Historical Performance and Investment Strategies during a Pandemic and Economic Lockdown

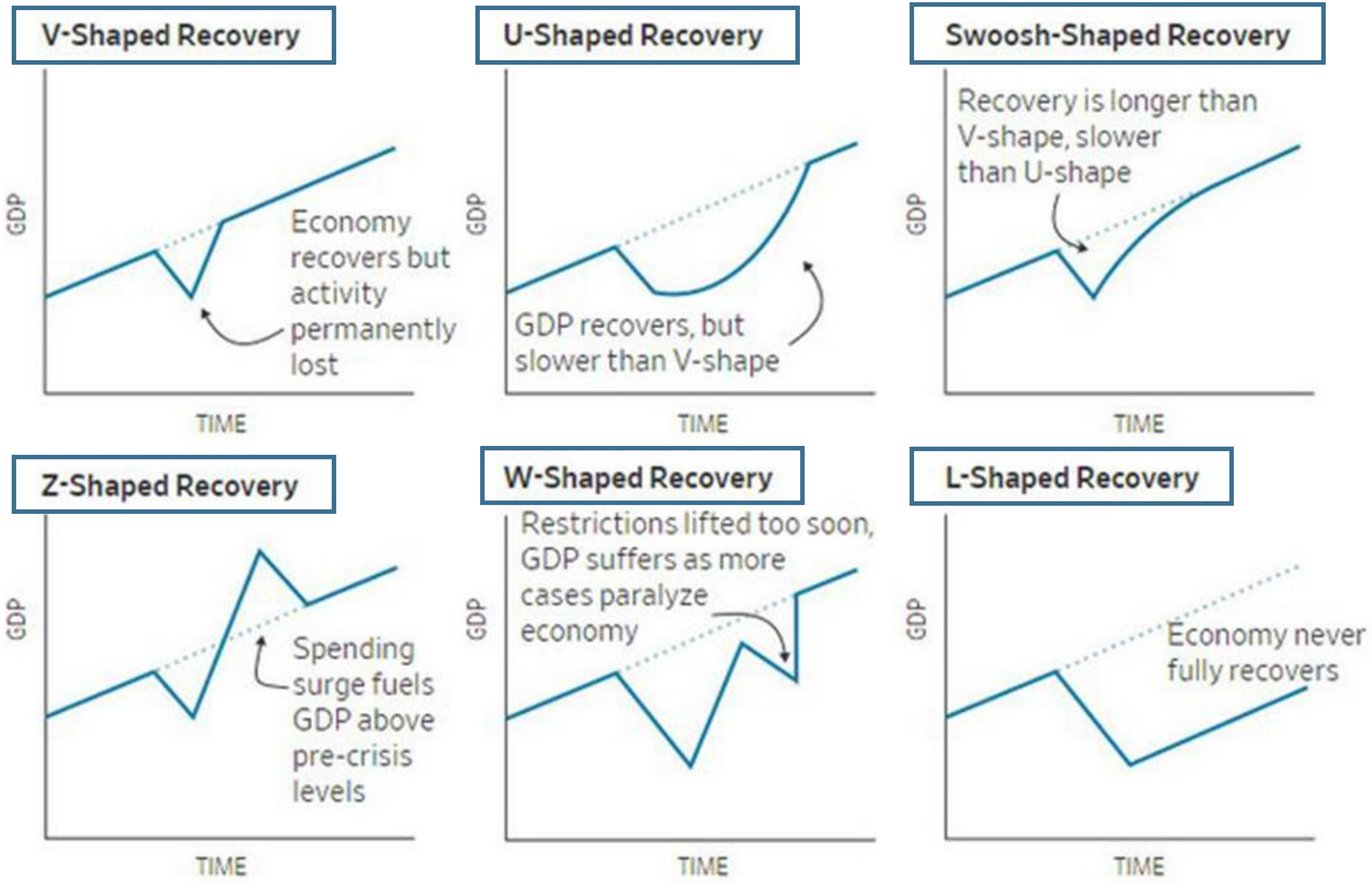
John F. Grady III, Managing Director

March 26, 2021

Big Bend Chapter

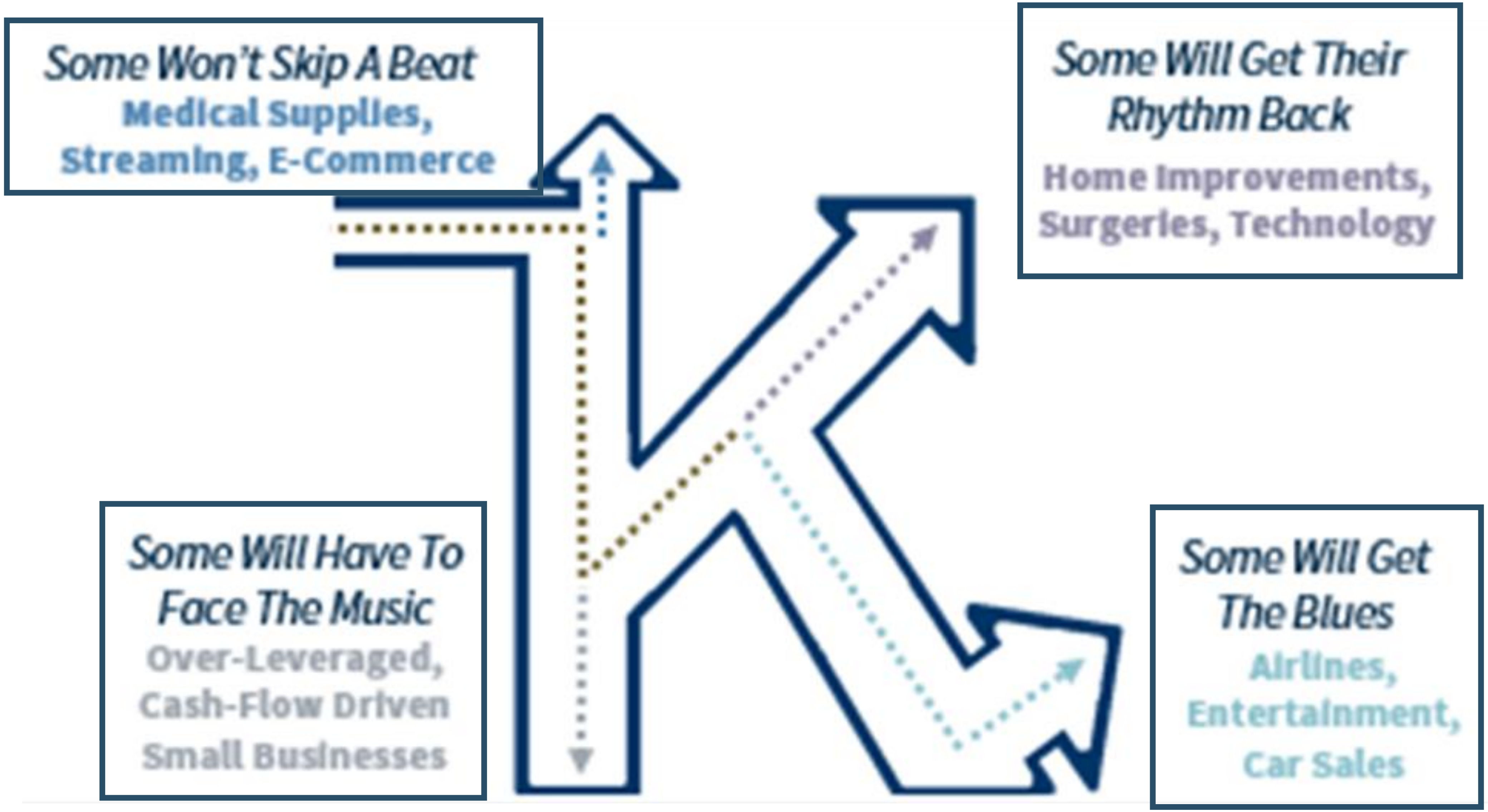
Yield Curves and Historical Performance

Recovery Scenarios



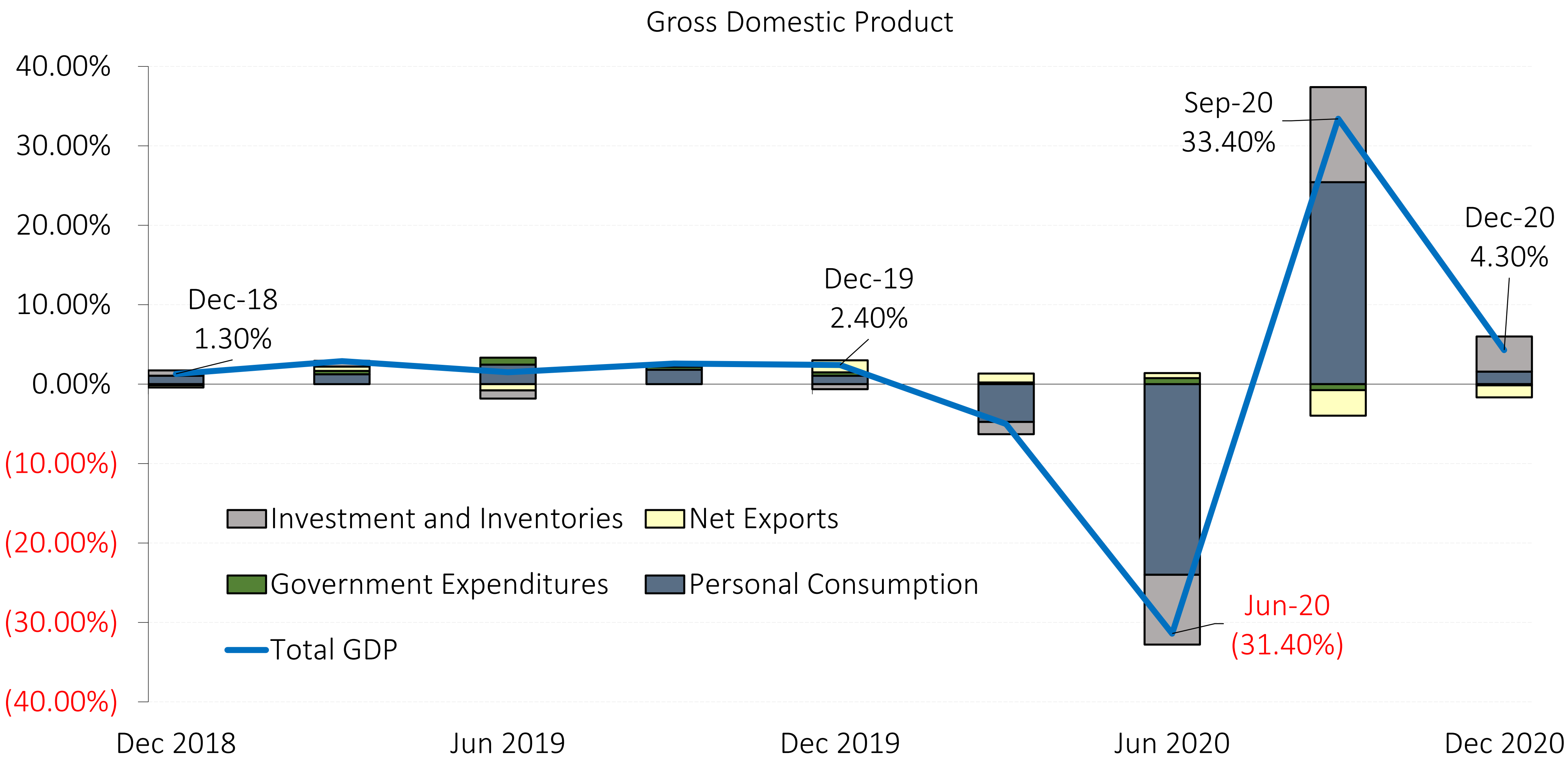
Source: Brookings Institute

The Newest Recovery Projection – The "K" Recovery



Source: Brookings Institute

Gross Domestic Product



Source: Big Bend Chapter

Bloomberg Forecast – March 2021 Survey

Indicator	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Economic Activity										
Real GDP (YoY%)	2.5	3.1	1.7	2.3	3.0	2.2	-3.5	5.5	3.8	2.4
Consumer Spending ...	3.0	3.8	2.8	2.6	2.7	2.4	-3.9	5.7	4.1	2.5
Government Spendin...	-0.9	1.8	1.8	0.9	1.8	2.3	1.1	1.2	1.6	0.6
Private Investment (...	5.6	5.5	-1.5	3.5	6.3	1.7	-5.3	10.6	4.8	3.4
Exports (YoY%)	4.2	0.4	0.3	3.9	3.0	-0.1	-13.0	8.0	6.0	5.2
Imports (YoY%)	5.0	5.2	1.7	4.7	4.1	1.1	-9.3	13.0	4.5	3.7
Industrial Production (Yo...	3.1	-1.0	-2.0	2.3	4.0		-7.0	6.3	3.7	2.5
Price Indices										
CPI (YoY%)	1.6	0.1	1.3	2.1	2.5	1.8	1.2	2.3	2.2	2.2
PCE Price Index (YoY%)							1.2	[illegible]	2.0	2.0
Core PCE (yoy%)	1.6	1.2	1.6	1.7	2.0	1.7	1.4	1.8	1.9	2.0

Source: Bloomberg

Poll Question #1

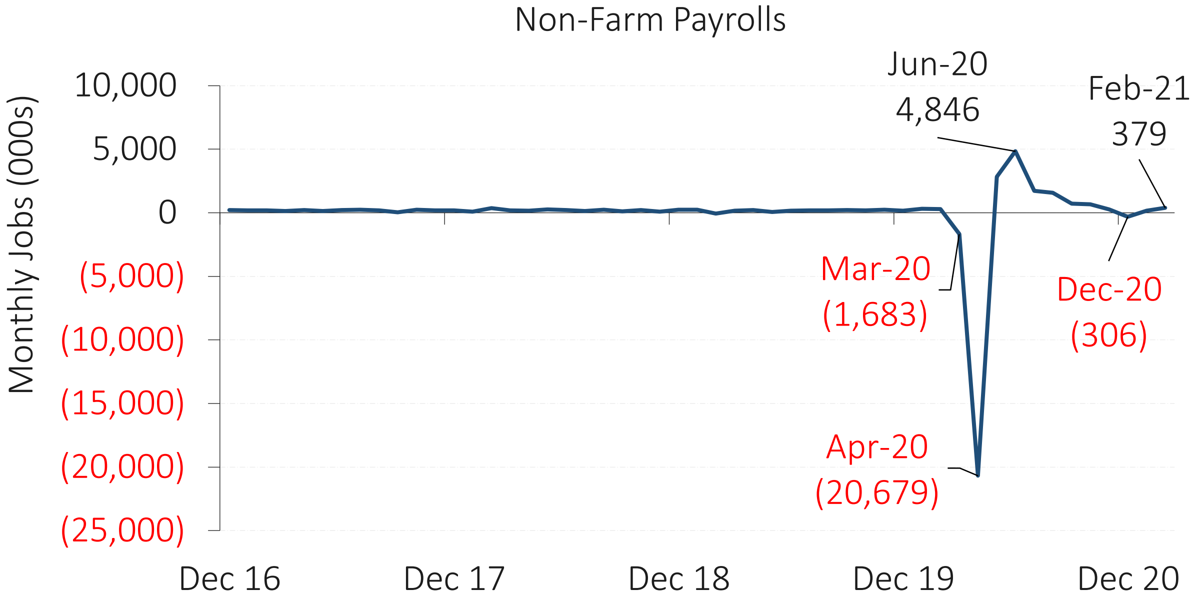
What type of recovery do you expect:

A. V-shaped – faster recovery time
B. U-shaped – longer recovery time
C. L-shaped – Economy never recovers
D. K-shaped – There will be winners and losers

The Labor Market

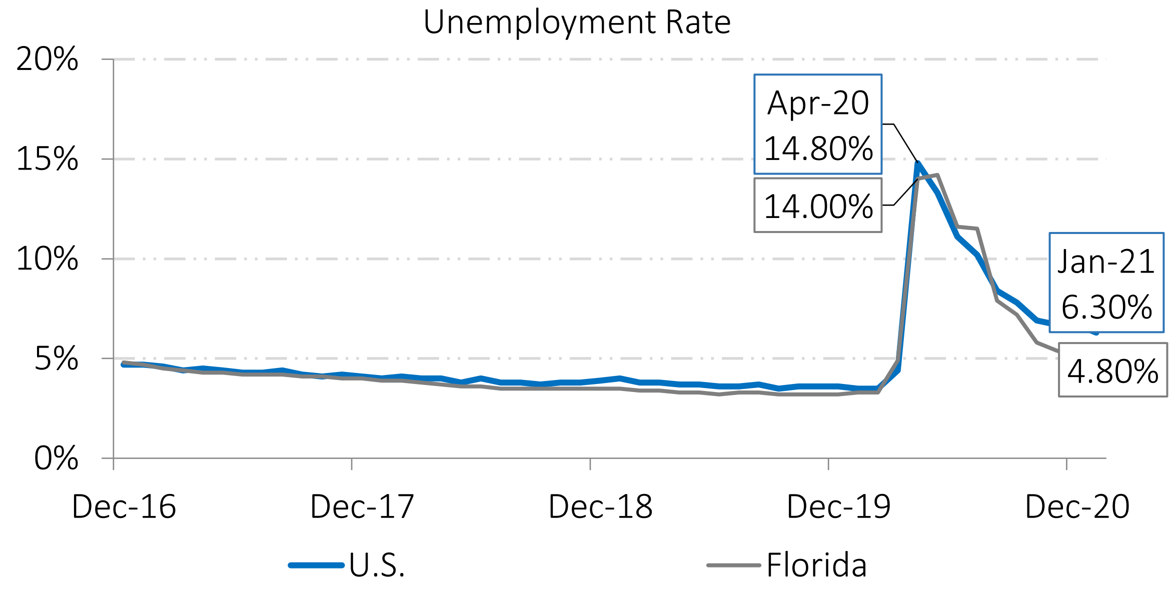
Nonfarm Payrolls

- Nonfarm payrolls rebounded in February with 379k jobs created during the month, significantly higher than the expected amount of 200k.
- The gain of 465k jobs in the private sector was offset by the 86k job losses in the government sector.



