First Midwest

WEALTH MANAGEMENT

Your Investment Program

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Agenda

- Investments – ILCS235 compliance/limitations
- Updating your Investment Policy Statement (IPS)
- Investment Options
- Key = CASHFLOW Projections
- Investment Performance and Impact of Fed Funds Rate
- ESG Criteria for Investing
- Market Outlook
- Illinois Capital Development Board – developing a Trust
- Questions

Illinois Public Funds Investment Act (ILCS235)

- Illinois Public Funds Investment Act
- Authorized Investments:
  - US Treasuries
  - US Agencies
  - Savings Accounts, CDs, Time Deposits
  - Corporate Bonds (>$500 mil capital; 3 years maturity; 3 highest ratings; one-third of public agency's funds)
  - Money Market Mutual Funds
  - Public Treasurers' Investment Pool
  - Community College District may invest in Mutual Funds
- Shall be governed by a written Investment Policy adopted by the public agency

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Updating Your Investment Policy Statement

- Investment of public funds should be governed by an adopted Investment Policy Statement (IPS)
- The IPS should address: safety of principal; return on investment; liquidity of funds – investment portfolio should be structured to provide liquidity to pay obligations
- Objectives = Legal, Safety, Liquidity, Prudence, Yield
- IPS can/should include:
  - Compliance with ILCS235 – but can be more restrictive
  - Authorized investments
  - Diversification of investments
  - Prudent Person Rule
  - System of internal control
  - Collateral requirements
  - Review and monitoring requirements; statements and reports
  - Investment performance measurement
  - Selection of advisors, financial institutions and money managers
  - Sustainability factors
- WHO has authority
- Risk Management, Risk Management, Risk Management

Investment Options

1. **Internal** – Community College can make internal decisions regarding the fund placement. Typically entails obtaining interest bearing account rates and CD rates.
2. **External** – the investment authority can be outsourced to a money manager. The investment manager should take on Fiduciary Responsibility and follow the Investment Policy Statement and comply with ILCS235.

Investment Options

- **Pros of internal:**
  - Low to no fees for bank accounts/bank products.
- **Cons of internal:**
  - Can be very time consuming;
  - May not obtain the highest yield for the funds.
- **Pros of external:**
  - Delegate Fiduciary responsibility;
  - Delegate Investment Authority;
  - Saves internal staff time;
  - Higher portfolio yield;
  - On-line access to information, statements;
  - Ease of transfers between bank accounts and investment account(s);
  - Dedicated Relationship Manager and Investment Management Team with access to Trading Platforms, Research, Pricing, Bond Issuance, etc.
- **Cons of external:**
  - Fees for investment management;
  - Requires refined cashflow predictions.

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Cashflow Projections

- Regardless of whether the investing of funds is done internally or externally, the KEY is cashflow projection. At least one year out but even better for two to three years out understanding it is an ESTIMATE.

- Monthly Cashflow – Inflows and Outflows

- Determines how far community college can go out in CD maturities and all other authorized investments, i.e. US Treasuries, US Agencies, Corporate Bonds. Ladder the maturities of these investments to meet payment obligations.

- Typically know when funds come in and when funds are needed for payments. Ongoing and adjust/adapt to actual inflows and outflows but utilize history as a proxy.

- The authorized investments are liquid and trade every day (except for bank CDs where a penalty is incurred) but the risk is the price on the day of sale is more than the price paid for the investment which could result in a realized loss. Better to generate a buy and hold strategy and hold investments until maturity for predictable investment results and income collection on bond coupon payments.

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Investment Performance and Impact of Fed Funds Rate

- In March 2020, the Federal Reserve reduced the Fed Funds rate to near zero
- That resulted in bank deposit accounts reducing interest bearing account rates to a range of .01% to .05%
- It also resulted in the 1 year Treasury yield coming down to .06%
- However, the yields on 7 and 10 year Treasuries have jumped
- 7 year Treasury on 12/31/20 was .65% and now is 1.34%
- 10 year Treasury on 12/31/20 was .925% and now is 1.67%
- As longer term yields rise, the price/market value of existing bonds goes down
- The jump in longer term yields is a result of inflation fears and expectations
- The Federal Reserve has stated that it will let the economy "heat up" and it will continue to keep the Fed Funds rate low
- Some Analysts predict the Fed may provide yield curve management later this year
- The impact to existing investment portfolios with Treasuries, Agencies and Corporate Bonds is bond prices going down
- In order to obtain higher yield, have to go out to longer maturity and pay a premium for bonds with stated higher interest/coupon rate

