Texas LGIP Strategy Update

Q2 2024

PREPARED BY

Benjamin Streed, CFA

Chief Investment Officer

DEEP BLUE INVESTMENT ADVISORS

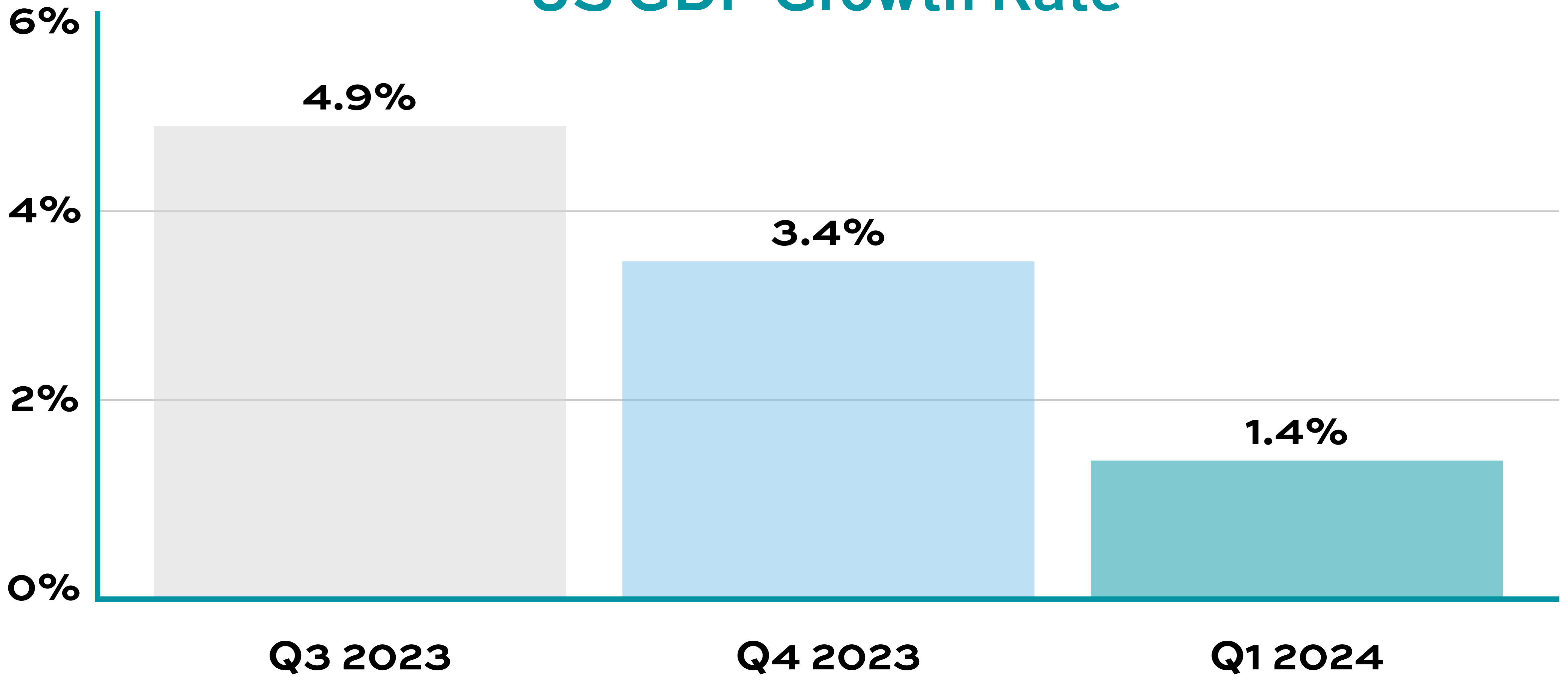
Economic Update

Q1 2024 Real US Gross Domestic Product (GDP), which subtracts out the effects of inflation, registered at 1.4% for its final revision, in line with expectations, but down from 2.2% in the first quarter of 2023. Consumer consumption, comprising ~70% of US GDP, is forecasted to moderate in 2024 while remaining strong overall. Fitch Ratings has now revised its real consumer spending forecast from 1.3% in February up to 1.9% as of May 2024 as consumers continue to show signs of strength despite lingering inflationary pressures.

Monthly US jobs reports continue to remain strong: Total nonfarm payrolls increased by 272k in May, exceeding expectations of 180k. The unemployment rate increased from 3.9% to 4.0%, and average hourly earnings increased by 0.4% month-over-month in May, exceeding expectations of 0.3%. JOLTS data (US job openings) indicates ~546,000 more job openings than pre-Covid peak levels, signaling ongoing tightness in the labor market.

The Federal Reserve policymakers agreed in June that it would be appropriate to maintain a restrictive stance *"for some time,"* **citing a need to gain greater confidence that inflation is heading back to their 2% target**. The Summary of Economic Projections showed a median forecast of 25 basis points of rate cuts in 2024, down from 75 basis points in March.

