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## CITY COUNCIL REPORT

DATE: 03/31/2016  
TO: Mayor and Councilmembers  
FROM: Sandy Corder, Interim Revenue Director  
CC: Josh Copley, Barbara Goodrich, Shane Dille, Leadership Team  
SUBJECT: 4th QUARTER 2015 INVESTMENT REPORT

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This City Council Report is the 4th quarter 2015 investment report for the period ending December 31, 2015.

### DISCUSSION

Every quarter, Council receives a quarterly investment report from staff. This investment report is for the fourth quarter of 2015.

The next page of the report contains highlights of the portfolio. The highlights include internally generated information and information pulled directly from the "Investment Performance Review" provided by The PFM Group (PFM). The Investment Performance Review provided by PFM begins on page 3.

### RECOMMENDATION / CONCLUSION

This report is for information only.

**INVESTMENT HIGHLIGHTS (Managed Portfolio)**  
(Approximate Numbers Used)

Item Description	4th Quarter 2015	Previous Quarter	Since Inception (July 2011)
Total Managed Portfolio	\$87 million	\$87 million	N/A
City Total Return	-0.57%	0.63%	0.84%
Benchmark Return	-0.65%	0.69%	0.81%
Return Spread (to Benchmark)	0.08%	0.02%	0.03%
Portfolio Duration (in Years)	2.60	2.44	N/A
Benchmark Duration (in Years)	2.60	2.59	N/A

**DEFINITIONS**

**Benchmark Return:** A comparative basis for measuring the performance of the portfolio. The City uses the ML 1-5 Year Government Index. The index consists primarily of debt issued by the United States Government.

**Return Spread:** The difference between the City Total Return and the Benchmark Return. (City Total Return minus Benchmark Return)

**Portfolio and Benchmark Duration:** The average length of time until all securities in the portfolio mature.

**COMMENTS**

- All investments comply with Arizona Revised Statutes and Flagstaff's Investment Policy.
- The total City resources on hand at the end of the quarter are as follows:

Item Description	Amount	Comments
Managed Portfolio	\$ 87 Million	PFM Managed Portfolio
City Managed	\$ 19.6 Million	CDs/Checking
Restricted Funds	\$ 13.0 Million	LGIP Landfill Closure Fund/Bond Proceeds/Other
<b>Total:</b>	\$119.7 Million	



# City of Flagstaff Quarterly Investment Report Quarter Ended December 31, 2015

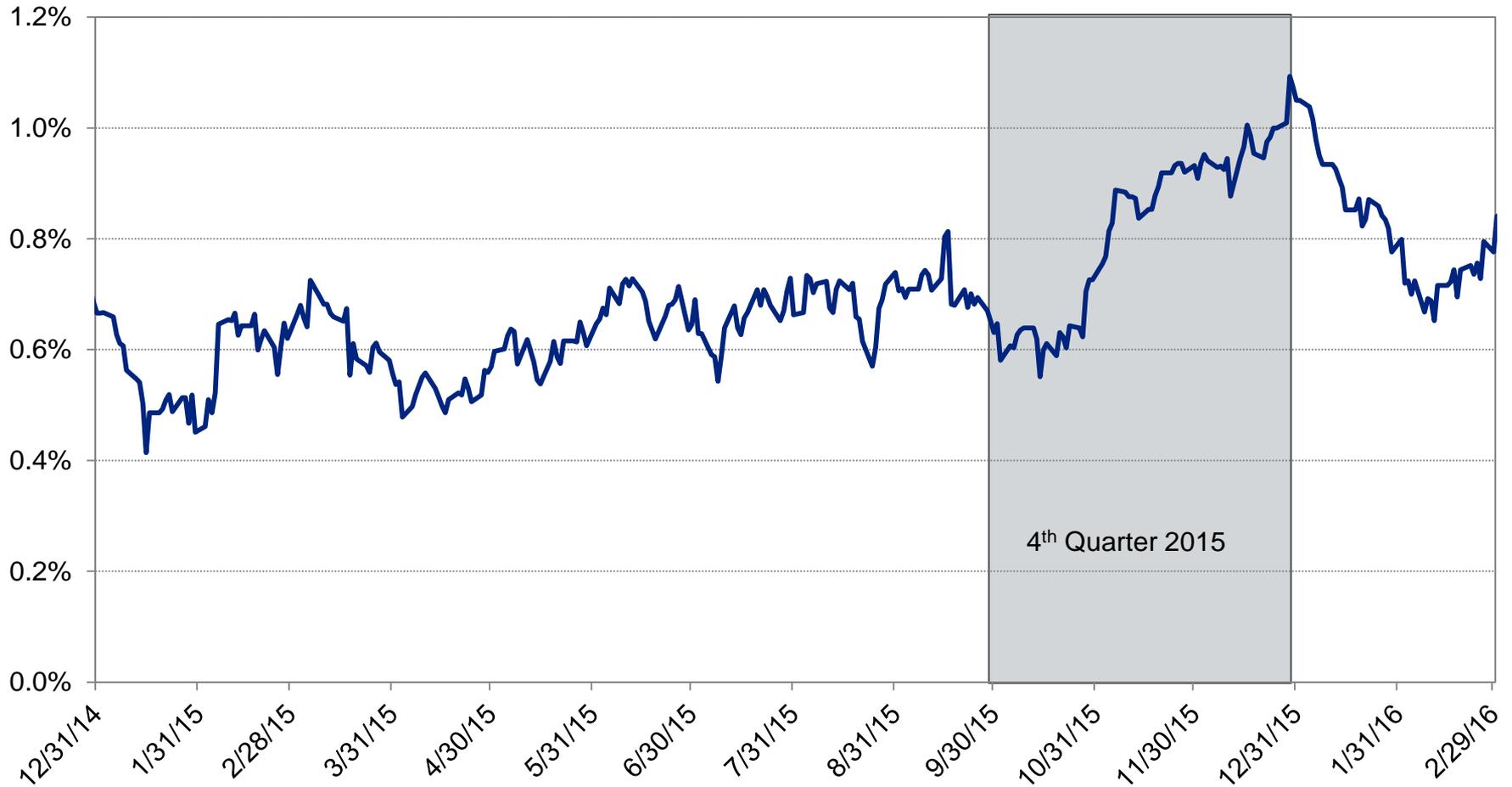


**The PFM Group**  
Financial & Investment Advisors

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Chandler, AZ 85225  
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# U.S. Treasury Yields

**2-Year Treasury Yield**  
December 31, 2014 – February 29, 2016



Source: Bloomberg.

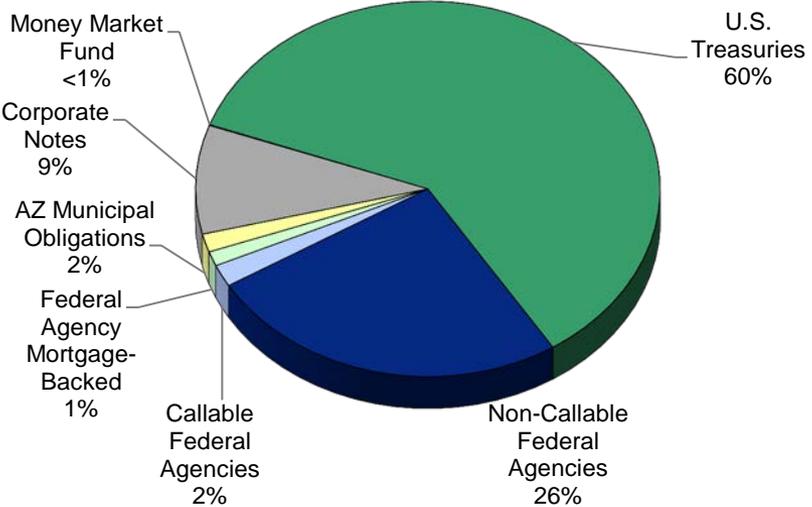
# Fourth Quarter 2015 Strategy and Recap

- While Treasury yields across the curve ended the quarter higher, the path towards higher rates varied by maturity.
  - Short-maturity yields rose steadily throughout the quarter as expectations for a December FOMC rate hike increased with an inflow of modestly strong economic data.
  - After increasing during the first half of the quarter, longer maturities leveled off as market participants priced in moderate growth expectations.
  - These factors combined to produce a flatter yield curve.
- Market reaction after the FOMC's announcement to raise the target range for the federal funds rate was relatively subdued, evidence that the action was in line with market expectations.
- PFMAM maintained a defensive duration position as rates trended higher. As rates approached the upper end of recent ranges, we extended duration from short of the benchmark's duration to a near-neutral position.
- The yield relationship between U.S. Treasury and federal agency securities remained stable throughout the fourth quarter. Our relative value analysis of these sectors continued to favor investments in U.S. Treasuries.
- PFMAM selectively added MBS issues that are expected to have limited sensitivity to interest rate volatility.

