

# City of Sarasota

## Quarterly Investment Committee Report

Quarter Ending March 31, 2007

### Economic Developments

The housing market is heading south but despite weak housing prices, Americans are still spending. Previous growth areas like Boston are in the pits, Florida isn't much better, even lucrative Las Vegas is suffering and in Michigan the situation is so bad it may not come back. Even Toll Brothers Construction, one of America's biggest builders of luxury homes, has a pessimistic view. Although the housing market had a few bright spots such as New York, Connecticut and Texas, the overall housing sector continues to look bleak.

The trouble with the housing market is that after the great global housing binge, the hangover is finally kicking in, especially in America. June is National Homeownership Month in America. National Foreclosure Month would be more apt. Some corners of the mortgage market – notably “sub-prime” loans aimed at those with poor credit records – have a nasty case of dry rot. One sub-prime borrower in eight is behind with the payments. As the introductory “teaser” rates on more loans expire and monthly payments outrun the means of more borrowers, hundreds of thousands of Americans are set to be thrown onto the street.

Recent national statistics suggests that the housing market may get even worse. On April 24<sup>th</sup> the National Association of Realtors reported that the sales of existing homes fell by 8.4% in March, the fastest decline in eighteen years. Government statistics suggested that sales of newly-built homes rose 2.6% in March, after plunging in the previous month. This was due to balmy days in December and January which pushed sales of existing homes up in those months while freezing temperatures in February deterred potential house-hunters, which meant fewer sales for March.

March's rebound was smaller than analysts had expected and sales of new homes were nearly a

quarter below their level of the previous year. But the weather cannot explain all the lack of demand. Tighter lending standards made it more difficult for sub-prime and other weak borrowers to get mortgages. And many buyers continue to wait for prices to fall further.

According to the S&P CaseShiller index of home prices in 20 of the largest cities, prices were down 1% in February from a year earlier. A narrower index of the ten biggest cities in America suggests house prices have fallen 1.5% from a year ago and clearly have further to go. There is a huge backlog of unsold homes, almost eight months' worth of new homes are up for sale. The plunge in sales for existing homes indicates that there is 7.3 months worth of supply on the market, up from 6.8 in February. The sub-prime mess will likely lead to forced sales, which will increase the stock of unsold homes and therefore push prices down even further.

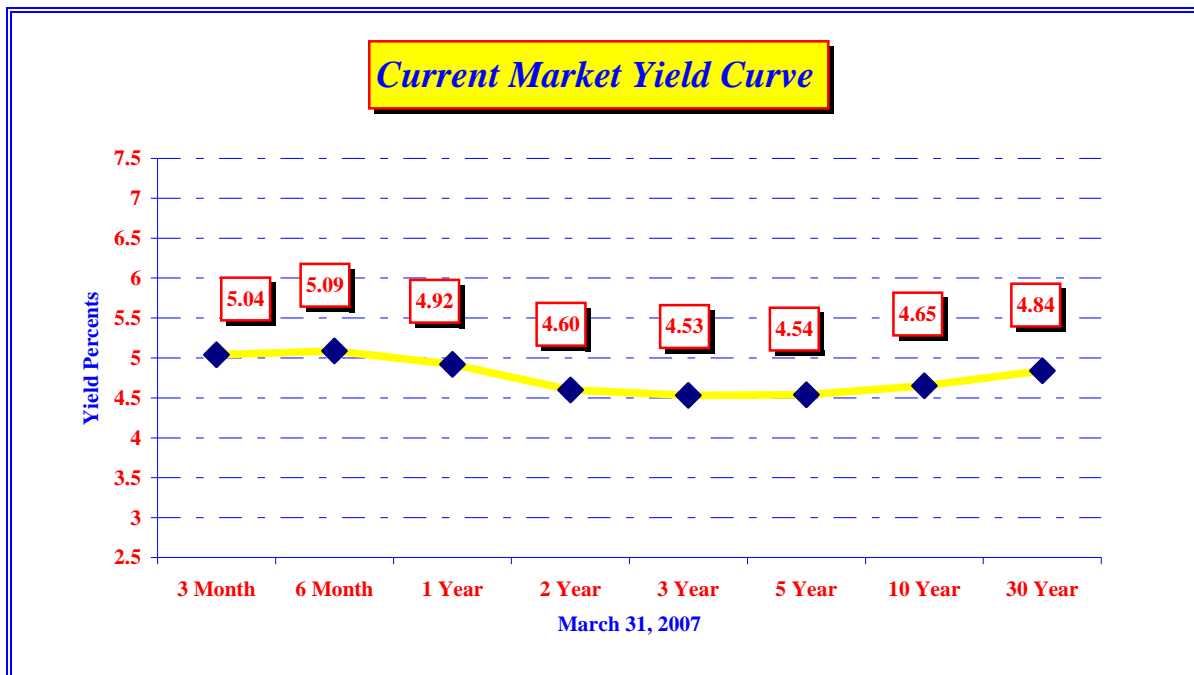
The big uncertainty is how much, and when, weaker house prices affect consumer spending. So far, flatter house prices and a drop in mortgage-equity withdrawal – the process through which people can extract cash from their homes – have not prompted Americans to scrimp. Consumer spending grew at an annual rate of 4.2% over the past six months.

