METROPOLITAN
COUNCIL

Report on Investments – 4th Quarter 2023

Economic Review.

What recession? Could the recession not come at all, and the Fed pull off a "soft landing"? There are many who still expect it to happen in 2024 or 2025. But for now, the economy just keeps humming along with continued strong growth, inflation rate coming down, and the labor showing surprising strength in December and January.

The first reading on 4Q GDP came in unexpectedly high at 3.3%, easily beating the 2.00% consensus forecast. This followed a strong 3.9% growth rate in the 3Q. GDP for all of 2023 is currently estimated to be 3.1%, with the 2nd half being especially strong. Also, the Atlanta Fed is forecasting over 4% growth in the 1Q of 2024. Consumption again led this quarter, with GDP growth primarily coming from increases in consumer spending, government spending and exports. This strong growth has put a damper on recession fears as growth has been widespread across most categories.

After increasing short-term interest rates 11 times between March 2022 and July 2023 to tame inflation, the Federal Reserve (Fed) has stopped hiking rates. Their last rate hike was July 2023. Inflation has come down from over 9.0% in mid-2022 to 3.4% at the end of 4Q23. This is almost at the Fed's goal of sustained 2.00% inflation. Another inflation indicator, the favorite of the Fed, the PCE Core Deflator, finished 2023 even lower at 2.9%. But, even though the pace of prices increases has slowed, prices are still higher than pre-pandemic levels putting pressure on many consumers budgets.

The labor market is still strong with low unemployment and higher wages. But job switching is not as easy as it was a year or two ago. The unemployment rate held very steady during the quarter around 3.70%, despite large strikes and tech industry layoffs. Job growth was steady as well. Hiring in the government, healthcare and leisure & hospitality industries continued to drive employment growth. December and January saw large numbers of jobs added. December payrolls rose by 333,000 and January saw 353,000, compared to under 200K in October and November. Throughout 2023, employment increased at an average of 255K per month, which marks a deceleration from 2022. Service jobs led the way in adding the most jobs.

The S&P 500 regained its winning ways in the fourth quarter, ripping higher by 11.7% to close at 4,769, just 1% below its all-time closing high reached in January 2022. The S&P 500 advanced a healthy 26.3% for the year 2023, a welcome reversal of the steep losses in 2022.

So, the economy keeps humming along despite all the Fed's rate hikes. So why is the Fed now saying they are done hiking and may even start decreasing interest rates? The Fed doesn't need to fight inflation any longer, they have mostly reached their 2.00% inflation goal. The Fed will most likely pause for several months to see how inflation and job markets perform, hoping that inflation just keeps doing what it's doing, coming down slowly. The Fed wants to keep the strong economy and strong labor markets. Many market experts are now predicting first rate cuts will be summer 2024, or after the Presidential election. Any rate cuts will be slow and deliberate. As long as the economy stays strong, there is really no reason to start cutting rates. It is even possible a continued strong economy could even cause inflation to increase. Those forecasters predicting a recession believe the higher rate environment will put pressure of corporate earnings leading to more layoffs, and the higher prices will put more hurt on consumers, both slowing growth. Also, as inflation comes down, real interest rates will increase, essentially causing further tightening. The Fed's next meeting is March 20.

Investment Results & Strategy

Short-term Portfolio. The Short-term portfolio invests available short-term cash around the Council's cash-flow. The portfolio outperformed for the quarter with a total return of 1.35%, compared to 1.29% for the portfolio's benchmark. The average yield of portfolio holdings increased to 5.45% during the quarter, up from 5.35% in the third quarter. Portfolio earnings rose to $17.6 million for the quarter, up from $15.2 million in the third quarter. The $1.3 billion portfolio was invested in U.S. Treasury Bills ($544 million, 42%), U.S. Government Agency Discount Notes ($494 million, 39%), and government money market funds ($247 million, 19%). Portfolio investments range from 0 to 5 months in length.