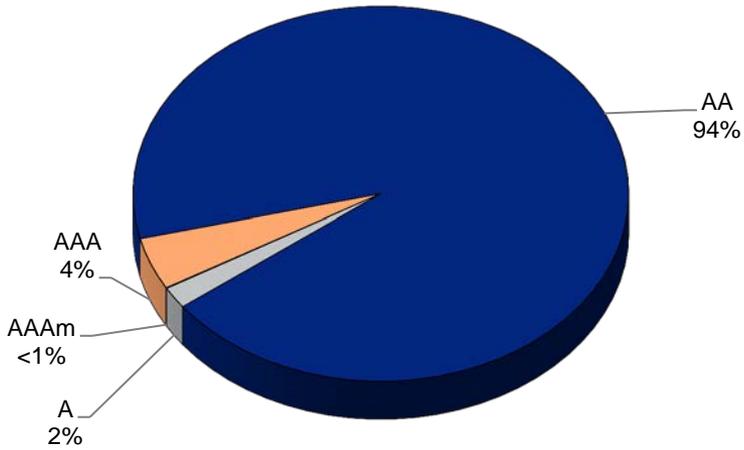
# Portfolio Composition and Credit Quality Characteristics

<u>Security Type<sup>1</sup></u>	<u>December 31, 2015</u>	<u>% of Portfolio</u>	<u>September 30, 2015</u>	<u>% of Portfolio</u>	<u>Permitted by Policy<sup>3</sup></u>
<b>U.S. Treasuries</b>	<b>\$52,534,767.08</b>	<b>60.4%</b>	\$50,377,069.60	57.6%	<b>100%</b>
<b>Federal Agencies<sup>2</sup></b>	<b>\$23,771,000.65</b>	<b>27.3%</b>	\$27,331,178.52	31.2%	<b>100%</b>
<i>Non-Callable Agencies</i>	\$22,119,694.95	25.4%	\$25,676,445.77	29.3%	100%
<i>Callable Agencies</i>	\$1,651,305.70	1.9%	\$1,654,732.75	1.9%	100%
<b>Federal Agency Mortgage-Backed</b>	<b>\$1,092,630.31</b>	<b>1.2%</b>	\$0.0	0.0%	<b>100%</b>
<b>AZ Municipal Obligations</b>	<b>\$1,366,641.00</b>	<b>1.6%</b>	\$1,368,430.50	1.6%	<b>50%</b>
<b>Corporate Notes</b>	<b>\$8,148,941.56</b>	<b>9.4%</b>	\$8,203,407.05	9.4%	<b>10%</b>
<b>Money Market Fund</b>	<b>\$56,173.41</b>	<b>0.1%</b>	\$188,856.45	0.2%	<b>25%</b>
<b>Totals</b>	<b>\$86,970,154.01</b>	<b>100.0%</b>	\$87,468,942.12	100.0%	

Operating Portfolio Composition



Operating Portfolio Credit Quality Distribution<sup>4</sup>

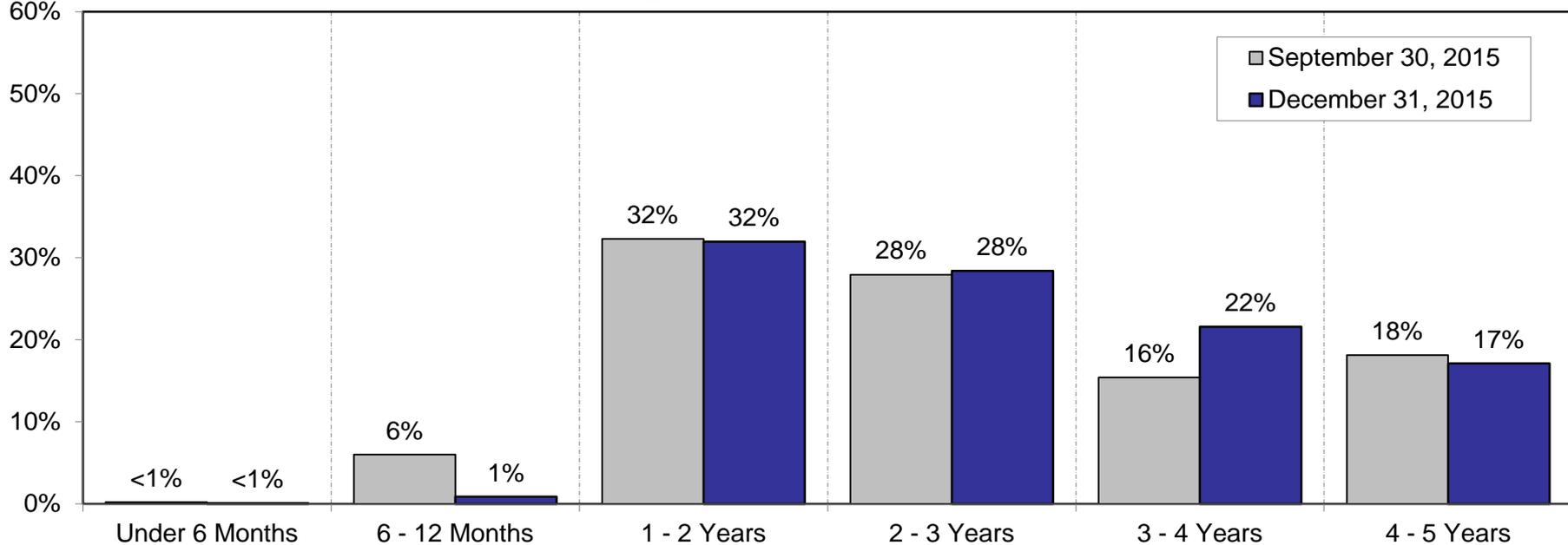


1. End of quarter trade-date market values of portfolio holdings, including accrued interest and Cash/Money Market Fund.  
 2. Federal agencies including, but not limited to, Fannie Mae, Freddie Mac, Federal Home Loan Bank system and Federal Farm Credit Banks.  
 3. Percentage limitations apply to aggregate investments.  
 4. Ratings by Standard & Poor's

# Operating Portfolio Maturity Distribution

<u>Maturity Distribution</u>	<u>December 31, 2015</u>	<u>September 30, 2015</u>
Under 6 Months	\$56,173.41	\$188,856.45
6–12 Months	\$763,545.00	\$5,256,089.71
1–2 Years	\$27,792,580.35	\$28,257,841.15
2–3 Years	\$24,687,381.21	\$24,437,486.45
3–4 Years	\$18,782,803.24	\$13,481,311.21
4–5 Years	\$14,887,670.80	\$15,847,357.15
<b>Totals</b>	<b>\$86,970,154.01</b>	<b>\$87,468,942.12</b>

Operating Portfolio Maturity Distribution <sup>1</sup>



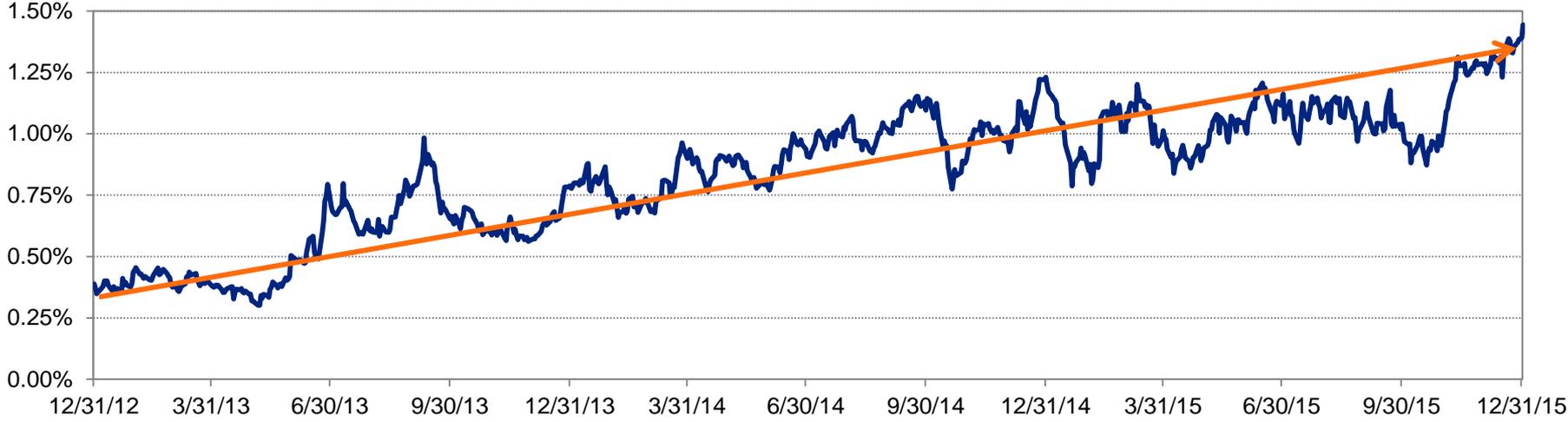
1. Callable securities in portfolio are included in the maturity distribution analysis to their stated maturity date, although they may be called prior to maturity.

