COTSWOLD DISTRICT COUNCIL

TREASURY MANAGEMENT OUTTURN REPORT

2019/20

1. Introduction

In February 2011 the Authority adopted the Chartered Institute of Public Finance and Accountancy's *Treasury Management in the Public Services: Code of Practice* (the CIPFA Code) which requires the Authority to approve a treasury management annual report after the end of each financial year.

This report fulfils the Authority's legal obligation to have regard to the CIPFA Code

The Authority's treasury management strategy for 2019/20 was approved at Council on the 26th February 2019. 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.

Treasury risk management at the authority is conducted within the framework of the Chartered Institute of Public Finance and Accountancy's Treasury Management in the Public Services: Code of Practice 2017 Edition (the CIPFA Code) which requires the Authority to approve a Treasury Management Strategy before the start of each financial year and, as a minimum, a semi-annual and annual treasury outturn report. This report fulfils the authority's legal obligation under the Local Government Act 2003 to have regard to the CIPFA Code.

2. Economic commentary

The UK's exit from the European Union and its 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 the UK's tenuous 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 of 2.5% to 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%.

3. 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 touch 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.

4. Credit background:

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-.

5. Local Context

On 31st March 2020, the Authority had net investments of £24.987m arising from its revenue and capital income and expenditure. The underlying need to borrow for capital purposes is measured by the Capital Financing Requirement (CFR), while usable reserves and working capital are the underlying resources available for investment. These factors are summarised in Table 1 below.

Table 1: Balance Sheet Summary

	31/3/2019 Actual £m	2019/20 Movement £m	31/3/2020 Actual £m
General Fund CFR	0	0	0
Less: External borrowing	0	0	0
Less: Usable reserves	27.890	(5.581)	22.309
Less: Working capital	4.313	(1.635)	2.678
Net Investments	**32.203**	**(7.216)**	**24.987**

The Council's strategy has been to diversify investments into pooled funds in order to reduce risk and increase returns. The treasury management position as at 31st March 2020 and the year-on-year change is shown in Table 2 below.

Table 2: Treasury Management Summary

	31/3/2019 Actual £m	2019/20 Movement £m	31/3/2020 Balance £m	31/3/2020 Rate %
Short-term borrowing	0	0	0	-
Total borrowing	**0**	**0**	**0**	**-**
Long-term investments	14.370	(3.178)	11.192	4.24
Short-term investments	13.190	(5.082)	8.108	0.94
Cash and cash equivalents	4.643	1.044	5.687	0.71
Total investments	**32.203**	**(7.216)**	**24.987**	**2.16**
Net investments	**32.203**	**(7.216)**	**24.987**	**2.16**

6. Investment Activity

The Council holds invested funds, representing income received in advance of expenditure plus balances and reserves held. During 2019/20, the Authority's investment balance ranged between £22.034 and £43.114 million due to timing differences between income and expenditure. The year-end investment position and the year-on-year change in show in table 3 below.

Table 3: Investment Position (Treasury Investments)

	31/3/2019 Actual £m	2019/20 Movement £m	31/3/2020 Balance £m	31/3/2020 Rate %
Banks & building societies (unsecured)	8.033	(2.033)	6.000	0.87%
Government (incl. local authorities)	5.010	(3.010)	2.000	1.00%
Money Market Funds/Call	6.712	(1.026)	5.687	0.39%
Pooled Funds	12.370	(1.178)	11.192	4.24%
Cash equivalents	0.78	0.31	0.109	N/A
Total investments	**32.203**	**(7.216)**	**24.987**	**2.16%**

Both the CIPFA Code and government guidance require the Council to invest its funds prudently, and to have regard to the security and liquidity of its investments before seeking the highest rate of return, or yield. The Council'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.

£12.5m of the Authority's investments are held in externally managed strategic pooled (bond, equity, multi-asset, property and cash) funds where short-term security and liquidity are lesser considerations, and the objectives instead are regular revenue income and long-term price stability. These funds generated a total return of £437,114 (4.24%), however capital reduced by £1.165m for reasons noted below, which are treated as an unrealised capital loss.

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.

