March 31, 2019

U.S. Bancorp Asset Management, Inc.

Quarterly Portfolio Manager Commentary

Cash Management Portfolios

Chief Investment Officer Jim Palmer

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

The Federal Reserve (Fed) exceeded market expectations for a more measured approach to monetary policy by signaling no 2019 rate hikes and ending balance sheet reduction by the end of September 2019. Markets applauded the Fed's commitment to patience but slowing U.S. and global growth – along with inversions of certain portions of the yield curve – have elevated investor concerns over a deeper economic slowdown.

Economic Activity – U.S. Gross Domestic Product (GDP) growth likely decelerated in the first quarter to 1.0% - 2.0%, lower than the fourth quarter's 2.2% pace. Transitory factors including the partial federal government shutdown, severe winter weather and the hangover from December's market swoon almost certainly had a negative impact on first quarter growth. The slowdown was reflected in March's ISM Manufacturing and Non-Manufacturing Index prints of 55.3 and 56.1, respectively, which while indicating continued expansion were also below levels seen for most of 2018. The ISM Non-Manufacturing Index reading – which represents a greater portion of U.S. GDP – was particularly disappointing and the lowest level seen since August 2017. Employment data were more mixed in the quarter, mirroring the overall economy. Non-farm Payrolls added a respectable 541,000 jobs in the quarter and the U3 and U6 Unemployment Rates fell to 3.8% and 7.3%, respectively. On the softer side, the labor force declined by 280,000 workers and Household Employment fell 197,000. Despite continued low unemployment rates, wage gains continued to be surprisingly restrained with March's Average Hourly Earnings posting a modest 3.2% year-over-year (YoY) gain. Inflation risks remain subdued with the most recent U.S. PCE Deflator and PCE Core prints rising 1.4% and 1.8% YoY, respectively, below the Fed's 2.00% target. The five-year TIPS vs. Treasury spread – a proxy for inflation expectations – recovered from a January 3rd low of 149.4 basis points (bps) to end the quarter at 179.7 bps. Investor sentiment has begun leaning toward concerns over the lack of inflation and the Fed's ability to counter deflationary secular forces such as demographics, technology and globalization.

Monetary Policy – The Fed held the federal funds target range at 2.25% - 2.50% at the March 20th meeting. Of greater importance, the Fed reversed previous guidance by changing its Dot Plot outlook to zero 2019 rate hikes from two in December. Further, the Fed announced significant adjustments to its balance sheet normalization path (a.k.a. quantitative tightening, or QT): QT will now conclude at the end of September 2019; the reduction in U.S. Treasury holdings will slow to $15 billion per month from $30 billion beginning in May 2019; and beginning in October 2019, reductions in agency and agency MBS debt will continue to be subject to a $20 billion monthly cap with principal payments reinvested in U.S. Treasuries roughly

Jim Palmer, CFA
Chief Investment Officer

Fed funds target rate:
225-250 basis points
Last Change: December 19, 2018

1-year Treasury Yield
March 31, 2019: 2.387%

-0.209%

Year-to-date

3-year Treasury Yield
March 31, 2019: 2.205%

-0.252%

Quarterly

Five-year Treasury Inflation-Protected Securities (TIPS) vs. Treasury breakeven rate: This rate is a snapshot of the current inflation expectations. The rate is calculated by subtracting the real yield on comparable maturity TIPS from the nominal Treasury yield. Example: If the nominal Treasury is yielding 2.68% and 5-year TIPS have a real yield of 1.20%, the market is currently pricing in expected inflation of 1.48% over the next 5 years.

matching the composition of Treasuries outstanding. Since the Fed's balance sheet reduction program began in October 2017, securities held outright and reserve balances have fallen $469.7B and $546.1B, respectively. The Fed's economic outlook was downgraded mildly in the March 20th releases. But during his press conference, Chairman Powell described the Fed's outlook as positive and underpinned by strong economic fundamentals, supporting the impression the Fed's dramatic reversal from its more hawkish policy outlook in late 2018 was primarily in response to December's tightening financial conditions and investor demands for greater patience and flexibility in Fed policy adjustments.

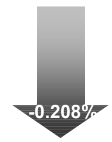
Fiscal Policy – After providing a lift to 2018 economic growth through corporate tax reform and tax cuts, fiscal policy is poised to drag on first quarter and overall 2019 growth. The partial federal government shutdown begun on December 22, 2018 ultimately lasted 35 days, lingering into January and chilling consumer spending and business confidence. The lack of progress on trade deals – with China in particular – continued to weigh on markets and hinder business planning and global trade. Further, the Trump Administration has floated potential proposals for shutting down the U.S.-Mexico border as part of a wider effort to stem the flow of undocumented workers entering the U.S. While nothing is concrete yet, such a move would complicate the transportation of goods across the border, further hindering trade and general commerce.