Unemployment Rate

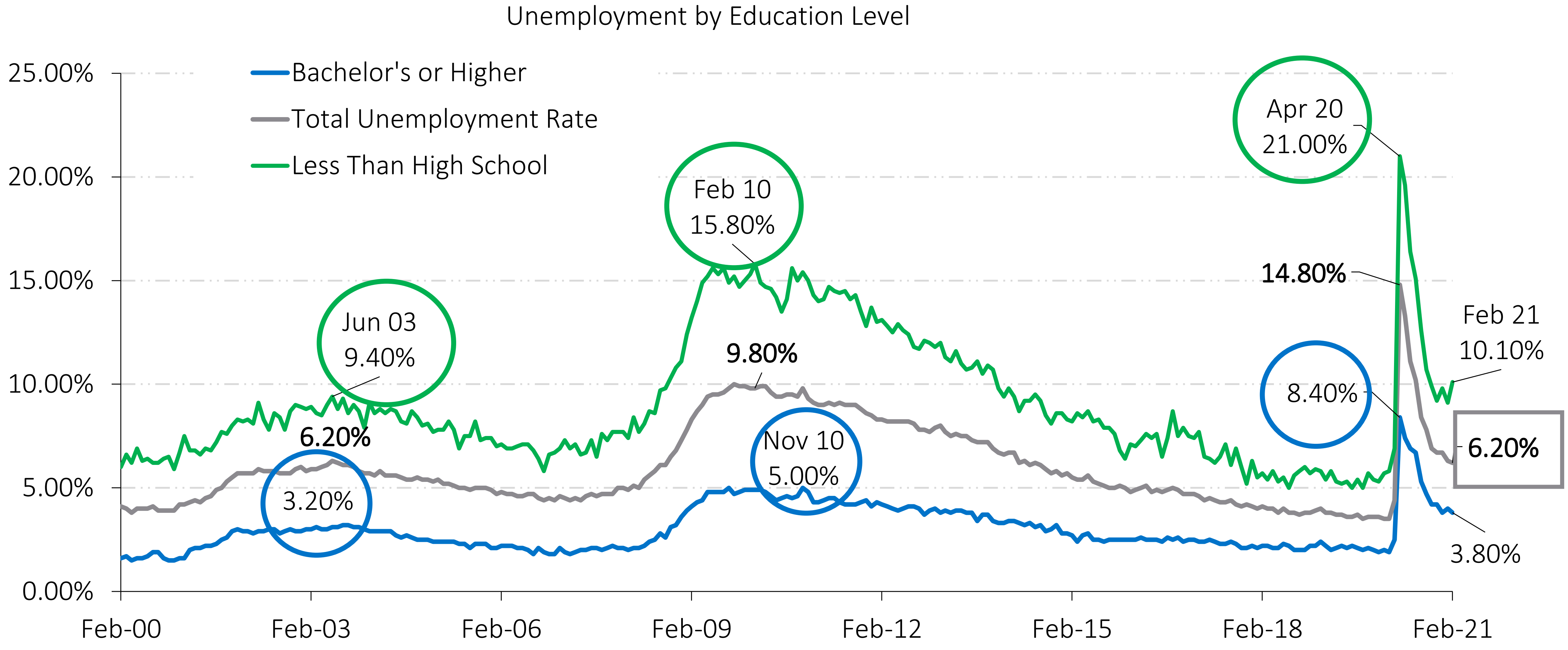
- The national unemployment rate declined to 6.2% in February, due improvement in the restaurant and hospitality industry.
- Florida unemployment continues to decline, dropping from a peak of 14.0% to 4.8% in January.
- The labor force participation rate of 61.4% in February is another sign of the challenges of a prolonged job recovery scenario. Labor force participation has experienced a significant long term decline since the late 1990s.



Source: Bloomberg

The Labor Market – Educational Trends

- Educations continues to play a role in the unemployment rate.



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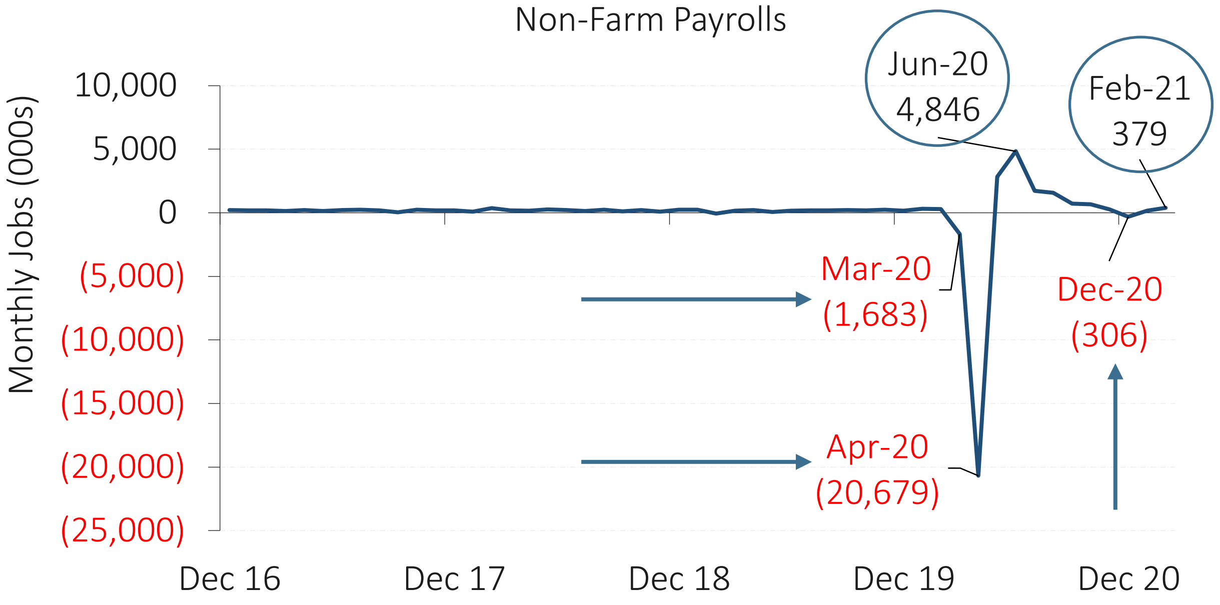
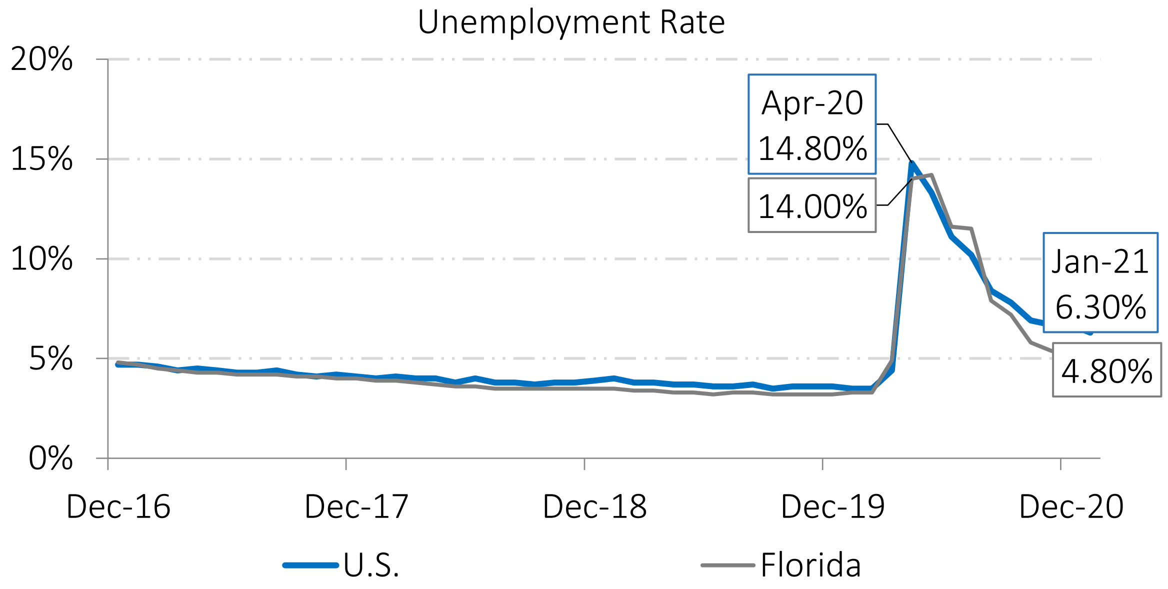


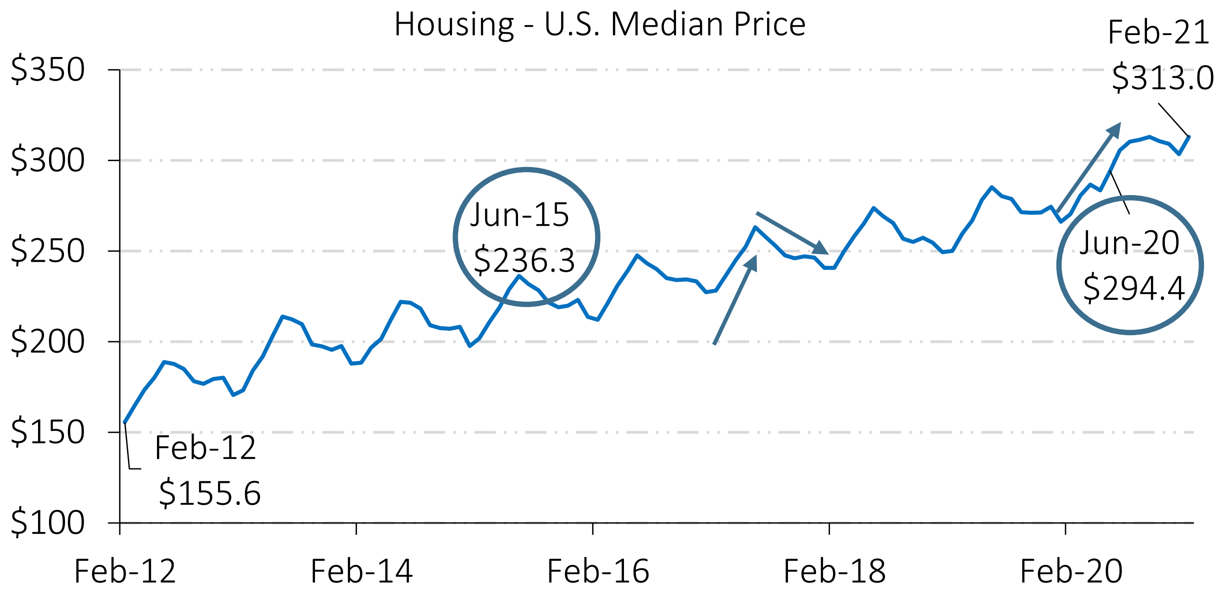


Source: Bloomberg

Housing

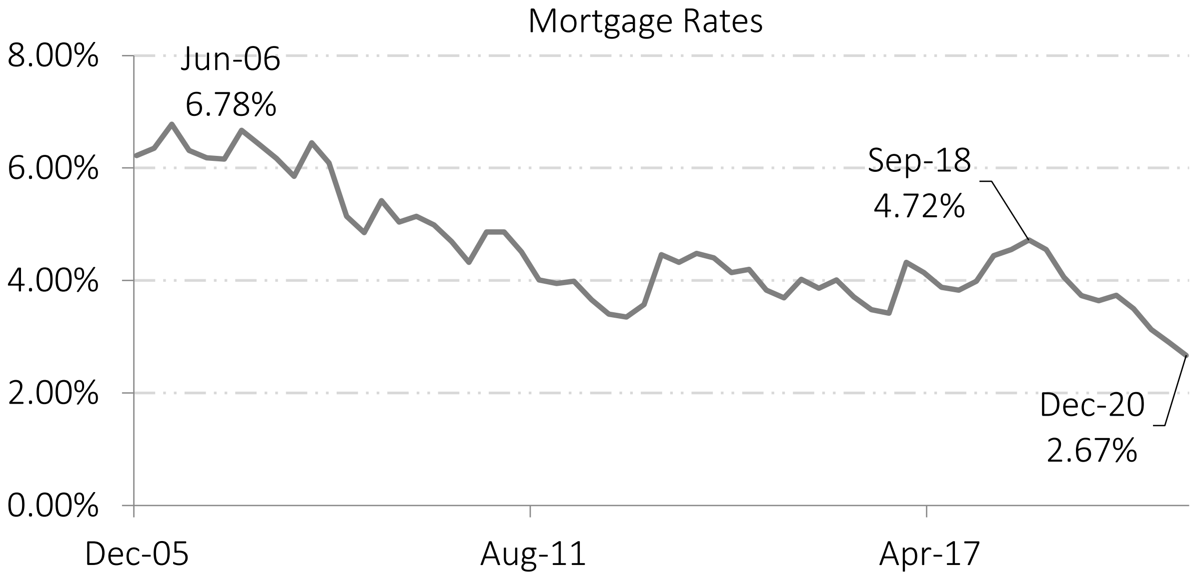
Demand Pushes Prices Higher

- Housing prices up 15.8% year over year as of February 2021.
- Prices are 101% higher nationally since February 2012 (nine years).
- Price increases can vary drastically based on supply and demand and the pandemic has also impacted due to migration.



Mortgage Rates

- Mortgage rates continued to decrease through the end of 2020.
- The national average 30 year rate was 2.67% in December. This is a decrease of 2.05% decrease since September 2018.



