Quarterly money market commentary

First American Money Market Funds

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

The second quarter of 2026 began with heightened concerns surrounding the conflict in the Middle East, rising energy prices, and the inflationary consequences of supply disruptions. As the quarter progressed, easing geopolitical tensions and a pullback in oil prices improved investor sentiment, allowing markets to refocus on economic fundamentals and monetary policy.

Economic Activity – Labor market conditions continued to normalize throughout the quarter, with payroll growth slowing and wage gains continuing to moderate, particularly among lower-income households. Despite this cooling, job openings remained elevated and layoffs historically low, reinforcing a “low-hire, low-fire” environment. While conditions are softening, we view the labor market as normalizing rather than deteriorating.

Economic growth remained supported by business investment, while consumer spending made its weakest contribution to Gross Domestic Product (GDP) in several years. Declining savings rates and slowing wage gains suggest continued moderation in consumption. Business investment remains a notable bright spot, particularly in technology, software, and AI-related capital expenditures, which continue to support business activity and productivity expectations. At the same time, strong demand for computing infrastructure has contributed to inflationary pressures in select technology segments. We expect economic growth to remain near current trends, with business investment offsetting signs of moderating consumer demand.

Inflation remained above the Federal Reserve’s (Fed) target throughout the quarter with headline inflation accelerating, driven primarily by higher energy prices. Core measures remained elevated as services inflation showed limited signs of improvement. Importantly, long-run inflation expectations stayed relatively well anchored despite higher headline readings. We believe headline inflation may be at or near its peak as energy prices retreat, but persistently elevated core inflation remains a concern for the Fed as it determines the near-term path of policy rates.

Have an investment goal? Let's talk.

Jim Palmer, CFA
Chief Investment Officer

Jeffrey Plotnik
Managing Director - Money Market Funds Portfolio Management

Mike Welle, CFA
Director - Senior Fixed Income Portfolio Manager

Eric Espeseth
Director - Senior Credit Research Analyst

FIRST AMERICAN FUNDS.
usbancorp. Asset Management, Advisor

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Monetary Policy – The quarter marked a significant transition at the Fed. The Federal Open Market Committee (FOMC) held its target range unchanged at 3.50% to 3.75% at Kevin Warsh's first meeting as Fed Chair. As expected, the Fed removed all forward guidance, signaling a more data-dependent approach. The June "dot plot" also shifted more hawkish, with nine policymakers projecting at least one rate hike in 2026. Given current market pricing, we see value in the front-end of the yield curve.

What were the major factors influencing investment-grade fixed income this quarter?

Interest Rates – U.S. Treasury yields rose across the curve during the second quarter as markets repriced the Federal Reserve's policy path amid energy-induced inflation concerns and a more hawkish policy outlook. The increase was most pronounced in shorter maturities, with the 2-year Treasury yield leading the move higher as markets priced in a reduced likelihood of policy easing and a growing probability of additional rate hikes.

The 3-month U.S. Treasury ended the quarter at 3.81%, 14 basis points (bps) higher. The 2-year, 5-year and 10-year U.S. Treasuries ended the quarter at 4.17%, 4.23%, and 4.47%, representing increases of +38 bps, +28 bps, and +28 bps, respectively.

Bond indices delivered mixed performance during the quarter as rising yields weighed on valuations, while elevated income supported returns. The ICE BofA 3-month and 2-year U.S. Treasury indices returned 0.88% and 0.27%, respectively. The 5-year U.S. Treasury index declined 0.17%, while the 10-year U.S. Treasury index returned 0.13%. The divergence in performance reflects the greater income available in longer maturities, which offset the larger valuation headwinds associated with rising yields.

Sector Performance – Excess returns were generally positive during the quarter as improving sentiment surrounding Middle East negotiations supported spread products. Despite robust issuance volumes, corporate bonds were the strongest performing sector, outperforming both asset-backed and mortgage-backed securities.

