MINUTES OF THE CITY'S INVESTMENT MANAGEMENT COMMITTEE

A meeting of the City's Investment Management Committee was held in the 6th floor conference room of Norfolk City Hall starting at 12:04 p.m. on March 20, 2025. In attendance, in person, were Committee members: Deputy City Manager Doug Beaver, Norfolk resident Henry U. (Sandy) Harris, III of Cerity Partners, Director of Finance Christine Garczynski, and Acting Director of Budget and Strategic Planning, Pamela Marino. Additional Committee members, City Treasurer Daun Hester and Chief Deputy City Attorney Adam Melita, joined later during the meeting. Also present in person were Senior Cash and Investments Analyst Henry Chong, Nelson Bush and Jack Schnorbus of PFM Asset Management, and remotely via meeting service, Floyd Simpson of PFM Asset Management.

C. Garczynski presented the minutes from the September 23, 2024, meeting, which were reviewed by the Committee. A motion to approve the minutes was made by C. Garczynski and seconded by S. Harris. The motion was passed unanimously by acclamation vote.

C. Garczynski reviewed the February 28, 2025, Flash Report of the City's cash and investments, which showed total funds of $541M, including $26M in cash. The report indicated that $3.9M was earned from interest on cash, LGIP funds, and managed funds during January and February 2025. The reduction in total balances compared to December 31, 2024, was noted as typical for this period (November, February and May) when cash positions tend to be lower just before tax payments. Additionally, the City had front-loaded expenditures for capital improvement projects ahead of issuing bonds, and to optimize earnings, it drew down $50M from the line of credit to capitalize on an interest-rate arbitrage opportunity— earning 4.4% with LGIP while paying 3.4% interest on the line-of-credit. Going forward, balances are expected to remain relatively constant due to larger debt expenses in March and April, and then rise with large tax receipts due in June.

S. Harris pointed out that the minutes emphasize the City's strategic use of the arbitrage opportunity, underscoring its importance as a core function of the Investment Committee's mandate to maximize the City's earnings.

C. Garczynski continued to review the City's holdings, highlighting that the majority of the City's cash position is in LGIP, while PFM Asset Management oversees the remaining funds in longer-term holdings. The City moves funds daily between LGIP and cash accounts. The LGIP allocation showed that 79% were unrestricted for operating expenses, while 21% were restricted for financial policy or bond-related set aside funds dedicated to earning a return. Year-over-year balances reflected a decline, partly due to the spending down of Federal stimulus funds and the repayment of a prior line of credit arbitrage opportunity in June 2024 (repaid in August 2024), as expectations shifted toward lower interest rates— though this has since changed, creating a new arbitrage opportunity. The months of August, September, and October represent the largest debt service payments for the City, totaling approximately $100M, along with a $40M payment to the retirement system in July, resulting in the observed cyclic trends in balances. The Sector Allocation, Credit Quality, and Maturity Distribution showed a diverse portfolio, with a slight increase in the allocation to shorter-term maturities (0-1 years) to 68.26% due to elevated short-term interest rates. The review concluded with a summary of the Permissible Investments section, detailing the types of securities deemed acceptable according to the City's Investment Policy.

J. Schnorbus provided an update of the U.S. markets using a hard-copy packet titled "Investment Committee Meeting," dated January 22, 2025, prepared by PFM Asset Management, containing 74 slides, which were distributed to all members during the meeting. The update covered the following key topics:

- Current market themes (Packet p. 4).
- The economic soft landing remained on track in Q4 2024, with GDP growth at 2.8%, and the Federal Reserve interest rate cuts being a primary focus throughout the year.
- Going into Q1 2025, there is uncertainty surrounding the incoming presidential administration and potential policy changes, especially concerning tariffs.
- The CPI for November 2024 was 2.7%, with February 2025 staying similar at 2.8%. The Federal Reserve's dual mandate remains focused on controlling inflation and reducing unemployment. However, inflation persists in sectors like housing, and certain sectors like eggs/food prices, and autos (Packet p. 5).
- Unemployment remained steady throughout Q4 2024, while Norfolk's unemployment rate was at 3.1%, slightly higher than the Commonwealth of Virginia's rate of 2.9%. In Q1 2025, the focus shifts to federal layoffs.

N. Bush noted that determining the impact of federal unemployment could take months, as proposed cuts face legislative hurdles. Headlines have dominated the conversation, often overshadowing official data, and while economic expansion has slowed, it hasn't yet reached recession levels. The Federal Reserve anticipates higher unemployment and transitory inflation. S. Harris added that while there has been significant media attention around federal unemployment, the situation could worsen if the private sector begins increasing layoffs.

