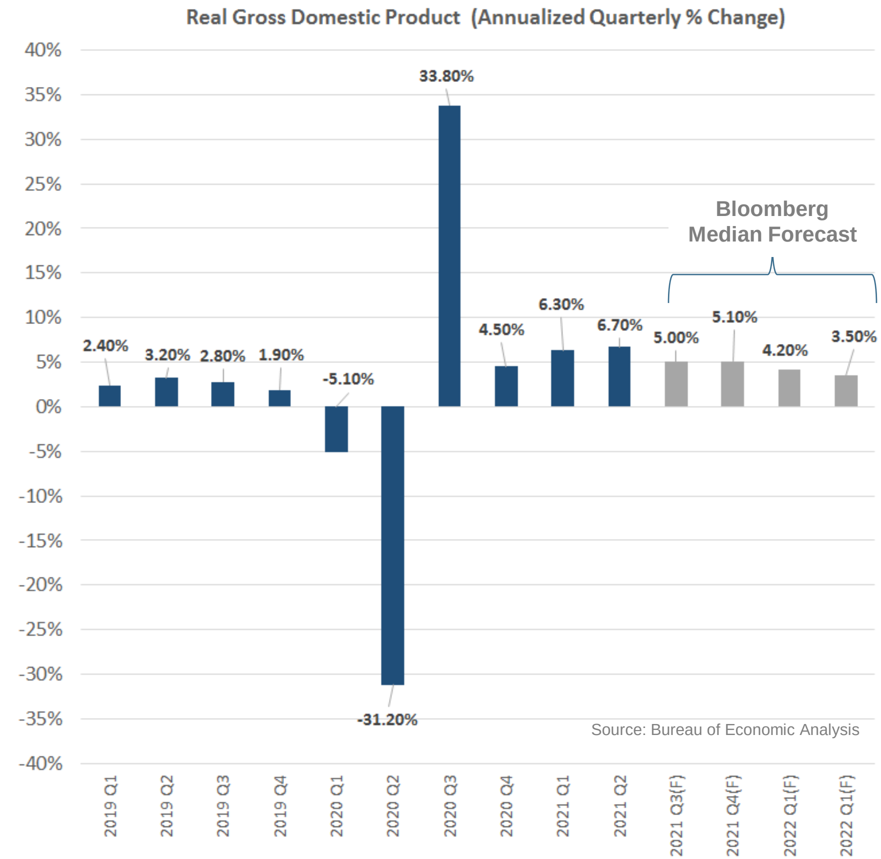
Economic Update and Portfolio Strategy Review

San Mateo County Transportation Authority

September 2021

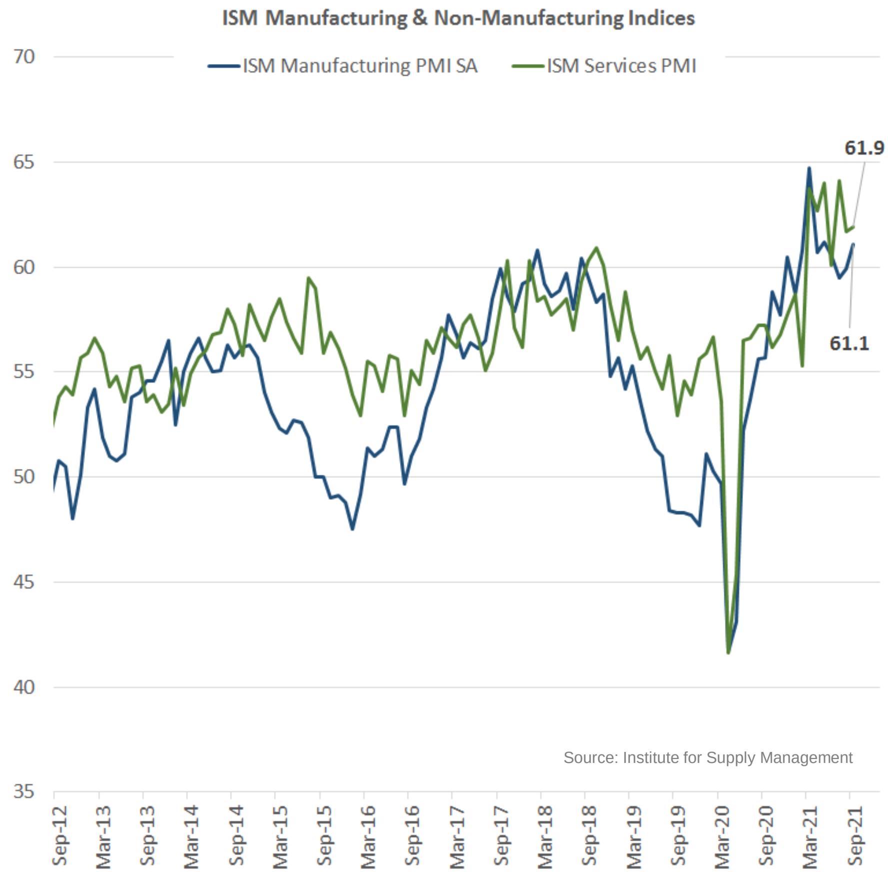
Economic Growth: The Economy Continues to Expand at an Above-Trend Pace

Headwinds Not Enough to Derail U.S. Economic Growth



The U.S Economy continues to expand despite a surge in COVID-19 cases and persistent supply chain disruptions and labor shortages.