In furtherance of these objectives, and given the increasing risk and low returns from short-term unsecured bank investments, the Council diversified into higher yielding asset classes during 2019/20. In November 2019 the Council invested £1m into the new Fundamentum Social Housing REIT which purchases property and holds long term leases with Housing Associations who house vulnerable adults. Since the launch of the Fundamentum Social Housing REIT, the Investment Advisor has overseen 7 transactions up to the end of March 2020. Returns of 5% are expected when the full portfolio of properties have been purchased.

Table 4: Pooled Funds Sold

	Initial Investment	Capital Value 31st March 2019	Capital Value When sold	Dividends paid out in 2018/19	Gain / (Loss) for 2019/20	Gain / (Loss) to Initial Principal
Payden Sterling Reserve Fund	1,000,000	1,013,640	1,007,919	7,538	-	7,919

Table 5: Current Pooled Funds

Fund Manager	Investment	31st March 2019	31st March 2020	Dividends Received 2019/20	2019/20 Gain/(Loss)	Gain/(Loss) v Original Investment
	£	£	£	£	£	£
CCLA Property	2,500,000	2,384,385	2,299,101	103,088	(85,284)	(200,899)
Schroders	1,000,000	930,978	621,563	71,005	(309,415)	(378,437)
M&G UK Income	2,000,000	1,932,672	1,561,084	96,605	(371,588)	(438,916)
Investec Div Income	2,000,000	2,027,051	1,837,499	83,378	(189,552)	(162,501)
Threadneedle Bond	2,000,000	2,026,591	1,915,356	50,210	(111,235)	(84,644)
CCLA Div	1,000,000	998,850	909,165	32,828	(89,685)	(90,835)
Federated Cash +	1,000,000	1,056,241	1,068,604	-	12,363	68,604
Fundamentum REIT	1,000,000	0	980,000	-	(20,000)	(20,000)
Total –current funds	**12,500,000**	**11,356,768**	**11,192,372**	**437,114**	**(1,164,396)**	**(1,307,628)**
Including Sold & Current		**12,370,408**	**11,192,372**	**444,652**	**(1,164,396)**	**(1,299,709)**

The Pooled Funds' have performed well in producing dividends amounting to £444,652 against a budgeted figure of £404,250 returning 4.24% for the year on the original £12.5m invested. In a relatively short period since the onset of the COVID-19 pandemic, the global economic fallout has been sharp and large. Market reaction has been extreme with the 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. The consequences of the fallout saw over £1.164m of the capital value of the existing Funds decrease from the same time as last year. The total capital funds value is now £1.300m less than the initial investments made (£12.5m). The nature of these funds is that values can fluctuate from one year to another. At the time of this report the Funds had gained £405k in capital value just in the first quarter of the current financial year. Their performance and suitability in meeting the Authority's investment objectives are monitored and discussed with Arlingclose on a regular basis. 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.

7. Financial Implications

The outturn for investment income received in 2019/20 was £533,568 which equates to a 2.16% return (18/19 – 1.26%) on an average investment portfolio of £33.544 million against a budgeted £533,568 on an average investment portfolio of £32.5 million at an average interest rate of 1.64%.

Net investments made an actual surplus of £106,049 for the 2019/20 financial year.

8. Compliance Report

The Chief Finance Officer is pleased to report that all treasury management activities undertaken during 2019/20 complied fully with the CIPFA Code of Practice and the Authority's approved Treasury Management Strategy. Compliance with specific investment limits is demonstrated in table 7 below.

Compliance with the authorised limit and operational boundary for external debt is demonstrated in table 7 below.

Table 6: Debt Limits

	31.3.20 Actual £m	2019/20 Operational Boundary £m	2019/20 Authorised Limit £m	Complied
Borrowing	0	7.8	10.8	✓

Since the operational boundary is a management tool for in-year monitoring it is not significant if the operational boundary is breached on occasions due to variations in cash flow, and this is not counted as a compliance failure. Total debt was never above the operational boundary during 2019/20.

9. Treasury Management Indicators

The Authority measures and manages its exposures to treasury management risks using the following indicators.

9.1. 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	2018/19 Target	Complied
Portfolio average credit	A	A-	✓

9.2. Principal Sums Invested for Periods Longer than 364 days:

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
Actual principal invested beyond year end	£11.5m	£11.5m	£11.5m
Limit on principal invested beyond year end	£20m	£20m	£20m
Complied	✓	✓	✓