Agenda

1. Call to Order
2. Approval of Agenda
3. Minutes from Past Meeting — November 13, 2018 (3Q18)
4. 4Q18 Cashflow
5. Presentation of 4Q18 Quarterly Report

Committee members:
Jon Commers, Committee Chair & Council member
Sandy Rummel, Committee Vice Chair & Council member
Jeannette Parr, CFA, Appointee
John Schweers, Appointee
Mary Bogie, CFO & Treasurer

Reference staff: (not members of the IRC)
Rich Koop, Senior Manager, Treasury
Lynn Greiner, Financial Analyst
Investment Review Committee
IRC Administrative Coordinator: Rich Koop (651)-602-1629

Minutes
November 13, 2018 (3Q18) at 1:00 P.M., in Robert Room 4B

Present
Committee members: Sandy Rummel, Committee Vice Chair & Council Member; Jeannette Parr, CFA, Appointee; John Schweers, Appointee;

Reference staff: Rich Koop, Senior Manager, Treasury; Lori Connery, Recording Secretary
Other attendees: Jacob LaVigne, Financial Analyst

Absent: Jon Commers, Committee Chair & Council Member; Mary Bogie, Chief Financial Officer & Treasurer

Call to Order
A quorum being present, Sandy Rummel called the quarterly meeting (3Q18) of the Investment Review Committee to order at 1:00 p.m. on Tuesday, November 13, 2018.

Approval of Agenda and Minutes
It was moved by John Schweers and seconded by Jeannette Parr to approve the agenda.
Motion carried.
It was moved by Jeannette Parr and seconded by John Schweers to approve the Tuesday August 14, 2018 Minutes.
Motion carried.

Topics Discussed

❖ 3Q18 Cashflow (R. Koop)
   ➢ Rich presented the Cashflows graph which showed monthly receipts, disbursements and cash balances going back 5 years. Committee members suggesting looking at a stacking type of graph for future reports. The committee agreed moving forward this graph only needs to be shown for the three months in the current quarter.

❖ Presentation of 3Q18 Quarterly Report: (R. Koop)
   ➢ Charts and details were shown on the PowerPoint presentation. It was noted on slide 11 the range should state 2-6 years. In the discussion of the types of investments in the short-term portfolio, it was discussed with the spread of US Treasury bills to Discount Notes being so close, it made sense to add US Treasury Bills in the portfolio.

   Members asked how the banking contract was coming along. Rich gave an update on the status and stated the pricing is better and the earnings credit is increasing to 85 basis points. This raised questions on how much we are leaving in the account to earn credit when we could be investing these funds at 2%. Rich agreed and stated will look at the divisions budgets and bring back a recommendation on what the balances kept at Wells daily can be reduced to.

For further questions, please contact Rich Koop directly at: 651-602-1629.

The next meeting is scheduled on February 12, 2019, 1:00 PM-2:00 PM, in Robert Room 4B.

Business completed, the meeting adjourned at 1:45 p.m.

Respectfully submitted,
**Economic Review**

4Q18. The top negative risks to US growth are the Fed rushing to “normalize” too quickly and the threat of a protected trade/technology war with China. The top positive risks are the oil boom and a Fed pause in rate hikes made possible by low inflation and weakening global growth. It’s no accident the Fed are on both bullish and bearish risk lists. They face a momentous decision in the first quarter of 2019. They can continue to make policy as they always have and blunder into a recession in late 2019 or early 2020; or they can take advantage of the opportunity provided by the recent inflation drop and pause with rate hikes for a few quarters or longer thus allowing the economy to stabilize and reaccelerate.

US oil booms in the 1910s and 1920s and in the 1950s and 1960s were accompanied by general economic prosperity. Oil production produces billions in income and it restores market pricing to a critical resource. Economies function much better when resources suppliers do not engineer periodic bouts of artificial scarcity.

China factory activity shrank in December for the first time in more than two years, intensifying pressure on Beijing to reverse an economic slowdown as it enters trade talks with the Trump administration. The purchasing managers index of the National Bureau of Statistics and an industry group, the China Federation of Logistics and Purchasing, fell to 49.4 from November’s 50.0. Any reading below 50 shows that activity is contracting. The December figure was the lowest since February 2016 and the first drop since July 2016.