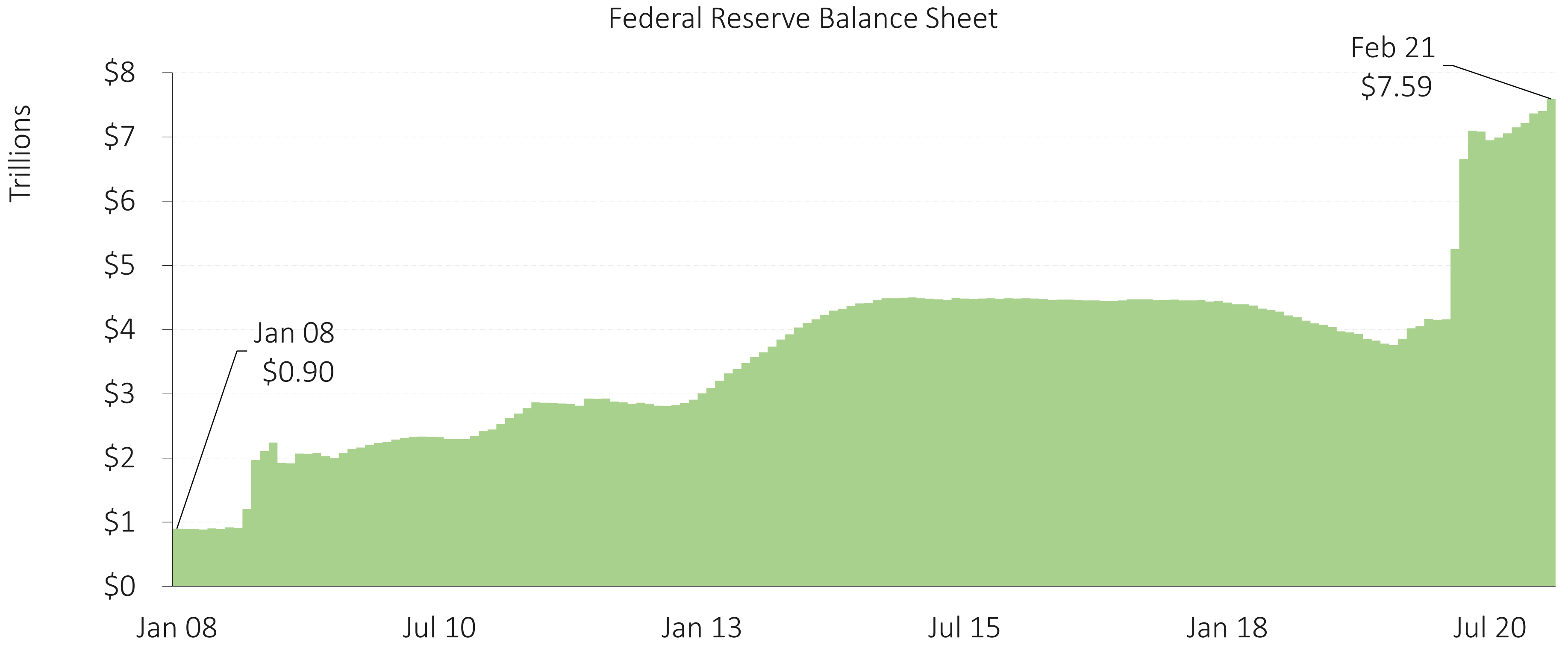
Source: Bloomberg

Federal Reserve Balance Sheet

Quantitative Easing and the Fed Balance Sheet

- The Fed's QE1, QE2 and QE3 increased the balance sheet from $910 billion in August 2008 to $4.5 trillion in August 2014, an increase of $3.6 trillion in six years.

- The QE 4 program launched in March 2020 has increased the balance sheet from $4.1 trillion in February 2020 to $7.4 trillion in January 2021, an increase of $3.3 trillion in 11 months.



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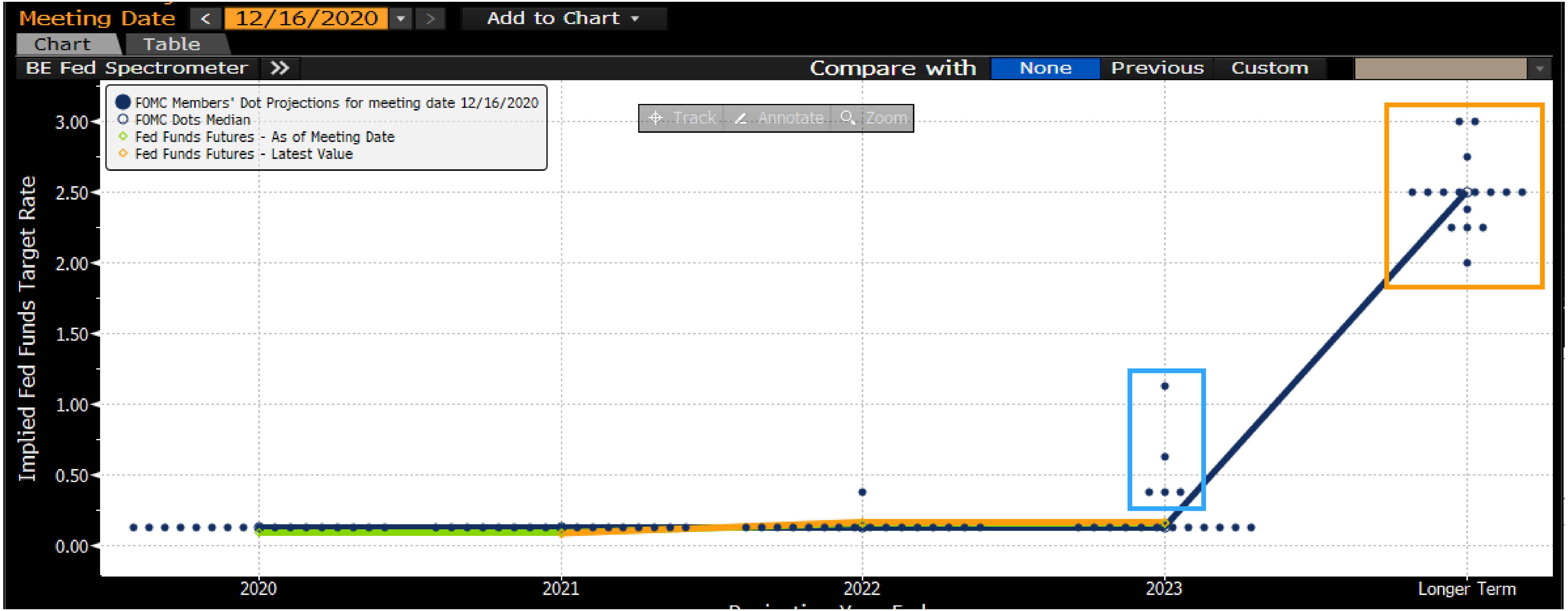
FOMC Dot Plot – December 16, 2020



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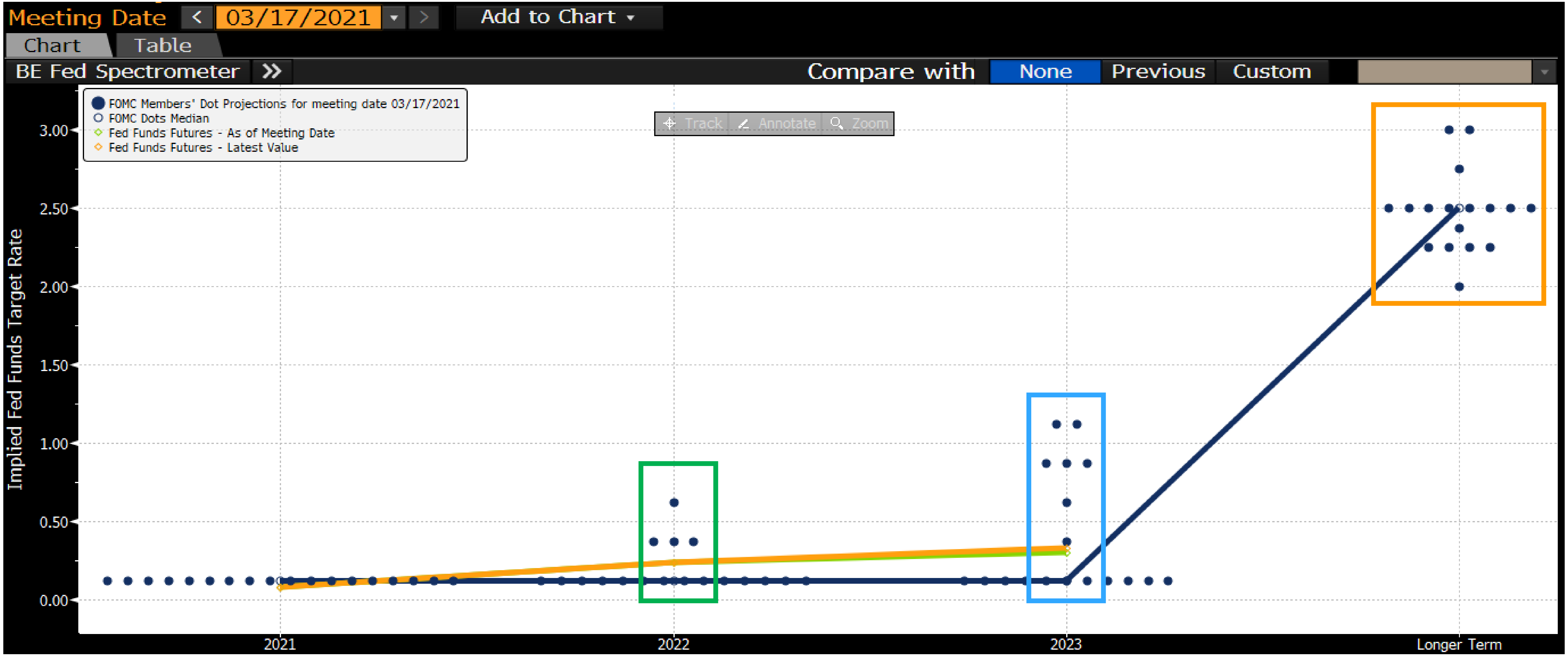

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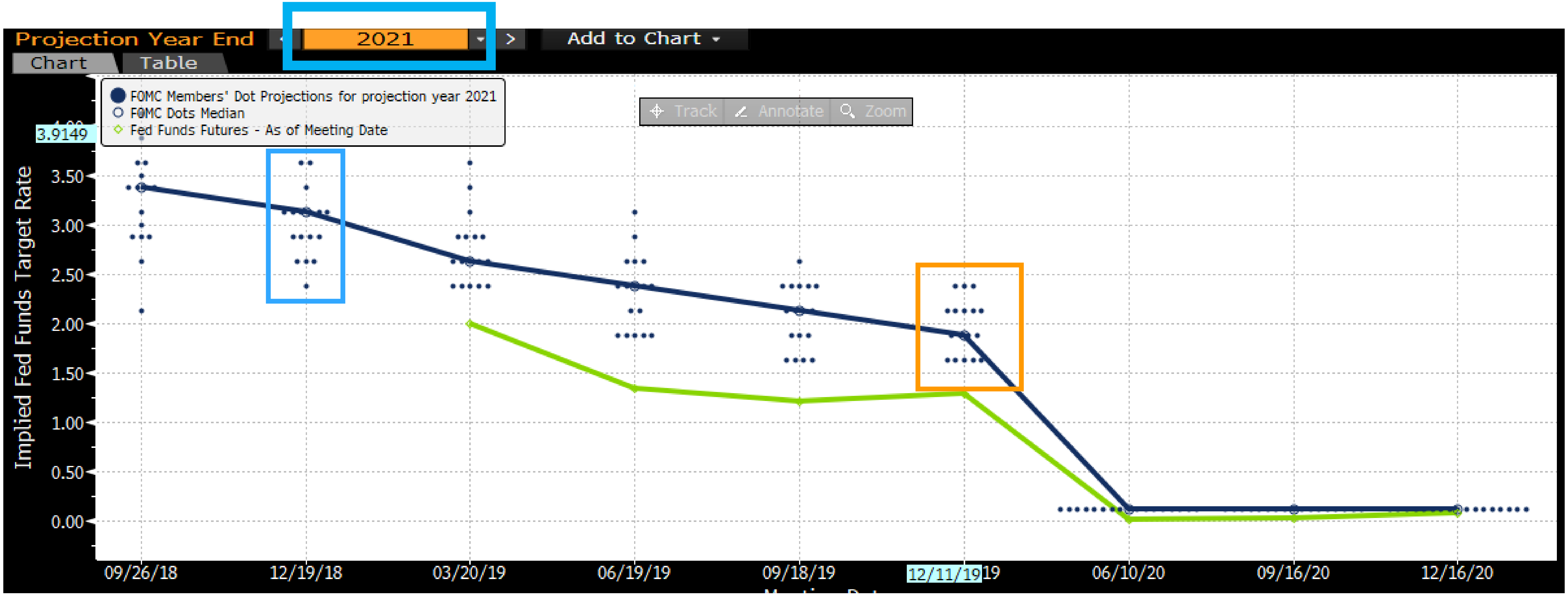
Historical FOMC Fed Funds Projections for 2021



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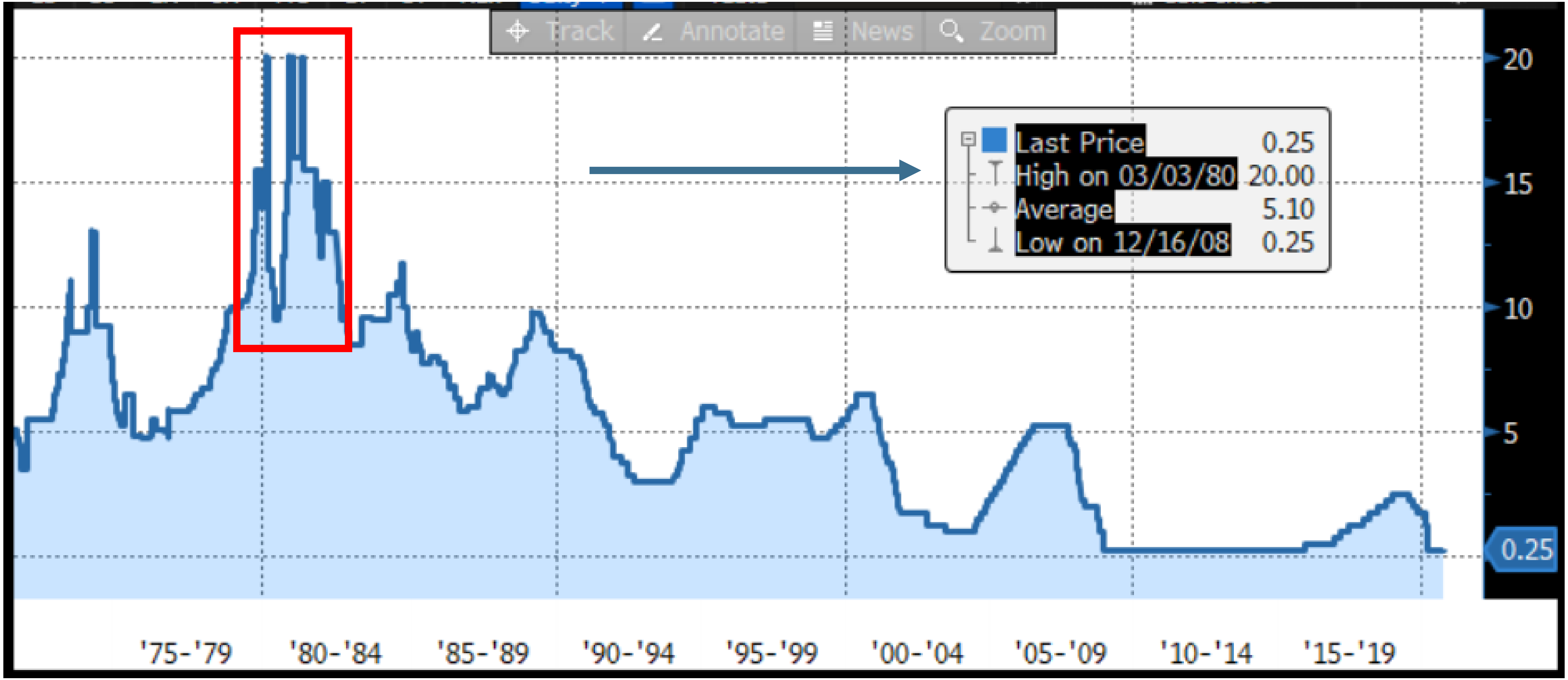
Poll Question #2