# Capitalized on Rising Treasury Yields

- Interest rates gradually increased throughout the quarter, pricing in rate hike expectations leading up to the FOMC meeting. We locked in attractive longer-term Treasury yields where we saw the opportunity, selling out of shorter-term and lower-yielding securities.
- These trades served both to generate additional earnings and to extend duration in line with the target.

Trade Date	Trade Type	Security	Maturity	Par Value	Yield
10/8/15	Buy	U.S. Treasury Notes	2/29/20	\$1,700,000	1.32%
11/3/15	Buy	U.S. Treasury Notes	4/30/18	\$1,415,000	0.98%
11/5/15	Buy	U.S. Treasury Notes	2/29/20	\$3,000,000	1.55%
12/1/15	Buy	U.S. Treasury Notes	7/31/20	\$2,450,000	1.58%
12/28/15	Buy	U.S. Treasury Notes	8/31/20	\$2,950,000	1.74%

**3-Year U.S. Treasury Yields**  
December 31, 2012 – December 31, 2015



Source: Bloomberg.

# Increased Allocation to Agency MBS Sector

- The agency mortgage-backed securities sector (MBS) produced a strong performance during the quarter as the slow rise in long-term rates helped to mitigate prepayment risk.
  - Prepayments typically occur when mortgage holders exercise the option to refinance, which can hurt bondholders.
- We increased the allocation of the MBS sector, adding issues that are expected to have limited sensitivity to interest rate volatility.

Trade Date	Trade Type	Security	Maturity	Par Value	Yield
10/7/15	Buy	FNMA MBS Series 2015	9/1/19	\$745,000	1.09%
11/6/15	Buy	FNMA MBS Series 2015	1/1/19	\$345,000	1.20%

# Reinvestment into Historically Higher Rates

- As expected in a rising rate environment, current holdings in the portfolio decrease in market value and can result in a realized loss when sold.
- However, reinvesting in the higher yields now available will ultimately provide greater earnings for the City in the long term.

Trade Date: 12/1/15				
Trade Type	Securities	Par Value	Yield on Cost	Earnings Through 12/31/16
Buy	U.S. Treasury Notes	\$2,450,000	1.58%	\$41,839
Sell	U.S. Treasury Notes	\$2,500,000	0.72%	(\$19,090)
				(\$451)
<b>Total benefit of trade</b>				<b>\$22,298</b>

< earnings on purchased security  
 < earnings giving up by selling  
 < realized loss on sale

# Fixed-Income Returns

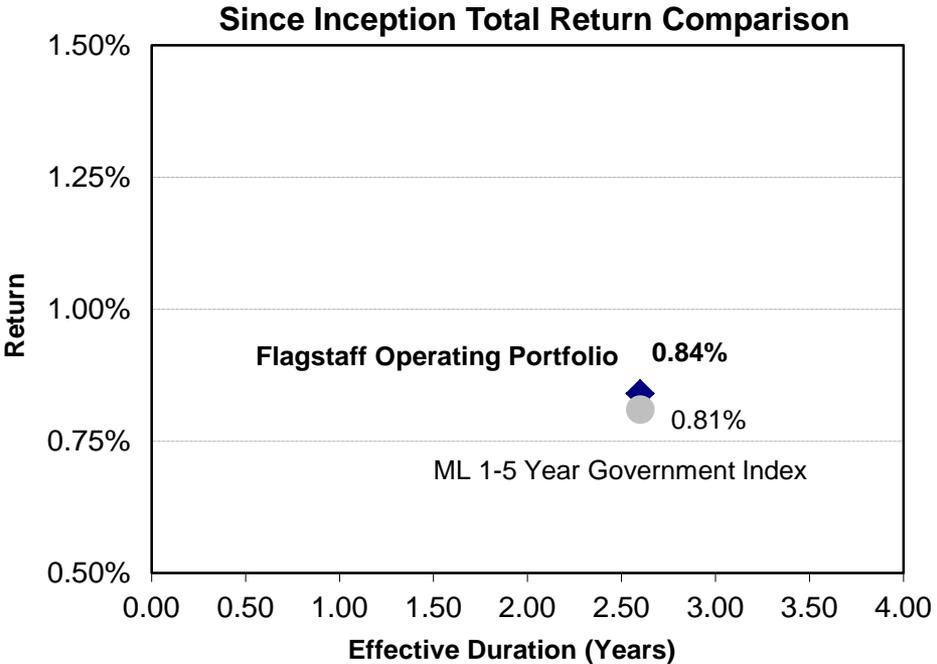
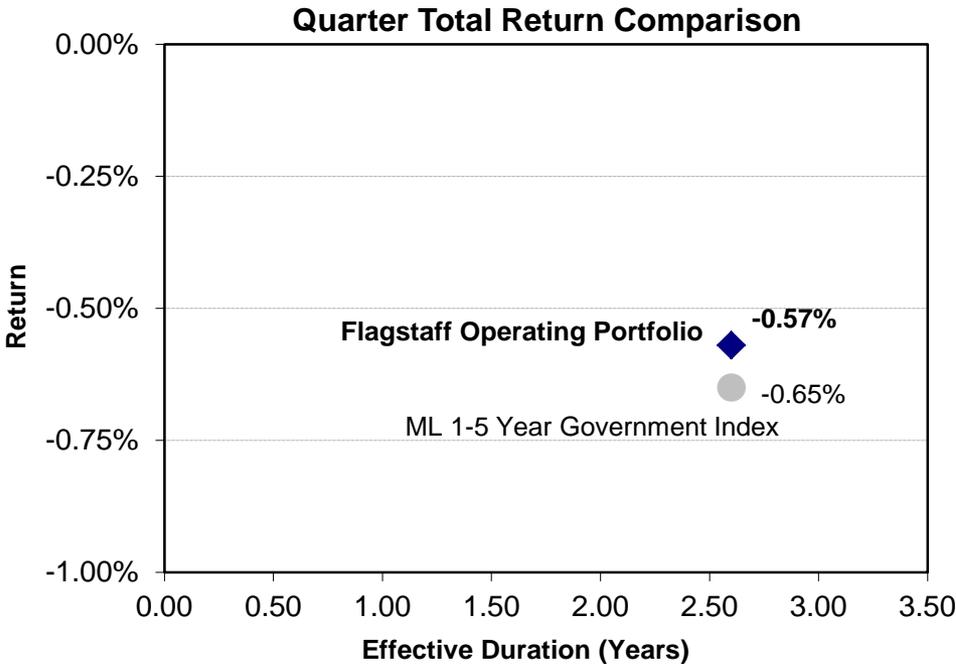
Overall rising interest rates and Fed rate hike

