First American Funds

Quarterly Portfolio Manager Commentary

April 2018

# First American Money Market Funds

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

Volatility returned with abandon in the first quarter of 2018. The S&P 500 retreated from its January highs with multiple one-day declines over 1%, including a treacherous 4.1% fall on February 5th – the first day of Jerome Powell's tenure as Federal Reserve (Fed) Chairman. Inflation concerns sent ten-year U.S. Treasury yields up almost 55 basis points (bps) from year-end levels, peaking at 2.95% before retreating to 2.74% at quarter end. President Trump's foray into steel and aluminum tariffs, along with his attacks on important tech and pharmaceutical companies, had investors questioning the President's pro-business loyalties.

**Economic Activity** – In the quarter, the U.S. economy is expected to grow in the 1% to 2% range, slower than Q4/17's 2.9% print, but in line with the developing trend of soft first quarter GDP data. ISM Manufacturing and Non-Manufacturing readings of 59.3 and 58.8, respectively, remained high vs. historical levels, signaling further expansion. Employment data reflected continued strength, with Non-farm Payrolls adding 605,000 jobs in the quarter and the U3 and U6 Unemployment Rates coming in at 4.1% and 8.0%, respectively. March's Non-farm Payrolls gain of 103,000 was well below estimates, but generally shrugged off as a smoothing of February's robust 326,000 print. Initial Jobless Claims – an excellent indicator of real-time employment conditions – remained near 50-year lows. Average Hourly Earnings (AHE) has become an increasingly important market focal point for building inflation pressures. March's AHE rose 0.30% resulting in a 2.72% gain year-over-year (yoy), meeting expectations but not triggering significant inflation concerns. Interestingly, a similar 0.26% monthly gain in January's AHE is credited with sparking inflation fears which, in turn, contributed to the jump in equity market volatility and pushed ten-year U.S. Treasury yields toward 3.00%. Inflation measures continued to trend higher at a controlled pace, with February's Consumer Price Index up 2.20% yoy and February's Core Personal Consumption Expenditure Index up 1.60% yoy. Given the consistent strength in ISM data and employment conditions, the risk of recession appears low through 2018, with higher inflation, increased debt levels in the system and an overly-aggressive Fed the principal threats to sustained growth and equity valuations.

**Credit Markets** – Reversing recent quarterly trends, credit spreads widened as market volatility, a decline in general market liquidity and negative market technicals pushed spreads wider in the last two months of the quarter. Three-month LIBOR jumped 62 bps in the quarter, far more than the single 25 bp hike in the Fed's key benchmark rates. The dramatic rise in LIBOR is more a function of supply and demand technicals in the short-term funding markets than an indication of growing bank or financial distress. LIBOR and, to a lesser extent, repo rates have been impacted by several factors affecting the supply and demand for U.S. dollar funding: 1) the Fed's methodical reduction in the size of its balance sheet is effectively reducing bank reserves in the system (increased issuer demand), 2) the Federal debt ceiling was extended into March 2019 allowing the U.S. Treasury to issue Treasuries – including T-bills – to replenish the cash balances held at the Fed back toward $350 billion (increased issuer demand), 3) anticipated

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higher federal budget deficits due to tax cuts and spending increases have increased the need for greater Treasury issuance (increased issuer demand), 4) U.S. tax code changes have made it less efficient for U.S. subsidiaries of foreign entities to receive dollar swapped funding from their parents which, in turn, forces those subsidiaries to obtain dollar funding on their own (increased issuer demand), and 5) repatriation and other U.S. tax code changes have reduced the appetite of cash-rich multinationals to invest in short corporate debt (reduced supply). While the increase in LIBOR rates and spreads negatively impacted the prices of legacy investments, investors did benefit from rolling over maturing debt into higher yielding instruments and holders of floating-rate notes benefitted from higher coupon resets.

| ICE BofAML Index | Q1 2018 Relative Perfomance* |
|---|---|
| 1-3 Year AAA-A U.S. Corporates and All Yankees | -0.302% |
| 1-3 Year U.S. Treasury | -0.130% |

