Quarterly portfolio manager commentary

Cash Management Portfolios

What market conditions had a direct impact on the bond market this quarter?

Economic Activity – The U.S. economy started the year stronger than expected, reflecting robust employment gains and resilient consumer spending. However, growth slowed into the end of the first quarter (Q1) as increased Federal Reserve (Fed) policy tightening and financial market disruption from the failure of Silicon Valley Bank (SVB) and Signature Bank weighed on economic activity and increased fears for a pending recession. Following solid 2.6% growth in the fourth quarter, U.S. Gross Domestic Product (GDP) growth is projected to have slowed to near 1.0% to 1.5% during Q1. Consumer spending grew at a moderate pace in Q1 as U.S. consumers continue to benefit from a tight labor market and solid balance sheets, supporting resilience to persistent inflation and tightening financial conditions. Labor market conditions strengthened further in the first part of Q1 but began to ease in March as Fed policy tightening slowly gains traction. Despite early signs of easing, employment conditions remain quite firm with February U.S. job openings standing at 9.9 million open positions versus total unemployed workers in the labor force of 5.8 million. Monthly Non-farm Payrolls (NFP) growth remains elevated, averaging 345,000 during Q1, and the U3 Unemployment Rate was 3.5% in March. Growth in Average Hourly Earnings trended lower throughout the quarter but continues to be elevated at 4.2% year-over-year (YoY), further emphasizing strong labor demand. Inflation pressures were mixed during the quarter with the headline Consumer Price Index (CPI) declining meaningfully to 5.0% in March (6.5% in December) while CPI ex. food and energy stayed stable throughout the quarter, rising 5.6% YoY in March. The Fed's preferred inflation index – the PCE Core Deflator Index – increased 4.6% YoY for February. While energy prices have declined from last year's highs and demand for goods has subsided, core services prices are proving stickier than expected and are likely to keep inflation elevated throughout 2023 as the Fed attempts to further slow demand through restrictive monetary policy.

Monetary Policy – The Fed continued to tighten monetary policy throughout the quarter but at a less aggressive pace as they approach their estimated terminal rate. The Fed raised the federal funds rate by 25 basis points (bps) at the February 1 and March 22 meetings leading to a target range of 4.75% to 5.0% at quarter-end. The Fed also continued to implement its balance sheet reduction program (quantitative tightening (QT)), with a monthly cap of $60 billion in Treasury securities and $35 billion of agency mortgage-backed securities. Following the March meeting, the Federal Open Market Committee (FOMC) released its updated Summary of Economic Projections which indicated expectations for lower real

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Fed funds target rate:
4.75-5.00 basis points
Last change: March 22, 2023

1-year Treasury Yield
March 31, 2023: 4.619%

-0.091%
Year-to-date

usbancorp
Asset Management, Inc.

March 31, 2023

GDP growth in 2023 and 2024 compared to projections from December, as well as modestly higher near-term inflation. Language surrounding further rate hikes was softened as the FOMC now anticipates “some additional policy firming may be appropriate” and the median projection for the federal funds rate at the end of 2023 was maintained at a range of 5.00% to 5.25%. The Fed continues to anticipate maintaining restrictive rate policies through 2023 to ease labor market conditions and bring inflation down toward its 2% target.

Fiscal Policy – Government spending was a drag on U.S. GDP in 2022, but this is set to change in 2023 following the late December passage of a $1.7 trillion spending bill for fiscal year 2023. The bill includes a 6% increase in spending for domestic initiatives and a 10% increase in defense programs. Split government, along with the near-term need to extend the debt ceiling and pass a federal budget, makes the likelihood of another significant fiscal package unlikely over the next two years. On the municipal side, state and local governments have seen early signs of tax collections starting to slow, but strong reserves have left them in a solid position if economic conditions weaken further.

Credit Markets – Despite the financial market stress in March, first quarter 2023 fixed income returns were positive for government and investment-grade debt. Spread widening in the quarter was primarily in the financial sector, with industrial debt strongly outperforming banks and insurance companies. The deterioration in financial conditions sparked by the failures of SVB and Signature Bank eased toward the end of March, as the sale of Credit Suisse to UBS and targeted liquidity programs from the Fed helped stabilize markets and bolster investor confidence.