December’s FOMC meeting marked the most significaute Fed communication error since Bernanke unleashed the “taper tantrum” in 2013. Five years ago, after sending the bond and stock markets into a tailspin by surprising traders with the end of QE3, Chairman Bernanke and other Fed participants spend considerable time and energy trying to understand trader thinking. Hopefully, the Powell Fed will respond in similar fashion after its December misstep.

When Chairman Powell explained why the FOMC chose to hike rates despite financial markets suggesting it might be wiser to hold off, he spoke mostly about stocks.

The equity market had a horrific quarter losing 16% in value with the S&P 500 beginning the quarter at 2,914 and finishing at 2,506. The yield on the 10-year Treasury note began the quarter at 3.06 ended the quarter at 2.69%. Nonfarm Payrolls added 312,000 jobs in December which was well above the consensus of 184,000 jobs, November was revised up 21,000 jobs to 176,000 and October was revised up 37,000. Unemployment ticked up to 3.9% which
is highest since April. The Federal Reserve Bank’s long-term estimate for full employment is between 5.2% and 5.5%, which means the US economy is well under levels of employment.

The U.S. joined other nations in a manufacturing slowdown. The ISM Manufacturing Index fell in December to 54.1 from 59.3 in November. This ISM manufacturing surprise showing a slowing in US manufacturing and falling inflation fundamentals certainly make a solid case for taking a break from rate hikes.

Present. Sales of new vehicles in the U.S. rose slightly in 2018, defying predictions and highlighting a strong economy. Automakers reported an increase of 0.3 percent over a year ago to 17.27 million vehicles. The increase came despite rising interest rates, a volatile stock market and rising car and truck prices that pushed some buyers out of the new-vehicle market.

A partial shutdown of the US federal government has stretched into a third week with virtually no end in sight. It now is the second-longest shutdown in US history. The closures are having an impact on 800,000 federal workers, many of whom will not receive paychecks for the first time since the standoff in Washington began just before Christmas.

Standing in the way of a resolution is Donald Trump’s demand for a wall on the US-Mexico border – a central promise of his presidential campaign. Despite repeatedly vowing that Mexico would pay for it, the president is now demanding $5.7bn in taxpayer money to proceed with construction of the border wall. Democrats are standing firm against the proposal while Trump has threatened that the shutdown could last for “months or even years”.

In October 2013, Republicans shut down the government for 16 days in an unsuccessful bid to strip funding from Barack Obama’s healthcare legislation, the Affordable Care Act. In January 2018, Democrats briefly shut down the government over an impasse on immigration legislation, as a way to demand Congress enact protections for undocumented immigrants who came to the county as children.

This shutdown is on the path of being the longest in history which is currently at 21 days. The impact of the shutdown will only worsen the longer it lasts. The nation’s food assistance program only has funding through the end of January and it probably could not meet the demand expected in February. Meanwhile, federal workers appear to be growing frustrated. Transportation Security employees have been increasingly calling in sick at airports across the country while at the Environmental Protection Agency are planning a “national sick day” to protest against the shutdown.

On December 19th the Fed raised rates 25 basis points to 2.25-2.50% and signaled a modestly slower path of tightening in 2019. Markets – expecting a pause – reacted as one might expect, with the yield curve flattening and stocks tanking. The message from both markets is that recession odds are a little higher now given the Fed’s defiance. The Fed did not change its assessment of the economy. In a statement they said, “The labor market has continued to strengthen and economic activity has been rising at a strong rate. Job gains have been strong, on average, in recent
months, and unemployment rate has remained low. Household spending has continued to grow strongly, while growth of business fixed investment has moderated from its rapid pace earlier in the year."

The biggest error on December 19th was not traders overestimating the Fed’s willingness to signal a pause, but the Fed choosing to ignore markets and double down on its commitment to continue raising interest rates. If, in interviews and speeches, FOMC participants continue to emphasize the need for rate hikes – gradual or otherwise – if Powell’s tone does not change significantly in the January press conference, the yield curve will invert before the end of January.

**Future.** Looking further ahead Fed members expect two rate hikes in 2019 bring rates to the 2.75-3.00% range. The dot plot medians are showing the possibility of one hike in 2020 bringing the median to 3.25%.

