3M, with an average rate of return of 1.5% as detailed in Table 1 below:

Table 1: Quarter 3 Internal Investments

Investments	At 31 December 2016 £000	Date of Maturity	Yield %	Rating
Cash				
Barclays Bank PLC	3,150	Call	0.30	A
Santander UK Plc	5,000	180 Day Notice	0.90	A-
Aberdeen MMF	8,000	MMF	0.31	A+
Blackrock MMF	3,035	MMF	0.27	A+
Deutsche MMF	60	MMF	0.26	AA-
Federated Prime MMF	8,000	MMF	0.29	A+
Goldman Sachs MMF	41	MMF	0.23	AA
HSBC MMF	37	MMF	0.25	AA-

Insight MMF	40	MMF	0.21	A+
Invesco MMF	6,000	MMF	0.30	AA-
J P Morgan MMF	1,405	MMF	0.27	AA-
Standard Life MMF	8,000	MMF	0.28	A+
Total Cash	42,768		0.29	
Corporate Bonds				
National Grid Gas plc	3,154	07/06/2017	0.87	BBB
Total Corporate Bonds	3,154		0.87	
Other Short Term Bonds				
Lloyds Bank Covered Bond	2,001	16/01/2017	0.51	AAA
Abbey National Treasury plc Covered Bond	3,001	20/01/2017	0.62	AAA
Nationwide Building Society Covered Bond	1,483	17/07/2017	0.50	AAA
Total Other Bonds	6,485		0.55	
Long Term Bonds				
Leeds Building Society Covered Bond	2,001	09/02/2018	0.64	AAA
Barclays Bank Covered Bond	1,000	12/02/2018	0.54	AAA
Yorkshire Building Society Covered Bond	3,156	12/08/2018	1.94	AA+
Nationwide Building Society Covered Bond	1,600	25/04/2019	0.86	AAA
Leeds Building Society Covered Bond	3,003	01/10/2019	0.75	AAA
European Investment Bank - Bond	1,069	15/04/2025	5.27	AAA
European Investment Bank - Bond	1,054	07/06/2025	5.16	AAA
European Investment Bank - Bond	1,039	07/06/2025	5.49	AAA
Total Long Term Bonds	13,924		2.09	

Total Bonds	23,561		1.51	
Total Internal Investments	66,330		1.50	
External Managed Funds <i>(see below)</i>	9,000		4.88	
Total Investments	75,330		2.34	

External Managed investments

The Council recently invested an additional £2M in property funds as an alternative to buying property directly bringing our investment to date to £9M. As previously reported these funds offer the potential for enhanced returns over the longer term, but may be more volatile in the shorter term and are managed by professional fund managers which allows the Authority to diversify into asset classes other than cash without the need to own and manage the underlying investments. As at the 30 December the sell price of our total investments were valued at £9.2M a notional "gain" of £0.2M against initial investments, this is lower than that previously reported as following 'Brexit' CCLA prudently adjusted the fund value downwards by approximately 4% for the end of September price, based on their valuer's advice which was in line with the 4 or 5% adjustments being made by other property funds at the time.

Our advisers Arlingclose have met with CCLA and they expect capital values to fall over the next two years but annual income should hold up around current levels. Arlingclose believes the negatives do not outweigh the potential for income generation and remain comfortable with the fund, they also advise that investment in the CCLA fund is less risky than buying individual properties, but given risks around the US election etc. not to invest in one lump sum but to space out smaller amounts. Following this advice £20M from the PIF has been allocated to invest in the CCLA and we will be investing an average of £2M a month, providing market conditions remain stable. It should be noted that investment in the CCLA does not constitute capital expenditure and is seen as a treasury management tool.

The current quoted dividend yield on the fund is currently 4.77%, which equates to 4.88% on the original £7M Treasury investment and is expected to return £340K for the year, plus PIF investments which based on current figures and an ongoing investment programme is going to return £66k at 4.4% for the year. This is lower than for existing Treasury investment as the buy in price is currently above previous investments and the net asset value price. The current average return across the whole of the portfolio against original investment, is 4.88%.

Investment Benchmarking as at 31st December 2016.

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. Previously we had reported that 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 that there was now more competition for bonds from both government bodies and other local authorities, so opportunities to replace maturing bonds were limited and that this alongside a reduction in the base rate would 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 area longer term investment, and to restrict temporary borrowing and therefore run our short term investments down.

During the last quarter we had £9.7M of bonds mature but as yet have only invested £2M in property funds as these can only be made at the end of the month and not during December.

We are currently planning on investing a further £8M by the end of March. As a result we had 46% (£34.6M) 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 March. Due to earlier investment decisions our income return on investments, at 1.24%, is still above average and we expect this to increase as more investments are made in property funds, however as detailed above the value of the funds are more volatile and can show a capital loss which effects the total return.



