Quarterly portfolio manager commentary

Cash Management Portfolios

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

Equity and credit markets continued their improvement in the final quarter of 2020, weathering a contentious Presidential election while riding a wave of fiscal and monetary stimulus. The longer-term economic outlook brightened with the development of several promising COVID-19 vaccines, while the near-term outlook suffered from increases in localized economic and social restrictions in response to growing virus infection rates.

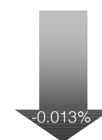
Economic Activity – Toward the end of the year, the economy showed signs of faltering under the weight of economic shutdowns. Consensus forecasts suggest fourth quarter U.S. Gross Domestic Product (GDP) grew at a 4.6% quarter-over-quarter annualized rate after exploding 33.4% in the third quarter. The pace of improvement in employment conditions slowed, with Q4 Non-farm Payrolls (NFP) adding 850,000 jobs in the quarter after gaining 3.965 million jobs in Q3. Notably, NFP lost 140,000 jobs in December, a reflection of additional economic restrictions put in place to combat wider outbreaks of the virus. Sadly, the economy has recovered only 12.321 million of the 22.160 million jobs lost in March and April. On the positive side, ISM Manufacturing and ISM Services beat expectations in December with readings of 60.7 and 57.2 respectively. For context, any reading over 50 indicates sector expansion and the 60.7 Manufacturing print was the second-highest level reached in the past decade. The Federal Reserve's (Fed) preferred inflation index – the PCE Core Deflator Index – remained subdued at 1.4% in November. However, inflation expectations as measured by the five-year TIPs vs. Treasuries have moved over 2%, driven by expectations for faster growth from increased fiscal stimulus and economic re-opening as vaccines are more widely distributed. Early 2021 growth expectations got a boost when Democrats gained control of the Senate, which should clear a path for more fiscal stimulus than would have been expected under a split government.

Monetary Policy – In what passes for a quiet period these days, the Fed did not alter current policies at either the November 3rd or December 15th meetings. Certain programs designed to support the corporate and municipal credit markets expired after Treasury Secretary Mnuchin asked the Fed to return $455 billion in unused funds to Congress for re-appropriation – part of which was used for the $900 billion fiscal relief package passed in late December. Despite some initial angst, the announcement had little

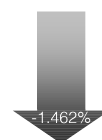
Jim Palmer, CFA
Chief Investment Officer

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

1-year Treasury Yield
December 31, 2020: 0.104%

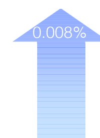


Quarterly



Year-to-date

3-year Treasury Yield
December 31, 2020: 0.165%



Quarterly

Year-to-date

NOT FDIC INSURED NO BANK GUARANTEE MAY LOSE VALUE

impact on the credit markets as the usage of the facilities had been light and a general view the programs could be re-instated if needed under a Biden administration. Despite the lack of new policy accommodation, the Fed's policy reaction function appears to be asymmetric, with economic and / or financial market declines met with vigorous policy responses while asset price appreciation and / or strong economic growth allowed to continue.

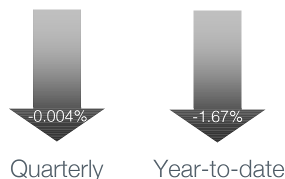
Current key Fed policies:

- **Interest Rates** – The Fed has indicated the current federal funds target range of 0.0% – 0.25% will remain in place at least through 2023.
- **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.

Fiscal Policy – After significant saber-rattling on both sides, Congress passed and President Trump signed a roughly $900 billion COVID relief package in the last week of December. The package includes a $600 payment to individuals based on income requirements, $300 in enhanced monthly unemployment benefits through March and $284 billion for a second round of Paycheck Protection Program loans for small businesses. With Democrats gaining control of the Senate, House and White House and a soft December employment report, further fiscal stimulus is almost assured in early 2021. Potential actions include a $2,000 payment to those most impacted by economic shutdowns, a reinstatement of state and local tax deductions and direct aid to state and local municipalities.