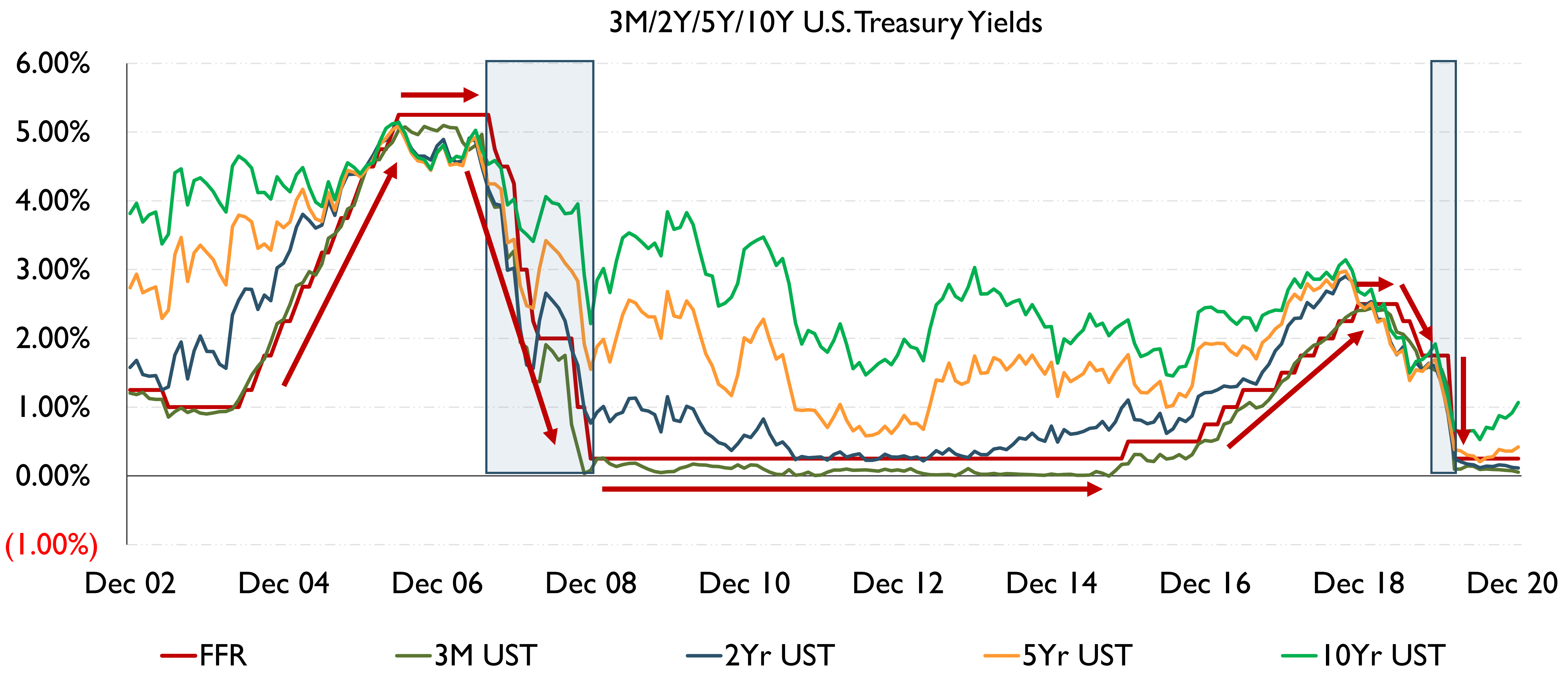
What was the highest ever Federal Funds Rate:

A. 10.25%
B. 20.00%
C. 15.50%
D. 17.00%
E. 12.75%

Poll Question #2



U.S. Treasury Yields



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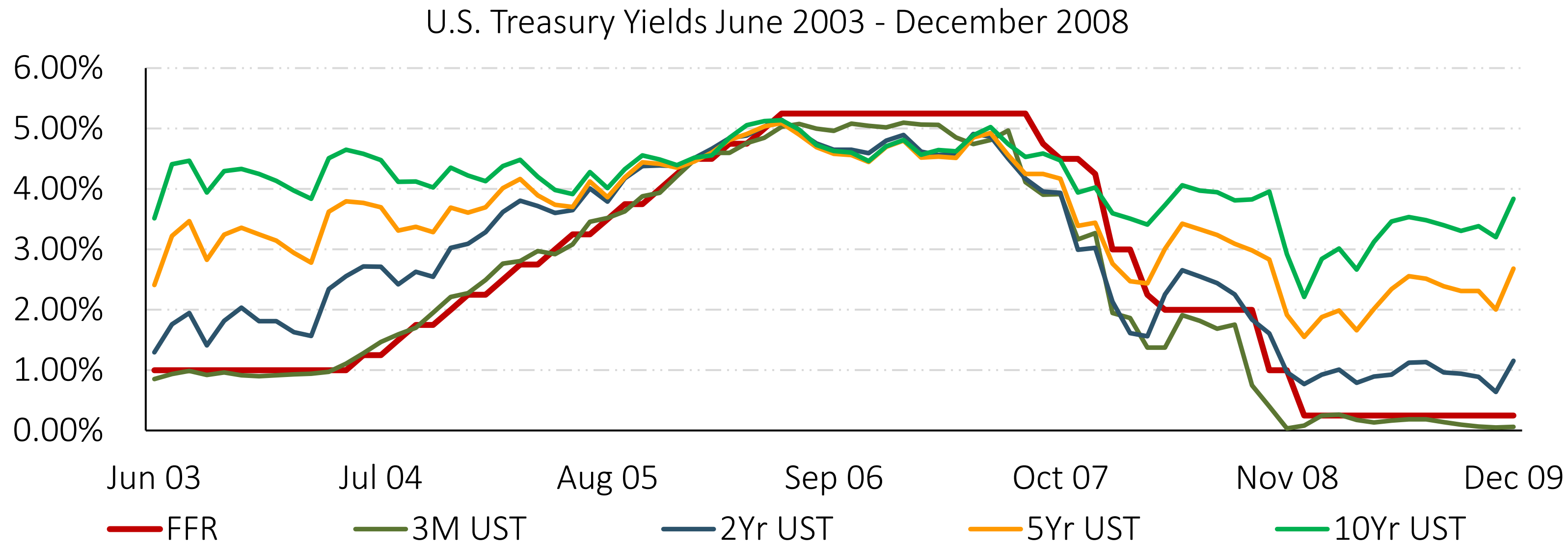
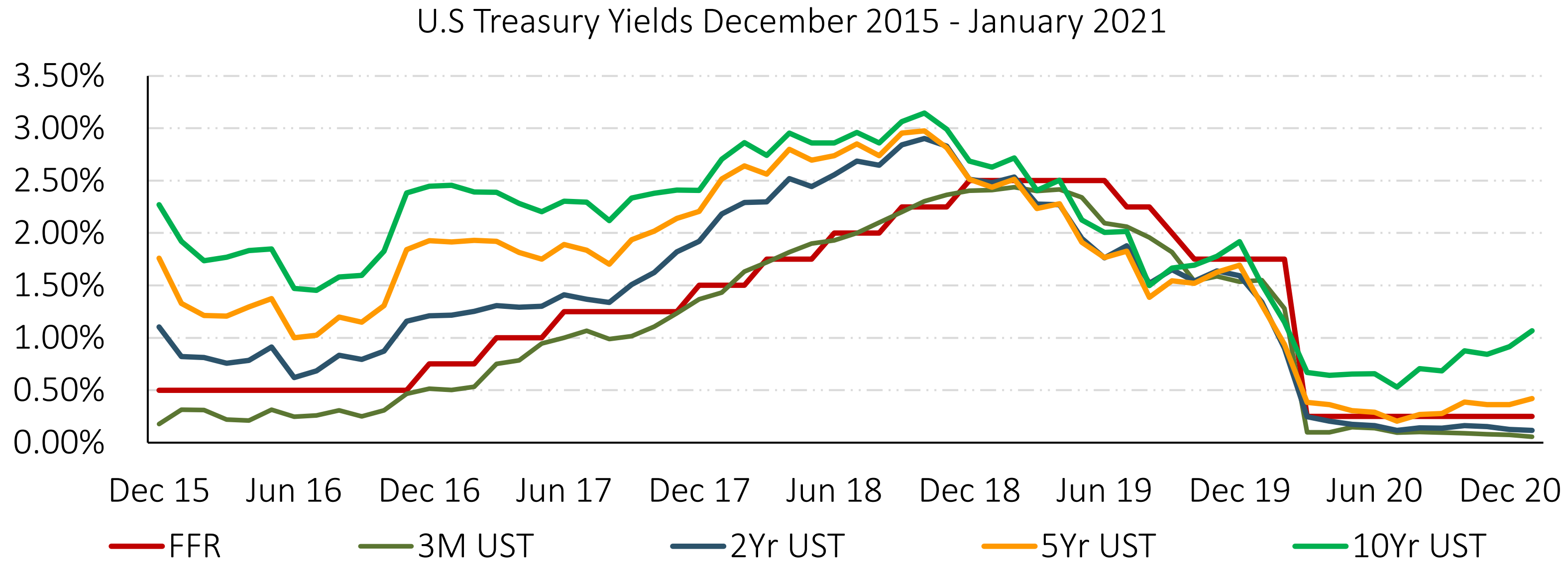
U.S. Treasury Yields – Interest Rate Cycle





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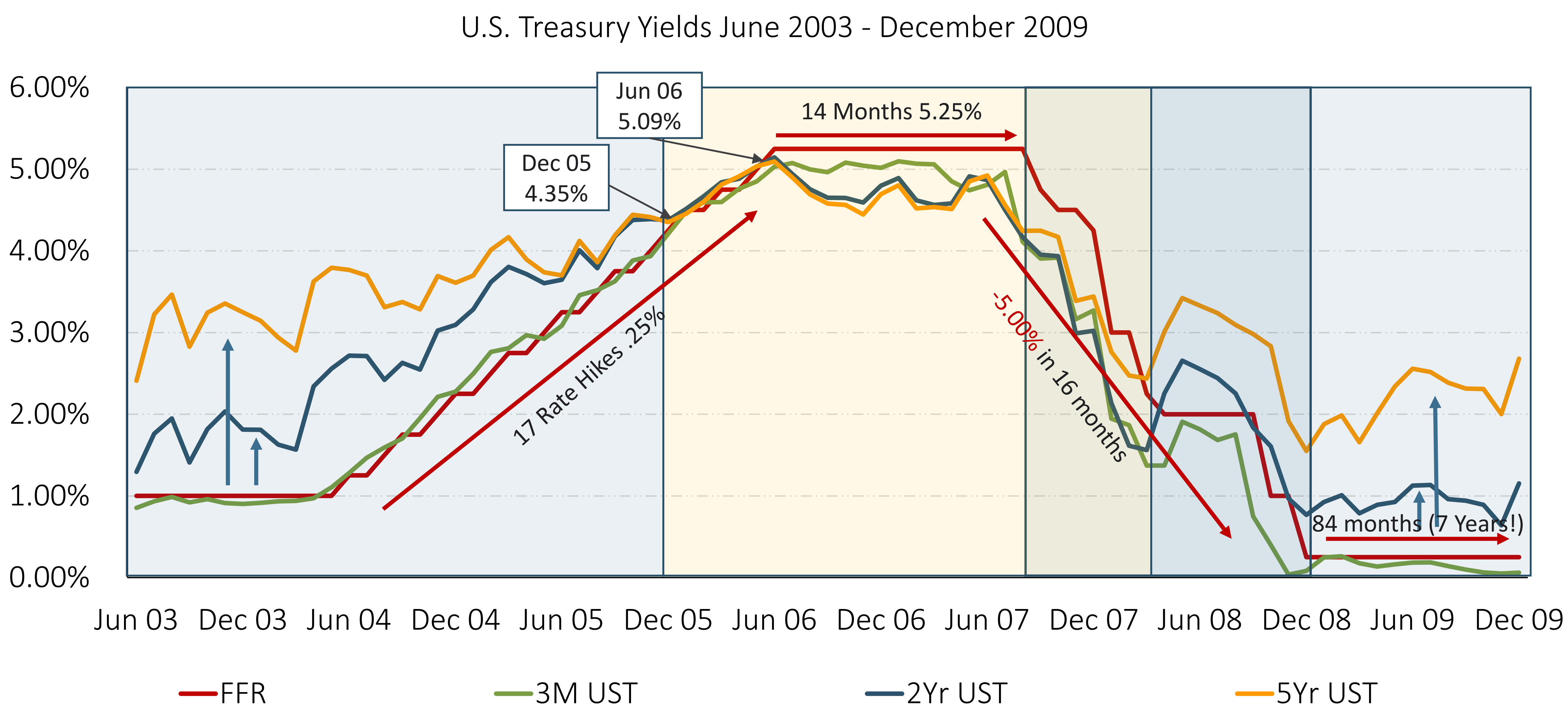

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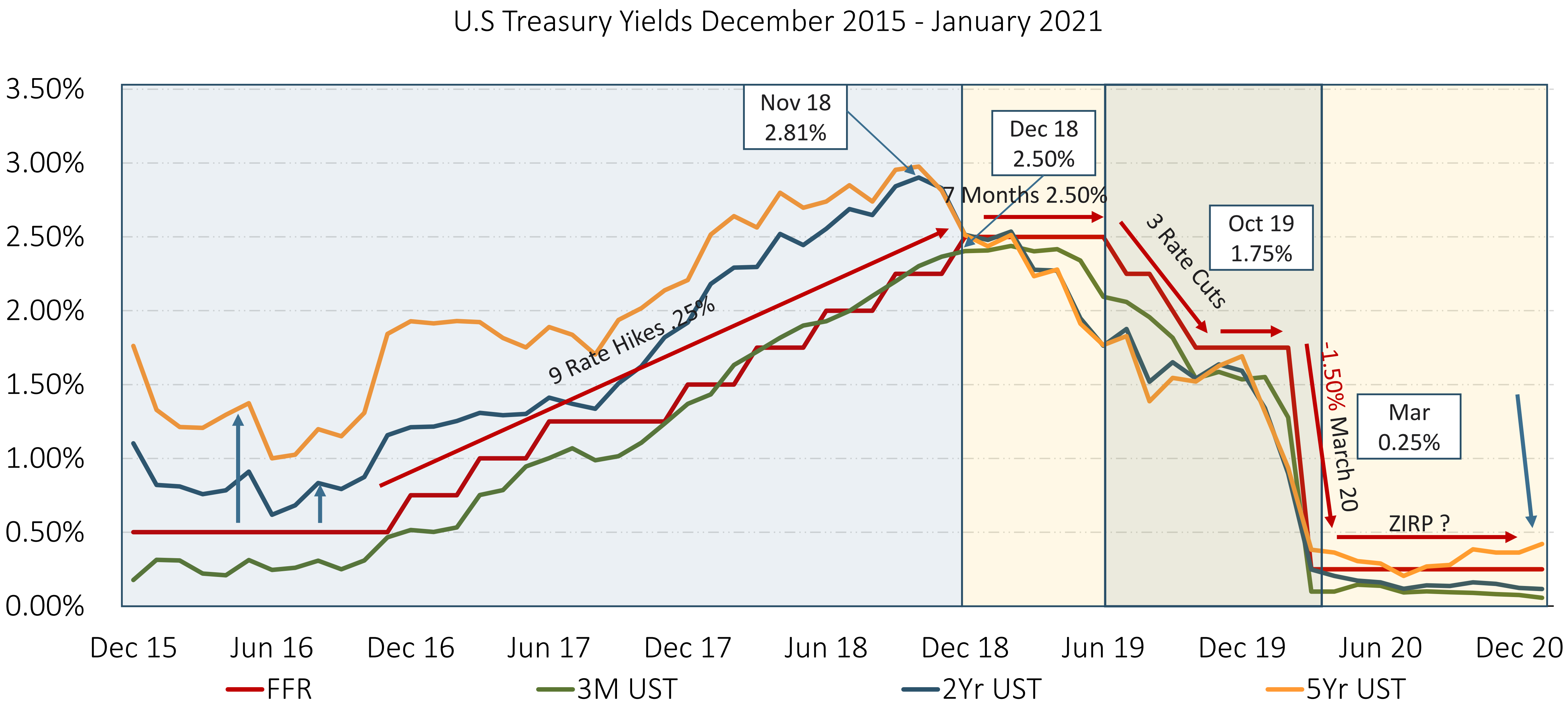

