Quarterly portfolio manager commentary

Cash Management Portfolios

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

Financial markets continued to strengthen in the third quarter on robust monetary and fiscal stimulus programs. Third quarter U.S. Gross Domestic Product (GDP) is expected to rebound smartly from the second quarter's historic 31.4% decline as the economy continued to make progress re-opening from the spring shutdowns. The Federal Reserve (Fed) adopted a new policy framework which suggests inflation above 2% and unemployment rates below 4% are not reasons enough to tighten monetary policy.

Economic Activity – Consensus forecasts suggest third quarter U.S. GDP expanded at a 30.0% quarter-over-quarter annualized pace, with some estimates reaching as high as 35%. Supported by enhanced government benefits and stronger labor markets, consumer spending was the primary catalyst for the impressive snap back in growth. Employment conditions improved in the quarter with Non-farm Payrolls adding 3.911 million jobs and the U3 Unemployment Rate falling from 11.1% to 7.9%. The economy has recovered 11.417 million of the 22.160 million jobs shed in March and April. Unfortunately, late September Initial Jobless Claims data suggested the pace of labor improvement has slowed and several large companies such as Disney, Shell and United Airlines have recently announced massive layoffs. Both ISM Manufacturing PMI and ISM Services PMI readings reflected solid expansion in the quarter, averaging 55.2 and 57.6 respectively. Inflation measures remain well below the Fed's 2% average target rate despite the massive monetary stimulus provided to date. Risks realizing current 4% fourth quarter growth estimates are further COVID-19 outbreaks as flu season approaches, reductions in additional fiscal stimulus and disruptions caused by contested Presidential and Congressional races.

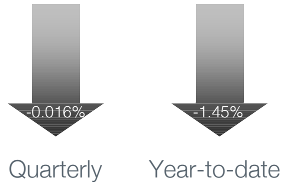
Monetary Policy – In August, the Fed adopted a new monetary policy framework targeting an average inflation rate of 2%. While the change had been anticipated, the Fed disappointed market observers by providing few details about the actual implementation of the new framework, such as defining the look-back period to calculate the average inflation rate. The lack of clarity provided at the September 16th FOMC meeting disappointed investors looking for more direct guidance on the path of monetary policy. Despite the lack of details, the Fed's policy reaction function appears to be asymmetric, with economic and financial market declines met with vigorous policy responses while asset price appreciation strong economic growth are allowed to persist.

Jim Palmer, CFA
Chief Investment Officer

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

1-year Treasury Yield
September 30, 2020: 0.117%

3-year Treasury Yield
September 30, 2020: 0.157%



usbancorp Asset Management, Inc.

September 30, 2020

Broad Fed Policy Initiatives

Policy Rates – The Fed indicated the current federal funds target range of 0.0% – 0.25% will remain in place at least through 2023, extending the horizon from 2022.

Asset Purchases – The Fed remains committed to monthly net purchases of $80 billion in U.S. Treasury Securities and $40 billion in agency and agency mortgage-backed securities. During the COVID-19 crisis period, "Securities Held Outright" on the Fed's balance sheet have grown $3.956.6 trillion, from $2.474.0 trillion on February 26th to $6,430.6 trillion on September 30th.

Targeted Credit Facilities – As of September 30th, the Fed has committed $8.589 billion to the Commercial Paper Funding Facility, $45.042 billion to Corporate Credit Facilities, $16.547 billion to the Main Street Lending Program and $16.547 to the Municipal Liquidity facility.

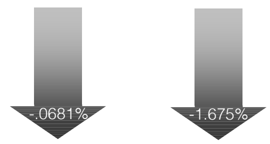
The Fed's large-scale asset purchases have likely had a greater impact easing financial conditions than the targeted credit facilities, which are relatively small vs. the overall size of the debt markets. The presence of these facilities and the Fed's willingness to use them has, however, boosted investor confidence to assume greater risks.

Fiscal Policy – With much of the CARES Act originally passed in March set to expire, additional fiscal stimulus prior to the November 3rd elections seems unlikely. Election-year politics has prevented a compromise plan between the smaller more COVID-focused plan favored by the Trump Administration and Senate Republicans and the more comprehensive bill pushed by House Democrats which includes greater aid for states and the reinstatement of the State and Local Income Tax Deduction. While an additional fiscal stimulus plan seems inevitable, delays in further relief will have a negative impact on consumer spending and increase the pace of small business closures.

Credit Markets – U.S. Treasury yields remained relatively range-bound in the quarter with few catalysts to spark a significant sell-off or rally in rates. The Fed's commitment to keeping policy rates at current levels through 2023 should keep front-end yields well-anchored. Further, the absence of a fiscal stimulus package in the fourth quarter will significantly reduce the U.S. Treasury's funding needs and in turn, U.S. T-Bill issuance and yields. Corporate credit spreads have essentially recovered to Pre-COVID levels on the Fed's massive liquidity injections and healthy investor demand for yield. Primary and secondary market conditions remain robust with ample liquidity across essentially all sectors. Negative public ratings actions have diminished considerably since the second quarter's downgrade wave.

