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CITY OF SAN JOSE
CAPITAL OF SILICON VALLEY

Memorandum

TO: HONORABLE MAYOR, CITY COUNCIL, CITY EMPLOYEES AND RETIREES

FROM: Debra Figone

SUBJECT: **FINANCIAL MARKET UPDATE #3 AND IMPACT ON CITY OF SAN JOSE**

DATE: October 31, 2008

INFORMATION

BACKGROUND

The unprecedented turmoil in the US financial markets continued throughout the world with an expansion of coordinated global financial market responses. This informational memo provides the Mayor, City Council and our employees' additional information on how these financial market events may impact the City and our ability to provide the services to our community.

As discussed in the first informational memo, the current market dislocation is the result of the unwinding of loose lending policies and excessive credit during the housing boom of the last decade. The subsequent contraction in economic activity and dislocation in financial markets has combined to create a worsening fiscal outlook for the City. On October 24, I provided the Mayor, City Council and our employees' with a memo describing how these events will increase the General Fund deficit figure projected for 2009-2010, which was last calculated at $46.6 million.

An abbreviated chronology of events was provided in the first two Financial Market Update memos dated September 29 and October 9, which outlined the major events which have occurred in the financial markets through October 9. Attached at the end of this memo are two graphs that illustrate what has occurred in the stock market and US Treasury market since the Federal Reserve first started to lower interest rates on September 18, 2007 in an attempt to contain the economic fallout from the stalling housing market.

The week of October 13 to October 17 continued to demonstrate extreme market volatility:

- ***Monday, October 13***
  - ✓ European Union ("EU") countries commit $1.8 trillion Euros to guarantee bank loans and take direct stakes in EU financial institutions
  - ✓ U.K. government announces plans to take equity stakes in Royal Bank of Scotland and HBOS plc, representing two of the five largest banks in England

- ✓ US Federal Reserve provides unlimited dollars to the European Central Bank, the Bank of England, and the Swiss National Bank in an effort to reduce money-market rates
- ✓ US Treasury confirms that they are designing a program to take equity stakes in financial firms
- ✓ Dow Jones Industrial average increases 936 points its best daily percentage advance since 1933

- ***Tuesday, October 14***
  - ✓ Treasury announces that $250 billion dollars of the $700 billion Troubled Assets Relief Program ("TARP") program will be used for direct equity stakes in financial institutions. Nine large US banks accepted $125 billion of the funding including: Bank of America, Wells Fargo Bank and JP Morgan
  - ✓ Dow Jones Industrial average declined 76 points
- ***Wednesday, October 15***
  - ✓ Federal Reserve Chairman Bernanke states that policy makers will probably toughen their stance on "excessive leverage"
  - ✓ State of California receives indications from the brokerage community that 86% of a projected $4 billion Revenue Anticipation Note ("RAN") issuance will be absorbed by retail investors
  - ✓ Dow Jones Industrial average declined 733 points, the second largest point drop ever
- ***Thursday, October 16***
  - ✓ Trimtabs Investment Research reports that hedge fund investors withdrew $47 billion in September
  - ✓ Dow Jones Industrial average increased 401 points or 4.7 percent
- ***Friday, October 17***
  - ✓ High investor demand allows the State of California to sell $5 billion in Revenue Anticipation Notes, a 25% increase from its initial $4 billion offering
  - ✓ Rates for one month high rated commercial paper fell to a 3 week low of 3.45 percent
- ***Friday, October 17*** – Market Closing Statistics
  - ✓ 3 month US Treasury bills 0.96 percent
  - ✓ Dow Jones Industrial average experienced extreme fluctuations throughout the week and closed at 8852 a 401 point increase for the week

The week of October 20 to October 24 the significant market events include:

- ***Monday, October 20***
  - ✓ Federal Reserve Chairman Bernanke endorsed an additional fiscal stimulus package in testimony before the House Budget Committee
  - ✓ Dow Jones Industrial average increased 413 points or 4.7 percent

