RICHMOND HILL
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Staff Report for Budget Committee of the Whole Meeting

Date of Meeting: June 26, 2019
Report Number: SRCFS.19.017

Department: **Corporate and Financial Services**
Division: **Financial Services**

Subject: SRCFS.19.017 – 2018 Investment Portfolio Results

Purpose:

To report on the performance of the City's Investment Portfolio for 2018, as required by Ontario Regulation 438/97 (as amended) of the *Municipal Act, 2001.*

Recommendation(s):

That staff report SRCFS.19.017 be received for information purposes.

Contact Person:

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Report Approval:

Submitted by: Mary-Anne Dempster, Commissioner of Corporate and Financial Services

Approved by: Neil Garbe, City Manager

All reports are electronically reviewed and/or approved by the Division Director, Treasurer (as required), City Solicitor (as required), Commissioner, and City Manager. Details of the reports approval are attached.

Background:

In accordance with reporting requirements of the *Municipal Act* and the City's Investment Policy, the Commissioner of Corporate and Financial Services and/or Treasurer is required to provide an investment report to Council at least annually, in order to provide an update on the status of the investment holdings including an analysis of the investment activity undertaken in the preceding fiscal year. This report contains the following:

- A statement about the performance of the investment portfolio during the calendar year 2018;
- A description of the estimated proportion of the total investments that are invested between long term and short term holdings and a description of the change, if any, in that estimated proportion since the previous year's report;
- A statement by the Treasurer as to whether or not, in his or her opinion, all investments are consistent with the Investment Policy and goals adopted by the City; and
- Updates on the Prudent Investor Standard.

The City's investments are governed by the *Municipal Act* and its Investment Policy, which establishes the guidelines in ensuring effective and professional management of all of the City's funds.

The objectives of the City's Investment Policy, in order of priority are:

1) Compliance to statutory requirements;
2) Preservation and security of capital;
3) Maintenance of necessary liquidity; and
4) Realizing a competitive rate of return.

Economic Conditions and Financial Markets

The global macro environment was much less stable in 2018 than compared to the prior year, which was mainly attributed to the increasing uncertainty surrounding global trade and rising interest rates. Global trade was an economic concern that carried over from 2017 but have since progressively escalated to a much higher degree due to increasing U.S. trade protectionism.

The risks surrounding global trade heightened upon the 25% steel and 10% aluminum tariffs that were imposed by the U.S. on all nations including Canada. This inevitably led to counter measures as trading partners fought back through retaliatory tariffs, in order to protect national interests. The global outlook deteriorated further when the U.S. imposed additional tariffs on imported goods from China that subsequently led to more retaliatory tariffs. Even with the new trade resolution for Canada, as presented with the new CUSMA (Canada-United States-Mexico Agreement), which was to replace the former NAFTA (North American Trade Agreement), trade conflicts between U.S. and China far outweighed this positivity. In an environment where global growth continuously becomes more synchronized, trade uncertainties from the two largest economies in the world, will certainly reverberate across the globe. Other geopolitical risks such as ongoing ‘Brexit’ negotiations between the U.K. and European Union, further acted as a drag on global growth.

The U.S. Federal Reserve stepped up its tightening pace of monetary policy. There was a total of four 25 basis point increases on its federal funds rate at quarterly intervals. This reflected the most aggressive stance from the central bank since its first rate hike in December 2016. This was justified on the backdrop of ongoing employment strength, a record low unemployment rate, robust economic growth and higher inflation. U.S. real GDP growth in 2018 was 2.9%, up from 2.3% in 2017 (Source: U.S. Bureau of Economic Analysis), which translated to the fastest rate of expansion since 2015 and was mostly attributed to the U.S. tax reform that supported strong consumer spending.

Canada experienced the opposite trend, as the economy grew at a tepid pace of only 1.8%, much slower compared to the prior year of 3.0% (Source: Statistics Canada). In addition to the negative impact from global trade uncertainty on businesses, higher borrowing costs and new mortgage rules further dampened household spending, especially during a period where household debt continues to remain elevated.

