

Great Lakes Water Authority

Investment Performance Report – March 2023



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PORTFOLIO RECAP

- **Safety** – The aggregate portfolio is diversified amongst cash, bank deposits, U.S. Treasuries, Federal Agencies, commercial paper, SEC-registered money market funds, and a local government investment pool. The total credit profile of the portfolio is strong with over 97% of the assets invested in bank deposits or securities that are rated within the two highest short and long-term rating classifications as established by Standard & Poor’s.
- **Liquidity** – Great Lakes Water Authority (“GLWA”) has continued to monitor its portfolio with the goal of limiting the allocation to cash and bank deposit accounts and maximizing the use of short-term investments to meet cash requirements. As of March 31, 2023, approximately 54% of the funds were held in cash and money market accounts maturing overnight. The percentage is slightly lower than last quarter due to higher short-term commercial paper yields.
- **Return** – The overall yield at market increased to 4.60% as of March 31, 2023, versus 4.33% as of December 31, 2023. The higher yield is reflective of the rise in interest rates experienced throughout the fiscal year. GLWA earned \$21.9 million (unaudited) in investment income for the first nine months of fiscal year 2023 on a book value basis. We expect the investment income for GLWA for FY 2023 to be approximately \$32.5 million (~\$13.0 million for construction bond proceeds funds; ~\$3.5 million for Improvement & Extension funds; ~\$3.4 million for Operating & Maintenance funds; and ~\$12.6 million for all other funds).

AVAILABLE FUNDS (Unaudited)

Type	Book Value	Market Value	Yield @ Cost (as of 3/31/23)	Yield @ Market (as of 3/31/23)
Deposit Account	\$9,052,640	\$9,052,640	3.03%	3.03%
Deposit Account - Retainage	\$26,553,530	\$26,553,530	0.01%	0.01%
Deposit Account – Flint Security Deposit	\$3,873,371	\$3,873,371	3.03%	3.03%
Trust Money Market Fund	\$395,491,204	\$395,491,204	4.61%	4.61%
Money Market Fund	\$14,000,009	\$14,000,009	3.07%	3.07%
Local Government Investment Pool	\$211,604,036	\$211,604,036	4.76%	4.76%
Managed Funds	\$576,816,401	\$572,747,953	4.13%	4.84%
<u>MARCH 2023 TOTALS:</u>	<u>\$1,237,391,191</u>	<u>\$1,233,322,743</u>	<u>4.27%</u>	<u>4.60%</u>
<u>PREVIOUS QUARTER TOTALS:</u>	<u>\$1,169,245,122</u>	<u>\$1,163,331,669</u>	<u>3.71%</u>	<u>4.33%</u>

Investment Strategy

OVERALL STRATEGY

- All investment activity is conducted subject to GLWA’s investment policy and state statutes while meeting the primary objectives of safety and liquidity. The portfolio is managed to a disciplined investment plan to provide improved safety and diversification while putting every dollar to work.
- GLWA, working with its investment advisor PFM Asset Management (“PFMAM”), has continued to invest its funds in a mixture of short and intermediate-term individual investment securities to ensure adequate liquidity to cover upcoming debt, pension payments, and operational requirements.
- PFMAM will continue to actively manage long-term portfolios with full discretion and align short-term balances with expected liabilities and identify strategies to maximize future investment income in the current interest rate environment, subject to GLWA’s investment policy and state statutes.

PORTFOLIO PERFORMANCE – CURRENT PERIOD*

- The overall portfolio’s original yield at cost went from 3.71% as of 12/31/2022 to 4.27% as of 3/31/2023.
- The total portfolio had a market yield of 4.60% at the end of March, compared to 4.33% as of December 31, 2022. Yield at market represents what the market would provide in return if the portfolio was purchased on March 31, 2023 (versus purchased in prior months / years). The higher yield is a result of the increase in rates throughout the fiscal year.
 - We utilize a variety of investment sectors, and because of that, this 4.60% yield at market as of 3/31/2023 is beneficial when compared to the 4.54% yield of the 3-Month U.S. Treasury Bill index, which is a comparable market indicator.

PORTFOLIO PERFORMANCE – PROJECTIONS

- GLWA earned over \$21.9 million (unaudited) in investment income for fiscal year-to-date 2023 (as of 3/31/23) on a book value basis.
- The current period earnings are in line with budgeted expectations, especially with no more Federal Reserve interest rate hikes priced into the market.
- The FY 2023 total interest earnings projection forecast is currently \$32.5 million.

** Yield at cost is based on the original cost of the individual investments from the purchase date to maturity. On the other hand, yield at market is calculated on a specific day (in this case, March 31, 2023) and assumes that all the securities in the portfolio are purchased given the market price/yield on that particular day. If one is to generally hold their investments to the stated maturity date, then the yield at cost would be the better number to use to gauge how the portfolio is performing.*

Summary Market Overview and Outlook

ECONOMIC HIGHLIGHTS UPDATE

- The Federal Reserve (“Fed”) raised its benchmark interest rate by 25 basis points on March 22nd, despite uncertainty caused by the announcement of two large bank failures in the U.S. The short-term Federal Funds rate is at a new target range of 4.75% to 5.00%. The accompanying Fed statement noted that job gains are running at a robust pace, the unemployment rate has remained low, and inflation remains elevated.
- The Fed’s latest Summary of Economic Projections suggest only more 0.25% rate hike this year, with the median expectation for the target rate to remain above 5.00% through the end of the year. Conversely, Fed Funds futures contracts have diverged markedly from Fed expectations, implying that markets are betting on rate cuts to begin within six months. Fed Chair Jerome Powell has reiterated that rate cuts were not the Fed’s “base case” assumption.
- Inflation (CPI year-over-year) fell for the ninth straight month to 5.0% in March, the lowest reading in almost two years. This was led by a decline in all major energy component indices but was more than offset by increases in shelter costs, which has a higher relative importance in the index and was the largest contributor to the month-over-month increase.
- Employers added 236,000 jobs in March, in line with expectations. The unemployment rate ticked lower to 3.5%. Wages grew 4.2% year-over-year, the slowest pace in 21 months, while job openings fell below 10 million for the first time in nearly two years.
- Factory orders and durable goods orders fell in February, while March readings for both the ISM manufacturing and services indices were lower. Fed district surveys from Philadelphia, New York, Kansas City, Richmond, and Dallas all showed signs of weakness.

ECONOMIC IMPACT ON PORTFOLIO

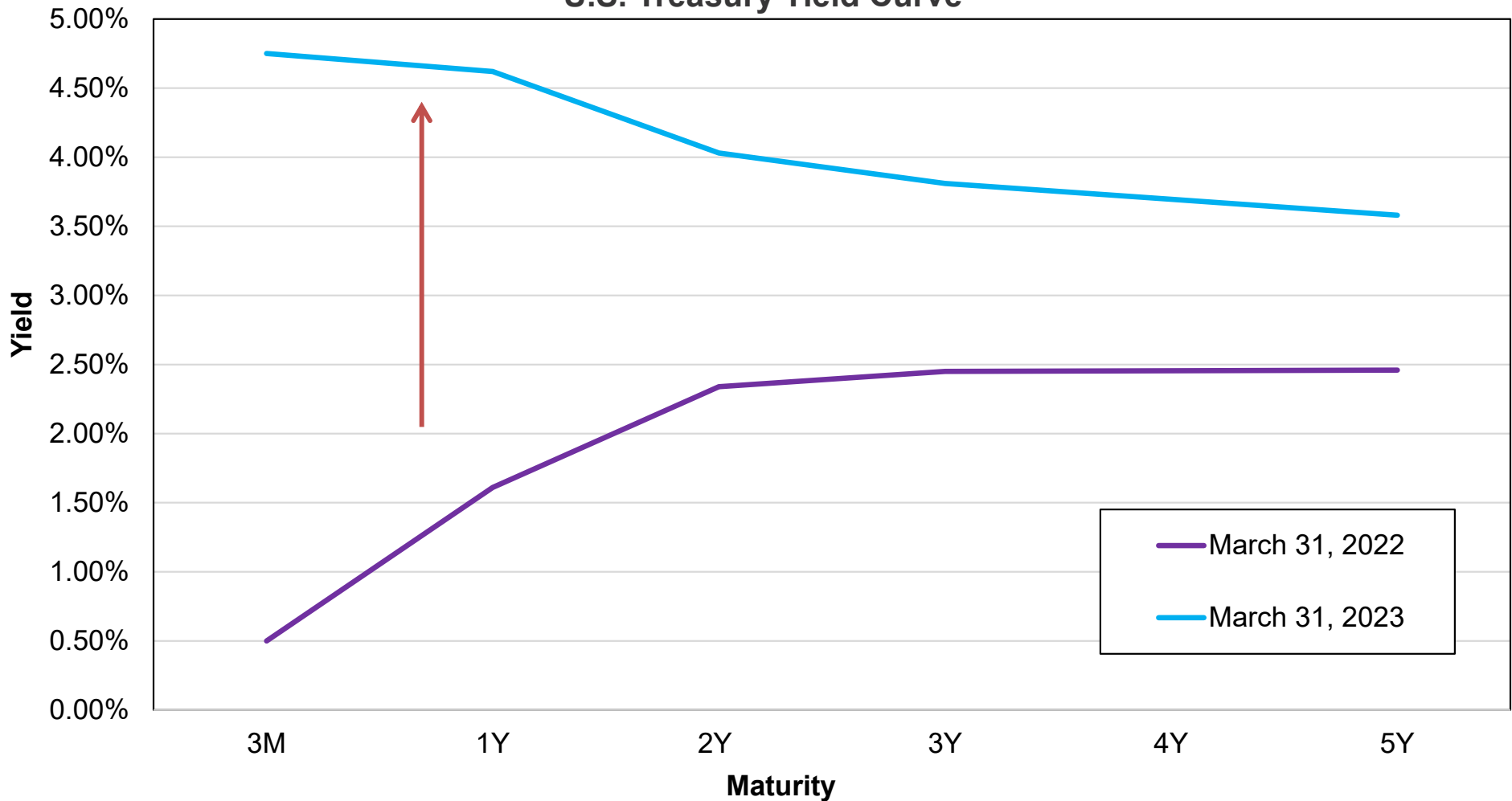
- Treasury yields moved sharply lower in March on reduced rate hike expectations, recession fears, and a “flight to quality.” The 2-year Treasury yield fell by 80 basis points during the month to 4.02%, reflecting increased bond market volatility which was exacerbated by recent banking concerns.
- Treasuries of all maturities rode the bond rally in March, as benchmark 3-month, 5-year, and 10-year U.S. Treasuries finished the quarter at 4.75%, 3.57%, and 3.47%, having fallen by 8, 61, and 45 basis points during the month of March alone, respectively. As a result, Treasury index returns advanced in the quarter.
- Portfolio Impact: In light of the recent news regarding the debt ceiling, we have taken a closer look at those accounts that held Treasuries around the time that the Treasury may default if a compromise is not reached by Congress to suspend or raise the debt ceiling. Treasury Secretary Yellen noted that the government could possibly run out of money by early June. We believe that a default is unlikely but understand that there may be sensitivity around holding Treasuries in this maturity area. As a result, we sold Treasuries in the Water and Sewer Pension Obligation and O&M Pension funds that were scheduled to mature on 6/15/2023, and were able to purchase commercial paper at yields above 5.00% which will diminish the impact of some of the realized losses.

