



# City of Colorado Springs Review of Investment Performance

Quarter-ended June 30, 2018

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PFM Asset Management LLC

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# **Economic and Market Update**

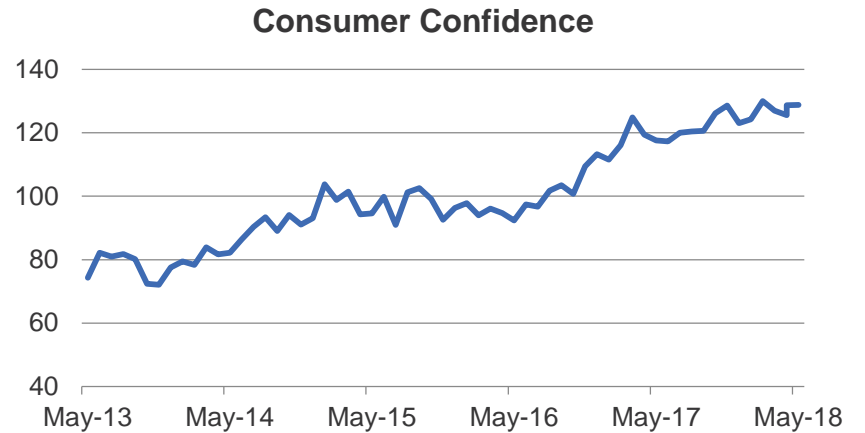
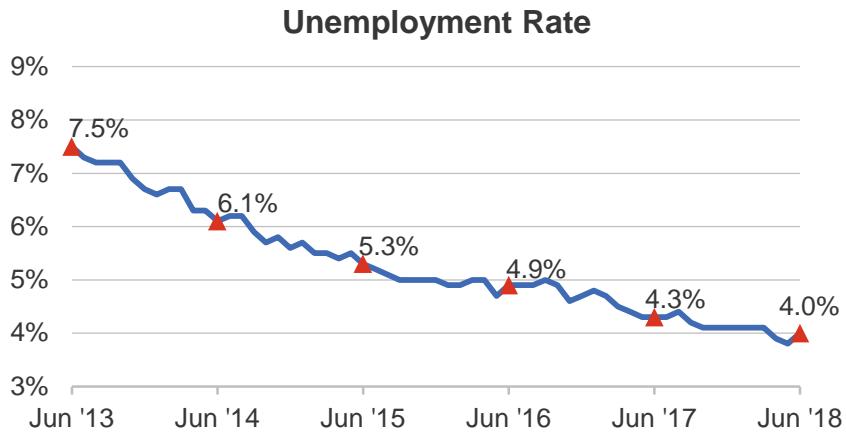
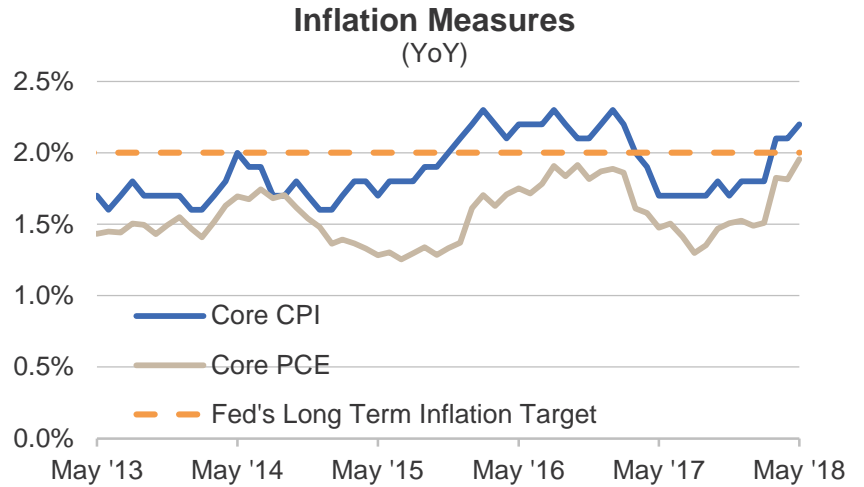
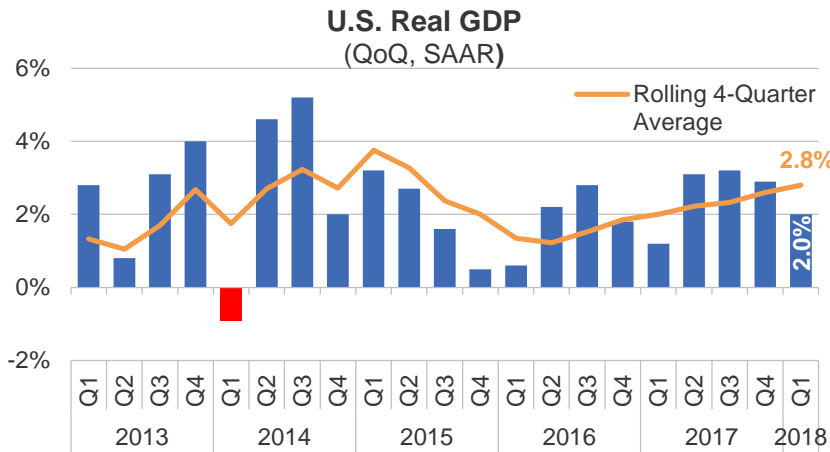
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## Current Market Themes

- U.S. economic conditions are characterized by:
  - A strong labor market with unemployment at 4.0%
  - Strong corporate profits driven in part by savings from tax cuts
  - Continued optimistic business outlook, with key indicators pointing to strong industrial and services output in the second quarter
  - Core inflation reached the Fed's long-run target of 2% for the first time in six years
- The Treasury yield curve flattened further in June as the 10-year yield was unchanged over the month, but shorter-term yields rose.
- The Fed raised the target range for the federal funds rate  $\frac{1}{4}$  percent at its June 13 meeting to 1.75% - 2.00%.
  - The median forecast for number of total rate hikes in 2018 was upgraded to 4
- S&P 500 index was up 0.5% in June, and up 1.7% for the year
  - The European Union, Canada, and India began implementing tariffs on U.S. imports, in retaliation for the steel and aluminum tariffs that went into effect earlier in June. Several corporations cited concerns about tariffs in relation to growth and sales going forward.
- Global political risks remain in the forefront as the Trump administration initiates controversial tariff programs that could trigger a trade war, the Eurozone grapples with migration problems, and denuclearization in North Korea remains unclear.

# Current Economic Conditions



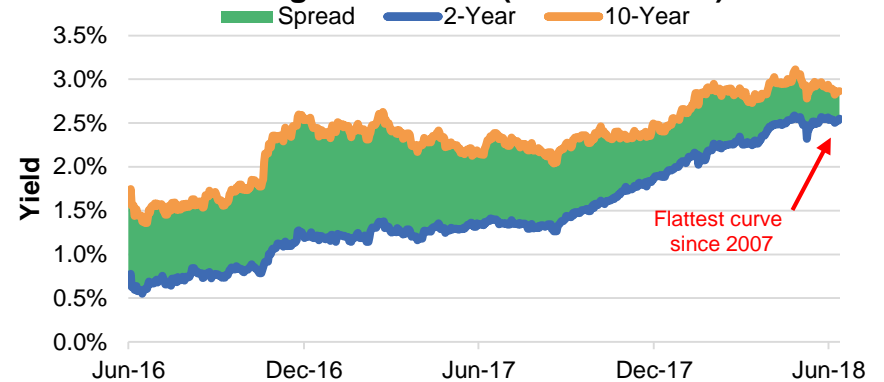
Source: Bloomberg, data available as of 6/30/18. SAAR is seasonally adjusted annualized rate.