Investment Benchmarking

31 December 2016

Southampton
22 English Unitaries Av & age
131 LA & Average

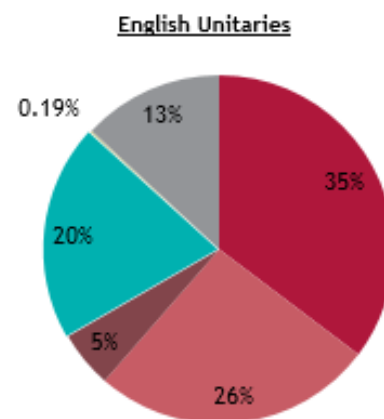
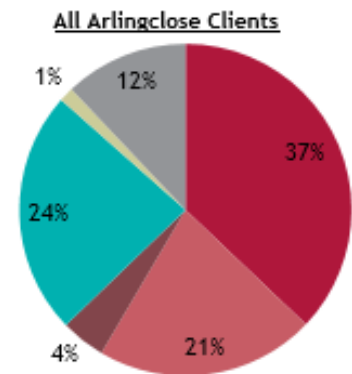
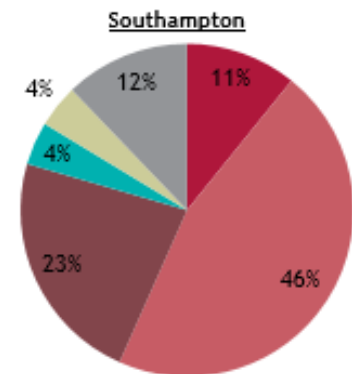
Internal Investments	£66.3m	£59.6m	£63.7m
External Funds	£9.2m	£8.1m	£8.5m
TOTAL INVESTMENTS	£75.5m	£67.8m	£72.2m

Security			
Average Credit Score	3.83	4.23	4.29
Average Credit Rating	AA-	AA-	AA-
Average Credit Score (time-weighted)	1.25	3.66	3.89
Average Credit Rating (time-weighted)	AAA	AA-	AA-
Number of Counterparties / Funds	22	14	17
Proportion Exposed to Bail-in	64%	66%	63%

Liquidity			
Proportion Available within 7 days	57%	45%	42%
Proportion Available within 100 days	63%	73%	71%
Average Days to Maturity	220	91	53

Market Risks			
Average Days to Next Rate Reset	161	94	72
External Fund Volatility	3.4%	1.4%	2.7%

Yield			
Internal Investment Return	0.76%	0.48%	0.53%
External Funds - Income Return	4.73%	4.01%	3.30%
External Funds - Capital Gains/Losses	-3.51%	-1.69%	-0.58%
External Funds - Total Return	1.23%	2.32%	2.72%
Total Investments - Income Return	1.24%	0.83%	0.82%
Total Investments - Total Return	0.81%	0.77%	0.91%



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.

Budgeted Income

The Council does not expect any losses from non-performance in relation to its investments by any of its counterparties. The UK Bank Rate had been maintained at 0.5% since March 2009 and until August 2016, when it was cut to 0.25%. It is now forecast to fall further towards zero but not to go beyond this to a negative figure, as a consequence short-term money market rates have fallen and are expected to fall further following 'Brexit'. Investments in Money Market Funds and call accounts currently generated an average rate of 0.50%. Investments in bonds have performed better returning an average of 1.36% for the year to date. The average cash balances during the quarter was £82.5M (range between £96.7M to £69.9M); these are expected to fall as the incidence of government grant income and council tax income is skewed towards the earlier part of the year.

The Authority's investment income for the year is forecast at £0.95M. As reported previously the Authority continues to review investments in suitable longer term financial instruments which will generate a better return, as it is envisaged that there be sufficient cash balances over the medium term.

3. Compliance with Prudential Indicators

The Council can confirm that it has complied with its Prudential Indicators for 2016/17 approved by Full Council on 10 February 2016. Table 2 below summarises the Key Prudential Indicators and performance to date:

Table 2: Compliance with Prudential Indicators

Indicator	Limit	Actual at 31 December 2016
Authorised Limit for external debt £M	£863M	£342M
Operational Limit for external debt £M	£700M	£342M
Maximum external borrowing year to date		£265M
Limit of fixed interest debt %	100%	83%
Limit of variable interest debt %	50%	17%
Limit for Non-specified investments £M	£115M	£26M

5. Financial Advisor's (Arlingclose) Summary and Outlook for the remainder of 2016/17

Summary for year to Date

Following the sharp decline in household, business and investor sentiment that was prompted by the unexpected outcome of the referendum on EU membership in Q2, the preliminary estimate of Q3 2016 GDP defied expectations as the economy grew 0.5% quarter-on-quarter, down only slightly from 0.7% in Q2 and year/year growth running at a healthy pace of 2.3%.