Summary Market Overview and Outlook

Treasury Yield Curve Presently Inverted

- It should be noted that, caught up in market volatility, Agency spreads widened, creating good investment and swap opportunities. The peak of the Treasury yield curve is now around the 6-month maturity range. Money market investors continue to benefit from the highest short-term yields in over 15 years.

U.S. Treasury Yield Curve



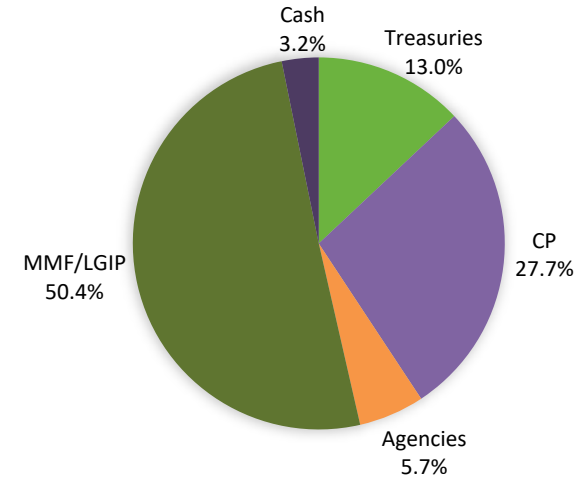
Portfolio Snapshot

Overall Portfolio Composition Summary

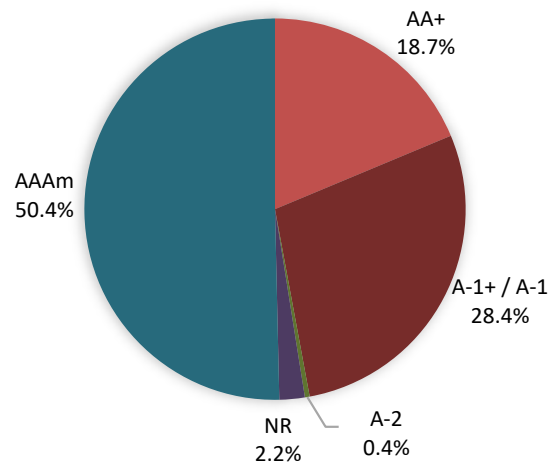
PORTFOLIO STATISTICS

Invested Amount	\$1.233 Billion
Duration	0.20 Years
Yield at Cost	4.27%
Yield at Market	4.60%

