First American Money Market Funds

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

Financial market sentiment took a U-turn in the fourth quarter, from being relatively sanguine to quite fearful. Wall Street estimates pivoted from expecting as many as four 2019 Federal Reserve (Fed) rate hikes to pricing in a potential rate cut. Slowing global growth, trade and tariff concerns, Fed policy tightening and communication errors conspired to push investors toward a decidedly risk-off mentality, particularly in December.

Economic Activity – Despite the fourth quarter's financial market volatility, U.S. Gross Domestic Product (GDP) is expected to grow 2.5% to 3.5% in the fourth quarter, reasonably in line with third quarter growth of 3.4%. Buttressed by low unemployment and higher wages, personal consumption – which makes up approximately 69% of U.S. GDP – is expected to remain supportive of overall GDP growth. For most of the quarter, ISM Manufacturing and Non-Manufacturing readings hovered near historic highs but declined to 54.1 and 57.6, respectively, in December. While both readings reflected continued expansion, the steep monthly decline was troubling and worth monitoring as an indicator of the potential impact tariffs and trade wars are having on business planning and production. Employment conditions remained strong despite the U3 Unemployment Rate rising to 3.9% from 3.7%, as the increase was primarily driven by a surge of 1.185 million workers in the Civilian Labor Force, a decidedly positive indicator for employment conditions. Hiring remained robust, with Nonfarm and Household employment adding 762,000 and 876,000 jobs, respectively, in the quarter. December's employment report was particularly helpful to investor attitudes, almost perfectly blending strong job growth and growing wages with a higher participation rate, signaling the potential for continued non-inflationary expansion. Inflation measures began rolling over with the U.S. PCE Deflator and Core PCE falling below the Fed's 2% target. Significantly, inflation expectations as measured by five-year TIPs vs. Treasuries fell to 1.49% at year-end, the lowest levels seen since 2016.

Credit Markets – Slowing global growth, trade and tariff concerns, Fed policy tightening and Fed communication errors all contributed to a decidedly risk-off investor mentality and a widening of credit spreads. Lower quality issuers suffered more than their higher-rated counterparts on concerns over the ability to refinance upcoming maturities and higher debt service costs. Market liquidity was available but more constrained than in previous quarters, exacerbating spread widening. Three-month LIBOR jumped 40 basis points (bps) in the quarter, countering the decline in U.S. Treasury yields and improving the upfront yield of floating-rate notes vs. comparable maturity fixed-rate debt.

Credit Spread Changes

ICE BofAML Index	OAS* (bps) 9/30/18	OAS* (bps) 12/31/18	Change (bps)
1-3 Year U.S. Agency Index	5	5	0
1-3 Year AAA-A U.S. Corporate and Yankees	14	13	-1
1-3 Year AA U.S. Corporate and Yankees	38	52	14
1-3 Year A U.S. Corporate and Yankees	48	75	27
1-3 Year BBB U.S. Corporate and Yankees	77	127	50
0-3 Year AAA U.S. Fixed-Rate ABS	34	53	19

*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	Q4 2018 Relative Performance*
1-3 Year AAA-A U.S. Corporate and Yankees	1.044%
1-3 Year BBB U.S. Corporate and Yankees	0.652%
1-3 Year U.S. Financial	0.839%
1-3 Year U.S. Non-Financial Corporate	0.782%
1-3 Year U.S. Treasury	1.292%

**AAA-A Corporate index underperformed the Treasury index by 24.8 bps in the quarter*

**AAA-A Corporate index outperformed the BBB Corporate index by 39.2 bps in the quarter*

**U.S. Financials outperformed U.S. Non-Financials by 5.7 bps in the quarter*

U.S. Treasuries outperformed corporate credit in the quarter and higher-rated corporates outperformed BBB issuers. However, corporate credit indexes still posted positive returns in the quarter, as coupon income and price appreciation from the drop in interest rates overcame the negative price impact of wider spreads. Financials outperformed their industrial counterparts, indicating recent financial market volatility was not due to perceived stress in the banking sector.