Yield Curve Shift

U.S. Treasury Curve	Yield Curve 12/31/2022	Yield Curve 3/31/2023	Change (bps)
3 Month	4.343%	4.693%	35.0
1 Year	4.687%	4.591%	-9.6
2 Year	4.426%	4.025%	-40.1
3 Year	4.224%	3.788%	-43.6
5 Year	4.004%	3.573%	-43.1
10 Year	3.875%	3.468%	-40.7

3-year Treasury Yield
March 31, 2023: 3.789%

-0.437%

Year-to-date

3-Month LIBOR
March 31, 2023: 5.192%

0.425%

Year-to-date

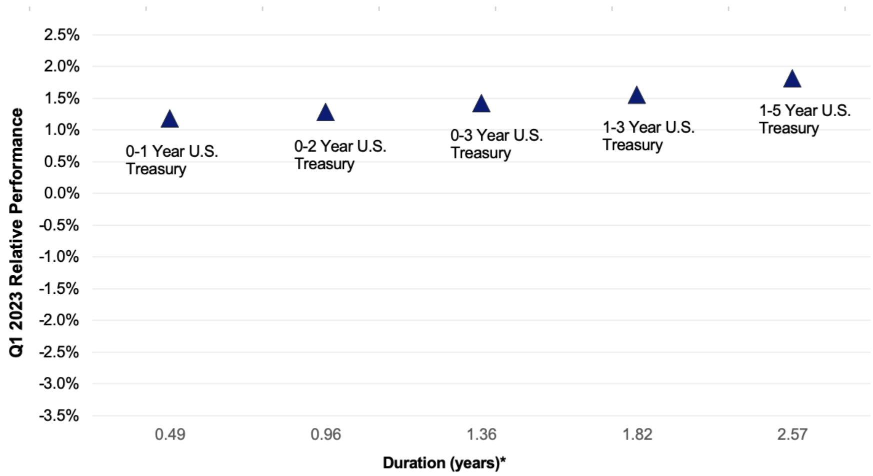
Unemployment Rate
March 31, 2023: 3.5%

0.1%

Year-to-date

Source: Bloomberg U.S. Treasury Actives Curve, US0003M and USURTOT Indices

Duration Relative Performance



Duration estimate is as of 3/31/2023

With all but the very shortest U.S. Treasury (UST) yields moving lower in the quarter, fixed income UST returns were positive across the board. The three-month to five-year portion of the yield curve inverted a further 78.1 bps in the quarter. The strong performance of two-year and longer UST debt and higher front-end yield benefitted portfolios with a barbell structure or overweight to longer portions of the yield curve.

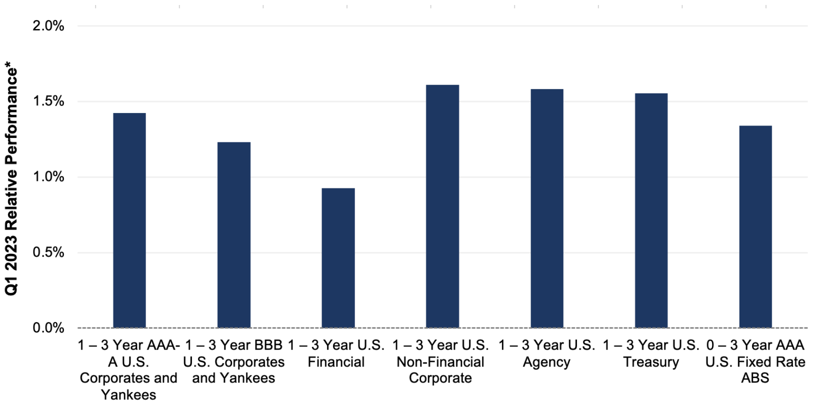
Credit Spread Changes

ICE BofA Index	OAS* (bps) 12/31/2022	OAS* (bps) 3/31/2023	Change (bps)
1-3 Year U.S. Agency Index	15	12	-3
1-3 Year AAA U.S. Corporate and Yankees	15	9	-6
1-3 Year AA U.S. Corporate and Yankees	39	28	-11
1-3 Year A U.S. Corporate and Yankees	72	91	19
1-3 Year BBB U.S. Corporate and Yankees	112	141	29
0-3 Year AAA U.S. Fixed-Rate ABS	80	92	12

*Option-Adjusted Spread (OAS) measures the spread of a fixed-income instrument against the risk-free rate of return. U.S. Treasury securities generally represent the risk-free rate.

A-rated and BBB-rated corporate credit spreads widened as the flight-to-quality mentality negatively impacted lower-rated credit while benefitting AA and better corporates. Despite their AAA ratings, asset-backed securities (ABS) spreads were caught in the negative sentiment toward financials and widened in the quarter.