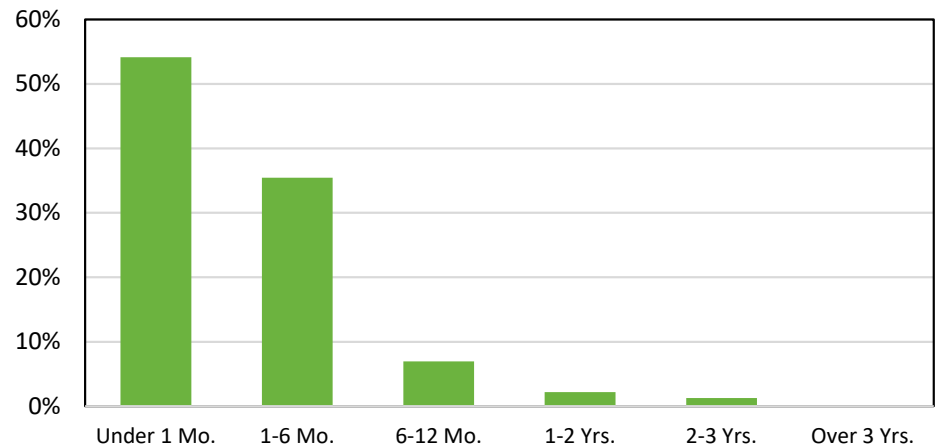
SECTOR ALLOCATION



CREDIT QUALITY



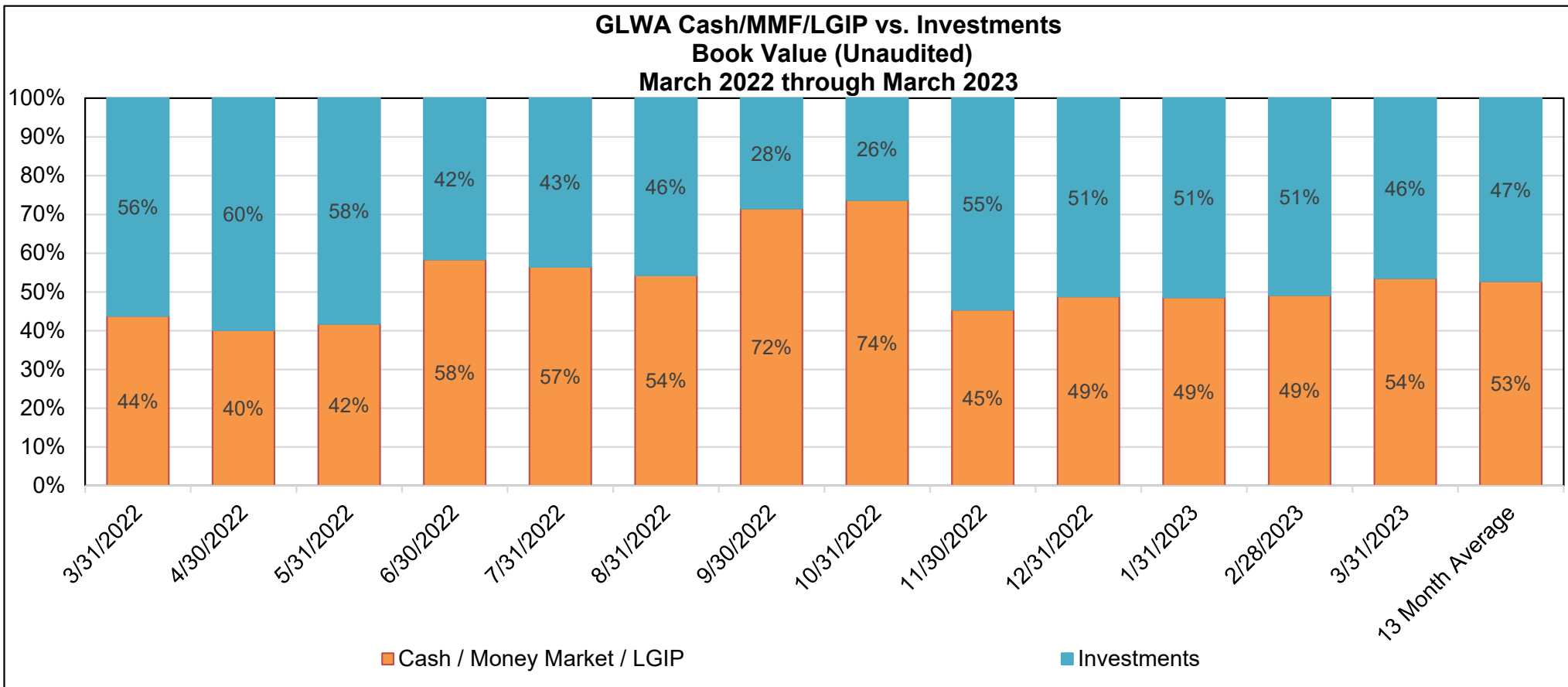
MATURITY DISTRIBUTION



Portfolio Snapshot

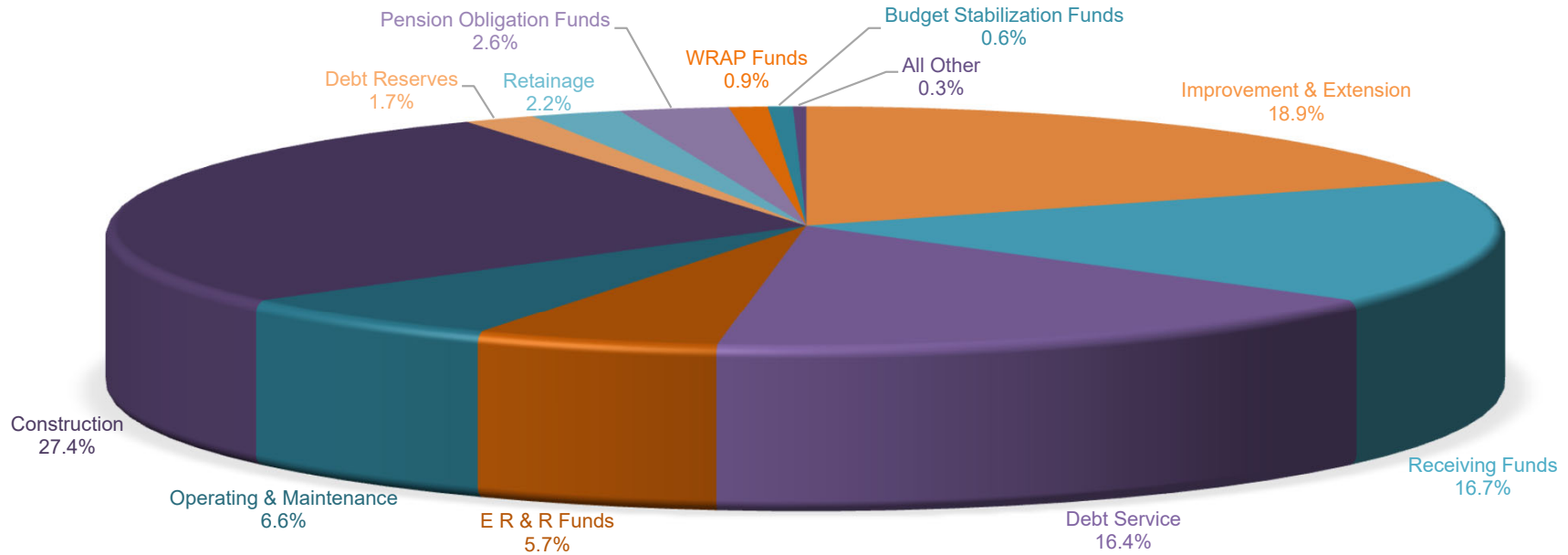
Portfolio Mix – Cash / Money Market vs. Investments

- GLWA’s liquidity requirements fluctuate each month based on operational requirements, capital funding, and debt payments. Based on a review of historical activity and refinement of cash flow projections, GLWA has continually tried to balance the allocation of the portfolio’s holdings to cash & money market accounts versus the allocation to investments for the portfolio holdings.
- The chart below compares the monthly allocation of the portfolio holdings to the 13-month average. The allocation between cash and investments will vary each month based on liquidity requirements. For March of 2023, 54% of the overall portfolio was invested in cash, LGIP, and/or overnight money market fund accounts. This is slightly higher than usual due to the timing of recent maturities that will be reinvested.



Portfolio Snapshot

Investments – By Account Purpose

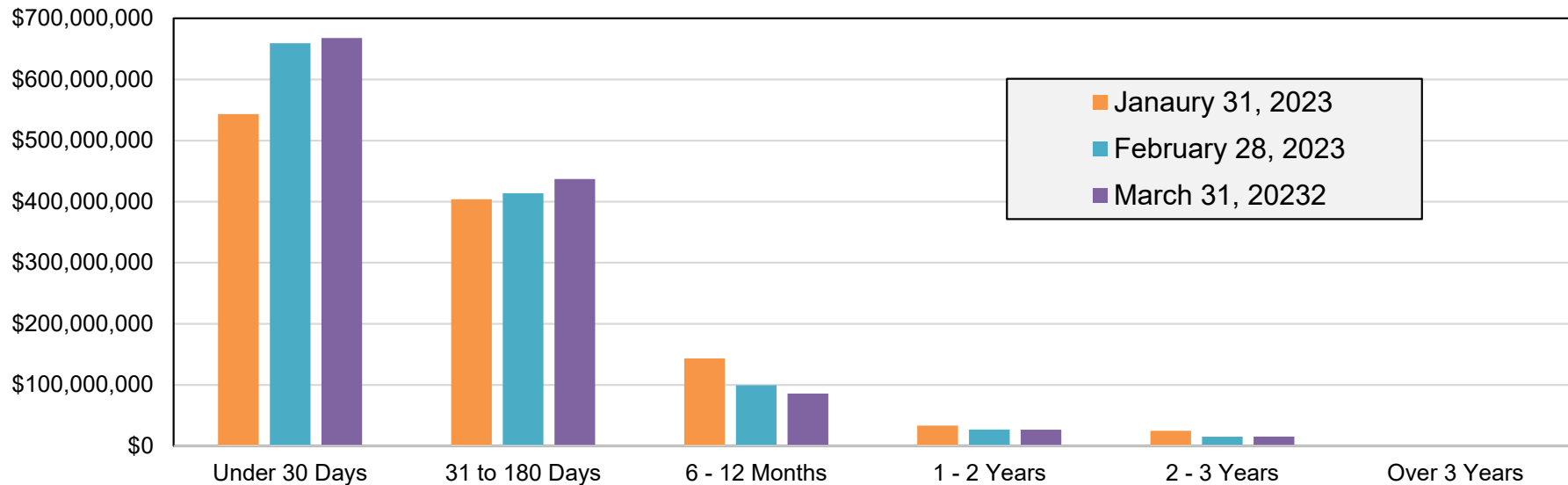


Account Purpose	Market Value	Allocation %	Cost at Yield	Market at Yield	Duration	Strategy
Construction	\$ 338,528,180	27.4%	5.34%	5.02%	0.228 Years	Cash Flow Driven
Improvement & Extension	\$ 233,532,524	18.9%	3.76%	4.78%	0.051 Years	Cash Flow Driven
Receiving Funds (includes lockbox account)	\$ 205,951,698	16.7%	3.86%	3.86%	0.003 years	Short Term
Debt Service	\$ 202,429,790	16.4%	5.45%	5.23%	0.235 Years	Short Term
Operating & Maintenance	\$ 81,265,351	6.6%	3.99%	3.99%	0.003 Years	Short Term
Extraordinary Repair & Replacement Funds	\$ 70,328,712	5.7%	1.42%	4.59%	1.159 Years	Long Term
Pension Obligation Funds	\$ 31,680,535	2.6%	4.73%	4.98%	0.205 Years	Short Term
Retainage	\$ 26,553,530	2.2%	0.01%	0.01%	0.003 Years	Restricted Short Term
Debt Reserves	\$ 20,801,799	1.7%	1.43%	4.67%	0.702 Years	Long Term
WRAP funds	\$ 11,174,933	0.9%	5.13%	5.04%	0.139 Years	Short Term
Budget Stabilization Funds	\$ 7,202,319	0.6%	1.67%	4.61%	1.076 Years	Long Term
Fling Security Deposit Account	\$ 3,873,371	0.3%	3.03%	3.03%	0.003 Years	Restricted Short Term
Total	\$ 1,233,322,743	100.0%	4.27%	4.60%	0.202 Years	

Portfolio Snapshot

Investments – By Maturity

Maturity Distribution	January 31, 2023		February 28, 2023		March 31, 2023	
	\$	%	\$	%	\$	%
Under 30 Days	\$ 543,419,922	47.3%	\$ 659,406,035	54.3%	\$ 667,940,574	54.2%
31 to 180 Days	403,938,414	35.1%	413,824,347	34.1%	437,096,206	35.4%
6 - 12 Months	143,495,542	12.5%	99,545,010	8.2%	85,860,988	7.0%
1 - 2 Years	33,415,270	2.9%	26,960,122	2.2%	26,890,919	2.2%
2 - 3 Years	24,929,107	2.2%	15,226,947	1.3%	15,534,056	1.3%
Over 3 Years	-	0.0%	-	0.0%	-	0.0%
Totals	\$ 1,149,198,254	100.0%	\$ 1,214,962,461	100.0%	\$ 1,233,322,743	100.0%



