STAFF REPORT

AGENDA NO: 8o

MEETING DATE: August 19, 2019

To: **Honorable Mayor and City Council**

Date: **August 19, 2019**

From: **Carol Augustine, Finance Director – (650) 558-7222**

Subject: **Quarterly Investment Report, Period Ending June 30, 2019**

RECOMMENDATION

Staff recommends that the City Council receive and approve the City's investment report for the quarter ended June 30, 2019.

BACKGROUND

This report represents the City's investment portfolio as of June 30, 2019. The report includes all invested City funds with the exception of bond proceeds, the City's account with the California Employers' Retiree Benefit Trust Fund (CERBT), which is used to pre-fund the City's retiree medical obligations, and the §115 trust account with the Public Agency Retirement Services (PARS) Pension Rate Stabilization Program. All other investments are covered by and in compliance with the City's adopted Statement of Investment Policy.

DISCUSSION

The City's investments are guided by the Statement of Investment Policy (the "Policy"), which is reviewed and approved by the Council annually. The Policy was last approved by the City Council on June 3, 2019. The Policy directs that investment objectives, in order by priority, are safety, liquidity, and return. This conservative approach ensures assets are available for use while also allowing the City to earn additional resources on idle funds. The City utilizes a core portfolio of investments managed by the City's investment advisor, PFM Asset Management (PFM), and also maintains funds invested in the State's Local Agency Investment Fund (LAIF) and the California Asset Management Program (CAMP) to achieve its investment goals.

CURRENT MARKET CONDITIONS

The second quarter of 2019 saw plunging interest rates, surging equity prices, and increasing global growth concerns. Recent economic data has been mixed, with a 49-year low unemployment rate and a pickup in retail sales on the positive side, but a slowing of manufacturing activity and sub-target inflation on the negative side. While few economists expect the decade-long U.S. expansion to end in the near-term, the Federal Reserve's (Fed) cautionary tone set the stage for rate cuts in the second half of the year.

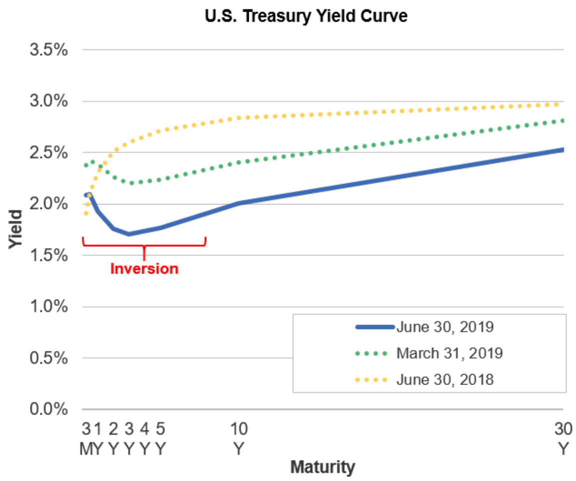
At its June meeting, the Federal Open Market Committee (FOMC) maintained the overnight fed funds rate at a target range of 2.25% – 2.50% but acknowledged soft business investment, declining market-based inflation measures, enhanced trade tensions, and increased uncertainty to the outlook. In their latest assessment of monetary policy, nearly half of respondents viewed two rate cuts as appropriate by year-end. Federal Reserve (Fed) Chair Jerome Powell affirmed that the Fed will "act as appropriate to sustain the expansion." Powell also acknowledged that acting preemptively to cut rates in light of a possible slowdown may be best for the economy, stating that "an ounce of prevention is worth a pound of cure." A month later, Mr. Powell followed through on those hints of rate cuts as the FOMC slashed the federal funds target range by 25 basis points (0.25%) to a new range of 2.00% - 2.25%, the first such cut in over a decade. Later in the day, Mr. Powell asserted that the cut was merely a "mid-cycle adjustment", not the beginning of a longer series of rate cuts.

According to the advanced estimate, U.S. Gross Domestic Product (GDP) grew by 2.1% during the second quarter of 2019, down from the first quarter's 3.1% growth rate. Growth during the second quarter was largely driven by consumer and government spending, while business investment was a detractor. Most economists expect the U.S. economy to continue to churn out positive growth and are largely projecting full-year 2019 growth of around 2%.