US GDP Growth Rate



KEY TAKEAWAY

Consumer consumption, comprising ~70% of US GDP, is forecasted to moderate in 2024 while remaining strong overall.

*Bureau of Economic Analysis | https://www.bea.gov/data/gdp/gross-domestic-product

Economic Update (cont.)

The May CPI data was one of the more encouraging CPI reports that we have seen in quite a while with the headline (3.3% YoY vs 3.4% estimate) and core (3.4% YoY vs 3.5% estimate) figures both coming in below expectations. The core print (which is the preferred inflation gauge by many economists), rose at the slowest pace in more than three years. It is encouraging to see inflationary pressures continue to moderate; however, inflation is still stubbornly above the Fed's target of 2%.

Markets are now pricing in one to two 25 basis point rate cuts in 2024 (~0.50%), a shift down from Q1 expectations of 5 to 6 quarter point cuts (~1.25 to 1.50%).

Volatility is expected to persist as investors balance the expectations for rate cuts with continued mixed economic data.

> **The May CPI data was one of the more encouraging CPI reports that we have seen in quite a while with the headline and core figures both coming in below expectations.**

US Treasury Yields

Date & Yield

Tenor	6/30/23	4/30/24	5/30/24	6/28/24
1M	5.24	5.48	5.48	5.47
3M	5.43	5.46	5.46	5.48
6M	5.47	5.44	5.42	5.33
1Y	5.40	5.25	5.19	5.09
2Y	4.87	5.04	4.92	4.71
3Y	4.49	4.87	4.74	4.52
5Y	4.13	4.72	4.57	4.33

US Department of the Treasury
https://home.treasury.gov/resource-center/data-chart-center/interest-rates/TextView?type=daily_treasury_yield_curve&field_tdr_date_value=2024

LGIP Investment Strategy

We believe the Fed will do everything in its power to fulfill its mandate of "stable prices (aka 2% inflation goal) by holding short-term rates at, or near current levels until CPI gets convincingly closer to their 2.00% goal.

At this juncture, we are **focused on relative value between fixed and floating-rate instruments**. Since early December, fixed rate bonds appear very expensive, while floating-rate appear unexpectedly cheap. A delay in rate cuts has made floating-rate securities more attractive. In our opinion, it makes sense to include both fixed- and floating-rate securities in most portfolios as each has unique characteristics and benefits.

Emphasis on quality: We continue to see value in US treasuries, high-quality municipal bonds, callable US Agencies, and tier-one (highest rated) commercial paper (where appropriate). Yield spreads remain near their lowest levels in years. Domestic bank credit, especially short-term corporate bonds, are an excellent alternative to traditional money market instruments and provide considerable yield pickup to most other instruments.

Compression in yield spreads (extra yield above a comparable treasury) in commercial paper and most corporate bonds has made treasuries and municipal bonds look more appealing on a relative basis. With spreads near historic lows, there is potential for spreads to widen on future news events, especially regarding inflation, global growth, US and global elections, and ongoing geopolitical events. We seek to identify what we believe are cheap, or fairly valued securities, and avoid instruments where yield spreads have moved too low. Our patient investment strategy allows us to take advantage of markets when they move in our favor, and we expect spreads to widen at some point.

KEY TAKEAWAY

We continue to see value in US treasuries, high-quality municipal bonds, callable US Agencies, and tier-one (highest rated) commercial paper (where appropriate). Yield spreads remain near their lowest levels in years.

STRATEGY

> **In our opinion, it makes sense to include both fixed- and floating-rate securities in most portfolios as each has unique characteristics and benefits.**

TX LGIP Comments

TX FIT Government Pool:

Yield continues to be driven by FDIC insured overnight deposits alongside laddered securities US Treasuries and Agencies, both fixed and floating-rate. In recent months, we actively broadened our money market funds, adding incremental yield while providing further capacity for additional deposits. Furthermore, there are significant opportunities in short-dated, agency MBS with final maturities within one year. We expect this pool to continue to track the S&P LGIPG 30-day index.

June 2024 YTD net return: 2.65%.

End of quarter net yield: 5.26%.

TX FIT Cash Pool:

We continue to seek relative value in the commercial paper market where yield spreads are near historical lows. Opportunities are available in asset-backed programs, and we remain committed to identifying the best opportunity sets, regardless of if/when rates begin to decline. Identifying alternative sources of yield, such as floating-rate US Treasuries can provide high relative yields compared with corporate credit. Additionally, we see value in callable US agencies, where the current coupon is at, or above money market rates. We are also adding duration to the pool while balancing liquidity sources (money markets, bank deposits and ultra-short bond funds) to remain nimble and take advantage of investment opportunities amidst ongoing volatility. We expect the pool to continue to outpace the S&P 30-day LGIP index.

June 2024 YTD net return: 2.77%.

End of quarter net yield: 5.48%.

Contact Us

KEN COUCH
ken@deepblue-inv.com
(210) 240-9464

ED POLANSKY
ed@deepblue-inv.com
(813) 992-3145