Portfolio Snapshot

Investment Accounts – Yield at Cost & Market

	As of March 31, 2023		As of December 31, 2022	
	YTM @ Cost	YTM @ Market	YTM @ Cost	YTM @ Market
Bank Deposits				
Bank A	0.01%	0.01%	0.01%	0.01%
Bank B	0.01%	0.01%	0.01%	0.01%
Flint Deposit Account	3.03%	3.03%	2.43%	2.43%
Bank C	3.03%	3.03%	2.43%	2.43%
Sub-Total Bank Deposits	0.61%	0.61%	1.12%	1.12%
Money Market Funds / LGIPs				
Local Government Investment Pool	4.76%	4.76%	4.28%	4.28%
Trust Money Market Fund	4.61%	4.61%	4.06%	4.06%
Money Market Fund	3.07%	3.07%	2.47%	2.47%
Sub-Total MMF / LGIPs	4.63%	4.63%	4.11%	4.11%
Investment Portfolios				
Sewage SR Debt Serv 5403	5.11%	5.06%	5.20%	5.00%
Sewage SR Res 5400	0.32%	4.43%	0.32%	4.51%
Sew 2nd Debt Serv 5403	5.01%	5.05%	4.97%	4.93%
Sewage 2nd Res 5481	4.17%	4.43%	4.17%	4.51%
Sew SRF Debt Serv 5410	5.26%	5.26%	4.80%	4.83%
Sewage ER & R	4.40%	4.37%	0.46%	4.52%
Sewer Improvement & Extension	0.77%	4.52%	0.91%	4.70%
Sewer Pension Obligation	4.46%	4.80%	4.11%	4.80%
Sewer Wrap Fund	4.68%	4.87%	4.13%	5.02%
Sewer Budget Stabilization Fund	0.45%	4.38%	0.47%	4.53%
Sewer Bond Fund	5.09%	4.87%	5.00%	4.86%
Sewer O&M Pension Sub Account	4.28%	4.79%	3.97%	4.78%
Water SR Debt Ser 5503	5.11%	5.05%	5.20%	5.02%
Water SR Reserve 5500	0.70%	4.54%	0.70%	4.57%
Water 2nd Debt Serv 5503	5.12%	5.03%	5.27%	4.94%
Water 2nd Res 5581	4.18%	4.54%	4.18%	4.57%
Water SRF Debt Serv 5575	5.05%	5.02%	4.64%	4.83%
Water ER & R	0.43%	4.37%	0.45%	4.53%
Water Improvement & Extension	0.36%	4.62%	0.38%	4.67%
Water Pension Obligation	4.43%	4.80%	4.09%	4.79%
Water Wrap Fund	4.91%	4.90%	4.30%	4.93%
Water Budget Stabilization Fund	0.45%	4.37%	0.47%	4.53%
Water Bond Fund	5.34%	4.99%	5.17%	4.96%
Water O&M Pension Sub Account	4.29%	4.79%	3.97%	4.78%
Sub-Total Investment Portfolios	4.13%	4.84%	3.61%	4.82%
Grand Total	4.27%	4.60%	3.71%	4.33%

YTM @ Cost is the expected return, based on the original cost, the annual interest receipts, maturity value and the time period from purchase date to maturity, stated as a percentage, on an annualized basis. YTM @ Market is the rate of return, based on the current market value, the annual interest receipts, maturity value and time period remaining until maturity, stated as a percentage, on an annualized basis.

Portfolio Snapshot

Peer Analysis Comparison

- The comparison agencies included in the list below were selected based on type and/or other non-performance-based criteria to show a broad range of water entities/utilities; this peer group list does not represent an endorsement of any of the public agencies or their services.
- The overall yield of GLWA's aggregate portfolio compares somewhat favorably to those of other short-term market indices (i.e., the S&P LGIP index and the 3-month U.S. Treasury index), despite the volatility of short-term interest rates and the limited ability in managing assets to a longer-term strategy.
- GLWA does have some limitations and unique constraints related to its ordinance and covenants that restricts the potential for a longer duration portfolio when compared to other similar water agencies.

As of March 31, 2023

	Market Value	YTM @ Market	Effective Duration	Weighted Average Maturity
GLWA				
Great Lakes Water Authority	\$1,233,322,743	4.60%	0.20 Years	73 Days
Short/Intermediate-Term Indices				
S&P Rated Government Investment Pool Index		4.46%	0.08 Years	30 Days
BoA / ML 3-Month Treasury Index		4.54%	0.14 Years	55 Days
BoA / ML 6-Month Treasury Index		4.78%	0.39 Years	146 Days
BoA / ML 1-Year Treasury Index		4.67%	0.89 Years	336 Days
BoA / ML 1-3 Year Treasury Index		4.20%	1.75 Years	668 Days
BoA / ML 1-5 Year Treasury Index		4.01%	2.50 Years	964 Days
Peer Analysis (Water Entities / Utilities)				
District of Columbia Water & Sewer Authority, DC	\$414,554,269	4.56%	0.81 Years	328 Days
DuPage Water Commission, IL	\$186,039,181	4.22%	1.96 Years	965 Days
Fairfax County Water Authority, VA	\$190,346,378	4.26%	1.97 Years	753 Days
Metro Wastewater Reclamation District, CO	\$205,835,543	4.15%	2.09 Years	837 Days
Metropolitan Water District of Southern California, CA	\$977,227,114	4.55%	1.07 Years	490 Days
Philadelphia Water Department, PA	\$200,668,906	4.70%	0.83 Years	318 Days
San Bernardino Valley Municipal Water District, CA	\$337,032,733	4.42%	1.58 Years	624 Days
Tohopekaliga Water Authority, FL	\$197,516,799	4.24%	1.63 Years	829 Days
Truckee Meadows Water Authority, NV	\$96,997,000	4.26%	2.06 Years	778 Days

The BoA / ML indexes are unmanaged indexes tracking on-the-run Treasuries. These indexes are produced and maintained by Bank of America / Merrill Lynch & Co. Yield to maturity is the rate of return, based on the current market value, the annual interest receipts, maturity value and time period remaining until maturity, stated as a percentage, on an annualized basis.

Portfolio Snapshot

Monthly Investment Income

(Book Value in 000's)

FY 2023 INVESTMENT INCOME BY MONTH (Unaudited)

Month	Interest Earned During Period <i>(in thousands)</i>	Realized Gain / Loss <i>(in thousands)</i>	Investment Income <i>(in thousands)</i>
July 2022	\$567.7	(\$310.2)*	\$257.5
August 2022	\$807.7	\$0.0	\$807.7
September 2022	\$1,638.1	(\$192.9)*	\$1,445.3
October 2022	\$2,191.1	(\$0.0)	\$2,191.1
November 2022	\$3,032.8	\$0.0	\$3,032.8
December 2022	\$3,493.9	\$0.0	\$3,493.9
January 2023	\$3,534.0	\$37.3	\$3,571.3
February 2023	\$3,455.3	\$0.0	\$3,455.3
March 2023	\$3,721.2	\$0.0	\$3,721.2
<u>FY 2023 Y-T-D</u>	<u>\$22,441.8</u>	<u>(\$465.7)</u>	<u>\$21,976.1</u>

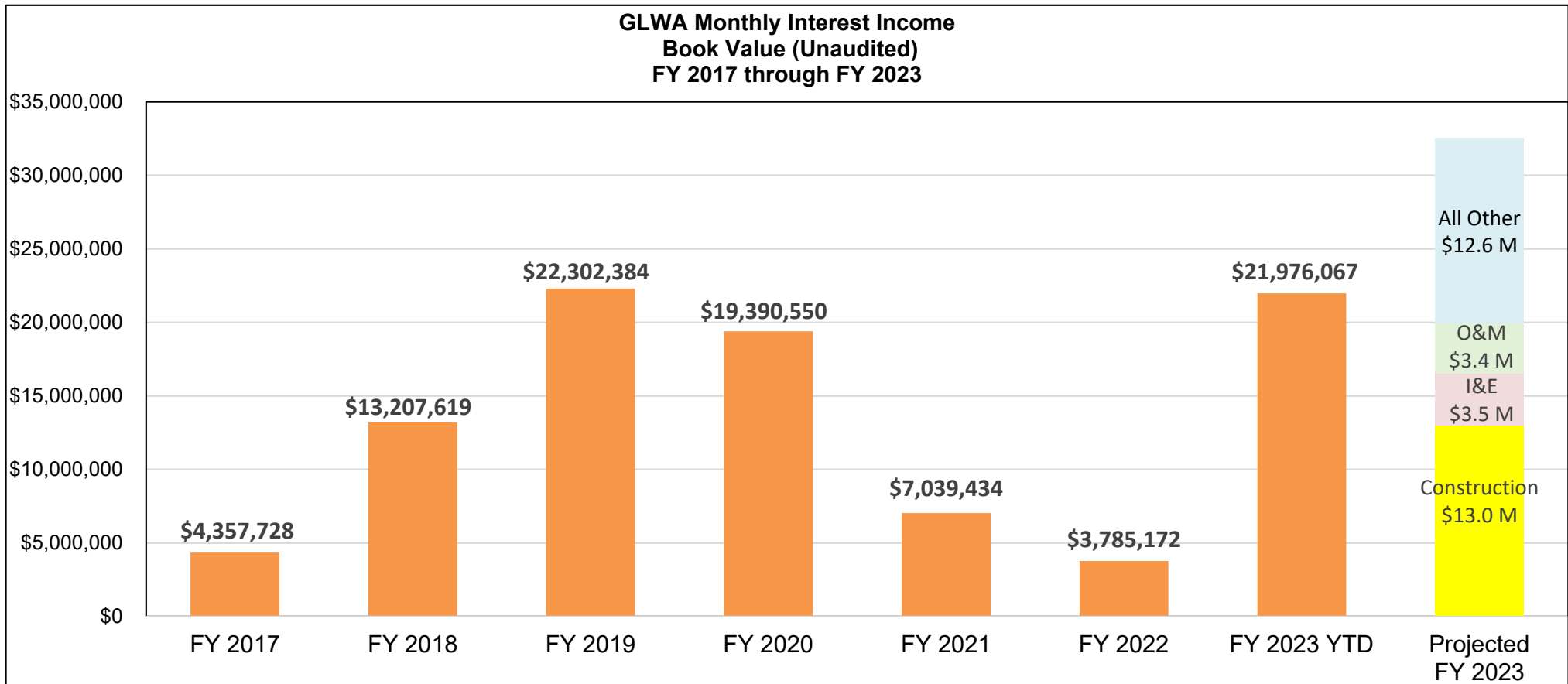
* The realized loss in July of 2022 was due to the sale of investments in the Water I&E account in anticipation of liquidity requirements. The realized loss in September of 2022 was due to the sale of investments to fund the Debt Service Reserve Fund ("DSRF") releases.