## What We're Watching...

### 1-5 Year Corporate Spreads



### Flattening Yield Curve (10-Yr vs. 2-Yr)



### 2Q GDP Expectations

Source	Forecast
Goldman Sachs	3.7%
Barclays	3.5%
New York Fed	2.8%
Atlanta Fed	4.1%

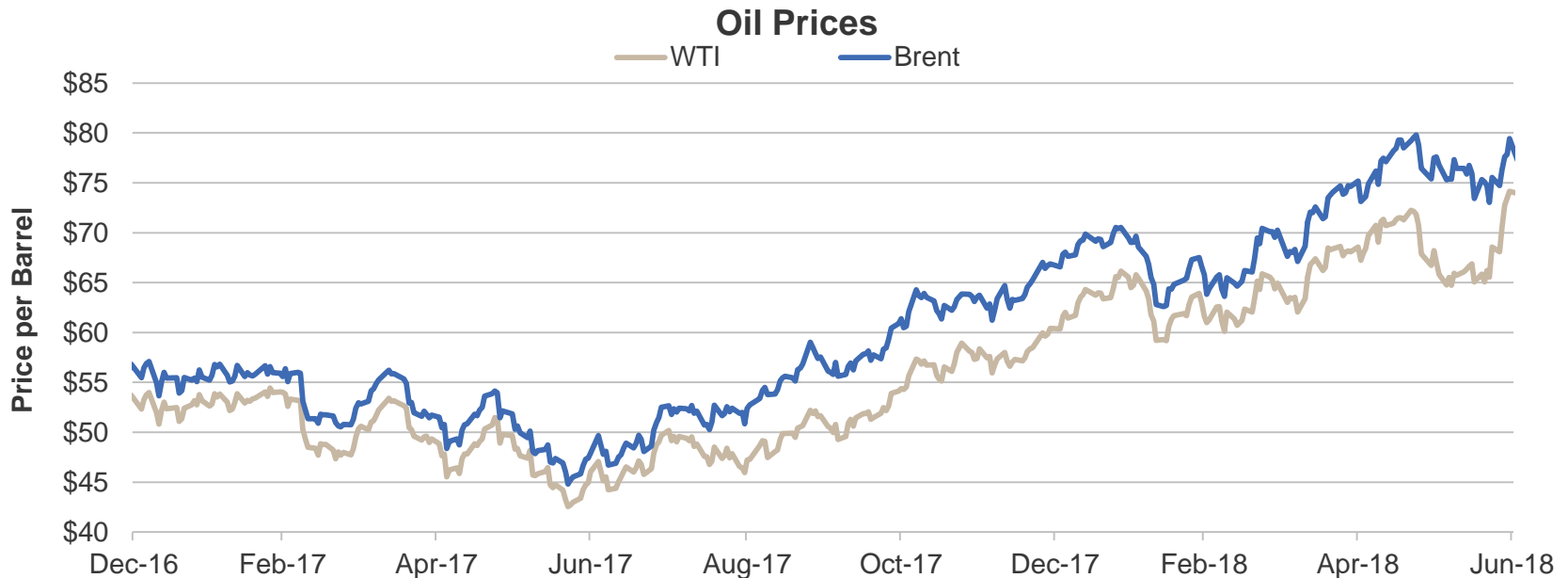
### Economic Indicators are Strong

Metrics At or Near Multi-Year Bests	
U.S. GDP	Unemployment Rate
Global Growth	Job Openings
Consumer Confidence	Corporate Profits
Home Prices	Inflation

Source: Bloomberg, ICE BofAML Indices, as of 6/30/18.

## OPEC Signals Supply Boost Post-Iran Sanctions

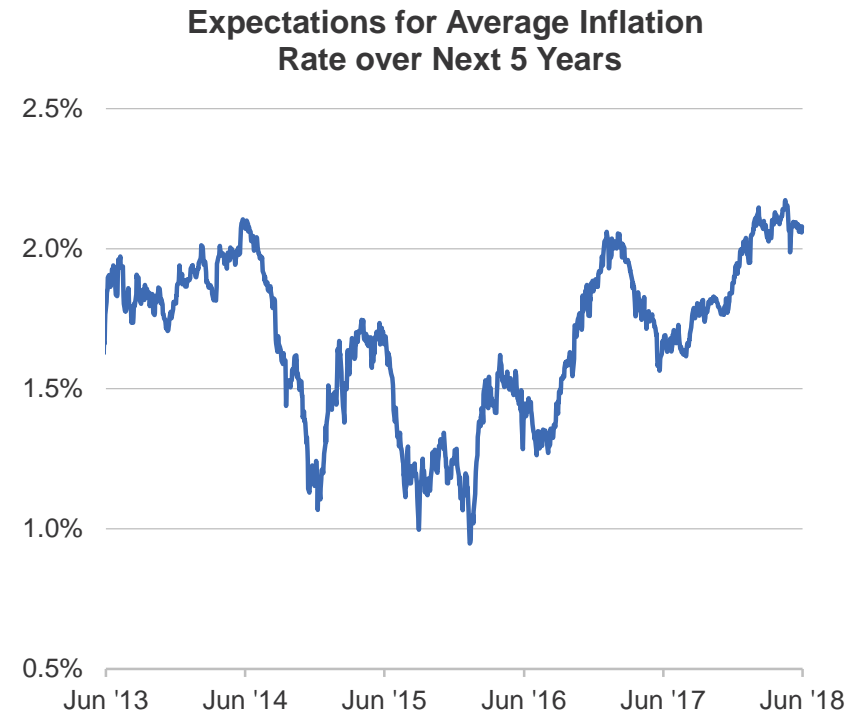
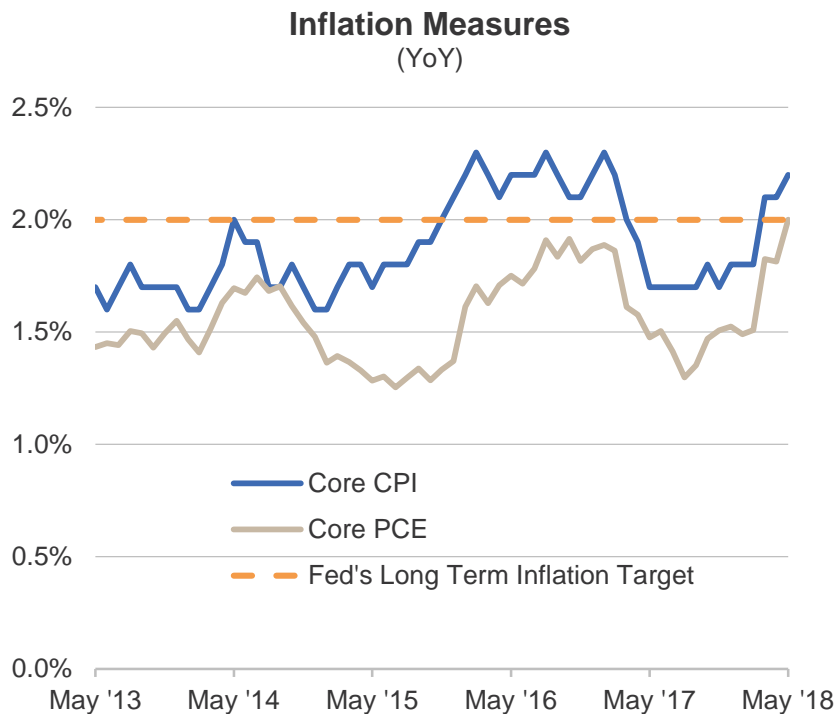
- OPEC and its non-OPEC allies met in Vienna in late June, and agreed to gradually increase production levels during the rest of 2018. However, details were murky, with some member countries identified as currently unable to increase production at all, and the real effect in barrels on the market left unclear.
- U.S. administration officials have stated that they expect U.S. allies to stop importing Iranian crude as soon as this November, putting pressure on OPEC to make up for that loss of supply in the market. Oil prices have continued to climb, with West Texas Intermediate trading near \$75/barrel.