**Council Impact.** As mentioned above, interest rate volatility will likely increase and dominate markets. Generally, changes in interest rates directly affect bond prices. The relationship between the two factors is an inverse one, such that, if interest rates rise, bond prices fall (and vice versa). In that case, our long-term portfolio which is comprised of 100% bonds will experience price depreciation. To minimize price loss, we intend to maintain a short duration stance versus our benchmark.

In our view, the fundamental credit outlook for municipal bonds remains positive.

We believe that the primary driver of municipal bond returns in the near future will be the Fed’s interest rate policy. We will continue to monitor this issue closely and will position the portfolio appropriately in order to take advantage of any changes in interest rates.

**Investment Results & Strategy**

**MCOA—Short-Term**

4Q18 Results: The portfolio outperformed its benchmark during the fourth quarter. Total return of 0.55% was above the index (0.50%) by 5 basis points. This portfolio has outperformed the benchmark by 17 bps over the last 10 years. For the quarter, the Council’s liquid cash was invested in government money market funds, Commercial Paper, US T-Bills and Federal Discount Notes.

The money market space continues to be dominated by a limited selection of eligible high-quality investments. A primary driver of the low supply includes the fact that corporations and government issuers continue to take advantage of the historically low interest rates by extending the terms of their debt (1-3 yr. maturity).
1Q19 Strategy: In the first quarter we will investing cash in a short timeframe and liquid to cover the capital expenses, debt service, SWLRT project costs and Payrolls. We have begun investing in US T-Bills as an additional security type.

Longer Strategy (12-months): We will continue to monitor the market environment and if the opportunity arises, invest in high credit quality investments which may include Treasury bills, agency discount notes, commercial paper, and government money market funds.

MCOA—Long-Term

4Q18 Results: The portfolio underperformed its benchmark during the fourth quarter. Total return of 1.59% was below the index (1.95%) by 36 basis points. The portfolio was comprised of 15% municipal bonds (yielding 4.57%), 69% of U.S. agency securities (yielding 2.04%), 15% was invested in government money market funds (yielding 2.34%), and less than 1% was invested in securitized mortgage backed securities (yielding 2.13%).

1Q19 Strategy: In terms of strategy, we will maintain a defensive stance and keep the portfolio duration position (2.20) below that of the benchmark (4.04). This strategy will include a cash balance to help us stay within our target duration in the 2-6-year range. We believe carrying a higher cash balance will provide greater flexibility to purchase higher yielding bonds in a rising-rate environment. We will continue to look for taxable municipal issues in a very cautious and selective manner.

Longer Strategy (12-months): Going forward, we will maintain a cautious and defensive strategy, which includes holding higher cash balances in the portfolio to offset price depreciation on our long bonds.

EFPMs – Hedging Accounts

Prices are tracking down in 4Q18. Diesel futures contracts have generated realized gains at quarter end of $885,297. With the bear market in oil prices beginning in Q418, we experienced $7,397,850 in unrealized losses. The current value of the diesel futures contract is $20.6 million as of December 31, 2018.

OPEB

4Q18 Results: Currently, the Council’s OPEB portfolio is invested in 60 percent equities, 40 percent U. S. Treasury securities and cash. At end of the fourth quarter, the OPEB portfolio and the Blended Index posted positive returns of (8.41%) and (7.45%), respectively. For the quarter, the portfolio had accumulated $25 million in unrealized losses and dividends from the portfolio paid $1.5 million providing a net unrealized loss of $23.5 million for the quarter.
As of the end of the quarter, $20.7 million in cash was sitting in the Money Market fund. Approximately $14.9 million in cash was brought back to the Council in August to cover 2018 OPEB costs.

**1Q19 Strategy:** We understand the OPEB portfolio is a long-term investment vehicle, similar to a pension fund, which will provide both positive and negative market movements over time. We feel over the long term, staying the course is a good strategy. With the rise in interest rates, investors will likely move away from fixed income products as the value of these securities will decline.

With the positive growth of the equities market, we have become fully funded in all three divisions with funding levels at or exceeding the 115% - 120% range. Since this fund is moving towards paying out rather than accumulation, the allocation mix between equities and fixed income has become more conservative and has hit the 60/40 allocation goal.

**Longer Strategy (12-months):** We will be migrated into an asset-liability management approach that allowed the Council to further reduce its investment risk exposure in equities in preparation of funding employee OPEB benefit distributions for divisions that have attained the full funding status in RA, ES and MT as described above.