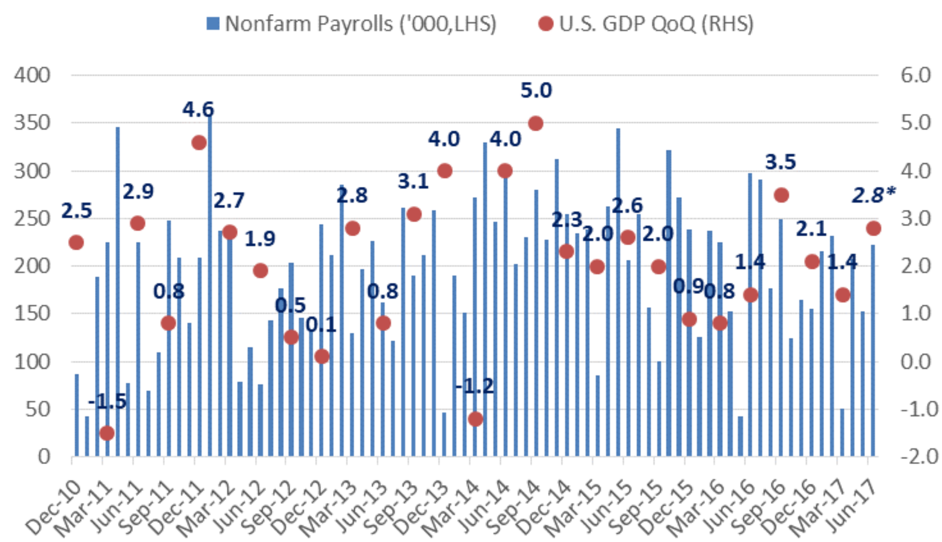
MARKET Commentary

Summer 2017

Steady as She Goes

The geopolitical uncertainty that cast a pall over markets at the beginning of the quarter (Syria, North Korea, French national election) faded allowing economic data and monetary policy to influence markets as the quarter closed. Domestic economic activity gained strength after weakening in the first quarter (see Figure 1). The Federal Reserve (Fed) delivered another hike and provided the framework for gradual balance sheet reduction while foreign developed economy central bank policy sounded slightly hawkish.

Figure 1: U.S. Economy



** Q2 2017 GDP is median consensus estimate* *Source: Bloomberg*

Portfolio returns benefited from exposure to corporate issuers which topped all investment grade sectors for the second straight quarter. Agency mortgage-backed securities (MBS) underperformed as investors prepared for the Fed's exit from the sector later this year. The yield curve flattened with short rates rising alongside fed funds while longer maturities declined on lower growth and inflation expectations.

The current investment environment is ideal for Clearwater Advisors clientele. A slow, steady rise in rates coupled with a constructive backdrop for credit exposure has delivered positive returns alongside higher reinvestment yields. We expect this to persist into year-end but look to take advantage of volatility should it arise.

Moving to Normal

The Fed stayed on task by boosting the federal funds rate 25 basis points at their June meeting. Fed officials attributed recent lower inflation data to transitory factors

US Treasuries
As of 30-June

Benchmark	Yield
3 Month	1.01%
6 Month	1.13%
1 Year	1.22%
2 Year	1.38%
5 Year	1.88%
10 Year	2.30%
30 Year	2.84%

Bank of America/Merrill Lynch Index Returns
Q2, 31-March to 30-June

Index	Return
1-3 Yr Gov/Corp ≥ A	0.26%
1-3 Yr Municipals	0.33%
1-3 Yr Agencies	0.25%
0-3 Month UST	0.20%
S&P 500	3.09%