The U.S. labor market remains on solid footing as the economy continues to add new jobs. June's jobs report surprised to the upside, indicating 224,000 new jobs added during the month, bringing the average monthly jobs gain for 2019 to 172,000. The unemployment rate registered at 3.7% in June, a slight uptick from the prior month but still near a 50-year low. Wage growth registered at 3.1% year-over-year, roughly in line with economists' expectations.

Inflation pressures have been tame. The Consumer Price Index (CPI) rose 1.6% over the past year. The Fed's preferred inflation gauge, the Core Personal Consumption Expenditure (PCE) Price Index, which excludes food and energy prices, also rose 1.6% over the past year, well below the Fed's stated inflation target of 2%.

Equity markets climbed to new record highs with the S&P 500 returning 4.3% for the second quarter and 17.4% for the first half of 2019, while U.S. Treasury yields continued their downward trend, and the yield curve flattened further. U.S. Treasury yields fell for a third consecutive quarter, with maturities beyond one year falling 40 to 50 basis points (0.40% - 0.50%). The yields on longer Treasury maturities are now near 18-month lows. At quarter-end, the yield on a 3-month Treasury bill stood at 2.09%, the 2-year note was 1.75%, the 5-year was 1.77%, and the 10-year was yielding 2.01%. During the quarter, the yield curve reached its greatest level of inversion since 2007 as the spread between the 10-year and 3-month Treasuries widened to -28 bps. However, the level of inversion narrowed by quarter-end as short-term rates trended lower in expectation of rate cuts.



Yield Curve History

Maturity	6/30/19	3/31/2019	Change
3-Mo.	2.09%	2.38%	-0.29%
6-Mo.	2.09%	2.42%	-0.33%
1-Yr.	1.93%	2.39%	-0.46%
2-Yr.	1.75%	2.26%	-0.51%
3-Yr.	1.71%	2.20%	-0.49%
5-Yr.	1.77%	2.23%	-0.46%
10-Yr.	2.01%	2.41%	-0.40%
30-Yr.	2.53%	2.81%	-0.28%

The City's cash, excluding bond proceeds, is pooled for investment purposes. As of March 31, 2019, invested funds totaled $181,082,031.45. These investments are assets of the City of Burlingame and include the General Fund, the enterprise funds (such as Water, Sewer, and Solid Waste), as well as various non-major funds. Note that the City's account with the California Employers' Retiree Benefit Trust Fund (CERBT), which is used to pre-fund the City's retiree medical obligations, is not included in the City's managed portfolio. Similarly, funds held within the City's §115 Trust account with the Public Agency Retirement Services (PARS) Pension Rate Stabilization Program are not part of the City's investment portfolio.

City's Investments Market Value as of June 30, 2019	
Main Investment Portfolio	$117,761,144.68
Main Investment Portfolio - Cash Balance in Custody Account	$152,880.61
CAMP Balance	$40,814,872.66
LAIF Balance	$29,780,982.85
	$188,509,880.80

In light of the recent change in stance by the Federal Reserve and market expectations for additional rate cuts, PFM has maintained a neutral duration stance relative to the benchmark (allowing for a 1% - 2% variance) in order to minimize risk and maximize relative performance. At the end of the quarter, the main portfolio's duration was 2.51 years, in line with the benchmark's duration of 2.56 years. Factoring in liquid investments, such as LAIF and CAMP, the effective duration of the City's aggregate investments was 1.56 years.

The City continues to benefit from a strategy of broad diversification, which serves to reduce the overall risk in the portfolio while providing for the opportunity for better returns over the long-term. Corporate yield spreads (the difference between yields on corporate and U.S. Treasury notes) remain relatively tight by historic standards but widened briefly amid trade tensions, creating attractive buying opportunities. Additionally, the positively sloped corporate yield curve offered incremental income on longer-dated corporate notes. In total, PFM recommended the purchase of $2.7 million of high-quality corporate notes during the quarter. In one instance, PFM recommended the purchase of a “AA-” rated Amazon corporate note at a yield of 2.71%, which represented an attractive yield pick-up of approximately 34 basis points (0.34%) over comparable-maturity U.S. Treasury notes.