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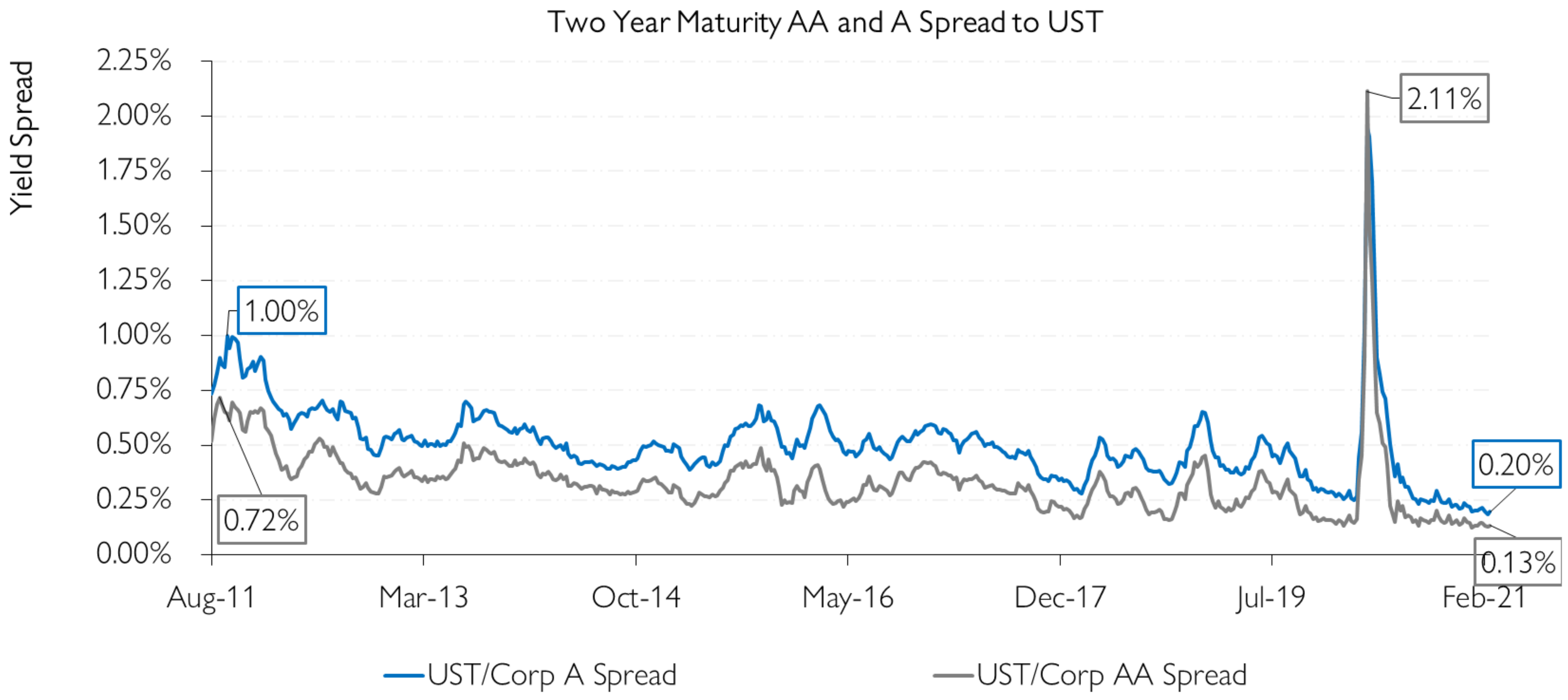
Corporate Credit Spreads



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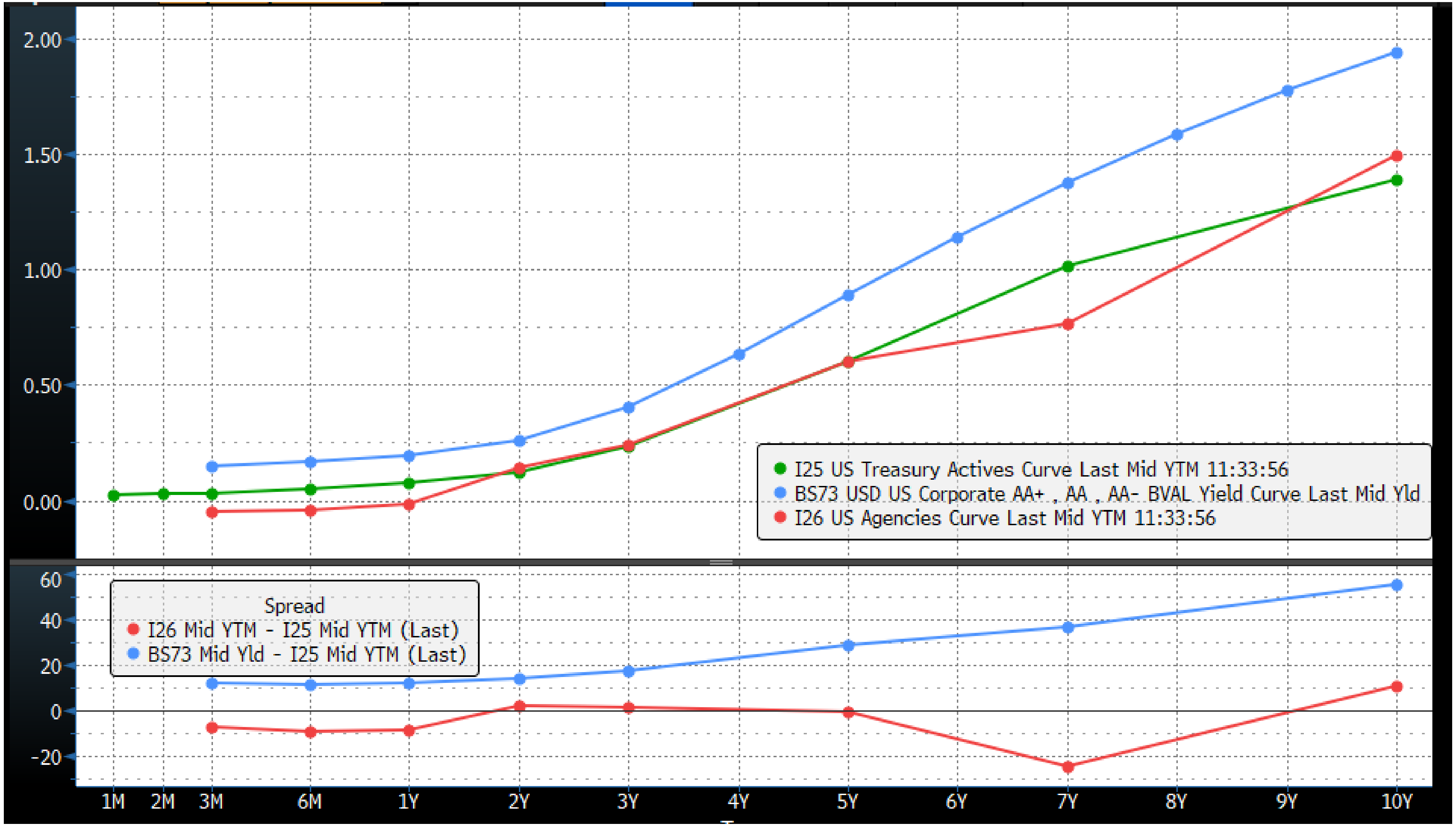
Yield Comparison



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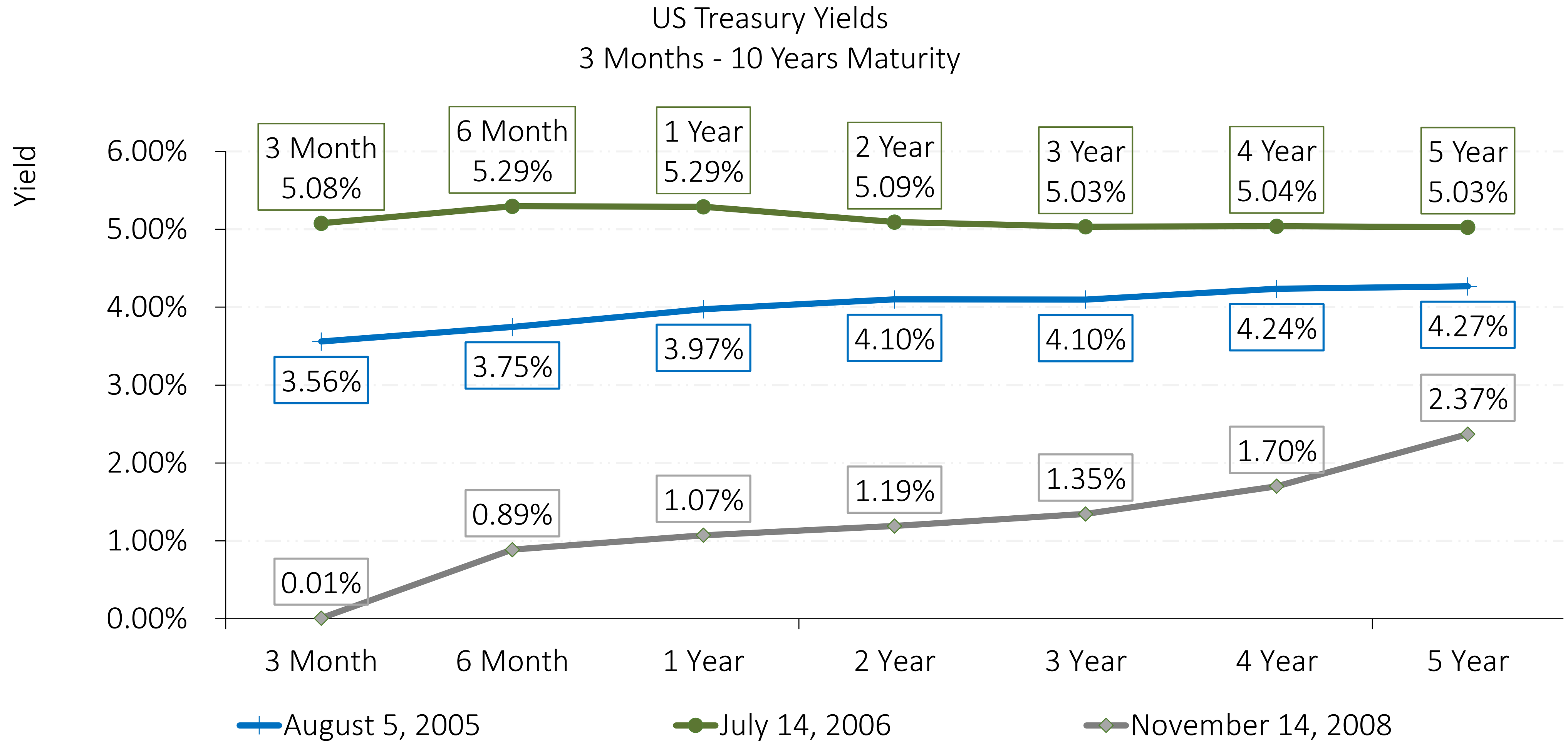
Yield Curve 2005 - 2008



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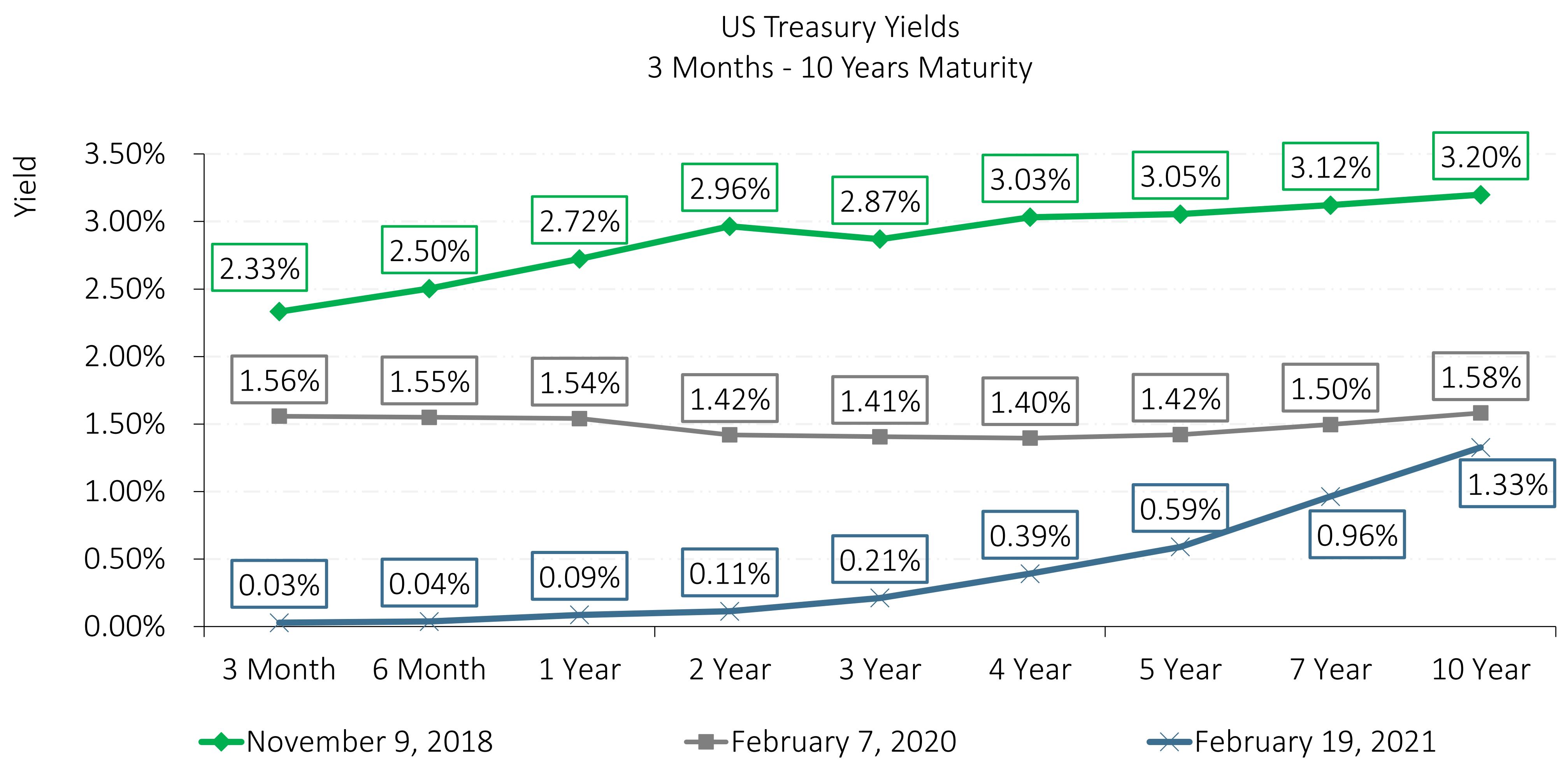
Yield Curve 2018 - 2021



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Role of Interest Rate Forecasting

- ✓ The selection of an appropriate benchmark defines the portfolio's strategic risk tolerance
- ✓ Adherence to strategy consistent with strategic risk profile is key long-term investment success
- ✓ Scenario analysis across varying rate scenarios (rising, falling, stable, etc.,) can assist in identifying appropriately constrained tactical duration management opportunities multiple rate scenarios.
- ✓ We expect nominal and real Treasury yields will remain lower than historical averages for longer
- ✓ Initial economic impact of COVID-19 is deflationary and will limit near-term yield increases
- ✓ The Fed's quantitative easing program is an explicit effort to lower longer-term interest rates
- ✓ Fed unlikely to raise short-term interest rates anytime soon
- ✓ Growing budget deficits and debt to fund fiscal stimulus efforts poses upside risk to rates
- ✓ Fed may consider additional QE programs or outright yield curve control to limit rate increases

