June 30, 2020

Quarterly Portfolio Manager Commentary

usbancorp Asset Management, Inc.

Cash Management Portfolios

Chief Investment Officer Jim Palmer

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

Financial markets recovered in the second quarter despite predictions for a historic plunge in U.S. Gross Domestic Product (GDP). Investors took confidence in the Federal Reserve's (Fed) robust response to the economic and market dislocation caused by COVID-19 and rolling economic shutdowns. Fiscal stimulus, primarily in form of the Coronavirus Aid, Relief and Economic Security Act (CARES), provided strong support for consumer income levels as unemployment rates soared.

Economic Activity – Second quarter U.S. GDP is expected to fall in the area of 35% on an annualized quarter-over-quarter basis, as activity collapsed from the economic shutdowns implemented to combat the spread of COVID-19. Despite the sharp decline in growth, employment conditions improved deeper in the quarter as portions of the country opened for business. After a disastrous April loss of 20.787 million jobs, Non-farm Payrolls grew 2.699 million in May and 4.800 million in June with both numbers beating expectations by a wide margin. After peaking at 14.7% in April, the U-3 U.S. Unemployment Rate fell to 11.1% in June. Initial Jobless Claims declined fourteen straight weeks after peaking at 6.867 million for the week ending March 24th. Unfortunately, the July 3rd Claims print was a stubbornly high 1.314 million, and for context, the average reading in February was 214,000 which was close to 50-year lows. Both ISM Manufacturing and ISM Non-Manufacturing have shown signs of recovery. The June manufacturing reading rose to 52.6 from a low of 41.5 in April, while the service reading rose to 57.1 from 41.8. It is important to note that while a reading above 50 indicates sector expansion, the information value may be diminished when businesses are building off a low base like the one seen in April. Various inflation measures remain visibly below the Fed's 2% target rate, giving the Fed ample room to supply stimulus with little worry over sparking inflation at this point. While analyst estimates point to robust growth in the second half of 2020, realizing a durable expansion is threatened by additional rounds of economic shutdowns as the number of positive COVID-19 tests rise in various parts of the country.

Monetary Policy – The Fed has continued to provide broad support for the smooth functioning of financial markets through low rates, asset purchases and targeted credit facilities. The Fed's policy reaction function appears to be asymmetric, with economic and / or financial market declines met with a vigorous policy response while asset price appreciation and strong growth are allowed to run.

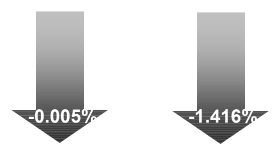
<u>Broad Fed Policy Initiatives</u>

Policy Rates – The Fed has indicated the current federal funds target range of 0.0% – 0.25% will remain in place at least through 2022.

Jim Palmer, CFA
Chief Investment Officer

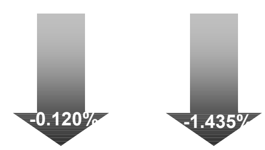
Fed funds target rate:
0-25 basis points
Last Change: March 16, 2020

1-year Treasury Yield
June 30, 2020: 0.150%



Quarterly | Year-to-date

3-year Treasury Yield
June 30, 2020: 0.173%



Quarterly | Year-to-date

Asset Purchases – The Fed has committed to monthly net purchases of $80 billion in U.S. Treasury Securities and $40 billion in agency and agency mortgage-backed securities. "Securities Held Outright" on Fed's balance sheet grew $1.326 trillion in the quarter (from $4,800.9 trillion on April 1st to $6,126.9 trillion on July 1st).

Targeted Credit Facilities – As of July 1st, the Fed had committed $12.799 billion to the Commercial Paper Funding Facility, $41.940 billion to Corporate Credit Facilities, $37.502 billion to the Main Street Lending Program and $16.081 to the Municipal Liquidity facility.

The Fed has been far more proactive implementing policy initiatives than during the Great Financial Crisis, when perceptions of Wall Street malfeasance presented moral hazard questions around monetary and fiscal responses.

Fiscal Policy – The primary fiscal response to the economic slowdown crisis was the CARES Act, which was passed into law on March 27th. CARES provided $260 billion in expanded unemployment benefits, including $600 per week in additional benefits which are set to expire on July 31st. The expanded benefits were meant to bridge the decline in employment compensation as the Unemployment Rate soared into the teens, and in some cases, analysts estimate the replacement value at well over 100% of previous wages. Government transfer payments have allowed many consumers to remain current on mortgage and other debt payments and bolster savings levels at the same time, which has in turn supported bank loan and securitized debt credit quality. There appears to be bipartisan support for another round of fiscal stimulus as the July 31st cliff approaches.