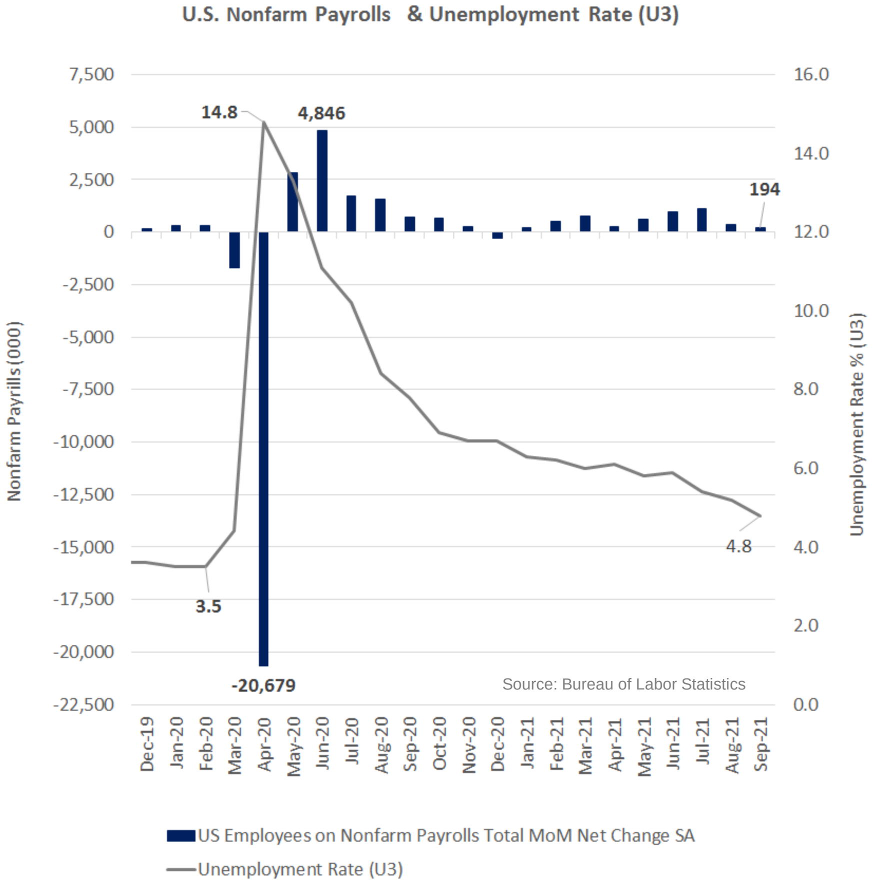
ISM Indices Highlight Supply Chain Bottlenecks and Labor Shortages



Current ISM index levels are consistent with expectations for continued above-trend near-term growth despite ongoing headwinds.

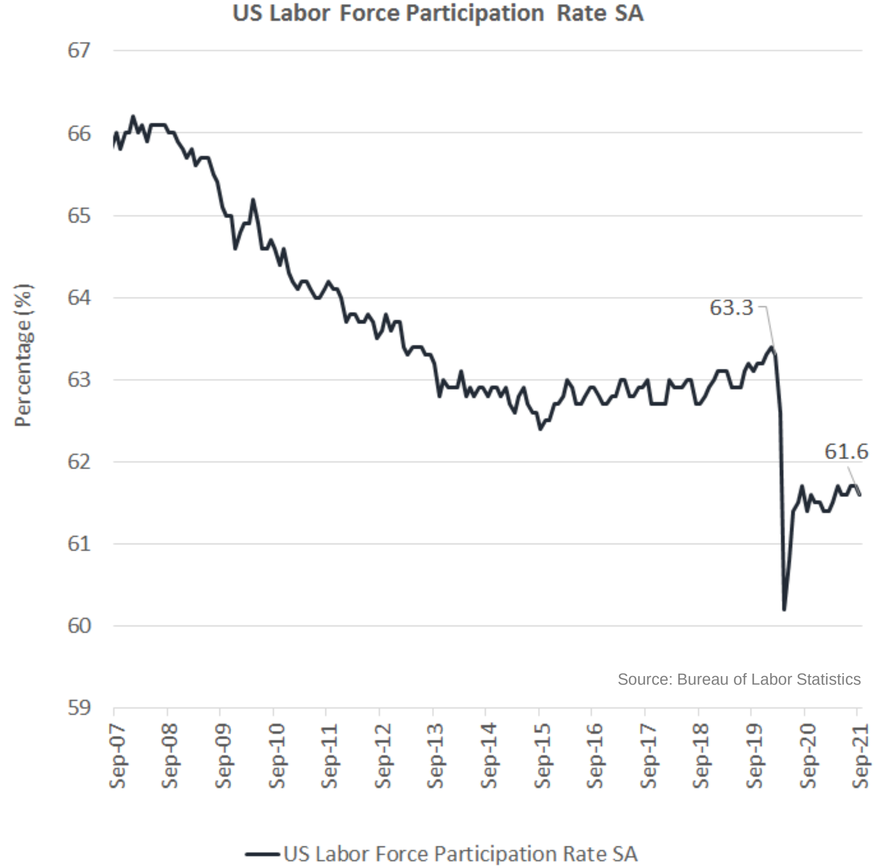
Labor Markets: Labor Market Recovery Slowed in the Third Quarter

