City of Aurora

Investment management quarterly report

October 2018

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Insight
INVESTMENT

US Fixed Income commentary
Third quarter 2018

The Federal Reserve (Fed) raised the overnight federal funds borrowing rate for the third time this year at its regular meeting in September. Consistent with what has been a strong US economy and labor market, the borrowing rate corridor was raised to 2.0% to 2.25%. The Summary of Economic Projections also included its first projection for 2021 and the Fed opted to cease describing policy as "accommodative" in the statement. Fed members expect a modestly restrictive policy stance relative to historical norms as the projected 3.4% policy rate is higher than the long run "normal" rate of 3.0%. Importantly, Chairman Powell has recently emphasized a "risk management" approach to monetary policy and has repeatedly downplayed the importance of these projections over longer periods of time.

Treasury yields migrated higher during the third quarter in expectation of this change in Fed policy. After characteristically suffering though low summer trading volumes and bouts of market stress from emerging market angst, 2-year Treasury notes continued its upward trend, climbing 29bp for the quarter to finish at 2.82%. Longer-term 10-year and 30-year tenors finished the quarter higher in yield at 3.06% and 3.21% respectively. Unlike the sensitivity to the Fed exhibited by the 2-year Treasury, the longer-term Treasuries failed to break higher in yield from well-established ranges.

Risk premiums for the credit sectors generally narrowed during the quarter, meaning that risk appetite generally improved for investors. Well-telegraphed seasonal supply and gradually rising Treasury yields helped narrow investment grade corporate spreads by 17bp[1] to 106bp. Linked more closely to equity performance, high yield rallied 47bp to 316bp in spread as the S&P 500 Index rallied another 7.7% during the quarter. The ABS and non-agency CMBS securitized sectors showed similar risk premium improvement, rallying 9bp and 13bp respectively.

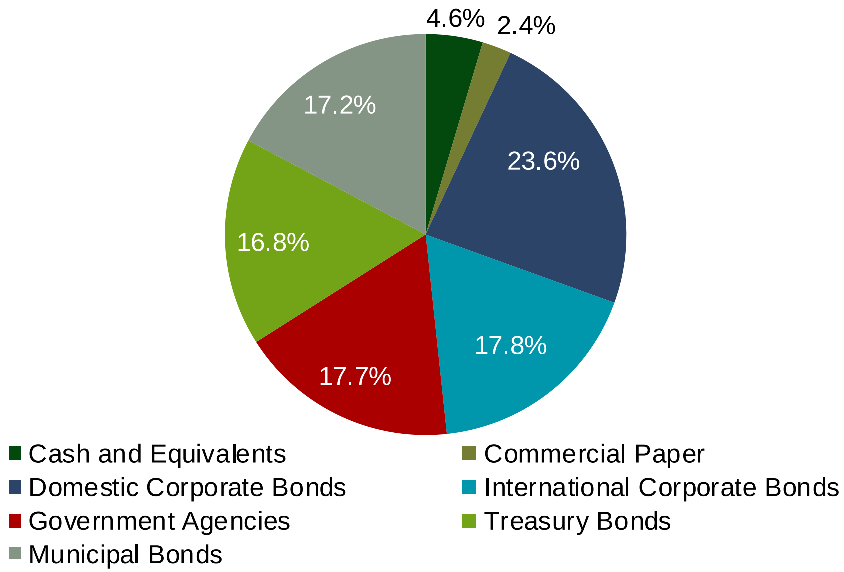
The benign environment for domestic fixed income investors stood in contrast to an increasingly volatile global trade narrative. The realization of and potential for further tariffs directed towards China did spark some moments of market disorder. Dollar strength continues to pressure twin deficit economies, those that issue debt in USD and are net importers of energy. Closer to home, consumer product companies, retailers and automobile manufacturers are facing increased input cost pressures. Yet the strength of the US economy is giving cover to some of these bubbling concerns and cover for the Fed to continue raising interest rates. Risks to a “continuation” thesis in 2019 could surface with further pressure on inflation or external markets exposed to US dollar strength. Until more profound evidence of these risks are observed, it seems that defensiveness to rising interest rates and exposures to non-government securities should remain the preferred fixed income portfolio allocation.

[1]Fixed income index data provided by Bloomberg Barclays as of September 28, 2018.

