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?

The U.S. economy and financial markets showed resilience and strength in the fourth quarter, buoyed by accommodative Federal Reserve (Fed) policies, brightening trade prospects and solid consumer health. Manufacturing measures continued to struggle but were offset by strengthening in the much larger non-manufacturing sector. Over the past 12 months, the S&P 500 and NASDAQ indexes gained a robust 28.9% and 35.2%, respectively, on a straight price change basis. Financial conditions are decidedly more positive entering 2020 than was the case in 2019, when a government shutdown, wider credit spreads and Fed tightening conspired to send global equity markets into a tailspin.

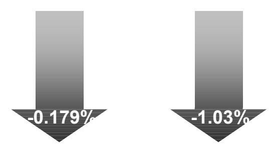
Economic Activity – Fourth quarter U.S. Gross Domestic Product (GDP) is forecast to grow in the 2.5% range, accelerating from the third quarter's respectable 2.1% pace. December's ISM Manufacturing Index fell to 47.2 after beginning the year at 54.3, reflecting significant sector contraction as investment spending waned in the wake of trade policy uncertainty earlier in the year. December's ISM Non-Manufacturing Index steadied to 55.0, further recovering from September's three-year low reading of 52.6. December's employment report was a mixed bag. The U3 Unemployment Rate remained at 3.5% while Non-farm Payrolls rose 145,000 – slightly below estimates – along with a negative 14,000 in revisions to previous data. Average Hourly Earnings rose .11%, bringing the year-over-year increase to a mild 2.87%. On the brighter side, Household Employment and the Labor Force rose 267,000 and 209,000, respectively, in December. The U6 Underemployment Rate – the broadest measure of unemployment – fell to a record low of 6.7%. Inflation remains stubbornly below the Fed's 2.0% target level, with November's U.S. PCE Core Price Index – the Fed's preferred measure of inflation – checking in at 1.612%. There was mixed progress with inflation expectations in the quarter. On the positive side, the five-year TIPS vs. Treasury spread ended the quarter at 1.70%, up 25 basis points (bps) from the intra-quarter low of 1.45% on October 31st. Countering the trend, the University of Michigan's survey, Expected Change in Prices During the Next 5 to 10 Years, fell to a near 40-year low of 2.2%.

Monetary Policy – The Fed cut the federal funds target range 25 bps at the October 30th meeting to a target range of 1.50% – 1.75% and left policy rates unchanged at the December 11th meeting. Fed officials signaled the Fed's most likely path was an extended pause in mid-cycle rate adjustments. The Fed's Dot Plot forecast indicated a single 25 bp rate hike in 2021 and a long-term target rate of 2.50%, which likely reflects the Fed's belief current policy rates are below neutral rather than a true forecast for the next policy action. In response to rate spikes seen in repo and the Secured Overnight Financing Rate (SOFR), the Fed flooded the market with liquidity through

Jim Palmer, CFA
Chief Investment Officer

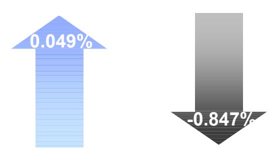
Fed funds target rate:
150-175 basis points
Last Change: October 30, 2019

1-year Treasury Yield
December 31, 2019: 1.566%



Quarterly | Year-to-date

3-year Treasury Yield
December 31, 2019: 1.609%



Quarterly | Year-to-date

overnight and term repo facilities to manage year-end funding demands. The Fed's actions were effective, as year-end repo levels traded within the federal funds target range. Chairman Powell suggested longer-term structural changes to managing the federal funds rate – including regulatory adjustments to bank liquidity requirements and standing repo facilities – require further study. The Fed will continue to purchase $60 billion in T-bills at least into April to ensure ample reserves are present in the banking system. If needed, the Chairman said the Fed is open to expanding balance sheet purchases into coupon Treasuries in addition to T-bills.

Fiscal Policy – U.S. / China trade tensions eased in December after the two countries agreed to phase one of a trade agreement expected to be signed in January. The deal is modest, with the U.S. cancelling a new round of tariffs which had been scheduled to take effect on December 15th in exchange for China purchasing more agricultural products and enhancements to intellectual property protections. While the deal's immediate impact on U.S. GDP is marginally positive, expected improvements in CEO and business confidence should provide an additional boost to the economy. Election and impeachment politics will dominate Washington's attention with little in the way of fiscal stimulus expected. Dysfunction surrounding the Presidential election will be a key market risk in the latter half of 2020, providing the Fed further cause to err toward patience or accommodation.

Credit Markets – The U.S. Treasury yield curve steepened noticeably in the quarter, relieving some of the recession risk implied by this historically relevant indicator. The decline in one-year and shorter yields was primarily driven by the Fed's October 30th rate cut while longer yields turned higher on the Fed's stated commitment to pausing mid-cycle rate adjustments and a brighter economic outlook. Another positive sign for financial conditions is the $5.77 trillion decline in the Barclays Global Aggregate Negative Yielding Debt from the August 29th high of $17.04 trillion. Credit continued to outperform Treasuries. BBB credit in particular saw significant spread tightening in the quarter despite the persistent hand-wringing by analysts of overvaluation and deteriorating credit standards. Global demand for yield continues to be the most powerful driver of U.S. corporate debt performance.