September Job Gains Missed Estimates for Second Straight Month



Public health concerns likely weighed on job growth in the third quarter, but declining cases should support labor markets in coming months.

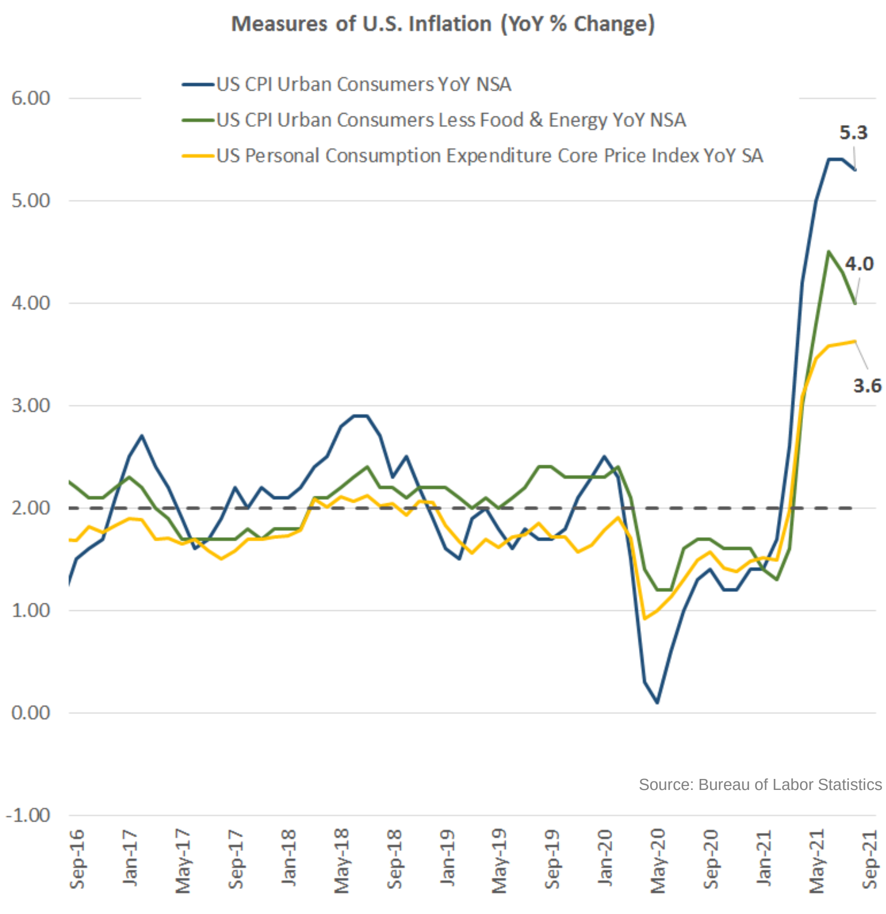
Labor Force Participation Rate Remains Subdued



The decline in September's labor force participation rate underscores the challenges for businesses looking to hire.