The importance of crude oil prices for the Canadian economy always remains a focus, given that it represents approximately a fifth of the country’s exports. Demand for the commodity weakened on heightened trade tensions throughout the year, while global oil production resumed higher. Collectively, this tilted global inventories back into an oversupplied state, which precipitated a collapse in crude oil prices in the fourth quarter. This worsened in Western Canada due to pipeline capacity constraints that led to a greater build-up in domestic inventories. As a result, lower investments and exports in the energy sector further curbed economic growth. This was reminiscent to the crash in crude oil prices that started in the second half of 2014, which prompted the Bank of Canada to cut interest rates twice in 2015, in order to stimulate the economy.

The interest rate environment in Canada followed closely behind the U.S. in regards to its pace and number of rate hikes. This was largely expected given the close integration between the two economies based on the trading relationships in place. The Bank of Canada increased its policy interest rate three times of 25 basis points each, effective January, July and October, equating to the overnight rate of 1.75%. In light of weaker economic data in the areas mentioned earlier, by building on the strength of the U.S. economy in addition to steady employment gains and firming inflation, the central bank reiterated its expectations for the need to lift its policy rate closer to their neutral stance of between 2.50% to 3.00%. Both short term and long term Government of Canada Bond yields trended higher throughout majority of the year as the Government of Canada 2 Year and 10 Year bond yields peaked at 2.35% and 2.60%, respectively. However, as financial conditions deteriorated rapidly towards the end of the year due to recession fears, global equity markets sold off as investors cut exposure to risky assets. Consequently, a flight to the safest securities such as federal government bonds, caused yields to plunge. The significance of this can be seen in the 10 Year yield, which actually ended the year lower than where it began, as shown in the chart below.

Chart 1 – 2 Year and 10 Year Government of Canada Bond Yields from January 2018 to December 2018

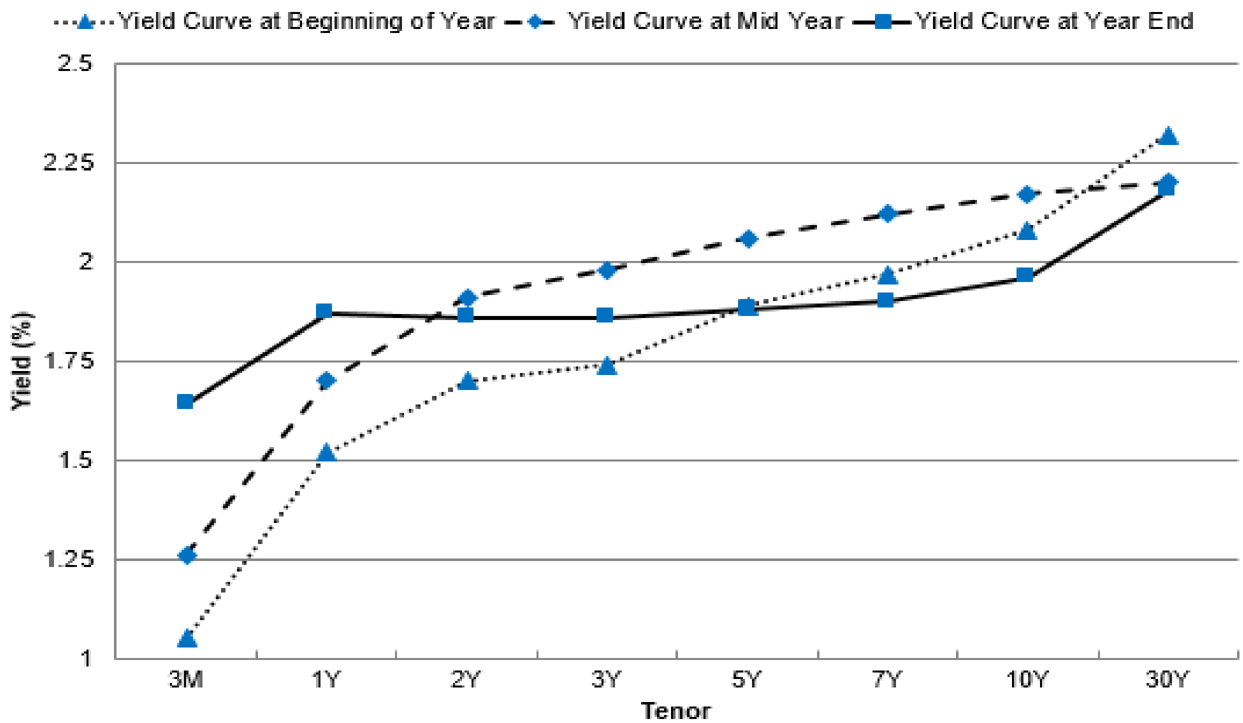
(Yields sourced from Bank of Canada)

The spread between the 10 Year yield and 2 Year yield declined from 35 basis points at the beginning of the year and reached a new low of 4 basis points, as financial markets became under greater stress towards year end.