**Corporate index underperformed the Treasury index by 17.2 bps in the quarter*

The rise in credit spreads was pervasive in the investment-grade space, with the ICE BofA Merrill Lynch (ICE BofAML) 1-5 Year AAA-A U.S. Corporates & Yankees Index's option-adjusted spread increasing 16 bps from 40 bps to 56 bps, while the 1-5 Year ICE BofAML BBB U.S. Corporate and Yankee Index spread widened 24 bp from 79 bps to 103.

| ICE BofAML Index | Duration | Q1 2018 Relative Performance* |
|---|---|---|
| 1-3 Year U.S. Treasury | ~1.92 years | -0.130% |
| 1-5 Year U.S. Treasury | ~2.66 years | -0.378% |

**Short index outperformed the long index by 24.8 bps in the quarter*

Short-term U.S. Treasury yields rose across the board, reflecting an almost parallel shift with one- and five-year yields rising 35.1 and 35.6 bps, respectively. Not surprisingly, short duration strategies outperformed their longer-term counterparts. The shift to higher rates was not unexpected given the combination of Fed rate increases and rising inflation expectations from higher projected economic growth fueled by December's tax cuts.

**Monetary Policy –** As expected, the Fed raised benchmark rates 25 bps at the March 21st meeting. The median forecast from the Fed Dot Plot saw policymakers forecasting two additional 25 bp rate hikes in 2018 and three more in 2019. The Fed continued to taper the principal re-investments of maturities and mortgage paydowns in its portfolio with a first quarter 2018 cap of $20 billion per month. To date, the pace of the Fed's balance sheet reduction has not been reaching the established caps, partially attributable to a decline in mortgage refinancing, due to higher mortgage rates. Investors focused on the March 21st statement, Dot Plot and press conference for greater clarity on the pace and magnitude of 2018 rate hikes given market strategists seem to have coalesced around four hikes in the year vs. the Fed's median forecast for three. For his part, Chairman Powell gave a strong and assured performance at his inaugural press conference, balancing a confident outlook with an alertness for signs of inflation acceleration. San Francisco Fed President John Williams has been appointed to fill the key role of President of the Federal Reserve Bank of New York, a permanent voting position on the Federal Open Market Committee.

**Fiscal Policy –** Financial markets continued to digest the impact of sweeping changes to the U.S. tax code. In addition to triggering expectations for faster U.S. growth and higher corporate after-tax earnings, the tax code changes have clearly impacted investor behavior and supply / demand dynamics in the funding markets. President Trump's tariffs on steel, aluminum and other products have sparked fears of a trade war with several U.S. trading partners – China in particular. There is a general sentiment the President's actions are more about positioning for future trade talks rather than a true desire to implement new taxes on American consumers and industries. However, China's retaliatory actions and rhetoric have increased concerns the situation could escalate into a full-blown trade war. The President's seemingly arbitrary attacks on certain U.S. companies – Amazon in particular – are in stark contrast to the Administration's earlier efforts to praise American companies and extol the virtues of the U.S. economy. The Administration's change of tone and perceived haphazard approach to policymaking has increased investor anxiety and, in turn, market volatility.

## What were the major factors influencing money market funds this quarter?

The first quarter of 2018 started off with excitement surrounding President Trump's new tax and stimulus plans. As a result, interest rates increased across the curve on the expectations of higher economic growth, higher inflation and increased deficits. On the front end of the curve rates received additional boosts from significantly increased T-bill / T-note supply due to the Fed's continued balance sheet normalization, the restoration of the U.S. Treasury's desired cash balance following the resolution of the debt ceiling and seasonal tax planning. As the quarter progressed, uncertainty was thrown into the mix as the White House introduced trade policies that surprised markets.