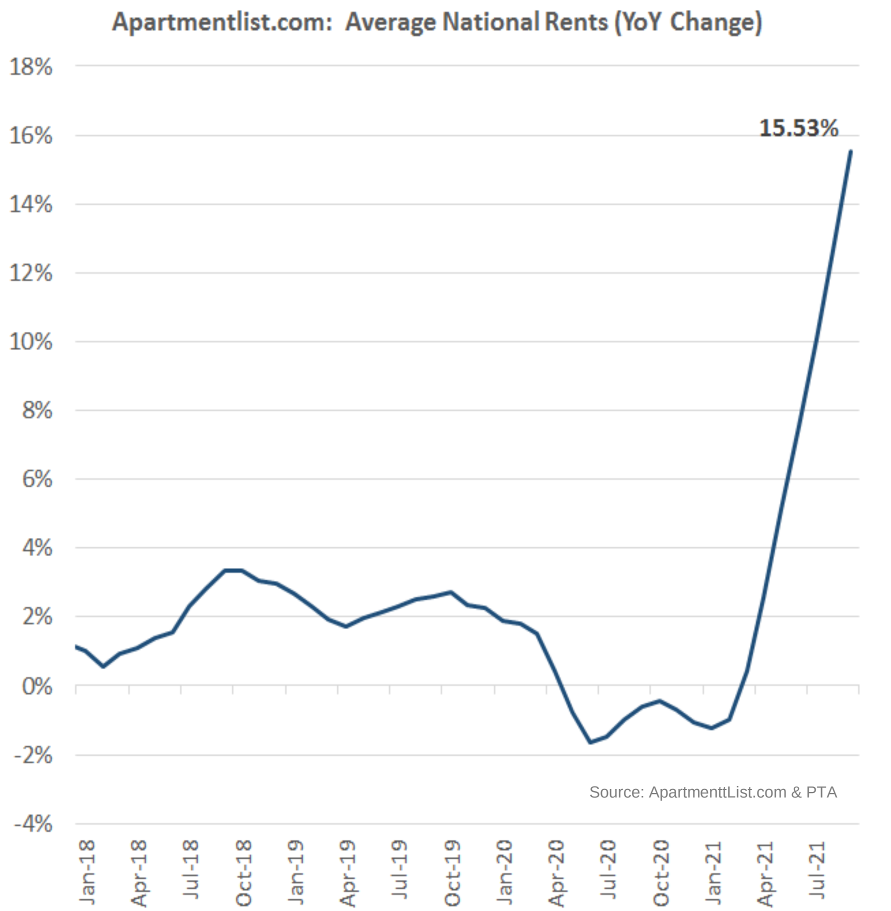
Inflation: Price Pressures Remain Elevated Testing the Fed's Transitory Assumption

Supply Chain Bottlenecks and Labor Shortages Spur Inflation



Consumer prices moderated in August but remain well above the Federal Reserve's stated 2% Target.

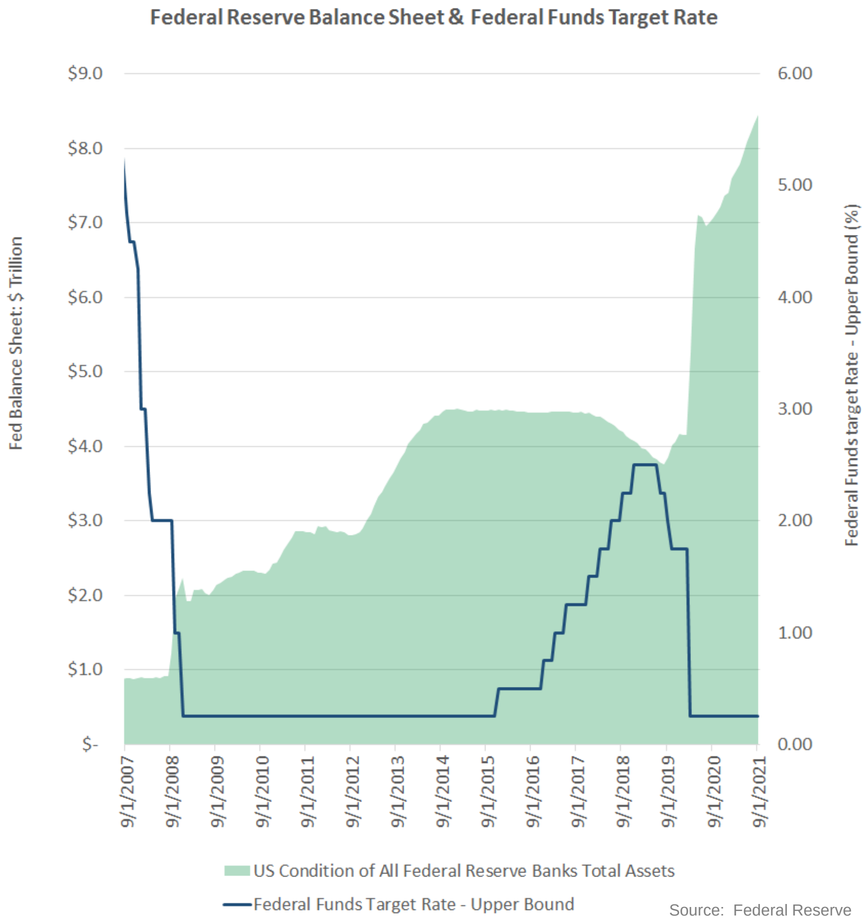
Record Home Price Appreciation Fueling a Surge in Rental Costs