- ***Tuesday, October 21***
  - ✓ Federal Reserve announces the creation of the Money Market Investor Funding Facility. The facility will provide $540 billion in funds to help money market funds meet redemptions.
  - ✓ Dow Jones Industrial average declined 231 points or 2.5 percent
- ***Wednesday, October 22***
  - ✓ Michigan lawmakers ask the Fed and Treasury to use their authority under the Emergency Economic Stabilization Act to provide liquidity to help the auto industry
  - ✓ Dow Jones Industrial average declined 514 points or 5.7 percent
- ***Thursday, October 23***
  - ✓ Former Federal Reserve Chairman Greenspan describes current conditions as a "once in a century credit tsunami" before the House Committee on Oversight and Reform
  - ✓ New York Federal Reserve releases data showing AIG has utilized $90.3 billion of its government $122.3 billion dollar credit facility
- ***Friday, October 24***
  - ✓ PNC Financial Services makes a $5.2 billion bid for National City, creating the 5th largest US bank by deposits, utilizing funds from the Treasury TARP program
  - ✓ Dow Jones Industrial average declines 312 points or 3.7 percent
- ***Friday, October 24*** – Market Closing Statistics
  - ✓ 3 month US Treasury bills closed 0.83 percent
  - ✓ Dow Jones Industrial average experienced extreme fluctuations throughout the week and closed at 8378 down 474 points for the week

The period of October 27 to October 30 the significant market events include:

- ***Monday, October 27***
  - ✓ European Central Bank (ECB) President signals that the ECB may lower rates at its November 6 meeting
  - ✓ At least 18 regional US banks announce participation in US Treasury's TARP program. Among regional banks included in the second round of Treasury financing were Capital One, Comerica, SunTrust, and KeyCorp.
  - ✓ Dow Jones Industrial average decreased 203 points or 2.4 percent
- ***Tuesday, October 28***
  - ✓ Federal Reserve begins first day of two day Federal Open Market Committee meeting.
  - ✓ Data from the Federal Reserve reveal that sales of long-term commercial paper increased 10 times after the first full day of operation for the Feds Commercial Paper Funding Facility
  - ✓ GMAC is approved for access to the Feds Commercial Paper Funding Facility
  - ✓ Dow Jones Industrial average increased 889 points or 11 percent

- ***Wednesday, October 29***
  - ✓ Federal Reserve cut the federal funds rate by half a percentage point to 1.00% at the conclusion of the Federal Open Market Committee meeting
  - ✓ FDIC Chairperson indicates that the Treasury in conjunction with FDIC is seeking ways to restructure mortgages
  - ✓ Ford Motor is approved for access to the Feds Commercial Paper Funding Facility
  - ✓ Dow Jones Industrial average declined 74 points or 0.8 percent
- ***Thursday, October 30***
  - ✓ Commerce Department reports that gross domestic product (GDP), a broad measure of the nations output of goods and services, declined at a 0.3% annual pace in the 3rd quarter
  - ✓ Federal Reserve Bank of San Francisco President Janet Yellen indicates the Fed could lower rates further if the economic environment warrants
  - ✓ Dow Jones Industrial average increased 189 points or 2.1 percent

As discussed in the informational memos dated September 29 and October 9, 2008, the ongoing stream of information and speculation on the state of the financial markets may have the effect of alarming members of the public, City staff continues to evaluate the impact on City operations and plan for the things the City can control, especially as it relates to taking appropriate budgetary actions (if necessary).

ANALYSIS

Key departmental staff met to open a dialogue on the areas of City operations which may be impacted by these unprecedented financial market conditions. The areas indentified for initial review, and included in the September 26th informational memo, were Interest Earnings on City Portfolio; Variable Rate Debt Service – City and Conduit (multi-family housing revenue bonds); Affordable Housing Program; Insurance Coverage and Claims Paying Ability; Near-term Market Access for upcoming Agency bond issue; and Retirement Plans.