ESG Criteria for Investing

ESG – Environmental, Social and Corporate Governance

- Three central factors to measuring the sustainability and societal impact of an investment in a company or business
- **Environmental** factors include how a company mitigates its greenhouse gas emissions, whether the products the company creates are sustainable, if it uses natural resources efficiently and how it deals with recycling.
- The **social** component includes factors both inside and outside the company. Does the business participate in community development, such as providing affordable housing or fair lending? Does it carefully consider diversity and equal employment opportunity in its hiring? Does the company prioritize human rights everywhere it does business, including other countries?
- **Governance** (or corporate governance) refers to the company's leadership and board, including whether executive pay is reasonable, if the company's board of directors is diverse and whether it's responsive to shareholders.
- It is typically built into your IPS

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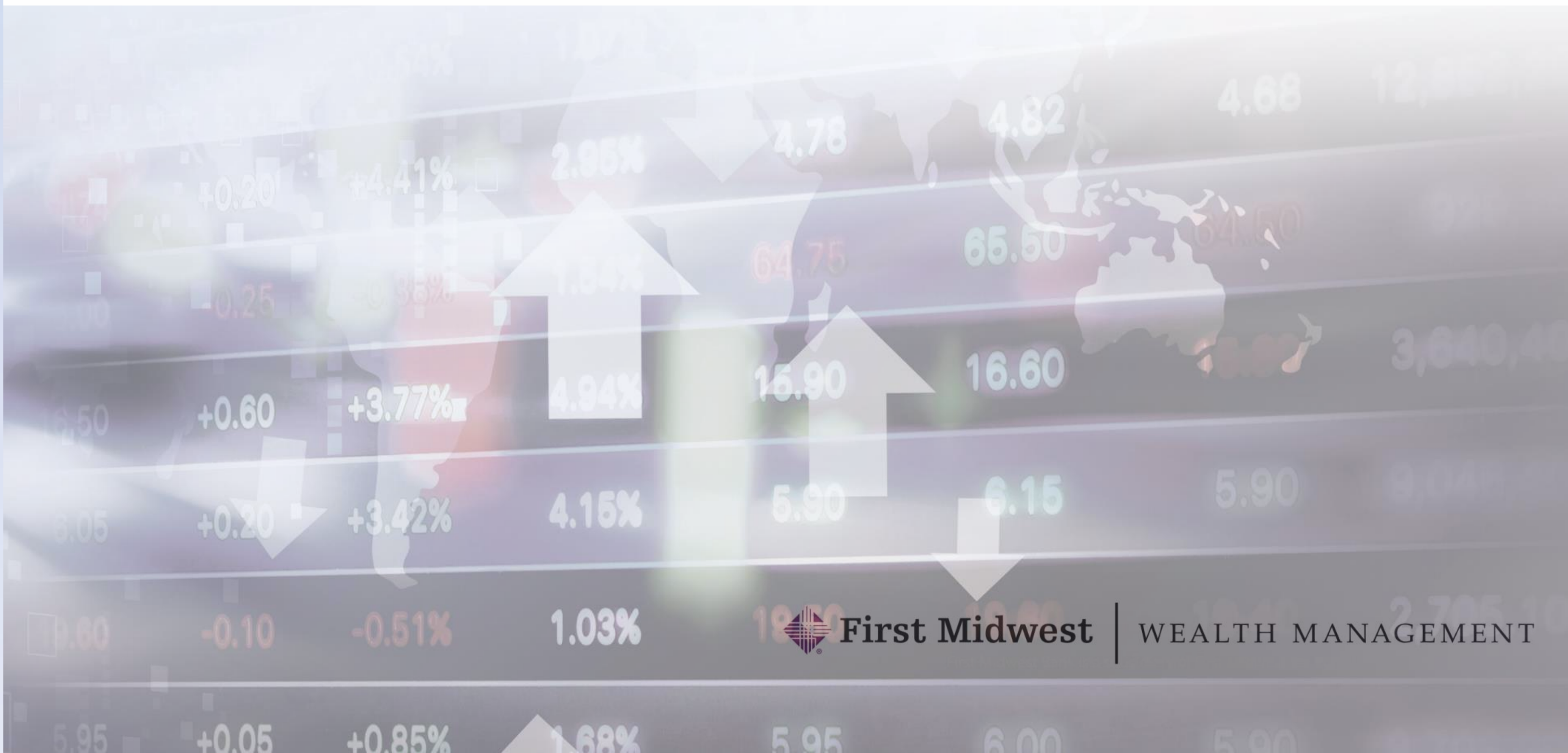
First Quarter 2021