Source: US Treasury, Bloomberg, BofA/ML, and S&P

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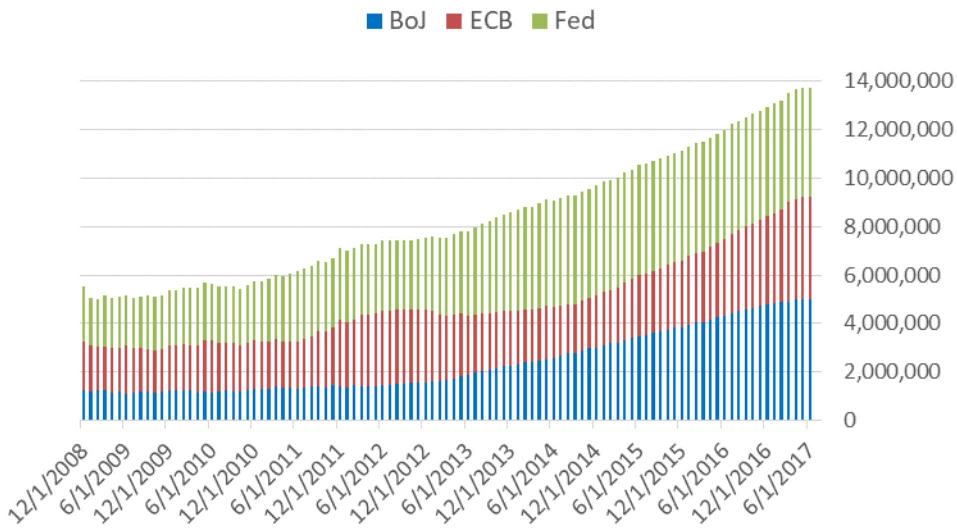
such as cheaper cell phone plans but will monitor the situation very closely. Further, they expect to hike once more this year and three times each of the next two years. Markets are less convinced of that trajectory, but are beginning to factor in more normal policy and pending balance sheet reduction.

The Fed outlined reduction plans indicating that it will passively reduce asset holdings by $10B per month ($6B Treasury and $4B MBS) by not reinvesting. The run-off will increase by $10B every three months until it reaches a maximum of $50B per month while maintaining the proportional 60/40 security-type split (max $30B Treasury and $20B MBS). No specific word on the start date nor the final size of the normalized balance sheet was provided. Analysts expect a September commencement and target $1.5-$2.0T residual balance sheet size, down from today's $4.5T.

Adding to the less accommodative mood, European Central Bank (ECB) President Draghi recently opined that "deflationary forces" have been replaced by reflationary ones hinting that policy might taper quicker which pushed European sovereign yields sharply higher. Further, hawkish, or more accurately, less dovish commentary out of the Bank of England and the Bank of Japan as well as a recent 25 basis point hike from the Bank of Canada have markets scrambling to assess global market impacts. The significant size of central bank balance sheets (see Figure 2) has made them major forces across asset classes. Draghi will be speaking at the Fed's annual Jackson Hole Symposium in late August and may prepare markets for policy changes.

Figure 2: Central Bank Balance Sheet Size ($mm)



Source: Bloomberg

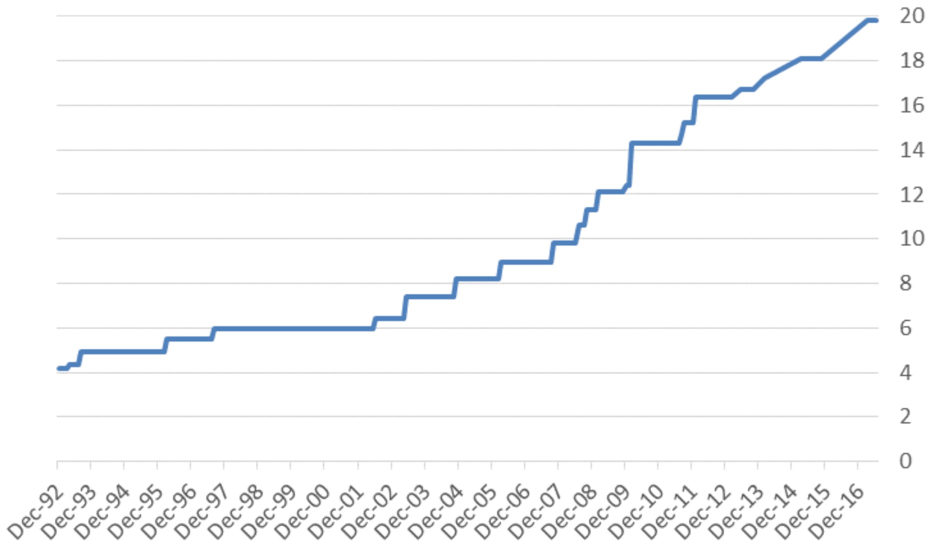
The economic backdrop looks capable of supporting less accommodative policy globally, but there will be additional volatility as markets determine appropriate valuation levels absent the distorting impacts of central bank policy.

Debt Ceiling Deadline

The U.S. Treasury has undertaken extraordinary measures to fund the government since the debt ceiling suspension ended this past March. Those measures are expected to be exhausted by early September according to Treasury Secretary Mnuchin. At that point, the government will be funded entirely by tax receipts and it is estimated that it will run out of cash by early October.