The strong stock-market may have helped. But spending has been resilient mainly because unemployment is low and Americans' pay packets are still fat. The jobless rate is 4.4% and real incomes have been rising even faster than spending. As long as jobs are plentiful and wages rising, the effect of weaker house prices will be muted. If they don't, the picture darkens quickly. “What happens if we get a recession and housing is still bad?” The results could be “cataclysmic”.

*continued on page 4)*

(Source: U.S. Treasury - Daily Treasury Yield Curve)  
 Treasury Yield Changes During the First Quarter of 2007

	3/31/2007	12/31/2006	BP Change
3 Month	5.04%	5.02%	0.02%
6 Month	5.09%	5.09%	0.00%
1 Yr.	4.92%	5.00%	-0.08%
2 Yr.	4.60%	4.82%	-0.22%
3 Yr.	4.53%	4.74%	-0.21%
5 Yr.	4.54%	4.70%	-0.16%
10 Yr.	4.65%	4.71%	-0.06%
30 Yr.	4.84%	4.81%	0.03%



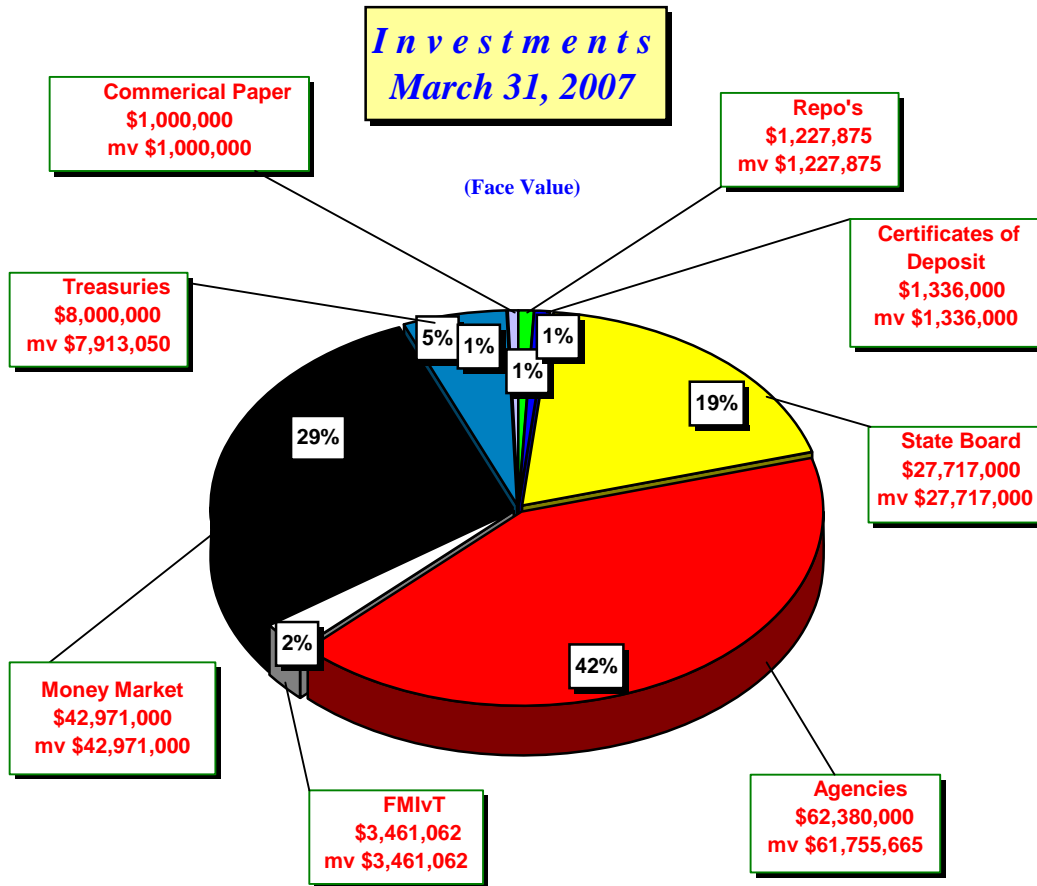
## Interest Revenue vs Budgetary Expectation

