Quarterly portfolio manager commentary

Cash Management Portfolios

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

Economic Activity – The fourth quarter (Q4) closed out a strong year for the U.S. economy with economic activity continuing to exceed expectations and growing at an above-trend pace throughout the year. U.S. gross domestic product (GDP) is projected to grow near 2.5% for Q4 amid still-firm domestic demand and consumer spending. Personal consumption remained healthy throughout the quarter as growing real wages and household wealth helped offset persistent headwinds from elevated prices and high interest rates. Labor market data was volatile during the quarter due to hurricane and strike-related impacts, but overall condiations suggest a resilient market that continues to normalize with stable hiring activity and low numbers of layoffs. November U.S. job openings rose modestly to 8.1 million open positions, while total unemployed workers in the labor force as of December were unchanged at 6.9 million. Monthly non-farm payrolls (NFP) growth remains healthy, averaging 170,000 during Q4 and the U3 unemployment rate was 4.1% in December, matching the level from September. Average hourly earnings growth is off its highs but remains solid at 3.9% year-over-year (YoY). The Consumer Price Index (CPI) increased to 2.7% in November versus 2.4% in September reflecting an uptick in energy prices. Core inflation's downward momentum stalled during the quarter with CPI ex- food and energy rising 3.3% YoY in November, consistent with the pace in September. The Federal Reserve's (Fed) preferred inflation index – the PCE Core Deflator Index – increased 2.8% YoY in November. The path back to the Fed's 2% inflation target remains elusive as minimal progress has been made to curtail elevated core services prices. While recent easing pressures within shelter costs offer an encouraging sign, the Fed is becoming increasingly wary of inflation risk leading to the potential for a longer pause in rate cuts to start the new year.

Monetary Policy – The Fed lowered its federal funds target range twice during the quarter, by 25 basis points (bps) at both the November 7 and December 18 meetings, ending the year at 4.25% to 4.50%. The Fed's post-meeting statement was little changed in December, only adding "the extent and timing" of additional rate moves will be based on the incoming data, the evolving outlook, and the balance of risks. The Fed also continues to implement its balance sheet reduction program (quantitative tightening), with a monthly cap of $25 billion in Treasury securities and $35 billion of agency mortgage-backed securities. The December rate cut was viewed as a "hawkish cut" by market participants with the Fed appearing to lay the groundwork for a slower pace of policy easing, including an anticipated pause at the upcoming meeting in January.

The Federal Open Market Committee (FOMC) released its updated Summary of Economic Projections at the December meeting which indicates additional rate cuts are coming, but later than previously forecast. The median projection for the federal

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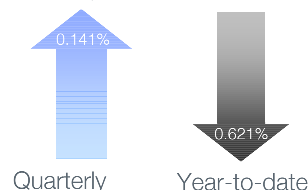
Fed funds target rate:
4.25-4.50 basis points
Last change: Dec. 18, 2024

1-year Treasury Yield
Dec. 31, 2024: 4.152%



Quarterly Year-to-date

usbancorp Asset Management, Inc.

December 31, 2024

funds rate at the end of 2025 was revised higher to a range of 3.75% to 4.0%, signaling 50 bps of rate cuts during the year versus 100 bps previously. The median dots show further rate cuts of 50 bps in 2026 and 25 bps in 2027, and the estimated longer-run neutral rate was increased to 3.0% (previously 2.875%). The FOMC's economic projections were revised to show higher expected core inflation in 2025 (2.5% vs. 2.2%) and 2026 (2.2% vs. 2.0%) compared to the prior release while revisions to GDP growth and unemployment forecasts were minimal. While the economic projections and dot plot are helpful in determining committee member's current expectations, we do not put too much stock in them as evolving economic conditions can quickly render them out-of-date. Additionally, the timing and economic impact from the incoming Trump Administration's policies on taxes, regulations, tariffs, and immigration will have an influence on the path of monetary policy in 2025.

Fiscal Policy – In an all too familiar scene, the federal government once again narrowly avoided a shutdown near the end of December, with Congress passing a continuing resolution to fund government operations at existing spending levels through March 14. The spending bill also included $100 billion in disaster and $30 billion in agricultural aid but did not include an extension of the debt ceiling, a late request by incoming President Trump. The debt ceiling, which was reinstated January 1, 2025, is not expected to become a binding issue until later in the year as the Treasury can use extraordinary measures and incoming tax receipts to continue funding the government over the near-term. The next year is anticipated to be an active period for fiscal policy. In addition to passing an annual budget and addressing the debt ceiling, legislation surrounding tax cuts and areas of spending reduction are expected to be high on the agenda for the new Congress and incoming Administration. On the municipal side, strong stock market performance in 2024 along with solid sales and property tax collections will aid state and local government budgets. As federal COVID money runs out, municipal entities that aligned the one-time revenues with one-time expenses will fare better than those that spent it on reoccurring expenditures.