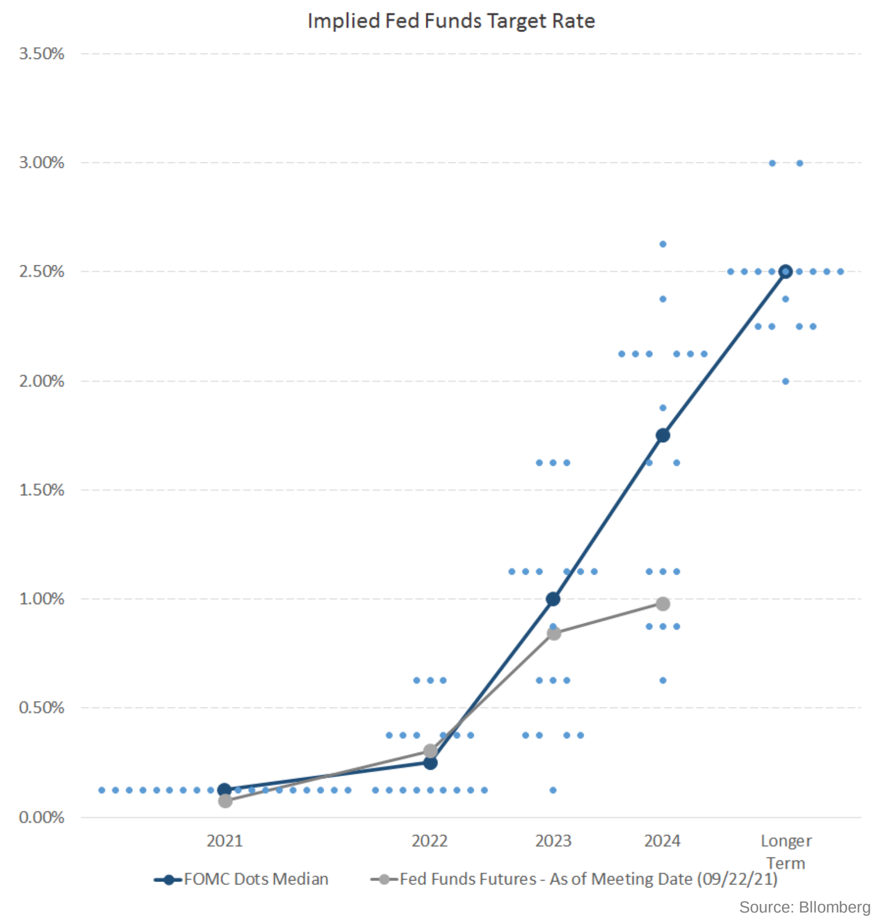
Swelling home prices have given rise to a surge in national rental rates that are expected to feed into measures of consumer inflation.

Monetary Policy: Fed Poised to Taper Balance Sheet Purchases but Rate Policy Remains Patient

Federal Reserve Poised to Taper Pace of Asset Purchases



First Rate Hike Not Anticipated Until December 2022

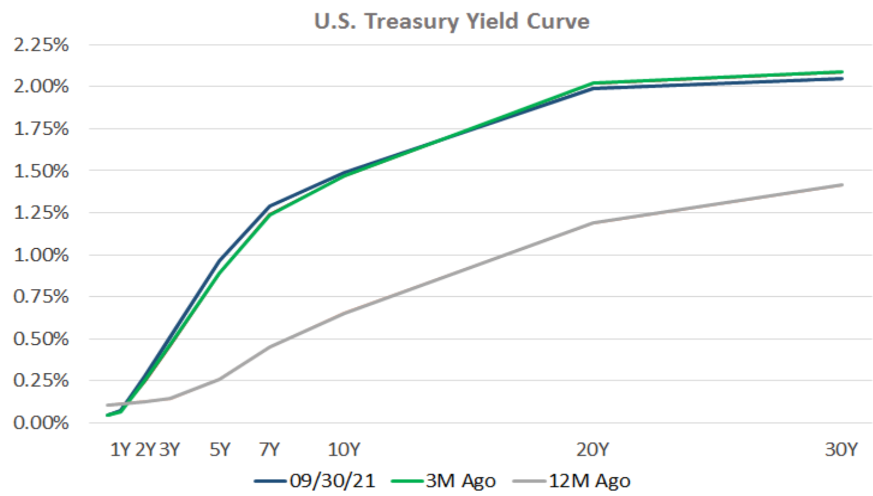


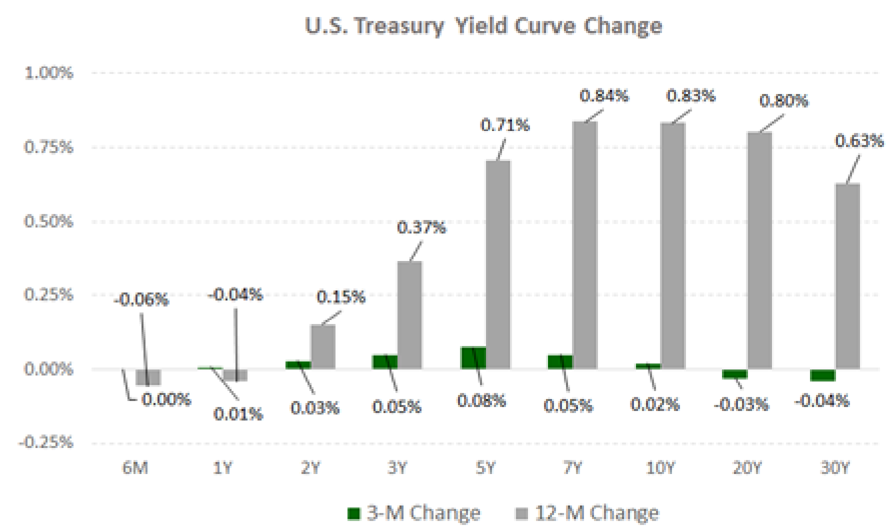
The Fed appears poised to announce a tapering in its $120 billion per month asset purchases at the November FOM meeting.

