December 31, 2018

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?

Financial market sentiment took a U-turn in the fourth quarter, from being relatively sanguine to quite fearful. Wall Street estimates pivoted from expecting as many as four 2019 Federal Reserve (Fed) rate hikes to pricing in a potential rate cut. Slowing global growth, trade and tariff concerns, Fed policy tightening and communication errors conspired to push investors toward a decidedly risk-off mentality, particularly in December.

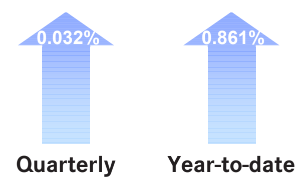
Economic Activity – Despite the fourth quarter's financial market volatility, U.S. Gross Domestic Product (GDP) is expected to grow 2.5% to 3.5% in the fourth quarter, reasonably in line with third quarter growth of 3.4%. Buttressed by low unemployment and higher wages, personal consumption – which makes up approximately 69% of U.S. GDP – is expected to remain supportive of overall GDP growth. For most of the quarter, ISM Manufacturing and Non-Manufacturing readings hovered near historic highs but declined to 54.1 and 57.6, respectively, in December. While both readings reflected continued expansion, the steep monthly decline was troubling and worth monitoring as an indicator of the potential impact tariffs and trade wars are having on business planning and production. Employment conditions remained strong despite the U3 Unemployment Rate rising to 3.9% from 3.7%, as the increase was primarily driven by a surge of 1.185 million workers in the Civilian Labor Force, a decidedly positive indicator for employment conditions. Hiring remained robust, with Nonfarm and Household employment adding 762,000 and 876,000 jobs, respectively, in the quarter. December's employment report was particularly helpful to investor attitudes, almost perfectly blending strong job growth and growing wages with a higher participation rate, signaling the potential for continued non-inflationary expansion. Inflation measures began rolling over with the U.S. PCE Deflator and Core PCE falling below the Fed's 2% target. Significantly, inflation expectations as measured by five-year TIPs vs. Treasuries fell to 1.49% at year-end, the lowest levels seen since 2016.

Credit Markets – Slowing global growth, trade and tariff concerns, Fed policy tightening and Fed communication errors all contributed to a decidedly risk-off investor mentality and a widening of credit spreads. Lower quality issuers suffered more than their higher-rated counterparts on concerns over the ability to refinance upcoming maturities and higher debt service costs. Market liquidity was available but more constrained than in previous quarters, exacerbating spread widening. Three-month LIBOR jumped 40 basis points (bps) in the quarter, countering the decline in U.S. Treasury yields and improving the upfront yield of floating-rate notes vs. comparable maturity fixed-rate debt.

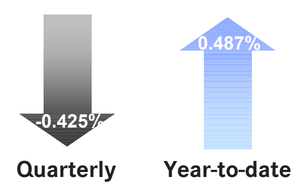
Jim Palmer, CFA
Chief Investment Officer

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

1-year Treasury Yield
December 31, 2018 : 2.599%



3-year Treasury Yield
December 31, 2018: 2.459%



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.

Credit Spread Changes

ICE BofAML Index	OAS* (bps) 9/30/18	OAS* (bps) 12/31/18	Change (bps)
1-3 Year U.S. Agency Index	5	5	0
1-3 Year AAA-A U.S. Corporate and Yankees	14	13	-1
1-3 Year AA U.S. Corporate and Yankees	38	52	14
1-3 Year A U.S. Corporate and Yankees	48	75	27
1-3 Year BBB U.S. Corporate and Yankees	77	127	50
0-3 Year AAA U.S. Fixed-Rate ABS	34	53	19
			*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	Q4 2018 Relative Performance*
1-3 Year AAA-A U.S. Corporate and Yankees	1.044%
1-3 Year BBB U.S. Corporate and Yankees	0.652%
1-3 Year U.S. Financial	0.839%
1-3 Year U.S. Non-Financial Corporate	0.782%
1-3 Year U.S. Treasury	1.292%

**AAA-A Corporate index underperformed the Treasury index by 24.8 bps in the quarter*

**AAA-A Corporate index outperformed the BBB Corporate index by 39.2 bps in the quarter*

**U.S. Financials outperformed U.S. Non-Financials by 5.7 bps in the quarter*

U.S. Treasuries outperformed corporate credit in the quarter and higher-rated corporates outperformed BBB issuers. However, corporate credit indexes still posted positive returns in the quarter, as coupon income and price appreciation from the drop in interest rates overcame the negative price impact of wider spreads. Financials outperformed their industrial counterparts, indicating recent financial market volatility was not due to perceived stress in the banking sector.

