METROPOLITAN COUNCIL

Report on Investments – 4th Quarter 2024

Economic Review. Financial markets had plenty to talk about in the 4Q. For starters, the election and deciphering potential new Federal policies, and Federal Reserve (Fed) rate cuts and a dramatic shift in fixed income yields. Gross Domestic Product (GDP) slowed slightly in 4Q but was still decent at +2.3%. It was again propped up by surprisingly strong consumer spending. 2024 full year growth was 2.8%, very similar to 2023's full year growth of 2.9%. For more context, the economy grew at an average of 2.4% during the 2010-2019 expansion. Inflation moved slightly higher late in the quarter but has mostly stalled and has been mostly moving sideways. Both the Consumer Price Index (CPI) and the Fed's favorite inflation measure, the Core Personal Consumption Expenditures Index (Core PCE) remain above the Fed's 2.00% target. Labor markets appear stable, easing recent concerns it would deteriorate. Job growth was strong in November and December, reversing a slow summer. The new administration is expected to be business-friendly and positive for job growth, but deportations could be an offset. The unemployment rate ended 2024 at 4.1%. The S&P 500 had its first back-to-back 20%+ years in the last 25 years. The S&P 500 rose 24% in 2023 and 23% in 2024.

Fixed income yields shifted dramatically in 4Q. The Fed began cutting short-term interest rates on September 18, cutting rates by .50%. They then cut rates two more times in the 4Q, .25% in November and .25% in December. These cuts brought the target overnight rate down 1.00%, bringing the short-end of the yield curve down from 5.25-5.50% to 4.25-4.50%. At the same time, longer-term yields climbed on expectations of higher growth and possibly higher inflation. The election and resulting policy changes shifted growth and inflation expectations higher, a recipe for higher yields and higher stock prices. Longer-term yields jumped during the 4Q.

The new year started off volatile. President Trump kicked off his second term with a high number of executive orders and threats of tariffs, which caused a great deal of uncertainty. The financial markets had trouble deciphering what ideas would turn into actual policy and which were speculative headlines. For sure change was happening and markets were nervous. The change in growth and inflation expectations, along with stalled inflation progress, caused the Fed to pause their rate cuts, with no cut at their January meeting leaving overnight interest rates unchanged at 4.25-4.50%. At the beginning of the 4Q the markets were expecting 4-5 rate cuts in 2025, but at the end of the 4Q expectations were down to two 2025 cuts. The markets are predicting the Fed will cut once in 3Q and once in 4Q. The Fed is in no rush to cut with inflation progress stalled, new Federal policies yet to take shape, and economic data has been suggesting the economy is in good shape.

Investment Results & Strategy

Short-term Portfolio. The Short-term portfolio invests available short-term cash around the Council's cash-flow. The portfolio invests in securities permissible under MN. Statutes Chapter 118A and in compliance with the Council's Investment Policy. The portfolio's total return for 4Q was 1.21%, compared to 1.23% for the portfolio's benchmark. The average annual yield of portfolio holdings decreased to 4.60% in 4Q, compared to 5.04% in 3Q. This reduction was due to the Federal Reserve cutting short-term interest rates by 1.00% between late September and the end of the year. Portfolio earnings for 4Q decreased to $17.1 million, compared to $18.7 million in 3Q. Portfolio earnings for the year 2024 were $69.3 million, up from $55.5 million for 2023. To end 4Q, the $1.43 billion portfolio was invested in U.S. Treasury Bills ($417 million, 29%), U.S. Government Agency Discount Notes ($328 million, 23%), and government money market funds ($685 million, 48%). Portfolio investments range in maturity length from 0 to 5 months.

Strategy. The portfolio was held very liquid in 4Q, with a large balance in daily liquid money funds, which had the highest yields among short-term securities used by the Council. There was no yield incentive to reduce liquidity and invest longer. The yield curve started the quarter inverted, even on very short maturities. But things changed on September 18, when the Fed began cutting short-term interest rates. Very short-term yields have decreased 1.00% and the curve is no longer inverted. If Fed rate cuts continue other securities may eventually offer higher yields than money funds providing an incentive to invest 3 to 6 months to pick up yield, this will also depend on Council cash flow. Overall, short-term rates are now lower, which will decrease earnings in the future.