Federal agency and supranational issuance remained relatively limited throughout the quarter, helping keep spreads near historically tight levels. Limited supply is likely to constrain excess return opportunities going forward.

Investment-grade corporate bonds benefited from strong investor demand and generally healthy corporate fundamentals. Credit spreads tightened back toward historically rich valuations, supporting excess returns during the quarter. While corporate fundamentals remain favorable, we believe limited room exists for further spread compression and expect income generation and carry to be the primary contributors to returns going forward.

AAA-rated asset-backed securities continued to benefit from resilient collateral performance and strong investor demand. Although spreads tightened during the quarter and valuations have become less compelling, we remain constructive on the sector given its diversification benefits and generally favorable fundamentals. We believe security selection will become increasingly important as spreads remain below long-term averages.

Agency-backed mortgage-backed securities generated positive excess returns during the quarter as demand remained strong and interest-rate volatility moderated. Agency CMBS also performed well, benefiting from favorable technical conditions. Despite recent performance, we continue to view valuations as rich relative to historical levels which may limit future excess return opportunities.

Given our expectation that the Fed will remain on hold into 2027, we continue to view all-in yields as attractive across fixed income sectors. However, given historically rich valuations, we expect income generation, carry, and security selection to be the most important drivers of return going forward.

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

The second quarter of 2026 was characterized by a more hawkish tone, driven by concerns that inflation may be becoming more entrenched. While the Federal Reserve held the target federal funds rate steady at 3.50% to 3.75%, federal funds futures began pricing in the possibility of rate hikes by year-end. Key economic indicators remained mixed, and the precise path of future Fed policy remains uncertain. Inflation continues to run above the Fed's preferred target, while the conflict in Iran, though appearing to moderate, left markets cautious regarding additional inflationary pressures. Labor market data also remained uneven, with near-term trends still unresolved.

While views differ regarding the timing and pace of future FOMC actions, market consensus currently reflects at least one rate hike by the end of 2026. The primary challenge for managers will be assessing how geopolitical developments, economic conditions, inflation trends, and employment data ultimately influence the yield curve, as well as the timing and direction of future Fed policy decisions.

Industry-wide, money market fund assets continued to trend higher during the quarter, as the product remained an attractive option relative to other short-term cash-equivalent alternatives.

First American Prime Obligations Funds

Amid uncertain interest rate, geopolitical, and economic environments, credit quality and trading conditions remained stable in the second quarter, while interest rates moved in line with the rising probability of potential rate hikes. Considering the shape of the yield curve and a conservative cash-flow framework, the First American Funds maintained strong portfolio liquidity metrics, influenced in part by shareholder composition. We continued to employ heightened credit discipline, emphasizing investments with minimal credit and headline risk for fund investors.

During the quarter, our primary investment objective was to prioritize liquidity while opportunistically enhancing portfolio yield through a combination of fixed- and floating-rate securities, consistent with our economic, credit, and interest rate outlook. We believe the current credit environment, combined with higher relative fund yields, supports the sector as an appropriate short-term investment option.

First American Government and Treasury Funds

The FOMC adopted a more hawkish posture in the second quarter, as Kevin Warsh was welcomed as the new chair of the FOMC and reaffirmed the Fed's commitment to its 2% inflation objective. Government money market funds became more defensive, which may position portfolios to better respond to the likelihood of higher federal funds rates over the next three to twelve months.

Breakeven yields made economic sense across the curve, but shortening durations indicated that managers were more focused on front-end value while preserving flexibility to capitalize on potentially higher rates later in the year. We believe the current market conditions support a more laddered investment strategy, as conviction regarding the direction, timing, and pace of rate moves continues to develop. We believe the positive implication for money market fund investors is that investments in the three- to twelve-month area of the curve remain accretive to portfolio yields.