These figures are based upon actual interest earned and posted to the Authority's various accounts via book value and does not include any earnings credit rate tied to the Authority's bank deposits.

Portfolio Snapshot

Year-Over-Year Investment Income

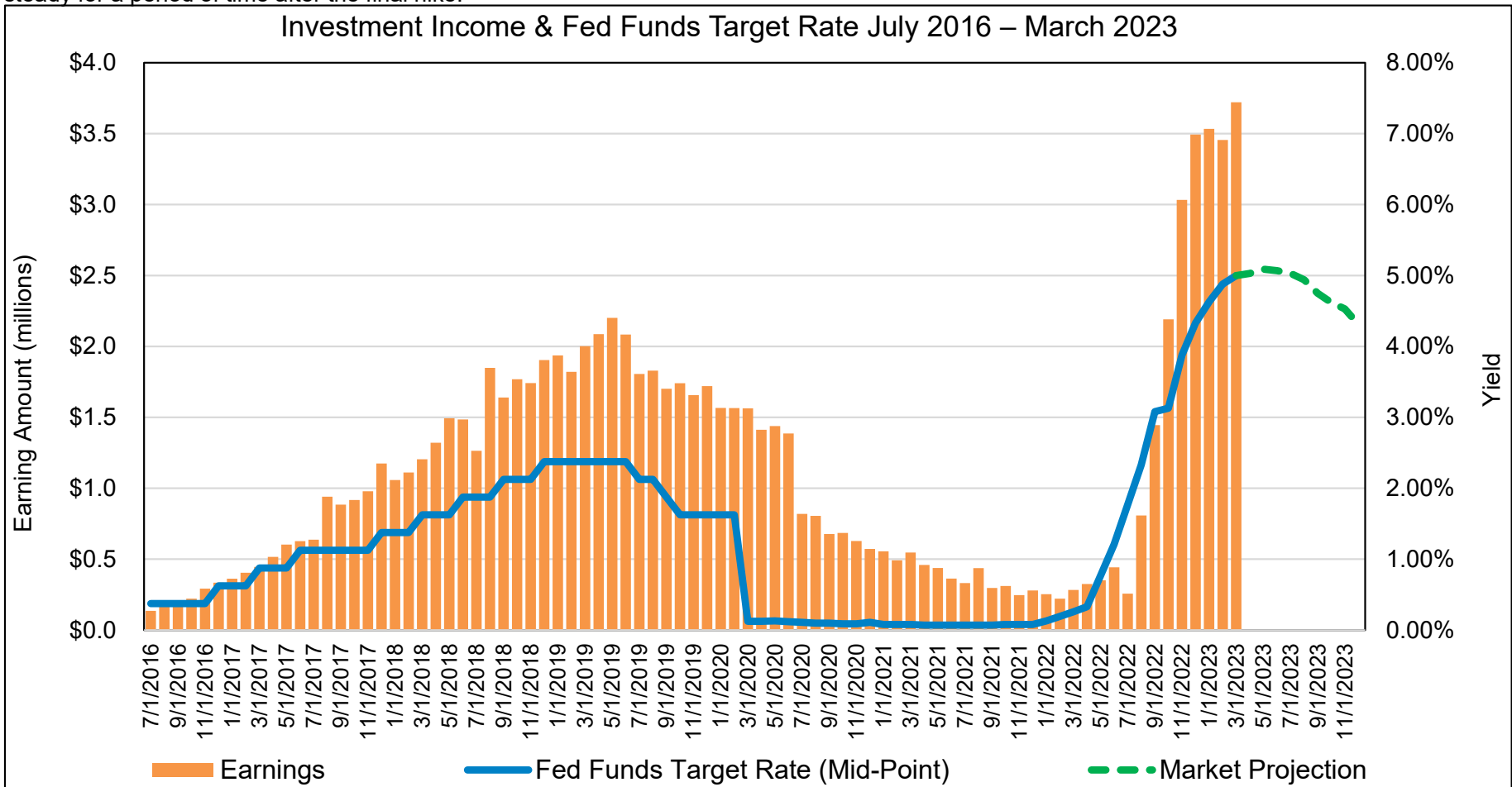
- GLWA earned \$21,976,067 in investment income for the first nine months of fiscal year 2023 on a book value basis compared to \$2,665,036 for the first nine months of fiscal year 2022.
- Based on current market assumptions and the addition of assets and proceeds from GLWA’s most recent bond fund issue, projected investment income for fiscal year 2023 is forecasted to be around \$32.5 million, as the market expects the overnight lending rate to hold steady over the next couple of months. This interest earnings projection forecast is consistent with previous expectations and also consistent with the budget amendments that were made in the second quarter of FY 2023.



Portfolio Snapshot

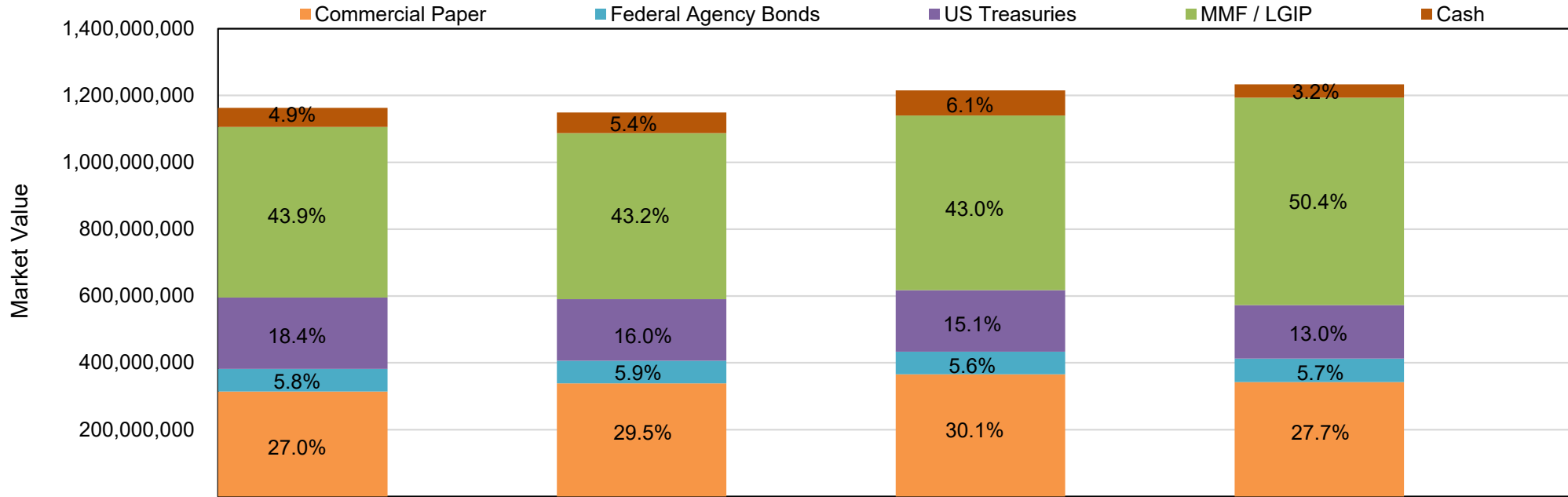
Monthly Investment Income Compared to Fed Funds Rate

- At least 50% of the GLWA portfolio is designated for obligations that are 12 months or less. As a result of the short-term duration of GLWA’s portfolio, it is heavily impacted by changes in the Fed Funds rate; the chart below shows that GLWA’s income has consistently followed the trend of the Fed Funds rate.
- The market is once again subject to the familiar tug of war between investors and the Federal Reserve, although after the banking turmoil in March, the fed is not pulling as hard, and investors are aggressively and consistently pricing in Fed cuts resulting from what they view as an impending recession; current Fed Funds futures have cuts priced in by January of next year, and for its part, the Fed maintains that is not likely and their predicted outcome is holding steady for a period of time after the final hike.