Long-term Portfolio. This portfolio invests the Council's longer-term reserves. Average yield and interest income continue to increase as lower yielding investments mature and funds are re-invested at higher yields. Average yield increased from 1.79% to 2.48% during 2024. 4Q interest income was $2.9 million, compared to $2.7 million in 3Q. The portfolio outperformed its benchmark for the quarter, with a total return of .30% vs -1.21% for its benchmark. The $483 million portfolio was invested very similar to the previous quarter holding U.S. Government Agency securities ($246 million, 51%), U.S. Treasury Notes ($113 million, 23%), taxable municipal bonds ($49 million, 10%), government money funds ($51 million, 11%), Certificates of Deposit ($24 million, 5%) and a small amount of mortgage-backed securities. Duration decreased slightly remaining short of the benchmark, 1.31 years vs 3.43 years.

Strategy. There was more activity in this portfolio than we had seen for quite some time. $57 million of investments matured or were called, and $26 million of new investments were made. Four 5-year callable US Government Agency bonds with limited optionality were purchased. There will be additional purchases made in 1Q25 to invest available cash and to increase duration and yield.

OPEB Trust. The OPEB Trust contains assets set aside to fund future OPEB liabilities, which stretch 30+ years into the future. Trust assets are held at a third-party custodian, managed by the Minnesota State Board of Investment, and allocated at the Council's direction. The trust had a total return of 1.29% for the 4Q, which outperformed its benchmark return of .22%. Overperformance occurred in the fixed income portion of the portfolio. The Trust's fixed income holdings consist of US Treasury and Agency bonds which are much shorter in length than the fixed income benchmark, therefore realizing smaller market value losses versus the index as intermediate and longer-term interest rates increased. The trust's fixed-income allocation lost -.80%, while the fixed income portion of the benchmark lost -3.06%. The equity portion of the trust had a decent 4Q, gaining 2.41%, essentially matching the return of the S&P Index. The market value of the Trust decreased $7.5 million during 4Q, going from $380.9 million to $373.4 million. The decrease was a combination of $7.5 million of market gains offset by the Council's annual OPEB expense reimbursement withdrawal of $12.5 million. Trust investments were allocated approximately 64% to the S&P 500 pool, 33% to US Treasury and Government Agency securities, and 3% to the cash pool.

Strategy. The trust uses the S&P 500 index pool to realize the historically higher average returns of the equity markets over the long term. OPEB liability funding levels and trust investment allocations are monitored monthly, and periodic adjustments are made to maintain the portfolio near the allocation target of 60/40 equity-to-fixed income/cash. The Trust returned 16.64% for the year 2024 and has averaged returns of 9.97% over the past 5 years and 9.92% over the past 10 years. Projected future OPEB liabilities are currently fully funded. The Council 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 fuel costs. Diesel Futures contracts are purchased based on fuel consumption forecasts for bus and Northstar commuter rail. Futures contracts are purchased for a term of 23 months and are sold one month before execution, resulting in realized gains or losses. Statute states the amount of fuel hedged cannot exceed forecasted fuel consumption, and Council policy further restricts hedging to 90% of forecasted consumption. The Council's hedge is compliant with both statute and policy.

The Council held $20.3 million market value of futures contracts at the end of 4Q, compared to $19.8 million at the end of 3Q. Realized losses on futures contracts sold during the quarter were ($490,417). The loss was due to a drop in market fuel prices pushing futures prices lower. 4Q YTD budgeted fuel cost was $18.6 million, versus the actual cost of fuel purchased of $12.2 million. Including the YTD hedging realized loss of ($1.2) million, the net YTD fuel cost after hedging was $13.4 million. 4Q YTD net fuel cost was under budget by $5.2 million.