FY 2019-20 Bexar County Investment Strategy

The Budget & Finance Department develops an annual investment strategy for use as a tool when making investment decisions throughout the fiscal year. The following provides a market overview, a summary of the County's cash flow projections, a description of the County's investment strategy, and the recommended diversification of the portfolio.

Economic Overview

Through the first three quarters of fiscal year (FY) 2018-19, the U.S. economy grew at an average rate of just under 2.5%, as measured by seasonally adjusted gross domestic product (GDP). Through the first three quarters of the previous fiscal year, the economy grew at an average rate of just under 3.0%. The slower relative growth experienced through the first three quarters of FY 2018-19 relative to the previous year can be attributed primarily to the effects of previous rate hikes by the Federal Reserve, increased global trade tensions, and a general anticipation by consumers and the investing public that a recession was on the horizon. The stock markets also experienced relatively more volatility in FY 2018-19 than the previous year. From October 2018 through September 2019, the S&P 500, Dow Jones, and NASDAQ grew by 2.6%, 1.4%, and 1.9% respectively. These levels of growth were significant drop from a very impressive FY 2017-18 for the markets. The unemployment rate fell slightly from 3.8% at the start of the year to 3.5% as the amount of overall slack left in the economy dwindled. The 3.5% unemployment rate registered in September 2019 was the lowest unemployment rate since December 1969. Overall inflation also continued to remain relatively muted during the fiscal year, as the 12-month inflation rate ending August 2019 was 1.7% compared to 1.8% the same year prior. This lack of inflation is one of several factors that gave the Federal Reserve ammunition to once again start instituting rate cuts during the fiscal year.

During the first quarter of FY 2018-19, GDP growth was 2.52%, which was in line with expectations. This brought total GDP growth for calendar year 2018 to 2.93%. Calendar year 2018 registered as the best year for the economy since 2015. Helping growth during the quarter was exports and nonresidential fixed investment, a key sign of business activity. Subtracting from overall growth during the quarter was reduced consumer spending and government expenditures at the state and national levels. Corporate profits ended the calendar year up 7.8%, which was significantly higher than the year prior growth of 3.2%. A large contributor to this increase in corporate profitability was the corporate tax cuts that were implemented in 2018. The Federal Reserve executed two separate 25 basis point (bps) rate hikes during the quarter, with the target Federal Funds rate ending the quarter at 2.25% - 2.5%. This would end up being last rate hike by the Federal Reserve to this point in time.

During the second quarter of FY 2018-19, GDP growth came in at a relatively stronger 2.65%. The quarter saw the economy add a healthy average of 186,000 jobs per month, which dropped the unemployment rate from 4.0% at the start of the quarter to 3.8%. However, economists began to see signs of softening global growth, which contributed to the Federal Reserve's decision to leave interest rates unchanged during the quarter. The housing segment rebounded sharply during the quarter, as existing home sales in February grew at an annualized rate of 5.5 million units. Disposable income also rose by 4.3% over the quarter. On the downside, corporate profits fell by 0.4% during the quarter. The markets had a very good quarter, as equities experienced the largest quarterly advance since the third quarter of 2009. The Federal Reserve softening its stance regarding the potential for further rate hikes played a large roll in this rally. Although the stance regarding potential rate hikes did soften, the Federal Reserve did continue the ongoing unwinding of its balance sheet.

During the 3rd quarter of FY 2018-19, GDP growth slowed somewhat compared to the previous quarter as the economy grew at a 2.28% clip. Unemployment held steady as an average of approximately 151,000 jobs were added each month. Continued protectionist trade policies coming from the U.S. as well as continued uncertainty regarding the outcome and impact of Brexit gave economists cause for concern about global growth. The effect of the tax cuts from 2018 also began to fade as corporate profits fell by 2.6%. Because of the slowing global growth as well as some slowing indicators, the Federal Reserve began to send signals that there was a significant chance of at least one rate cut in the year. This was a reversal from late 2018, when it was expected that there would additional rate hikes in 2019. Illustrating this change in expectations, the yield on the 5-year Treasury started the quarter at 2.23% and ended the quarter at 1.80%. As you will see below, the Federal Reserve held true to these signals later in the fiscal year.

Although official numbers have not yet been released at the time of this publishing, GDP growth for the fourth quarter of FY 2018-19 is expected to come in around 1.8% - 2.0%. A major contributor to this relatively lower anticipated growth, as well as a recent downturn in the equity markets, was a string of poor U.S. manufacturing data. The Institute for Supply Management has indicated that manufacturing activity in September contracted to its lowest level in more than 10 years. Also contributing to the relatively weaker market performance during the quarter was China's continuing slowing growth, which was further hindered by the lack of a solution to the U.S – China trade disputes. Largely because of the aforementioned concerns, the Federal Reserve executed two rate cuts during the quarter, with the target overnight rate ending the quarter at 1.75% - 2.00%. These were the first rate cuts since December 2008 in the aftermath of the Great Recession. That being said, Federal Reserve officials were publicly split over the second 25 bps rate cut in September, which made the picture for future Fed action cloudier for market participants.

