City of Aurora

Investment management quarterly report

January 2018

A BNY MELLON COMPANY℠

Insight INVESTMENT

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US Fixed Income commentary

Fourth quarter 2017

During the fourth quarter, the Federal Reserve (Fed) made good on their 2017 forecast by raising the overnight lending rate for the third time during the calendar year. The upper bound of 1.5% is still historically accommodative as inflation measures range closer to 2.0%. This implies a negative real borrowing rate for member banks. This nuance partially explains why financial conditions remain benign despite the rising central bank rate.

The other significant explanatory variable for the benign and low volatility market environment is the observed strength of the US and global economies. In the third quarter of 2017, US GDP growth was 3.2% despite the potential slow down effects from the summer hurricanes. The unemployment rate has plumbed new lows of 4.1% through December. Higher frequency consumer and business confidence measures remain high both domestically and globally, with Europe and Japan in particular experiencing upticks in economic activity. The resulting narrative is being characterized as a "synchronization" of global growth.

The fixed income market result for the fourth quarter and for the year was therefore constructive for investors. Beginning with Treasuries, an active Fed combined with accommodative financial conditions and modest inflation expectations resulted in a flattening of the Treasury curve. For the year, 2-year Treasuries rose by 70bp while 30-year Treasuries fell by 32bp. This stability in longer maturity securities coupled with the higher yields being earned on shorter maturity securities actually resulted in positive absolute returns for the year. Intermediate tenor Treasuries returned 2.09% and long maturity Treasuries returned 2.69% in 2017 according to Bloomberg Barclays indexes.

Non Treasury fixed income investments fared even better. Risk premiums narrowed for the unsecured corporate and structured credit sectors alike. Investment grade spreads narrowed 29bp for the year to add 3.35% in excess returns versus Treasuries. High yield excess returns registered 6.10% versus Treasuries and 7.50% in absolute terms for the year. The structured credit sectors including agency MBS, commercial MBS and consumer ABS also enjoyed positive absolute and Treasury-relative returns for the year.

Thinking ahead, 2018 appears to be on track to build on what occurred in 2017: namely, sustained economic growth, further improvement in labor markets, and central bank policy that continues to step back from an ultra-accommodative stance. This is true not only in the US, but in other developed markets as well. Treasury curves could therefore continue to flatten and risk premiums for the credit sectors could continue to narrow.

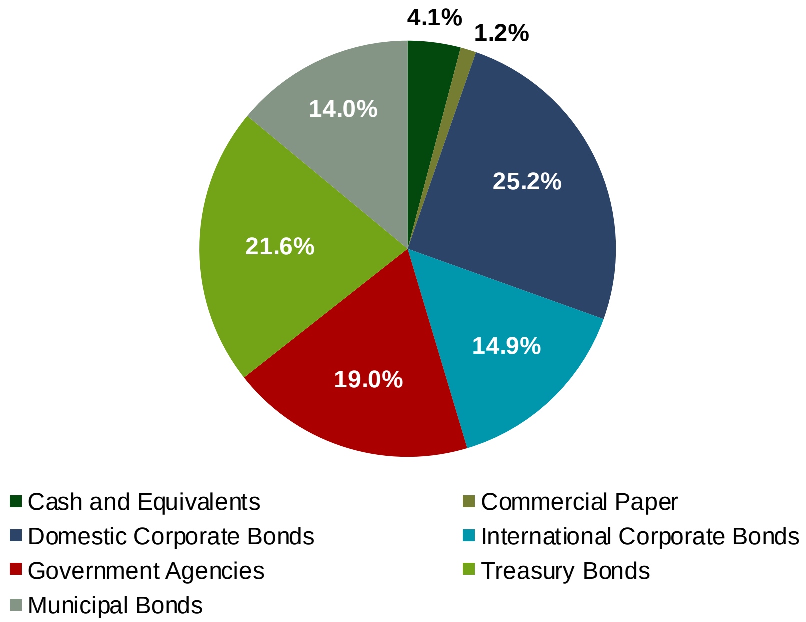
While this outlook is the most likely outcome, we would caution that these themes are market-consensus views and perhaps pricing already reflects this outcome. Market volatility is notably low and probably continues to remain low with stable economic growth and central bank gradualism. Yet if volatility does spike, avoiding the most crowded positioning should result in the most prudent portfolio.

