City of Aurora

Investment management quarterly report

January 2019

Part of BNY MELLON

Insight INVESTMENT

US Fixed Income commentary

Fourth quarter 2018

Seemingly stable risk markets pivoted quickly during the fourth quarter. Beginning with the United Kingdom, the probability of a “crash out Brexit” increased as cabinet members resigned and a vote of confidence in Prime Minister Theresa May was required. The proposed deal to exit the European Union still may not be ratified by the March 2019 deadline. Within Europe, a popular rebuke of proposed taxes in France resulted in domestic violence while Italy continued to challenge protocol by proposing spending budgets in excess of Monetary Union guidelines. European growth slowed and interest rates remained depressed. Within emerging markets, China growth slowed as the US tariffs began to take effect and Mexico’s new government revealed signs that it was not going to be as market friendly as hoped.

US markets and economic expectations had remained largely immune to these exogenous pressures building in the global economy. Third quarter US GDP registered 3.4% growth and is tracking to 2.5-2.9% growth for the year. The labor market remained strong, registering 762,000 new non-farm payrolls added during the 4th quarter coupled with an unemployment rate of merely 3.9%[1] . Wage growth has also passed 3%, which supported strong holiday spending. The Federal Reserve (Fed) raised interest rates for the fourth time in 2019 as a result of this economic strength and signaled a continued but slower pace of rate increases for 2019.

	Total return		Excess return versus Treasuries	
	1Q18-3Q18	4Q18	1Q18-3Q18	4Q18
S&P 500	10.6%	-13.5%		
High Yield Corp	2.6%	-4.5%	3.27%	-6.75%
IG Corp	-2.3%	-0.2%	-0.11%	-3.10%
US MBS	-1.7%	2.1%	-0.07%	-0.53%
US Treasury	-1.7%	2.6%		

To be fair, this type of risk-reversal hints at underlying factors beyond just another 25bp rise in the Fed Funds rate or those international issues previously described. The US midterm elections proved to be a referendum against many facets of the current administration with Democrats easily retaking the House of Representatives. The President’s response so far has been acrimonious and unpredictable. Outward criticism of monetary policy was heightened, which raised the stakes for the Fed to deliver the right message without jeopardizing its independence. It was a no-win situation for Chairman Powell.

An unpredictable decision to end military operations in the Middle East resulted in another round of cabinet member departures. Separately, a televised confrontation between the administration and congressional leaders ultimately led to another government shutdown with red lines drawn over border security. Divided government has historically been proven positive for risk markets and economic growth, but the current situation has proved too much for risk assets to end 2018. It is also worth mentioning that several high profile ratings downgrades of A-rated companies to BBB and profit warnings due to international trade added to this toxic brew.

2019 Outlook

Confidence is a fragile thing. It has taken 10 years and significant changes to fiscal policy to return consumer and business confidence to pre-financial crisis expectations. Yet the most recent Institution for Supply Management manufacturing survey showed how quickly this confidence can fade, declining by the most in a monthly reading since 2008, though it remains in positive territory. The challenge with the recent external and internal exogenous events is that it can have an outsized effect on financial conditions, which then affects confidence and ultimately economic output.

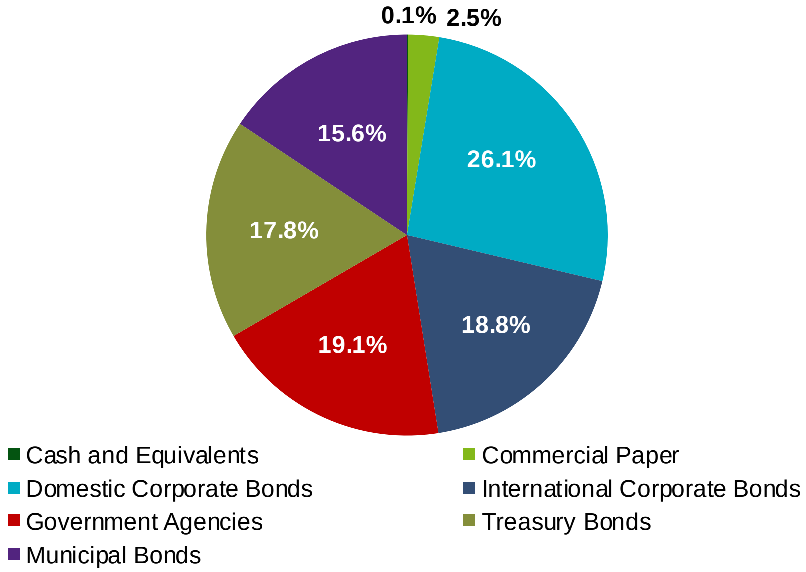
While we expect 2019 economic growth to slow, it is still projected to be above economic potential thereby creating jobs, inflationary pressure and the likelihood that the Fed nudges the borrowing rate higher. Risk markets will likely remain volatile during this process as it is unclear if financial conditions can remain consistently calm amidst domestic and international geopolitical uncertainties. That being said, volatility creates opportunity as the market gyrates between expected recession and continued expansion. We anticipate opportunity for fixed income investors to safely add yield again in 2019 as interest rates and risk premiums rise, in the context of a slower but growing economy.

