City of Aurora

Investment management quarterly report

July 2018

Part of BNY MELLON

Insight INVESTMENT

US Fixed Income commentary
Second quarter 2018

Political narratives dictated market sentiment during the second quarter 2018 as risk markets largely ignored strong US economic data. Italian politics introduced unexpected and significant market volatility during the last week in May as populist-leaning parliamentary parties combined platforms. Markets quickly recalculated this renewed threat to European unity by sending US Treasury 10-year yields lower by 30bp during the week. Italian sovereign bonds maturing in two years had yields spike by over 200bp to 2.75%.

While the Italian political narrative exploded and then quickly settled, the US political narrative surrounding trade tariffs behaved more akin to a Hawaiian lava flow. The initial tariff rhetoric provoked intellectual curiosity and dismissiveness by most outside of the obvious targeted industries such as autos, commodities and agriculture. Yet the increasing intensity and scope of economic regions affected began to stress risk markets as the quarter ended. Especially given the renewed strength in US Dollars versus other currencies, emerging markets with current account deficits and European economies more dependent on exports began to show weakness, which raised concern in US markets.

The result for US Treasury yields again appears to be the familiar refrain of the “range bound” environment. US Treasury 10-year yields tested the cycle and multi-year highs, but failed to hold above 3.05% as events unfolded. This oft-watched benchmark settled the quarter at 2.86%, which seems firmly in the middle of a 2.65% to 3.05% long-term range.

Investment grade corporate investors found no reprieve from the first quarter underperformance in this environment. New issue industrial supply was elevated and the escalation of international risks encouraged investors to command higher risk premiums versus Treasuries. The banking and financial sectors similarly languished as flattening yield curves likely impede forward-looking profitability. Investment grade corporates lost 1% in excess returns versus Treasuries for the quarter and are trailing by 1.8% for the year.

High yield corporate investors were alternatively rewarded for the quarter with 96bp of excess returns versus Treasuries. This sector remains largely insulated from the international macroeconomic narratives affecting Treasuries and high grade. High yield is instead more influenced by the domestic growth outlook, which is tracking near 4% for the second quarter. This divergence is also seen in equity markets as the domestically focused Russell 2000 small cap index outperformed the SP 500 index, 7.8% versus 3.4% for the quarter respectively.

The US-focus benefitted the securitized sectors as well. US agency MBS, ABS and non-agency CMBS all registered small positive excess returns versus Treasuries during the second quarter. The small positive contribution in US agency MBS can mostly be attributed to the settling of interest rates into the indicated long-term ranges.

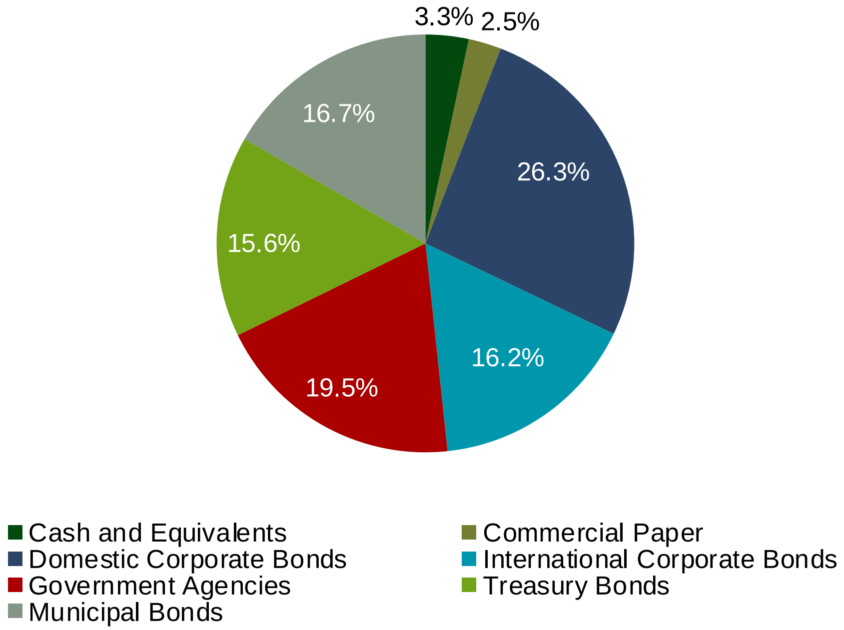
Thinking ahead for the balance of 2018, US economic growth appears durable and the Federal Reserve appears willing to raise lending rates slowly so long as financial conditions remain accommodative. Known threats to the US growth thesis are seemingly external and are having little direct impact through the second quarter. Consumer and business sentiment surveys should be a leading indicator if this narrative is poised to change. Until that evidence begins to reveal itself, it is possible that Treasury yields will continue to rise and US-focused investments can be steady performers.

