City of Aurora

Investment management quarterly report

June 2017

A BNY MELLON COMPANY℠

Insight INVESTMENT

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US Fixed Income commentary

Second quarter 2017

US first quarter growth was revised up marginally in June, but still remains disappointing at just 1.4%. A number of technical factors affected the data, including seasonal adjustments, the impact of warm weather on energy spending, as well as base effects from the autos-boom, which had set a high hurdle for consumption growth. Business investment remained strong and this underpins our expectations for a rebound later this year. The Bloomberg average expectation for second quarter GDP is 2.4%, but its outcome is likely dependent on a rebuild in inventories from the first quarter.

As expected, the Federal Reserve (Fed) raised the interest rate corridor for the federal funds target rate by 25bp at its June meeting, moving ahead with its very gradual rate hiking cycle. The lower bound of 1% is now just in line with the lowest level of rates reached during the 2000s rate-cutting cycle. Based on the Fed’s medium projections, they plan to raise rates one more time this year with more aggressive rises penciled in thereafter. Market pricing remains far more skeptical and even a move in December is only partially factored in. Further, a plan for the Fed’s balance sheet runoff has been outlined which involves a tiered adjustment in their securities holdings. Fed balance sheet reduction could begin in September should the economy progress as expected. Beyond looking at the likely interest rate and balance sheet profiles, we continue to watch for President Trump’s appointments to the Fed.

Despite slower than anticipated economic growth and higher interest rates set by the Fed, credit risk-based assets performed well during the quarter and also for the first half of the year. US Investment grade credit tightened further to 103bp in option adjusted spread, according to the Bloomberg Barclays Indexes. Excess returns for the year now exceed like-maturity Treasury securities by 1.48%. Intuitively, year-to-date excess return for high yield was significantly positive at 3.64%. Agency mortgage-backed investments continued their struggle versus investment alternatives as investors demand more risk premium from the Fed reinvesting fewer bonds. Year-to-date excess returns for this Fed-sensitive asset class trail Treasuries by 20bp.

Long-term US Treasury yields have performed well year-to-date as short-term yields have lagged. For the year, 10-year yields have fallen by 14bp to 2.30% while two-year yields have risen by 19bp to 1.38%. This curve flattening is a typical market response to the Fed raising interest rates to tighten monetary policy. It remains to be seen, however, if Fed policy will eventually become tight or if the projected path merely becomes normal. Other influences affecting long-term Treasuries include the growing probability of increased Treasury issuance, economic growth expectations and inflationary price pressures.

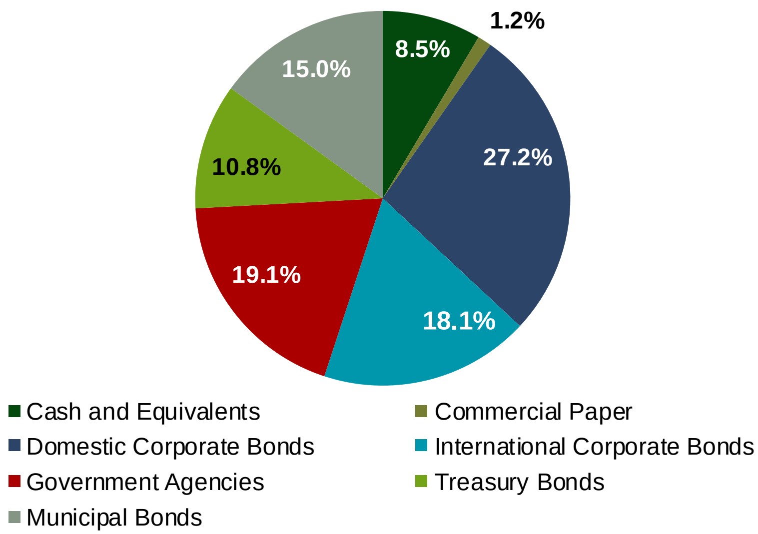
However, the positive pricing pressures that started to build in the second half of 2016 have reversed in recent months. A downward pressure on headline inflation may well persist with oil prices now 20% below their 2016 levels. Labor market tightness has yet to translate into wage pressures and it may be that there are structural reasons behind this phenomenon. At some point though, it seems reasonable to assume that a shrinking supply of available workers will cause the price of labor to rise. For now however, real disposable incomes are improving and central banks are confronted with an environment where the removal of emergency stimulus can happen in a gradual way. This gradual path may ultimately better protect the economy during the normalization of interest rates and further extend the current growth cycle.