At the time of this publishing, the Federal Reserve has just executed an additional 25 bps rate cut at its October meeting, bringing the target federal funds rate down to 1.50% to 1.75%. After the cute, the Fed Chairman signaled that the default position moving forward would be no additional cuts and that the economy would have to show significant signs of slowing if additional cuts were to be enacted. As it currently stands, the market is pricing in an approximately 73% chance of at least an additional 25 rate cut in FY 2019-20. This signals that many market participants believe the economy will send signals to the Federal Reserve that an additional cut is warranted at some point in the near future. That being said, these probabilities have been volatile as of late and can change significantly in a short period of time, even daily.

Concerns about global growth, a lack of a solution to tensions with China, a still un-resolved Brexit, as well as 2020 being an election year should have market participants expecting continued volatility heading into 2020. While some economic prognosticators are still predicting a recession during 2020, the Federal Reserve has proven that they are willing to keep rates low and even cut more in order to soften the blow of a downturn. Although some general economic indicators in the U.S. have slowed down somewhat compared to the first two years of the new presidential administration, the U.S. economy still remains in a relatively healthy place in isolation. Unemployment is at an all-time low, GDP is still well above 2.0%, and although the equity markets have experienced a few significant bouts of volatility, they have continued to weather the storm overall. It is the aforementioned global and political concerns primarily that investors must be on the lookout for as we move into the new fiscal year.

Cash Flow Projections

Below are some key points regarding the cash flow analysis.

- This projection includes the General, Debt Service, Capital Projects and Special Revenue Funds.

- The beginning balance in total investments and cash equivalents for the Pooled Funds is $856,168,448. This balance is $145 million or 20.6% more than last year's beginning balance of $711,193,484. This is primarily because the County issued $215 million in Certificates of Obligation in December 2018. This was the first Certificates of Obligation issuance since December 2016.

- Property tax revenue collection, the largest recurring revenue source for the County, is projected to follow the normal annual collection pattern with $376.3 million, or 80.6%, being collected between October 2019 and January 2020.

- Other revenues (revenues other than property taxes) are collected at varying levels over the fiscal year due to different collection patterns for different revenues, i.e. monthly, quarterly, weekly or daily collection periods. Overall, net collections generally only differ by a few percentage points per month.

- A total of $152 million is tentatively scheduled to be issued in FY 2019-20 to fund approved FY 2019-20 Capital Improvement Projects and Road Projects, to include new projects and additional funding for existing projects. Conversely, total capital expenditures are forecasted to reach $222 million during FY 2019-20.

- All other County expenditures are projected to remain relatively level during the year, with a peak in December to make the interest payment on the County's outstanding debt and another peak in June to make a principal and interest payment.

Strategy by Fund

The County will utilize an investment strategy that is broken out by the five funds that make up the overall portfolio: General Fund, Debt Service Fund, Venue Fund, Other Funds, and Capital Funds. The strategy for each fund is as follows:

- General Fund – The County's General Fund is utilized for the general day-to-day operations of the County. The fund has a relatively predictable expenditure schedule and the vast majority of funds collected through ad valorem taxes each year will be spent within that year. To that end, this fund will utilize a laddering strategy with an approximately equal amount of maturities each month in a normal upward-sloping yield curve environment. Purchases in this fund will generally not exceed one year.

- Debt Service Fund – The County's Debt Service Fund collects ad valorem taxes and makes debt service payments on the County's outstanding debt on an annual basis. This fund will utilize a modified laddering strategy with maturities generally centered around debt service payments in June and December of each year. Purchases in the fund will generally not exceed one year.

- Venue Fund – The County's Venue Fund collects hotel/motel occupancy tax and motor vehicle rental tax revenue on a monthly basis. This fund will utilize a laddering strategy. The majority of purchases will remain within one year however a certain portion of purchases may also exceed one year contingent on any cash draw considerations.

- Other Funds – Other Funds represent the other operating funds the County has in which funds are expensed at the discretion of the County. Some of the major Other Funds include the Road & Bridge Fund, Flood Control M&O Fund, the County Clerk Records Management Fund, and the Technology Improvement Fund. Similar to the General Fund, revenues and expenditures for these funds are generally collected and expensed within the same year. To that end, this fund will utilize a laddering strategy. Purchases in this fund will generally not exceed one year.