Credit Markets – The three-month to 10-year portion of the U.S. Treasury yield curve steepened a hefty 109.1 bps in the quarter, as short rates fell on two 25 bps Fed rate cuts and long-rates moved higher on markets reducing the number of expected Fed rate cuts and growing skepticism over future progress on inflation. The yield curve shift resulted in the first positively shaped curve since Q4 2022. The severe yield curve steepening resulted in short duration strategies outperforming longer duration strategies. Lower-rated credit spreads outperformed their higher-rated counterparts.

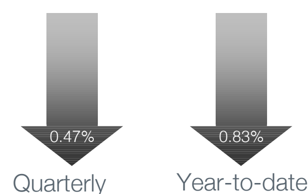
Yield Curve Shift

U.S. Treasury Curve	Yield Curve 9/30/2024	Yield Curve 12/31/2024	Change (bps)
3 Month	4.617%	4.314%	-30.3
1 Year	4.002%	4.143%	14.1
2 Year	3.641%	4.242%	60.1
3 Year	3.549%	4.273%	72.4
5 Year	3.558%	4.382%	82.4
10 Year	3.781%	4.569%	78.8

3-year Treasury Yield
Dec. 31, 2024: 4.274%

Quarterly Year-to-date

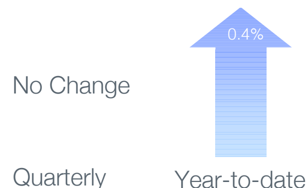
3-Month SOFR
Dec. 31, 2024: 4.49%



Quarterly Year-to-date

Unemployment Rate
Dec. 31, 2024: 4.1%

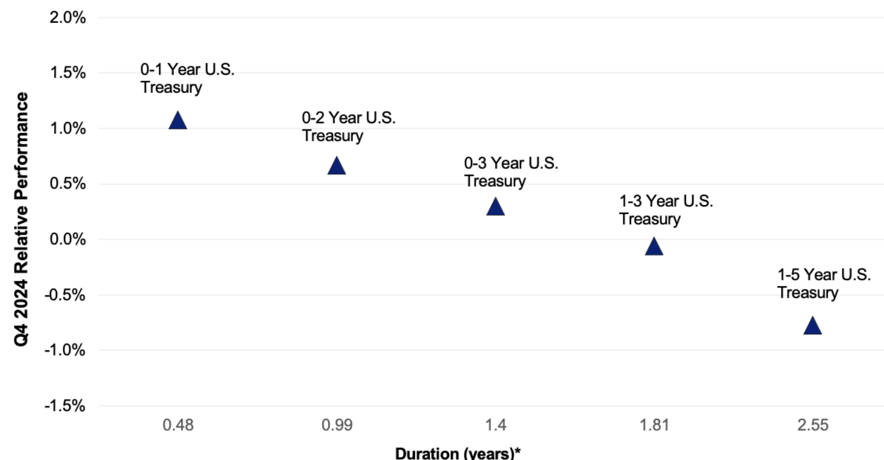
No Change



Quarterly Year-to-date

Source: Bloomberg U.S. Treasury Actives Curve, SOFRRATE and USURTOT Indices

Duration Relative Performance



Duration estimate is as of 12/31/2024

For the year, the three-month to ten-year portion of the yield curve steepened 170.8 bps, with three-month yields falling just over 100 bps and ten-yield yields rising 69 bps. The severe steepening pivoted around the two-year yield which ended 2024 only 0.8 bps lower than the end of 2023.

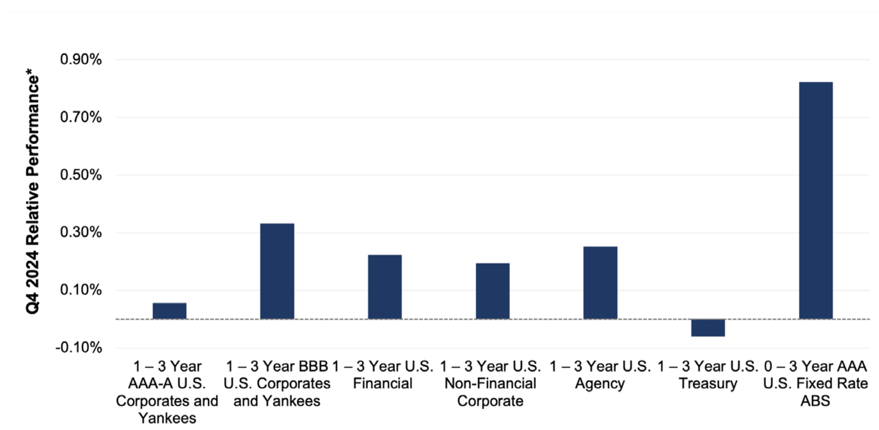
Credit Spread Changes

ICE BofA Index	OAS* (bps) 9/30/2024	OAS* (bps) 12/31/2024	Change (bps)
1-3 Year U.S. Agency Index	3	4	1
1-3 Year AAA U.S. Corporate and Yankees	7	14	7
1-3 Year AA U.S. Corporate and Yankees	26	30	4
1-3 Year A U.S. Corporate and Yankees	50	49	-1
1-3 Year BBB U.S. Corporate and Yankees	80	75	-5
0-3 Year AAA U.S. Fixed-Rate ABS	58	38	-20

Corporate credit spread performance diverged in the quarter, with higher quality issuers widening and BBB credit spreads tightening. Neither move was significant, but did result in solid outperformance for BBB corporates versus corporates in the AAA-A rated category. ABS spreads outperformed all corporate investment-grade sectors by tightening 20 bps in the quarter.