Interest Rate Strategy in Light of the COVID-19 Pandemic

Pre-COVID Strategies

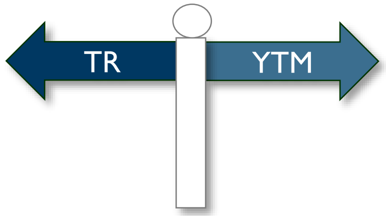
- ✓ Neutral to modestly long duration
- ✓ Reduced allocation to corporate bonds and other credit sensitive sectors
- ✓ Shortened spread duration in anticipation of wider credit spreads
- ✓ Yield curve allocation positioned for anticipated modest steepening
- ✓ Increased allocations to U.S. Treasury securities, Focus on most liquid securities

Post-COVID Strategies

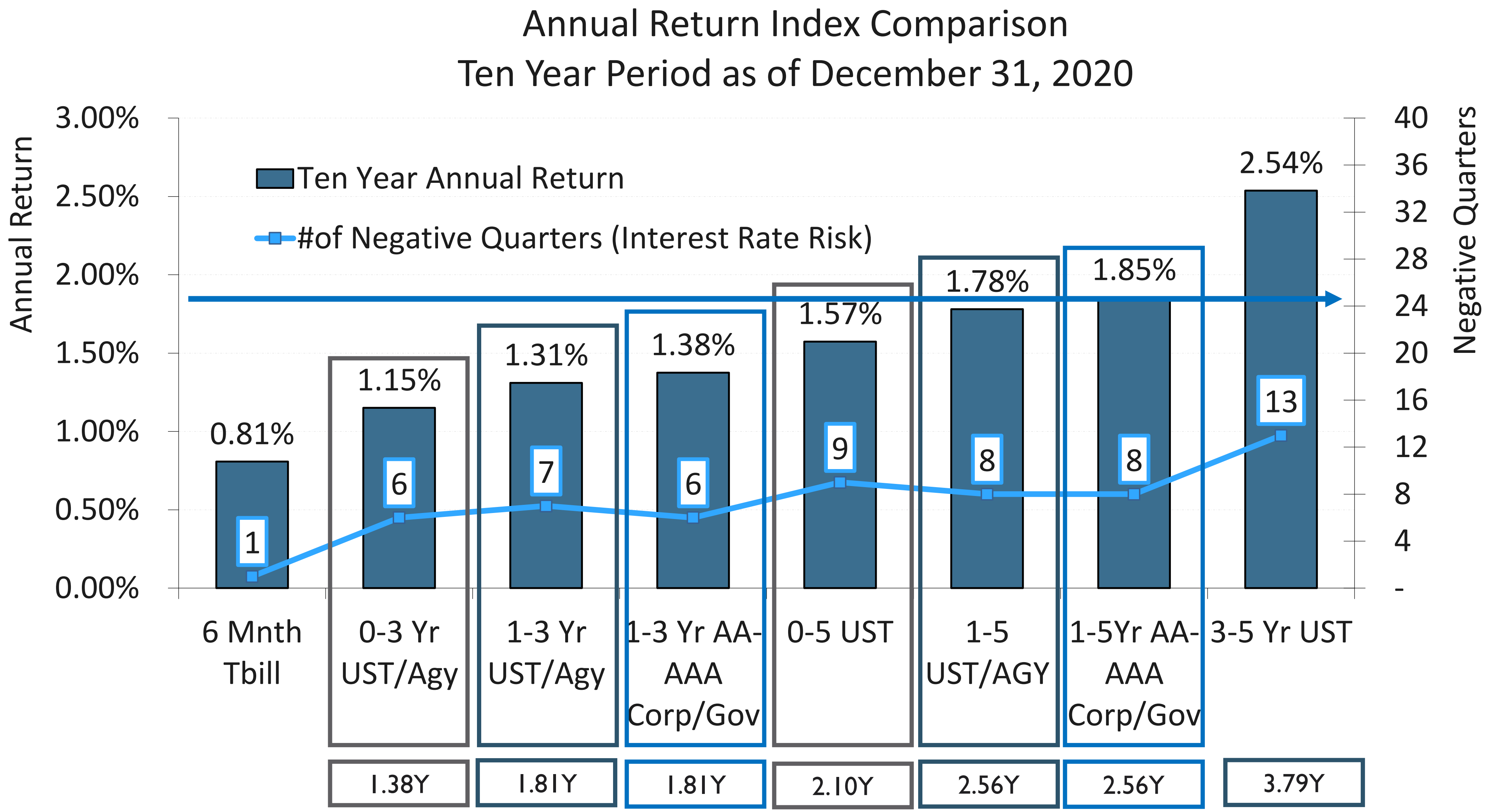
- ✓ Focus on ensuring sufficient liquidity given local agency revenue uncertainties
- ✓ Review liquidity versus core portfolio allocations and G/L status
- ✓ Re-allocating corporate holdings to strongest credits in the investment grade universe
- ✓ Increasing allocations to U.S. Agency and GSE debt given widening of yield spreads
- ✓ Increasing allocations to high quality taxable and tax-exempt municipal debt given valuations
- ✓ Maintaining portfolio durations neutral to benchmark given rate and curve uncertainties

Yield to Maturity vs. Total Return

- Yield To Maturity is a bond's internal rate of return based on the bond's projected cash flows, and price. Assumes all coupon payments are reinvested at the YTM.
  - Yield to Maturity is Forward Looking – Expected Earnings based on Price and Coupon
  - Book Yield to Maturity and Market Yield to Maturity
  - Book Yield reflects the Yield on the Book Value
- Total return is the return of the bond (or portfolio) since settlement. This includes income earned, realized gains and losses and the change in market value.
- Total Return calculates what has been earned for a Period of Time
- Includes Unrealized Gains and Losses
- Total Return Reflects the difference in the Market Value vs. Book Value



Historical Annual Returns – 10 Year Scenario



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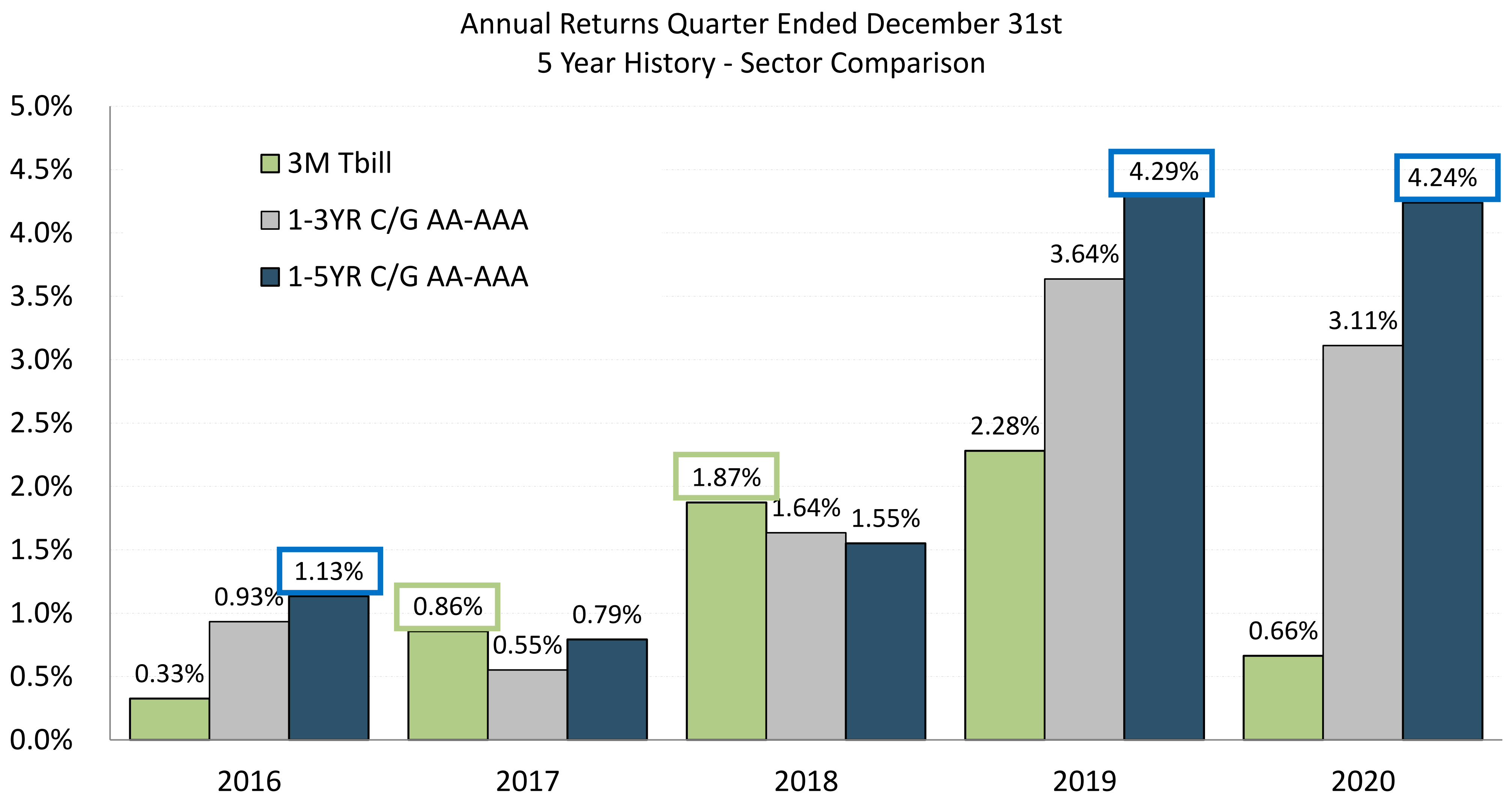

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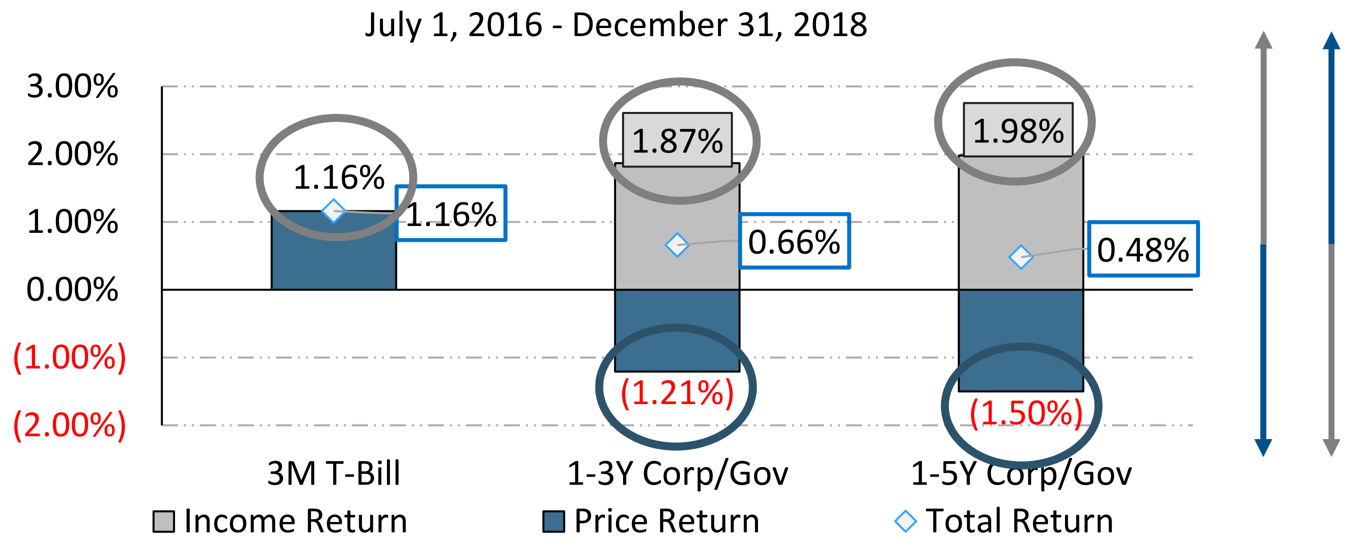
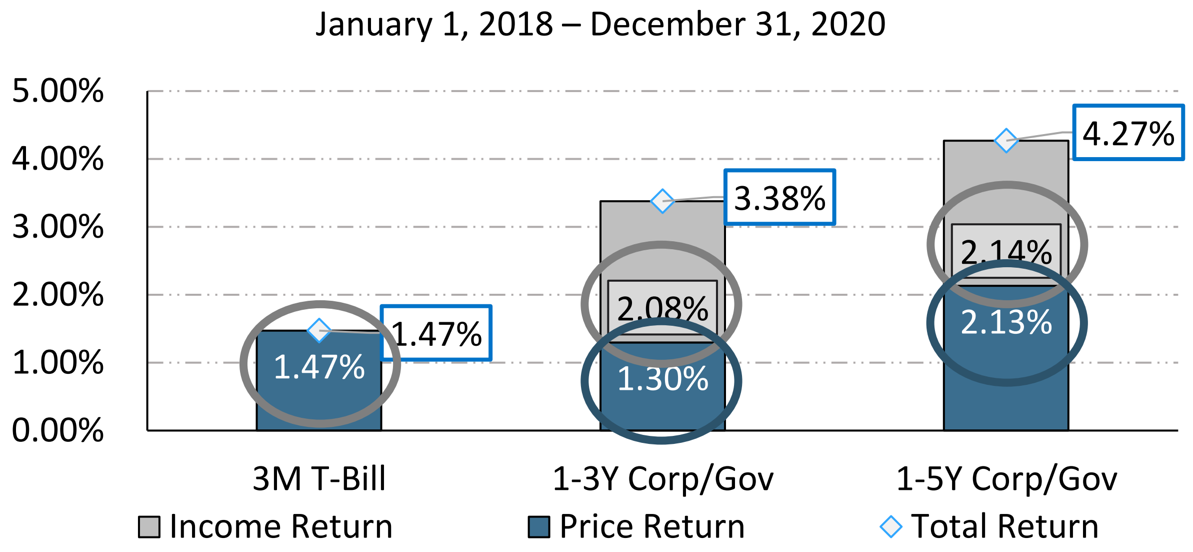
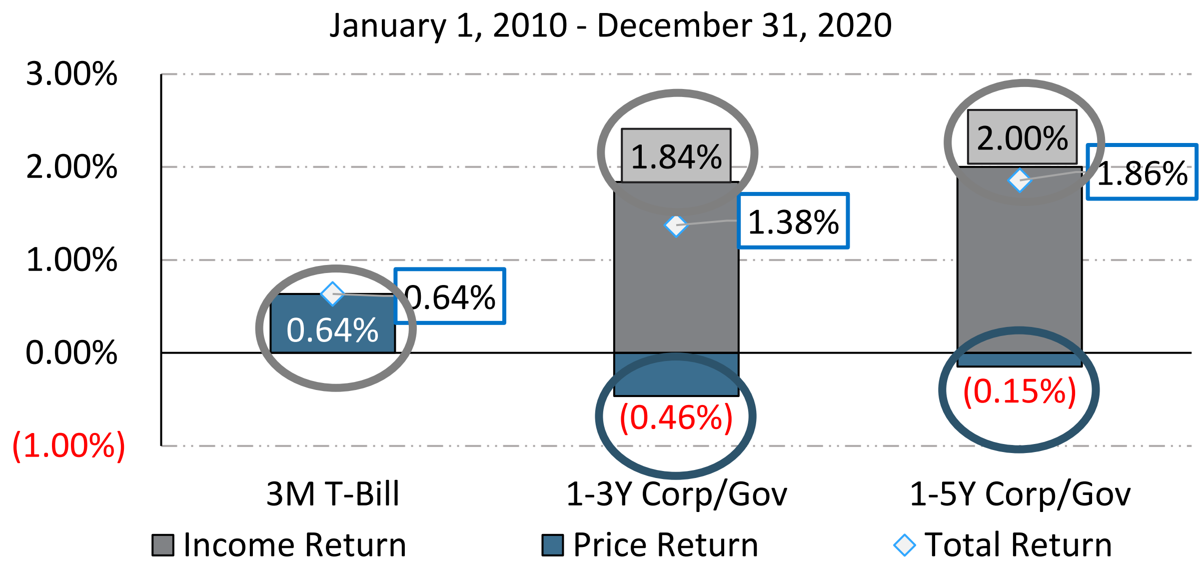
Components of Total Return – Price vs. Income Return