Credit Sector Relative Performance of ICE BofA Indexes



**AAA-A Corporate index underperformed the Treasury index by 12.9 bps.*

AAA-A Corporate index outperformed the BBB Corporate index by 19.5 bps

U.S. Financials underperformed U.S. Non-Financials by 68.3 bps

A rated and BBB rated credit underperformed higher quality debt on wider credit spreads. Not surprising given the deterioration in financial conditions, U.S. financials meaningfully underperformed non-financial corporate debt.

What strategic moves were made and why?

Taxable Portfolios – Despite the turmoil and financial market stress in March, fixed income returns were positive in the quarter for government and investment-grade credit. Overall, the decline in two-year and longer yields in the quarter and the significant coupon cushion now present in portfolios outweighed the impact of wider corporate and ABS spreads. As one would expect, credit spreads on banks' financials bore the brunt of the fallout from the failures of SVB and Signature Bank, along with the uncertainty around Credit Suisse, and underperformed industrials. The deepening yield curve inversion benefitted portfolios with a barbell structure and overweight to longer-duration debt. Portfolio book yields continued to climb as cash flows were reinvested into higher yielding instruments, particularly for very short portfolios, which benefitted from two additional Fed rate hikes. For our investment-grade universe, fundamental credit quality remains solid, although investor confidence has been dented by the events in March. While stresses are evident in the system, we do not believe any of our portfolio holdings represents a threat to principal.

Tax Exempt and Tax-Efficient Portfolios – The last few months have been a turbulent period for short-term municipal bond investors with rates moving sharply in both directions. The interest rate volatility was both a function of the changing economic environment and strong reinvestment flows from bond maturities and coupon payments. New issue supply, or lack of it, was an impediment to meaningful duration management. Municipalities raised just under $62 billion during Q1, which was about $20 billion less than Q1 2022. The Securities Industry and Financial Markets Association Municipal Swap Index (SIFMA), a measure of variable rate demand notes, averaged 2.85% during the quarter. Variable rate demand notes (VRDNs) were purchased due to higher current yields versus fixed rate alternatives. We were also active buyers of taxable municipal bonds in February and early March. The yields on these securities far exceeded the income offered by traditional municipals on a taxable equivalent comparison. Late in the quarter, we added duration with 3-year tax-exempt bonds. These extension trades were initiated primarily due to tax-free accounts being well below benchmark levels.

How are you planning on positioning portfolios going forward?

Taxable Portfolios – We anticipate the Fed will raise rates 25 bps at the May 3 meeting and pause after reaching its stated federal funds target range of 5.00% to 5.25%. Of more importance, our outlook is for the Fed to maintain these levels and not cut rates in 2023. Our outlook is for the economy to enter a shallow recession, but with inflation remaining elevated and core services inflation to be stickier than anticipated. We believe the Fed will prioritize inflation over economic growth, and as a result, quarter-end yield curve levels are too low and do not reflect our anticipated path of Fed policy. Given this outlook and the steep inversion of the yield curve, we will position portfolios mildly short-to-benchmark duration with a focus on overweighting front-end positions to capture higher yields. We will look to bring portfolios closer to neutral should rates back up, as bond markets remain skittish and vulnerable to sharp short-term declines in yields. Tactics to accomplish our front-end strategy include short-term commercial paper and SOFR-based floating-rate debt, which are currently providing yields well above 5.0%. Yields on callable agency debt have benefitted from recent yield curve volatility and offer rates comparable to single-A industrial corporates while assuming call risk in lieu of credit risk. Slowing growth, declining corporate profitability and recent financial system stress all argue for enhanced scrutiny of issuers and security selection, such as focusing on bank-level debt rather than holding company debt. Auto, credit card and equipment loan ABS remain a favored sector on continued consumer resilience and strong underlying credit metrics.

Tax Exempt and Tax-Efficient Portfolios – We remain intent on moving durations for municipal mandates closer to benchmark levels. Ideally, we would like to see some further retracement of the March move before initiating those extension trades. However, we are also cognizant of the strong municipal technical conditions during the June-August period. Supply is likely to be an even greater challenge during this time. We also acknowledge that, while not our base case, risks for a harder economic landing have increased recently. VRDN/cash sweep allocations are expected to provide attractive income in the near term. Given the uncertain outlook, a mix of both fixed and variable rate investments remains prudent.

Sources

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