Portfolio Snapshot

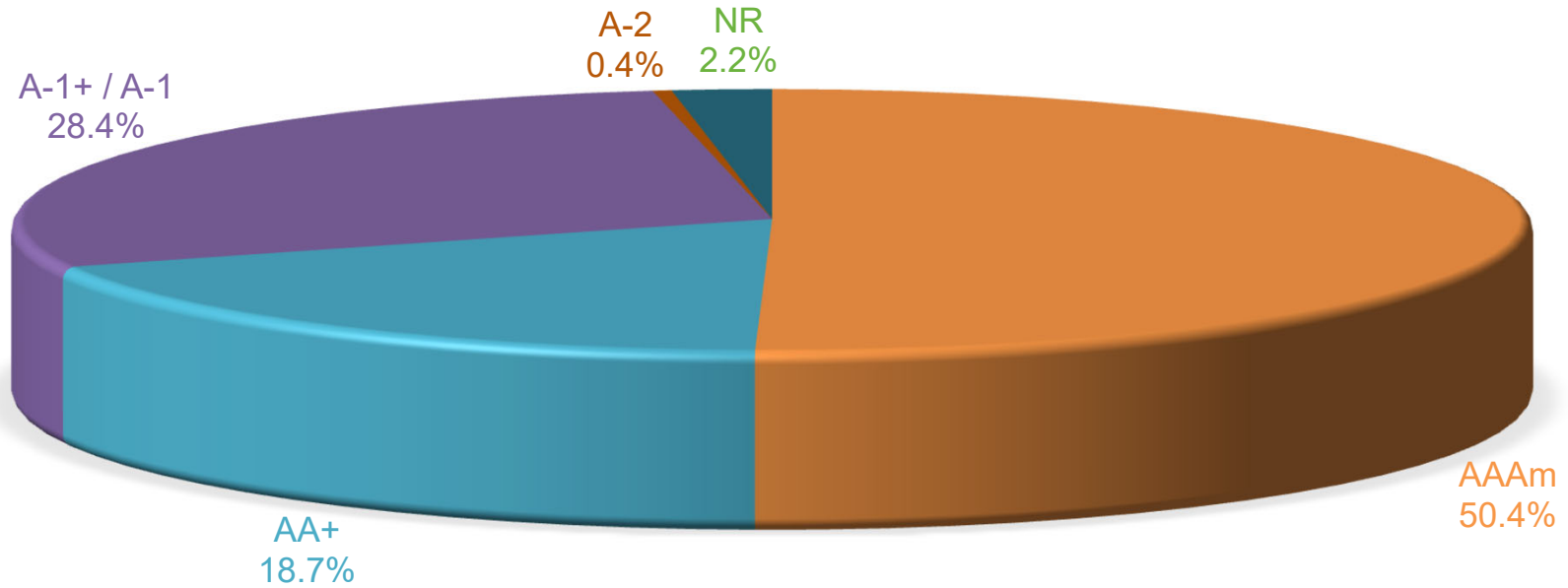
Investments – By Security Type



Security Type	December		January		February		March	
	Market Value	Asset Allocation	Market Value	Asset Allocation	Market Value	Asset Allocation	Market Value	Asset Allocation
Commercial Paper	314,135,724	27.0%	338,525,776	29.5%	365,495,393	30.1%	342,072,816	27.7%
Federal Agencies	67,460,122	5.8%	67,697,334	5.9%	67,917,716	5.6%	70,382,441	5.7%
U.S. Treasuries	213,595,594	18.4%	184,271,936	16.0%	183,988,354	15.1%	160,241,668	13.0%
MMF / LGIP	510,834,246	43.9%	496,951,304	43.2%	523,004,241	43.0%	621,095,249	50.4%
Cash	57,305,984	4.9%	61,751,904	5.4%	74,556,758	6.1%	39,530,568	3.2%
Total	1,163,331,669	100.0%	1,149,198,254	100.0%	1,214,962,461	100.0%	1,233,322,743	100.0%

Portfolio Snapshot

Investments – By Credit Quality



Credit Quality	Market Value	Asset Allocation
Ratings		
AAAm	621,095,249	50.4%
AA+	230,670,551	18.7%
A-1 + / A-1	349,986,377	28.4%
A-2	5,017,036	0.4%
NR	26,553,530	2.2%
Totals	1,233,322,743	100.0%

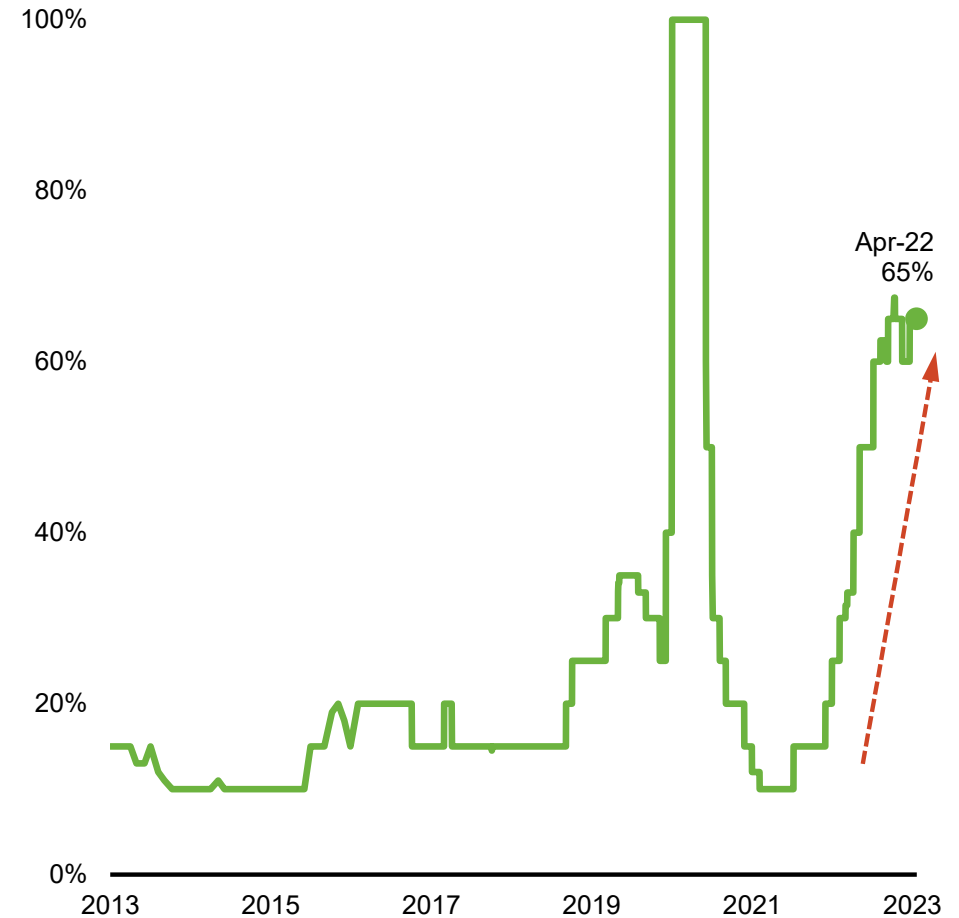
Appendix I: Economic Update

Strong Consumer Spending Keeps GDP Positive Despite Slowdown

GDP Contributors

	Q2 2022	Q3 2022	Q4 2022	Q1 2023
U.S. Real GDP	-0.6%	3.2%	2.6%	1.1%
<i>Personal Consumption</i>	1.4%	1.5%	0.7%	2.5%
<i>Fixed Investment</i>	-0.9%	-0.6%	-0.7%	-0.1%
<i>Private Inventories</i>	-1.9%	-1.2%	1.5%	-2.3%
<i>Net Exports</i>	1.2%	2.9%	0.4%	0.1%
<i>Gov't Expenditures</i>	-0.3%	0.6%	0.6%	0.8%

U.S. 1-Year Recession Probability (Bloomberg Median Economist Forecast)

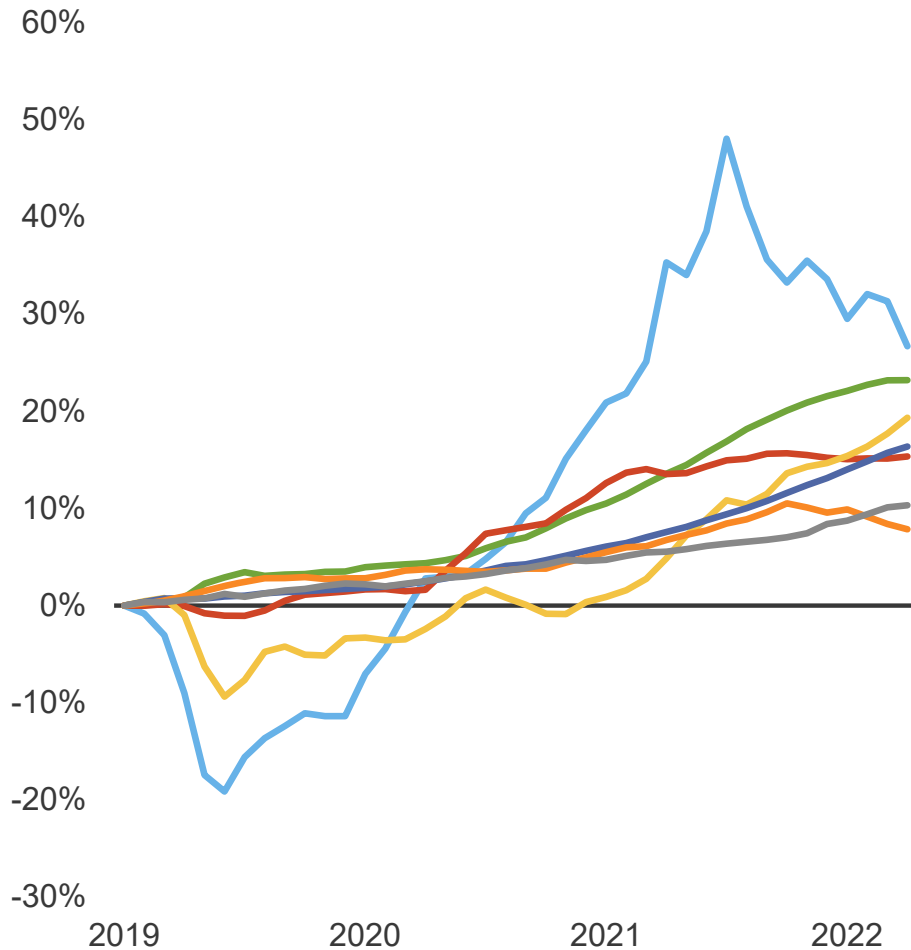


Source: Bloomberg, Bureau of Economic Analysis, real gross domestic product first quarter advance estimate as of April 2023. Detail may not add to total due to rounding.