December 31, 2015	Effective Duration	Yield	YTD	1 Month	3 Month	1 Year	3 Years	5 Years
<b>1-3 Year Indices</b>								
U.S. Treasury	1.87	1.06%	0.54%	(0.09%)	(0.44%)	0.54%	0.51%	0.70%
Agency	1.73	1.14%	0.69%	(0.13%)	(0.37%)	0.69%	0.61%	0.84%
Corp A-AAA	1.90	1.82%	1.16%	(0.16%)	(0.05%)	1.16%	1.22%	1.85%
MBS (0 to 3 Years)	1.89	1.46%	1.68%	0.10%	0.98%	1.68%	1.20%	1.67%
Municipals	1.84	0.96%	0.76%	(0.02%)	(0.08%)	0.76%	0.85%	1.19%
<b>1-5 Year Indices</b>								
U.S. Treasury	2.70	1.29%	0.98%	(0.15%)	(0.66%)	0.98%	0.67%	1.25%
Agency	2.20	1.31%	0.97%	(0.16%)	(0.49%)	0.97%	0.76%	1.22%
Corp A-AAA	2.71	2.13%	1.52%	(0.26%)	(0.16%)	1.52%	1.59%	2.62%
MBS (0 to 5 Years)	3.35	2.23%	1.22%	(0.04%)	0.16%	1.22%	1.69%	2.52%
Municipals	2.52	1.15%	1.20%	0.03%	0.08%	1.20%	1.24%	1.80%
<b>Master Indices (Maturities 1 Year and Greater)</b>								
U.S. Treasury	6.19	1.77%	0.83%	(0.16%)	(0.93%)	0.83%	1.09%	2.99%
Agency	3.75	1.69%	0.99%	(0.25%)	(0.65%)	0.99%	1.05%	2.16%
Corp A-AAA	6.64	3.08%	0.67%	(0.42%)	(0.09%)	0.67%	1.97%	4.40%
MBS (0 to 30 Years)	4.53	2.63%	1.46%	(0.03%)	(0.06%)	1.46%	2.00%	2.93%
Municipals	6.74	2.34%	3.55%	0.79%	1.72%	3.55%	3.35%	5.65%

Source: BofA Merrill Lynch Indices. Returns greater than one year are annualized.

# Portfolio Performance

Total Return <sup>1,2,3,4</sup>	Quarter Ended December 31, 2015	Past 12 Months	Past 2 Years	Past 3 Years	Since Inception
<b>Flagstaff Operating Portfolio</b>	<b>-0.57%</b>	<b>0.96%</b>	<b>1.10%</b>	<b>0.68%</b>	<b>0.84%</b>
ML 1-5 Year Government Index	-0.65%	0.97%	1.11%	0.68%	0.81%
Effective Duration	December 31, 2015	September 30, 2015	Yields	December 31, 2015	September 30, 2015
<b>Flagstaff Operating Portfolio</b>	<b>2.60</b>	<b>2.44</b>	Yield at Market	1.33%	0.87%
ML 1-5 Year Government Index	2.60	2.59	Yield on Cost	1.22%	1.11%



1. Performance on trade date basis, gross (i.e., before fees), in accordance with the CFA Institute's Global Investment Performance Standards (GIPS).  
 2. The portfolio's inception date is September 7, 2011.  
 3. Merrill Lynch Indices provided by Bloomberg Financial Markets.  
 4. Quarterly returns are presented on an unannualized basis. Performance numbers for periods greater than one year are presented on an annualized basis.

# First Quarter 2016 Outlook and Strategy

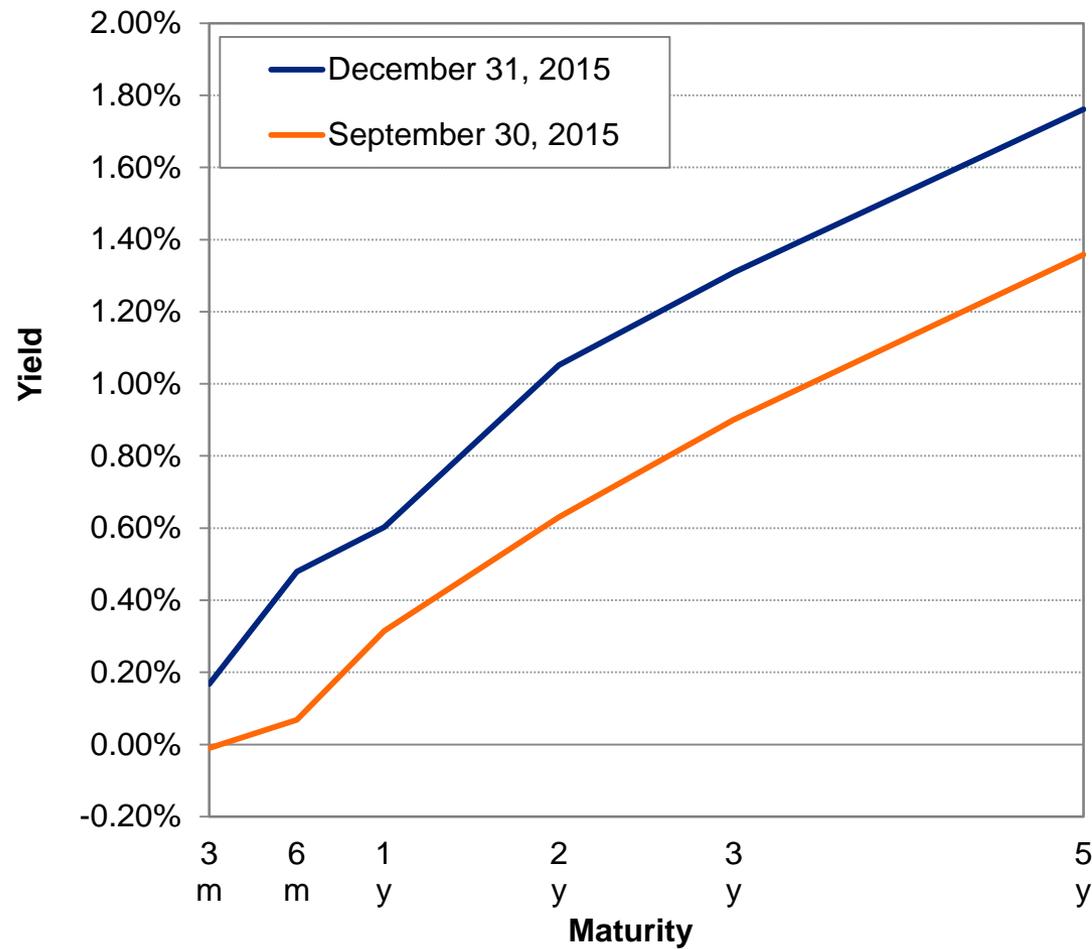
- We will continue to monitor any spillover effect that modest global growth and muted inflation may have on the U.S. economy.
- Recent FOMC projections indicate that Committee members anticipate that three or four rate hikes may be appropriate in 2016—projections that most market participants believe to be overstated. We believe:
  - Expectations for low inflation will limit this year’s rate hikes to two or three;
  - Short-term yields will trend only modestly higher in the near term; and,
  - Long-term rates will remain within modest ranges, resulting in further flattening of the yield curve.
- Given the low likelihood that rates will move significantly higher in the near-term, we started the new quarter with the portfolio’s duration positioned closer to the benchmark’s duration
- Because of narrow yield spreads, federal agencies currently have limited appeal relative to comparable-maturity U.S. Treasuries.
  - We will monitor the yield relationship between the two sectors and take advantage of opportunities that may arise—opportunities that are most likely to occur with new-issue securities.
- The corporate sector will remain a point of emphasis.



## Economic Update

# Interest Rates Rose Across the Curve in Q4

**U.S. Treasury Yield Curves**



	9/30/15	12/31/15	Change
<b>3 Month</b>	-0.02%	0.17%	+0.19%
<b>6 Month</b>	0.07%	0.48%	+0.41%
<b>1 Year</b>	0.31%	0.60%	+0.29%
<b>2 Year</b>	0.63%	1.05%	+0.42%
<b>3 Year</b>	0.90%	1.31%	+0.41%
<b>5 Year</b>	1.36%	1.76%	+0.40%
<b>10 Year</b>	2.04%	2.27%	+0.23%
<b>30 Year</b>	2.85%	3.02%	+0.17%

Source: Bloomberg.