As of June 30, 2018.
Fixed income index data provided by Bloomberg Barclays as of June 29, 2018.

Market environment and strategies

Asset allocation

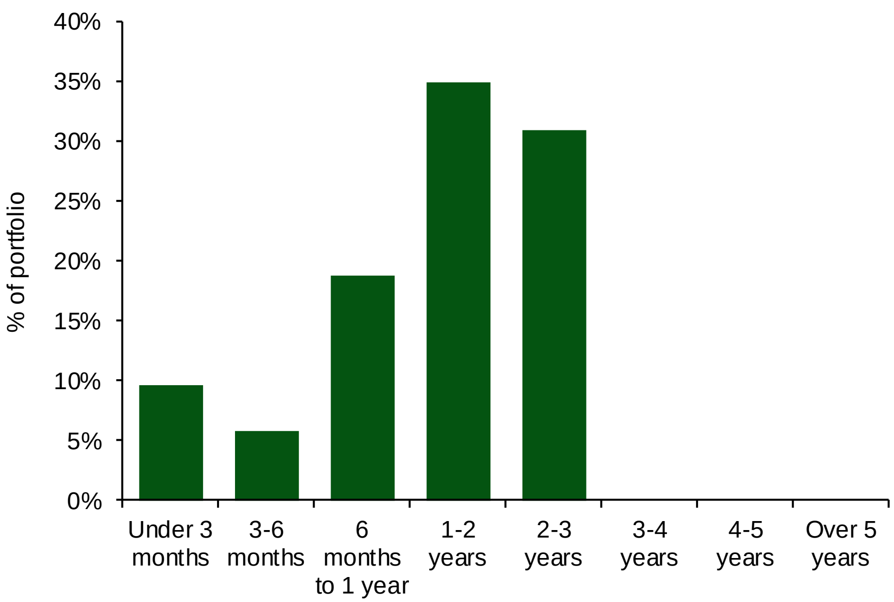
Investment Type	Allocation	Maturity (days)
Cash and equivalents	3.3%	1
Commercial paper	2.5%	222
Domestic corporate bonds	26.3%	492
International corporate bonds	16.2%	377
Government agencies	19.5%	622
Treasury bonds	15.6%	695
Municipal bonds	16.7%	575
Total	**100.0%**	**521**



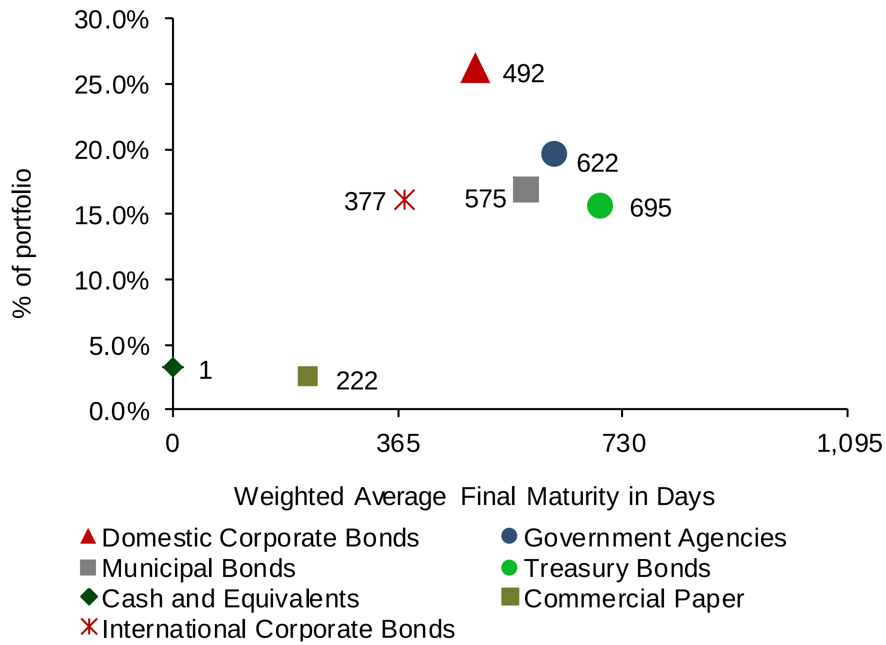
As of June 30, 2018. Asset allocations are subject to change without notice, may not represent current or future decisions and should not be construed as investment recommendations. Please refer to the important disclosures at the back of this presentation

Market environment and strategies

Maturity distribution



Maturity allocation map



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