First American Funds

Quarterly Portfolio Manager Commentary July 2018

First American Money Market Funds

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

While far from serene, financial market volatility fell in the second quarter vs. the tumultuous first quarter, with U.S. equity markets showing gains – highlighted by the NASDAQ's healthy 6.33% advance. Increased tensions with key trading partners impacted markets, mostly to the negative. The Federal Reserve (Fed) continued to normalize monetary policy through rate hikes and balance sheet reduction at a self-described gradual pace. Global markets were temporarily roiled by May's Italian elections, which saw anti-establishment / anti-European Union (EU) parties make strong gains in Parliament and forced investors to revisit EU debt and growth problems.

Economic Activity – In the second quarter, analysts forecast GDP growth in the 3 - 4% range driven by gains in business investment, government spending and consumer consumption. June's ISM Manufacturing and Non-Manufacturing readings of 60.2 and 59.1, respectively, remained high vs. historical levels, signaling continued economic strength and expansion. Employment conditions continued to improve, highlighted by Non-farm Payrolls adding 632,000 jobs in the quarter. June's 4.0% U3 Unemployment Rate was actually higher than May's 3.8% reading. Rather than being a sign of waning demand for labor, the jump was entirely attributable to June's big 601,000 increase in the labor force, a positive development signaling potentially higher labor slack in the economy. Average Hourly Earnings – an increasingly important market focal point for building inflation pressures – rose only 0.2% in June, a touch below analyst expectations. Inflation measures have essentially reached the Fed's 2% target, as May's Consumer Price Index reached 2.8%, while the Fed's favored inflation measure – the Core Personal Consumption Expenditure Index – was up 2.0% year-over-year (yoy). Given the consistent strength in ISM data and employment conditions, we feel the risk of recession remains low through 2019. Unexpectedly higher inflation, increased debt levels in the system and an overly-aggressive Fed are the principal threats to sustained growth and equity valuations.

Credit Markets – In line with the lower volatility in most risk assets, credit spread movement was relatively well contained in the quarter. After jumping 61.7 basis points (bps) in the first quarter, three-month LIBOR ended the second quarter at 2.336%, a mere 2.4 bps higher than March's final 2.312% reading. The tempering of LIBOR movement implies bank funding demand has stabilized and the market has seemingly absorbed the double-barrel disruption of tax code changes and the massive increase in T-bill issuance.

Credit Spread Changes

ICE BofAML Index	OAS* (bps) 3/31/18	OAS* (bps) 6/30/18	Change (bps)
1-3 Year U.S. Agency Index	7	8	1
1-3 Year AAA-A U.S. Corporate and Yankees	18	18	0
1-3 Year AA U.S. Corporate and Yankees	53	51	-2
1-3 Year A U.S. Corporate and Yankees	68	64	-4
1-3 Year BBB U.S. Corporate and Yankees	93	95	2
0-3 Year AAA U.S. Fixed-Rate ABS	52	48	-4

*OAS = Option-Adjusted Spread

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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 Relative Performance

ICE BofAML Index	Q2 2018 Performance*
1-3 Year AAA-A U.S. Corporate and Yankees	0.414%
1-3 Year BBB U.S. Corporate and Yankees	0.449%
1-3 Year U.S. Financial Index	0.465%
1-3 Year U.S. Non-Financial Index	0.473%
1-3 Year U.S. Treasury	0.222%

**AAA-A Corporate index outperformed the Treasury index by 19.2 bps in the quarter*
**AAA-A Corporate index underperformed the BBB Corporate index by 3.5 bps in the quarter*
**U.S. Financials underperformed U.S. Non-Financials by 0.8 bps in the quarter*

Corporate credit and spread product outperformed comparable-duration Treasuries in the quarter. The relative stability of spreads allowed lower-quality debt to outperform higher-quality issuers, primarily on its embedded coupon income advantage. Headline risk in the form of mergers and acquisitions impacted large issuers including AT&T, Disney and Comcast. Ratings actions remained rather muted, with issuer downgrades generally restricted to one notch. Year-to-date (YTD) through May, there has been $555.4 billion in investment-grade corporate debt issuance, a decline of 14.8% from 2017 levels.

Yield Curve Shift

U.S. Treasury Curve	Yield Curve 3/31/18	Yield Curve 6/30/18	Change (bps)*
3 Month	1.700%	1.912%	21.2
1 Year	2.082%	2.312%	23.0
2 Year	2.266%	2.528%	26.2
3 Year	2.383%	2.622%	23.9
5 Year	2.562%	2.738%	17.6
10 Year	2.739%	2.860%	12.1

**Interest rose across the yield curve in the quarter*
**U.S. Treasury Yield Curve from 1 to 5 years flattened 5.4 bps*
**U.S. Treasury Yield Curve from 2 to 10 years flattened 14.1 bps*

Duration Relative Performance

ICE BofAML Index	Duration (years)*	Q2 2018 Performance**
0-1 Year U.S. Treasury	0.51	0.462%
0-2 Year U.S. Treasury	1.00	0.375%
0-3 Year U.S. Treasury	1.43	0.302%
1-3 Year U.S. Treasury	1.87	0.222%
1-5 Year U.S. Treasury	2.65	0.126%

**Duration estimate is as of 6/30/18*
***In general, shorter duration indexes outperformed longer indexes*

U.S. Treasury yields rose across the curve in the quarter, allowing short-duration strategies to outperform their longer-term counterparts. The continued move upward in rates was not unexpected given the June Fed rate hike and growing anticipation for two additional hikes in 2018. The yield curve flattened in the quarter, as the Fed-induced increase in short-term rates outpaced the rise in longer-term rates, which tend to move more on overall growth and inflation outlooks.

