Investment Review Committee

IRC Administrative Coordinator: Mark Thompson (651)-602-1629

Agenda – May 11, 2021

1. Call to Order
2. Approval of Agenda
3. Approval of Minutes from last meeting — February 9, 2021 (4Q20)
4. Introduction of new committee Chair
5. Update - Certificate of Deposit Program
6. Investment Presentation - 1st Quarter 2021
7. Investment information on website
8. Investment policy update
9. IRC closed meetings

Committee members:
Judy Johnson, *Council member and Committee Chair*
Chris Ferguson, *Council member and Committee Vice Chair*
Phillip Sterner, *Council member*
Marie Henderson, *Acting CFO*
Cory Kampf, *Appointee*
Michael Solomon, *Appointee*

Reference staff: *(not members of IRC)*
Mark Thompson, *Senior Manager, Treasury*
Lori Connery, *Recording Secretary*

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Minutes

February 9, 2021 (4Q20) at 1:03 P.M., in WebEx Virtual

Present

Committee members: Phillip Sterner, Committee Chair & Council Member; Christopher Ferguson, Council Member; Marie Henderson, Acting CFO; Cory Kampf, CFO, Finance and Central Services Division Manager – Anoka County; Michael Solomon, City Treasurer, City of Saint Paul

Reference staff: Mark Thompson, Senior Manager, Treasury; Lori Connery, Recording Secretary

Other attendees; Jacob LaVigne, Financial Analyst; Lynn Greiner, Financial Analyst

Absent:

Call to Order

A quorum being present, Committee Vice Chair Christopher Ferguson called the quarterly meeting (3Q20) of the Investment Review Committee to order at 1:03 p.m. on Tuesday, November 10, 2020.

Motion carried on the following roll call vote:

Aye:	5	Henderson, Kampf, Solomon, Sterner
Nay:	0	
Absent:	0	Ferguson

Approval of Agenda and Minutes

There were no changes to the agenda.

It was moved by Ferguson and seconded by Kampf to approve the Tuesday, August 18, 2020 minutes (2Q20) as submitted.

Motion carried on the following roll call vote:

Aye:	5	Henderson, Kampf, Solomon, Sterner
Nay:	0	
Absent:	0	Ferguson

Topics Discussed

- **Certificate of Deposit (CD) Pilot Update: (M. Thompson)**
  - Mark presented the update.
  - Discussion on how the program is doing in the current environment, what we have done to solicit, next steps and CD rates.

- **Financial Institutions List: (M. Thompson)**
  - Mark reviewed the Financial Institutions list; there were no comments or discussion.

- **4Q20 Investment Results Presentation: (M. Thompson)**

  4Q20 Investment Committee Presenta

  - Mark went through report presentation.
  - Discussion on how to move back to 60/40 on the OPEB program.

For further questions, please contact Mark Thompson directly at: 651-602-1629.

The next meeting is scheduled on Tuesday May 11, 2021 at 2:00 PM-3:00 PM, via WebEx.

Business completed; the meeting adjourned at 1:52 p.m.

Respectfully submitted,
Lori Connery
Recording Secretary

Report on Investments

First Quarter, 2021

Economic Review

1Q21. Vaccines and Stimulus. There was plenty of economic optimism is the first quarter, coming mostly from increased vaccinations, more stimulus from the Federal government, and the Federal Reserve (Fed) continuing to stimulate activity by keeping interest rates low. Vaccines rose from 270,000 per day in late December to 2,750,000 per day by late March. With more than 2 million people getting vaccinated daily, economic expectations rose quickly. A second round of stimulus money was distributed to taxpayers in March, and the Fed reiterated they will continue to stimulate the economy by keeping interest rates low until full employment is reached, which could take years, and until inflation is sustained at 2% for some time. March economic data underscored the first quarter's strength. Retail sales rose 9.8%, manufacturing production rose 2.7% and production levels hit a 37-year high, and housing starts soared 19.4% to their highest since 2006. Also, consumers have a stockpile of cash, $4 trillion, as savings rates increased dramatically during the pandemic and from stimulus. If vaccines result in low enough COVID numbers to allow the service and travel sectors to fully open, the economy will remain robust for the next few quarters.

But, while many parts of the economy are strong, some parts continued to struggle during the first quarter. Employment is improving each month, but the services sector reopening is slow as companies are struggling to find workers for lower paying positions and there are 17.6 million people still collecting unemployment. For perspective, during the 2009 financial crisis, unemployment beneficiaries peaked near 7 million. Also, the pandemic has shifted spending away from services toward goods, reflecting the environment where people are forced to stay home more and have limits on the services they can consume. The strong demand for goods is straining COVID-constrained supply chains causing delivery delays and higher prices, especially for commodities such as oil and lumber, stoking fears of inflation. Although most economists, and the Fed, believe that an inflation spike will be transitory.