**First American Institutional Prime Obligations Fund**

First American Institutional Prime Obligations Fund remains a smaller fund in the smaller post-reform universe. However, shareholders have adjusted well to the new floating net asset value (NAV) landscape and the First American Institutional Prime Obligations Fund has found a solid shareholder base. With comfort around the fund's base size, management was able to invest accordingly, seeking to take advantage of the dynamic investment environment. The fund continued to ladder fixed-rate securities in the 30- to 90-day range and purchase six- to nine-month floating-rate instruments. Most fixed-rate investments were strategically purchased to mature around key Fed meetings to better manage NAV stability in a rising rate environment. Throughout the quarter, the fund was able to exploit steepening on the very front end of the yield curve (the 30- to 90-day range). The steepening was a result of rapidly rising LIBOR rates, reflecting market dislocations from increased Treasury yields coupled with a reduction in demand in money market credit products, as the much smaller prime money market fund universe was unable to absorb the amount of product in had in years past. Floating-rate securities were the main purchase targets, as the rising coupon rates resetting off rapidly rising LIBOR levels were aggressive yield enhancers. By the end of the first quarter, three-month LIBOR rose to 2.311% and one-month LIBOR rose to 1.883%. With the credit environment stable, our main investment objective was to continue striving to enhance portfolio yield while judiciously extending the portfolio weighted average maturity (WAM) and weighted average life (WAL) in ways that minimized potential NAV volatility based on our credit, economic and interest rate outlook.

**First American Retail Prime Obligations Fund**

Similar to the institutional prime universe, the First American Retail Prime Obligations Fund continued with its core strategy to purchase short-term fixed-rate securities in the 30- to 90-day range and longer term floating-rate instruments in the six-month to one-year range. The First American Retail Obligations Fund benefited from the same market influences as the institutional fund and first quarter fund yields reflected the increase in three- and one-month LIBOR to 2.311% and 1.883%, respectively. Due to the stable NAV and predictable nature of the retail shareholder base, portfolio management was able to better capitalize on the rising interest rate environment reflected in LIBOR yields. The investment environment for prime funds remained attractive and we believe yields will be sustainable, making the sector an attractive short-term cash option for retail investors.

**First American Government Obligations Fund**

During the first quarter, supply became plentiful as Treasury issuance increased significantly, putting pressure on Treasury, government-sponsored enterprise (GSE) and repo yields. Yield compression in agency securities subsided as supply and demand dynamics impacted prices. The Fed's Reverse Repo Program (RRP) remains an important rate control tool, however it was utilized infrequently as dealer repo was plentiful and significantly cheaper. We continued the purchase of Treasury and agency securities with maturities as long as two years. We found value in two- to four-month fixed-rate GSE securities that made sense within our anticipated pace of Fed tightening. We also capitalized on opportunities to purchase floating-rate securities, maturing well into 2020. We believe that floating-rate securities will perform well, as we expect LIBOR to remain elevated relative to the RRP and government securities, due to lighter demand in short bank and corporate debt coupled with higher overall interest rate expectations. We will seek to add value and continue to employ this strategy as the market and portfolio metrics allow.

**First American Treasury Obligations and U.S. Treasury Money Market Funds**

Treasury funds experienced a similar investment environment to government funds. Treasury floating-rate note spreads, while compressing, were still positive and wide enough to offset the risk of a market flight to Treasury bills and remained an attractive addition to Treasury portfolios vs. overnight repo. In addition, we added economic value by purchasing fixed-rate term securities within 2a-7 guidelines, with yields and durations that best incorporated our interest rate forecast. Because Treasury portfolios are the most dependent on interest rate increases, anticipated Fed movement continued to have the largest impact on fund management decisions and overall yields.

**First American Retail Tax Free Obligations Fund**
Market conditions have resulted in dramatic swings in variable-rate demand note (VRDN) rates. The record municipal issuance in December inevitably and predictably disappeared in the first quarter, as tax reform changes precluding the tax-exempt issuance of advance refunding bonds became effective. Reinvestment demand briefly forced SIFMA resets below 1% – a drop of over 70 bps from the end of December. The fund was well-positioned during this time, with a longer WAM compared to many peers. Previously purchased six- to eight-month fixed-rate securities added significant value. Another fed funds rate hike, as well as quarter-end pressures on broker dealers to reduce inventory on balance sheets, resulted in a nearly 50 bp recovery in SIFMA rates during March, benefitting the fund's yield.

