Appendix A

A summary of the strategy agreed for 2022/23 and the economic factors affecting this strategy.

1. Background information

1.1 Full Council approved the annual Treasury Management Strategy report in February 2022, which sets out the proposed strategy for the year ahead. This strategy includes the limits and criteria for organisations to be used for the investment of cash surpluses and has to be approved by the Council.

1.2 This Council has always adopted a prudent approach to its investment strategy and in the last few years, there have been regular changes to the list of the approved organisations used for investment of surpluses. This list is regularly reviewed to ensure that the Council is able to invest in the best available rates consistent with low risk; the organisations are regularly monitored to ensure that their financial strength and low risk has been maintained.

1.3 The original strategy for 2022/23 was prepared within the context of the financial challenge being faced by the County Council over the Medium Term Financial Plan:

- Utilising long term cash balances as effectively as possible by investing in longer term instruments and/or using to fund borrowing to reduce borrowing costs;
- Ensuring the investment portfolio is working hard to maximise income in a rising interest rate environment.
- Ensuring effective management of the borrowing portfolio by exploring rescheduling opportunities and identifying and exploiting the most cost effective ways of funding the Council's borrowing requirement.

1.4 At the same time, the Treasury Management Policy Statement was agreed as unchanged for 2022/23.

East Sussex County Council defined its treasury management activities as:

"The management of the organisation's cash flows, its banking, money market and Capital market transactions (other than those of the Pension Fund) the effective management of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks."

The Council regards the successful identification, monitoring and management of risk to be the prime criteria by which the effectiveness of its treasury management activities will be measured. Accordingly, the analysis and reporting of treasury management activities will focus on their risk implications for the organisation.

This authority acknowledges that effective treasury management will provide support towards the achievement of its business and service objectives. It is therefore committed to the principles of achieving best value in treasury management, and to employing suitable performance measurement techniques, within the context of effective risk management."

2. Investment

2.1 When the strategy was agreed in February 2022, it emphasised the continued importance of taking account of the current and predicted future state of the financial sector. The Treasury Management Advisors (Link Asset Services) commented on short term interest rates, the UK economy, inflation, the outlook for long term interest rates and these factors were taken into account when setting the Strategy.

2.2 The Council continued to explore Investment options that meet Environmental, Social and Governance (ESG) aims. The parameter acts as an added 4^{th} consideration to investment decisions behind Security, Liquidity and Yield. The preservation of capital is the Council's principal and overriding priority.

2.3 The Council, in addition to other tools, uses the creditworthiness service provided by Link Asset Services. This service employs a sophisticated modelling approach utilising credit ratings from the three main credit rating agencies - Fitch, Moody's and Standard and Poor's. The credit ratings of counterparties are supplemented with the following overlays:

- credit watches and credit outlooks from credit rating agencies;
- credit default swap (CDS) spreads to give early warning of likely changes in credit ratings; and
- sovereign ratings to select counterparties from only the most creditworthy countries.

2.4 The strategy continued with the policy of ensuring minimum risk, but was also intended to deliver secure investment income on the Councils cash balances.

2.5 The strategy aimed to ensure that in the economic climate it was essential that a prudent approach was maintained. This would be achieved through investing with selected banks and funds which met the Council's rating criteria. The emphasis would continue on security (protection of the capital sum invested) and liquidity (keeping money readily available for expenditure when needed) rather than yield. The strategy continued with this prudent approach.

3. Borrowing

3.1 The capital expenditure plans of the Council were set out in the Capital Strategy Report sent to Council in February 2022. The treasury management function ensures that the Council's cash is organised in accordance with the relevant professional codes so that sufficient cash is available to meet the capital expenditure plans.

3.2 Capital investment that is not funded from these new and/or existing resources (e.g. capital grants, receipts from asset sales, revenue contributions or earmarked reserves) increases the Council's need to borrow. However, external borrowing does not have to take place immediately to finance its related capital expenditure: the Council can utilise cash being held for other purposes (such as earmarked reserves and working capital balances) to temporarily defer the need for external borrowing. This is known as 'internal borrowing'.

3.3 The Council's primary objective is to strike an appropriate balance between securing cost certainty, securing low interest rates. The Council's cumulative need to borrow is known as the Capital Financing Requirement (CFR). The CFR and the actual level of external borrowing will differ according to decisions made to react to expected changes in interest rates and the prevailing economic environment. Where a decision to defer borrowing (or internally borrow) is made, the Council will be under borrowed. Where a decision to borrow in advance of need to secure cost certainty, the Council will be overborrowed.