This memorandum provides information in the following area:

- Economic Data Continues to Show an Increased Chance of Recession
- Municipal Bond Market Thaw and Impact on City
- Redevelopment Agency Bond Sale
- Investment Program Interest Earnings

A brief discussion is provided below on each of these areas. Staff continues to actively monitor the financial markets and will provide periodic updates as necessary.

Economic Data Continues to Show an Increased Chance of Recession

As noted above, The Federal Reserve Open Market Committee (Feds) reduced the target for federal funds rate 50 basis points to 1.00%. This was the second 50 basis point reduction in the federal funds rate in the month of October. The Federal Reserve, in their statement release, predicated their actions on evidence of continued economic weakening. Below is a quote from the release:

> *"The pace of economic activity appears to have slowed markedly, owing importantly to a decline in consumer expenditures. Business equipment spending and industrial production have weakened in recent months, and slowing economic activity in many foreign economies is damping the prospects for U.S. exports. Moreover, the intensification of financial market turmoil is likely to exert additional restraint on spending, partly by further reducing the ability of households and businesses to obtain credit."*

Economic data releases for the past two weeks continued to be troubling with economists predicting that a US recession is likely currently under way.

- Commerce Department reported that retail sales had its biggest drop in three years falling 1.2 percent in September. The decline in September retail sales was the third consecutive monthly decline which has not occurred since 1992. Consumer spending represents nearly 70 percent of US economic activity.
- Reuters/ University of Michigan preliminary index of consumer confidence for the month of October declined to 57.5 percent from 70.3 percent in September, a record single month decline. The index conducts phone interviews and reflects the percentage of respondents that feel confident about the economy.
- Commerce Department reported that construction of new homes fell 6.3 percent for September to its second lowest level in 50 years as builders tried to trim housing inventories.
- In related housing data the Federal Housing Finance Agency reported that home prices declined 5.9 percent in August compared to a year earlier.
- In an indication that declining housing values may be attracting buyers, the National Association of Realtors reported that existing home sales increased 5.5 percent for September over the previous month.

Municipal Bond Market Thaw and Impact on City

Week of October 20 to October 24 was one of significant improvement in the tax-exempt municipal bond market. The "firmness" in the market is expected to continue through next week. The yields in the municipal market declined on Friday, October 24 for the fourth straight day as retail and institutional demand for tax-exempt bonds persisted throughout the week. According to Municipal Market Data (MMD), triple-A 30-year general obligation bond yields were 5.90% last Monday (10/20), but as of Friday's (10/24) close yields were at a 5.17%; 73 basis point decline. The primary municipal market "came back to life" with $5.1 billion in municipal bonds priced with both institutional and retail accounts supporting the primary market.

The dollar volume of bonds expected to reach the market in the next 30 days remains heavy at $17.5 billion. The short-term, variable rate market experienced similar improvement with the Securities Industry and Financial Markets Association (SIFMA) tax-exempt weekly rate declining from 3.45% on October 15 to 2.28% on October 22; a 117 basis point decline; and further improvement was experienced this week with SIFMA reset at 1.82%, a 46 basis point improvement.

Impacts on City's Variable Rate Bond Program

The average estimated interest rates used for the City's 2008-09 budget for the City's outstanding variable rate debt were 2.80% for tax-exempt bonds, 2.90% for Alternative Minimum Tax (AMT) bonds, and 4.00% for taxable bonds. Due to the recent market disruption, interest rates paid on the City's outstanding variable rate bonds increased to their highest levels during the week of September 22, 2008, hitting an average of 7.36%, 7.70%, and 7.88% for tax-exempt, AMT, and taxable bonds respectively. The interest rates paid on the City's variable rate bonds have since returned to levels experienced prior to the most recent disruption that began in September 2008.

