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?

Positive economic data bolstered risk assets, tightened credit spreads and sent Treasury yields higher in the quarter. The Federal Reserve (Fed) continued to normalize monetary policy through rate hikes and balance sheet reduction at a self-described gradual pace. Trade conflicts continue to influence markets, but the impact on the real economy has been muted to date.

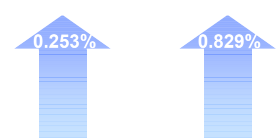
Economic Activity – While down from the second quarter's robust 4.2% growth rate, U.S. Gross Domestic Product is forecasted to grow in the 3.0% to 3.5% range in the fourth quarter, a healthy pace expected to continue into 2019. September's ISM Manufacturing and Non-Manufacturing readings of 59.8 and 61.6, respectively, reflect considerable strength and argue for a sustainable expansion. The labor market showed no sign of losing momentum with the U3 Unemployment Rate falling to 3.7% and Initial Jobless Claims averaging 211,000 in the quarter – both near 49-year lows. September's Non-farm Payroll (NFP) reading of +134,000 jobs was soft relative to expectations – likely weakened by Hurricane Florence – but was offset by a positive revision of 87,000 jobs in July and August's readings. Overall, NFP added a healthy 569,000 jobs in the quarter. The Civilian Labor Force fell 214,000 workers in the quarter while Individuals Not in the Labor Force rose a disappointing 862,000. Despite the combination of employment growth and a decline in available workers, September's Average Hourly Earnings – a widely watched harbinger of wage-push inflation pressures – rose just 0.3% month-over-month (MoM) and 2.8% year-over-year (YoY). Inflation measures have essentially reached the Fed's 2% target, with August's Consumer Price Index reaching 2.7% YoY and August's Core Personal Consumption Expenditure Index – the Fed's preferred inflation measure – up 2.0% YoY. Leading indicators suggest the risk of a U.S. recession is low through 2020. Near-term risks to the expansion and financial market stability include overly-hawkish Fed policies, emerging market stress and a meaningful escalation of trade conflicts.

Credit Markets – Positive economic data and a general risk-on investor mentality tightened credit spreads across the board, with lower rated issuers performing particularly well. Three-month LIBOR began trending higher on the September 26th rate hike, but overall gains after the first quarter's big 61.7 basis point (bps) move upward have been subdued. Market technicals are supportive of corporate credit, with issuance declining as repatriated profits are being utilized to support dividends, share repurchases and paying off maturing debt.

Jim Palmer, CFA
Chief Investment Officer

Fed funds target rate:
200-225 basis points
Last Change: September 26, 2018

1-year Treasury Yield
September 28, 2018 : 2.567%



Quarterly Year-to-date

3-year Treasury Yield
September 28, 2018: 2.884%

Quarterly Year-to-date

Credit Spread Changes

ICE BofAML Index	OAS* (bps) 6/30/18	OAS* (bps) 9/30/18	Change (bps)
1-3 Year U.S. Agency Index	8	5	-3
1-3 Year AAA-A U.S. Corporate and Yankees	18	14	-4
1-3 Year AA U.S. Corporate and Yankees	51	38	-13
1-3 Year A U.S. Corporate and Yankees	64	48	-16
1-3 Year BBB U.S. Corporate and Yankees	95	77	-18
0-3 Year AAA U.S. Fixed-Rate ABS	48	34	-14
*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

ICE BofAML Index	Q3 2018 Relative Performance*
1-3 Year AAA-A U.S. Corporate and Yankees	0.572%
1-3 Year BBB U.S. Corporate and Yankees	0.812%
1-3 Year U.S. Financial Index	0.753%
1-3 Year U.S. Non-Financial Index	0.697%
1-3 Year U.S. Treasury	0.195%

**AAA-A Corporate index outperformed the Treasury index by 37.7 bps in the quarter*

**AAA-A Corporate index underperformed the BBB Corporate index by 24 bps in the quarter*

**U.S. Financials outperformed U.S. Non-Financials by 5.6 bps in the quarter*

Buoyed by strong GDP numbers and investor demand for risk assets, corporate credit and spread product handily outperformed comparable-duration Treasuries in the quarter with the BBB sector performing particularly well. Credit spreads tightened virtually across the board, adding further return to the embedded coupon income advantage. Not unexpectedly given the favorable credit environment, financials outperformed their industrial counterparts. Technicals provided support for corporate debt performance, as year-to-date through August, new issue investment-grade corporate debt issuance has declined 17.3% from $1,145 billion in 2017 to $947 billion.