Monetary Policy – As expected, at the June 13th meeting the Fed raised the target range for the federal funds (fed funds) rate 25 bps to 1.75% - 2.00%. The Fed raised the Interest on Excess Reserves (IOER) only 20 bps in an effort to push the fed funds effective rate lower in the target range. In addition, the Fed Dot Plot raised expectations for a total of four 2018 rate hikes vs. March's projection of three. The Fed remains upbeat on employment conditions in the medium term, forecasting a 3.5% U3 Unemployment Rate for 2019 and 2020 – far below the expected longer run rate of 4.5%. Core PCE Inflation is projected to increase 2.1% in 2019 and 2020, reflecting the Fed's confidence in meeting its 2% longer run goal while downplaying the risk of meaningfully higher inflation. In an effort to increase transparency into the Fed's decision-making process, Chairman Powell announced he will be holding a press conference after every Fed meeting rather than the current every-other meeting pace. The change would also give the Fed greater flexibility to accelerate the pace of policy normalization, although the Fed retained language in the June 13th statement stating it expects "further gradual increases" in the fed funds rate – which the market has interpreted as maintaining the current pace of every other meeting. The Fed continued to taper principal re-investments of maturities and mortgage pay downs in its portfolio with a second quarter cap of $30 billion per month, growing to $40 billion per month next quarter. Since the Fed's balance sheet reduction program began, "securities held outright" and "reserve balances" have fallen $138.4B and $237.9B, respectively, since September 27, 2017.

Fiscal Policy – The Trump Administration aggressively pursued revised trade agreements through both enacting and threatening large scale tariffs on key trade partners including China, Canada, Mexico and the EU. Recent U.S. tariffs include 25% on steel imports, 10% on aluminum imports, a 25% tariff on $50 billion in certain Chinese imports, a proposed but yet to be implemented tariff on an additional $200 billion in Chinese imports and a 25% tariff on car imports from the EU. President Trump clearly believes tariffs are an effective tool to bring trade partners to the negotiating table and that the potential impact on GDP growth (estimated to be -0.25%) and inflation (estimated to be +0.20%) is relatively small. Financial markets and risk assets have been increasingly influenced by trade war headlines – both U.S. proposals and the in-kind retaliation. Recent corporate tax reductions continued to work their way through the economy and financial markets, supporting equity markets with higher expected after-tax returns and impacting corporate capital flows, including new issuance.

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

The second quarter of 2018 continued to deliver solid economic and jobs data, setting expectations for higher interest rates. As expected, the Fed increased rates another 25 bps on June 13th, but delivered a bit more hawkish message for 2018, solidifying a call for four total rate hikes in 2018. Deficit spending coupled with balance sheet normalization kept T-bill / T-note supply plentiful, which also added pressure to front-end yields. As the quarter progressed, geo-political uncertainty continued as the White House introduced and executed trade and foreign policies that kept markets on edge.

First American Institutional Prime Obligations Fund
While slowly growing in the post-reform era, the First American Institutional Prime Obligations Fund remains a much smaller fund in a much smaller universe. However, shareholders have adjusted well to the new floating net asset value (NAV) landscape and the 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 exploited the steepening of the very front end of the yield curve (the 30- to 90-day range). The steepening was a result of rising LIBOR rates (most pronounced in one-month LIBOR), reflecting market dislocations from increased Treasury yields, coupled with a reduction in demand for money market credit products, as the much smaller prime money market fund universe was unable to absorb the amount of product it had in years past. Floating-rate securities were the main investment focus, as

the rising coupon rates reset off elevated LIBOR levels. By the end of the second quarter, three-month LIBOR only rose about 2 bps to 2.336% and one-month LIBOR rose to 2.090%. Management was more active in one-month LIBOR floaters due to the rather stagnant behavior of the three-month LIBOR Index. With the credit environment stable, our main investment objective was to continue 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 second quarter fund yields reflected the increase in three- and one-month LIBOR to 2.336% and 2.090%, 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

Government funds continue to hold the majority of cash that migrated as a result of money market fund reform. During the first quarter supply became plentiful and that continued into the second quarter, as Treasury issuance increased significantly putting pressure on Treasury, agency and repo yields. Yield compression in agency securities subsided as supply and demand dynamics impacted prices. The Fed's Reverse Repo Program (RRP) remained an important rate control tool, however it was utilized infrequently outside of quarter end, as dealer Repo was plentiful and significantly cheaper. We continued to purchase Treasury and agency securities with maturities as long as two years. We found value in two- to four-month fixed-rate agency 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