Yield Curve Shift

U.S. Treasury Curve	Yield Curve 09/30/19	Yield Curve 12/31/19	Change (bps)*
3 Month	1.807%	1.544%	-26.3
1 Year	1.745%	1.566%	-17.9
2 Year	1.622%	1.569%	-5.3
3 Year	1.560%	1.609%	4.9
5 Year	1.544%	1.691%	14.7
10 Year	1.665%	1.917%	25.2

The 3-month to 10-year portion of the yield curve steepened 51.5 bps in the quarter and has not been inverted since October 10, 2019. The 2-year to 10-year portion of the yield curve steepened 30.5 bps in the quarter and has not been inverted since August 30, 2019.

3-Month LIBOR
December 31, 2019: 1.908%

-0.177% Quarterly

-0.899% Year-to-date

Unemployment Rate
December 31, 2019: 3.5%

Unchanged Quarterly

-0.4% Year-to-Date

Source: Bloomberg

Duration Relative Performance

**Duration estimate is as of 12/31/19*

In general, shorter duration indexes outperformed their longer counterparts. The significant steepening of the yield curve and the jump in yields for maturities three years and longer negatively impacted indexes and portfolios with exposure to securities in this sector.

Credit Spread Changes

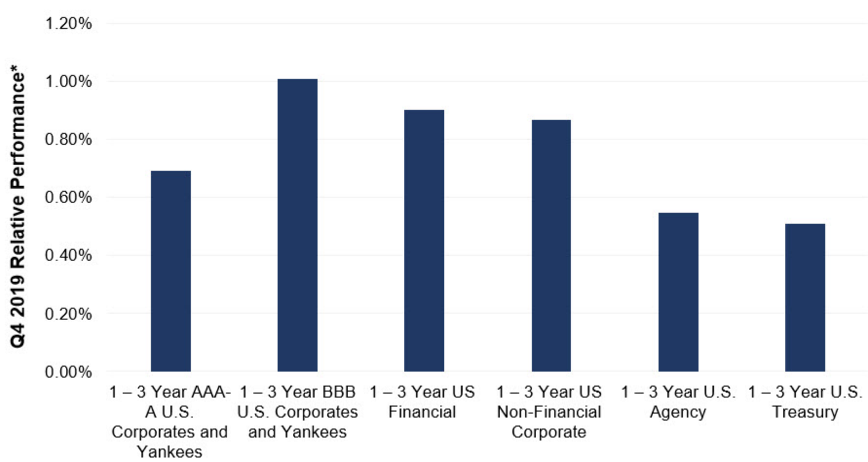
ICE BofAML Index	OAS* (bps) 09/30/19	OAS* (bps) 12/31/19	Change (bps)
1-3 Year U.S. Agency Index	3	3	0
1-3 Year AAA-A U.S. Corporate and Yankees	8	10	2
1-3 Year AA U.S. Corporate and Yankees	30	27	-3
1-3 Year A U.S. Corporate and Yankees	48	40	-8
1-3 Year BBB U.S. Corporate and Yankees	80	68	-12
0-3 Year AAA U.S. Fixed-Rate ABS	34	42	8

*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 spreads grinded tighter in the quarter. AAA-rated ABS spreads widened in the quarter with most of the adjustment occurring in the back-half of December, most likely due to light year-end trading and dealer balance sheet window dressing rather than a dramatic weakening in investor sentiment.

Credit Sector Relative Performance of ICE BofA Indexes



**AAA-A Corporate index outperformed the Treasury index by 18.2 bps in the quarter.*

AAA-A Corporate index underperformed the BBB Corporate index by 31.8 bps in the quarter.

U.S. Financials outperformed U.S. Non-Financials by 3.7 bps in the quarter.

Fourth quarter U.S. corporate credit performance benefitted from tighter spreads with a general trend of lower-rated credit outperforming higher-rated credit. Financials mildly outperformed their non-financial counterparts. Agencies outperformed Treasuries by 3.6 bps in the quarter.

What strategic moves were made and why?

Taxable Portfolios – The U.S. Treasury yield curve steepened in the quarter. The October 30th Fed rate cut pushed yields in the zero- to two-year portion of the curve down, while improved growth and trade prospects – along with the Fed's commitment to pausing mid-cycle rate cuts – pushed yields for maturities greater than two years higher. As a result, short duration indexes and portfolios outperformed their longer-term counterparts. Despite the climb in longer rates, zero- to five-year benchmark returns were positive, with coupon income overcoming the negative price impact of higher rates. Credit continued its impressive run vs. Treasuries, benefitting from incremental coupon income and price appreciation from spread tightening. Overall, BBB category credit strongly outperformed its AAA-A rated counterparts. Investment-grade credit quality remained solid with few meaningfully negative ratings actions in the quarter. Financials marginally outperformed non-financials in the one- to three-year space. USBAM views the idiosyncratic risk associated with individual company headline risk as a threat to public ratings rather than to principal.