N. Bush also highlighted that while federal layoffs are mostly localized, the bigger concern is the potential loss of federal funds and grants, such as Pell Grants, due to department cuts. The consensus is that Q1 GDP may be negative, driven by corporations heavily importing to avoid potential tariffs. Consumer sentiment surveys indicate rising inflation expectations, and contracting consumer spending is a key concern that could trigger more layoffs and push the economy toward a recession. While consumer spending showed month-over-month increases, the slower growth points to a slowdown rather than a full recession, which requires two consecutive quarters of negative GDP growth.

J. Schnorbus continuing the update with the following points:

- The 2-Year U.S. Treasury yield (Packet p.11) showed that, despite fluctuating yields from December 2023 to December 2024, it ended roughly the same, losing just 0.01% after factoring in the Federal Reserve interest rate cuts.

- At the most recent Federal Reserve Open Market Committee meeting, the Fed revised its forecasts, lowering GDP growth, while increasing projections for inflation and unemployment.

- The Fed remains dovish, not planning to make any hasty decisions based on headline news. They are committed to focusing on data-driving decisions.

- The U.S. Treasury Yield Curve is positively sloped, with the curve steepening in January (Packet p.12), offering some reward on the longer end of the curve, while the shorter end remains fluid and persistently elevated. 30-year mortgages are yielding around 6.7%.

N. Bush commented that the 2-Year Treasury is currently trading at 3.95%, which is particularly notable because the longest part of the City's portfolios managed by PFMAM has an average duration of two years, making the 2-Year Treasury a good proxy for the City's portfolio in terms of potential yield scenarios. The recent dip in yield since Q4 2024 is attributed to concerns about potential tariffs, layoffs, and federal program cuts under the new administration. Although the Fed still anticipates two rate cuts, consensus has shifted, with most members now expecting just one. A key concern is the impact of tariffs on consumers, with effects expected to take months to appear in the data.

Markets are predicting a rate cut in June, with possibly another in the fall. While a significant portion of the City's funds remain in very short-term overnight holdings, earning around 4.4%, the City would earn 3.95% if shifted to a longer-term 2-year duration portfolio strategy under current conditions and needs to consider if locking in now is beneficial. Through 2024, credit spreads on corporate notes, commercial paper, and municipal bonds in the portfolio have narrowed compared to the 2-year Treasury, reducing the value of these investments. As market participants move towards short-term fixed income due to safety concerns and an expensive equity market, new credit security allocations in the City's portfolios have decreased and are expected to decline further if spreads continue to narrow, as the risk-to-reward profile becomes less attractive.

Agency Mortgage-Backed Securities (MBS) are being considered for addition to portfolios due to relatively better value. Over the next year focus will be on monetary and fiscal policy, as well as inflation.

Reviewing Packet p. 19, N. Bush noted that all portfolio allocations remain in line with the City's adopted investment policies.

S. Harris inquired about potential changes to the City's Investment Policy, to which N. Bush suggested increasing short-term investments in commercial paper and negotiable certificates of deposit, as well as adding Agency Mortgage-Backed Securities (MBS) to long-term portfolios. S. Harris agreed, stressing that diversification reduces risk and expressed concern over issues such as the dollar's value, rising gold prices, the growing push toward digital currency, emphasizing that the City should adapt to these current market conditions.

C. Garczynski asked S. Harris what percentage of asset-backed securities he would consider comfortable holding in the City's portfolio, given her concerns about their risk profile. N. Bush noted that Agency MBS would make the most sense in our Long-Term Portfolio, to which S. Harris agreed, highlighting that short-term liquidity is critical to the City's Operating Portfolio needs, while the Long-Term Portfolio could absorb slightly more volatility. N. Bush added that the Code of Virginia allows for investments in FNMA (Fannie Mae), Freddie Mac, and Federal Home Loan Bank (FHLB) mortgage-backed securities, which are pools of residential and commercial mortgages guaranteed by the respective agencies. However, he pointed out that the main downside of adding Agency MBS is headline risk, as the public still associates them with the 2007-08 financial crisis, and they are often difficult to explain to stakeholders.