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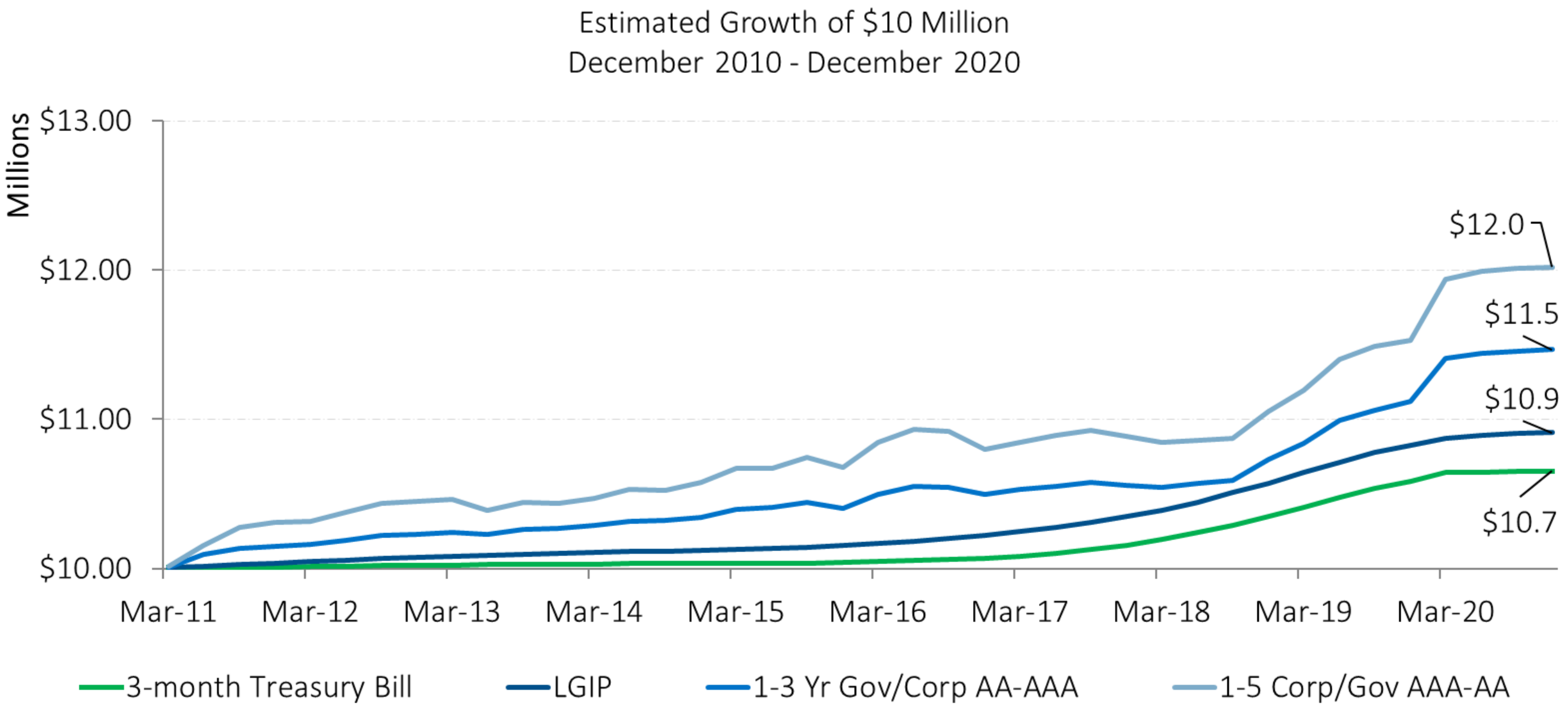
Poll Question #3

Historically the largest contribution to fixed income investment returns is:

A. Price return
B. Price volatility
C. Income return
D. Duration

Growth of Funds – 10 Year Scenario



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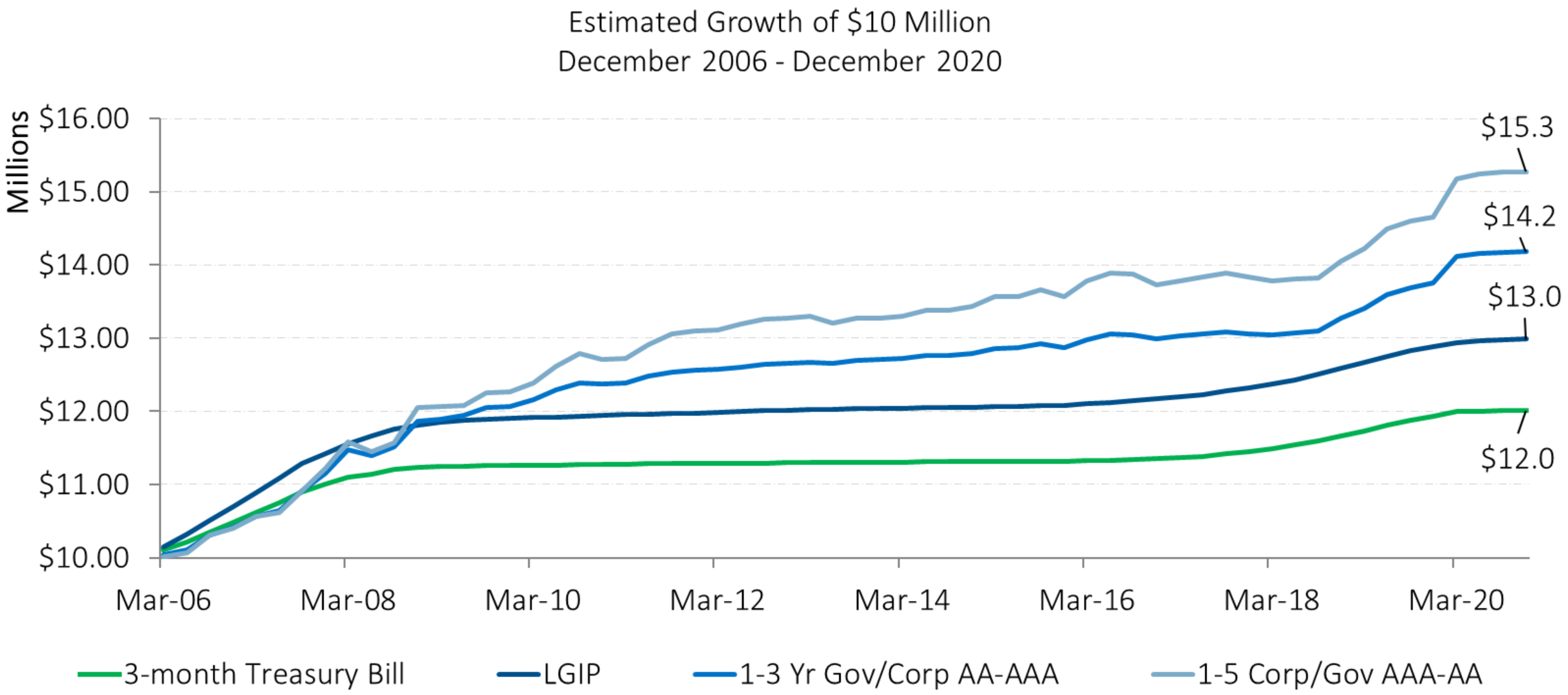
Growth of Funds – 15 Year Scenario



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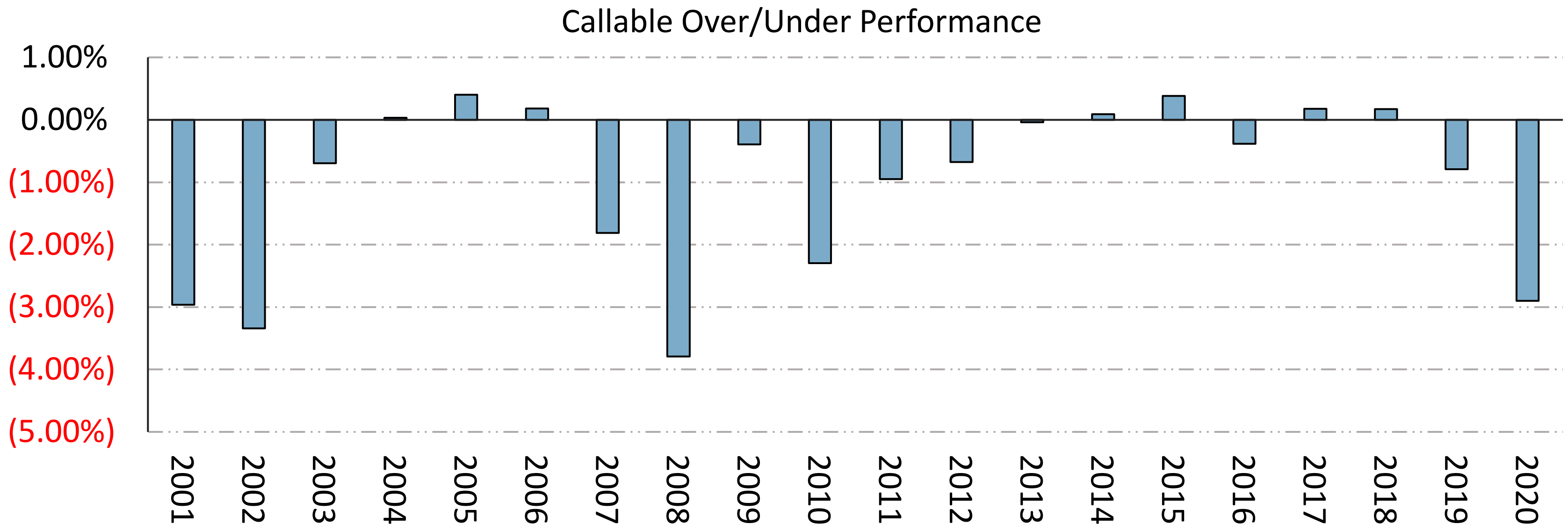
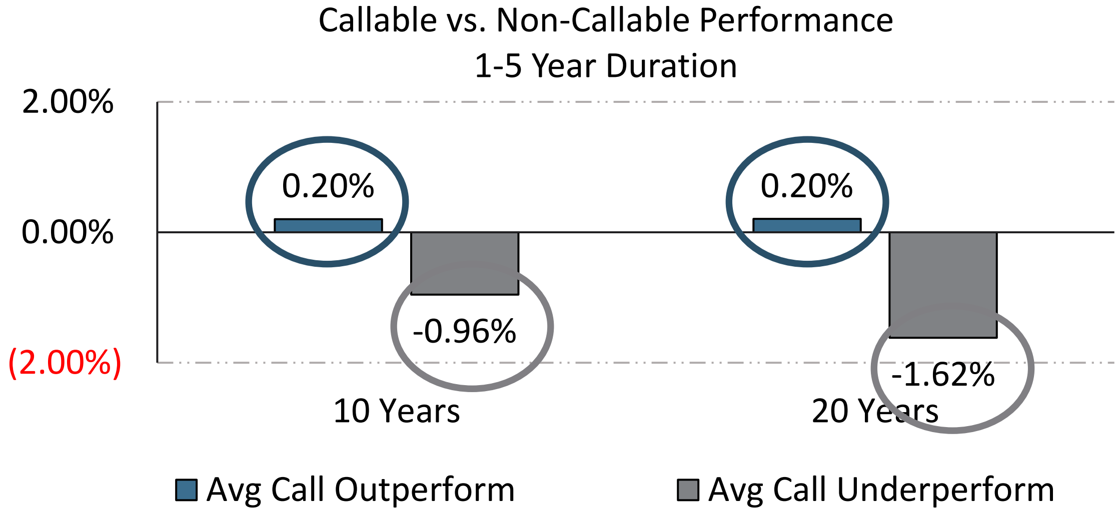
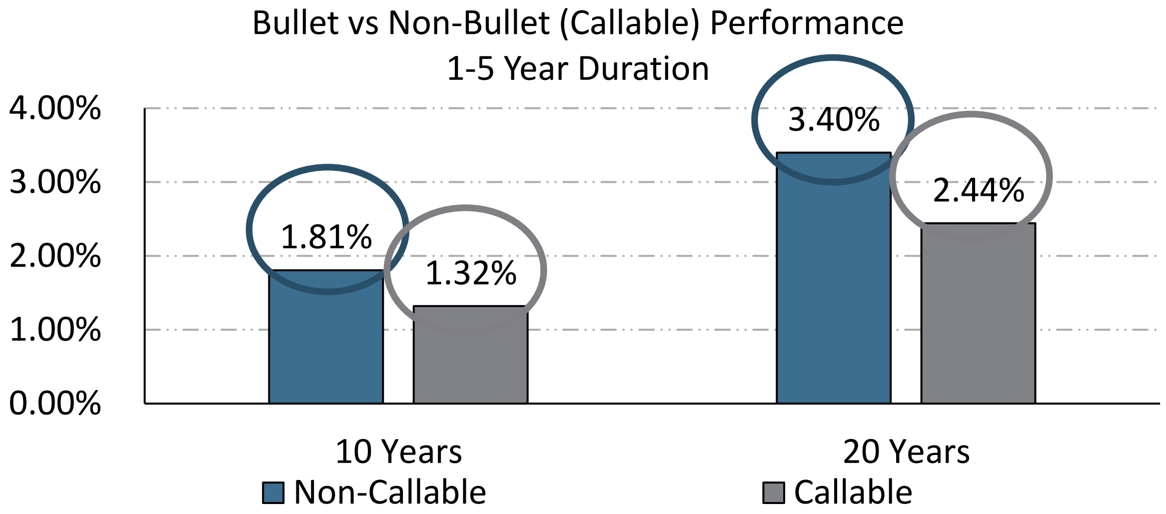
Callable vs. Bullet: 1-5 Year Duration Index Comparison





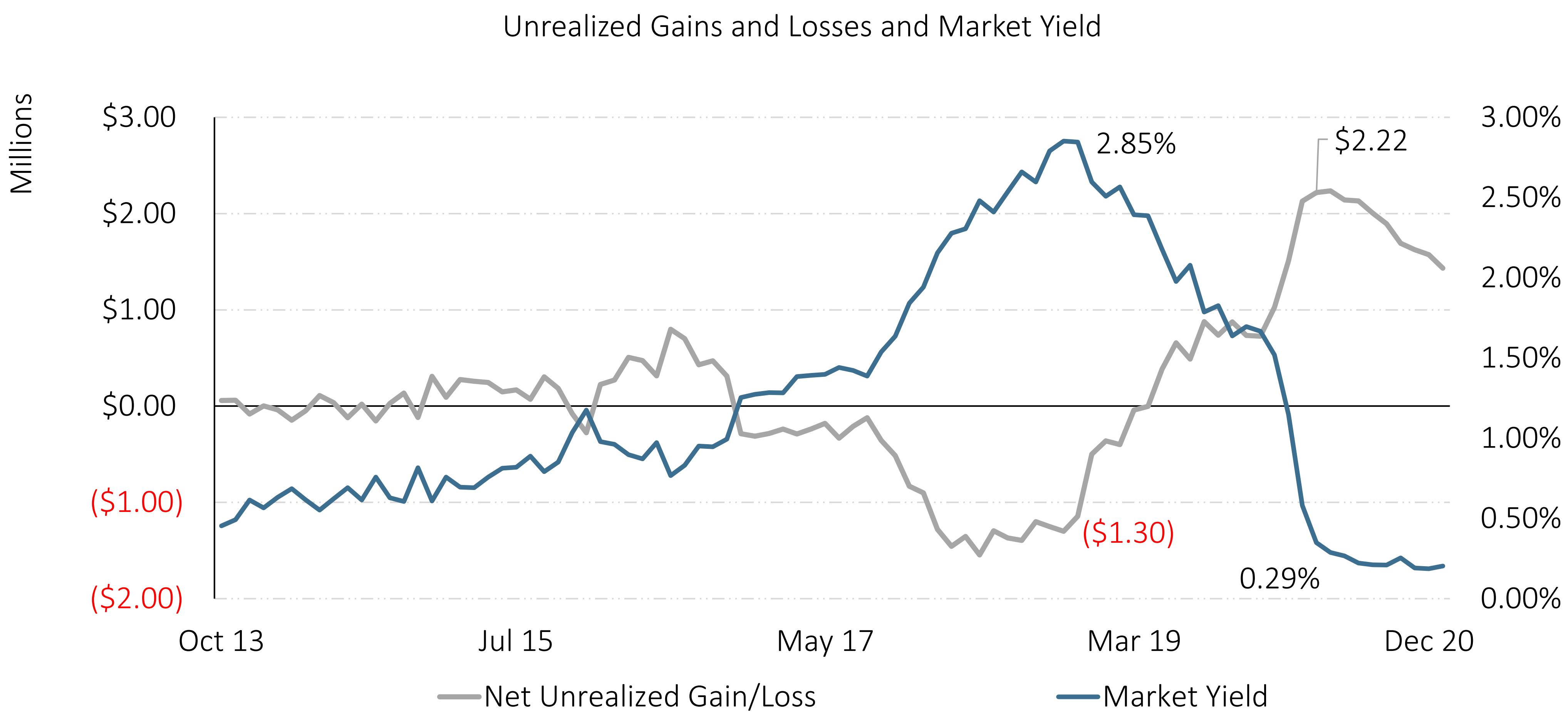


Source: Bloomberg - ICE BofA Fixed Income Indices. FLPRIME. Please reference disclosure page for additional information.