- Capital Funds – The County's Capital Funds include the Capital Improvement Fund, the Flood Control Fund, and the ATD/TxDOT Pass-Through Roads Fund. The primary source of revenues for these funds is the issuance of debt that goes to fund various capital projects. Expenditures for capital projects are more long-term by nature and are generally spent over a one to three year period. To that end, the vast majority of these funds will be invested in the one to three year range. Utilizing these funds to purchase longer-term securities will allow the County to take advantage of the longer end of the yield curve when it is advantageous.

When viewed from an overall portfolio perspective, the distribution of maturities is shorter-term in nature as of the FY 2018-19 4th quarter investment report. This is because the overnight investment options available to the County have offered a yield that is very competitive with, if not beating, the yields that are offered for going out further on the yield curve. The yield curve was inverted for a significant portion of FY 2018-19 and while it ended the quarter somewhat less so, the inversion was still present from six months going out to five years. In this environment, the County is incentivized to keep more funds in overnight options and short-term securities than it otherwise would in a normal yield curve environment. Moving forward, the County will most likely continue to hold a relatively larger portion of its funds in shorter-term securities than it has historically. That being said, if changes in the yield curve incentivize the County to utilize a greater proportion of its funds to go further out on the yield curve, the County will adjust its strategy accordingly. Regardless of changes in the slope of the yield curve, yields on overnight options will continue to fall as they catch up to recent Federal Reserve rate cuts, which in itself should result in the County allocating a progressively smaller portion of its portfolio in these overnight options as the year goes on.

Portfolio Diversification

Of the pooled funds, approximately 10 - 25% will be held in cash or cash equivalents, specifically local government investment pools and money market accounts. The County currently has two approved local government investment pools: TexPool and TexStar. Cash will be held in the County's bank depository and will be swept into a money market account on a nightly basis. These investments will provide the County with the necessary liquidity to meet monthly obligations as well as effectively provide for a portion of the portfolio to be invested in adjustable rate instruments. This corridor is relatively wider to allow the County to hold a larger portion of its funds in overnight options when it is advantageous, as it was for much of FY 2018-19.

Approximately 40 - 55% of the pooled funds will be invested in United States Federal Agencies and Treasury securities. Agency issuers will include Fannie Mae, Freddie Mac, the Federal Home Loan Bank and the Federal Farm Credit Bank. These government-sponsored enterprises are considered to be among the safest types of investments; therefore, the County has substantially higher holdings in these types of securities. Additionally, the County plans to execute a debt issuance in FY 2019-20 to fund capital projects approved in the Adopted Budget. Because the cash draw on capital projects is general 1 – 3 years, the County will utilize a significant portion of these funds to purchase Federal securities.

Approximately 15 - 25% of the pooled funds will be invested in top-tier domestic corporate commercial paper rated A-1/P-1 or better. Issuers will include such names as JP Morgan, Toyota Motor Credit, BNP Paribas, and Nestle. A base level of exposure to the corporate market provides the County with needed diversity for its overall portfolio. The County will continue to look for new, top-tier corporate issuers to add to the portfolio throughout the fiscal year.

Approximately 7 - 20% of the pooled funds will be invested in municipal bonds and commercial paper. Issuers the County has purchased from in the past include The University of Texas, Harvard University, City of Austin, Harris County, and Duke University. Similar to corporate issuers, the County will maintain a certain base level allocation to municipal issuers to provide for a certain level of overall diversification. The County will also continue to look for new, top-tier municipal issuers to add to the portfolio throughout the fiscal year.

Throughout the fiscal year, the Budget and Finance Department will retain the flexibility to alter the allocation of the portfolio and/or add new investments permitted by the Public Funds Investment Act. For example, if the expectation for future rate cuts were to reverse and the yield curve steepen, the County may increase its allocation to Federal Agency and Treasury securities. County staff is in constant communication with its investment advisors regarding market expectations and is prepared to make allocation changes as necessary. This diligence includes individual issuers, as the County is always monitoring the credit ratings (long-term and short-term) of its individual holdings to ensure they are still at an acceptable level. If an individual issuer's credit rating falls below the required minimum rating, prudent measures will be taken to liquidate holdings in that issuer.

As we move forward through the first half of FY 2019-20, the weighted average yield of the portfolio should continually to gradually fall as longer-dated securities continue to mature and are reinvested at now lower rates. As previously mentioned the County expects to execute a debt issuance during FY 2019-20. This will significantly increase the book value of the portfolio for a significant portion of the year. Contingent on longer-term rates offering relatively competitive yields, the County will utilize a significant portion of these proceeds to purchases securities in the 1 – 3 year range. This should have the effect of increasing the weighted average maturity of the County's portfolio. Actual changes to this strategy will be recommended based on significant economic events that affect market conditions and a rebalancing of the portfolio and investment options will be considered. Any new investments or adjustments will be discussed with the Chief Investment Officer and continue to be acted upon within the four primary objectives, listed in order of priority: (1) safety of principal; (2) liquidity; (3) yield and (4) public trust.