### General Operating Fund

	<u>12/31/06</u>	<u>03/31/07</u>	<u>06/30/07</u>	<u>09/30/07</u>
Interest Revenue	\$346,378	\$503,272	\$000,000	\$000,000
Budgetary Expectation	<u>312,500</u>	<u>312,500</u>	<u>312,500</u>	<u>312,500</u>
Excess (Shortfall)	<u>\$33,878</u>	<u>\$190,772</u>	<u>\$(312,500)</u>	<u>\$(312,500)</u>

### Water & Sewer Operating Fund

	<u>12/31/06</u>	<u>03/31/07</u>	<u>06/30/07</u>	<u>09/30/07</u>
Interest Revenue	\$ 50,263	\$ 23,030	\$ 00,000	\$ 00,000
Budgetary Expectation	<u>31,250</u>	<u>31,250</u>	<u>31,250</u>	<u>31,250</u>
Excess (Shortfall)	<u>\$ 19,013</u>	<u>\$(8,220)</u>	<u>\$(31,250)</u>	<u>\$(31,250)</u>



Total Investment - \$148,092,937

Market Value - \$147,381,652

Total Portfolio Weighted Avg. Maturity - 1.0 Years

CD'S & Agency Bond Weighted Avg. Maturity - 1.91 Years

*(continued from page 1)*

What might a flagging American economy mean for the rest of the world? Although America's economy is tiring, other global players are continuing to expand at a good pace. As the March quarter drew to a close, the IMF marked down its forecast of American GDP growth, but detected no loss of puff in the rest of the world. The IMF forecast that world output would grow by 4.9% in both 2007 and 2008. It has also raised its estimates for the Euro area and for developing countries in Asia and elsewhere.

This is consistent with the idea that Asia and Europe have become "decoupled" from America, despite the growth of international trade and financial integration. Some economists have seen signs that Asian and European domestic demand will be strong enough to withstand an American slowdown. Others are not so sure: the Asian Development Bank said it could find "no evidence" that fast-growing East Asian economies were detaching themselves from America, Europe and Japan.

America's recent slowdown has so far had little effect beyond Canada and Mexico – but also that it has been largely confined to housing and manufacturing. The risk that it will spill over to consumption and therefore, via imports, to other countries, has not materialized.

However, other countries are looking nervously at America. An American recession would scarcely be welcome – even if for the moment Asian and European economies appear to be doing nicely on their own account. The true cause for concern is that just as America's housing boom was part of a synchronized global binge on cheap money, its bust may be part of a global story too.