The spread on asset-backed securities (ABS) relative to treasuries declined to 10-year lows throughout the first half of the quarter, limiting attractive buying opportunities; however, towards the end of the second quarter, spreads on high-quality ABS had begun to widen. PFM sought to take advantage of widening spreads by recommending the purchase of several newly-issued ABS securities in late May. Specifically, PFM recommended the purchase of $1.6 million of ABS issued by Honda, Nissan, and Capital One at an average yield of 2.53%, all of which were rated in the AAA category. The purchase of these securities served to boost the overall yield of the portfolio without altering the portfolio’s duration.

Please see below for a summary of transactions for the quarter ended June 30, 2019:

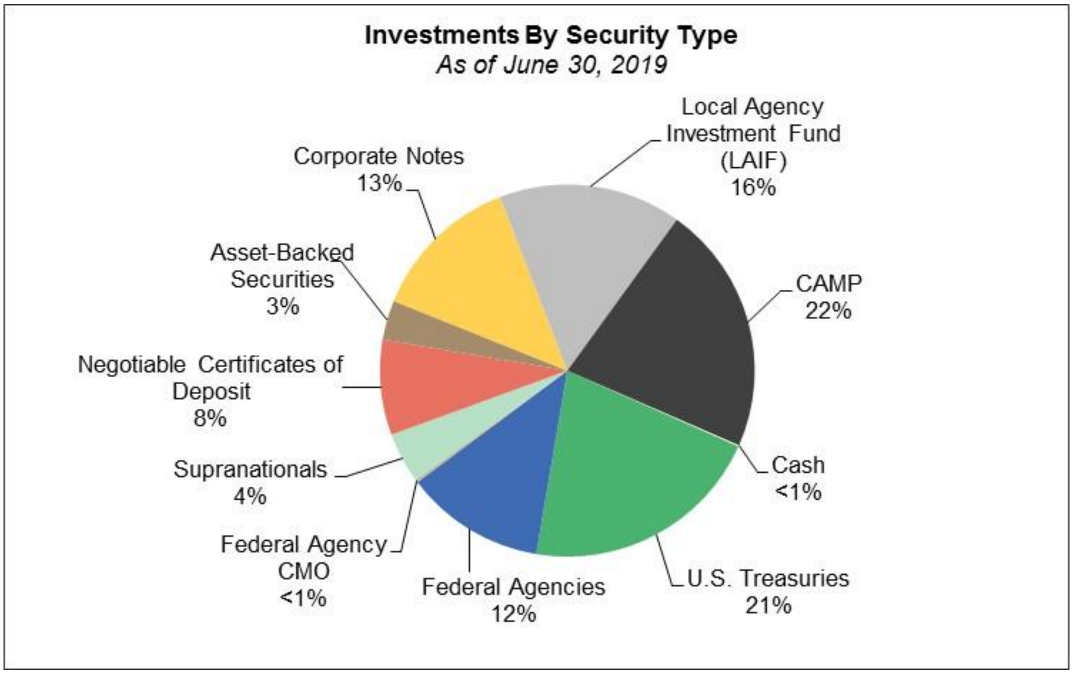
Trade Date	Settlement Date	Transaction	CUSIP	Issuer	Term (Mths)	Yield	Principal
4/2/2019	4/4/2019	Sale	912828B90	U.S. Treasury Notes	23	2.33%	1,125,000
4/2/2019	4/4/2019	Sale	46625HLW8	JP Morgan Chase Notes	15	2.72%	965,000
4/3/2019	4/4/2019	Sale	22532XHT8	Credit Agricole NY CD	12	3.01%	900,000
4/2/2019	4/4/2019	Purchase	46647PBB1	JP Morgan Chase Notes	48	3.06%	965,000
4/2/2019	4/4/2019	Purchase	912828S92	U.S. Treasury Notes	52	2.28%	1,330,000
4/3/2019	4/4/2019	Purchase	22535CDU2	Credit Agricole NY CD	24	2.83%	900,000
4/3/2019	4/8/2019	Sale	912828WY2	U.S. Treasury Notes	28	2.31%	525,000
4/3/2019	4/10/2019	Purchase	44932NAD2	Hyundai ABS	50	2.68%	525,000
4/9/2019	4/11/2019	Sale	3135G0N82	FNMA Notes	28	2.37%	235,000
4/9/2019	4/11/2019	Sale	3135G0N82	FNMA Notes	28	2.37%	180,000
4/9/2019	4/17/2019	Purchase	14316LAC7	Carmax ABS	59	2.92%	405,000
4/12/2019	4/16/2019	Sale	912828P38	U.S. Treasury Notes	46	2.36%	1,770,000
4/12/2019	4/16/2019	Purchase	023135AW6	Amazon Corporate Note	46	2.71%	1,750,000
5/1/2019	5/3/2019	Purchase	9128285D8	U.S. Treasury Notes	53	2.25%	1,890,000