Market Outlook

Jason R. Bulinski, CFA® Donald A. Powell, CFA® Joseph W. Styrna, CFA®



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Economic Outlook

Fiscal Relief Provides Boost. The Federal Reserve raised its forecast for U.S. growth to 6.5% in 2021, up from 4.2%. This would be the fastest pace in decades, with the acceleration expected this spring and summer. The update is based on COVID vaccination rates, additional fiscal relief, further re-openings, pent-up demand for services, and ongoing job gains. The $1.9T fiscal relief package signed in March funds vaccinations, boosts school openings, sends direct payments to most U.S. households and continues enhanced unemployment benefits. On the monetary side, the Fed has signaled no change in its accommodative approach. We are seeing low short-term interest rates and continued purchases of fixed income instruments to maintain lower long-term rates – no "taper" yet. Global growth forecasts from the IMF and OECD were also boosted. The two largest economies in the world, U.S. and China, are each estimated to grow around 6%, so the global recovery is expected to continue into 2022. The recovery in

Asia has continued, though growth stagnated in Europe due to rising virus cases, increased lockdowns, and struggles with vaccination rollouts.

	2021	2020	2019
GDP[1] U.S. Growth Rate	Q4/20: 4.3%; Q1/21: 4.7%E 2021 Estimate: 5.7%	-3.5%	2.20%
Unemployment Rate	Mar: 6.0%	6.70%	3.60%
Payroll Additions[2]	Mar: 916,000 YTD: 1,617,000	-9,416,000	2,054,000
Consumer Price Index	Feb YOY: 1.7%	1.2%	1.8%
Employment Cost Index	Q4/20 YOY: 2.7%	2.5%	2.7%

Source:
[1] Bureau of Economic Analysis, Next GDP Release: April 29, 2021. GDP Estimates from Bloomberg.
[2] Bureau of Labor Statistics, Next Jobs Release: May 7, 2021.

Tailwinds to Recovery:

- Vaccines. Over 100M vaccinations had been given by the end of March. The Biden administration is targeting late April for vaccinations to be readily available for most adults. Vaccinations are on the rise and are outpacing the number of new cases.
- Fiscal Boost. The American Rescue Plan Act sent $1400 payments to most Americans. This may boost consumption. Some studies have shown portions of past direct payments were used to pay down debt or increase savings, which improves consumer balance sheets.
- **Central Banks Keep Rates Low.** While the global economy is healing, global central banks including the Fed, Bank of Canada, Bank of England, Bank of Japan, and the European Central Bank have all re-committed to working towards supporting the recovery.
- Rising Confidence. Business confidence has remained solid for the past few quarters. In March we also saw steep increases in consumer confidence, which previously had stagnated at low levels. Further high readings would point to pent-up demand heading into summer, as opposed to a one-time temporary boost based on the transfer payments.
- Another Infrastructure Bill. The Biden Administration proposed an additional $2T+ spending package that includes plans to improve the nation's highways and airports, boost broadband access, improve water quality, and modernize the electrical grid. If enacted, the spending would likely boost GDP, although the proposal includes the drag of some tax increases.