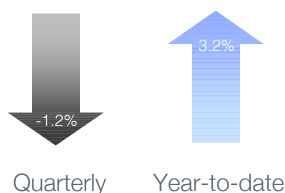
Credit Markets – Front-end U.S. Treasury yields remained relatively stable in the quarter. The Fed's commitment to keeping policy rates near zero through 2023 limits the downside risk of yields moving higher, while low absolute yield curve levels offer little room for further declines absent a severe economic or market downturn. Going forward, shifts in the short end of the yield curve are likely to be driven by technical factors such as U.S Treasury issuance patterns and the duration composition of Fed asset purchases. Yields beyond five-years appear to be more vulnerable to positive economic and vaccine news. Which in turn could be a catalyst for higher inflation expectations, the key driver of shifts on the longer-end of the curve.

3-Month LIBOR
December 31, 2020: 0.238%



Quarterly Year-to-date

Unemployment Rate
December 31, 2020: 6.7%



Quarterly Year-to-date

Source: Bloomberg

usbancorp Asset Management, Inc.

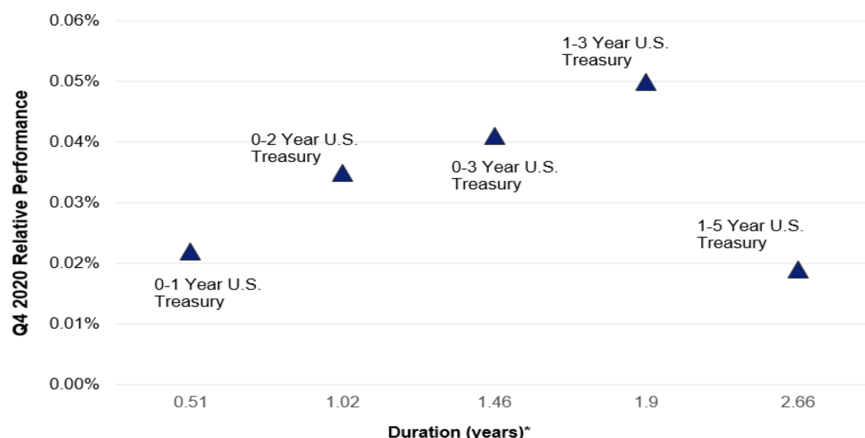
NOT FDIC INSURED NO BANK GUARANTEE MAY LOSE VALUE

Yield Curve Shift

U.S. Treasury Curve	Yield Curve 09/30/2020	Yield Curve 12/31/2020	Change (bps)*
3 Month	0.092%	0.058%	-3.3
1 Year	0.117%	0.104%	-1.3
2 Year	0.127%	0.121%	-0.6
3 Year	0.157%	0.165%	0.8
5 Year	0.277%	0.361%	8.4
10 Year	0.684%	0.913%	22.9

The three-month to ten-year portion of the yield curve steepened 26.3 basis points (bps) to 85.5 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 12/31/2020*

Given the absolute low level of rates and the minor yield curve movements for U.S. Treasuries inside of five-years, the differential in short duration U.S. Treasury index returns were minimal.

Credit Spread Changes

ICE BofA Index	OAS* (bps) 09/30/2020	OAS* (bps) 12/31/2020	Change (bps)
1-3 Year U.S. Agency Index	11	6	-5
1-3 Year AAA U.S. Corporate and Yankees	15	11	-4
1-3 Year AA U.S. Corporate and Yankees	34	22	-13
1-3 Year A U.S. Corporate and Yankees	49	33	-16
1-3 Year BBB U.S. Corporate and Yankees	108	69	-39
0-3 Year AAA U.S. Fixed-Rate ABS	40	31	-9
*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.

usbancorp Asset Management, Inc.