Source: Bloomberg, as of 6/30/2018.

## Inflation Hit Fed's 2% Target for the First Time in Six Years in May

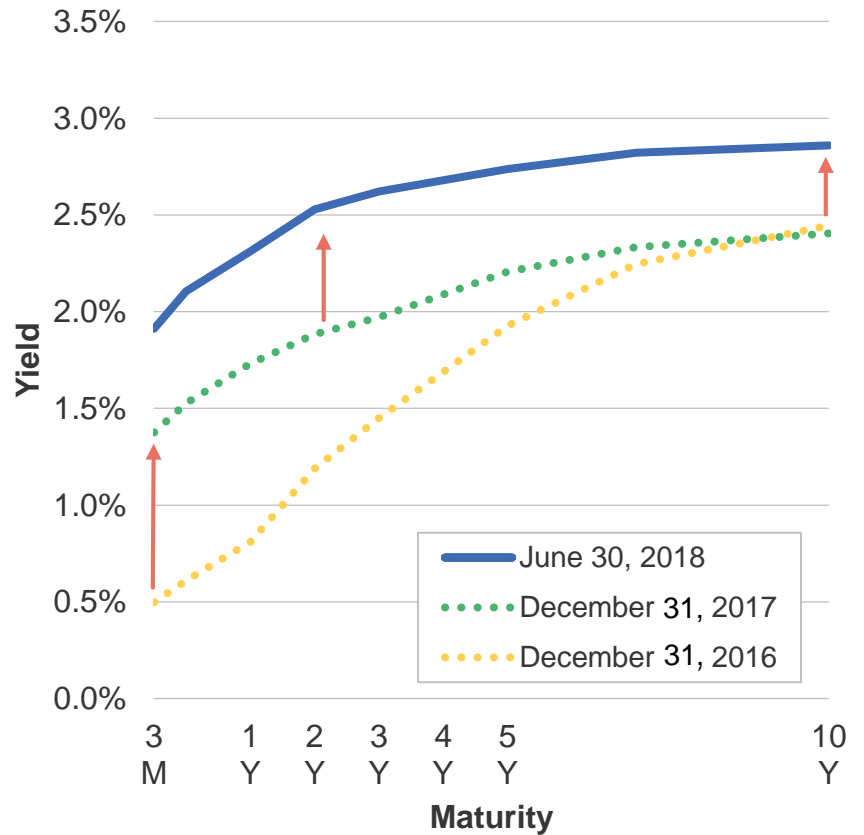
- The core personal consumption expenditures (PCE) price index, the Fed's preferred measure of inflation, rose to 2.0% year-over-year in May
- Forward-looking inflation expectations remain anchored around the 2% level



Source: Bloomberg, latest data available as of June 2018. Inflation expectations based on yield difference between 5-year Treasury note and 5-year Treasury Inflation Protected Securities (TIPS).

## U.S. Treasury Yield Curve

	Current 6/30/18	Year-End 12/31/17	Year-End 12/31/16
3 month	1.91%	1.38%	0.50%
6 month	2.10%	1.53%	0.61%
1 year	2.31%	1.73%	0.81%
2 year	2.53%	1.88%	1.19%
3 year	2.62%	1.97%	1.45%
5 year	2.74%	2.21%	1.93%
10 year	2.86%	2.41%	2.44%



Source: Bloomberg, as of 6/30/2018.



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## Yield Environment as of June 30, 2018

Maturity	Treasury	Federal Agency	AA Corporate	A Corporate
3-Month	1.91%	1.93%	2.10%	2.23%
6-Month	2.10%	1.95%	2.30%	2.43%
1-Year	2.31%	2.12%	2.57%	2.76%
2-Year	2.53%	2.54%	2.86%	3.04%
3-Year	2.62%	2.68%	3.03%	3.22%
5-Year	2.74%	2.83%	3.28%	3.45%
10-Year	2.86%	3.06%	3.74%	3.91%

Source: Bloomberg BVAL yield curves for Treasury and Corporate. TradeWeb for Federal Agency yields. 3 and 6 month corporate yields from commercial paper; A-1+ for AA and A-1 for A. Yields are for indicative purposes only; actual yields may vary by issue.

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## FOMC Statement Highlights