Strategy. Investment maturities align with large cash outflows such as capital expenditures, payroll, and debt service. The portfolio is diversified among high quality short-term securities permissible under MN. Statutes Chapter 118A. Allocation to U.S. Treasury Bills and U.S. Government Discount Notes increased during the quarter to increase duration and lock-in yields for a longer period because the Federal Reserve is expected to decrease short-term interest rates in mid-2024.

Long-term Portfolio. The Long-term portfolio invests the Council's longer-term reserves. Portfolio average yield and interest income increased during the quarter, but the portfolio underperformed on a total return basis, with a total return of 2.60% vs 3.90% for the portfolio's benchmark. The portfolio underperformed on a total return basis due to its short duration versus the benchmark, therefore not realizing as much price appreciation on paper when interest rates decreased during the quarter. Average yield increased to 1.73% from 1.39% in the third quarter, and interest income was $1.88 million vs. $1.46 million for the third quarter. The $473 million portfolio was invested in U.S. Government Agency securities ($264 million, 56%), U.S. Treasury Notes ($110 million, 23%), taxable municipal bonds ($49 million, 10%), government money funds ($41 million, 9%), Certificates of Deposit ($9 million, 2%) and a very small amount of mortgage-backed securities. The duration of the portfolio remains short of the benchmark, 1.37 years vs 3.35 years.

Strategy. There has been only a small amount of activity in the portfolio over the past few quarters due to a lack of maturing investments. That will change in January when reinvestment opportunities allow for yield pick-up and duration extension. The Council has also begun to reinvest in Certificates of Deposit (CD) with local community banks. The Council's CD program had been inactive since the 'banking crisis' of spring 2023. The CD Program reached its investment goal of $20-25 million in January 2024.

OPEB Trust. The OPEB Trust contains assets set aside to fund future OPEB liabilities, which stretch 30+ years into the future. The trust had a total return of 8.4% for the quarter, which underperformed the benchmark return of 9.7%. Quarterly underperformance occurred in the fixed income allocation, as fixed income securities held in the allocation had a shorter duration than the benchmark and therefore realized less market price appreciation as interest rates decreased during the quarter. For the year 2023, the trust total return was 17.95%, which slightly outperformed the benchmark total return of 17.69%. The market value of the Trust increased from $318.8.9 million to $330.9 million during the quarter. At year end, trust investments were allocated 64% to the S&P 500 pool, 36% to US Treasury and Government Agency securities, and <1%% to the cash pool.

Strategy. Trust assets are managed by the Minnesota State Board of Investment but allocated at the Council's direction. The trust uses the S&P 500 index pool to realize the historically higher average returns of the equity markets over the long term. Trust returns have averaged 10.9% over the past 5 years and 9.6% over the past 10 years. These solid returns have resulted in projected future OPEB liabilities being currently fully funded. OPEB liability funding levels and trust investment allocations are monitored monthly. Periodic adjustments are made to trust investments to remain near the allocation target of 60/40 equity-to-fixed income/cash. The Council also withdraws funds from the trust annually to fund OPEB benefits.

Fuel Hedging. Hedging is used to smooth diesel fuel price volatility and bring budget certainty to Transit. Futures contracts are purchased based on diesel consumption forecasts for bus and Northstar commuter rail. Futures contracts are purchased for a term of 23 months. Futures contracts are sold, before execution, resulting in realized gains/losses. State statute dictates hedging cannot exceed forecasted fuel consumption and Council policy further restricts hedging to a maximum of 90% of forecasted fuel consumption. The Council's fuel hedge was compliant with both statute and policy for all of 2023.

Realized gains on futures contracts for the quarter were $1,063,104, compared to $682,189 for the prior quarter. The Council held $21.6 million market value of futures contracts at the end of 4Q23, compared to $21.3 million at the end of 3Q23. The fuel cost budgeted for 2023 was $14.33 million, and the actual cost of fuel purchased was $14.28 million. Hedging realized gains were $5.2 million in 2023, resulting in a 2023 fuel cost after hedging of $9.1 million.