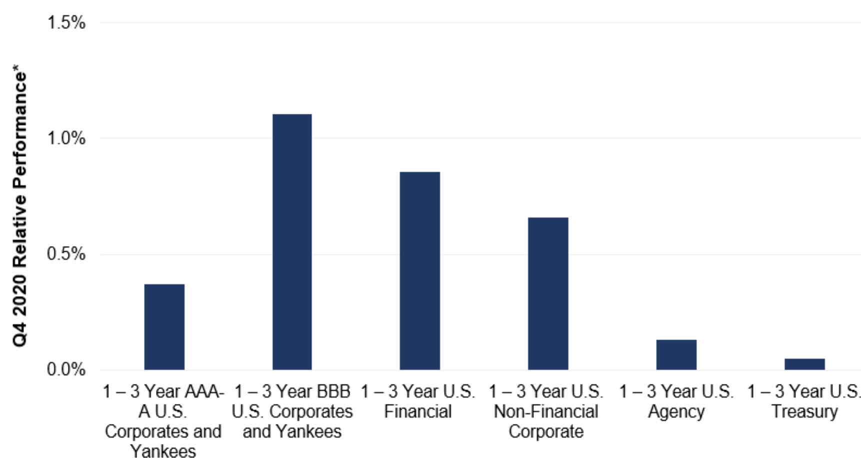
NOT FDIC INSURED NO BANK GUARANTEE MAY LOSE VALUE

Backed by central banks accommodation, vaccine-inspired economic enthusiasm and strong demand for any form of yield, credit spreads continued to tighten at a brisk pace in the fourth quarter, capping a remarkable recovery from the wides seen in March. Adding further value for investment-grade (IG) investors, the corporate IG credit curve flattened 12.7 bps for three-month vs. five-year debt.

For the year, the gyrations of the ICE BofA 1-5 Year U.S. Corporate Index (CVA0) OAS illustrate the remarkable widening and recovery in corporate credit spreads:

Date	OAS (bps)	Effective Yield	Implied UST Yield
12/31/2019	61	2.24%	1.63%
03/23/2020	430	4.65%	0.35%
12/31/2020	60	0.79%	0.19%

Credit Sector Relative Performance of ICE BofA Indexes



**AAA-A Corporate index outperformed the Treasury index by 32.2 bps in the quarter.*

AAA-A Corporate index underperformed the BBB Corporate index by 73.3 bps in the quarter.

U.S. Financials outperformed U.S. Non-Financials by 19.9 bps in the quarter.

For the third straight quarter, corporate credit and spread product generated significant excess returns over U.S. Treasuries, with lower-rated credit outperforming their higher-rated counterparts. Financials outperformed non-financials after sector spreads tightened more for banks than industrials.

What strategic moves were made and why?

Taxable Portfolios – Credit-sensitive assets were the main drivers of excess performance in the fourth quarter, outperforming Treasuries as spreads continued to constrict from already tight levels. Strong investor demand for yield, massive Fed liquidity injections and reduced front-end corporate supply have pulled investment-grade spreads essentially back to year-end 2019 levels. Negative public credit rating actions were muted in the quarter and

usbancorp Asset Management, Inc.

NOT FDIC INSURED NO BANK GUARANTEE MAY LOSE VALUE

no individual issuer 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. Where permitted, we opportunistically sold positions of large industrial issuers whose credit spreads moved into the low-single digits. Given the absolute low level of interest rates and relatively minor moves in the yield curve, duration strategies had little impact on excess returns for portfolios with duration targets less than three years. For longer portfolios, the steepening of the curve and the jump in ten-year U.S. Treasury yields to more than 0.90% favored bulleted structures with a short duration bias.