Credit Markets – The U.S. Treasury yield curve settled into its current low levels as the Fed has indicated, and investors expect, policy rates will remain at the present 0.0 to 0.25% target range through at least the end of 2022. Corporate credit spreads recovered much of the damage done in March, primarily due to the Fed's massive commitment to easing financial conditions and liquifying Wall Street balance sheets. Companies issued a record $1.225 trillion in new debt in the first half of 2020, more than doubling 2019's year-to-date total of $597 billion. Secondary market liquidity is strong across virtually all sectors. Negative public ratings actions diminished toward the end of June, after numerous sector and individual company ratings downgrades.

Yield Curve Shift

U.S. Treasury Curve	Yield Curve 03/31/2020	Yield Curve 06/30/2020	Change (bps)*
3 Month	0.061%	0.129%	6.8
1 Year	0.155%	0.150%	-0.5
2 Year	0.246%	0.149%	-9.7
3 Year	0.293%	0.173%	-12.0
5 Year	0.380%	0.288%	-9.2
10 Year	0.669%	0.656%	-1.3

The 3-month to 10-year portion of the yield curve flattened by 8.1 bps, driven primarily from a small recovery in 3-month T-Bill yields after severe downward pressure on short-term rates in late March. Given the enormous amount of Fed intervention into the U.S. Treasury curve, the information value of a flatter / steeper yield curve has diminished.

3-Month LIBOR
June 30, 2020: 0.302%

-1.149% Quarterly
-1.606% Year-to-Date

Unemployment Rate
June 30, 2020: 11.1%

6.7% Quarterly
7.6% Year-to-Date

Source: Bloomberg

Duration Relative Performance

**Duration estimate is as of 6/30/2020*

U.S. Treasury indexes basically earned its coupon rate in the quarter with minimal room for additional price appreciation return from lower yields. Each of the ICE BofA U.S. Treasury Indexes listed saw quarter-end duration levels rise from the end of the first quarter, as the massive net issuance of Treasuries in the second quarter tended to be longer than the average duration of securities previously held in the benchmark.

Credit Spread Changes

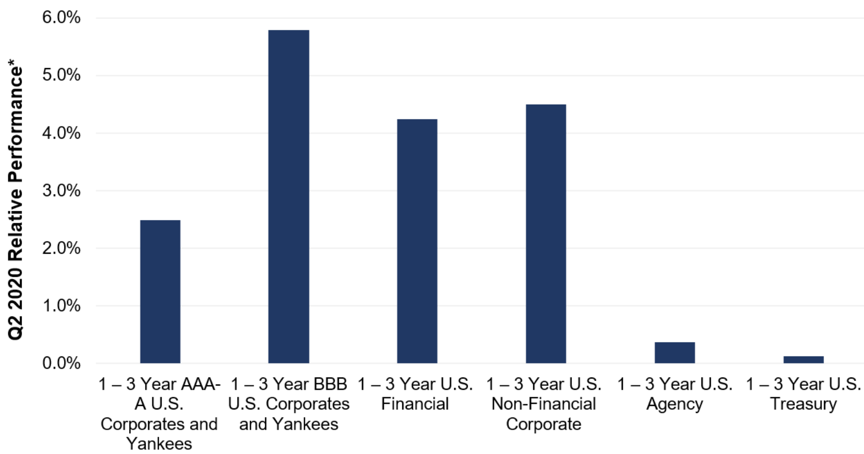
ICE BofA Index	OAS* (bps) 3/31/2020	OAS* (bps) 6/30/2020	Change (bps)
1-3 Year U.S. Agency Index	37	20	-17
1-3 Year AAA U.S. Corporate and Yankees	43	16	-27
1-3 Year AA U.S. Corporate and Yankees	153	39	-114
1-3 Year A U.S. Corporate and Yankees	221	63	-158
1-3 Year BBB U.S. Corporate and Yankees	426	142	-284
0-3 Year AAA U.S. Fixed-Rate ABS	256	59	-197

*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 recovered a significant portion of the widening seen in the second quarter. The primary driver for credit's strong second-half performance was the Fed's decisive actions to support and liquify the credit markets, including quantitative easing and the direct purchase of corporate debt and investment-grade ETFs. OAS spreads remain wider than December 31, 2019 levels, which is reasonable given the uncertain outlook for the economy and credit markets.

Credit Sector Relative Performance of ICE BofA Indexes



**AAA-A Corporate index outperformed the Treasury index by 235.5 bps in the quarter.*

AAA-A Corporate index underperformed the BBB Corporate index by 329.8 bps in the quarter.

U.S. Financials underperformed U.S. Non-Financials by 24.9 bps in the quarter.

Given the Fed's strong support for the credit markets and a decidedly risk-on attitude of investors in the second quarter, lower-rated corporate credit handily outperformed their higher-rated counterparts. Non-financials outperformed financials by 24.9 bps and industrial companies took advantage of robust primary market conditions to issue longer-term debt to build cash balances, pay down bank lines, refinance commercial paper and pre-fund upcoming debt maturities.