Since 1993, the debt limit has been raised more than 20 times by Congress (see Figure 3) including the infamous 2011 incident that led to the S&P sovereign ratings downgrade from AAA to AA+ due to "political brinkmanship".

Figure 3: U.S. Statutory Debt Limit ($T)



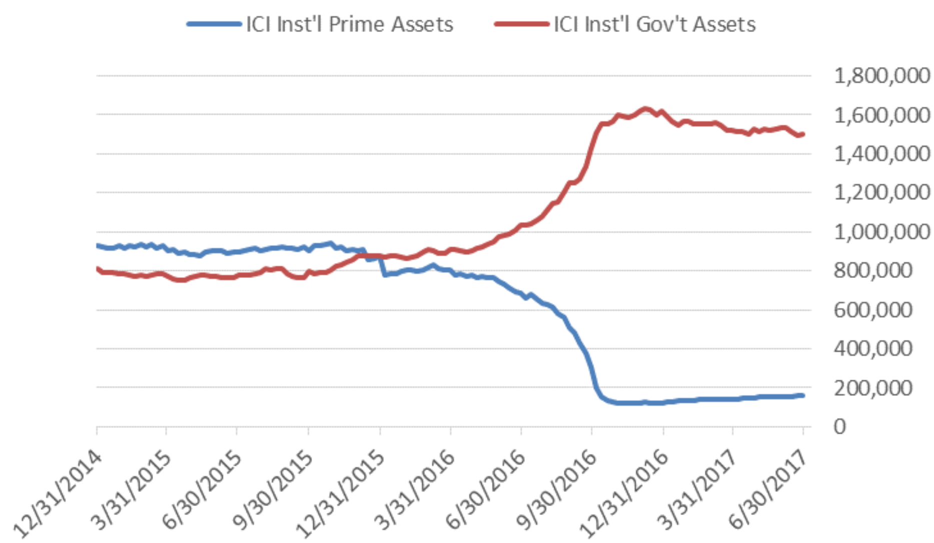
Source: Bloomberg

We don't expect a replay of 2011, but Congress' plate is full ahead of their postponed August recess with healthcare reform the primary focus. The budget and appropriation bills that fund the government for the next fiscal year as well as tax reform will be priorities after they return in September. We will monitor the situation closely and take advantage of any dislocations that occur as well as minimize exposure to problematic maturity dates in the Treasury market should Congress fail to make progress.

The Fine Print

Money market reform implementation is coming up on its one year anniversary this October. Assets are trickling back into prime funds while government money funds and bank deposits remain favored short-term investment options (see Figure 4). While investors might be comfortable with a prime fund's floating net asset value, the liquidity fees and redemption gates present and now stated in the prospectus certainly give them pause. For example, a liquidity fee of 2%, as found on the JPMorgan Institutional Prime Fund, when the fund's liquid assets fall below 30% of total assets and a 1% fee when liquid assets fall below 10% on any business day adds a layer of monitoring complexity and operational risk most corporate treasury groups are unwilling to bear.

Figure 4: Money Market Fund Balances ($mm)



Source: Bloomberg

Since reform went into place, the Fed has raised rates three times to the 1.00-1.25% target range currently. However, bank deposit holders haven't seen a commensurate rise in interest rates. Deposit rates have lagged the rise in money market yields as banks are awash in deposits allowing institutions to keep deposit rates low to boost profitability. For example, Bank of America paid an average of 0.09% across all bank deposits in Q1 during a period when the fed funds rate was 0.50-0.75%. Admittedly, corporate deposits are getting a higher rate than consumers, but we are hearing from clients that banks are reluctantly increasing rates usually after prodding.

Therefore, if you have excess liquidity in a government fund or bank deposit, there are attractive investments within six months to maturity that bear consideration and can be realized via the added flexibility and transparency of a separately managed account (SMA).

Looking Forward

Major developed economic growth has reached a level that is allowing central banks to gradually remove the exceptionally loose policy of recent years. Monetary policy uncertainty will weigh on markets as participants price in reduced central bank liquidity. Adding another wrinkle, Fed Chair Yellen's term ends in February 2018 and if she is to be replaced that announcement should come later in the quarter after candidates are floated to the market. The tumultuous political environment in the U.S. remains a risk, but we view market disruptions as potential opportunities to add exposure to select credit and securitized sectors.

Current markets are favorable for Clearwater Advisors clients as money market rates trend higher and spread sectors cushion the impact of higher yields.

Please contact the desk with questions or to discuss investment opportunities as we head into an eventful second half of the year.

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