Tax Exempt and Tax-Efficient Portfolios – As prospects for fiscal aid to states and local governments increasingly hinged on election results, many municipalities chose to take this uncertainty off the table. Normal issuance patterns were disrupted, as more than $45 billion in tax-exempt bonds and approximately $27 billion in taxable municipal deals were placed – the highest combined monthly volume of 2020. Yields for tax-exempt debt in the front-end (one to three years) cheapened by about eight bps during this surge. With most of our current inquiry consisting of tax-efficient buyers, this wasn't enough to change the dynamic for us. The benefit for the tax-exemption at these low interest rate levels is just not worth all that much and corporates continued to offer the best after-tax value. With corporate credit spreads so compressed, we opted to focus the majority of our trading efforts on maturities around a year or shorter. These purchases allowed for meaningful income pick-up vs. cash sweep, with minimal risk. Taxable municipal credit spreads were fairly resilient despite the heavy issuance. We were inclined to add to positions in this sector based on yields comparable to corporates, diversification benefits and better relative credit quality. Overall, this quarter was one of the more difficult and challenging reinvestment periods with little perceived value.

How are you planning on positioning portfolios going forward?

Taxable Portfolios – Our investment themes for the first quarter of 2021 are eerily similar to our strategies to end 2020. With corporate, bank and ABS positions marked essentially at pre-COVID levels and the U.S. Treasury yield curve near historic lows, we expect first quarter portfolio returns to be dominated by coupon income with less opportunity for price appreciation from tighter spreads or lower yield curve levels. We continue to be impressed with the ability of high-quality corporate debt to tighten from historically expensive levels and will continue to purchase investment-grade corporate debt for client portfolios. Tactically, we view corporate securities with exceedingly tight credit spreads as sources of cash to be redeployed into higher-yielding or higher-quality debt and seek to emphasize opportunities in the new issue market where spreads generally exceed secondary market securities. In general, we regard any credit spread widening due to political 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. As we believe the Fed is fully committed to maintaining a 0.0% to 0.25% federal funds target rate through 2023, we expect short-end yields to be range-bound near current levels for the foreseeable future with little risk of a sharp sell-off in bonds maturing in three-years and less. For duration management, we favor keeping the duration of portfolios to 90-100% of benchmark duration with a bias toward the higher end of the duration band. The recent steepening of the yield curve offers some investment opportunities to tactically extend portfolio duration with more yield curve rolldown capacity than seen in the last quarter, with the added benefit of lowering reinvestment risk by locking in acceptable markets yields should rates drift lower.

Tax Exempt and Tax-Efficient Portfolios – Corporate bonds will likely continue to take the lead for tax-efficient reinvestment needs. Positioning thoughts are similar to what has already been described under the taxable section of this commentary. As we look ahead to 2021, the "blue wave" is perhaps the most bullish outcome for municipal investors. Post-election odds for a larger stimulus package have increased, as has the probability for states to be directly targeted. Tax increases will almost assuredly be required to pay for these massive fiscal efforts and it is quite reasonable to expect demand for exempt income to grow at both the corporate and individual level. Some municipal strategists have also speculated on a good chance an infrastructure package may finally be on the way. This would help support state and local economies and improve credit profiles. Prospects for fiscal aid, tax-reform and infrastructure spending are good reasons to expect a stable environment for short-term municipal investors – albeit at these painfully low levels of interest rates.

[See next page for important disclosure information]

NOT FDIC INSURED NO BANK GUARANTEE MAY LOSE VALUE

Sources:

Bloomberg

Federal Reserve

This information represents the opinion of U.S. Bancorp Asset Management, Inc., and is not intended to be a forecast of future events, a guarantee of future results, or investment advice. It is not intended to provide specific advice or to be construed as an offering of securities or a recommendation to invest. The factual information has been obtained from sources believed to be reliable but is not guaranteed as to accuracy or completeness. Past performance does not guarantee future results.

U.S. Bancorp Asset Management, Inc. is a registered investment adviser and subsidiary of U.S. Bank National Association. U.S. Bank National Association is a separate entity and wholly owned subsidiary of U.S. Bancorp. U.S. Bank is not responsible for and does not guarantee the products, services or performance of U.S. Bancorp Asset Management, Inc.

1/2021 0070-20

NOT FDIC INSURED NO BANK GUARANTEE MAY LOSE VALUE