Fixed income index data provided by Bloomberg Barclays as of December 31, 2018. [1] Bureau of Labor Statistics.

Market environment and strategies

Asset allocation

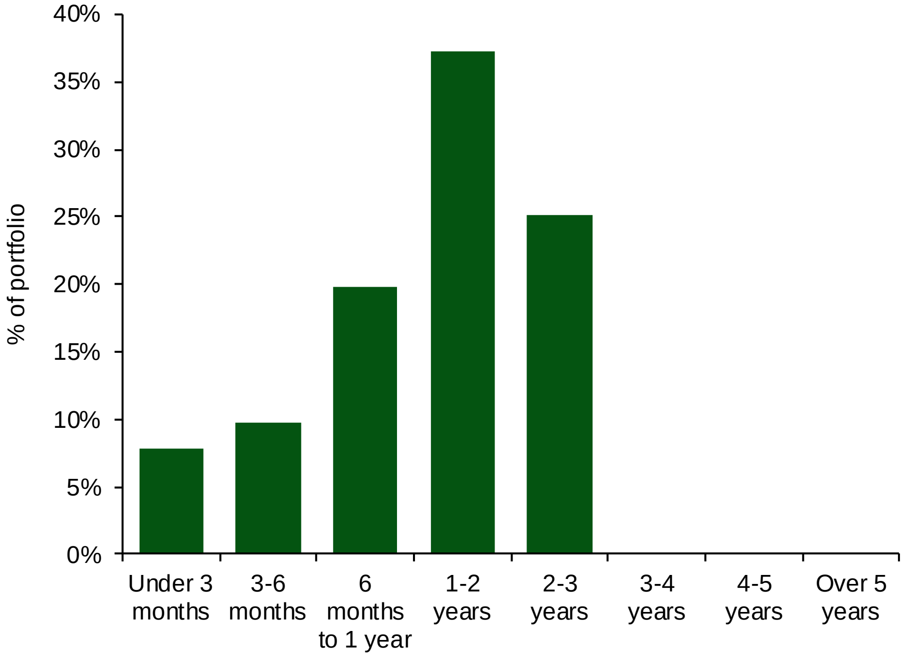
Investment type	Par value	Final maturity	Allocation
Cash and equivalents	433,129	1	0.1%
Commercial paper	13,000,000	38	2.5%
Domestic corporate bonds	136,005,000	388	26.1%
International corporate bonds	97,951,000	385	18.8%
Government agencies	99,500,000	600	19.1%
Treasury bonds	92,500,000	616	17.8%
Municipal bonds	81,435,000	610	15.6%
Total	**520,824,129**	**494**	**100.0%**



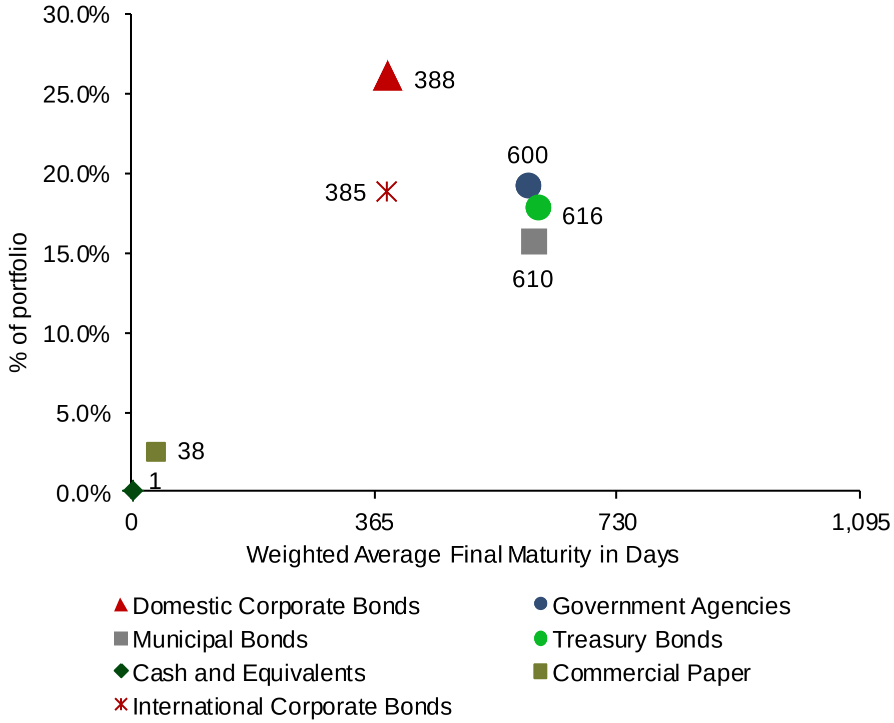
As of December 31, 2018. Asset allocations are subject to change without notice, may not represent current or future decisions and should not be construed as investment recommendations. Please refer to the important disclosures at the back of this presentation.

Market environment and strategies

Maturity distribution



Maturity allocation map



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