June

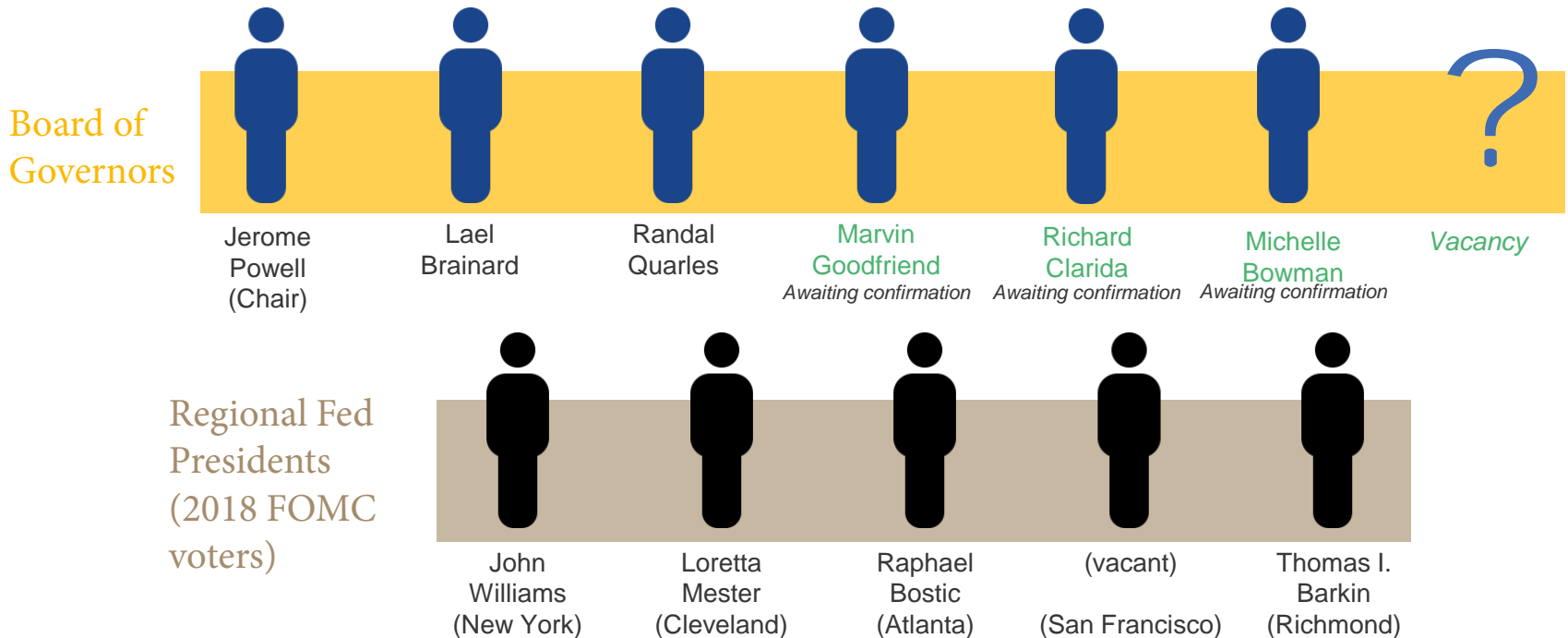
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- Information received since the FOMC met in May indicates that the labor market has continued to strengthen and that **economic activity has been rising at a solid rate**. Job gains have been strong in recent months, and the unemployment rate has **declined**. Recent data suggest that growth of household spending **has picked up**, and business fixed investment **has** continued to grow strongly.
  - In view of realized and expected labor market conditions and inflation, the Committee decided to **raise the target range for the federal funds rate  $\frac{1}{4}$  percent to  $1\frac{3}{4}$  to 2 percent**.
  - The committee noted that **further gradual increases in the target range for the federal funds rate will be consistent with sustained expansion** of labor market conditions **and inflation** near the Committee's symmetric 2 percent objective over the medium term.
- **The IOER**, which the Fed adjusts to set the upper bound of its target rate, **was lifted by only 20 basis points to 1.95 percent**. This technical adjustment is being made because the effective fed funds rate has recently been trading at the top of the range.
  - Powell announced starting in January 2019, he will **begin holding press conferences after every central bank meeting**. Powell stressed that it will enhance communication and not necessarily signal anything about timing or pace of future rate changes.

Source: Federal Reserve.

## Looking Ahead: Expected 2018 FOMC Membership

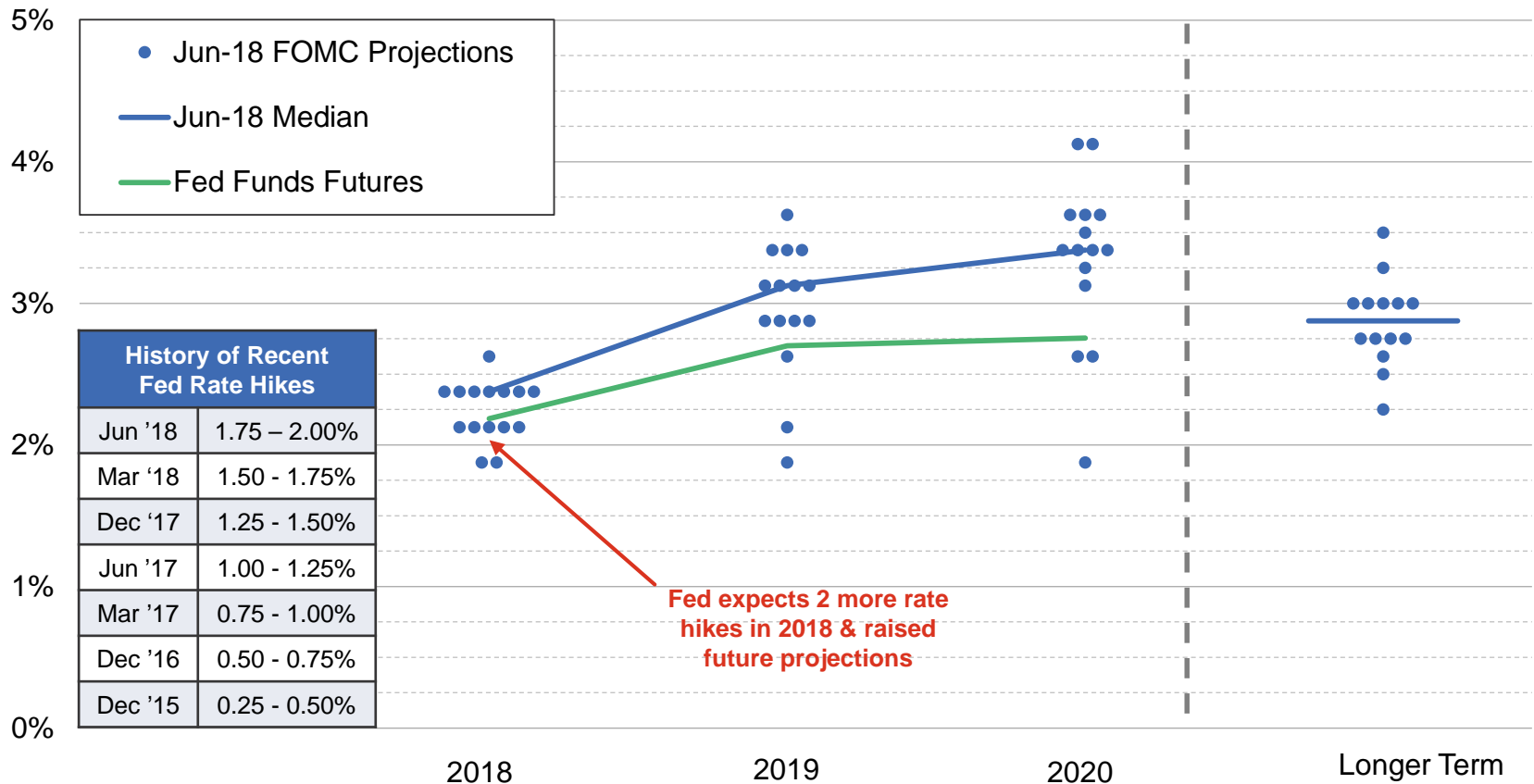
- The Federal Reserve Bank of New York has announced John Williams, who has served the San Francisco Fed since 2011, will become its next leader. Williams began his new role on June 18, 2018, following the last day for current president William Dudley.
- President Trump can further re-shape the FOMC given the three remaining vacancies on the Board. His previous nominations include Randal Quarles who was confirmed by the Senate as Vice Chair for Supervision, and Jerome Powell who replaced Yellen when she resigned in February.



Source: The Federal Reserve. The Federal Reserve Bank of New York and Richmond are both currently conducting a search for a new president.