Yield Curve Shift

U.S. Treasury Curve	Yield Curve 6/30/18	Yield Curve 9/30/18	Change (bps)*
3 Month	1.912%	2.196%	28.4
1 Year	2.312%	2.563%	25.1
2 Year	2.528%	2.819%	29.1
3 Year	2.622%	2.883%	26.1
5 Year	2.738%	2.953%	21.5
10 Year	2.860%	3.061%	20.1

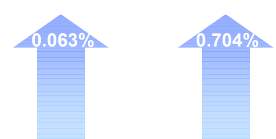
**Interest rose across the yield curve in the quarter*

**U.S. Treasury Yield Curve from 1 to 5 years flattened 3.6 bps*

**U.S. Treasury Yield Curve from 2 to 10 years flattened 9.0 bps*

3-Month LIBOR

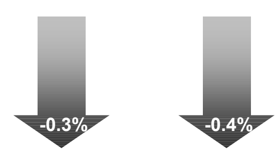
September 28, 2018: 2.398%



Quarterly Year-to-date

Unemployment Rate

September 30, 2018: 3.7%



Quarterly Year-to-Date

Source: Bloomberg

Duration Relative Performance

ICE BofAML Index	Duration (years)*	Q3 2018 Relative Performance**
0-1 Year U.S. Treasury	0.50	0.491%
0-2 Year U.S. Treasury	1.00	0.390%
0-3 Year U.S. Treasury	1.42	0.293%
1-3 Year U.S. Treasury	1.87	0.195%
1-5 Year U.S. Treasury	2.64	0.051%

**Duration estimate is as of 9/30/18*

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

Continuing a general trend in 2018, U.S. Treasury yields rose across the curve in the quarter, allowing short-duration strategies to outperform their longer-term counterparts. The upward jump in rates reflects the late June and September 26th Fed rate hikes as well as the anticipation of additional hikes in December and 2019. The yield curve flattened in the quarter, as the Fed-induced increase in short-term rates, outpaced the rise in longer-term rates which tend to move on overall growth and inflation outlooks.

Monetary Policy – As fully expected by the markets, the Fed raised the federal funds (fed funds) target range 25 bps to 2.00% - 2.25% at the September 26th meeting. The accompanying Fed Dot Plot predicted one additional rate hike in 2018 and three more in 2019. The Fed remains upbeat on employment conditions, forecasting a 3.5% U3 Unemployment Rate for 2019 and 2020 – far below the expected longer run rate of 4.5%. Core PCE Inflation is projected to increase to 2.1% in 2019 and 2020, reflecting the Fed's confidence in sustaining its 2% longer run goal while downplaying the risk of meaningfully higher inflation. In the September 26th statement, the Fed continued to expect further gradual increases in the fed funds rate – which the market has interpreted as maintaining the current every other meeting pace – while removing language stating the stance of monetary policy remains accommodative. Fed Chairman Powell seemed to contradict the latter comment when in an October 3rd interview he suggested "interest rates are still accommodative" and that the Fed "may go past neutral. But we're a long way from neutral at this point, probably." The contradiction alarmed investors, lifting interest rates further and steepening the yield curve. The Fed continues to taper principal re-investments of maturities and mortgage pay downs in its portfolio, ultimately reaching its maximum cap of $50 billion in securities purchase reductions per month in the fourth quarter. Since the Fed's balance sheet reduction program began in October 2017, securities held outright and reserve balances have fallen $242.9B and $340.9B, respectively.

Fiscal Policy – The Trump Administration continued to aggressively pursue revised trade agreements through both enacting and threatening large scale tariffs. In a positive development for markets, the U.S., Canada and Mexico agreed to a revised NAFTA agreement – now called USMCA. While the differences may be relatively minor, the agreement was hailed as a victory by the Trump Administration and seemed to bolster the President's resolve on trade conflicts. Hopes for an early resolution to trade hostilities with China have faded, particularly after a Bloomberg News report of Chinese hacking of microchips in U.S. computer networks and President Trump's accusation of Chinese meddling in U.S. elections.

Recent corporate tax reductions continue to work their way through the economy and financial markets, supporting equity markets with higher expected after-tax returns and impacting corporate capital flows, including new corporate debt issuance. Net U.S. Treasury issuance is expected to increase significantly in the coming quarters as tax cuts and increased federal spending push annual fiscal deficits toward $1 trillion.

What strategic moves were made and why?