3-Month LIBOR

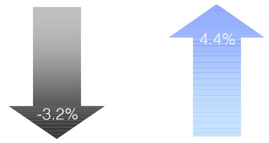
September 30, 2020: 0.234%



Quarterly Year-to-date

Unemployment Rate

September 30, 2020: 7.9%



Quarterly Year-to-date

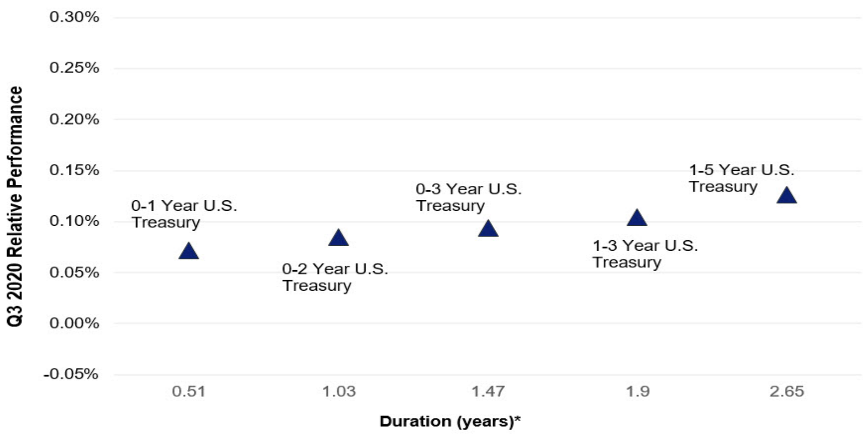
Source: Bloomberg

Yield Curve Shift

U.S. Treasury Curve	Yield Curve 06/30/2020	Yield Curve 09/30/2020	Change (bps)*
3 Month	0.129%	0.092%	-3.8
1 Year	0.150%	0.117%	-3.3
2 Year	0.149%	0.127%	-2.2
3 Year	0.173%	0.157%	-1.6
5 Year	0.288%	0.277%	-1.1
10 Year	0.656%	0.684%	2.8

The three-month to ten-year portion of the yield curve steepened 6.6 bps to 59.2 bps. Given the enormous amount of Fed intervention into the U.S. Treasury curve, the information value of a flatter / steeper yield curve has diminished.

Duration Relative Performance



**Duration estimate is as of 9/30/2020*

With only mild yield curve movements, U.S. Treasury index returns were dominated by coupon interest with minimal room impact from price appreciation return from lower yields.

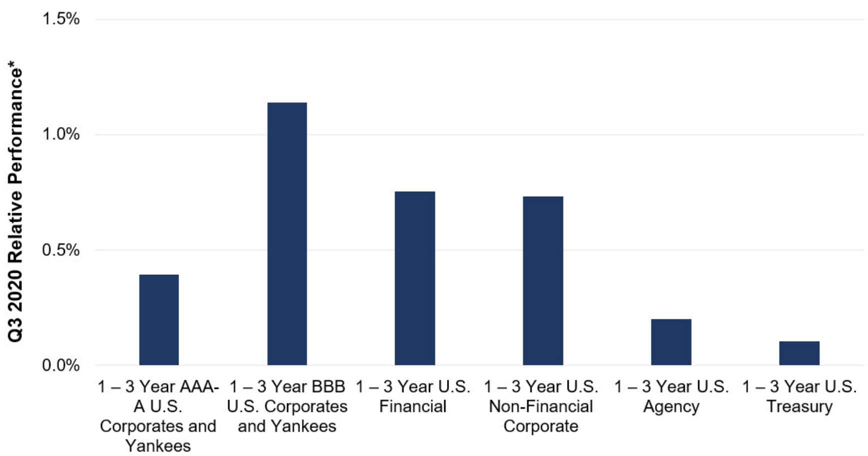
Credit Spread Changes

ICE BofA Index	OAS* (bps) 6/30/2020	OAS* (bps) 9/30/2020	Change (bps)
1-3 Year U.S. Agency Index	20	11	-9
1-3 Year AAA U.S. Corporate and Yankees	16	15	-1
1-3 Year AA U.S. Corporate and Yankees	39	34	-5
1-3 Year A U.S. Corporate and Yankees	63	49	-14
1-3 Year BBB U.S. Corporate and Yankees	142	108	-34
0-3 Year AAA U.S. Fixed-Rate ABS	59	40	-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 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 29.0 bps in the quarter.*

AAA-A Corporate index underperformed the BBB Corporate index by 74.4 bps in the quarter.