The median of FOMC's "dot plot" is consistent with current market expectations for rate liftoff to occur in December 2022

Treasury Market: Yields Little Changed over the Quarter Despite Volatile Trading Ranges

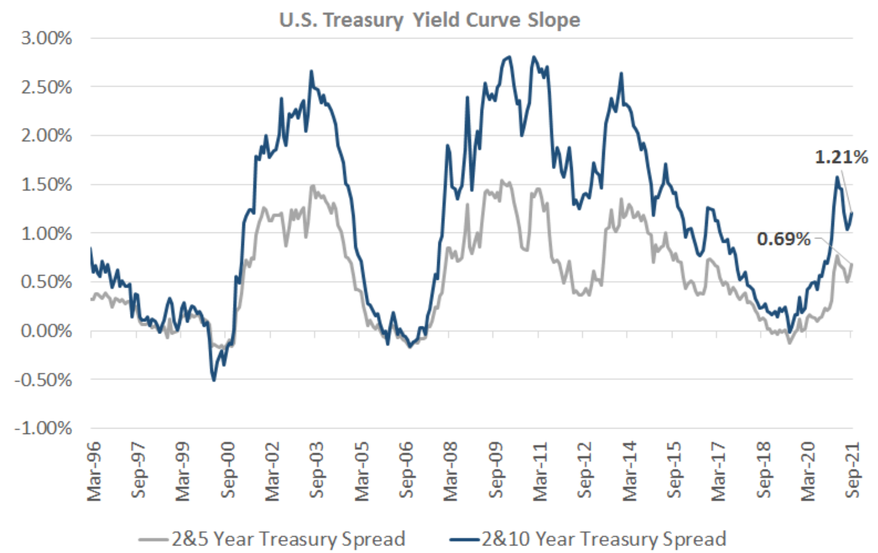
Treasury Yields Little Changed Over the Quarter Amidst Uncertainty





Source: Bloomberg

Yield Curve Steepens on Economic Recovery and Rising Inflation



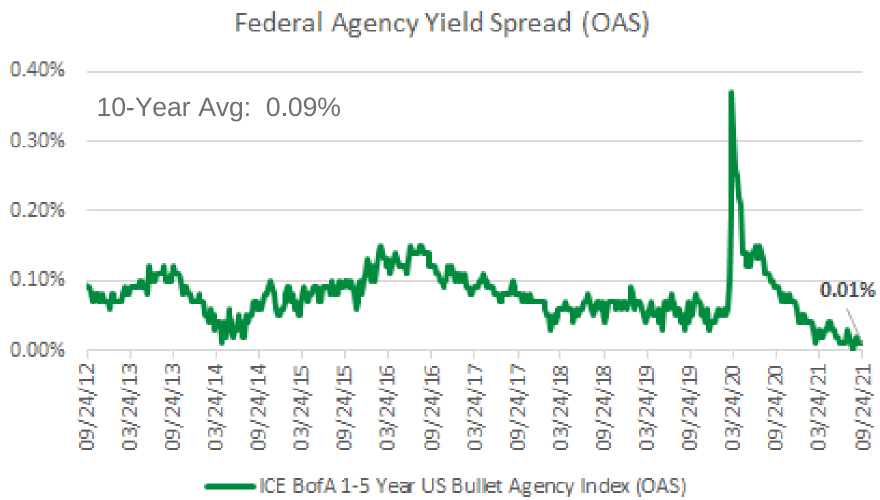
Source: Bloomberg

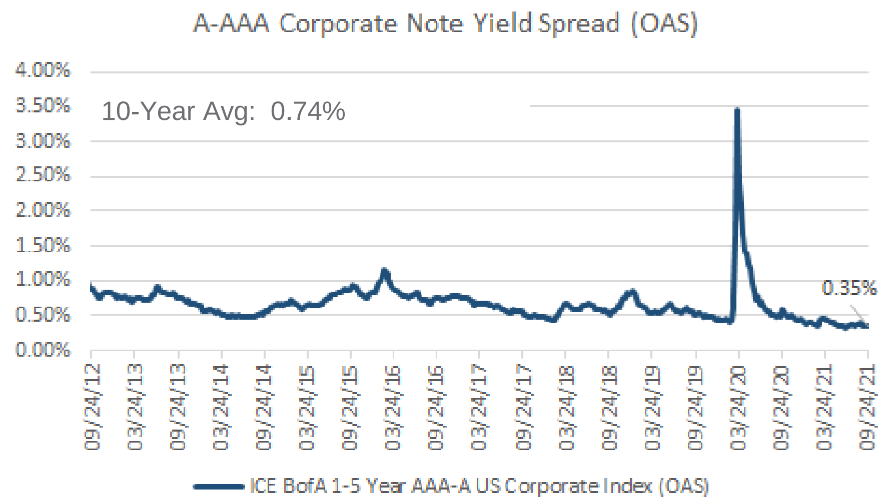
After rising dramatically over the past 12 months, Treasury yields were volatile but closed little changed over the quarter as the Federal Reserve maintained short-term interest rates near zero.