As of December 31, 2017.

Market environment and strategies

Asset allocation

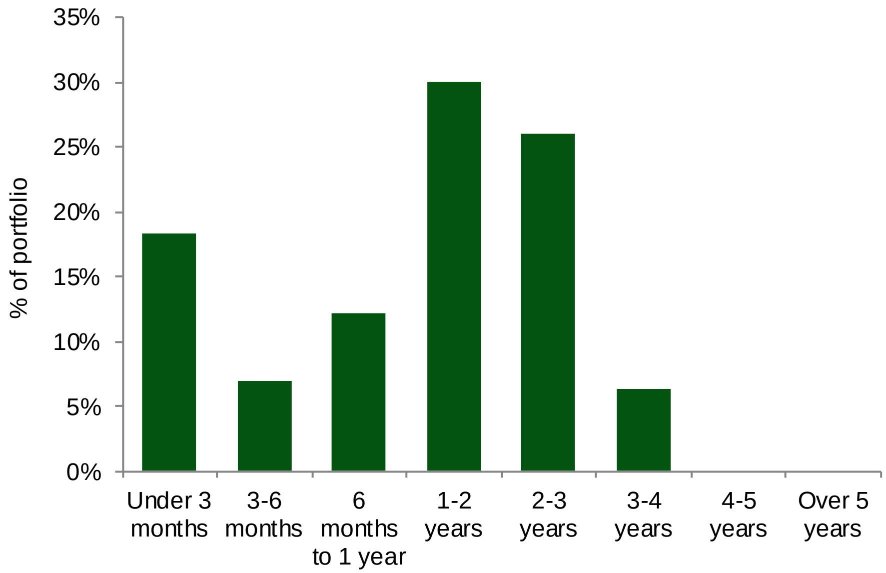
Investment Type	Allocation	Maturity (days)
Cash and Equivalents	4.1%	1
Commercial Paper	1.2%	37
Domestic Corporate Bonds	25.2%	591
International Corporate Bonds	14.9%	412
Government Agencies	19.0%	625
Treasury Bonds	21.6%	475
Municipal Bonds	14.0%	629
Total	**100.0%**	**520**



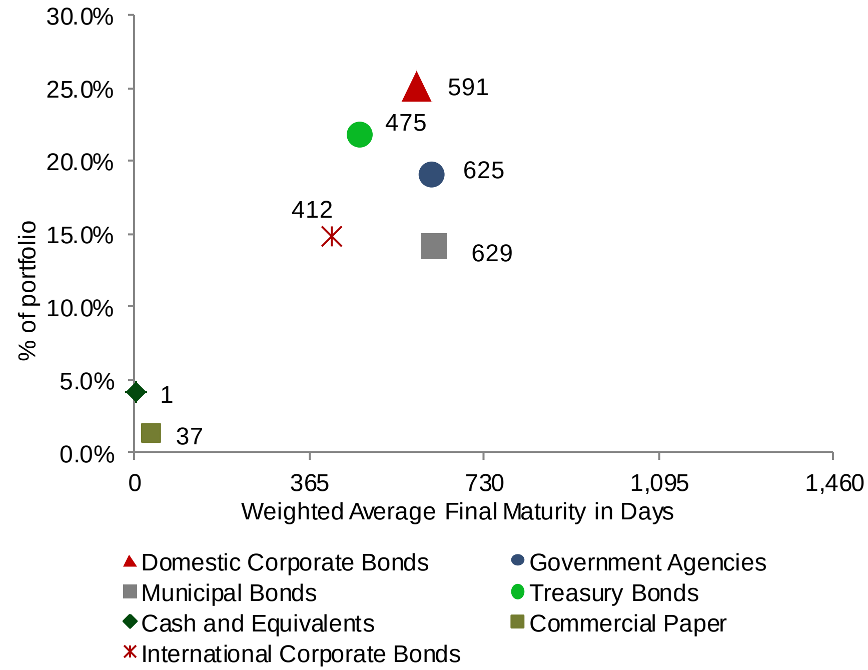
As of December 31, 2017. Asset allocations are subject to change without notice, may not represent current or future decisions and should not be construed as investment recommendations. Please refer to the important disclosures at the back of this presentation

Market environment and strategies

Maturity distribution



Maturity allocation map



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Important disclosures

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