# At Last! Fed Raises Interest Rates

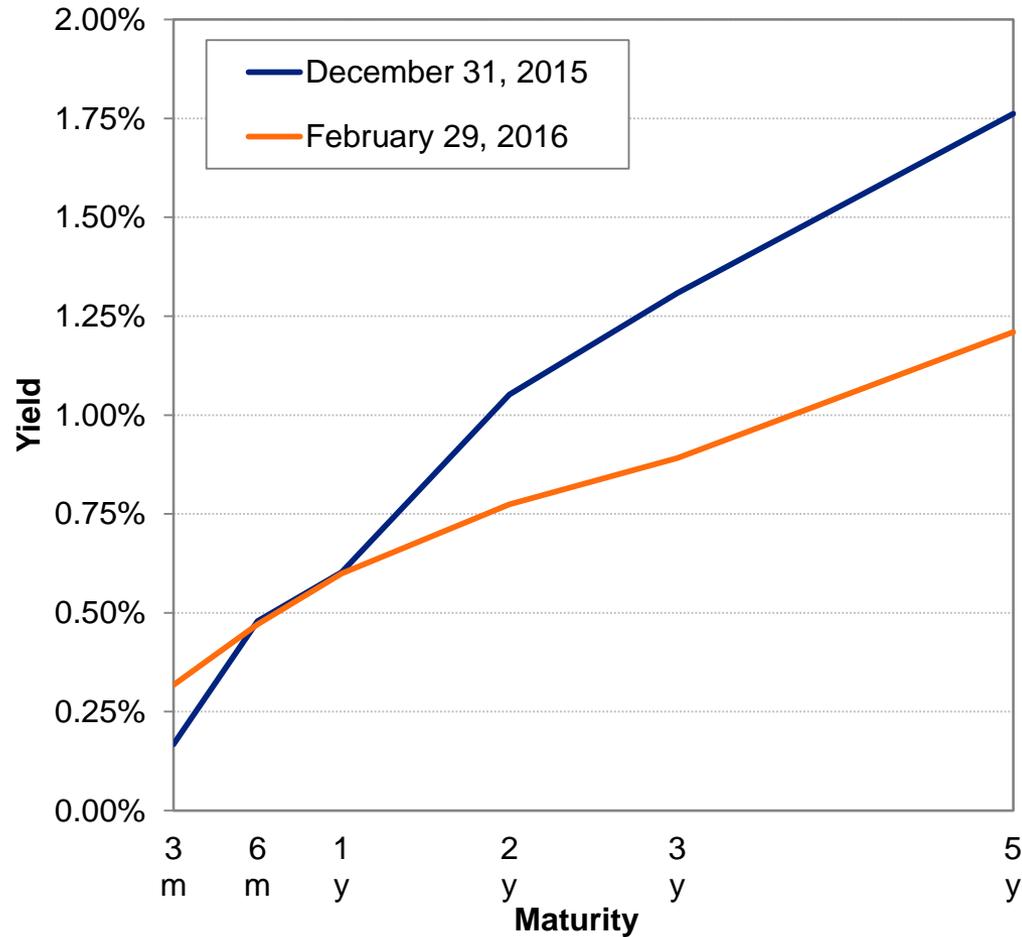
## FOMC December 15-16 Statement



- A range of recent labor market indicators, including ongoing job gains and declining unemployment, shows further improvement and confirms that **underutilization of labor resources has diminished appreciably since early this year.**
- Inflation has continued to run below the Committee's 2% longer-run objective, partly reflecting declines in energy prices and in prices of non-energy imports . . . Some survey-based measures of longer-term inflation expectations have edged down . . . [the Committee] is reasonably **confident that inflation will rise, over the medium term, to its 2% objective.**
- Given the economic outlook, and recognizing the time it takes for policy actions to affect future economic outcomes, the Committee decided to **raise the target range for the federal funds rate to 0.25 – 0.50%** . . . the stance of monetary policy remains accommodative.
- In light of the current shortfall of inflation from 2%, the Committee will carefully monitor actual and expected progress toward its inflation goal. The Committee expects that economic conditions will evolve in a manner that will warrant only **gradual increases in the federal funds rate.**

# Yields Down Sharply Since Year End

## U.S. Treasury Curves

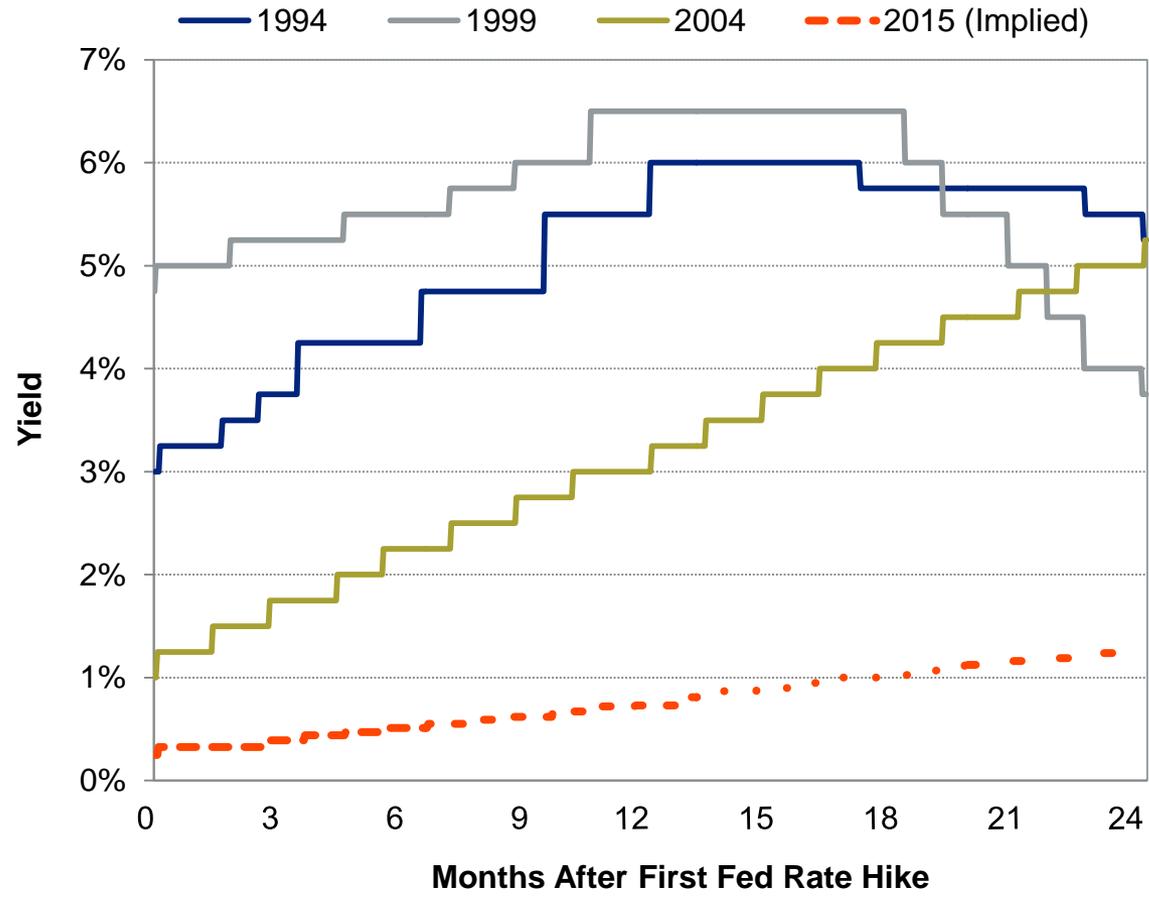


	12/31/15	2/29/16	Change
<b>3 Month</b>	0.17%	0.32%	+0.15%
<b>6 Month</b>	0.48%	0.47%	-0.01%
<b>1 Year</b>	0.60%	0.60%	0.00%
<b>2 Year</b>	1.05%	0.77%	-0.28%
<b>3 Year</b>	1.31%	0.89%	-0.42%
<b>5 Year</b>	1.76%	1.21%	-0.55%
<b>10 Year</b>	2.27%	1.73%	-0.54%
<b>30 Year</b>	3.02%	2.60%	-0.42%

Source: Bloomberg.