# FOMC “Dot Plot” – June 2018 Update

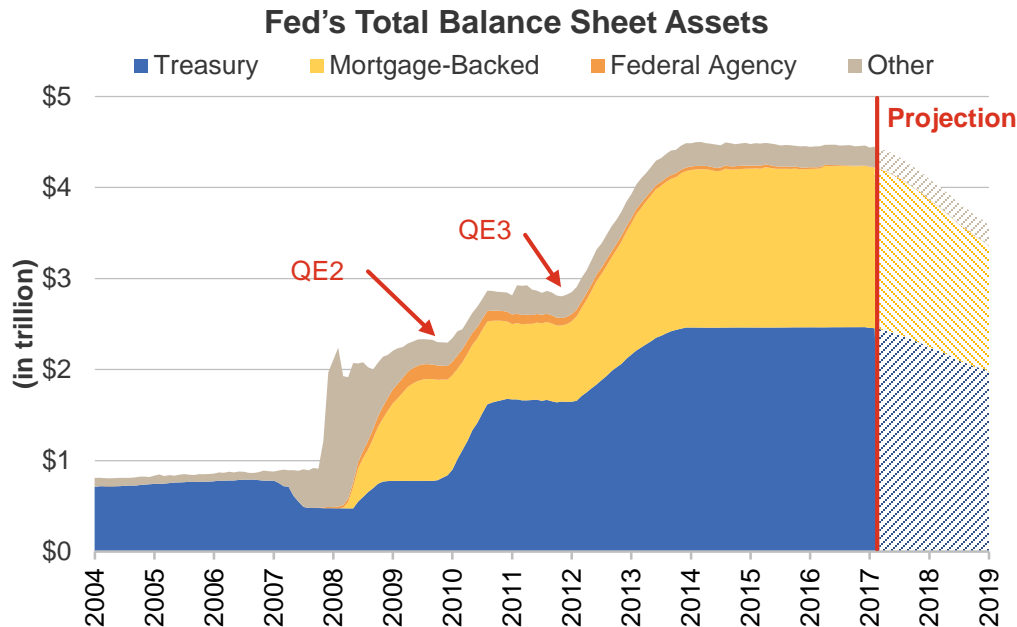
## Fed Participants’ Assessments of ‘Appropriate’ Monetary Policy



Source: Federal Reserve and Bloomberg. Individual dots represent each Fed members’ judgement of the midpoint of the appropriate target range for the federal funds rate at each year-end. Fed funds futures as of 6/14/18.

## Fed's Balance Sheet Normalization Plan

- The Federal Reserve began reducing the size of its balance sheet in October 2017 by decreasing reinvestments of principal payments on its holdings of U.S. Treasury and agency mortgage-backed securities.
- The pace of the decline started at \$10 billion per month in 2017 Q4, \$20 billion per month in 2018 Q1, and stepped up to \$30 billion per month in 2018 Q2.



(in billion)	Treasury Holdings	MBS Holdings	Total Fed Assets
Dec 2017	\$2,454	\$1,765	\$4,449
Dec 2019 (Projected)	\$1,970	\$1,357*	\$3,331
<b>Difference:</b>	<b>\$(484)</b>	<b>\$(408)*</b>	<b>\$(1,118)</b>

\*MBS projection assumes that principal payments will always exceed the cap over the horizon period (i.e. the monthly run off amount is equal to the cap).

Source: PFM, Bloomberg, The Federal Reserve, FRB of St. Louis, as of 12/31/17. Projection is based on maturity schedule of Fed's Treasury holdings and caps on reinvestments as described in FOMC's June 2017 addendum to the Policy Normalization Principles and Plans.

## China's Retaliation to Tariffs May Hurt Top U.S. Exports

### Top U.S. Export Products to China (Products in red are targeted for a potential 25% tariff)

Product	US's exports to China (Bil. US\$)	Share in US's exports (%)	US's exports to China (% of GDP)
Seeds and fruits	14.9	53.7	0.08
- Soya beans	14.2	62.0	0.08
Aircraft	14.6	10.8	0.08
Electrical machinery	12.4	7.4	0.07
Mechanical appliances	11.4	6.0	0.06
Vehicles	11.0	8.9	0.06
- Motor cars	8.9	16.4	0.05
Optical products	8.3	10.1	0.04
Plastics	4.9	8.4	0.03
Chemicals	4.5	7.6	0.02
Pulp	3.4	39.9	0.02
Mineral fuels	2.6	2.8	0.01
Nonferrous metal and products*	2.6	21.3	0.01
Wood products	2.5	28.2	0.01
Pharmaceutical products	2.0	4.3	0.01
Copper	1.7	26.9	0.01
Cereals	1.3	7.0	0.01

Source: Moody's Investor Service, 05/10/2018.

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# **Portfolio Characteristics and Investment Strategy**

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## Portfolio Recap

- ◆ Despite the myriad of global headwinds to economic growth, including global trade wars and geopolitical uncertainty, the strength and resolve of domestic economic themes continued to rule the day as the U.S. economy continued to expand. In June 2018, the Fed raised short-term interest rates another  $\frac{1}{4}$  percent.
- ◆ U.S. Treasury yields increased during the quarter and the yield curve flattened to a new post-recession low.
- ◆ In what we viewed as a well-choreographed interest rate environment, we continued to strategically position portfolios with a modestly-defensive duration bias relative to benchmarks. However, with rates near multi-year highs, there were also opportunities to selectively capture higher yields in some parts of the yield curve when rebalancing portfolios or participating in new issues.
- ◆ Most investment-grade sectors contributed positive excess returns (returns in excess of similar-duration Treasuries) to fixed income portfolios for the quarter:
  - Federal agency yield spreads remained very narrow throughout the quarter. Limited incremental yield in combination with light issuance influenced our continued preference to reduce allocations to agencies.
  - In the supranational sector, Q1 was a period of seasonally high issuance volume and wider-than-average spreads, offering an attractive opportunity to add to allocations. In Q2, portfolios holding supranationals benefited from modest spread tightening as new supply fell significantly, as we had anticipated.
  - In the corporate sector, our fundamental outlook remained favorable, as corporate profits surged in Q1 and Q2, in part due to the 2017 tax cuts. When yield spreads widened in Q1, a result of global issues rather than any fundamental credit concerns, we viewed the wider spreads as an opportunity to increase allocations to credit.
  - Short-term, high-quality commercial paper and negotiable certificates of deposit continued to offer considerable value relative to not only similar-maturity government securities but also somewhat longer Treasury maturities.
  - The mortgage-backed security (MBS) sector rebounded in Q2, following significant underperformance in Q1. Although we are cognizant of looming headwinds facing the MBS sector, we carefully sought opportunities to add attractive issues to portfolios at increased yield spreads.