Canada’s yield curve, which serves as the benchmark for the Canadian fixed income market, is constructed using Government of Canada bond yields of increasing terms to maturity. It is a widely used tool to depict the relationship between the yield environment and economic variables such as global growth conditions and the outlook on inflation. In addition to illustrating the different yield spreads between federal government bonds of various terms to maturity including 10 Year and 2 Year mentioned previously, it generally reflects the additional yield an investor can earn by purchasing bonds of longer-dated maturities compared to shorter terms.

The flattening yield curve is characterized by either shorter term yields increasing more than longer term yields or longer term yields declining more than shorter term yields. This is portrayed by the change of the curve at beginning of the year, mid-year and year end, as displayed in the following chart.

Chart 2 – Government of Canada Bond Yield Curve in 2018



(Yields sourced from Bank of Canada)

Bank of Canada increased its overnight rate three times in 2018, which is best shown in upward shifts of the 3 month (3M) Treasury bill yield throughout the year. However, the overall slope of the yield curve has been on an ongoing decline, which was most prominent in the tenors of 2 years (2Y) to 10 years (10Y). More importantly, Government of Canada bond yields of 5 year terms and farther, actually ended the year slightly lower than where it began.

The significance of the flattening yield curve was attributed to market pricing of slowing global growth and lower inflation. This signaled greater demand on longer term bonds, as investors locked in yields based on the expectation that they will decline even more in the future.

Investment Portfolio Results

In 2018, the City's investment portfolio realized total income of $14.6 million based on an average portfolio balance of $531.0 million. This resulted in an income return of 2.76%. The average balance is only used for the return calculation as it provides the most accurate measure by incorporating the number of days the balance was held at specific levels during the calendar year based on the amount and timing of all cash flows related to investment purchases, maturities and sales. The income return reflects investment income earned on all investments and directly translates to the amount of interest allocated between the operating budget and reserve funds.

The following table provides a summary of the breakdown for investment income realized between short term and long term investments. Investments with a term of 1 year or less including cash balances are classified as short term and over 1 year as long term.

Table 1 – Portfolio Income Return and Year over Year Comparison

Year	Term Type	Average Balance (millions)	Investment Income (millions)	Portfolio Income Return
2018	Short Term	$128.5	$2.7	2.14%
	Long Term	$402.5	$11.9	2.96%
	Total	**$531.0**	**$14.6**	**2.76%**
2017	Short Term	$129.2	$1.9	1.45%
	Long Term	$388.1	$11.8	3.06%
	Total	**$517.4**	**$13.7**	**2.65%**

Financial markets experienced much greater volatility in 2018 than compared to the previous year, most notably in the final quarter. Given that the Bank of Canada increased its overnight rate three times, this translated to a 75 basis point increase in the prime rate set by the major Canadian financial institutions, ending at 3.95%. As a result, the investment portfolio was able to generate much higher income on its cash balances and short term securities. However, the flattening yield curve continued to present a challenge on long term holdings as the yield spread between longer term and shorter term bond yields declined even further from the prior year.

In order to facilitate objective performance measurement, the second method of evaluation is total return. This combines realized investment income with Mark-to-Market adjustments, which reflects the change in market values of the underlying securities in the investment portfolio. This provides an assessment in measuring how the investment portfolio performed against a market benchmark based on industry standards.

As outlined in the Investment Policy, the most suitable benchmark is a combination of FTSE (Financial Times Stock Exchange) Canada Debt Market Indices and the S&P/TSX (Standard & Poor's/Toronto Stock Exchange) Composite Index. Both are leading indicators used in measuring Canadian market performance in fixed income and equities, respectively. The custom benchmark will be derived from a weighted blend of relevant components from the indices based on the investment portfolio's asset mix including sector types, credit quality and term to maturities.

In 2018, the total return of the investment portfolio was 2.11%, after incorporating a negative market impact. The following table provides a summary of the breakdown.