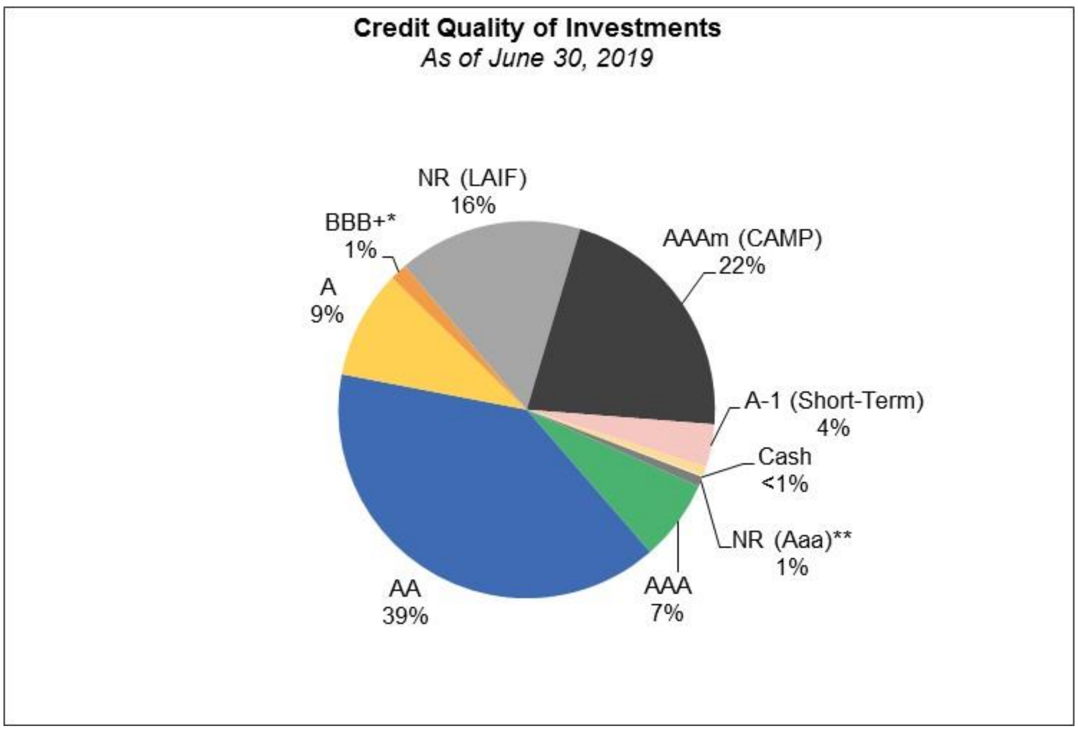
Trade Date	Settlement Date	Transaction	CUSIP	Issuer	Term (Mths)	Yield	Principal
5/3/2019	5/3/2019	Maturity	86563YVN0	Sumitomo Mitsui Bank NY CD	-	-	1,600,000
5/21/2019	5/28/2019	Sale	912828F96	U.S. Treasury Notes	29	2.22%	1,005,000
5/21/2019	5/28/2019	Sale	912828D72	U.S. Treasury Notes	27	2.24%	590,000
5/21/2019	5/30/2019	Purchase	14042WAC4	Capital One ABS	54	2.53%	330,000
5/21/2019	5/29/2019	Purchase	43815MAC0	Honda ABS	49	2.54%	610,000
5/21/2019	5/28/2019	Purchase	65479HAC1	Nissan ABS	54	2.52%	650,000
6/3/2019	6/5/2019	Sale	3137EAEL9	FHLMC Notes	20	1.96%	600,000
6/3/2019	6/5/2019	Sale	912828P87	U.S. Treasury Notes	21	1.95%	955,000
6/3/2019	6/5/2019	Sale	912828R77	U.S. Treasury Notes	24	1.89%	620,000
6/3/2019	6/5/2019	Purchase	912828X70	U.S. Treasury Notes	59	1.90%	2,300,000