Tax Exempt and Tax-Efficient Portfolios – The trend for the fourth quarter was toward slightly lower municipal yields, though with good market timing and security selection, we were able to find some pockets of opportunity. Trading activity was laddered with maturities from six months to three years. Our rationale for this yield curve positioning reflected an outlook for fairly stable short-term rates over the coming year. Municipal vs. Treasury relative ratios (two-year maturities) reached 2019 highs and briefly hovered near 80% early in the quarter. Corporates, however, remained the favored option for tax-efficient accounts due to after-tax yield advantages and a supportive credit environment.

How are you planning on positioning portfolios going forward?

Taxable Portfolios – With policy risks decidedly skewed toward patience and accommodation over tightening, we expect the short-end of the yield curve – defined as five-years and in – to spend the next several months trading within a band of 1.50% to 1.70%. We would view rates above 1.60% as an opportunity to extend duration and bring portfolios closer to neutral vs. their benchmarks. For credit and spread product, credit spreads are tight on a historical basis, but are reasonably valued given our outlook for continued growth and monetary accommodation. In environments where the compensation for credit risk is reduced, USBAM strives to increase overall portfolio credit quality by focusing on higher quality / higher rated issuers and shortening the maturity tenor of low-A and BBB-rated companies. Additionally, tighter credit spreads and lower Treasury yields provide an opportunity to sell positions in issuers which may have fallen out of favor, been recently downgraded or are significantly overvalued, which in turn provides dry powder to re-engage credits at wider spreads or to re-invest in higher-quality debt. AAA-rated asset-backed securities (ABS) backed by prime credit cards, auto loans and large equipment loans are an effective option to obtain mid-A industrial-type spreads with higher ratings and reduced headline risk. ABS are also an excellent method to increase exposure to U.S. consumers, who are benefitting from low unemployment and growing wages. The spread between three-month LIBOR and two-year Treasuries tightened in the fourth quarter, but remains attractive at approximately 35 bps, making LIBOR-based floating-rate notes a compelling investment opportunity based on higher up-front coupon yields.

Tax Exempt and Tax-Efficient Portfolios – Our preference is to reinvest upcoming maturities toward the longer-end of portfolio limits, but we will continue to be opportunistic. The historically heavy redemption months of January and February will likely present challenges in the municipal market. We suspect timing will improve into March and April, potentially allowing us to be more aggressive. For tax-efficient investing, tight corporate credit spreads are a bit of an obstacle, although the environment is expected to remain supportive in the year ahead. Many strategists are forecasting a surge in taxable municipal issuance. As the spreads become more compelling, we may look to increase allocations to these investments, while also enjoying some diversification benefits.

2020 Outlook

U.S. GDP should grow at the current modest but durable range of 2.0% to 2.5%, with low recession risk over the next 12 months. Key factors influencing our views include:

- Strong labor market and consumer spending conditions are expected to outweigh tepid manufacturing and business investment growth.
- Monetary stimulus will provide a tailwind for 2020 growth as the 75 bps in 2019 Fed rate cuts and renewed balance sheet expansion work through the typical one- to two-year lag time.
- The lack of excesses built-up in the real economy reduces recession risk.
- With GDP growth heavily tilted toward consumer spending, the large jump in household net worth from stock market gains provides a solid floor for 2020 growth. However, extended equity valuations and tight credit spreads leave financial markets especially vulnerable to unforeseen shocks and risks.

Our base case outlook is for the Federal Reserve to maintain current policy rates through 2020. Policy risk to our outlook is decidedly skewed toward further accommodation, with virtually no risk of a 2020 rate hike. The reasons for our call are varied:

- Policymakers have signaled a willingness to allow inflation to exceed their 2% target and believe there is untapped capacity in the labor markets.
- Prevailing macro risks (examples: trade, Iran, stretched market valuations) are more negatively biased.
- The risk of financial market volatility caused by political dysfunction in the November elections seems unusually high this year, bolstering the case for patience and accommodation over rate hikes in the back half of 2020.
- We expect the Fed to extend the $60 billion T-bill purchase program beyond April, until bank reserves are ample enough to unclog funding flows. The Fed will ultimately extend the current asset purchase program into coupon notes – pushing the current policy objective away from building bank reserves toward full-blown quantitative easing.
- While year-end funding pressures were kept firmly under control by the Fed's massive liquidity injections in the fourth quarter, the underlying causes of the repo spike persist and have not been fully addressed. We expect more permanent repo facilities will be created in the coming year to boost bank lending liquidity.

Sources:

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