Table 2 – Summary of Portfolio Total Return

Year	Average Balance (millions)	Investment Income (millions)	Portfolio Income Return	Mark-to-Market (millions)	Portfolio Total Return
2018	$531.0	$14.6	2.76%	$(3.4)	2.11%
2017	$517.4	$13.7	2.65%	$1.9	3.02%

The negative Mark-to-Market resulted from a few factors including an overall higher interest rate environment, especially shorter term yields, as well as wider credit spreads relative to the prior year. A credit spread captures the difference in yield between two debt securities of similar maturity but different credit quality. Given the inverse correlation between bond prices and yields and credit spreads, this led to a negative market impact. This is especially considering that the investment portfolio is more weighted towards the corporate sector such as banks, which historically provides higher returns than government bonds, except during periods of market turbulence.

The greater contributor to the negative Mark-to-Market adjustment was in regards to the portion of long term holdings, which the valuation is correlated to the performance of equity markets. This comprises of the securities that are principal protected and holdings in the 'Equity' portfolio with the ONE Investment program, the latter which is restricted to a maximum of 5% of the total portfolio. This is based on the primary objective of capital preservation in the Investment Policy, but given that overall equity prices registered declines for the year, both investment types were inevitably impacted.

The total return of the City's benchmark was 0.91%, which the investment portfolio exceeded its benchmark by 1.20%, as presented in the next table.

Table 3 – Portfolio Total Return versus Benchmark Total Return

Year	Portfolio Total Return	Benchmark Total Return	Difference
2018	2.11%	0.91%	1.20%
2017	3.02%	2.62%	0.40%

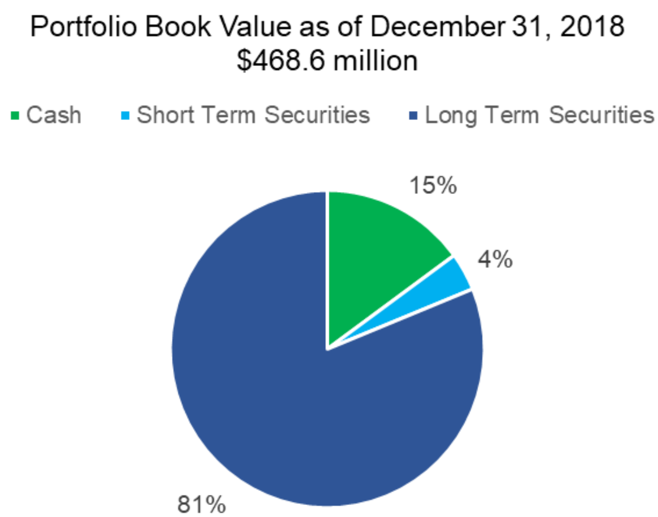
A major factor that supported the greater performance of the investment portfolio relative to its benchmark was related to short term investments. This was due to the City's attractive variable interest rate structure in earning deposit interest on its cash balances. This enabled it to realize a much more competitive yield due to a higher bank prime rate than compared to money market instruments such as the Government of Canada 3-month T-bill. In addition, staff proceeded to onboard another investment broker, in order to obtain greater access to large credit union issuers for more competitive yields within short term investments.

The other factor that contributed to the positive difference between the total returns of the investment portfolio and benchmark, was due to the portion of long term investments where returns are linked to the performance of equity markets. The market valuation of these holdings experienced a smaller decline than compared to its benchmark.