Given the uncertainty around future Fed rate decisions, PFM continues to recommend a neutral duration positioning and a continued strategy of broad diversification across the high-quality sectors permitted by California Government Code and the City's Statement of Investment Policy.

PFM continues to monitor the markets and recommend relative-value trades as appropriate in order to safely enhance the City's portfolio earnings. However, the priority will always be to maintain the safety and liquidity of the City's investments. PFM will continue to carefully monitor the creditworthiness of all current issues in the City's portfolio and any new issues recommended for purchase, particularly in light of slowing global growth and trade tensions.

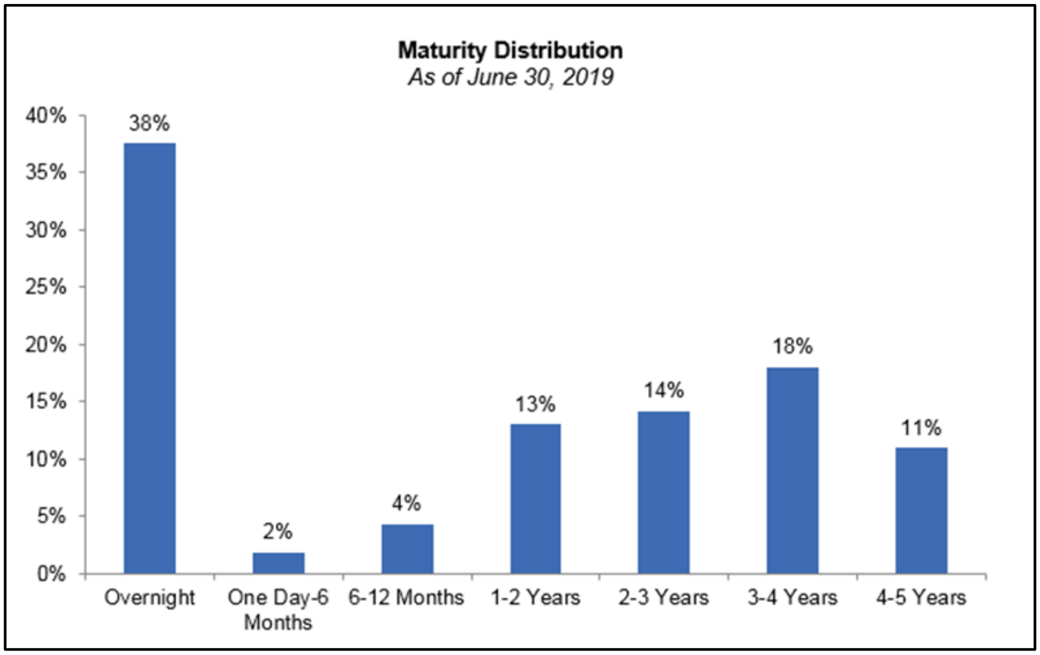
As noted in the following pie charts, the City's investment portfolio, as of June 30, 2019, was heavily weighted towards the State Local Agency Investment Fund (LAIF), the AAAm-rated CAMP Fund, and high-quality (AA+ rated) federal agency and U.S. Treasury securities to maintain the focus on safety and liquidity.





**The"BBB+" category comprises securities rated in the category of A or better by Moody's and/or Fitch, which meets the credit rating criteria established in the City's Statement of Investment Policy.*
*** The NR (Aaa) category comprises asset-backed securities that are not rated by S&P but are rated Aaa by Moody's.*

As of June 30, 2019, 38% of the City's funds were invested in very short-term liquid investments, 19% of the funds were invested with maturities between one day and two years, and 43% of the investment portfolio had a maturity ranging from two to five years. This distribution gives the City the necessary liquidity to meet operational and emergency cash needs while maximizing returns on funds not needed in the immediate future. The City's aggregate investments maintain an effective duration of 1.56 years and currently generate annual income of 2.46% before investment expenses. The City's funds are invested in high credit quality investments and continue to meet the City's goals of safety, liquidity and yield/return.