Yield Curve Shift

U.S. Treasury Curve	Yield Curve 9/30/18	Yield Curve 12/30/18	Change (bps)*
3 Month	2.196%	2.355%	15.9
1 Year	2.563%	2.596%	3.3
2 Year	2.819%	2.488%	-33.1
3 Year	2.883%	2.456%	-42.7
5 Year	2.953%	2.511%	-44.2
10 Year	3.061%	2.684%	-37.7

**Yield Spread between 3-month and 10-year U.S. Treasuries is 32.9 bps (not inverted)*

**U.S. Treasury Yield Curve from 1 to 5 years flattened 47.5 bps*

**U.S. Treasury Yield Curve from 2 to 10 years flattened 4.6 bps*

Treasury yields beyond one-year collapsed with the flight-to-quality trade, deflation concerns, Fed policy reversal and slowing U.S. / global growth all sharing in the blame. The fall in yields was severe, as investors shifted from expecting 2019 rate hikes to fed funds futures implying a 12.8% probability for a rate cut within the next twelve months. The yield curve – as quantified by the Fed's preferred measure of three-month to ten-year yields – flattened 53.6 bps in the quarter, but importantly remained at a positive 32.9 bps overall. The brief inversion between two- and five-year yields gathered media and investor attention, but was likely linked to strong demand for five-year Treasuries related to credit-default swap hedging in the higher volatility credit environment.

Duration Relative Performance

ICE BofAML Index	Duration (years)*	Q4 2018 Relative Performance**
0-1 Year U.S. Treasury	0.49	0.632%
0-2 Year U.S. Treasury	0.99	0.833%
0-3 Year U.S. Treasury	1.43	1.081%
1-3 Year U.S. Treasury	1.87	1.292%
1-5 Year U.S. Treasury	2.62	1.722%

**Duration estimate is as of 12/31/18*

***In general, shorter duration indexes underperformed longer indexes*

With the sharp decline in U.S. Treasury yields, short-duration strategies noticeably underperformed their longer-term counterparts. With the flattening of the yield curve, barbell-structured portfolios performed particularly well in the quarter.

Monetary Policy – The Fed raised the federal funds (fed funds) target range 25 bps to 2.25% - 2.50% at the December 19th meeting. While the increase met market expectations, there was less investor conviction about the likelihood of a rate hike than typically seen close to a Fed meeting. The accompanying Fed statement and Dot Plot predicting two 2019 rate hikes was less dovish than investors hoped for given recent market declines. During the post-meeting press conference, Chairman Jay Powell suggested the Fed's balance sheet reduction program – currently capped at $50 billion per month in maximum asset purchase reductions – was on autopilot, unnerving investors hoping for greater flexibility and open-mindedness from Fed officials in dealing with tightening financial conditions. Fed officials have begun walking back the impression of rigidity and acknowledged the difficulty of managing the twin normalization policies of raising rates and balance sheet reduction. Since the Fed's balance sheet reduction program began in October 2017, securities held outright and reserve balances have fallen $360.1B and $517.9B, respectively.

Fiscal Policy – With the initial benefits of tax reform waning, the dual headwinds of a federal government shutdown and trade wars have begun to bite into the economy's growth prospects. From a GDP standpoint, a brief government shutdown is marginally negative. But as the current shutdown enters record territory, the effect will begin extending beyond government workers and public inconveniences, negatively impacting government contractors, air travel and business planning in general. The lack of progress and antipathy between President Trump and Congressional Democrats has dampened investor confidence and contributed to December's downturn in risk assets. Trade hostilities with China continued to skew markets to the downside. The financial market interest in a trade deal with China is obvious, as positive headlines or comments on trade negotiations from the Administration tend to lead to market rallies and negative news to sell-offs. The lack of progress has weighed on risk assets and the economy, but may provide upside to growth and markets should a reasonable deal with China be struck.