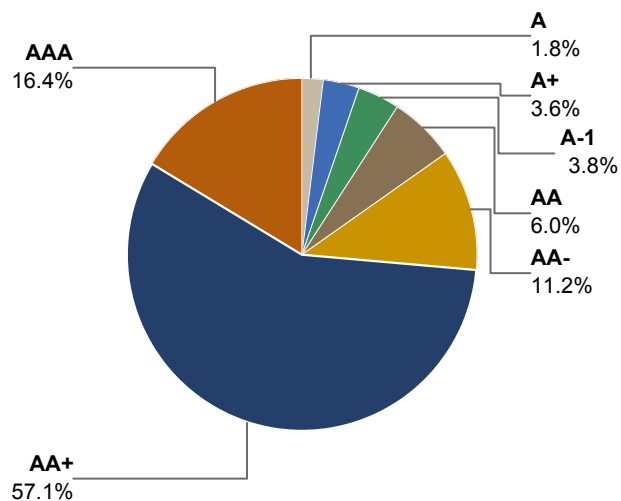


**Portfolio Statistics**

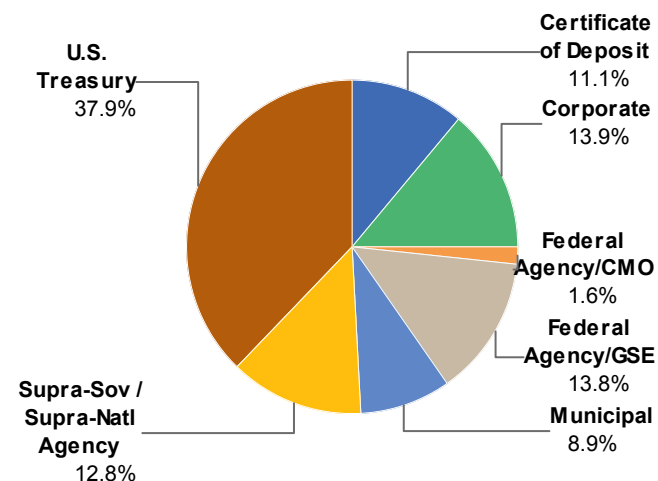
As of June 30, 2018

<b>Par Value:</b>	\$76,492,518
<b>Total Market Value:</b>	\$75,516,177
<b>Security Market Value:</b>	\$75,064,047
<b>Accrued Interest:</b>	\$339,026
<b>Cash:</b>	\$113,104
<b>Amortized Cost:</b>	\$76,606,952
<b>Yield at Market:</b>	2.66%
<b>Yield at Cost:</b>	1.80%
<b>Effective Duration:</b>	2.39 Years
<b>Duration to Worst:</b>	2.38 Years
<b>Average Maturity:</b>	2.50 Years
<b>Average Credit: *</b>	AA

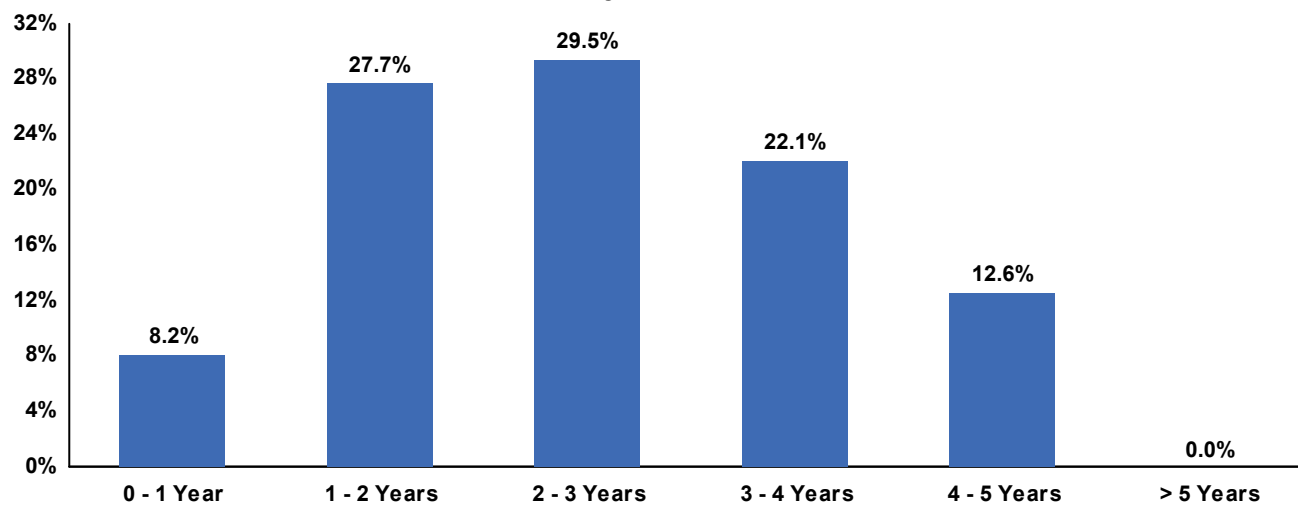
**Credit Quality (S&P Ratings)**



**Sector Allocation**



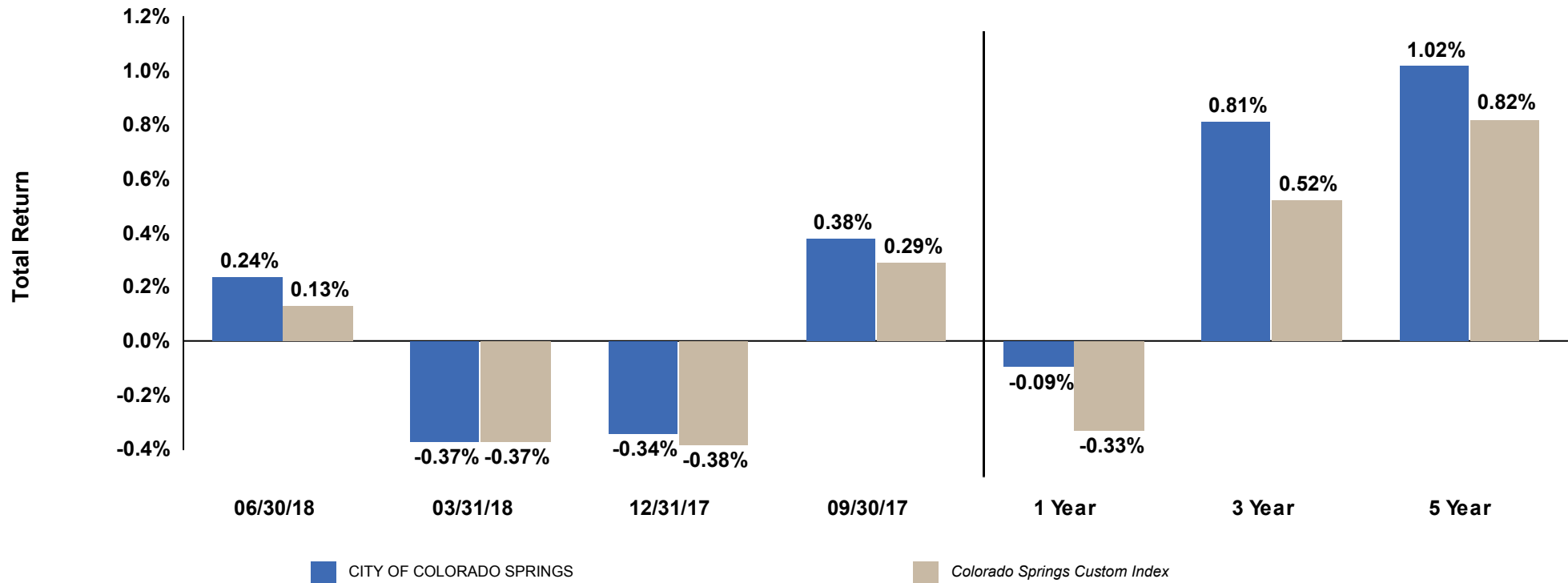
**Maturity Distribution**



\* An average of each security's credit rating assigned a numeric value and adjusted for its relative weighting in the portfolio.