Energy and Food Prices Fall While Shelter Remains Biggest Contributor to Inflation

Price Change of Major CPI Components

Since December 2019



CPI Component	12-mo. Change	Weight ¹	Contribution to YoY CPI
Energy	-6.4%	7.0%	-0.4%
Food	8.5%	13.5%	1.1%
Transportation	13.8%	5.8%	0.8%
Shelter	8.2%	34.5%	2.8%
Goods	1.6%	21.3%	0.3%
Other Services ²	4.4%	11.4%	0.5%
Medical Services	1.0%	6.5%	0.1%
Overall	5.0%		

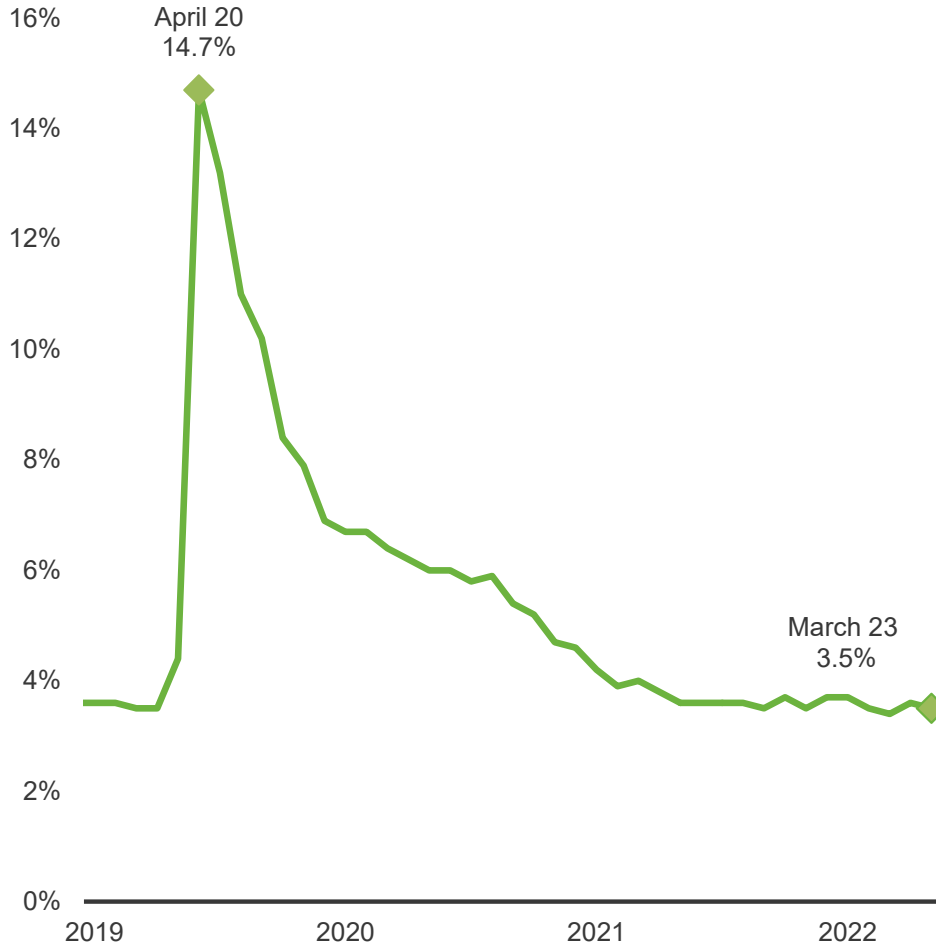
Source: Bloomberg, Bureau of Labor Statistics as of March 2023.

¹ Index weights are as of March 2023 as they are published on a one-month lag.

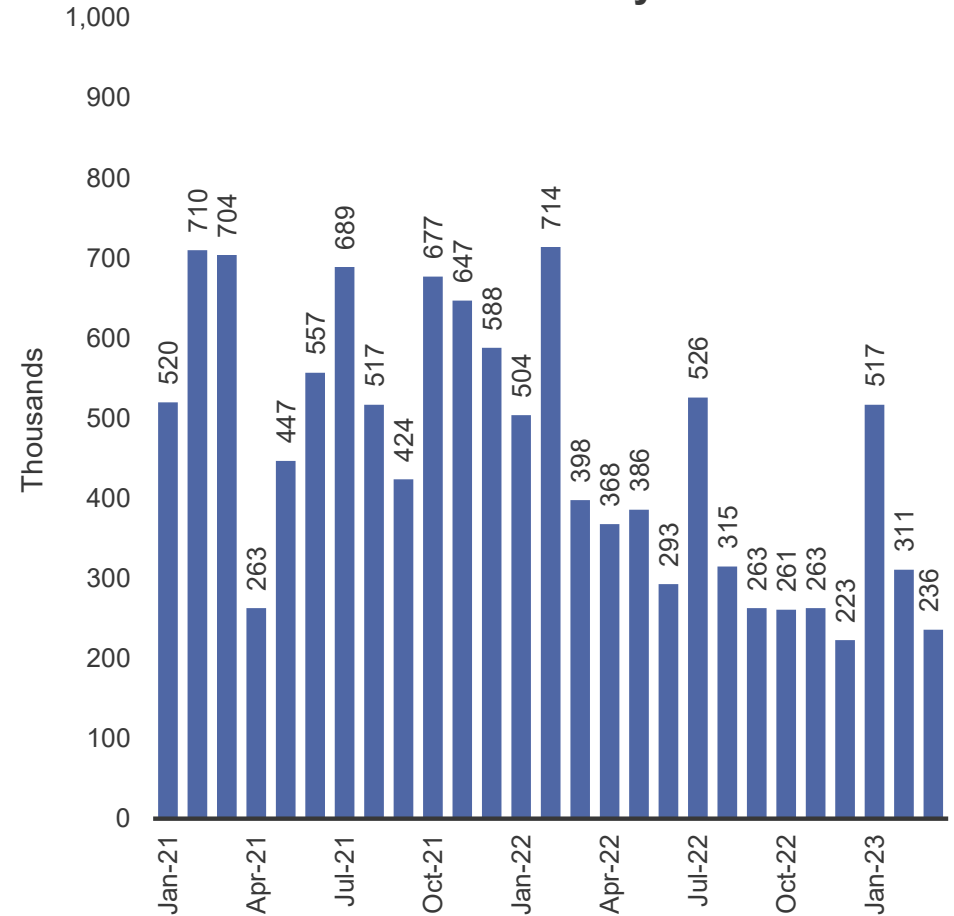
² Other services is a weighted blend of Water/Sewer/Trash, Household Operations, Recreation, and Education and Communication services.