Yield Curve Shift

U.S. Treasury Curve	Yield Curve 9/30/18	Yield Curve 12/30/18	Change (bps)*
3 Month	2.196%	2.355%	15.9
1 Year	2.563%	2.596%	3.3
2 Year	2.819%	2.488%	-33.1
3 Year	2.883%	2.456%	-42.7
5 Year	2.953%	2.511%	-44.2
10 Year	3.061%	2.684%	-37.7

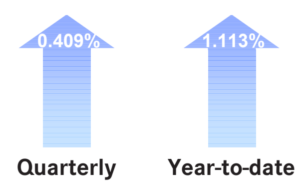
**Yield Spread between 3-month and 10-year U.S. Treasuries is 32.9 bps (not inverted)*

**U.S. Treasury Yield Curve from 1 to 5 years flattened 47.5 bps*

**U.S. Treasury Yield Curve from 2 to 10 years flattened 4.6 bps*

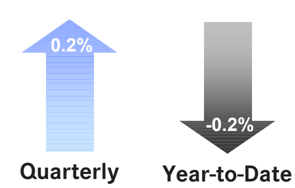
3-Month LIBOR

December 31, 2018: 2.808%



Unemployment Rate

December 31, 2018: 3.9%



Source: Bloomberg

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Treasury yields beyond one-year collapsed with the flight-to-quality trade, deflation concerns, Fed policy reversal and slowing U.S. / global growth all sharing in the blame. The fall in yields was severe, as investors shifted from expecting 2019 rate hikes to fed funds futures implying a 12.8% probability for a rate cut within the next twelve months. The yield curve – as quantified by the Fed's preferred measure of three-month to ten-year yields – flattened 53.6 bps in the quarter, but importantly remained at a positive 32.9 bps overall. The brief inversion between two- and five-year yields gathered media and investor attention, but was likely linked to strong demand for five-year Treasuries related to credit-default swap hedging in the higher volatility credit environment.

Duration Relative Performance

ICE BofAML Index	Duration (years)*	Q4 2018 Relative Performance**
0-1 Year U.S. Treasury	0.49	0.632%
0-2 Year U.S. Treasury	0.99	0.833%
0-3 Year U.S. Treasury	1.43	1.081%
1-3 Year U.S. Treasury	1.87	1.292%
1-5 Year U.S. Treasury	2.62	1.722%

**Duration estimate is as of 12/31/18*

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

With the sharp decline in U.S. Treasury yields, short-duration strategies noticeably underperformed their longer-term counterparts. With the flattening of the yield curve, barbell-structured portfolios performed particularly well in the quarter.

Monetary Policy – The Fed raised the federal funds (fed funds) target range 25 bps to 2.25% - 2.50% at the December 19th meeting. While the increase met market expectations, there was less investor conviction about the likelihood of a rate hike than typically seen close to a Fed meeting. The accompanying Fed statement and Dot Plot predicting two 2019 rate hikes was less dovish than investors hoped for given recent market declines. During the post-meeting press conference, Chairman Jay Powell suggested the Fed's balance sheet reduction program – currently capped at $50 billion per month in maximum asset purchase reductions – was on autopilot, unnerving investors hoping for greater flexibility and open-mindedness from Fed officials in dealing with tightening financial conditions. Fed officials have begun walking back the impression of rigidity and acknowledged the difficulty of managing the twin normalization policies of raising rates and balance sheet reduction. Since the Fed's balance sheet reduction program began in October 2017, securities held outright and reserve balances have fallen $360.1B and $517.9B, respectively.

Fiscal Policy – With the initial benefits of tax reform waning, the dual headwinds of a federal government shutdown and trade wars have begun to bite into the economy's growth prospects. From a GDP standpoint, a brief government shutdown is marginally negative. But as the current shutdown enters record territory, the effect will begin extending beyond government workers and public inconveniences, negatively impacting government contractors, air travel and business planning in general. The lack of progress and antipathy between President Trump and Congressional Democrats has dampened investor confidence and contributed to December's downturn in risk assets. Trade hostilities with China continued to skew markets to the downside. The financial market interest in a trade deal with China is obvious, as positive headlines or comments on trade negotiations from the Administration tend to lead to market rallies and negative news to sell-offs. The lack of progress has weighed on risk assets and the economy, but may provide upside to growth and markets should a reasonable deal with China be struck.

What strategic moves were made and why?

Taxable Portfolios – The market's turn toward a risk-off mentality pushed U.S. Treasury yields for securities maturing beyond one year lower and drove credit spreads wider, both of which worked against USBAM's key investment strategies. Entering the quarter, USBAM's interest rate outlook called for a December Fed rate hike – which was ultimately realized – and a flattening of the yield curve, with short-end yields rising and yields over two years rising slightly on the margin. We also viewed interest rate risk tilted toward higher long-term rates as investors seemed anxious to push long rates up on the slightest provocation from inflation or growth data. Given our outlook, we positioned portfolios short to benchmark durations and focused on purchasing floating-rate securities and fixed-rate debt maturing in eighteen months and less, which would better position portfolios to re-invest at expected higher yields. The strategy was only partially effective as the Fed did lift rates in late December, which in turn pushed overnight and LIBOR rates higher allowing portfolios to increase book yield. However, longer yields fell convincingly and short duration strategies noticeably underperformed. On credit, USBAM has been positive on investment-grade credit conditions and we focused on overweighting spread product (corporates, ABS, CDs) to maximize coupon income – a key component of investment returns for short-fixed income principal preservation strategies. The visible move wider in spreads impacted all credit sectors and resulted in underperformance vs. Treasuries. USBAM continued to favor financials over industrials on higher relative yields, strong balance sheet fundamentals and lower headline risk. The focus was mildly positive for quarterly returns, as financials outperformed comparable duration industrials.