Portfolio Performance (Total Return)

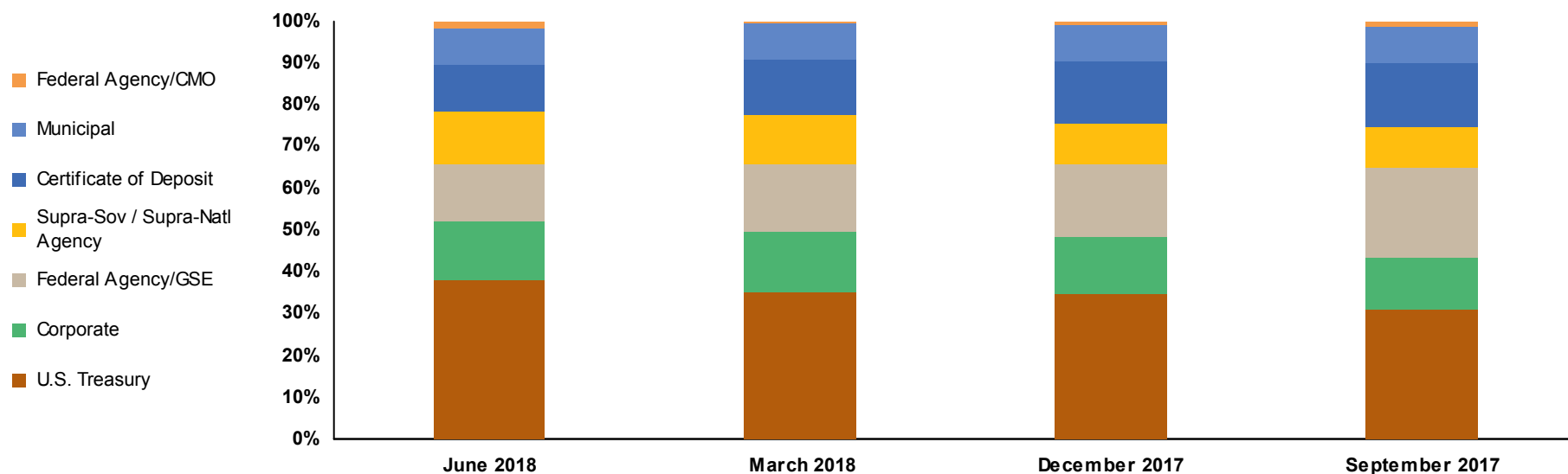
Portfolio/Benchmark	Effective Duration	Quarter Ended				1 Year	Annualized Return	
		06/30/18	03/31/18	12/31/17	09/30/17		3 Year	5 Year
CITY OF COLORADO SPRINGS	2.39	0.24%	-0.37%	-0.34%	0.38%	-0.09%	0.81%	1.02%
Colorado Springs Custom Index	2.55	0.13%	-0.37%	-0.38%	0.29%	-0.33%	0.52%	0.82%
Difference		0.11%	0.00%	0.04%	0.09%	0.24%	0.29%	0.20%



Portfolio performance is gross of fees unless otherwise indicated.

### Sector Allocation

Sector	June 30, 2018		March 31, 2018		December 31, 2017		September 30, 2017	
	MV (\$MM)	% of Total	MV (\$MM)	% of Total	MV (\$MM)	% of Total	MV (\$MM)	% of Total
U.S. Treasury	28.4	37.9%	26.4	35.2%	25.9	34.5%	23.3	31.1%
Corporate	10.5	13.9%	10.7	14.3%	10.3	13.7%	9.2	12.2%
Federal Agency/GSE	10.4	13.8%	11.9	16.0%	13.0	17.3%	16.0	21.3%
Supra-Sov / Supra-Natl Agency	9.6	12.8%	9.2	12.2%	7.4	9.9%	7.5	10.0%
Certificate of Deposit	8.3	11.1%	9.8	13.1%	11.3	15.1%	11.4	15.2%
Municipal	6.7	8.9%	6.5	8.7%	6.5	8.7%	6.6	8.8%
Federal Agency/CMO	1.2	1.6%	0.4	0.5%	0.6	0.8%	1.0	1.4%
<b>Total</b>	<b>\$75.1</b>	<b>100.0%</b>	<b>\$74.9</b>	<b>100.0%</b>	<b>\$75.0</b>	<b>100.0%</b>	<b>\$74.9</b>	<b>100.0%</b>



Detail may not add to total due to rounding.

## Sector/Issuer Distribution

As of June 30, 2018

Sector / Issuer	Market Value (\$)	% of Sector	% of Total Portfolio
<b>Certificate of Deposit</b>			
BANK OF NOVA SCOTIA	1,441,578	17.4%	1.9%
CANADIAN IMPERIAL BANK OF COMMERCE	1,446,210	17.4%	1.9%
NORDEA BANK AB	1,442,351	17.4%	1.9%
SKANDINAVISKA ENSKILDA BANKEN AB	1,437,491	17.3%	1.9%
SWEDBANK AB	1,419,721	17.1%	1.9%
WESTPAC BANKING CORP	1,117,037	13.5%	1.5%
<b>Sector Total</b>	<b>8,304,389</b>	<b>100.0%</b>	<b>11.1%</b>
<b>Corporate</b>			
ANZ BANKING GROUP LTD	487,892	4.7%	0.6%
APPLE INC	1,429,485	13.7%	1.9%
BERKSHIRE HATHAWAY INC	403,831	3.9%	0.5%
CHEVRON CORPORATION	1,346,084	12.9%	1.8%
COCA-COLA COMPANY	766,874	7.3%	1.0%
EXXON MOBIL CORP	1,429,620	13.7%	1.9%
MICROSOFT CORP	1,328,443	12.7%	1.8%
PROCTER & GAMBLE CO	469,858	4.5%	0.6%
TOYOTA MOTOR CORP	1,253,670	12.0%	1.7%
WAL-MART STORES INC	1,040,135	10.0%	1.4%
WELLS FARGO & COMPANY	494,552	4.7%	0.7%

Sector / Issuer	Market Value (\$)	% of Sector	% of Total Portfolio
<b>Sector Total</b>	<b>10,450,444</b>	<b>100.0%</b>	<b>13.9%</b>
<b>Federal Agency/CMO</b>			
FANNIE MAE	793,244	67.0%	1.1%
FREDDIE MAC	390,151	33.0%	0.5%
<b>Sector Total</b>	<b>1,183,396</b>	<b>100.0%</b>	<b>1.6%</b>
<b>Federal Agency/GSE</b>			
FANNIE MAE	6,018,095	58.0%	8.0%
FEDERAL HOME LOAN BANKS	2,499,869	24.1%	3.3%
FREDDIE MAC	1,855,612	17.9%	2.5%
<b>Sector Total</b>	<b>10,373,577</b>	<b>100.0%</b>	<b>13.8%</b>
<b>Municipal</b>			
CALIFORNIA ST	897,858	13.4%	1.2%
CITY OF NEW YORK CITY, NY	995,920	14.8%	1.3%
FLORIDA ST HURRICAN CAT FUND	1,441,025	21.5%	1.9%
MISSISSIPPI STATE	593,946	8.9%	0.8%
NEW YORK CITY NY TRANSITIONAL	1,421,493	21.2%	1.9%
STATE OF CONNECTICUT	1,359,889	20.3%	1.8%
<b>Sector Total</b>	<b>6,710,131</b>	<b>100.0%</b>	<b>8.9%</b>
<b>Supra-Sov / Supra-Natl Agency</b>			
AFRICAN DEVELOPMENT BANK	4,332,588	45.1%	5.8%