Credit Markets – Slowing global growth and diminishing inflation expectations have inverted certain portions of the U.S. Treasury yield curve, a phenomenon which historically has been a reliable predictor of future recessions. The strong performance of investment-grade and high-yield credit spreads tells a different story, with tightening spreads signaling expectations for continued economic strength. Market liquidity has noticeably improved from December's morass.

Credit Spread Changes

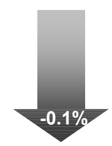
ICE BofAML Index	OAS* (bps) 12/31/18	OAS* (bps) 03/31/19	Change (bps)
1-3 Year U.S. Agency Index	5	5	0
1-3 Year AAA-A U.S. Corporate and Yankees	13	11	-2
1-3 Year AA U.S. Corporate and Yankees	52	37	-15
1-3 Year A U.S. Corporate and Yankees	75	51	-24
1-3 Year BBB U.S. Corporate and Yankees	127	89	-38
0-3 Year AAA U.S. Fixed-Rate ABS	53	36	-17
*OAS = Option-Adjusted Spread			

3-Month LIBOR
March 31, 2019: 2.6%



Year-to-date

Unemployment Rate
March 31, 2019: 3.8%



Year-to-Date

Source: Bloomberg

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.

Corporate Credit Relative Performance

ICE BofAML Index	Q1 2019 Relative Performance*
1-3 Year AAA-A U.S. Corporate and Yankees	1.484%
1-3 Year BBB U.S. Corporate and Yankees	2.133%
1-3 Year U.S. Financial	1.882%
1-3 Year U.S. Non-Financial Corporate	1.818%
1-3 Year U.S. Agency	0.967%
1-3 Year U.S. Treasury	0.984%

**AAA-A Corporate index outperformed the Treasury index by 50.0 bps in the quarter*
**AAA-A Corporate index underperformed the BBB Corporate index by 64.9 bps in the quarter*
**U.S. Financials outperformed U.S. Non-Financials by 6.4 bps in the quarter*

While declining yields boosted the returns of all fixed income indexes, the market's decidedly risk-on sentiment tightened credit spreads and rewarded credit investors. Lower-rated issuers outperformed higher-rated counterparts, but essentially all levels of credit risk benefitted from a meaningful tightening in spreads. Financials mildly outperformed their non-financial counterparts. Interestingly, agencies slightly underperformed Treasuries, likely due to increased call activity seen in the sector which muted the benefits of declining yields.

Yield Curve Shift

U.S. Treasury Curve	Yield Curve 12/31/18	Yield Curve 03/31/19	Change (bps)*
3 Month	2.355%	2.381%	+2.6
1 Year	2.596%	2.387%	-20.9
2 Year	2.488%	2.260%	-22.8
3 Year	2.456%	2.205%	-25.2
5 Year	2.511%	2.233%	-27.8
10 Year	2.684%	2.405%	-27.9

**Yield Spread between 3-month and 10-year U.S. Treasuries is 2.4 bps (flat but not inverted)*
**U.S. Treasury Yield Curve from 1 to 5 years flattened 6.9 bps and is inverted by 15.4 bps*
**U.S. Treasury Yield Curve from 2 to 10 years flattened 9 bps, but is not inverted*

March's decline in yields was largely due to the Fed's commitment to patience, highlighted by the Dot Plot's change to zero 2019 rate hikes from December's outlook for two. If anything, the yield curve began to anticipate the next policy move would be a rate cut. The wide inversion between three-month and two- and three-year yields clearly reflects investor expectations for a rate cut by year end. Quarter-end federal funds futures bolster that view with a 45% and 64% probability of rate cuts by the September 18th and December 11th meetings, respectively. The plunge in longer bond yields was likely turbo-boosted by mortgage investor hedging. Duration on mortgage-backed securities (MBS) tends to fall when interest rates decline as more home owners look to refinance at lower rates, forcing MBS and bond index investors to buy longer dated bonds and derivatives to maintain duration targets.

Duration Relative Performance

ICE BofAML Index	Duration (years)*	Q1 2019 Relative Performance**
0-1 Year U.S. Treasury	0.50	0.685%
0-2 Year U.S. Treasury	1.00	0.785%
0-3 Year U.S. Treasury	1.44	0.888%
1-3 Year U.S. Treasury	1.87	0.984%
1-5 Year U.S. Treasury	2.62	1.216%

**Duration estimate is as of 3/31/19*

***In general, shorter duration indexes underperformed longer indexes*

Given the sharp decline in U.S. Treasury yields, short-duration strategies noticeably underperformed longer duration strategies. Very short duration and money-market-like strategies benefitted from re-investment in higher-yielding instruments post the Fed's December 19th rate hike.