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

First American Institutional Prime Obligations Fund

As with the institutional prime money fund industry, the First American Institutional Prime Obligations Fund remains a smaller fund in a smaller universe. However, shareholders have adjusted to the new floating net asset value (NAV) landscape and the First American Institutional Prime Obligations Fund has found a solid and modestly expanding shareholder base. With comfort around the fund's base size, management invested accordingly, seeking to take advantage of the dynamic investment environment. The fund laddered fixed-rate securities in the 30- to 90-day range and purchased 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. Throughout the quarter, the very front end of the yield curve flattened as market expectations for future rate hikes diminished. The curve flattening resulted in somewhat less robust yields in the prime sector vs. those produced in the first three quarters. Management was active in one-month LIBOR floaters due to stable pricing and more predictable resets. We also participated in three-month LIBOR floaters which offered attractive yields. With the credit environment stable, our main investment objective was 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, for the majority of the quarter the First American Retail Prime Obligations Fund continued with its core strategy of purchasing 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 fund benefited from the same market influences as the institutional fund and fourth quarter fund yields reflected the increase in three- and one-month LIBOR to 2.808% and 2.503%, respectively. Due to the stable NAV and predictable nature of the retail shareholder base, portfolio management was able to better capitalize on and get ahead of the yield curve flattening and invest in some longer fixed-rate securities with higher yields in the six- to nine-month space. Despite less certainty around Fed policy, 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 be the benefactor of the cash migration resulting from money market fund reform. Since the first quarter of 2018 supply has been plentiful as Treasury, Government-sponsored Enterprise (GSE) and dealer repo supply have kept government money market fund yields elevated. While the Fed's Reverse Repo Program (RRP) remained an important rate control tool, it was utilized infrequently outside of quarter end, as dealer repo was plentiful and significantly cheaper. The First American Government Obligations Fund often participated in bi-weekly Federal Home Loan Bank discount note auctions to capitalize on one- to six-month discount note opportunities that outperformed repo and made sense within our anticipated pace of Fed tightening. We also found value in Treasury and agency floating-rate securities with maturities out to two years. We purchased diversified floating-rate securities maturing well into 2020 tied to one- and three-month LIBOR, fed funds, three-month T-bills and Secured Overnight Financing Rate indexes, as we believe that floating-rate securities will perform well. We expect LIBOR to remain elevated relative to the RRP vs. other government securities and we anticipate the alternative indexes listed above will provide a meaningful spread to overnight repo while responding quickly to changes in interest rates. We will seek to add value by continuing 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 were 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

Tax-exempt money funds finished the year strong with the universe seeing nine consecutive weeks of inflows totaling more than $11 billion. December is typically one of the larger months of the year for bond maturities and coupon reinvestment. In addition, equity market volatility encouraged some investors to reduce stock holdings and move to cash and the First American Tax Free Obligations Fund was a benefactor. The level of tax exempt money market fund assets now exceeds the outstanding supply of variable rate demand notes (VRDNs), limiting the impact of December's fed funds increase on tax exempt money find rates. The SIFMA index of variable rate demand notes was much more stable vs. recent quarters with a range of just 15 bps. While variable rates generally moved higher during the quarter, yields on fixed-rate investments fell as the market priced in downside economic concerns for 2019. Some of the more liquid notes offered in August 2019 saw adjustments of approximately 20 bps.

What near-term considerations will affect fund management?

In the coming quarters, we still anticipate yields on non-government debt to remain elevated relative to government securities due to elevated LIBOR levels, positive credit conditions and simple supply vs. demand dynamics. 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. With the Fed data dependent and the market sensitive to any economic and political outputs, management will judiciously extend portfolios when opportunities arise and be more cautious when markets work against our rate expectation. Yields in the GSE and Treasury space will remain influenced by Fed policy and U.S. Treasury bill / note supply. We expect continued strong demand from investors in this sector. We will continue to seek opportunities – in all asset classes – that arise from market volatility based on domestic and global economic / market data as well as Fed rate expectations. In terms of factors affecting the First American Retail Tax Free Obligations Fund, we expect municipal bond reinvestment demand to accelerate early in 2019 resulting in some imbalances vs. available supply. We anticipate broker dealers will be aggressive with moving VRDN resets lower during this time. Fed policy appears set for a pause and the market has priced out any expected rate hikes during 2019. These market conditions present some challenges finding value with longer extension trades, leading us to favor shorter fixed-rate options.

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

Sources

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Federal Reserve Statistical Release, Factors Affecting Reserve Balances, December 27, 2018
FOMC Statement, Projection Materials and Press Conference Transcript, December 19, 2018
Bloomberg, "Powell Says Fed May Lift Rates to Levels That Restrain Growth", October 3, 2018
Investment Company Institutue statistics

Definitions

Barbell is a bond investment strategy that concentrates holdings in both very short-term and extremely long-term maturities. This is also known as the "dumbbell" or "barbelling."
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.
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.
Secured Overnight Financing Rate (**SOFR**) is part of the LIBOR reform introduced this year by the U.S. Alternative Reference Rates Committee. For the U.S. rate market, SOFR is calculated using actual transactions in repurchase agreements collateralized with U.S. Treasuries and not with 'predictive transactions' as with LIBOR.
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.

[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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