Taxable Portfolios – Spread tightening in the corporate, bank and asset-backed sectors positively impacted USBAM's core strategy of focusing on coupon income through higher allocations to credit and spread product. Spreads tightened particularly hard for corporates maturing in less than one year on increased investor demand for short-term assets. The increase in demand, particularly from corporate treasurers, is likely due to a combination of factors: 1) rising rates have made short-term investments a more attractive option, 2) a desire to not exacerbate unrealized losses in portfolio holdings, and 3) increased need for liquidity as corporations begin to formalize longer-term plans post tax reform. Rising rates depressed absolute returns but portfolio coupon income has, for the most part, grown high enough to prevent negative quarterly returns in all but the longest duration portfolios. As expected, our short duration strategy bolstered portfolio performance relative to benchmarks. Three-month LIBOR floating-rate notes benefitted from tightening spreads and we began to see LIBOR indexes rise again after stalling out following the outsized 61 bp jump in the first quarter.

Tax Exempt and Tax-Efficient Portfolios – Sector selection played a leading performance role during the quarter. Corporate bonds were favored as we looked to increase after-tax income, with taxable municipals also providing some value and diversification benefits. Tax-exempt muni market valuations reached extreme levels in July, as heavy reinvestment demand from bond maturities and coupon payments overwhelmed available supply. Outside of variable-rate demand notes (VRDNs) which were used as cash alternatives, we did not find value in adding to tax-exempt positions. For active trading accounts, we were able to take advantage of the rich conditions to do some opportunistic selling of municipals and reposition portfolios into higher yielding taxable securities. Economic data justify some further Fed action and higher short-term interest rates. Accordingly, portfolio durations continued to be managed on the shorter side.

How are you planning on positioning portfolios going forward?

Taxable Portfolios – The U.S. economy continues to reflect considerable strength and leading indicators suggest recession risk is very low through 2020 – all of which is supportive of overall credit conditions. Given this outlook, we remain committed to our overweight to credit strategy despite the relative tightness of spreads and length of the expansion. However, there is an increased need to be more selective in security purchases, particularly for industrial issuers and for securities maturing in one year or less where spreads to Treasuries have fallen to single digits for many high profile companies. Within this environment, participation in new-issue markets is a key strategy for obtaining both quality bonds and proper spreads. Asset-backed securities (ABS) continue to offer a favorable risk-return profile vs. agencies and AA-rated corporates and provide investors more focused exposure to U.S. consumers, who are benefitting from low unemployment and growing wages. We continue to favor financials – particularly U.S. banks – over industrials on higher absolute yields, lower event risk and strong balance sheet fundamentals. From a rates standpoint, yield curve levels will almost certainly rise in the fourth quarter given the Fed is projected to lift policy rates 25 bps at the December 19th meeting and, more importantly, given Chairman Powell's suggestions monetary policy remains accommodative and that the Fed may eventually need to go beyond neutral. Over time, we would expect the yield curve to flatten further with short rates rising faster than longer-term rates. With our outlook for higher rates by year end, we will continue to be short duration to benchmarks and continue to migrate toward a more bulleted portfolio structure, increasing our ability to re-invest portfolio cash flows into higher-yielding instruments. A limiting factor to portfolio construction and re-balancing is the jump in yields, which has created unrealized losses for most legacy fixed-rate positions. For portfolios with sensitivity to realized losses, maturities and other cash flows are the best options for re-balancing, which can limit the scale of any adjustments, particularly in duration management. Chairman Powell's comments challenge our assumption that muted inflation increases would stay the Fed from the more assertive plan outlined in its Dot Plot. In the near-term, our short duration call actually benefits from the market pricing of a more aggressive Fed and offers time to reassess our outlook should market conditions warrant.

Tax Exempt and Tax-Efficient Portfolios – The strong technical factors in the muni market are fading. Bond maturity payments which averaged upwards of $43 billion per month in June through August are expected to be closer to $25 billion per month in the near term. This fits the typical muni seasonal pattern and may allow for some better reinvestment options in the fourth quarter. However, while higher muni yields will occupy more space on our radar, the new corporate tax rates of 21% set a high hurdle for an increase in our participation. Most likely taxable alternatives will remain better options and our allocations to corporates and taxable munis should continue to grow. Being on the shorter side of duration remains a prudent strategy, as the Fed is indicating further moves and the yield we would give-up by being longer is limited. We can be content with a combination of floating-rate notes and short fixed-rate purchases focused in the one- to two-year part of the curve.

Sources

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FOMC Statement and materials, September 26, 2018

U.S. Department of Labor, September 2018 statistics