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October 15, 2018

The Honorable Members of the Board of Supervisors
County of Solano County
675 Texas Street, Suite 6500
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Honorable Members of the Board:

It is my pleasure to present the quarterly report for the first quarter of FY2018/19.

State of the Treasury

The $1 billion Treasurer's pool is managed in accordance with the tenets of California Government Code §53600.5 to provide for the safety of principal, adequate liquidity for all anticipated cash flow requirements, and a consistent rate of return commensurate with the established risk profile.

A careful examination of historical cash flow patterns shows the size of the Treasurer's pool is currently at or near its annual minimum balance as spending remains constant going into the first fiscal quarter and revenues from property taxes increase. The $406 million currently held in cash and investments with six months or less left to maturity should provide adequate funding for all anticipated cash needs, while also affording the Treasury an opportunity to invest excess liquidity at higher rates.

Current Market Conditions Impacting the Treasury Pool

At the September meeting, the Federal Reserve Open Market Committee (FOMC) continued raising the Federal Funds rate that currently stands at 2.25%; an increase of one full percentage point from the level seen at the start of the current calendar year. It is anticipated that the rate will continue to increase, with an additional hike of 0.25% by December forecast by more than 93% of surveyed economists.

With the overnight Federal Funds rate at 2.25% and anticipated to rise further, it's prudent to consider the potential impact this may have to pool earnings that stand at 1.87% for the month of September. As rates rise, the yield on cash holdings will rise with them and maturing investments are expected to be replaced with higher yielding securities. The average yield on investments maturing in the next six months is 1.85% with a reasonable replacement yield for projection purposes of 2.25%. Should the funds replacement take place as anticipated, the treasury pool should produce an additional $2.5 million in earnings on an annualized basis when the benefits of repricing are fully realized.

Subsequent to the end of the reporting period, bond and equity markets have experienced a sharp rise in volatility, indicating a potential increase in risks going forward. Volatility as measured by the Volatility Index (VIX) has spiked as high as 25.1 as compared to the calendar year to date average of 15.2 and the recent norm of 12.0. Higher VIX numbers are indicative of greater day to day swings in market prices as evidenced by a swing of more than 1,500 points in the Dow Jones industrial average over the course of just two days.

To mitigate various risks, the treasury pool is maintained with a duration designed to stabilize yields and prevent rapid increases or decreases in earnings. The treasury pool is also diversified from a credit risk perspective by maintaining a mix of investments that includes 15.8% in cash and cash equivalents, 22.5% in US Treasuries, 28.4% in Government Sponsored Enterprises, 14.9% in US Corporations, and 10.5% in Municipals; with the balance of 7.9% held in a variety of assets including mutual funds, commercial paper, and other holdings allowable under §53600.5.

Treasury Managers monitor FOMC releases, and other data, to remain abreast of economic changes that may potentially impact the performance of the Treasurer's pool to ensure the portfolio is properly positioned on the yield curve to balance risk and return. A material portion of the monitored information from the FOMC can be found in the regional reports from the 12 Federal Reserve Districts that are compiled in Beige Book reports published 8 times a year.

Expectations going forward

The FOMC has announced it expects funds rates to continue to increase in 2018; therefore the market value of the portfolio will likely remain lower than the book value for the foreseeable future. This difference is recognized in the Treasury accounting as an unrealized mark to market loss.

In addition to the expectation for rising rates, a number of macro-economic and political issues have the potential to impact the treasury pool. These include the increasing risks for a trade war with China, the political changes in Italy that may result in its choosing to violate European Union rules on sovereign debt to gross domestic product, the quickly approaching US midterm elections, and the potential fiscal impact of higher interest rates on the Federal budget.

A trade war could spark inflation, debt covenant violations could lead to another debt crisis within the European Union, unexpected election results could result in political upheaval, and higher borrowing costs, coupled with a lack of entitlement reform have the potential to place a fiscal drag on the domestic economy over the coming decade. Treasury staff monitor the risks and adjust the pool accordingly.

Respectfully Submitted,
CHARLES LOMELI
Treasurer – Tax Collector – County Clerk