Headwinds to Recovery:

- Delays in Herd Immunity. As states re-opened from the holiday lockdowns, COVID cases began to rise in some areas, which was further complicated by new variants of the virus. Delays in global vaccinations resulting from supply shortages, difficult rollouts, and other factors could lead to a slower-than-expected or delayed global recovery.
- Inflation Fears. We expect headline inflation to increase in the coming months. Year-over-year comparisons may show a marked jump, since inflation is coming off very low levels from the pandemic – the CPI bottomed at 0.12% YoY in May 2020. Commodity prices have picked up. Oil is back near pre-pandemic levels. Supply chains remain a challenge, which may continue to boost prices in the near-term. We expect "headline" inflation measures above 3%, although "core" inflation rates will be lower, since they are less impacted by commodity prices. The Fed may label any inflation rise as "transitory."
- Market Interest Rates Tick-Up. The Fed maintains short-term rates, however market interest rates can and do fluctuate. For example, the 10-Year Treasury Bond started 2020 near 1.90%, fell to near 0.50% in the summer of 2020 and since then has steadily risen to around 1.75%. While still historically low, some measures of market interest rates that may be priced off the 10-Year Treasury, such as mortgage rates or student loan rates, could increase, thereby increasing consumer interest rate expenses.
- Labor Market. Weekly claims are hovering near 700k, a very high number. The under-employment rate (U-6) remains elevated, at 10.7%. Full employment by U-6 is closer to 8%.
- Record Debt. U.S. debt levels were rising before the pandemic. Since then, they have increased by an additional $5T on relief efforts. With rising debt comes less future financial flexibility.
- Geo-Politics, Elections, and Unknowns. There is the uncertainty of overseas elections later in the year. Plus, the new administration is having a bumpy transition in relations with countries like China, Iran, N. Korea, and Russia. These factors could impact short-term business and consumer confidence.

Stocks

The Great Investor Rotation. Investors rotated into reopening equity classes. Small and medium sized companies outperformed, along with value investments. Large cap growth stocks underperformed. The market saw significant inflows into stock mutual funds and ETFs for the first time since 2009. In fact, there was record buying during the first quarter: U.S. equity ETFs alone exceeded $207 billion in inflows, according to State Street Research. The markets are set to see S&P 500 earnings growth higher than 26% for 2021 and higher than 15% for 2022.

The expected future acceleration of earnings growth reduces stock valuation concerns. The forward 12-month price-to-earnings ratio for the S&P 500 is 22.4, above the 5-year average of 17.8 and the 10-year average of 15.9. During this phase of recovery, we should continue to see the stock multiple decline as earnings increase faster than the price level of the S&P 500. The stock market rotation should continue and broaden out globally. Value stocks are expected to grow earnings at a higher rate than the broader market and offer a lower stock multiple.
This supports a sustainable rotation with this style.

The energy and financial sectors, last year's biggest losers, were the biggest winners in the first quarter, along with materials and real estate. Laggers last quarter included consumer staples and utilities, which are defensive investments, along with the more expensive technology sector.

S&P 500 Operating Earnings Growth

	Qtr 1	Qtr 2	Qtr 3	Qtr 4	Year
2018	24.8%	25.0%	19.3%	10.6%	20.1%
2019	-0.3%	-0.4%	-2.1%	0.9%	0.1%
2020	-15.0%	-31.6%	-5.7%	4.0%	-11.2%
2021	24.5%E	53.1%E	19.2%E	14.8%E	26.3%E

Source: FactSet

The Possibility of a Global Synchronized Stock Rally. While interest rates have been the market's focus this year, the 4% increase in the U.S. dollar index – a strong performance – made emerging market stocks the biggest victim. A strong dollar and higher U.S. interest rates create headwinds for both emerging market stocks and bonds. The level of investors betting on the U.S. dollar falling is, on a relative scale, as crowded as the level buying large cap growth stocks. This may keep buying pressure on the U.S. dollar in the short term. In the long term, we are watching the performance of the Chinese Yuan – it has become the best gauge of relative global economic strength. A global synchronized stock rally would most likely materialize first in a flat or weaker U.S. dollar, before signs of relative stock outperformance. For investors with an intermediate or long-term horizon, we expect a broader stock portfolio that includes both value and international stocks to do better and with less risk than a portfolio concentrated in expensive U.S. large cap growth stocks. We have continued to shift investment allocations to include more value and cyclical equity classes, along with more global equity allocations and continued reductions in U.S. growth stocks.