As of June 30, 2017.

Market environment and strategies

Asset allocation

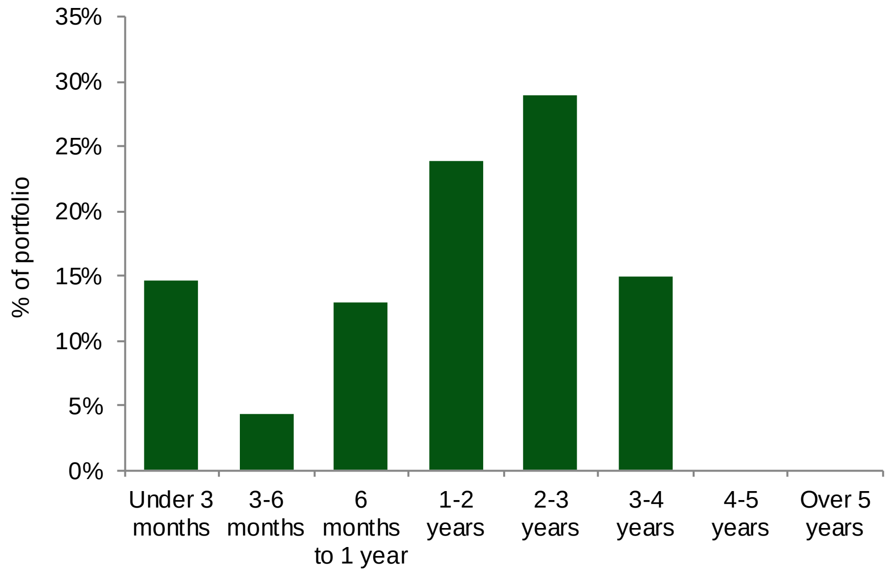
Investment Type	Allocation	Maturity (days)
Cash and Equivalents	8.5%	1
Commercial Paper	1.2%	6
Domestic Corporate Bonds	27.2%	669
International Corporate Bonds	18.1%	509
Government Agencies	19.1%	713
Treasury Bonds	10.9%	842
Municipal Bonds	15.0%	465
Total	**100.0%**	**572**



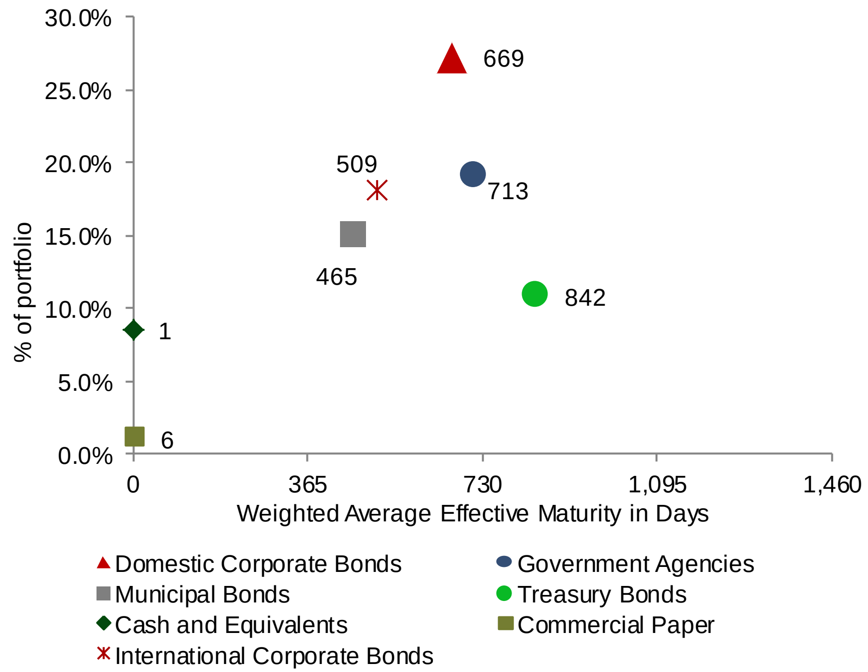
As of June 30, 2017. Asset allocations are subject to change without notice, may not represent current or future decisions and should not be construed as investment recommendations. Please refer to the important disclosures at the back of this presentation

Market environment and strategies

Maturity distribution



Maturity allocation map



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