3.4 On 25 November 2020 the Chancellor announced the conclusion to the review of margins over gilt yields for PWLB rates; the standard and certainty margins were reduced by 1% but a prohibition was introduced to deny access to PWLB borrowing for any local authority which intended to purchase assets primarily for yield in its three year capital programme. The reduction in future borrowing costs will be factored into the funding of the capital programme which contains no such assets for yield purchases.

3.5 While the Council will not be able to avoid borrowing to finance new capital expenditure, to replace maturing debt and the rundown of reserves, there will be a cost of carry, (the difference between higher borrowing costs and lower investment returns), to any new borrowing that causes a temporary increase in cash balances as this position will, most likely, incur a revenue cost.

4. The economy in 2022/23 – Commentary from Link Asset Services (Treasury Management Advisors) in April 2023

4.1 Against a backdrop of stubborn inflationary pressures, the easing of Covid restrictions in most developed economies, the Russian invasion of Ukraine, and a range of different UK Government policies, it is no surprise that UK interest rates have been volatile right across the curve, from Bank Rate through to 50-year gilt yields, for all of 2022/23.

4.2 Market commentators' misplaced optimism around inflation has been the root cause of the rout in the bond markets with, for example, UK, EZ and US 10-year yields all rising by over 200bps in 2022. The table below provides a snapshot of the conundrum facing central banks: inflation is elevated but labour markets are extra-ordinarily tight, making it an issue of fine judgment as to how far monetary policy needs to tighten.

4.3 Gilt yields fell Q2 of 2022 saw UK GDP deliver growth of +0.1% q/q, but this was quickly reversed in the third quarter, albeit some of the fall in GDP can be placed at the foot of the extra Bank Holiday in the wake of the Queen's passing. Q4 GDP was positive at 0.1% q/q. Most recently, January saw a 0.3% m/m increase in GDP as the number of strikes reduced compared to December. In addition, the resilience in activity at the end of 2022 was, in part, due to a 1.3% q/q rise in real household disposable incomes. A big part of that reflected the £5.7bn payments received by households from the government under the Energy Bills Support Scheme.

4.4 CPI inflation picked up to what should be a peak reading of 11.1% in October, although hopes for significant falls from this level will very much rest on the movements in the gas and electricity markets, as well as the supply-side factors impacting food prices. On balance, most commentators expect the CPI measure of inflation to drop back towards 4% by the end of 2023. As of February 2023, CPI was 10.4%.

4.5 The UK unemployment rate fell through 2022 to a 48-year low of 3.6%, and this despite a net migration increase of c500k. The fact remains, however, that with many economic participants registered as long-term sick, the UK labour force shrunk by c500k in the year to June. Without an increase in the labour force participation rate, it is hard to see how the UK economy will be able to grow its way to prosperity, and with average wage increases running at over 6% the MPC will be concerned that wage inflation will prove just as sticky as major supply-side shocks to food (up 18.3% y/y in February 2023) and energy that have endured since Russia's invasion of Ukraine on 22 February 2022

4.6 Central banks' Bank Rate increased steadily throughout 2022/23, starting at 0.75% and finishing at 4.25%.

4.7 GDP has been tepid throughout 2022/23, although the most recent composite Purchasing Manager Indices for the UK, US, EZ and China have all surprised to the upside, registering survey scores just above 50 (below suggests economies are contracting, and above suggests expansion). Whether that means a shallow recession, or worse, will be avoided is still unclear. Ultimately, the MPC will want to see material evidence of a reduction in inflationary pressures and a loosening in labour markets. Realistically, that is an unlikely outcome without unemployment rising and wage settlements falling from their current levels. At present, the bigger rise in employment kept the ILO unemployment rate unchanged at 3.7% in January. Also, while the number of job vacancies fell for the ninth consecutive month in February, they remained around 40% above pre-pandemic levels.

4.8 Equity markets, the FTSE 100 started 2023 strongly, rising to a record high of 8,014 on 20th February, as resilient data and falling inflation boosted earnings. But global equities fell sharply after concerns over the health of the global banking system emerged early in March. The fall in the FTSE 100 was bigger than the drop in the US S&P 500. Indeed, at around 7,600 now, the FTSE is 5.2% below its record high on 20th February, while the S&P 500 is only 1.9% lower over the same period. That's despite UK banks having been less exposed and equity prices in the UK's financial sector not falling as far. It may be due to the smaller decline in UK interest rate expectations and bond yields, which raise the discounted value of future earnings, compared to the US.