The IMF looked back at the effects of five American recessions and two milder "mid-cycle slowdowns" in the past 30-odd years. On average, growth in other regions fell during the recessions by about half as much as in America. The fall varied across both recessions and regions. Synchronized declines have tended not to be the result of spillovers from America, but to have global causes. In 2001, many regions were caught by the bursting of the tech bubble, tumbling stock markets and declining investment. In 1974-75, the first oil-price shock was a common factor.

America's 1991 recession, in contrast, was a more local affair, after the savings-and-loan crisis. Regional differences also matter. In 1982, Asia and Latin America were hurt more than industrial countries. Latin America suffered especially as rich-world interest rates rose, bringing on the region's debt crisis.

The mid-cycle slowdowns, in 1986 and 1995, were much tamer. American GDP growth fell by only a percentage point on average; the median decline in other industrial countries was only a tenth of that; and growth in other regions rose. So far, notes the IMF, today's American slowdown fits this pattern – mild with local causes. In other words, so far the slowing American economy is of just the type to leave Asia and Europe undisturbed.

## **INVESTMENT STRATEGY**

The March quarter closed with Fed Chairman Bernanke indicating that the Fed continued to be satisfied with the current pace of growth. Interest rates are expected to remain in a fairly narrow band. Similar to the previous quarter, economists continue to predict that the Fed will ease rates in the coming months. However, inflation continues to be the focal point of concern for the Fed and it's unlikely that any cuts will materialize in the near future. Therefore, with the housing sector in turmoil and technical statistics indicating that a potential acceleration in inflation may materialize, a defensive strategy may prove prudent given the current economic environment. Therefore, longer maturities of U.S. Treasuries and Agency Securities with twelve month call features will be increased to lock in existing yields. Certificates of Deposit and Commercial Paper in the 90 to 180 day range with a rating of A1, P1 or better will be purchased for the purpose of diversity. Overnight liquidity will continue to decrease during the quarter as investment opportunities develop going forward. Short-term (3-12 months) will be set at 10% to 12% or approximately \$15 to \$18 million. The medium term range (12-36 months) will continue to be targeted at approximately 65% or \$96 million of the portfolio. Long-term range (3-5 years) will continue to be reduced as call options are exercised and agencies securities mature or are sold.

## **Investment Policy**

The City Commission adopted resolution NO. 01R-1397 on September 4, 2001, authorizing the Finance Director to invest surplus funds, as delegated by the City Manager. Quarterly reports are submitted to the investment

committee which consists of the City Manager, Finance Director, Cash and Investment Manager and the City Auditor and Clerk.

### **Performance Measurements:**

- 1) 4.05% Target rate based on U.S. Treasury Market Securities on 03/31/2007.
- 2) 4.94% Rate of return based on Lehman Brothers 1-3 Yr. Index for U.S. Governments maturing in March 2008, which is the duration equivalent of the portfolio's weighted average maturity.
- 3) 4.50% Annualized rate of return based on portfolio Investments on 03/31/07.
- 4) 4.16% Annualized rate of return based on Treasury, Agency and C. D. portion of the portfolio on 03/31/2007.

### **Authorized Investment Institution and Dealers:**

#### **Bank -**

- 1) Wachovia Bank, NA

#### **Region Firms -**

- 1) Sun Trust Equitable Securities Corp.
- 2) Vining Sparks Securities
- 3) Shay Financial Services, Inc.
- 4) Brookstreet Securities Corp.
- 5) Sovereign Securities Corporation, LLC

#### **Primary Dealers -**

- 1) Morgan Stanley Dean Witter, Inc.
- 2) Paine Webber Incorporated
- 3) Solomon Smith Barney, Inc.
- 4) Prudential Securities

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Periodical publications used as source documents for articles appearing in March 2007 report.

1. The Wall Street Journal
2. The Economist Magazine
3. U. S. News Magazine