*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.

Credit Sector Relative Performance of ICE BofA Indexes



**AAA-A Corporate index outperformed the Treasury index by 8.6 bps.*

AAA-A Corporate index underperformed the BBB Corporate index by 27.6 bps

U.S. Financials outperformed U.S. Non-Financials by 3.0 bps

Given the jump in longer rates, absolute performance in longer fixed income indices was muted. AAA-rated ABS was the only notable outperformer, driven by the healthy 20 bps tightening in credit spreads. BBB credit outperformed the AAA-A-rated category on higher coupon income and better spread performance in the quarter.

What strategic moves were made and why?

Taxable Portfolios – Given the sharp steepening of the yield curve, cash and short duration strategies outperformed their longer duration counterparts. The move higher in yields lead to subdued or negative absolute fixed income returns for the quarter. Corporate and bank credit outperformed treasuries on higher coupon income and, on balance, relatively stable credit spreads. Asset backed securities (ABS) was an outlier with strong credit spread performance in the quarter, leading the sector to meaningfully outperform corporate credit. There were no significant credit or rating events in the quarter, and no single issuer or position had a meaningfully positive or negative impact on portfolio performance.

Tax Exempt and Tax-Efficient Portfolios – Municipal securities responded to Q4's stronger economic data and election outcomes in a similar way as was witnessed across other fixed income sectors. Yields on tax-exempt bonds with 2-5 year maturities increased by approximately 50 bps in Q4. Our municipal portfolios were well positioned for this rising rate environment, with shorter durations versus benchmarks. We initiated some extension trades throughout the quarter that were mostly defensive. These purchases were intended to keep portfolio durations from drifting too far from benchmarks. We believe this duration management was prudent given the recent interest rate volatility and the continued economic uncertainty. It is notable that 2024 was a record year of issuance for the municipal market. Tax-exempt volumes exceeded $460 billion, an increase of approximately 40% versus last year - and easily surpassing the prior high mark of $422 billion in 2007.

How are you planning on positioning portfolios going forward?

Taxable Portfolios – With markets pulling back on the number of expected 2025 Fed rate cuts to one or two 25 bps cuts, yield curve levels in the one to five-year

area are viewed as an attractive entry point to add duration and maintain portfolio durations near 100% of benchmarks. We also believe the balance of risks leans toward lower rather than higher rates through the end of the year. We base this outlook on 1) the Fed's asymmetric reaction function with policymakers tolerating stronger economic or employment data, but prepared to ease should conditions weaken, and 2) the market's bias to take rates down, implying the weight of evidence must reflect re-acceleration of inflation concerns to move yield curve levels higher. Credit spreads remain tight from a historical level, but we expect to maintain on overweight to credit on solid corporate fundamentals and a sanguine outlook for 2025 growth. The credit spread differential between higher and lower-rated issuers is historically tight, and USBAM remains focused on higher-quality issuers on relative value considerations. With agency spreads to comparable duration treasuries in the low to mid-single digits, our focus remains on treasuries in the fixed government space and opportunistically adding callable agencies when appropriate. ABS credit spreads tightened in the fourth quarter, bringing those valuations in line with corporate credit and tighter than historical averages. Despite more expensive valuations and some deterioration in underlying consumer metrics, particularly in sub-prime, we still view the sector favorably and will continue to focus on well-structured prime auto, credit card and equipment loan AAA-rated structures.

Tax Exempt and Tax-Efficient Portfolios – Municipal investors have much to contemplate going into 2025. Shifting expectations for Federal Reserve policy has led to big swings in interest rates over the last six months. And incoming economic data needs to be monitored closely. Additionally, municipal market participants would be wise to keep an eye on upcoming discussions involving the Tax and Jobs Cut Act (TJCA). Many of these TJCA provisions are set to expire by December 2025. Presuming legislators are intent on an extension, they will be in search of revenue offsets, and there is some chatter the municipal tax exemption may be considered as one of the options available to them. It remains to be seen if Congress would target certain sectors, such as higher education and healthcare, or if the potential changes could be broad-based. Existing municipal bonds would almost certainly be "grandfathered in" and remain tax-exempt. However, some potential market disruption/higher rates could arise in a situation where issuers get anxious about the threat and rush to place new deals ahead of anticipated legislative deadlines. Absent any of these tax-related changes, most municipal strategists are still forecasting another strong year for issuance. Supply for all of 2025 is expected to be positive on a "net" basis by nearly $45 billion and will likely be a periodic headwind for the municipal market. These supply/demand technical conditions are an important component in shaping our duration strategies. Accordingly, we may opt to keep portfolio durations on municipal mandates somewhat shorter at times relative to our taxable strategy ranges.

Sources

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