U.S. Financials outperformed U.S. Non-Financials by 2.2 bps in the quarter.

Corporate credit and spread product generated significant excess returns over U.S. Treasuries in the quarter, but still paled in comparison to second quarter's stellar returns as the degree of spread tightening slowed. Not surprisingly given the recovery in risk assets and strong equity market returns, lower-rated credit outperformed their higher-rated counterparts.

What strategic moves were made and why?

Taxable Portfolios – Credit-sensitive assets performed well in the quarter as spreads continued to tighten, albeit at a much slower pace than second quarter's remarkable recovery. Strong investor demand for yield combined with massive Fed liquidity injections have pushed credit spreads basically back to pre-COVID levels. The impact on performance of duration strategies, either long or short, was muted given the limited movements along the U.S. Treasury yield curve. New issue opportunities in investment-grade corporate debt were less frequent after the record setting pace of the second quarter. The pace of negative credit rating actions declined considerably in the quarter and no individual issuers in our approved universe suffered meaningfully negative price action due to a credit downgrade. We viewed tight credit spreads as a low opportunity-cost strategy to raise overall portfolio credit quality by pruning positions in issuers believed to be more vulnerable to another economic downturn.

Tax Exempt and Tax-Efficient Portfolios – It was a relatively calm and uneventful quarter for short-term municipal markets. Yields continued to decline, but only marginally. While budget pressures and lack of additional federal support remained in focus for investors, these concerns did not translate into any meaningful move in credit spreads – which ended the quarter slightly tighter vs. second quarter. It is also worth noting that since the pandemic started, Moody's and S&P have downgraded a mere 1% of rated municipal borrowers. Corporate securities still comprise the majority of tax-efficient portfolio holdings as the sector continues to offer the highest taxable-equivalent yields. Issuance of taxable municipals surged nearly 30% vs. third quarter 2019 and presented some compelling alternatives. We added several new positions in this asset class to enhance diversification and overall credit quality. Portfolio duration and yield curve positioning strategies were varied, with some clients requesting higher liquidity levels while other mandates looked to preserve as much income as possible.

How are you planning on positioning portfolios going forward?

Taxable Portfolios – With corporate, bank and ABS positions marked essentially at pre-COVID levels and the U.S. Treasury yield curve near historic lows, we expect portfolio returns in the fourth quarter to be dominated by coupon income with little opportunity for price appreciation from tighter spreads or lower yield curve levels. For duration management, we favor keeping portfolio duration to 90 to 100% of benchmark duration with a bias toward the higher end of the duration band. The strategy does not seek to capture incremental return from declining yields, but rather to mitigate reinvestment risk by locking in market yields should rates plunge toward zero. While we believe the risk of the Fed implementing negative rate policies in the current cycle is low – but not zero – we do believe market forces can drive short-term yields toward zero or even negative given the Fed's forecast for maintaining a 0.0% to 0.25% federal funds target rate through 2023. Sector-wise, we have resumed purchases of triple-A rated ABS debt backed by prime auto, credit card and equipment loans. During the COVID-19 market and economic disruptions, we believed it was prudent to monitor underlying ABS loan performance in a high unemployment environment. Our research suggests loan performance in these structures has remained solid. Surprisingly, several credit card programs reflected lower delinquency and default rates in September than in February. We continue to purchase investment-grade corporate debt for client portfolios and seek to emphasize new issue opportunities. We continue to monitor credit spreads in all positions and will seek to reduce exposure to securities not pricing in our risk assessment. We have added and will continue to add exposure to callable agencies as a straight yield-enhancing / low credit-risk investment in a period where interest rate risk is expected to be muted. Overall, we would view any credit spread widening due to election concerns or other macro events as an opportunity to add portfolio yield, as we believe any disruption would be short-lived or would be addressed with additional Fed accommodation and liquidity injections.

Tax Exempt and Tax-Efficient Portfolios – The upcoming elections present risk and uncertainties for all financial markets including municipals. The outcome will potentially impact municipalities in the following ways – the size of Federal aid for state and local governments, potential changes to tax rates at both the corporate and personal level, and an infrastructure plan that could add significantly to supply. While it's just as easy to construct bullish scenarios, many issuers have chosen to come to market in October rather than wait for results. To the extent this increased supply leads to higher yields, it may create some additional opportunities especially with taxable municipals. Spreads for this asset class have been resilient in 2020, even as issuance has surged. Perhaps this can be viewed as a testament to market support. We have been biased toward higher-quality issuers for some time and that will remain in place. It continues to be prudent to limit exposures to more COVID sensitive sectors (i.e. Transportation, sales tax, smaller colleges and universities) as the prospects for a second wave persist. Beyond that security selection will be driven by those issuers best able to withstand a deterioration in credit fundamentals.

Sources:

Bloomberg

Federal Reserve

U.S. Department of Treasury

[See next page for important disclosure information]

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