usbancorp 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?

After raising policy rates throughout 2018, the Federal Reserve (Fed) pivoted toward easing monetary policy, with markets pricing in a 100% probability the Fed will cut rates at least 25 basis points (bps) at the July 31st meeting. The Fed's dovishness supported risk assets and pushed equity markets toward record highs. U.S. growth slowed in the second quarter, as the disruption from President Trump's capricious strategy of threatening tariffs for both economic (China) and non-economic (Mexico) reasons weighed on business and consumer confidence.

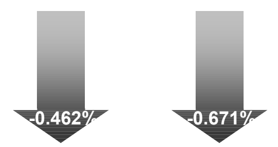
Economic Activity – After posting a surprisingly strong 3.1% growth rate in the first quarter, U.S. Gross Domestic Product (GDP) decelerated in the second quarter to an expected 1.0% - 2.0% pace. Trade and tariff concerns weighed on the economic outlook, triggering a decline in both manufacturing output and business confidence – a critical component of future investment. Employment conditions remain solid, but have slowed as the expansion cycle matures. Monthly Non-farm Payrolls averaged 171,000 jobs in the quarter, strong enough to put downward pressure on the current 3.7% U-3 Unemployment Rate, but below 2018's monthly average gain of 223,000 jobs. Importantly, high employment levels have failed to translate into outsized wage gains, highlighted by the well-contained June Average Hourly Earnings 3.1% year-over-year (YoY) print. The ISM Manufacturing and Non-Manufacturing indices both declined in June to 51.7 and 55.1, respectively, although each sector reflects continued growth. Inflation remains muted and well below the Fed's symmetrical target of 2%. May's U.S. PCE Deflator and Core PCE – the Fed's preferred measure of inflation – rose only 1.5% and 1.6% YoY, respectively, in May. The five-year TIPS vs. Treasury spread – a proxy for inflation expectations – ended the quarter at 1.54%, down 34 bps from the April 23rd high of 1.88%. Slow global growth rates have been a headwind to the U.S., with China posting its lowest growth rate in a decade at 6.4% YoY and Japan and Europe hovering around 1.0% and 2.0% YoY, respectively.

Monetary Policy – The Fed held the federal funds target range at 2.25% - 2.50% at the May 1st and June 19th meetings. However, Chairman Powell and the Fed have signaled a clear willingness to lower policy rates. At his July 10th testimony before Congress, Chairman Powell cited concerns that "crosscurrents, such as trade tensions and concerns about global growth, have been weighing on economic activity and the outlook." Those comments, coupled with observations that inflation remains persistently below the Fed's 2% symmetrical target, were in harmony with market expectations and likely cemented a 25 bp rate cut at the July 31st meeting. Further, in his testimonies before Congress, Chairman Powell downplayed

Jim Palmer, CFA
Chief Investment Officer

Fed funds target rate:
225-250 basis points
Last Change: December 20, 2018

1-year Treasury Yield
June 30, 2019: 1.925%



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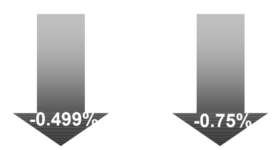
3-year Treasury Yield
June 30, 2019: 1.706%



Quarterly | Year-to-date

the link between low unemployment and inflation, undermining what had previously been considered a key rationale for the Fed's rate hike cycle. Post-testimony, federal funds futures priced in a 72% probability of an additional 25 bp rate cut in September and a 52% chance of a third rate cut by the end of 2019. Addressing direct challenges from the Executive branch to Fed independence, Chairman Powell stated during testimony he would not resign if asked by President Trump.

Fiscal Policy – Increased trade tensions between the U.S. and China have had a dampening impact on business confidence and spending, slowing manufacturing activity and lowering Q2 GDP expectations in the process. After meeting with Chinese Chairman Xi at the June G20 meeting, President Trump decided not to levy additional 25% tariffs on Chinese goods based on progress made with trade talks. The development heartened risk markets but will require follow-through to bolster business investment. Concerns over the Federal debt ceiling – currently anticipated to be reached in late September / early October – have become more pronounced, with lawmakers and analysts acknowledging the increased risk and potential disruption to markets as the debt ceiling approaches without a legislative solution.