Despite the rate volatility and the recent spike in interest rates, the average interest rate paid to date for all series of the City's variable rate bonds still remains below the budgeted rate, with the exception of the San Jose-Santa Clara Clean Water Financing Authority Series 2005B Bonds ("CWFA 2005B"). The CWFA 2005B bonds have been impacted by the recent downgrade of Depfa Bank, the liquidity provider for these bonds. The City is pursuing alternative financing structures to eliminate the exposure to Depfa and reduce the current interest rate paid on the bonds.

The table below provides a summary of the budgeted debt service rate, fiscal year-to-date average interest rate and interest rate as of October 30, 2008. Interest rates on these variable rate programs are reset weekly.

Series	Budget Debt Service Rate	Fiscal Year to Date Average	Rate as of 10/30/08
Tax-Exempt			
CSJFA 2008A (Civic Center)	2.80%	2.19%	0.80%
CSJFA 2008B (Employee Garage)	2.80%	2.51%	1.30%
CSJFA 2008C (Hayes Mansion)	2.80%	2.46%	1.18%
CWFA 2005B*	2.80%	4.14%	8.75%
AMT			
RDA Housing Set Aside 2005C	2.90%	2.74%	1.49%
RDA Housing Set Aside 2005D	2.90%	2.68%	1.60%
Multi-family Housing Average	N/A	2.84%	1.77%
Taxable			
CSJFA 2001D (Hayes Mansion)	4.00%	3.99%	6.00%
CSJFA 2001E (Ice Centre)	4.00%	3.68%	3.00%
CSJFA 2008F (Land Acquisition)	4.00%	3.92%	3.75%

** Portions of the CWFA 2005B Bonds have been tendered to the Bank and pursuant to the Standby Bond Purchase Agreement with Depha the interest rate on the Bonds is set at the Bank's prime rate, which is currently 4.00%. The rate indicated above as of 10/30/08 is for the bonds which are still being remarketed (approximately 22% are being remarketed weekly by Citi; the remarketing agent.*

Redevelopment Agency Bond Sale

On Tuesday, October 28 the Redevelopment Agency solicited competitive bids for two series of bonds, Series 2008A taxable bonds and 2008B tax-exempt bonds with estimated par amounts at $30.1 million and $70.4 million, respectively. The Agency received no bids on its Series 2008A (taxable) offering. Despite indications that up to seven bidders would bid, no qualifying bids were received for Series 2008A. Feedback from the market participants indicates that the Series 2008A may require higher than the authorized 8.5% interest rate to be currently marketable. The Agency received three bids for the tax-exempt Series 2008B, which was won by Stone &Youngberg at a 6.88% true interest cost (TIC). The other bidders were Bank of America Securities, LLC and Citigroup Global Markets, with bids of 6.97% and 7.00%, respectively. The Redevelopment Agency increased the size of the Series 2008B bonds in order to realize just over $80 million in par value. Depending on market conditions, the Agency will seek to sell Series 2008A at a later date.

Investment Program Interest Earnings

Based on current market trends, the Finance Department currently anticipates that the economic conditions during the remainder of the fiscal year will result in reduced interest earnings on the City's investment portfolio. Since the Finance Department's initial interest rate assumption in developing the FY 2008-09 Budget, the Federal Reserve has reduced the Federal Funds rate an additional 200 basis points to 1.00%.

In addition, market conditions have also reduced investment yields on the type of securities predominately included within the City's investment portfolio (US Government Agencies) as other market participants seek the safety of US Government issues in their efforts to minimize their financial exposures, thus increasing demand for the bonds which results in lower yields. An example of this trend is shown on the attached graph that provides a comparison of the US Treasury yield since the Federal Reserve first started to lower interest rates in September 2007 to the current yield as of October 30th; the US Government was paying investors 3.87% on a one month US Treasury Note on September 18, 2007 compared with a yield of .14% today (October 30th), representing over a 96% drop in the yield (373 basis points.) The chart shows the yields the US Government is paying investors for US Treasury Note investments ranging from a duration of one month to five years (note: in regards to allowable investments for the City's general portfolio, the City's Investment Policy and the California Government Code prohibits the City from making investments with durations greater than five years.)