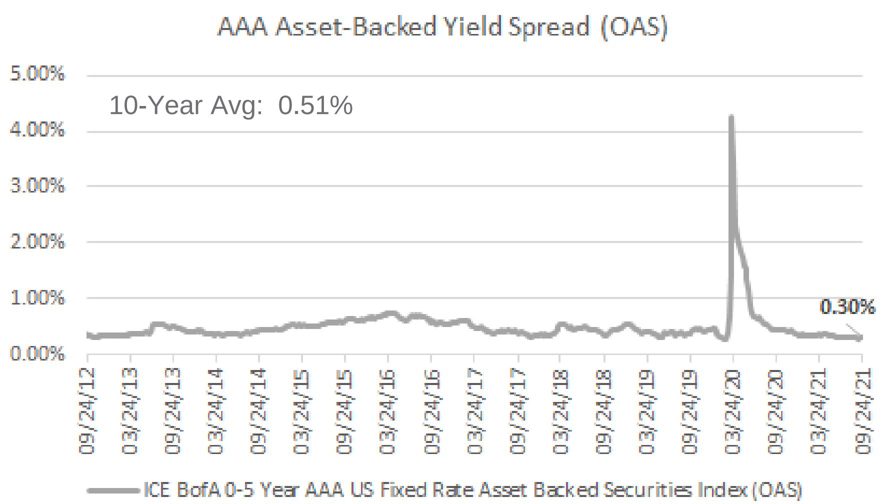
Looking ahead, the yield curve appears poised to steepen further as inflation persists well above the Fed's 2% target and the ongoing economic recovery prompts the Fed to taper the pace of balance sheet expansion.

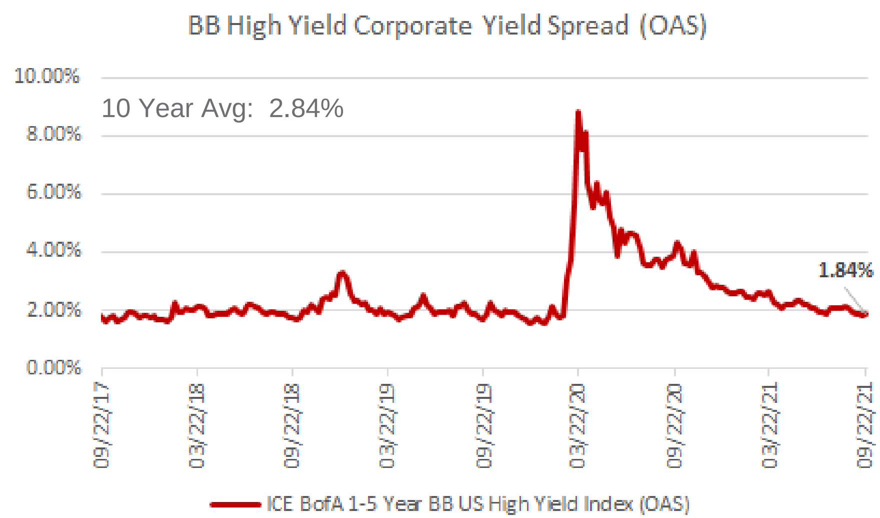
The Fed's taper may ignite volatility as asse markets adjust to a diminished flow of liquidity.

Credit Markets: Credit Spreads Remain Compressed Amidst Accommodative Financial Conditions









Source: Bloomberg

Portfolio Recap

Economic Growth: The U.S. economy continues to expand despite ongoing virus concerns and persistent supply chain bottlenecks and labor shortages. Amidst a surge in COVID-19 cases over the quarter, economists downgraded their forecasts for growth over the remainder of the year as rising public health concerns weigh on consumer confidence and threaten to derail the developing service sector recovery. While the pace of growth is expected to moderate from last quarter's 6.7% annualized rate, it is expected to remain well above trend in coming quarters as the economic reopening continues and then moderate to a more sustainable long-term growth trajectory. The Institute for Supply Management's manufacturing and service sector indices provide a range of important insights into the breadth and vitality of underlying economic momentum. While readings above 50 denote expansion, current index levels are consistent with expectations for continued above-trend near-term growth. Importantly, survey respondents continue to report that persistent supply chain disruptions and labor scarcity continue to impede their ability to meet growing demand and represent significant barriers to more robust growth.