Book vs. Market Yield

Source: Public Trust. Please reference disclosure page for additional information.

Unrealized Gains Losses vs. Market Yield



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Poll Question #4

My entity’s largest revenue source is:

A. Ad Valorem
B. Sales Tax
C. Charges for Service
D. Tourist Related Taxes

Cash Flows and the Impact of COVID-19 on Future Revenues

- The impact of COVID-19 has been significant on local and state revenues.
- Our approach beginning in March was to discuss potential liquidity needs in the near term.
- We continued client conversations as the depth and scope of the impact of the pandemic became more apparent.
- Confirmed overall investment program structure and allocation to overnight assets and longer term assets.
- Client needs vary based on available balances, revenue sources, and immediate and short-term requirements .
- Provide scenario analysis for liquidity including security sale vs. bank/LGIP withdrawal.
- We believe the ultimate impact will be dramatically different based on factors such as geography, demographics, primary economic contributions (tourism, hospitality, technology), and primary revenue sources for the local entities.
- We continue to discuss revenue results from a budget vs. actual and also an historical perspective and provide longer term investment programs based on projected cash flows.

Considerations for Investment Strategies

- Market Timing: Shifting investment strategies may result in loss of interest income, increase in market risk volatility, or both.
- Multiple Duration Strategies: Utilizing short and longer term maturity strategies may provide reduced overall risk during several interest rate cycles.
  - Liquidity options including DDA, LGIP, MMF, CP, Discount Notes*
  - Maturities between one and five years for reserves*
- Consider Investment Risks: All investments have risks
  - Reinvestment Rate Risk
  - Market Risk (Interest Rate Risk)
  - Liquidity Risk

Considerations for Investment Strategies

Authorized Investment- Sector Type	Minimum Rating Requirement	Maturity Limits	Maximum Allocation	Individual Issuer Limit
Cash and Cash Equivalents	N/A	NA	100%	N/A
Florida PRIME Fund	AAAm	NA	40%	N/A
United States Government Securities	N/A	5 Years	100%	N/A
United States Government Agencies	AAA	5 Years	50%	25%
Federal Instrumentalities (United States Government Sponsored Enterprises "GSE")*	AA	5 Years	80%	25%
Mortgage Backed Securities "MBS"*	AAA	5 Years	20%	15%
Interest Bearing Time Deposit or Savings Accounts	N/A	1 Year	25% t	15%
Commercial Paper****	Highest two ratings by two NRSROs***	270 Days	35%	10%
Corporate Notes****	Single "A" category by any two NRSROs***	3 Years	35%	5%
Asset-Backed Securities (ABS)****	Double "A" category by any two NRSROs***	5 Years	20%	5%
State and/or Local Government Taxable and/or Tax-Exempt Debt	Single "A" category by two NRSROs***	5 Years	20%	5%
Registered Investment Companies (Money Market Mutual Funds)	AAAm	N/A	25%	10%
Intergovernmental Investment Pools	AAAm	N/A	40%	40%

Considerations for Investment Strategies - Active

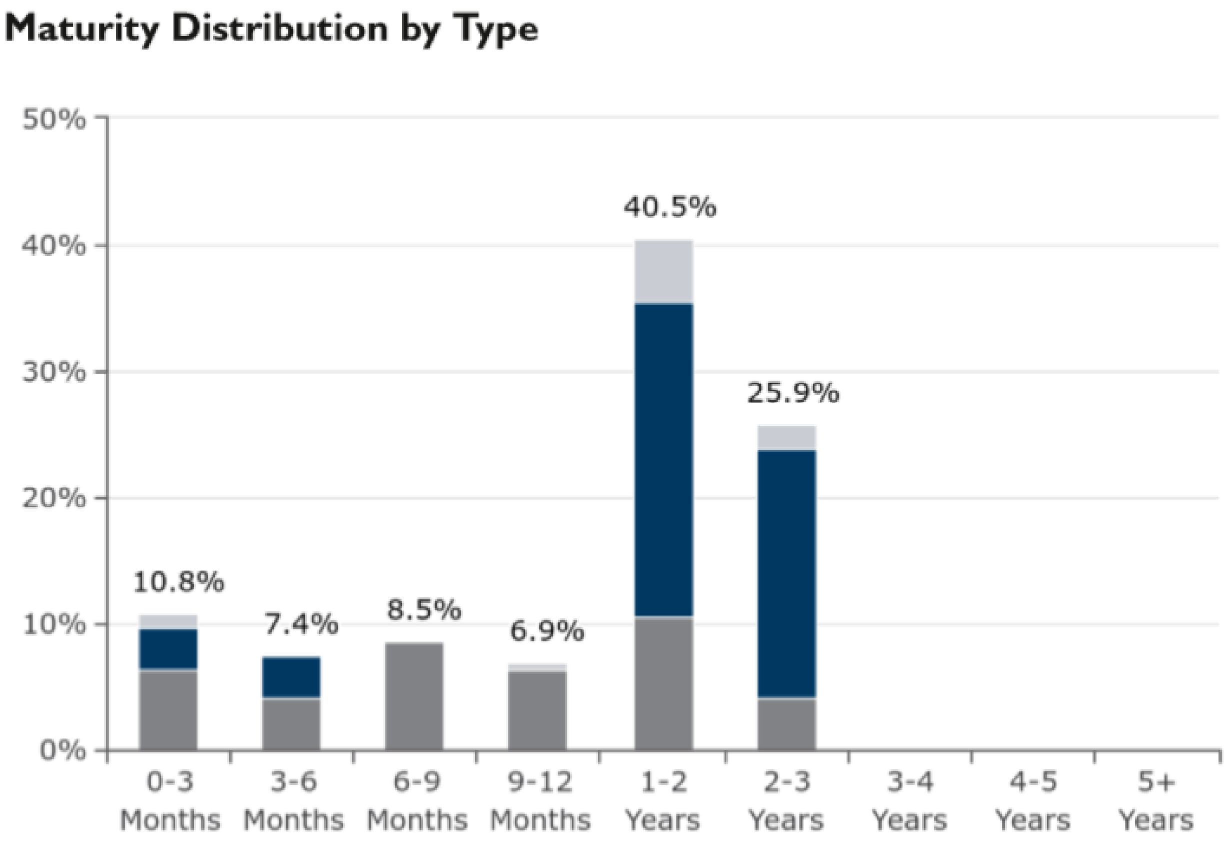
- Active vs. Passive Investing: Portfolios may be managed with a buy and hold strategy (passive) or an active strategy that maintains a defined target duration.
  - Both may use a laddered or barbell maturity structure.
  - Active strategy reported on a total return basis.
  - Active strategy performance is measured against a designated benchmark
  - Duration typically stays within 10% - 20% of benchmark duration.
  - Active strategy realizes gains and losses from trading activity.
  - In a pure active strategy realized losses may not be made up from reinvestment.
  - Active strategy seeks to benefit from changes in market conditions while maintaining duration and asset allocation parameters.

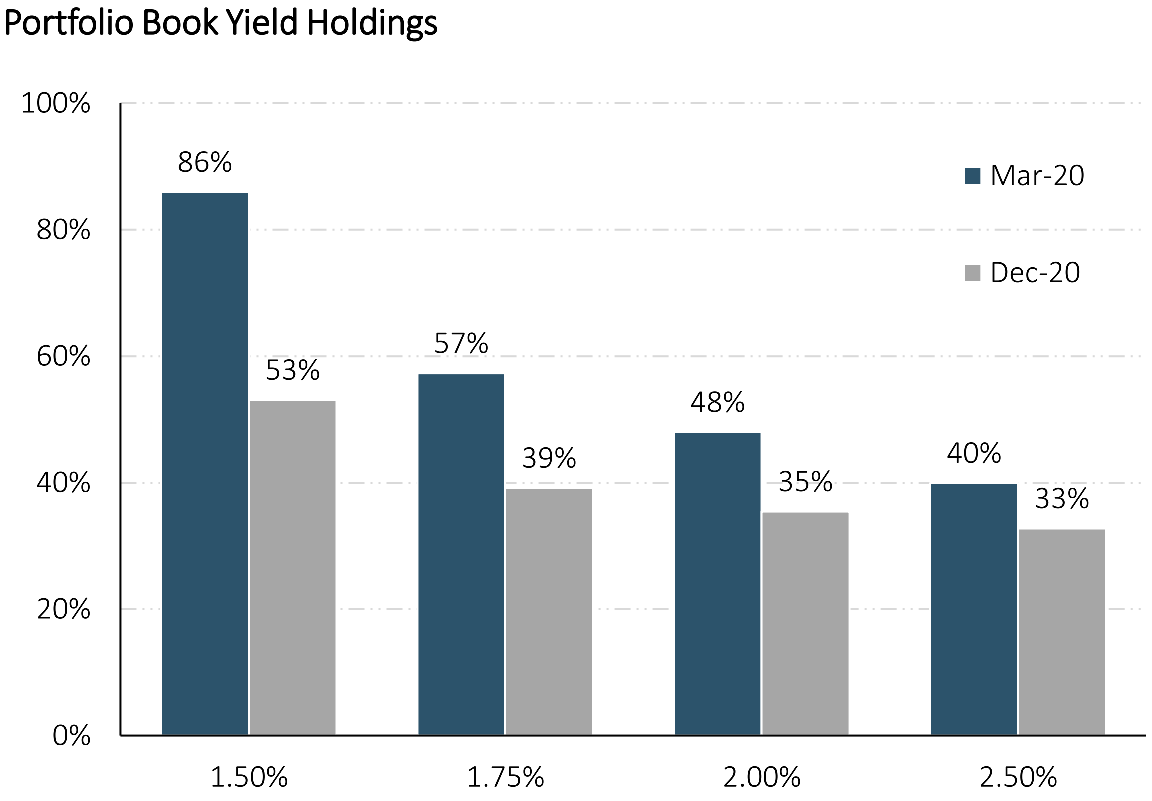
Considerations for Investment Strategies - Passive

- Active vs. Passive Investing: Portfolios may be managed with a buy and hold strategy (passive) or an active strategy that maintains a defined target duration.
  - Both may use a laddered or barbell maturity structure.
  - Passive strategy may be compared to a yield on a security with a similar duration (2 year avg. maturity compared to a 2 year U.S. Treasury yield.
  - Passive strategy duration not as defined as active strategy.
  - There are no realized gains or losses since securities are not sold prior to maturity.
  - Does not utilize changing market conditions (yield curves, spreads etc.) as part of strategy – reinvestments are based on existing market conditions.

Characteristics of a 1-3 Year Duration Portfolio

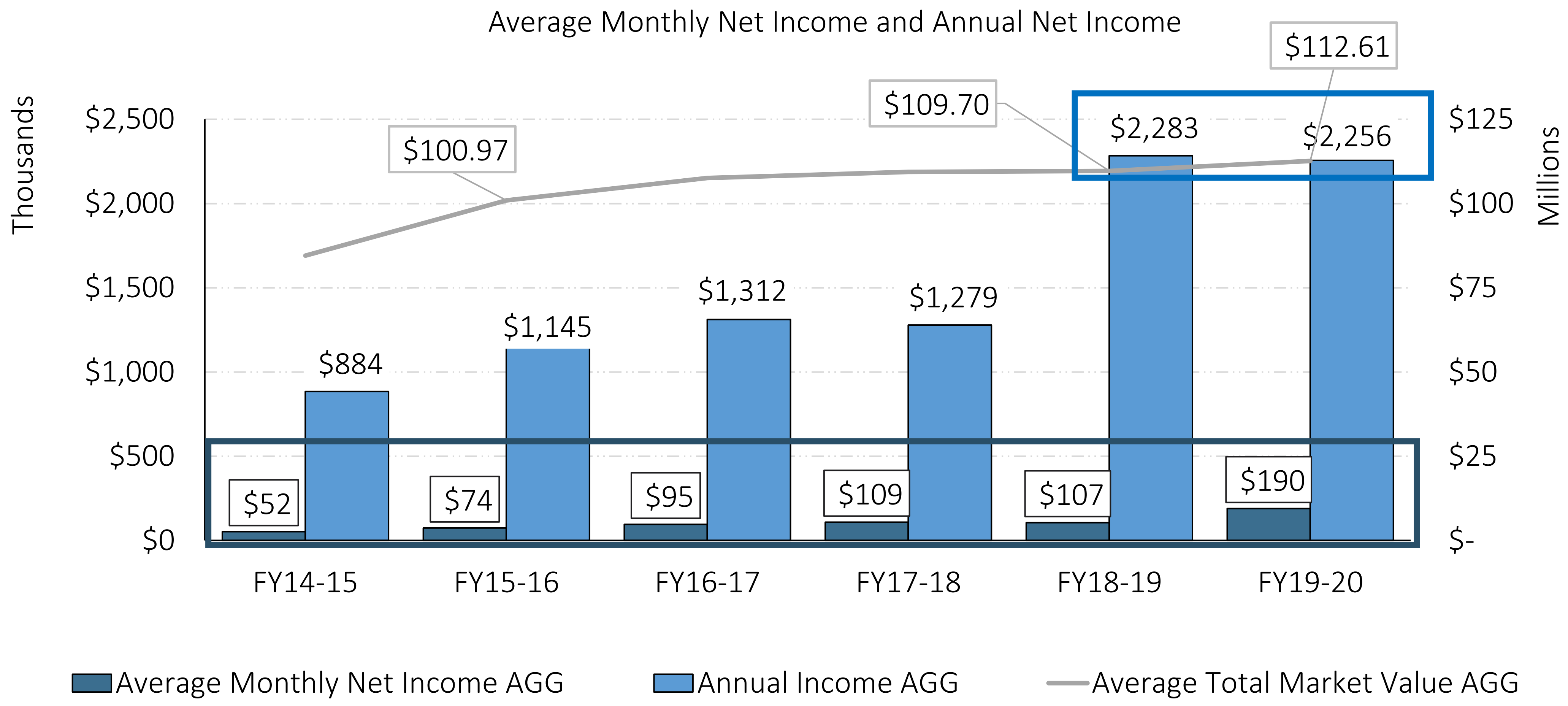
- The maturity structure of a longer-term portfolio can hedge against declining interest rates.





Source: Public Trust. Please reference disclosure page for additional information.

Sample Earnings Analysis of a 1-3 Year Duration Portfolio



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