Based on these developments, the Finance Department provided the City Manager's Budget Office an updated interest rate assumption of 3.22% for FY 2008-09 versus the 3.41% assumption originally provided. In addition, the Finance Department is currently working on updated interest rate assumptions for the City Manager's Budget Office in developing a preliminary 2010-2014 five year General Fund Forecast.

SUMMARY

With all of the continuing news regarding the US and global financial disruption, it is important to stay focused on the impact on San Jose and our ability to provide services to the community. Key points to keep at the forefront of any discussion include:

- The City invests funds to meet day-to-day cash flow needs and we do not anticipate the need to issue bonds to meet our day to day operational costs.
- The City's conservative investment policy ensures investments are made with the principals of safety, liquidity and yield (in that order)
- Budget monitoring efforts are ongoing and proactive to take any necessary actions to make adjustments in revenues and expenditures in order to maintain a balanced budget.

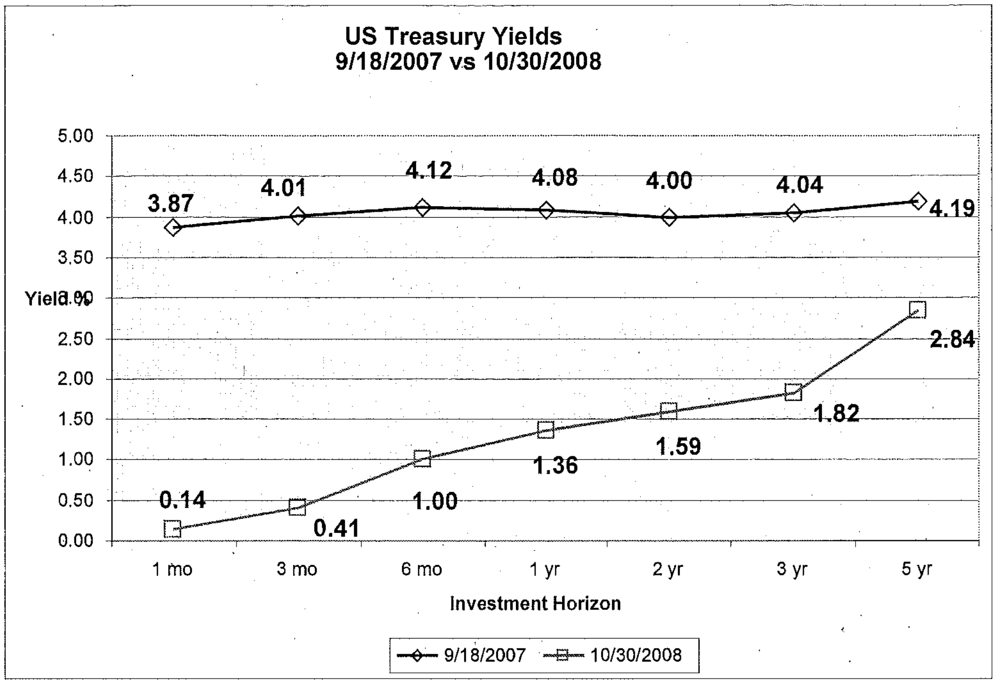
COORDINATION

The interdepartmental team tracking and monitoring the potential impacts on the organization include representatives from the Finance, Human Resources, Housing, Public Works, Retirement Departments, Redevelopment Agency and the City Manager's Budget Office. The effort is being led by the Director of Finance.

DEBRA FIGONE
City Manager

For questions please contact SCOTT P. JOHNSON, Director of Finance, at (408) 535-7000

US Treasury Yield Curve Comparison



Dow Jones Industrial average since the Federal Reserve started to lower interest rates; average was 13,739 on 9/18/2007 and 9,180 on 10/30/2008, a 33% decline.