<u>GDP</u>
GDP rose 6.4% for the first quarter, a little less than expected but up from 4.0% in the fourth quarter 2020. A recent Bloomberg survey of economists showed most are predicting GDP will be in the 7.00-8.00% range for the second and third quarters and decline slightly to 5.00% in the fourth quarter. Long-term trend is +2% annually.

<u>Employment</u>
March employment numbers were very strong, U.S. employers added the most jobs in seven months. Over 1 million jobs were filled. The labor markets still have a long way to go as millions are on still unemployment. The strong March numbers reflect more vaccinations and fewer COVID restrictions. Private service producing industries added 597,000 jobs, which is good news for the struggling sector. The unemployment rate fell from 6.25 to 6.0%. At the same time as millions are unemployed, the service and travel sectors are having trouble finding workers as they reopen. Hopefully this imbalance corrects as the reopening progresses.

Inflation

Inflation expectations increased during the 1st quarter. The Consumer Price Index (CPI) rose 0.6% in March — the most since a 0.8% rise in 2009 — for a 2.6% year-over-year gain. The core CPI (excluding food and energy) rose 0.3% on the month for a 1.6% yearly increase. These increases follow three months of subdued core inflation. The reopening of the US economy, while much of the world is unable to reopen due to COVID, is contributing to bottlenecks that are causing prices to rise in the US. Strong demand on the demand side and bottlenecks on the supply side. The Fed and most economists believe this spike in inflation will be transitory over the few quarters as the reopening progresses.

Interest Rates

During the first quarter the Fed kept short-term interest rates pegged at near zero and intermediate interest rates increased because of expectations for the economy to heat up and on inflation fears. Interest rates two years and shorter stayed relatively the same (near zero) and rates longer than two years increased. Expectations are the Fed will keep short interest rates near zero into 2022. The U.S. Treasury yield curve continued to steepen 2 years and longer on expectations of strong economic performance as the economy reopens and inflation pressures.

Equity Markets

Optimism over US stimulus, the vaccine rollout, strong earnings reports, and expectations for a strong recovery kept the S&P 500 moving up. The S&P 500 finished up 5.8% for the quarter. It's fourth straight quarterly gain. Tech stocks provided much of the gains for the quarter, while financials and energy stocks pulled back.

Present. The markets have focused on vaccines and recovery prospects in recent quarters, and now we can add inflation. The Fed remains very accommodative and plans to keep short-term rates near zero until full employment is reached and inflation maintains 2% for a period of time. Expectations are short rates will stay near zero into 2022. Intermediate and longer-term interest rates have increased the past two quarters on vaccine progress and the expectation of a strong reopening economy and inflation pressures. Corporate earnings mostly beat expectations recently and the housing market has been very strong stoked by low interest rates. The economy is generally very strong, but we continue to wait and see how fast the service sector can open and more people can get back to work.

Future. COVID numbers and the strength and speed of the reopening will dictate the markets for the remainder of 2021 and into 2022. The Fed is on hold and is expected to keep short-term rates very low at least into 2022.

Council Impact. The Council's short-term portfolio is directly impacted by the Fed maintaining short-term rates near zero. Low short interest rates directly affect portfolio earnings. The Council's long-term portfolio has and will continue to selectively take advantage of the increase in intermediate yields. The long-term portfolio has experienced price depreciation on its holdings as intermediate-term interest rates increased, but we have been capturing higher yields on new investments. Because the Council is a buy and hold investor price depreciation is on paper only. To minimize price loss and avoid locking in low rates for a long term, we have maintained duration slightly shorter than the benchmark. The strong performance of the equity markets has greatly benefitted the OPEB Trust.

Investment Results & Strategy

MCOA—Short-Term

1Q21 Results: The Short-term portfolio outperformed its benchmark during the first quarter with a total return of 0.013%, compared to its benchmark, the Crane Government Money Fund index, total return of 0.0005%. The portfolio has outperformed its benchmark by an average of 17 bps annually over the past 10 years. At the end of the first quarter, the $704.9 million portfolio was invested in U.S. Treasury Bills (47%), government money market funds (32%), U.S. Government Agency Discount Notes (21%) and a municipal bond (.5%). Investments are generally 0-9 months in length and the portfolio has a duration of .15 years, which is slightly longer than its benchmark duration of .12 years. The average yield of the portfolio has dropped steadily over the past 12 months and is now at .05%, the same as the previous two quarters.