Market environment and strategies

Asset allocation

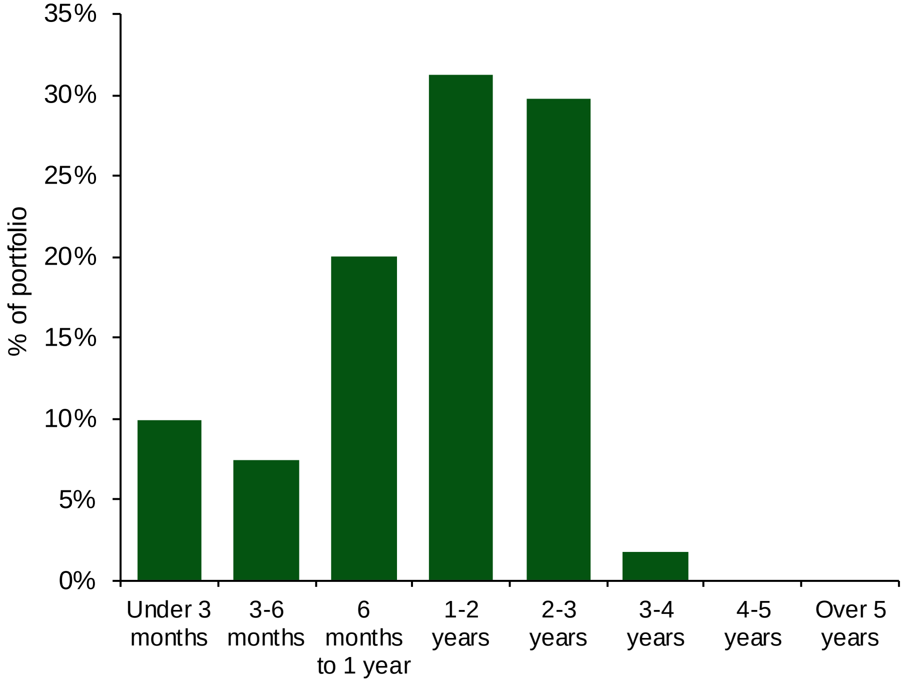
Investment Type	Final Maturity	Allocation
Cash and equivalents	1	4.6%
Commercial paper	130	2.4%
Domestic corporate bonds	419	23.6%
International corporate bonds	477	17.8%
Government agencies	630	17.7%
Treasury bonds	708	16.8%
Municipal bonds	567	17.2%
Total	**515**	**100.0%**



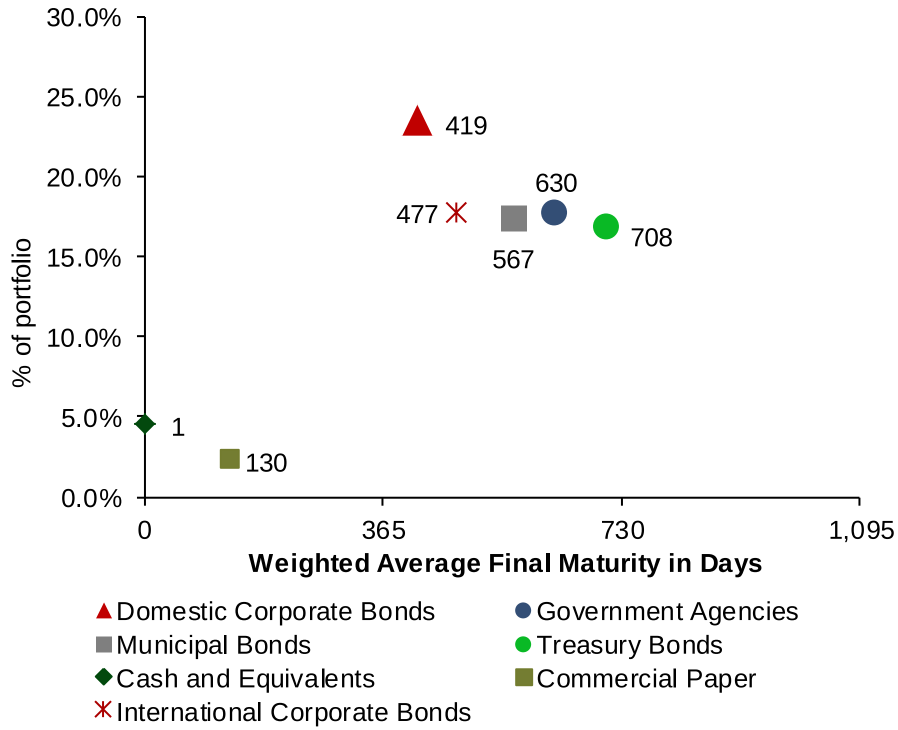
As of September 30, 2018. Asset allocations are subject to change without notice, may not represent current or future decisions and should not be construed as investment recommendations. Please refer to the important disclosures at the back of this presentation.

Market environment and strategies

Maturity distribution



Maturity allocation map



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