What strategic moves were made and why?

Taxable Portfolios – The U.S. Treasury yield curve and corporate credit spreads sent out unexpectedly different messages during the quarter. U.S Treasury yields continued to slide, triggered by slowing global growth, fading inflation expectations and the Fed's Dot Plot move toward no 2019 rate hikes. The decline in yields penalized the short-to-benchmark positioning in many of our strategies. After the Fed's complete capitulation to investor demands for patience at the March 20th meeting, we expected yields to be relatively range bound with minor risk of meaningful sell-offs or rallies. The sharp decline in yields in the latter half of March was a bit surprising, as was the severity of the turn in investor sentiment toward expectations for a 2019 rate cut. The strong performance of credit in the quarter was more in line with – but exceeded – our expectations and the tighter credit spreads benefitted our bias toward corporate, asset-backed securities (ABS) and bank debt. Portfolios with shorter maturities benefitted from re-investment into higher yielding instruments post the December 19th rate hike, although price gains from the decline in longer yields was muted for these strategies. Floating-rate notes (FRNs) performed well given the tightening of credit spreads, although LIBOR-based FRNs have or will be resetting at lower levels, as three-month LIBOR fell 21 bps in the quarter.

Tax Exempt and Tax-Efficient Portfolios – Slowing economic growth and further dovish shifts in Fed policy were the dominant themes, as municipals followed the broader trends toward lower fixed-income yields. Relative valuations for municipals remained rich relative to comparable Treasury securities. This was most evident in the front end of the yield curve where ratios hovered near 65%. While new issue supply is up 12% year to date, the majority of those bonds carried longer maturities to match the longer- term nature of the projects they were funding. Most of the investor demand has been concentrated shorter on the curve for various reasons – creating a significant imbalance. We continue to see municipal portfolio allocations decline across our tax-efficient strategies in favor of corporate investments based on relative value. With yields drifting lower during the quarter, we focused primarily on securities with maturities inside of 18 months. We expect better opportunities to emerge as it becomes evident that recession risks remain low and the economy will not require Fed cuts in 2019.

How are you planning on positioning portfolios going forward?

Taxable Portfolios – Previously, USBAM had forecasted one additional rate hike in late 2019, based on our opinion the Fed believed policy rates were below neutral and aspired to get there when more benign market conditions were met (financial market stability, sustainable growth, steeper yield curve, target inflation). We believed – and still believe – those conditions will be met in the back half of 2019, but the Fed's revised guidance has us changing our outlook to no rate hikes for 2019. We also do not expect the Fed to lower policy rates in 2019, despite fed funds futures predicting a 64% chance of 25 bps or more in rate cuts by the December 11th meeting. We remain optimistic on the durability of the current U.S. expansion, taking our lead from the tightening spreads in the corporate investment grade and high yield space rather than the inversion of the yield curve. The significant decline in yield curve levels in March was surprising, as our outlook was for relatively stable rates. Given our outlook for continued solid growth, we expect one- to five-year yields to be biased upward in the coming quarter with little room for meaningful declines absent a collapse in economic data or some form of financial market distress – neither of which are in our forecast. Credit spreads tightened significantly in the first quarter and we see little room for further spread compression. In such environments where the compensation for credit risk is reduced, USBAM strives to increase overall portfolio credit quality by focusing on higher quality / rated issuers and shortening the maturity tenor of low-A and BBB-rated companies. ABS backed by prime credit cards, auto loans and large equipment loans continue to be a favored sector with AAA-rated ABS tranches typically offering higher yields and lower event risk than mid-A industrials. ABS are also an excellent method to increase exposure to U.S. consumers, who are benefitting from low unemployment and growing wages.

Tax Exempt and Tax-Efficient Portfolios – The Fed has gone out of its way to reassure markets it will be taking a patient approach for 2019. We have changed our base case outlook accordingly to project a stable fed funds rate. Economic growth near 2% should be sufficient to provide an upward bias to the Treasury curve from the current low levels. These conditions would also be supportive of both municipal and corporate credit. Our expectation would be for corporates to remain in favor for tax-efficient mandates. We are mindful, however, of the significant spread tightening experienced in the first quarter. Our approach will be to look for issuers in the higher rating categories. BBB-rated names will likely be on a shorter maturity leash and could be considered as opportunistic sale candidates on a name by name basis.

Sources

Bloomberg

Federal Reserve Press Release and Projection Materials, FOMC Meeting, December 19, 2018

Federal Reserve Press Release and Projection Materials, FOMC Meeting, March 20, 2019

Federal Reserve Press Release, Balance Sheet Normalization Principles and Plans, March 20, 2019

4/2019 0046-19