A more normalized repo/Secured Overnight Financing Rate (SOFR) rate environment has made short Treasury bills and GSE discount notes logical substitutes for repo, providing incremental yield opportunities. Strategically, when appropriate value was identified, managers added floating-rate investments expected to benefit shareholders over the securities' holding periods. Going forward, investment strategy will remain focused on the pace and direction of potential rate actions as markets assess the Fed's tolerance for inflation, labor market volatility, and economic growth, all of which will influence the timing and magnitude of future policy decisions.

First American Tax-Free Fund

Tax-exempt money market funds experienced a dynamic rate environment during the second quarter. Variable Rate Demand Notes (VRDNs) traded across a wide range, with the SIFMA Index reaching a high of 3.65% in April before declining to a low of 1.57% later in the quarter. Rate volatility was driven by several technical factors, including individual income tax payments, elevated levels of municipal bond issuance and settlement activity, and broker-dealer efforts to maintain lighter inventory positions around quarter-end. These factors periodically reduced available liquidity and contributed to higher VRDN reset rates. On average, the SIFMA Index traded around 60 bps above the first-quarter levels. One-year municipal note yields also moved steadily higher during the quarter, increasing approximately 25 bps. The rise largely reflected evolving market expectations for Fed policy, as investors considered the changing leadership, resilient economic data and persistent inflation concerns.

What near-term considerations will affect fund management?

Prime fund yields should continue to benefit from modest spread widening relative to government securities amid ongoing market uncertainty and volatility. On the margin, this dynamic is expected to further increase the yield differential between Prime and Government portfolios. In addition, front-end corporate yields should remain supported by ample supply, term risk premiums, and a steepening front-end yield curve.

In the coming quarters, we will continue to capitalize on investment opportunities that are economically attractive based on market outlooks and breakeven analysis. The Institutional and Retail Prime Obligations Funds should remain compelling short-term investment options for investors seeking enhanced yields on cash positions while assuming minimal incremental credit risk.

Yields within the government-sponsored enterprise (GSE) and Treasury sectors are expected to move in line with anticipated and realized Federal Reserve rate actions. Government and Treasury fund yields may drift upward as higher-yielding securities are purchased into the portfolios. However, with future Federal Reserve action uncertain, duration strategy will likely remain balanced, as managers avoid being overexposed to any single potential outcome.

The market expects some upward pressure on repo levels because of increased Treasury bill supply and reduced Treasury bill purchases by the Fed. We expect supply dislocations and market dynamics to allow funds to opportunistically purchase short Treasury bills and GSE discount notes as effective repo substitutes. Floating-rate securities will remain a core component of the overall investment strategy, contributing incremental yield, enhanced diversification, and price stability.

For more information about the portfolio holdings, please visit
https://www.firstamericanfunds.com/index/FundPerformance/PortfolioHoldings.html

Sources

Bloomberg

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.
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 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.
Government-Sponsored Enterprise (GSE) is a quasi-governmental entity established to enhance the flow of credit to specific sectors of the American economy. Created by acts of Congress, these agencies, through privately held, provide public financial services. GSEs help to facilitate borrowing for all sorts of individuals, from students to farmers to homeowners.

Gross Domestic Product (GDP) is the total monetary or market value of all the finished goods and services produced within a country's borders in a specific time period.
ICE BofA 3-Month U.S. Treasury Index tracks the performance of a single U.S. Treasury issue with approximately 3 months to maturity, purchased at the beginning of the month, held for a full month, and then rolled over..
ICE BofA 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.
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.
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.
Secured Overnight Financing Rate (SOFR) is a benchmark interest rate for dollar-denominated derivatives and loans that replaced the London Interbank Offered Rate (LIBOR).
SIFMA is the Securities Industry and Financial Markets Association Municipal Swap index, which is a 7-day high-grade market index comprised of tax-exempt VRDOs reset rates that are reported to the Municipal Securities Rule Making Board's (MSRB's) SHORT reporting system.
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.
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).
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.