Credit Markets – Yield curve levels continued to fall in the quarter, driven by the Fed's pivot toward easing policy rates, slowing global growth, low inflation expectations and U.S. / China trade concerns. The three-month to ten-year portion of the yield curve inverted during the quarter, which historically has been viewed as a reliable signal of future recession. Countering the inverted yield curve, relatively low and stable BBB and high-yield spreads, coupled with an upward sloping U.S. corporate credit curve, suggest a U.S. recession is not imminent. Further, longer-term U.S. yields are almost certainly being driven lower by the extremely low or negative rates seen in Europe and Japan as well as strong U.S. pension fund demand for longer duration assets, which exacerbates the inversion of the yield curve.

Yield Curve Shift

U.S. Treasury Curve	Yield Curve 03/31/19	Yield Curve 06/30/19	Change (bps)*
3 Month	2.381%	2.087%	-29.4
1 Year	2.387%	1.925%	-46.2
2 Year	2.260%	1.755%	-50.5
3 Year	2.205%	1.706%	-49.8
5 Year	2.233%	1.766%	-46.7
10 Year	2.405%	2.005%	-40.0

**Yield Spread between 3-month and 10-year U.S. Treasuries is -8.2 bps*

3-Month LIBOR
June 28, 2019: 2.320%

-0.280% Quarterly
-0.488% Year-to-date

Unemployment Rate
June 30, 2019: 3.7%

-0.1% Quarterly
-0.2% Year-to-Date

Source: Bloomberg

Duration Relative Performance

**Duration estimate is as of 6/30/19*

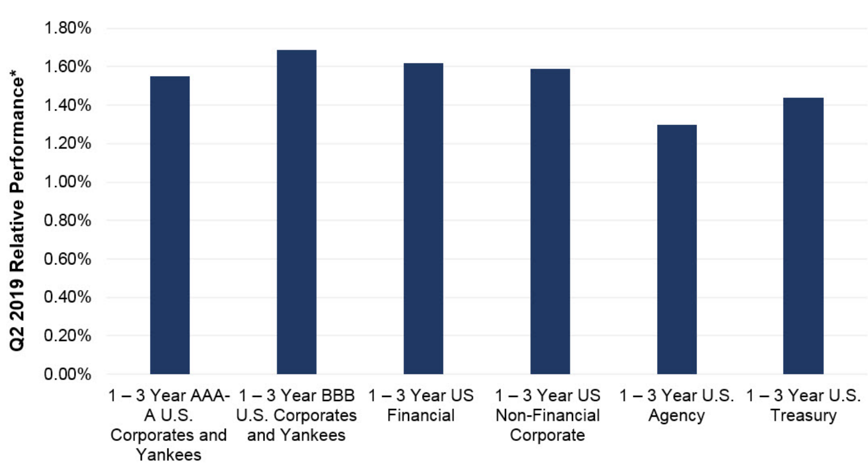
As expected given the sharp decline in U.S. Treasury yields, short-duration strategies noticeably underperformed longer-duration strategies.

Credit Spread Changes

ICE BofAML Index	OAS* (bps) 03/31/19	OAS* (bps) 06/30/19	Change (bps)
1-3 Year U.S. Agency Index	5	2	-3
1-3 Year AAA-A U.S. Corporate and Yankees	11	10	-1
1-3 Year AA U.S. Corporate and Yankees	37	39	2
1-3 Year A U.S. Corporate and Yankees	51	54	3
1-3 Year BBB U.S. Corporate and Yankees	89	91	2
0-3 Year AAA U.S. Fixed-Rate ABS	36	36	0
		*OAS = Option-Adjusted Spread	

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 of BofAML Indices



**AAA-A Corporate index outperformed the Treasury index by 11.2 bps in the quarter.*

AAA-A Corporate index underperformed the BBB Corporate index by 13.7 bps in the quarter.

U.S. Financials outperformed U.S. Non-Financials by 3.0 bps in the quarter.