# A New Path for the Fed

**Federal Funds Target Rate**

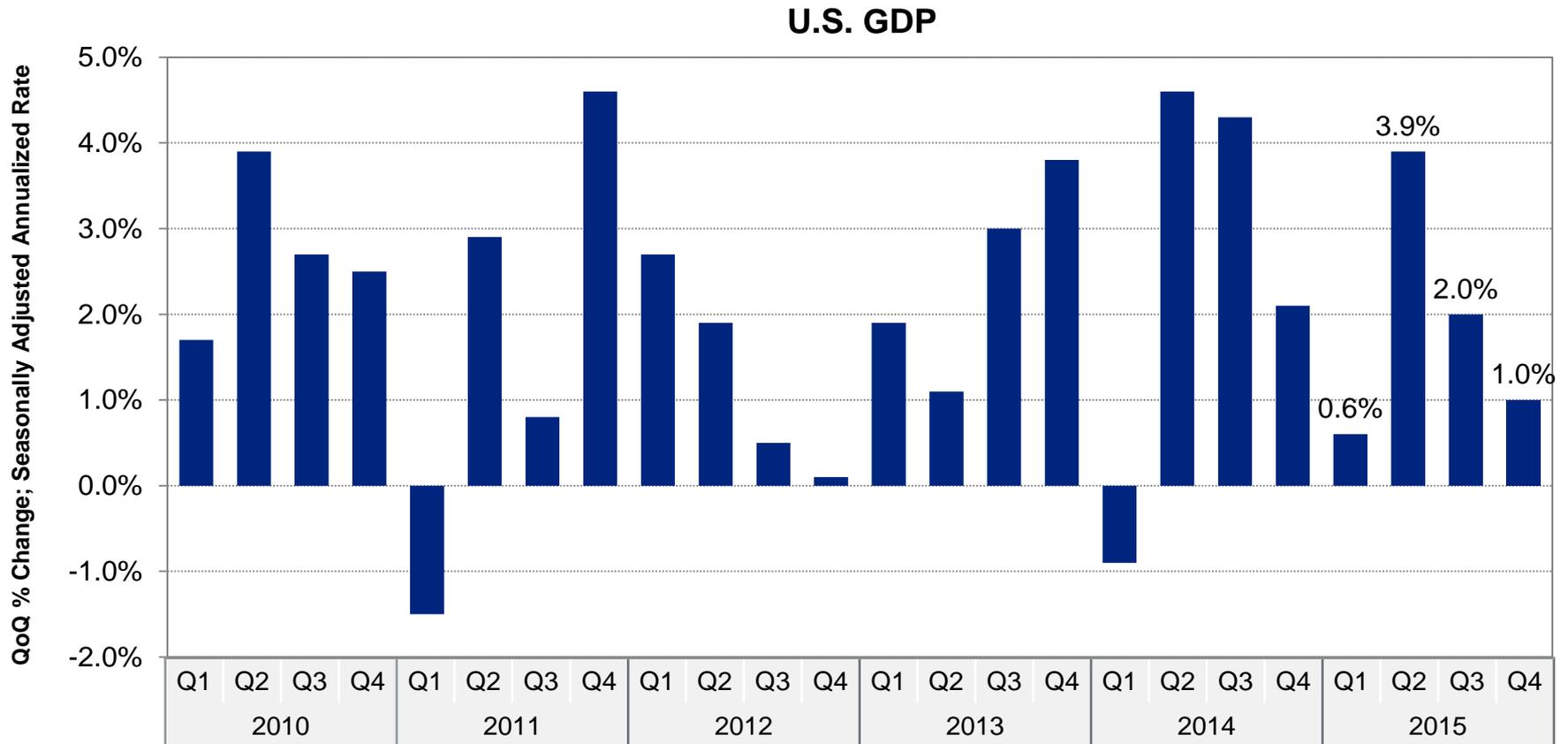


United States	
1) Overview	
2) Future Implied Probabilities	
Current Implied Probabilities	
Dates	Meeting <input checked="" type="radio"/> Calculated <input type="radio"/>
Meeting	Prob Of Hike
03/16/2016	4.0%
04/27/2016	9.8%
06/15/2016	18.8%
07/27/2016	20.4%
09/21/2016	26.8%
11/02/2016	28.3%
12/14/2016	41.1%
02/01/2017	41.1%

Source: Bloomberg as of 2/18/16. 2015 forecast is based on federal funds futures contracts as of 2/18/16.

# U.S. Economy Cooled in Fourth Quarter

- The second reading of fourth quarter GDP indicated the economy expanded at 1.0%, and is continuing to cool from the rate of expansion seen in the second and third quarters.
- For 2015, GDP expanded 2.4% for a second year in a row, led by the biggest gain in consumer spending in a decade.

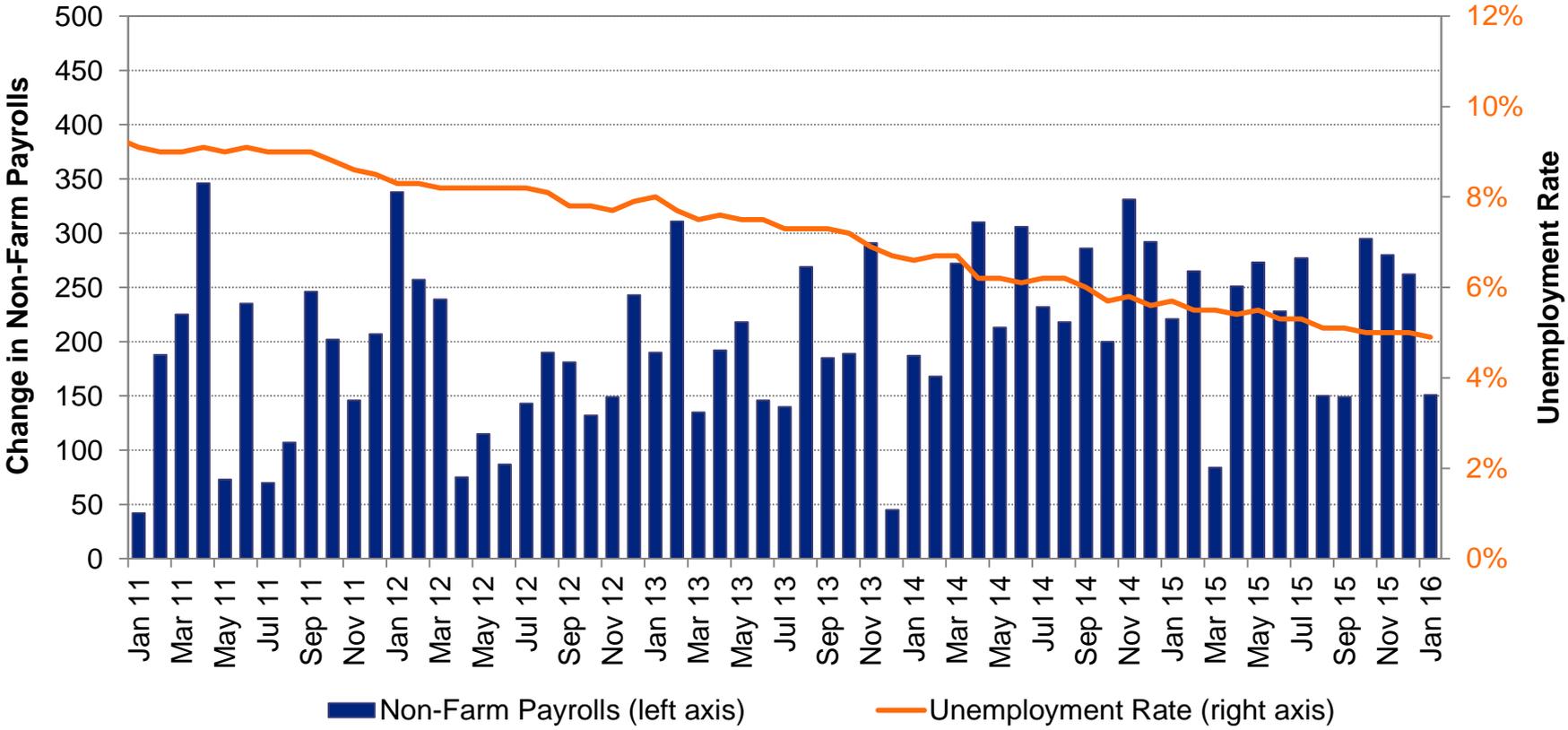


Source: Bureau Of Economic Analysis; Bloomberg.

# U.S. Economy Continued to Create Jobs

- The U.S. labor market added an average 222,000 jobs per month over the past year.
- The unemployment rate is at 4.9%, which is considered to be near “full employment.”