Year-end Investment Portfolio Metrics

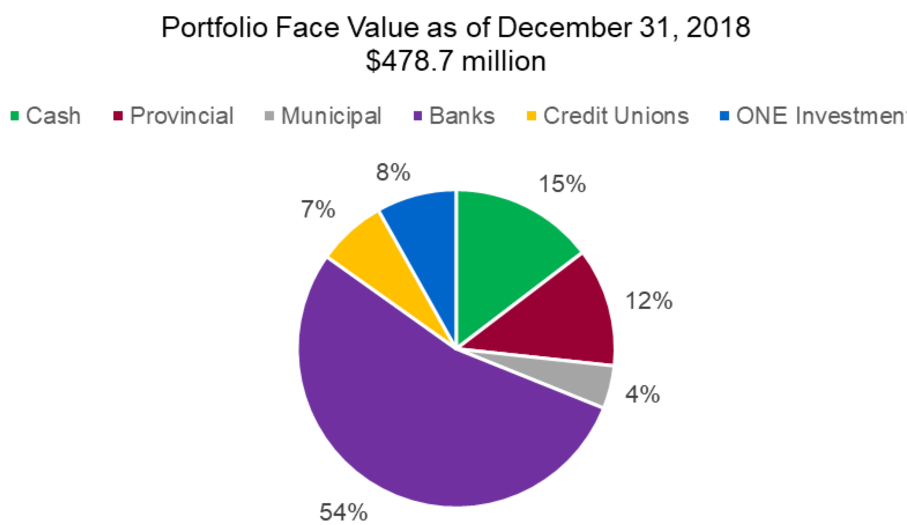
The book value of total investments held at year end, which represented the cost of all holdings (Appendix "A") was $468.6 million, which included cash balances totaling $70.0 million, short term holdings of $18.1 million and long term holdings of $380.4 million. This translated proportionately to the total portfolio balance of 15%, 4% and 81%, respectively. The City maintained a higher cash balance towards year end due to uncertainty in the financial markets yet still earning attractive deposit interest. The higher liquidity was also maintained in order to support the City's working capital requirements for the 1st half of 2019, based on the investment portfolio's maturity schedule and ongoing cash flow projections. The following chart displays the breakdown of the total portfolio.

Chart 3 – Portfolio Breakdown between Cash, Short Term Holdings and Long Term Holdings



The face value of total investments held at year end was $478.7 million. This acts as an ongoing measure to ensure compliance with the Investment Policy based on the portfolio breakdown in authorized investments, as shown in the following chart.

Chart 4 – Portfolio Breakdown by Authorized Investments



As cash plays an integral role in the overall asset mix, the City continued its focus on maintaining appropriate levels of liquidity through cash flow management. This enabled the portfolio to maximize investment income while adequately meeting financial obligations related to both operating and capital expenditures.

The term structure of the investment portfolio was shortened from a weighted average term to maturity of 3.2 years to 2.3 years in 2018 (Appendix “B”). This was reflected in the greater weight of the portfolio in short term holdings based on a higher cash balance maintained at year end. The lower portfolio duration was also in response to the higher future interest rate expectations during the first half of the year and the declining yield spread in longer term bonds relative to shorter term bonds, based on the flattening yield curve.

Prudent Investor Standard

As part of the new regulations that came into force March 1, 2018, Section 418.1 of the *Municipal Act* was updated in authorizing municipalities to adopt the “Prudent Investor” status. The framework is directed towards broadening municipal investment powers in order to better support the maintenance and growth of its infrastructure based on funds not immediately required. Municipalities will have the opportunity to invest into a much greater selection of investment vehicles as well as the ability to obtain exposure in global markets. This is in significant contrast to the existing prescribed list of eligible securities, which the Investment Policy is established upon. Under the new rules, a municipality may choose to continue investing under the enhanced existing guidelines or invest under the new standard if qualified to do so. However, a municipality is required to pass a By-law in order to start investing according to the new standard. An ‘Investment Board’ or ‘Joint Investment Board’ will need to be established to exercise oversight, control and management of the funds being invested. The ONE Investment Board was established in 2018 and is in the process of preparing new investment solutions and services that will benefit municipalities. This will encompass those that decide to move towards the new standard or continue investing under the existing prescribed list of eligible securities.

The City is already currently utilizing the ONE Investment Program as part of its investment strategy. This is a co-mingled investment program that is specifically designed and catered to Ontario municipalities, which is jointly operated by LAS (Local Authority Services) and CHUMS Financing Corporation (a subsidiary of the Municipal Finance Officers’ Association of Ontario).

The “Prudent Investor” regime is still in its early stages, considering that the City of Toronto, being the earliest adopting municipality in Ontario, is still going through its transition process. Other municipalities are taking a more patient approach, given that their financial needs can significantly vary in terms of both capacity and timing, and that one cannot simply opt out of the arrangement due to the required structure for an ‘Investment Board’.

Staff will continue to monitor any new developments and report back in 2020 with any further information.

Looking at 2019 and Moving Forward

The financial market narrative that emerged towards the end of 2018, was based on increasing probabilities of a near term recession. However, the economic outlook appears to have reversed course so far, with the recent slowdown now only expected to be temporary, and that global growth is to reaccelerate in the second half of the year.