U.S. Economy Added 236,000 Jobs in March; Unemployment Rate Decreased to 3.5%

Unemployment Rate



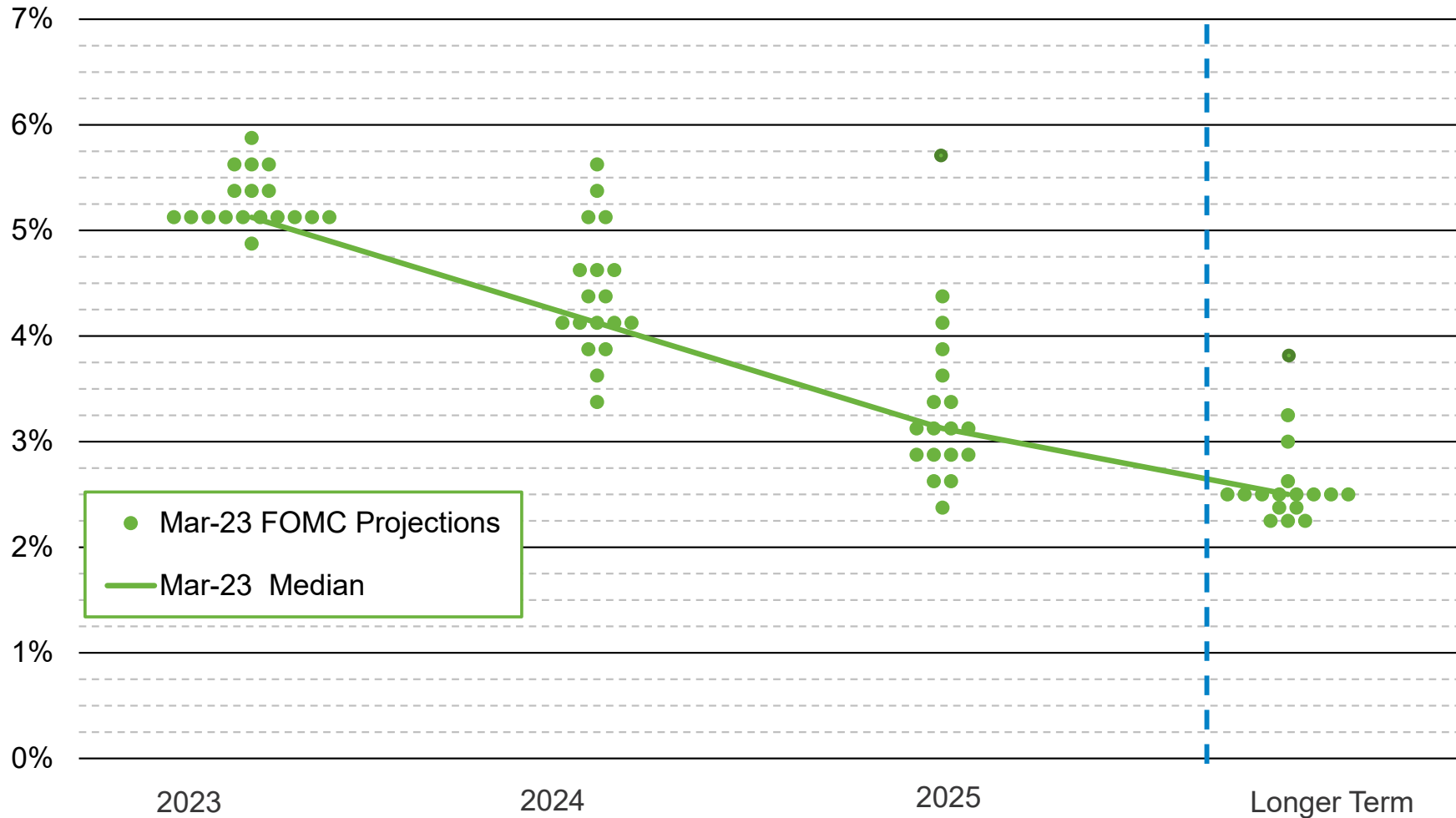
Monthly Change In Nonfarm Payrolls



Source: Bloomberg, as of March 2023. Data is seasonally adjusted.

Fed’s “Dot Plot” Indicates We Are Nearing Sufficiently Restrictive Territory

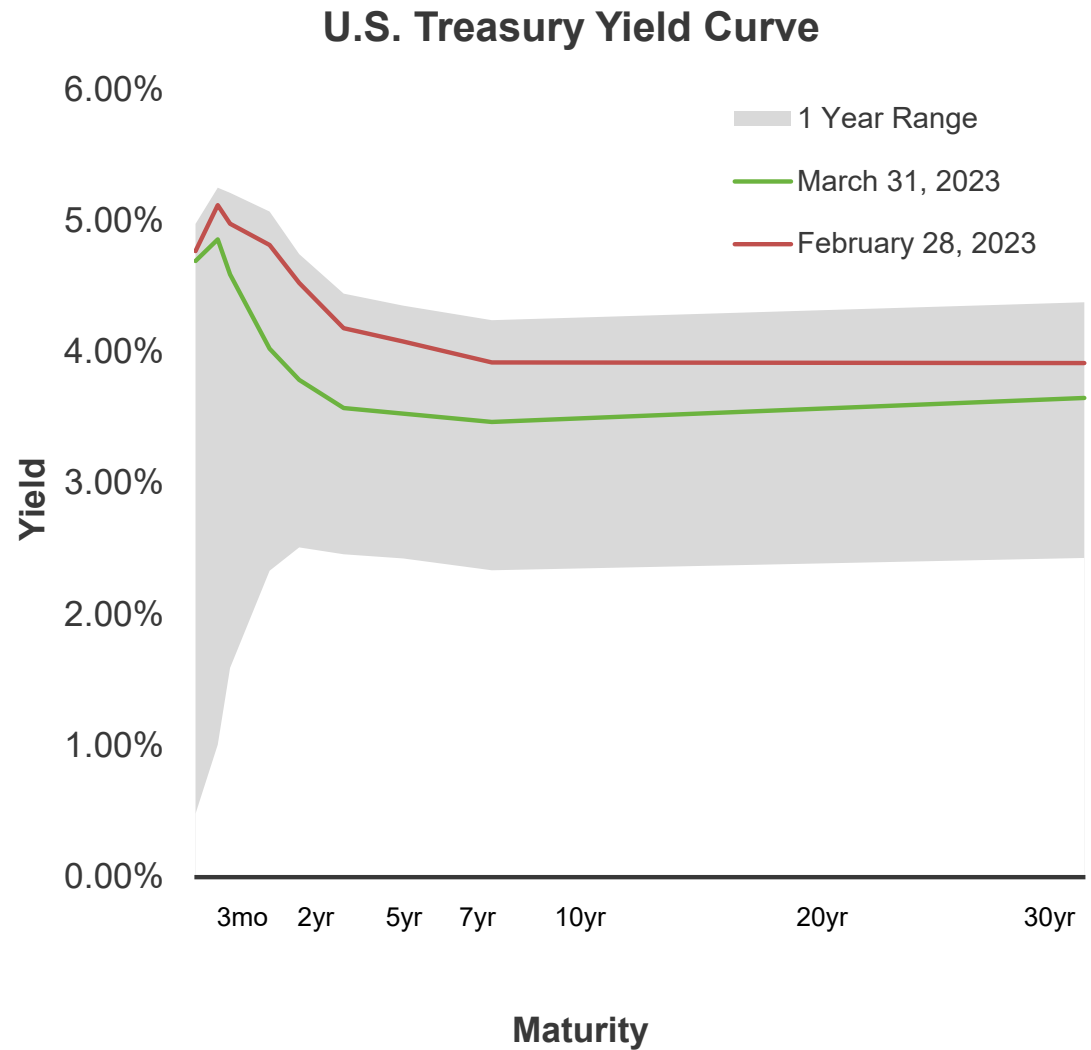
Fed Participants’ Assessments of ‘Appropriate’ Monetary Policy



Source: Federal Reserve and Bloomberg. Individual dots represent each Fed members' judgement of the midpoint of the appropriate target range for the Federal Funds rate at each year-end.

Treasury Yield Curve

	02/28/2023	03/31/2023	Change
3 month	4.77%	4.69%	-0.08%
6 month	5.12%	4.86%	-0.26%
1 year	4.98%	4.59%	-0.39%
2 year	4.82%	4.03%	-0.79%
3 year	4.53%	3.79%	-0.74%
5 year	4.00%	3.57%	-0.43%
10 year	3.92%	3.47%	-0.45%
30 year	2.44%	3.65%	1.21%



Source: Bloomberg, as of 02/28/2023 and 03/31/2023, as indicated.

Fixed Income Market Overview and Outlook

FIXED INCOME MARKET – ECONOMIC HIGHLIGHTS

- In the previous quarter, U.S. economic conditions were characterized by:
 - Lingering inflation that remains well above the Federal Reserve’s (“Fed”) long-term inflation target
 - A labor market that may be showing the first signs of moderation
 - Greater economic uncertainty following debt ceiling debates and financial industry volatility, including the surprise failure of Silicon Valley Bank and Signature Bank

- The scope for the Fed to continue its rate-hiking path has narrowed dramatically with the recent developments in the banking sector and the outlook for economic growth
 - Following two rate hikes in the first quarter of calendar year 2023 (a 25-basis point increase in both February and March), the overnight target rate is now in a range of 4.75% to 5.00%
 - Fed Chair Jerome Powell noted that events in the banking system might also “contribute to significant tightening in credit conditions over time, and in principle, that means that monetary policy may have less work to do”
 - Markets now firmly expect the Fed is at or very near its terminal peak rate
 - While the Fed has maintained that they will keep rates elevated for some time, a disconnect has emerged in Fed Funds futures, which indicate that the market anticipates rate cuts during the latter half of 2023

- The U.S. hit its debt ceiling (\$31.4 trillion) in January, triggering the U.S. Treasury Department to start taking extraordinary measures to prevent a default
 - Congress and the President need to agree on a budget for the federal government by October 1st
 - Treasury Secretary Janet Yellen warned and sent word that the so-called X date of when the U.S. government could run out of cash to cover its expenses is closer upon us, “potentially as early as June 1st”
 - Congress can avert the looming economic catastrophe by authorizing more government borrowing so the U.S. can keep paying its bills and avoid an unprecedented default on its financial obligations

Fixed Income Market Overview and Outlook

FIXED INCOME MARKET – ECONOMIC HIGHLIGHTS

- The sharp fall in rates through March was led by the 2-year U.S. Treasury, which declined by 104 basis points from its March high of 5.07% to close the quarter at 4.03%
 - Longer-term U.S. Treasury yields declined notably during the quarter as well, but to a lesser extent, as the inversion in the yield curve (measured by the difference between 2-year and 10-year U.S. Treasury yields) weakened from an intra-quarter low of -108 basis points to finish the quarter at -56 basis points)
 - U.S. Treasuries, coming off one of the most volatile quarters in 15 years, posted firmly positive total returns as yields declined across the board

- Fed policy tightening may be nearly complete
 - The need for more rate hikes has become less clear
 - Although the Fed has acknowledged the impact of the recent bank failures, their March updated Summary of Economic Projections were little changed from December
 - The Fed has maintained they will keep rates elevated for some time, but the market is pricing in cuts beginning this year

- Bond markets saw unprecedented volatility in March
 - In a classic “flight to quality,” Treasury yields fell sharply, with the 2-year Treasury falling from 5.07% on March 8th to under 4.00% on March 17th
 - The curve inversion from 3 months to 10 years reached the deepest levels in over 40 years
 - Credit yield spreads widened, especially those on banks, but not nearly to levels seen during the global financial crisis

- Diversification away from U.S. Treasury investment securities was a mixed bag for fixed-income performance during the first quarter of calendar year 2023 as market volatility and the fall in interest rates largely dictated the relative performance of non-Treasury sectors

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