Volatility in tax-free money market rates continued, with one of the widest intra-quarter ranges in VRDN yields (76 bps) that we have seen in some time. Income tax payments in April pressured rates early in the quarter. As fund redemptions increased during tax season, so too did the yields on VRDNs, with SIFMA reaching a high of 1.81% in mid-April. Flows stabilized in May and with much lighter inventories, dealers aggressively lowered floater rates to near 1.00% for a short time. Investors began to push back against these levels in June and rates ultimately recovered by approximately 50 bps. The June Fed rate hike was a contributing factor toward the reversal in rates, as was a cautious dealer community which was sensitive to inventories going into quarter end. Proper allocations between fixed- and floating-rate securities were very impactful to performance results. The fund had benefitted during the first quarter from a higher allocation to fixed-rate securities, however this strategy was not nearly as effective in Q2, as floaters tended to outperform. We were able to execute some swaps during the quarter to lessen this impact on performance and add floating-rate exposure.

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 T-bill / T-note supply. We expect continued strong demand from investors in the government and Treasury fund space. 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. In terms of First American Retail Tax-Free Obligations Fund, we anticipate net-negative overall issuance of municipal bonds in July and August to negatively impact VRDN rates. However, as we experienced weeks ago, there is a breaking point after which investors will seek alternatives and broker-dealers may not proceed as aggressively this time around. The Fed is likely to continue its tightening pace and hike rates in September, which would be a counter-balance to the municipal negative supply technical conditions. Continued positive economic data in the first half of 2018 has added to our conviction for further 2018 Fed moves. Accordingly, we have shortened our portfolio WAM and increased allocations toward floating-rate investments.

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

Sources

Bloomberg
Federal Reserve Statistical Release, June 28, 2018
FOMC Press Release, June 13, 2018

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.
Duration is a measure of a security's price sensitivity to changes in interest rates. Securities with longer durations are more sensitive to changes in interest rates than securities of shorter durations.
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 BofAML 0-1 Year U.S. Treasury Index tracks the performance of U.S. dollar denominated sovereign debt publicly issued by the U.S. government in its domestic market with maturities less than one year.
ICE BofAML 0-2 Year U.S. Treasury Index tracks the performance of U.S. dollar denominated sovereign debt publicly issued by the U.S. government in its domestic market with maturities less than two years.
ICE BofAML 0-3 Year AAA U.S. Fixed Rate Asset Backed Securities Index is a subset of ICE BofAML U.S. Fixed Rate Asset Backed Securities Index including all securities with a remaining term to final maturity less than three years and rated AAA.
ICE BofAML 0-3 Year U.S. Treasury Index tracks the performance of U.S. dollar denominated sovereign debt publicly issued by the U.S. government in its domestic market with maturities less than three years.
ICE BofAML 1-3 Year AAA-A U.S. Corporates & All Yankees Index is a subset of the BofA Merrill Lynch U.S. Corporate & Yankees Index including all securities with a remaining term to final maturity less than three years and rated AAA through A3, inclusive.
ICE BofAML 1-3 Year AA U.S. Corporates & All Yankees Index is a subset of the BofA Merrill Lynch U.S. Corporate & Yankees Index including all securities with a remaining term to final maturity less than three years and rated AA1 through AA3, inclusive.

ICE BofAML 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 BBB1 through BBB3, inclusive.
ICE BofAML 1-3 Year Single-A U.S. Corporates & All Yankees Index is a subset of the BofA Merrill Lynch U.S. Corporate & Yankees Index including all securities with a remaining term to final maturity less than three years and rated A1 through A3, inclusive.
ICE BofAML 1-3 Year U.S. Agency Index is a subset of ICE BofAML U.S. Agency Index including all securities with a remaining term to final maturity less than three years.
ICE BofAML 1-3 Year U.S. Financial Index is a subset of ICE BofAML U.S. Corporate Index including all securities of Financial issuers with a remaining term to financial maturity less than three years.
ICE BofAML 1-3 Year U.S. Non-Financial Corporate Index is a subset of ICE BofAML U.S. Non-Financial Index including all securities with a remaining term to final maturity less than three years.
ICE BofAML 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 BofAML 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.
ISM Manufacturing Index is a monthly index released by the Institute of Supply Management, an industry association for supply management professionals, which tracks manufacturing activity, including employment, production inventories, new orders and supplier deliveries. This is index is a key measure of the national economy.
ISM Non-Manufacturing Index is a monthly index of more than 400 non-manufacturing firms' purchasing and supply executives within 60 sectors across the nation, released by the Institute of Supply Management (ISM).The ISM Non-Manufacturing Index includes seasonally adjusted figures for several of its components, unlike the ISM Manufacturing Index.
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.
NASDAQ Composite Index is an unmanaged index which tracks all common stocks listed on the NASDAQ and is used primarily to track technology stocks.
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.
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.
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.
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.