Tax Exempt and Tax-Efficient Portfolios – Financial markets focused on downside risks to the economic outlook late in 2018, pulling interest rates lower for all fixed income securities. Short municipal bonds under-performed taxable alternatives on a total return basis, as munis entered the quarter with valuations already a bit stretched. The increased market volatility did not compel us to make any material adjustments to our core strategies, as we strongly disagreed with the market's main premise of an imminent recession. Portfolio durations remained short and edged lower, consistent with our view the higher rate trend was likely to persist. Looking back, the yield highs of early November could be considered a missed opportunity to extend durations. However, Powell's hawkish October commentary indicating rates were "well below neutral" kept us from being more aggressive. Market sentiment turned decidedly negative late in the quarter, effectively making these duration-related investment decisions much easier, supporting our short-duration bias. The sharp decline in yields – and flattening of the curve – offered no value vs. our base case outlook for at least one additional rate hike in 2019. Corporate bond allocations continued to grow in tax efficient accounts, as relative yields remained attractive vs. municipals. Taxable municipals were purchased to enhance diversification and municipal variable rate demand notes (VRDNs) were attractive at times for cash management.

How are you planning on positioning portfolios going forward?

Taxable Portfolios – Fourth quarter's financial market volatility forced investors to revisit assumptions regarding economic growth, Fed policy and credit quality. On the economy, we believe the U.S. has considerable growth momentum, as employment strength coupled with a lack of sector bubbles in the real economy lead us to expect 2019 GDP growth to be in the range of 2.0% - 2.5% (solid, if unspectacular) with low recession risk through year end. We would put some upside risk on this forecast should a workable and effective trade deal with China be signed. On the Fed, we believe Fed officials – Chairman Powell in particular – feel policy rates are below neutral and are biased to continue tightening. In order to lift rates further, the Fed will need to wait for calmer financial conditions, a resolution to federal budget and debt ceiling hurdles and some steepening of the yield curve – as we believe the Fed is loath to invert the yield curve with a rate hike. We look for these conditions to be met over time, which has us forecasting a mid-year rate hike. Given our outlook, we see interest rates rising from current levels leading us to retain a short duration strategy, but with a quicker trigger to extend portfolios should yield curve levels reach previous highs. Given the flatness of the yield curve, twelve-month and shorter fixed-rate investments offer comparable yields with lower interest rate risk. Currently, floating-rate notes (FRNs) offer higher upfront yields vs. comparable maturity fixed-rate debt and we have started the year expanding our floater positions. On credit and spread product, current corporate spreads in the AAA-A rating category offer significant value, particularly in the banking sector. Slower growth and higher interest rates will present a refinancing challenge for lower-rated issuers. As a result, we are biased to keep purchases of BBB category issuers on a shorter maturity leash with extensions in credit duration focused on stronger balance sheets. ABS continue to offer a favorable risk-return profile vs. agencies and corporates while providing investors more focused exposure to U.S. consumers, who are benefitting from low unemployment and growing wages.

Tax Exempt and Tax-Efficient Portfolios – Our bias to short-duration remains in place for the first quarter due to current market pricing as well as an expectation that economic data in the first half of 2019 will be supportive of another Fed hike, potentially around mid-year. That said, an overly-aggressive Fed appears to be much less of a concern for us than it was several months ago, as it has walked back previous hawkish comments and communicated lower 2019 rate expectations via the Dot Plot. Accordingly, we will be more inclined to take advantage of opportunities to add to duration following any meaningful increase in yields. For now, FRNs offer better value vs. fixed-rate bonds and we will look to increase portfolio floater positions. Since corporate tax rates were lowered to 21%, municipal bonds have not been competitive on a taxable equivalent basis. A strong surge in municipal supply is necessary to restore value for corporate buyers. With most municipal strategists suggesting only a modest increase in 2019 muni supply and maturities between $220 - $250 billion (possibly the largest year ever), the catalysts for higher muni allocations do not appear to be present. Economic conditions remain supportive of both municipal and corporate credits. However, GDP growth is projected to slow in the year ahead and we feel it is prudent to limit credit duration for lower-rated (BBB) issuers and focus on higher quality bonds when initiating positions with longer maturities.

Sources

Bloomberg

Federal Reserve Statistical Release, Factors Affecting Reserve Balances, December 27, 2018

FOMC Statement, Projection Materials and Press Conference Transcript, December 19, 2018

Bloomberg, "Powell Says Fed May Lift Rates to Levels That Restrain Growth", October 3, 2018

[See next page for important disclosure information]

U.S. Bancorp Asset Management, Inc.

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