What strategic moves were made and why?

Taxable Portfolios – Credit spreads recovered a significant portion of the damage done in March, providing strong performance for all credit-sensitive assets, with lower-quality issuers outperforming higher-quality issuers. The Fed's massive asset purchase program helped remove most of the liquidity premium seen in credit spreads at the end of March, and secondary market demand for corporate credit provided ample liquidity for most investment-grade assets. Price appreciation from a decline in U.S. Treasury yield curve levels were minimal in the quarter with little room left for yields to compress further. After coming under considerable pressure in April and May, downgrades of issuer public ratings slowed in June. The primary market for corporate debt enhanced performance for portfolios, providing an ample supply of new product across numerous sectors and issuers along with strong after-market spread tightening and performance.

Tax Exempt and Tax-Efficient Portfolios – The most impactful strategy decisions during the quarter were related to credit, sector and security selection. It was a challenging period to ascertain value as uncertainties associated with COVID-19 continued to weigh on the economic outlook. To intensify said challenges, market rallies were swift and seemingly based much more on technical factors rather than any potential turn in fundamentals. For muni-only mandates, we were active in swapping out of variable rate demand notes into fixed-rate maturities. Many of these trades are likely to add at least 75 bps of income over the next 1-2 years. We were conscious of security selection in choosing larger municipal issuers with more significant reserves and balance sheet flexibility to navigate a tough road ahead. For tax-efficient buyers, corporates continued to be the predominant choice based on higher tax-adjusted yields. We played credit from both sides – taking advantage of some tightening in spreads to prune some portfolio names while also finding reasonable value in others. As the quarter progressed, somewhat higher than typical cash balances reflected apprehension to chase yields much further.

How are you planning on positioning portfolios going forward?

Taxable Portfolios – With corporate, bank and ABS positions marked at meaningfully tighter spreads than at the beginning of the second quarter, we expect only marginal price appreciation in credit assets during the third quarter. Further, the Fed's forecast to keep policy rates at current levels through at least 2022 should keep yield curve rates from fluctuating significantly from quarter-end levels. Given our outlook for credit spreads and the yield curve, the majority of portfolio performance is expected to come from coupon income rather than price appreciation from current marks. After a record-setting first half of 2020 for investment-grade debt issuance, new issue opportunities are expected to decline significantly as many companies have fulfilled their financing needs for the year. The number of issuer or sector credit ratings downgrades is likely to be lower in the third quarter than what has been experienced since March, and any negative actions and resulting spread widening should be incremental rather than multi-notch. Because of the uncertain outlook for the economy and a solution to the COVID-19 virus, we continue to focus on higher-quality corporate issuers with strong balance sheets and the ability to withstand further economic shutdowns. We are maintaining a cautious approach to adding additional exposure to consumer ABS. We remain confident in our approved AAA-rated ABS traunches and structures, but the converging pressures of high unemployment, declining incomes and auto company stress argue in favor of a conservative approach to the sector. We prefer to monitor the impact of these negative pressures on underlying asset performance and any further fiscal policy support of consumer incomes before adding additional exposure. From a duration standpoint, the Fed appears to be on hold for the foreseeable future which limits the risk of a policy-induced U.S. Treasury sell-off. We will look to move portfolios closer to benchmark durations as a way to add incremental income and mitigate the risk to portfolio income levels of an unexpected decline in the yield curve due to either market forces, or an unforeseen change in Fed policies. While we always recommend match-funding known portfolio withdrawals, particularly so in such a variable environment, the Fed's commitment to providing financial accommodation has significantly lowered the risk of market illiquidity.

Tax Exempt and Tax-Efficient Portfolios – Looking at the present market conditions, regarding both rates and credit spreads, we are hard-pressed to find scenarios that would offer much in the way of upside. At best, investors may pick up modest incremental income if spreads remain stable. Downside risk could bring much greater volatility as infections increase and re-openings falter. Municipalities are crafting budgets for fiscal 2021, which include federal aid that may or may not materialize to their expectations. Any shortfalls in assistance received could result in significant layoffs and / or debt issuance. Some large school districts in California have already announced plans for online-only education in the fall and more announcements are expected in the coming weeks. These are crucial decisions that impact return to office plans and economic productivity. While we see limited risk to extending duration, the yield curve already reflects a low interest rate environment for the next several years and offers little incentive to be aggressive. With respect to credit, a defensive positioning is the clear and prudent choice. We will continue to focus heavily on security selection and maintain a preference for higher quality issuers.

Sources:

Bloomberg

Federal Reserve

U.S. Department of Treasury

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