Sector / Issuer	Market Value (\$)	% of Sector	% of Total Portfolio
ASIAN DEVELOPMENT BANK	2,615,882	27.3%	3.5%
INTER-AMERICAN DEVELOPMENT BANK	957,677	10.0%	1.3%
INTL BANK OF RECONSTRUCTION AND DEV	1,692,099	17.6%	2.3%
<b>Sector Total</b>	<b>9,598,246</b>	<b>100.0%</b>	<b>12.8%</b>
<b>U.S. Treasury</b>			
UNITED STATES TREASURY	28,443,864	100.0%	37.9%
<b>Sector Total</b>	<b>28,443,864</b>	<b>100.0%</b>	<b>37.9%</b>
<b>Portfolio Total</b>	<b>75,064,047</b>	<b>100.0%</b>	<b>100.0%</b>

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## Investment Outlook and Strategy

- ◆ In light of continued economic growth, inflation near the Fed's symmetric target of 2%, and strong labor market conditions, the Fed appears poised to raise rates further. As a result of the expectation for one or two additional hikes in 2018 and three to four more in 2019, our view remains that the general trend of interest rates will be to increase gradually over the near-term. Therefore, we plan to maintain a defensive duration posture to mitigate a portion of interest rate risk relative to benchmarks.
- ◆ Our outlook for each of the major investment-grade fixed-income sectors are as follows:
  - Federal agency securities remain expensive, as most maturities offer less than five basis points of incremental yield relative to U.S. Treasuries. We will continue to reduce exposure to agencies in maturities where spreads are tight, seeking better value in either Treasuries or other sectors.
  - Given light expected supply of supranationals over the coming months, additional purchases may be limited. However, current allocations are expected to be maintained as portfolios benefit from modest incremental income relative to traditional agencies.
  - While fundamentals remain generally healthy and incremental income is still modestly attractive, potential headwinds in the corporate sector are beginning to temper our overall constructive guidance. As a result, our view on the sector has shifted to a more neutral and selectively opportunistic stance.
  - In conjunction with our somewhat more defensive posture, negotiable certificates of deposit (CD) and asset-backed securities (ABS) offer attractive incremental income compared to government security alternatives.
  - As the Fed balance sheet is set to reduce mortgage-backed securities (MBS) exposure more significantly over the next six months, the sector may experience spread pressures through the second half of the year.
  - Short-term money market investors continue to reap the rewards of current monetary policy tightening and higher overnight target rates. Further, the yield curve for high-quality commercial paper and negotiable certificates of deposit (CP/CD) is quite steep and attractive, offering opportunities to extend maturities and add to allocations in this space.

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## IMPORTANT DISCLOSURES

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- Market values that include accrued interest are derived from closing bid prices as of the last business day of the month as supplied by Interactive Data, Bloomberg, or Telerate. Where prices are not available from generally recognized sources, the securities are priced using a yield based matrix system to arrive at an estimated market value.
- In accordance with generally accepted accounting principles, information is presented on a trade date basis; forward settling purchases are included in the monthly balances, and forward settling sales are excluded.
- Performance is presented in accordance with the CFA Institute's Global Investment Performance Standards (GIPS). Unless otherwise noted, performance is shown gross of fees. Quarterly returns are presented on an unannualized basis. Returns for periods greater than one year are presented on an annualized basis. Past performance is not indicative of future returns.
- Bank of America/Merrill Lynch Indices provided by Bloomberg Financial Markets.
- Money market fund/cash balances are included in performance and duration computations.
- Standard & Poor's is the source of the credit ratings. Distribution of credit rating is exclusive of money market fund/LGIP holdings.
- Callable securities in the portfolio are included in the maturity distribution analysis to their stated maturity date, although, they may be called prior to maturity.
- MBS maturities are represented by expected average life.



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## GLOSSARY

- **ACCRUED INTEREST:** Interest that is due on a bond or other fixed income security since the last interest payment was made.
- **AGENCIES:** Federal agency securities and/or Government-sponsored enterprises.
- **AMORTIZED COST:** The original cost of the principal of the security is adjusted for the amount of the periodic reduction of any discount or premium from the purchase date until the date of the report. Discount or premium with respect to short-term securities (those with less than one year to maturity at time of issuance) is amortized on a straight line basis. Such discount or premium with respect to longer-term securities is amortized using the constant yield basis.
- **BANKERS' ACCEPTANCE:** A draft or bill of exchange accepted by a bank or trust company. The accepting institution guarantees payment of the bill as well as the insurer.
- **COMMERCIAL PAPER:** An unsecured obligation issued by a corporation or bank to finance its short-term credit needs, such as accounts receivable and inventory.
- **CONTRIBUTION TO DURATION:** Represents each sector or maturity range's relative contribution to the overall duration of the portfolio measured as a percentage weighting. Since duration is a key measure of interest rate sensitivity, the contribution to duration measures the relative amount or contribution of that sector or maturity range to the total rate sensitivity of the portfolio.
- **DURATION TO WORST:** A measure of the sensitivity of a security's price to a change in interest rates, stated in years, computed from cash flows to the maturity date or to the put date, whichever results in the highest yield to the investor.
- **EFFECTIVE DURATION:** A measure of the sensitivity of a security's price to a change in interest rates, stated in years.
- **EFFECTIVE YIELD:** The total yield an investor receives in relation to the nominal yield or coupon of a bond. Effective yield takes into account the power of compounding on investment returns, while nominal yield does not.
- **FDIC:** Federal Deposit Insurance Corporation. A federal agency that insures bank deposits to a specified amount.
- **INTEREST RATE:** Interest per year divided by principal amount and expressed as a percentage.
- **MARKET VALUE:** The value that would be received or paid for an investment in an orderly transaction between market participants at the measurement date.
- **MATURITY:** The date upon which the principal or stated value of an investment becomes due and payable.
- **NEGOTIABLE CERTIFICATES OF DEPOSIT:** A CD with a very large denomination, usually \$1 million or more, that can be traded in secondary markets.
- **PAR VALUE:** The nominal dollar face amount of a security.

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## GLOSSARY

- **PASS THROUGH SECURITY:** A security representing pooled debt obligations that passes income from debtors to its shareholders. The most common type is the mortgage-backed security.
- **REPURCHASE AGREEMENTS:** A holder of securities sells these securities to an investor with an agreement to repurchase them at a fixed price on a fixed date.
- **SETTLE DATE:** The date on which the transaction is settled and monies/securities are exchanged. If the settle date of the transaction (i.e., coupon payments and maturity proceeds) occurs on a non-business day, the funds are exchanged on the next business day.
- **TRADE DATE:** The date on which the transaction occurred; however, the final consummation of the security transaction and payment has not yet taken place.
- **UNSETTLED TRADE:** A trade which has been executed; however, the final consummation of the security transaction and payment has not yet taken place.
- **U.S. TREASURY:** The department of the U.S. government that issues Treasury securities.
- **YIELD:** The rate of return based on the current market value, the annual interest receipts, maturity value, and the time period remaining until maturity, stated as a percentage on an annualized basis.
- **YTM AT COST:** The yield to maturity at cost is the expected rate of return based on the original cost, the annual interest receipts, maturity value, and the time period from purchase date to maturity, stated as a percentage on an annualized basis.
- **YTM AT MARKET:** The yield to maturity at market is the rate of return based on the current market value, the annual interest receipts, maturity value, and the time period remaining until maturity, stated as a percentage on an annualized basis.