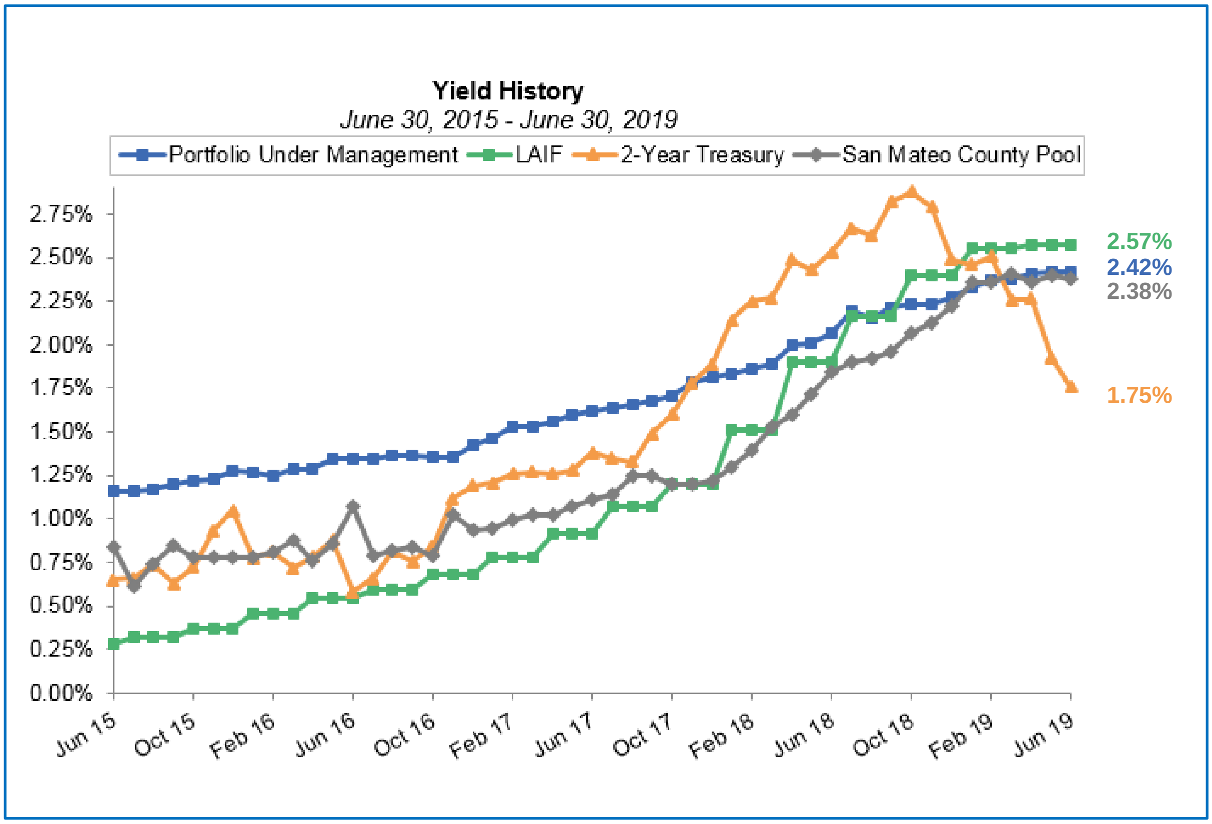


As of June 30, 2019, the yield to maturity at cost on the main portfolio of securities was 2.42%. Including additional investments such as LAIF and CAMP, the average yield to maturity**** on the City's aggregate investments was 2.46%. During the quarter, the main portfolio generated amortized cost basis earnings (which includes interest earnings and realized gains and losses) of $671,442.