## What near-term considerations will affect fund management?

In the coming quarters, we anticipate yields on non-government debt to remain elevated relative to government securities in the face of rising interest rates, supply / demand dynamics and the spirited political environment. We believe both the institutional and retail prime obligations funds will remain attractive short-term investment options for investors seeking higher yields on cash positions while still assuming minimal credit risk. Yields in the agency and Treasury space will remain influenced by Fed policy and U.S. T-bill / T-note supply. We expect continued strong demand from investors in this space. In the municipal space, we anticipate rates could be influenced by seasonality around April income tax payments, continued low longer-term issuance and the likelihood of another rate hike in June. We will be mindful of the potential for more VRDN supply should issuers choose to convert direct loans with banks to more cost effective variable-rate financing. We will continue to seek opportunities – in all asset classes – that arise from market volatility based on domestic and global economic / market data and Fed rate expectations.

For more information about the portfolio holdings, please visit
https://www.firstamericanfunds.com/home/portfolio-holdings.aspx.

## Sources

Bloomberg
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Federal Reserve, Chair's FOMC Statement, December 13, 2017
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Municipal Market Monitor

## Definitions

**Basis Point (bps)** is one one-hundredths of a percentage point. This term is often used in describing changes in interest rates. For example, if a bond yield increases from 7.50% to 7.88%, it has moved up 38 basis points.
**Consumer Price Index (CPI)** is an inflationary indicator that measures the change in the cost of a fixed basket of products and services, including housing, electricity, food, and transportation. The CPI is published monthly.
**Federal Funds Rate (fed funds rate)** is the interest rate at which a depository institution lends immediately available funds (balances at the Federal Reserve) to another depository institution overnight.
**Federal Reserve (Fed)** is the United States central banking system. It is comprised of 12 regional central banks, known as the Federal Reserve Banks, which are owned by private banks. The Fed is governed by a seven-member Board of Governors, who regulates interest rates, availability of bank credit and sets other monetary policies such as legal reserve requirements for banks.
**Fed Reverse Repo Facility** is a repo program in which the Fed sells Treasury or agency securities to approved counterparties with an agreement to repurchase them back from the same counterparties at a specified price and date in the future.