Labor Markets: The pace of job growth slowed dramatically in the final two months of the quarter as concerns over surging COVID-19 cases likely weighed on hiring. Following job gains of nearly 1.1 million in July, the pace of hiring stalled in August and September with payrolls rising a much less-than-expected 366K and 194K, respectively. While the unemployment rate fell sharply to 4.8% in September from 5.2% the prior month, much of that drop is due to declines in the labor force participation rate which indicates a number of workers displaced during the pandemic remain on the sidelines. Businesses continue to report that hiring challenges continue to represent a significant headwind to meeting customer demand and the recent slowdown in hiring likely reflects, in part, the struggle between businesses striving to meet demand and job candidates seeking better opportunity and remaining slow to re-enter the labor force.

Inflation: Measures of consumer price inflation have risen sharply in recent months as logistical challenges associated with reviving previously shuttered global supply chains collided with resurgent consumer demand as global economies began to reopen. While the moderating pace of price gains in August is consistent with the Fed's contention that current price flare ups are transitory, mounting wage pressures stemming from persistent labor scarcity and record home price appreciation and related rent increases may prove more enduring and keep core inflation above the Fed's 2% target for some time. Through August, the core consumer price index and personal consumption expenditure index are up 4.0% and 3.6%, respectively.

Monetary Policy: Speaking at the Federal Reserve's August policy summit, Chair Jerome Powell said the U.S. central bank may begin tapering its monthly asset purchases by the end of the year as the economy continues to recover from the pandemic. Striking a cautiously optimistic tone, Powell reiterated that the Fed's framework for raising interest rates includes a "different and substantially more stringent test." This message was clearly received by the market, with a rate hike still not anticipated until the end of 2022. While the median of the Fed's so-called "dot plot" is consistent with current market expectations for the first rate hike next December, pricing of federal funds futures contracts indicate that market participants are less optimistic in the Fed's ability to reach their perceived longer-term neutral rate of 2.50%. As of the September 22nd FOMC meeting, fed funds futures markets reflect expectations of the overnight reaching only 1.0% by the end of 2024, well short of the Fed's median dots.

Investment Strategy Outlook

Interest Rate & Markets: Although Treasury yields were little changed over the quarter, the net change over the period masks the volatility that characterized fixed income markets over the period. In response to the surge in virus cases that took place in August through mid September, Treasury yields traded lower as rising economic uncertainties resulted in a wave of downgraded third quarter growth forecasts. As new cases crested in mid September and began to retreat, yields rose dramatically in the final two weeks of the quarter on the improving public health backdrop and on the expectation that the Federal Reserve would commence the balance sheet taper in November. Over the quarter, 2-, 5-,and 10- year Treasury yields traded in ranges of between, 0.13% - 0.30% (2-2ear), 0.57% - 1.02% (5-year) and 1.17% - 1.54% (10-year), respectively. While uncertainties to the outlook remain, continued public health progress coupled with persistent fiscal deficits and the likely tapering of the Fed's balance sheet support expectations for higher interest rates and a steeper yield curve in the quarters ahead

In his remarks at the Kansas City Fed's annual Jackson Hole Symposium, Fed chair Powell all but cemented market expectations for the November tapering of the Fed's large scale asset purchase program. It our view, the reduction in liquidity stemming from the tapering asset purchases has the potential to reawaken volatility in credit markets and exert upward pressure on still extraordinarily narrow credit spreads. As credit markets eventually normalize to reflect less Fed intervention, robust credit analysis and thoughtful issuer selection will remain important drivers of risk-adjusted returns. Against this backdrop Public Trust anticipates maintaining a somewhat defensive posture in the portfolio summarized as follows:

Duration: Public trust anticipates maintain portfolio duration generally neutral to the portfolio benchmark as market participants and policy makers seek to determine whether recent economic momentum and related inflationary pressures reflect a more enduring improvement in underlying economic fundamentals or the transitory effects of the highly accommodative monetary and fiscal policies. As incoming data alters the perceived likelihood of potential economic and policy outcomes, PTA may implement certain tactical duration adjustments as bouts of volatility present opportunities to improve risk-adjusted returns.

Yield Curve Positioning: The Federal Reserve's stated tolerance for currently well above-target inflation coupled with still extraordinarily accommodative monetary policy, expectations for persistent federal budget deficits, and an improving public health outlook support expectations for the continued steepening of the yield curve. As incoming data shapes inflation and policy expectations, PTA will review opportunities to tactically underweight or overweight certain maturity tenors to capitalize on anticipated changes in the slope of the yield curve.

Asset Allocation: Credit spreads available on corporate bonds and other credit-sensitive sectors (e.g., ABS & CD's) remain deeply compressed in response to the Federal Reserve's aggressive actions to support market liquidity and financial conditions more generally. In Public Trust's view, such credit-sensitive sectors continue to warrant caution as credit spreads remain extraordinarily compressed and provide little protection against modest spread widening. Corporate bond allocation is expected to be maintained in a range of between 10% to 15% with a focus on issuer and maturity selection. Other credit-sensitive sectors, such as CD's and ABS, are expected to be maintained at 10% or less of total portfolio market value given narrow credit spreads and market liquidity considerations.

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