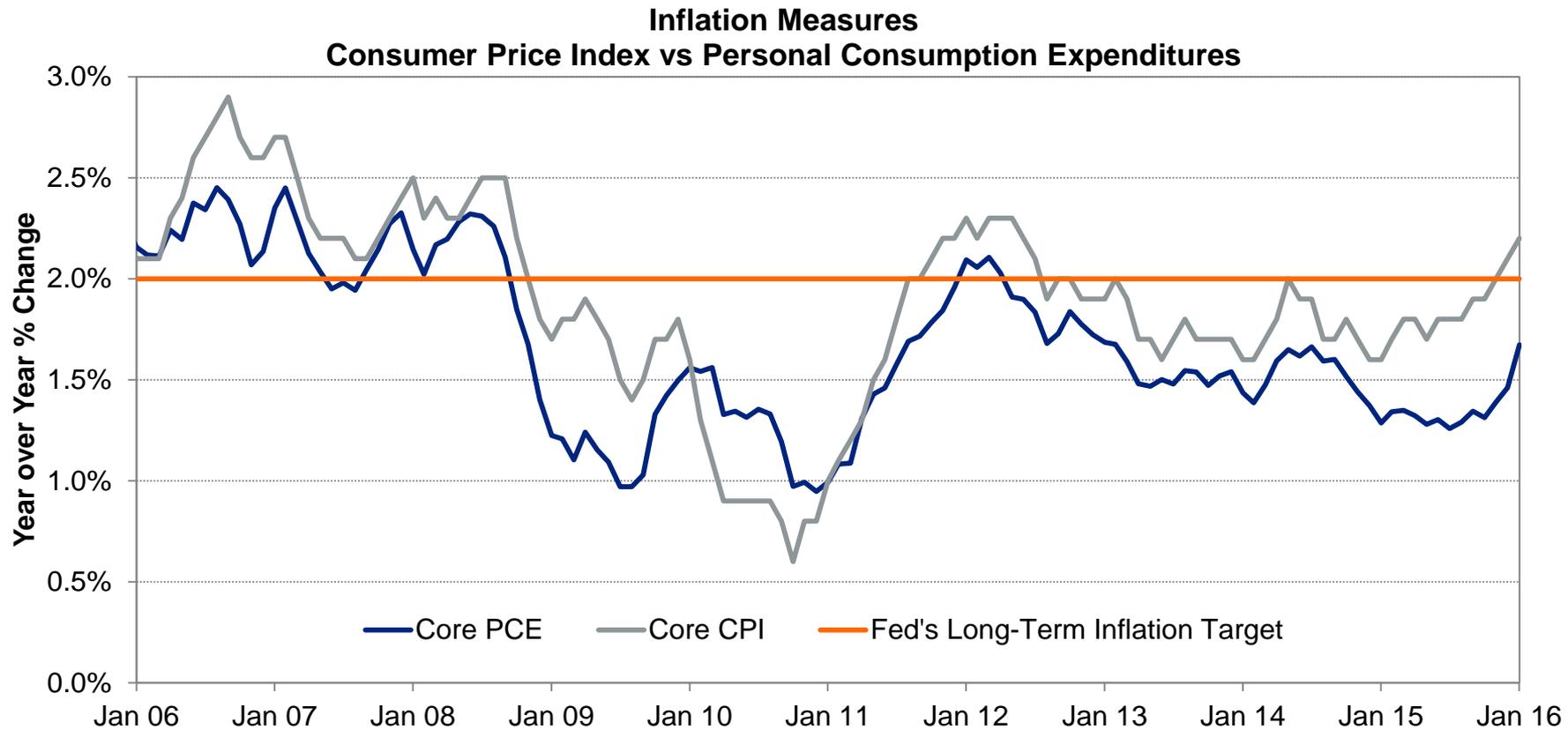
Monthly Change in Non-Farm Payrolls and Unemployment Rate



Source: Bureau of Labor Statistics; Bloomberg.

# Inflation Remained Muted

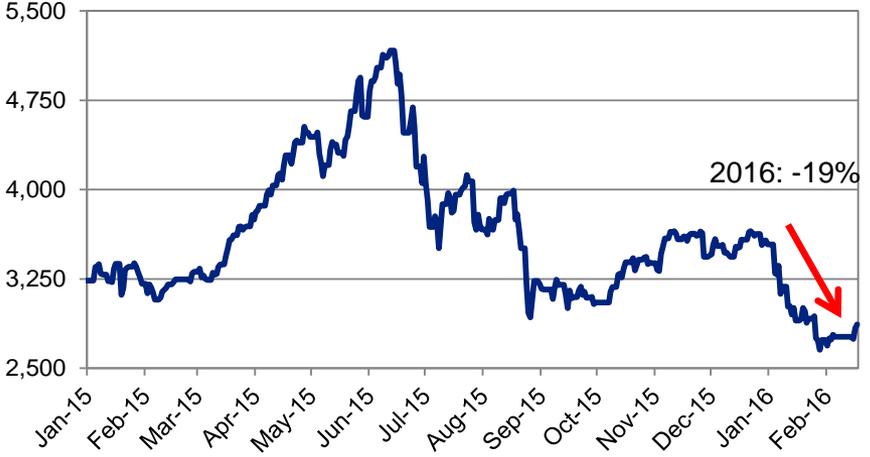
- The personal consumption expenditures (PCE) price index, the Fed's preferred gauge of core inflation, remained under the 2% target; it advanced 1.7% year-over-year through January.



Source: Bloomberg.