Economic data continued to challenge the current sentiment throughout the quarter. Consumer Price Inflation (CPI) fell to 0.9% in October but rose to 1.2% in November, both predominantly driven by clothing, fuel and hotel prices although the Office for National Statistics (ONS) were quick to point out that there was little evidence to link this rise to the decline in the value of

sterling. With sterling having now fallen by around 20% with its impact on prices still to come, according to the ONS, CPI will be heading close towards the Bank of England's target rate of 2% in the first half of 2017, consistent with the forecasts contained within the Bank's last quarterly Inflation Report issued in November 2016.

After a weak August, British consumers picked up the pace of their spending in Q3. UK retail sales growth surged to a 14-year high in October as consumers kept spending and colder weather boosted clothing sales. According to the British Retail Consortium (BRC), fears over Brexit are likely to weigh on sales in the period ahead.

Labour market data also proved resilient, showing a small rise in the level of unemployment by 10,000, and average earnings dipping slightly, but at 2.3% still delivering real earnings growth although clearly under pressure from higher prices. The ILO unemployment rate remained at 4.9%, its lowest level in 11 years.

At its August meeting, the Bank of England's Monetary Policy Committee (MPC) had stated that the majority of members expected to support a further cut in Bank Rate at one of the MPC's forthcoming meetings during the course of the year. However, in the final calendar quarter of 2016 the MPC kept Bank Rate unchanged at 0.25% and asset purchases at £435 bn.

In a further twist to an extraordinary year in political events, the US voted Donald Trump as the 45th President of the United States who will take up office on 20th January 2017. Uncertainty surrounds whether or not the President-elect will make good the fiscal, regulatory and policy initiatives and changes which were central to his campaign and, if so, their timing and size and their effect on growth, employment and inflation both domestic and globally.

Following a strengthening labour market, in a move that was largely anticipated, at its meeting in December, the Federal Reserve's Open Market Committee (FOMC) increased the target range for official interest rates for just the second time in the last decade. The range was increased to between 0.5% and 0.75%, from 0.25% and 0.5%. In the accompanying statement, FOMC Chair Janet Yellen also highlighted the expectation of three further rate hikes in 2017, followed by three hikes in each of 2018 and 2019.

Market reaction: Following the referendum result, gilt yields had fallen sharply across the maturity spectrum on the view that Bank Rate would remain extremely low for the foreseeable future. Since September there has been a reversal in longer dated gilt yields which have moved higher, largely due to the MPC revising its earlier forecast that Bank Rate would be dropping to near 0% by the end of 2016. The yield on the 10-year gilt rose from 0.75% at the end of September to 1.24% at the end of December, which is almost back at pre-Brexit levels of 1.37% on 23rd June. 20- and 50-year gilt yields have also risen considerably in the third quarter to 1.76% and 1.7% respectively, and are nearly back up to pre-Brexit levels.

However, this recovery was not realised across all maturities. The 1 year gilt yield dropped from 0.13% at the end of September to -0.004% at the end of December. The one year gilt yield first went negative at the beginning of December, having only been negative intra-day previously. 2 and 3 year gilt yields have also continued to fall.

After recovering from an initial sharp drop in Quarter 2, equity markets appear to have continued their rally, although displaying some volatility at the beginning of November following the US presidential election result. The FTSE-100 and FTSE All Share indices closed at 7142.83 and 3873.22 respectively on 30th December, up 3.5% and 3.1% over the quarter.

Money market rates for very short-dated periods (overnight to 1 month) have largely started recovering from a noticeable fall in the previous quarter. 7-day and 1-month LIBID rates increased by about 0.1%, to 0.35% and 0.61% respectively. Longer-dated periods (6 months to 2 years) also increased by between 10 and 20 basis points; on 30th December the 6-month LIBID rate was 0.64%, 12-month 0.81% and the 2-year swap rate 0.60%.

Outlook

Globally, the outlook is uncertain and risks remain weighted to the downside. The UK domestic outlook is uncertain, but likely to be weaker in the short/medium term than previously expected.

The Arlingclose central case is for Bank Rate to remain at 0.25%, but there is a low possibility of a drop to close to zero, with a very small chance of a reduction below zero.

	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20
Official Bank Rate													
Upside risk	0.00	0.00	0.00	0.00	0.00	0.00	0.25	0.25	0.25	0.25	0.25	0.25	0.25
Arlingclose Central Case	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25
Downside risk	0.25	0.25	0.25	0.25	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50

Gilt yields have risen over the past quarter, but remain at relatively low levels. The Arlingclose central case is for yields to decline when the government triggers Article 50.