Declining yields continued to boost the absolute returns of all fixed-income indices. Credit spreads were essentially unchanged in the quarter, with credit outperforming Treasuries on higher coupon income. Financials mildly outperformed their non-financial counterparts. Agencies meaningfully underperformed Treasuries in the quarter despite comparable yields, likely due to increased call activity seen in the sector which muted the benefits of declining yields on the price return of the index.

What strategic moves were made and why?

Taxable Portfolios – The significant drop in U.S. Treasury yields drove absolute returns of fixed-income portfolios higher, but was a decided negative for relative performance of shorter portfolios or portfolios which were short to their benchmark durations. The decline in market yields reflected slowing global growth, stubbornly low inflation measures and expectations for Fed rate cuts in the future. The Fed's pivot toward accommodation was at least partially influenced by equity and bond investors' demand for easing, putting the Fed in the awkward position of following markets rather than being data dependent as previously claimed. The federal funds futures market has baked in a July 25 bp rate cut with a roughly 50/50 chance of three rate cuts by year end. After credit's strong first quarter performance, there was less room for price gains from spread compression and spread product essentially outperformed U.S. Treasuries on incremental coupon income. Investment-grade credit quality remains solid. USBAM views the idiosyncratic risk associated with individual company mergers and acquisitions as a threat to public ratings rather than to principal.

Tax Exempt and Tax-Efficient Portfolios – Intense demand for tax-exempt bonds continued as muni bond fund inflows surpassed most annual levels at only the half-way point for the year. Fueled by the SALT deduction caps, these year-to-date contributions exceed $45 billion. New issue supply is only 1.7% ahead of last year's pace. Fixed-income yields in all sectors moved lower in response to escalating trade tensions and moderating economic growth. These market conditions made it difficult to find attractive investment options. We sold into the strength for some tax-efficient mandates, replacing municipal positions with higher income corporate bonds. We were cautious about locking in low yields past two years, although we did participate to a limited degree mainly as insurance against extreme interest rate scenarios. Better relative valuations for munis (post May's Treasury rally) and a strong seasonal period expected over the upcoming months moderately increased our comfort level with extending muni only mandates. Municipal yield changes tend to be less volatile in both directions – the recent quarter seeing one- to five-year maturities declining 25 bps vs. 50 bps for comparable duration Treasuries.

How are you planning on positioning portfolios going forward?

Taxable Portfolios – Clearly, USBAM's outlook for no rate cuts in 2019 played against our short duration strategy in the second quarter and was reflected in relative performance. That said, we believe the federal funds market is overpricing the magnitude of future rate cuts which, in turn, has pushed the yield curve below what we view as fair value. To be sure, Chairman Powell offered no pushback to market expectations for a July rate cut and certainly seemed to enjoy the friendly welcome from lawmakers at his Congressional testimonies – leading many to believe Mr. Powell is a hidden dove on monetary accommodation. However, we remain optimistic on the durability of the current U.S. expansion and look for growth rates to recover toward trend growth of 2.5% after the trade and tariff induced slowdown seen in the second quarter. Our Fed call includes a July 31st rate cut of 25 bps with a bias toward an additional September rate cut. Regardless, firming economic data should remove some of the more aggressive rate cut expectations which should put upward pressure on yield curve levels. For credit and spread product, credit spreads reflect fair but not particularly compelling valuation with little opportunity for further spread compression. In 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. Asset-backed securities (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 benefiting from low unemployment and growing wages.

Tax Exempt and Tax-Efficient Portfolios – A high level of uncertainty around the outlook for Fed policy is creating a challenging investing environment to say the least. With several interest rate cuts already priced into the market, the value in adding duration as insurance against a more dovish Fed is seemingly limited. If markets were to rally further in anticipation of more easing, we would need to carefully consider selling into that strength. Lower-rated securities are good sell candidates. While our base case outlook remains for moderate growth, swaps moving up in credit are worth evaluating and perhaps the best way to currently guard against alternative economic outcomes.

Sources

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Federal Reserve Press Release and Projection Materials, FOMC Meeting, June 19, 2019

Federal Reserve Chair Jerome Powell, Semiannual Monetary Policy Report to the Congress, July 10, 2019