S. Harris acknowledged the headline risk but suggested that the potential to add value to the City's portfolio could justify the investment. N. Bush further noted that the most pressing question regarding Agency MBS is whether Fannie Mae and Freddie Mac would be privatized, and how that might impact the classification of these securities under the Code of Virginia. C. Garczynski mentioned that there might be an opportunity within the transfer of some of the SWIFT funds to the Long-Term portfolio and that she would consider it for the upcoming meeting, though she still had reservations regarding the potential risks.

H. Chong asked when in the economic cycle would be the best time to invest in Agency MBS and commented on how increased spreads tend to correlate with increased risk. N. Bush responded that there is no specific "opportune" time to invest in Agency MBS, aside from when credit spreads are the widest relative to other government securities with the same credit quality. He explained that a 1% allocation in the Long-Term portfolio (Packet p. 30) carries a low probability of downside risk, but it could serve as a good diversifier compared to Treasuries. Agency MBS are less sensitive to interest rate fluctuations, potentially making them a useful addition. He clarified that Agency MBS share the same credit risk as Treasuries, since they are federally guaranteed, ensuring the repayment of both principal and interest. However, their complexity and limited market participation result in higher yields. Compared to other high-quality fixed income assets, Agency MBS offer strong relative value, making them a valid investment strategy in PFM Asset Management's view. Notably, PFMAM has avoided recent purchases of residential MBS, instead opting for commercial MBS.

C. Garczynski, N. Bush and S. Harris further discussed the potential scenarios regarding Fannie Mae or Freddie Mac's conservatorship, particularly considering the current political climate. N. Bush explained that if the federal government were to end the conservatorship of Fannie Mae and Freddie Mac, transitioning to an implied backing, credit spreads would likely widen, making these securities more attractive as investments. He also noted that there are ongoing discussions in Washington about the possibility of this change.

N. Bush then continued with a review of the Portfolio Performance for Q4 2024 (Packet p.31):

- Due to rising interest rates, the City's portfolio market values in the short end decreased by -0.03%, although this was still better than the ICE BofA 1-3 Year U.S. Treasury Index, which was down -0.06%.

- The City's portfolios remained strongly positive in the long end with total returns of 1.70% and 1.40% since inception, outperforming the ICE benchmark returns of 1.50% and 1.21%, respectively.

N. Bush turned to F. Simpson for a review of market conditions in Q4 and the current climate relative to the NPT Investment Strategy Review (Packet p.33). F. Simpson noted that, while returns for 2024 were strong across major indexes, there was a pullback towards the end of Q4 due to reduced rate cut expectations, rising 10-Yr Treasury yields, and uncertainties surrounding the incoming Presidential administration. Currently, the markets are experiencing a correction, down about 10% from the highs due to an over-priced market. However, the City's allocation in international equities has helped the NPT portfolio withstand the recent downturn. For example, while the Russell 2000 is down -3.44%, the MSCI AC World ex-USA (ACWI) index is up 9.15%, benefiting from lower valuations in international equities compared to domestic equities (Packet p.34).

N. Bush reiterated the strong performance, adding that in February, the total return for the Pension Funding Trust portfolio was a positive 0.7%, which outperformed the -8% to -9% downturn seen in the broader equities market. He attributed this resilience to the fact that the portfolio is now weighted 50/50 between equities and fixed income, with a portion of those equities in growth-oriented markets abroad, providing much needed diversification from U.S. markets.

C. Garczynski inquired about the international equities' exposure to China, and N. Bush responded that growth was primarily in developed European markets, particularly in sectors such as defense contractors. F. Simpson listed key contributing countries, including Germany, the UK, France, South Korea, Taiwan, and China. H. Chong noted the Pension Trust's reallocation from an overweight position in REITs back to international equities. N. Bush explained that the allocation, added in Q4, was later removed due uncertainties surrounding interest rates and tariffs. C. Garczynski added that, since the portfolio is funded with bond proceeds for the pension system, efforts have been made to de-risk it over the past two years.

N. Bush also reviewed the Pension Trust securities (Packet p.35), explaining that all holdings are passive index allocations, split 50/50 between domestic and international equities, and fixed income. In reviewing the NPT Asset Liability Portfolio (Packet p.44-45), N. Bush broke out the portfolio's holdings, noting that, as a liability-driven portfolio, the expectation is that the funds are being spent down, with approximately $9 million returned to the City around June 30th of each year. This concluded N. Bush's report.

The next Committee meeting is scheduled for April 23, 2025.

The Committee adjourned at 1:03 p.m.

Respectfully submitted,

Adam Melita
Acting Secretary