City's Investments Statistical Information	
Market Value	$188,509,880.80
Effective Duration	1.56 Years
Average Credit Quality*	AA
Yield to Maturity**	2.46%

** Ratings by Standard & Poor's. Average excludes 'Not Rated' securities.*
*** Yield to maturity at cost.*

The chart below compares the yield of the City's managed portfolio to the yields on the 2-year U.S. Treasury note, LAIF, and the San Mateo County Pool. As of June 30, 2019, the gross yield on the City's managed portfolio was 2.42%; net of PFM's investment advisory fees, the yield on the City's managed portfolio was 2.34%.



Below is a summary of Burlingame's cash and investment holdings held by each fund as of June 30, 2019, which includes invested funds, debt service reserves, amounts held in overnight (liquid) accounts, the City's main checking account, and other operating funds:

	Cash and Investments by Fund		
	As of 06/30/19	As of 03/31/19	Change $
General Fund	$ 40,074,550	$ 29,792,398	$ 10,282,152
Capital Project Funds	57,775,643	60,258,108	(2,482,465)
Internal Service Funds	19,737,315	19,390,243	347,072
Water Fund	18,165,708	17,565,128	600,580
Sewer Fund	19,251,907	20,239,273	(987,367)
Solid Waste Fund	4,624,332	4,732,143	(107,811)
Parking Fund	10,280,142	9,779,415	500,727
Building Fund	12,221,730	11,139,607	1,082,124
Landfill Fund	1,805,810	1,713,928	91,882
Debt Service Fund	8,353,106	11,456,769	(3,103,663)
Subtotal, Operating Funds	192,290,242	186,067,011	6,223,231
Other Funds	14,294,571	12,892,454	1,402,117
Total Cash and Investments	$ 206,584,813	$ 198,959,465	$ 7,625,348

Cash holdings in the General Fund increased in the fourth quarter of the 2018-19 fiscal year due to major property tax receipts in April and June ($7.7 million combined). Other major receipts included nearly $1.0 million from building plan check fees from development on Airport Boulevard (Building Fund); and Storm Drain Fees of just over $1 million (collected with property taxes), which are reflected as an increase in "Other Funds". Capital Project Funds decreased as payments were made on the design, specs, and other preparations for the New Community Center Project ($975,000); progress was also made on the Ray Park Playground ($612,000), as well as the Fire Station 35 HVAC project (158,000). Capital spending was also high in the Sewer Fund, with $765,000 expended on the Easton Sewer Rehab project alone. The Debt Service Fund balance decreased as a result of annual debt service (principal and interest payments) of nearly $2.9 million on outstanding bonds, including $1.1 million on the Corp Yard bonds (Series 2010), approximately $1.4 million for Storm Drain bond payments due on July 1st, and $400,000 for the streetscape bonds (Series 2012).

As for performance of the City's trust funds, which adhere to different strategies than reflected in the City's Investment Policy for its main portfolio, the most recent statements are attached to this staff report. Because the City's funding of its retiree medical obligations is relatively low (<20%), the City's trust account is invested in the most aggressive (Strategy 1) portfolio available with the California Employers' Retiree Benefit Trust (CERBT) Fund. The net return for the portfolio for the year ended June 30th was 6.22%. The PARS §115 trust account for funding the City's pension liabilities (established in October 2017), reflects a 3.81% return for the month and 7.29 % for the past fiscal year.

CONCLUSION

All City funds are invested in accordance with the approved Statement of Investment Policy with an emphasis on safety, liquidity, and return (in that order). The City's investment strategy of balancing the investment portfolio between short-term investments (to meet cash flow needs) and longer-term maturities (to realize a higher rate of return) is appropriate, given current market conditions.

Due to the ease of access of the City's funds in liquid accounts such as LAIF and CAMP, the City has more than sufficient funds available to meet its liquidity (expenditure) requirements for the next six months.

Staff and the City's investment advisor will continue to closely monitor the City's investments to ensure the mitigation of risk and ability to meet the City's investment goals while being able to respond to changes in market conditions.

FISCAL IMPACT

Quarterly reporting of the City's Investment Portfolio will not result in any direct impact on City resources.

Exhibits:
- Portfolio Holdings as of June 30, 2019
- CERBT Stategy 1 Statement for June 30, 2019
- PARS Annual Statement for June 30, 2019