Since the beginning of the year, financial market conditions have taken a major shift and improved dramatically. The two major economic uncertainties that have persisted throughout most of the past year, were rising interest rates from excessive tightening in monetary policy and risks surrounding global trade. The concern surrounding higher interest rates from additional rate hikes have now largely de-escalated and instead, transitioned into a supportive fundamental, in order to further extend the global economic expansion. This was driven by global central banks strongly backtracking on their stance of monetary policy, in response to slowing economic growth and diminishing inflationary pressures. The U.S. Federal Reserve and Bank of Canada are expected to remain on hold from further interest rate hikes in 2019.

Global equity markets, particularly in U.S. and Canada, have significantly recovered from the steep sell-off during the fourth quarter of last year. In addition to drawing support from global central banks, initial positive developments on trade negotiations between U.S. and China and expectations of a near term agreement, have also bolstered market sentiment for risky assets. However, global trade concerns have since resurfaced and further escalated through increased tariffs and subsequent retaliatory tariffs from both countries, as they continue to encounter conflicts in reconciling their trade differences.

An important observation is that government bond yields have not conformed to the same initial market expectations for a rebound in global growth, as implied by the recovery and positive performance seen in global equity prices. Yields continue to be weighed down by global central banks adjusting their position, such that a less restrictive monetary policy remains warranted until economic data improves. Renewed trade tensions have also placed further downward pressure on yields. As a reference, the Government of Canada 2 Year and 10 Year bond yields have trended even lower than compared to the levels ending 2018.

Canada has experienced weaker economic activity since the beginning of the year, notably in housing activity and consumer spending, but projected to pick up in subsequent quarters per the Bank of Canada. The key developments being monitored by the central bank involves household spending, oil markets and global trade policy. These have been frequently cited as the main areas of focus, particularly household spending due to high levels of Canadian household debt.

Bank of Canada has reduced the neutral range for its policy rate by 25 basis points, now estimated to be between 2.25% to 3.25%, which is needed to sustain economic output at its potential level and maintain target inflation. However, it has omitted its reference that its policy interest rate will need to rise to a neutral range, as of its April interest rate announcement. This marks a significant contrast to the interest rate outlook back in October 2018, when the central bank had increased its overnight rate for the fifth time since it started back in July 2017.

Since the financial crisis over a decade ago, the current global economic expansion is on track to be the longest once we progress into the second half of the year. Given recent changes in the monetary policy outlook by global central banks, it is now becoming more probable that the rate hike cycle may be closer to ending than initially expected. Even though financial market conditions have improved from the recent downturn from late 2018, there still remains much uncertainty on future economic growth and inflation. This is especially considering the late stage of the business cycle that we are in and degree of the negative impact that the elevated trade risks may have on the global economy.

Staff will continue to monitor the global macroeconomic environment and market conditions to adjust accordingly in balancing out risks and opportunities to preserve capital and realize competitive returns.

Financial/Staffing/Other Implications:

The City's investment portfolio earned a total of $14.6 million in investment income for 2018, in which $2.8 million was allocated to the operating budget and the remaining amount of $11.8 million allocated to reserve funds.

Relationship to the Strategic Plan:

The Treasurer is of the opinion that the investment portfolio and all transactions undertaken in 2018 adhered to all required standards of the *Municipal Act,* Investment Policy and goals adopted by the City. The Investment performance demonstrated effective use and application regarding all of the City's available monies through wise management of public funds.

Conclusion:

The City's investment portfolio generated a total realized investment income of $14.6 million, which equated to an income return of 2.76%. These results are reflected as positive amid the low interest rate environment given that capital preservation remains as the top priority.

Attachments:

The following attached documents may include scanned images of appendices, maps and photographs. If you require an alternative format please call the contact person listed in this document.

- Appendix "A" – List of Portfolio Holdings
- Appendix "B" – Portfolio Breakdown by Term

Report Approval Details

Document Title:	SRCFS.19.017 – 2018 Investment Portfolio Results.docx
Attachments:	- Appendix “A” – List of Portfolio Holdings - Appendix “B” – Portfolio Breakdown by Term
Final Approval Date:	May 23, 2019

This report and all of its attachments were approved and signed as outlined below:

David Dexter - May 23, 2019 - 7:46 AM

MaryAnne Dempster - May 23, 2019 - 2:49 PM

Neil Garbe - May 23, 2019 - 4:39 PM