**ICE BofA Merrill Lynch 1-3 Year AAA-A U.S. Corporates & All Yankees Index** is a subset of the BofA Merrill Lynch US Corporate & Yankees Index including all securities with a remaining term to final maturity less than three years and rated AAA through A3, inclusive.
**ICE BofA Merrill Lynch 1-3 Year BBB U.S. Corporates & All Yankees Index** is a subset of the BofA Merrill Lynch US Corporate & Yankees Index including all securities with a remaining term to final maturity less than three years and rated BBB through B3, inclusive.
**ICE BofA Merrill Lynch 1-5 Year AAA-A U.S. Corporates & All Yankees Index** is a subset of the BofA Merrill Lynch US Corporate & Yankees Index including all securities with a remaining term to final maturity less than five years and rated AAA through A3, inclusive.
**ICE BofA Merrill Lynch 1-3 Year U.S. Treasury Index** is a subset of the BofA Merrill Lynch U.S. Treasury Index including all securities with a remaining term to final maturity less than three years.
**ICE BofA Merrill Lynch 1-5 Year U.S. Treasury Index** is a subset of the BofA Merrill Lynch U.S. Treasury Index including all securities with a remaining term to final maturity less than five years.
**Inflation** is defined as a sustained increase in the general level of prices for goods and services. It is measured as an annual percentage increase. As inflation rises, every dollar you own buys a smaller percentage of a good or service.
**Laddering** is a technique for reducing the impact of interest rate risk by stucturing a portfolio with different bond issues that mature at different dates.
**LIBOR (London Interbank Offered Rate)** is the interest rate at which banks can borrow funds from other banks in the London interbank market. It is the world's most widely used benchmark for short-term interest rates.
**LIBOR Rates** are rates that the most creditworthy international banks dealing in eurodollars charge each other for large loans. The LIBOR rate is usually the base for other large eurodollar loans to less creditworthy corporate and government borrowers.
**Maturity** is the date on which the principal amount of a note, draft, acceptance, bond, or other debt instrument becomes due and payable. Also, termination or due date on which an installment loan must be paid in full.
**Monetary Policy** is the actions of a central bank, currency board or other regulatory committee that determine the size and rate of growth of the money supply, which in turn affects interest rates.
**Personal Consumption Expenditures Index** is a measure of price changes in consumer goods and services. It is essentially a measure of goods and services targeted toward individuals and consumed by individuals.
**SIFMA** is the Securities Industry and Financial Markets Association, a United States based trade group representing banks, brokerages and asset management firms.
**S&P 500 Index** is an unmanaged index of 500 stocks chosen for market size, liquidity and industry grouping, among other factors. The S&P 500 is designed to be a leading indicator of U.S. equities and is meant to reflect the risk/return characteristics of the large cap universe.
**Treasury** is negotiable debt obligation of the U.S. government, secured by its Full Faith and Credit and issued at various schedules and maturities. The income from Treasury securities is exempt from state and local, but not federal, taxes.
**U.S. Treasury Note** is a marketable U.S. government debt security with a fixed interest rate and a maturity between one and 10 years. Treasury notes can be bought either directly from the U.S. government or through a bank.
**U3 Unemployment Rate** is the commonly-referred to unemployment rate. It includes people out of work who have been actively seeking employment over the last four weeks.
**U6 Unemployment Rate** is the group of people who are unemployed but marginally attached to the workforce, meaning they are available to work but not looking, or who work part-time when they wish to be working full time.
**Variable Rate Demand Note (VRDN)** is a debt instrument that represents borrowed funds that are payable on demand and accrue interest based on a prevailing money market rate, such as the prime rates. The interest rate applicable to the borrowed funds is specified from the outset of the debt and is typically equal to the specified money market rate plus an extra margin. Also referred to as a variable rate demand obligation (VRDO).
**Weighted Average Life**, also known as Weighted Average Final Maturity, (WAL) is the average time to maturity of all the securities held in the portfolio, weighted by each security's percentage of total investments. Unlike WAM, the WAL calculation takes into account the final maturity date for each security held in the portfolio. WAL measures a fund's sensitivity to potential credit spread changes.
**Weighted Average Maturity (WAM)** is the average time to maturity of all the securities held in the portfolio, weighted by each security's percentage of total investments. This calculation takes into account the final maturity date for a fixed income security and the interest rate reset date for a floating rate security, which is allowed by Rule 2a-7 provisions. WAM measures a fund's sensitivity to interest rate changes.
**Yield Curve** is a line tracing relative yields on a type of bond over a spectrum of maturities ranging from three months to 30 years.

*[See next page for important disclosure information.]*

The information and views expressed are provided by the funds' portfolio manager(s) and are current only through the date on this report. They are not intended to provide specific advice or to be construed as an offering of securities or a recommendation to invest. One cannot invest directly in an index. This information is subject to change at any time based on upon market or other conditions and may not be relied on as a forecast of future events or a guarantee of future results. Fund holdings, sector and portfolio allocations are subject to change at any time and are not recommendations to buy or sell any security. **Past performance does not guarantee future results.**

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For U.S. Treasury, Treasury Obligations and Government Obligations – *You could lose money by investing in the Fund. Although the Fund seeks to preserve the value of your investment at $1.00 per share, it cannot guarantee it will do so. An investment in the Fund is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. The Fund's sponsor has no legal obligation to provide financial support to the Fund, and you should not expect that the sponsor will provide financial support to the Fund at any time.*

For Retail Prime Obligations and Retail Tax-Free Obligations – *You could lose money by investing in the Fund. Although the Fund seeks to preserve the value of your investment at $1.00 per share, it cannot guarantee it will do so. The Fund may impose a fee upon sale of your shares or may temporarily suspend your ability to sell shares if the Fund's liquidity falls below required minimums because of market conditions or other factors. An investment in the Fund is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. The Fund's sponsor has no legal obligation to provide financial support to the Fund, and you should not expect that the sponsor will provide financial support to the Fund at any time.*

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