2Q21 Strategy: Earnings in this portfolio will continue to be hurt by the extremely low short-term interest rate environment. We expect this to continue for the remainder of 2021. The portfolio will continue to be managed to provide the liquidity needed for Council cash flows, investments often match large cash flow needs such as capital expenditures, payroll, and debt service. The Council follows MN. Statutes Chapter 118A and diversifies this portfolio using high quality short-term securities such as U.S Treasury Bills, U.S. Government Agency Discount Notes, government money market funds, taxable municipal bonds and possibly the highest rated Commercial Paper.

Longer Strategy: The portfolio will continue to be managed to meet cash flow needs and invested in high quality statute eligible securities with maturities generally less than 1 year. We will continue to monitor the short-term interest rate environment and economic expectations. The Federal Reserve (Fed) sets short-term interest rates and their current target rate is 0-.25%. The Fed has stated they will maintain their very accommodative monetary policy until the labor market has reached maximum employment and inflation exceeds 2% for some time. Even though most the financial markets have high expectations for a strong reopening of the economy, it is generally expected that the Federal Reserve's employment and inflation goals will not be met in 2021. We will continue to monitor and compare available security types looking to maximize yield.

MCOA—Long-Term

1Q21 Results: The Long-term portfolio also outperformed its benchmark for the first quarter. Portfolio total return was -.548%, versus the benchmark BAML Agency Master index return of -1.769%. Negative returns were the result of interest rates increasing and causing price depreciation. These price decreases are on paper only for the Council. The duration of the portfolio was extended slightly during the quarter to take advantage of the increase in yields and a steepening yield curve in the 3-7 year area. Duration at the end of the quarter was 1.99 years compared to 1.53 years last quarter. The benchmark has a duration of 4.09 years, so the Long-term portfolio has a defensive position against rising interest rates. This shorter duration benefited the performance of the portfolio relative to its benchmark as yields increased and the curve steepened. At the end of the quarter, the $471.9 million long-term portfolio was invested in U.S. Government Agency securities (78%), municipal bonds (9%), U.S. Treasury Notes (6%), government money market funds (3%), Certificate of Deposits with local community banks (3%), and less than 1% in mortgage backed securities.

2Q21 Strategy: Short-term yields continue to be anchored at zero by the Fed, but yields in the 3-7 year area increased during the first quarter. This part of the curve provides the best opportunity to increase portfolio yields and will continue to be the focus. Some of the highest yielding securities available to the Council in this part of the curve are U.S. Treasuries and taxable municipal bonds. The Council also has capacity to add investments in the CD program. This means purchasing more Certificates of Deposits with qualifying community banks and credit unions that have a successful track record of supporting minority and female owned small businesses, affordable housing, and community development.

Longer Strategy: Over the course of 2021 we will continue to watch the progress of the expected post COVID-19 economic recovery and the market expectations for changes to interest rates. We will look to take advantage of any yield curve steepening and/or a rise in interest rates to help increase the earnings of this portfolio. We will also look to achieve and maintain full allocation in the CD program.

EFPMs – Hedging Accounts

1Q21 Results: Fuel prices have begun to regain some of their losses, which resulted in the net realized loss on diesel futures contracts at quarter end to be just over half of the loss at the end of last quarter ($747,314 quarterly net realized loss in 1Q21 compared to $1,259,811 net realized loss in 4Q20). Unrealized gains were nearly identical at $3,151,612. The current value of the diesel futures contract is $21.3 million as of March 31, 2021.

OPEB

1Q21 Results: The OPEB Trust outperformed its index during the first quarter. The OPEB Trust returned 4.62% versus 2.35% for the trust's Equity/Bond blended index. The value of the OPEB Trust increased from $315.8 to $330.4 million, an increase of $14.6 million. The OPEB Trust is managed by the State Board of Investment and is invested 63% in an S&P 500 index equity pool, 33% in U.S. Treasury and Agency securities, and 4% in a money market pool.

2Q21 Strategy: The OPEB Trust portfolio contains assets set aside to fund future OPEB liabilities and has a long-term investment horizon. The trust uses equity markets exposure to realize the higher historical average returns available in the equity markets over the long run. This may also increase volatility and the trust may experience positive and negative movements. We experienced this in 2020 with the historic volatility in the equity markets caused by the economic effects of the COVID-19 pandemic, which have since recovered. With the Council's future OPEB liabilities in a strong funding position, the trust has a targeted allocation of 60% equities and 40% fixed income/cash. Occasionally adjustments are made to maintain this allocation.

Longer Strategy: The Council is moving to an asset-liability management approach which may mean further reducing the investment risk of equities and using trust assets to fund employee OPEB benefit distributions.