Largest Risks to a Global Stock Rally. We see two major risks. First, long term interest rates may move too high too fast, ultimately choking off expected economic growth. Second, the Federal Reserve may signal a quicker-than-expected change in its loose monetary policy, which may provoke a stock valuation reset – also known as a stock market correction.

Major Stock Index Performance

	1st Quarter Returns	2020 Returns	2019 Returns	2018 Returns
S&P 500	6.8%	18.4%	31.5%	-4.5%
Russell 2000 Index	12.7%	19.9%	25.5%	-11.0%
NASDAQ Composite	2.8%	43.6%	35.2%	-3.9%
International Developed Index	3.5%	8.27%	22.0%	-13.8%
Emerging Markets Index	2.3%	18.7%	18.4%	-14.6%

Source: Bloomberg

Bonds and Interest Rates

Interest Rate Outlook – Short Rates Lower, Long Rates Higher. In the two most recent FOMC statements, the Fed supported its case for short term interest rates at the "zero lower bound" of 0% to 0.25%. Fed Chair Powell reiterated that the Fed has a new policy framework: the Fed will not raise rates until the economy reaches full employment, inflation has reached 2% and there is a significant likelihood inflation will moderately exceed 2% for a time. The Fed's new framework is reactive, not proactive.

The Fed has updated its forecast for GDP growth to 6.5% for 2021. Wall Street estimates run from 6% to 8% GDP growth. The strong growth outlook and the combination of $600 billion in stimulus in December and $1.9 trillion in March, along with stronger than expected jobs data, brought out the bond vigilantes, who forced rates higher at the longer end of the yield curve.

Inflation expectations were on the rise last quarter, even though actual inflation data, as measured by CPI, rose just 1.4% in January and 1.7% in February. The Fed's preferred measure is PCE (Personal Consumption Expenditures) which rose 1.5% in January and 1.4% in February, both ex-food and energy, the most volatile pieces of the PCE index. Both inflation measures are short of the Fed's goal of a sustained 2%. We will probably see a rise in those indices for March, given that in March 2020, the comparison point, the economy was shut down and the stock market bottomed. Inflation at that time was briefly negative, which is why the Fed believes these inflation readings are "transitory." This type of comparison won't be available in the summer months, when inflation started to rise again.

Last quarter, U.S Treasury yields were flat to slightly lower in the 3-month to 3-year section of the yield curve. The 5-year to 30-year section of the curve saw a 0.56% to 0.85% rise. The biggest moves were in the 7- to 10-year yields, as investors anticipated higher inflation from the stimulus
and the economy re-opening. The U.S. vaccine timeline has moved up to April 19 – the date when any adult who wants the vaccine should be able to get it. This indicates the economy will open sooner than expected and people will likely gather for Independence Day. While yield rates have stabilized for now, a full reopening will be the next catalyst for another move higher on the long end. The 10-Year Treasury is currently yielding 1.63% and the 30-Year Treasury is yielding 2.32%. The last time those rates were that high was January 2020.

Bonds: Focus on Credit Quality and Duration Management. Longer term interest rates have made a significant move in a very short time. We could see another bump higher if the economy is open by Independence Day. However, if CPI and PCE continue to fall short of 2%, those moves could become more stable until the 2% threshold is achieved near term. The 30+ year bond bull market is behind us. Investors should start bracing for higher rates in the coming years. Reinvestments should focus on the 4- to 6-year maturities – we have found value in that part of the yield curve. We continue to recommend an overweight to corporate debt for accounts that allow those mandates.

	03/31/21 Yields	**1st Quarter Returns**	12/31/20 Yields	12/31/19 Yields
3 Month T-Bill	0.02%	0.01%	0.06%	1.54%
2 Year Treasury	0.16%	0.00%	0.12%	1.57%
10 Year Treasury	1.74%	-2.49%	0.91%	1.92%
2-10 Year Spread	+1.58		+0.80	+0.35
BB Int Gov/Credit		-1.86%		

Source: Bloomberg

Illinois Capital Development Board – establishing a Trust

- If your college has a project supported by the Illinois Capital Development Board, a Trust needs to be established. First Midwest Bank and most Trust Companies can establish a Trust, complete and sign the CDB documents and provide investment management. Please contact Lori Kazich at 708-576-7152 for more information.

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Thank You & Questions

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