# Significant Volatility Across the Financial Markets

### Shanghai Composite



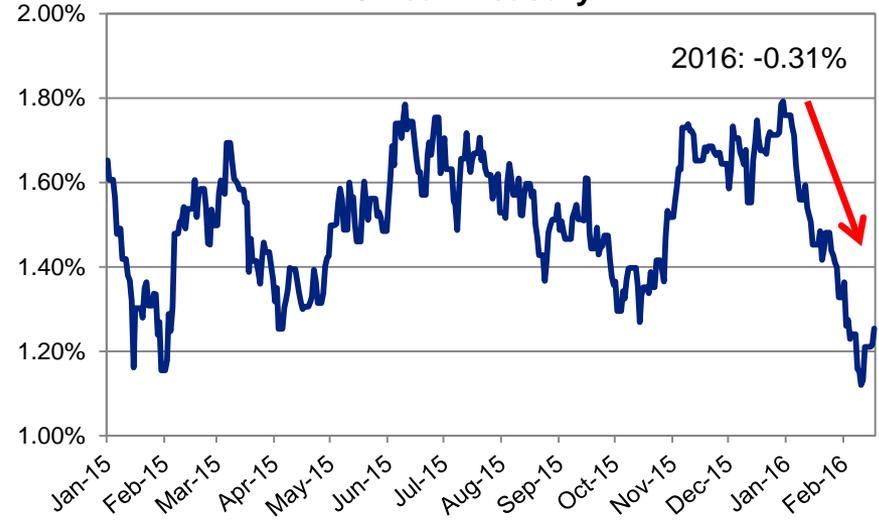
### S&P 500



### WTI Crude Oil (per barrel)

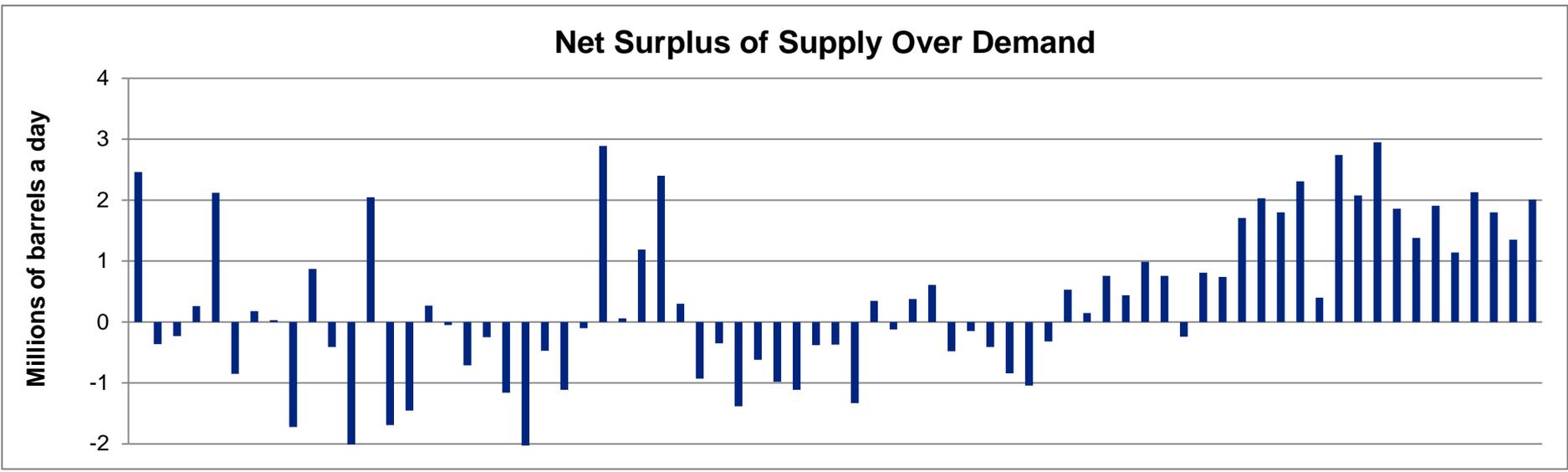
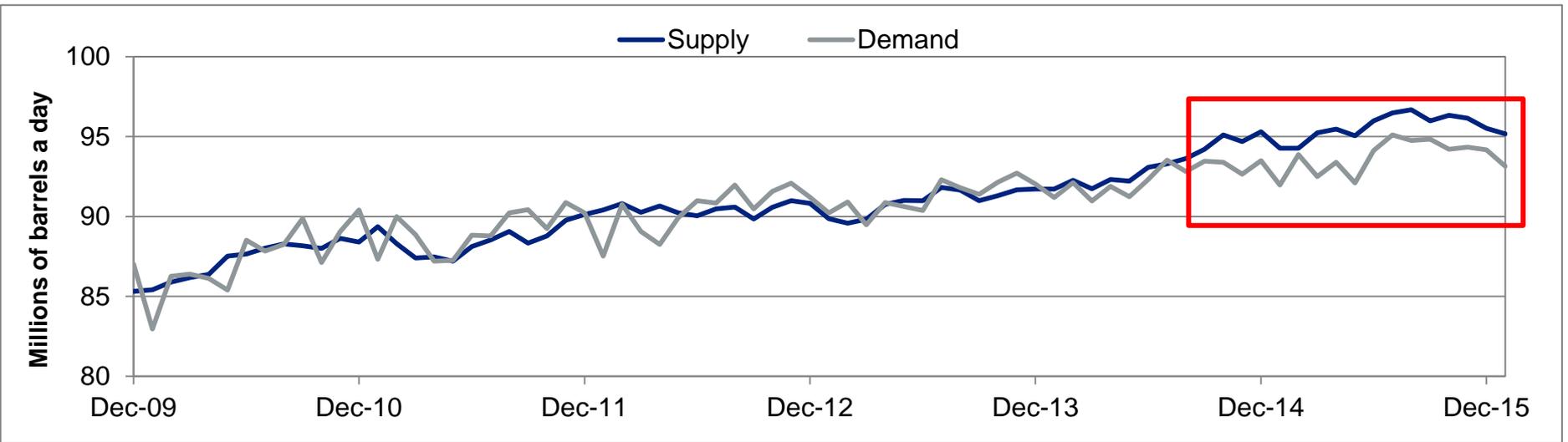


### 5-Year Treasury



Source: Bloomberg, as of 2/16/16.

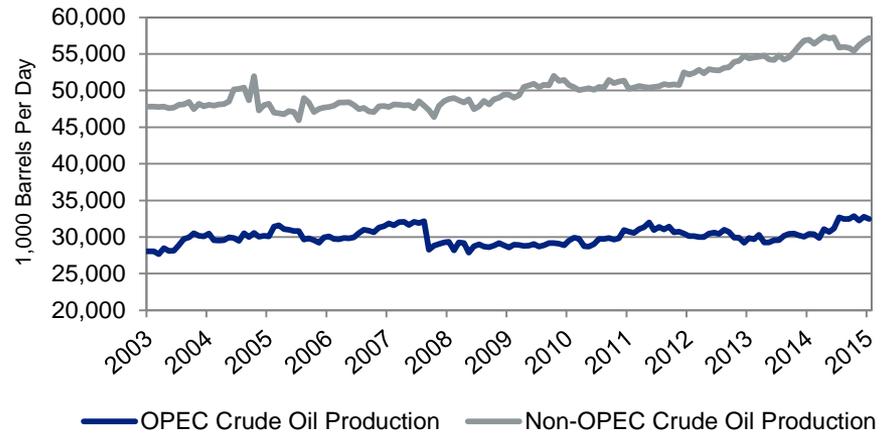
# Supply-Demand Imbalance in Oil



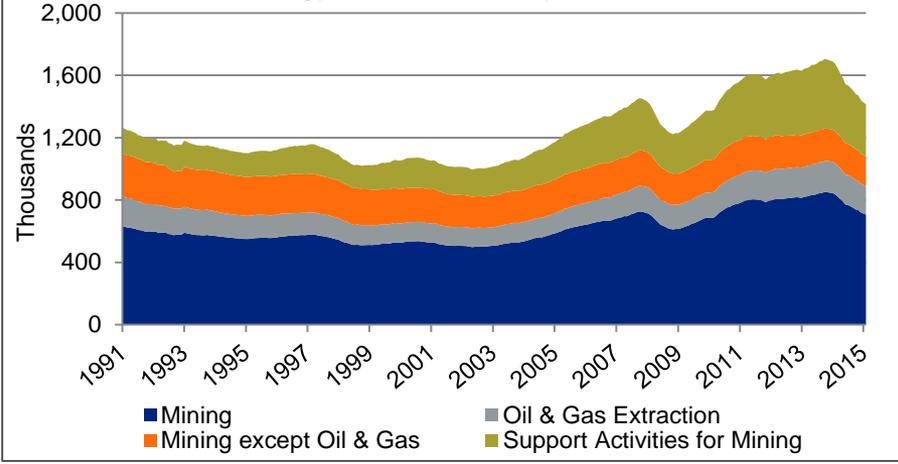
Source: Bloomberg; U.S. Department of Energy.

# Far-Reaching Effects of Oil Market Performance

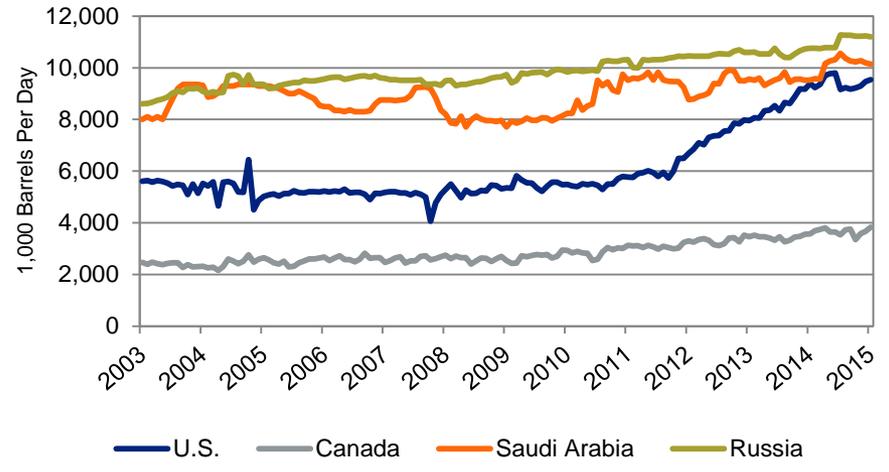
**OPEC vs Non-OPEC Crude Production**



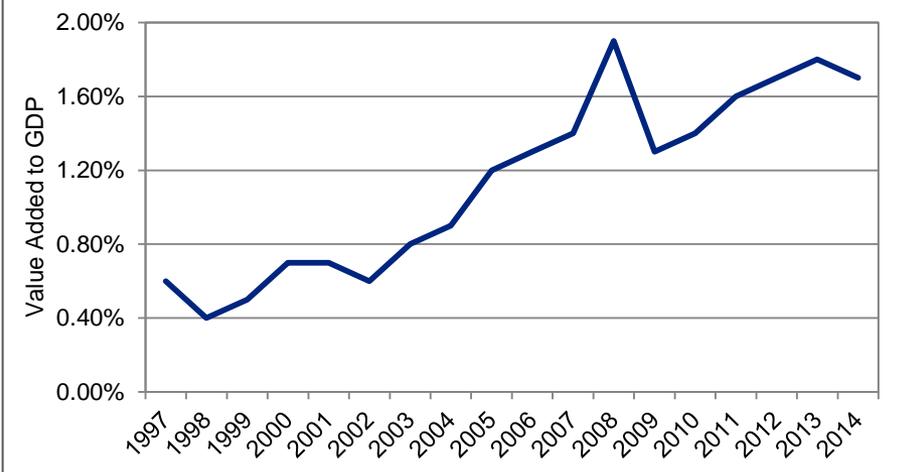
**Energy-Related Employment in U.S.**



**Crude Oil Production**



**U.S. Oil and Gas Extraction as % of U.S. GDP**



Source: Bloomberg; Energy Intelligence Group.