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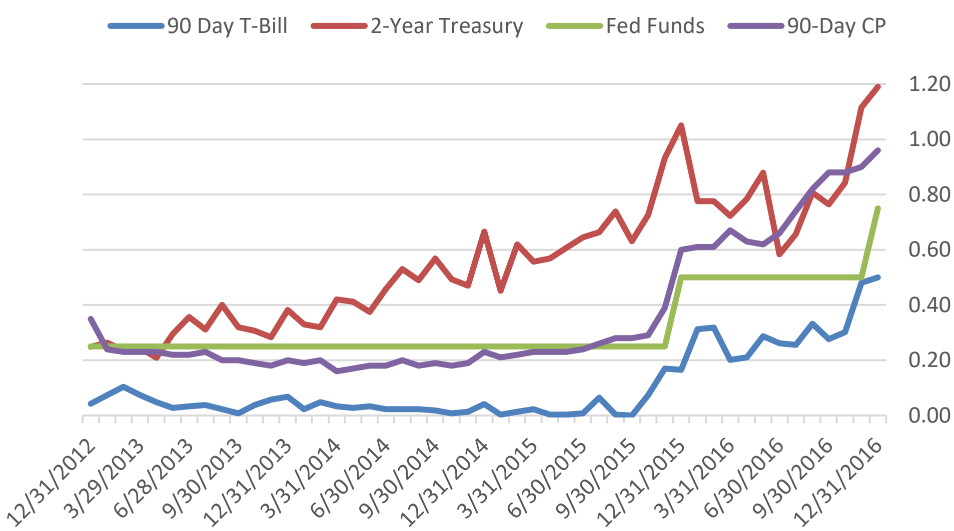
MARKET Commentary

Winter 2017

New Year, New Optimism

The U.S. national election outcome quickly altered market conditions as expectations of reflationary policy spurred both risk assets and Treasury yields higher. Over the fourth quarter, the bond market experienced its biggest quarterly selloff in more than twenty years as the yield curve significantly bear steepened – the two-year rose 43 bps while the thirty-year Treasury yield increased 75 bps. Economic optimism surged, allowing the Federal Reserve (Fed) to raise its benchmark rate 25 bps in December. Fixed income markets were primed for a hike and took the move in stride while money market rates experienced a welcome rise (see Figure 1).

Figure 1: December Fed Hike



Source: Bloomberg

Portfolio returns benefited from exposure to corporate issuers which topped all investment grade sectors over the quarter and year. Further, returns across credit quality favored lower-rated issuers over their higher-rated counterparts.

Markets are now focused on the path of future rate hikes with a keen eye on domestic fiscal policy. The first part of 2017 should provide an indication on whether expectations for government action will come to fruition. Fed forecasts call for three rate hikes in 2017, which look likely provided the pace of inflation ticks higher. We look to take advantage of attractive relative value opportunities mindful of evolving fiscal and monetary policy impacts.

2016 – Year in Review

2016 got off to a rocky start as risk assets and commodity prices, spooked by less

US Treasuries
As of 31-December

Benchmark	Yield
3 Month	0.50%
6 Month	0.61%
1 Year	0.81%
2 Year	1.19%
5 Year	1.93%
10 Year	2.44%
30 Year	3.07%

Bank of America/Merrill Lynch Index Returns
Q4, 30-September to 31-December

Index	Return
1-3 Yr Gov/Corp ≥ A	-0.41%
1-3 Yr Municipals	-0.47%
1-3 Yr Agencies	-0.34%
0-3 Month UST	0.07%
S&P 500	3.82%

Source: British Bankers' Association, Federal Reserve, US Treasury, Bloomberg, Barclays, BofA/ML, and S&P

Contact Us

Sean Tierney
stierney@clearwateradvisors.com

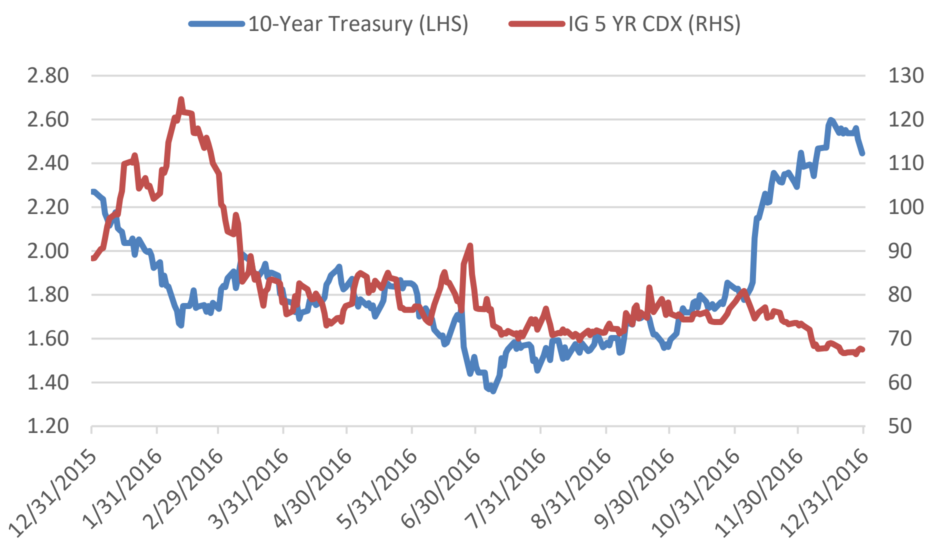
Richard Wehrmann
rwehrmann@clearwateradvisors.com

www.ClearwaterAdvisors.com

accommodative Fed policy and emerging market concerns, swooned early in the year. Major domestic equity indices suffered corrections (down 10%) while several overseas indices closed in on bear market territory (down 20%). Oil prices plummeted sending shockwaves through energy related sectors. By June, markets recovered only to be jolted by the British vote to exit (Brexit) the European Union (EU). Expectations of continued accommodative monetary policy reached a fevered pitch shortly thereafter pulling global bond yields lower and buoying risk assets. The U.S. Treasury market reached record low yields for certain tenors (10-year yield touched 1.36% while the 30-year hit 2.10%) in early July. Decent economic activity in the U.S. and Europe coupled with expectations of a possible Fed hike reversed the decline in yields heading into the U.S national election.

The Treasury market ended the year at modestly higher levels after the Trump Tantrum pushed yields markedly higher from the low levels experienced post-Brexit (see Figure 2). Investment grade credit spreads marched steadily lower after the early year sell-off and equity markets rallied to new highs as investors became confident President-elect Trump's pro-growth, reflationary policies would be implemented by the Republican dominated legislative branch. Further adding to the positive tone, OPEC agreed on production cuts in late November ending the two year pump-at-will policy that pummeled oil prices. Investment grade corporate issuers came to market with record issuance ($1.3T) surpassing last year's record level. Demand remained robust as overseas, yield-starved investors contributed to a strong technical backdrop.

Figure 2: Bond Market



Source: Bloomberg

The Fed embarked on 2016 intent on raising rates (forecasting four hikes) but managed to do so only once. Tepid economic growth, low inflation and global economic unrest all contributed to the Fed's reticence. Overseas, most developed central banks kept policy accommodative and remain on that path as 2017 dawns.

2016 fixed income performance rewarded high-quality spread sectors and modest duration exposure. The annual return for the 90-Day T-bill was +0.33% while the 2-Year U.S. Treasury Index returned +0.66%.

Further, as illustrated in Figure 3, investment grade corporate and asset-backed security exposure delivered solid returns in a year that saw Treasury yields rise modestly.

Figure 3: 2016 Fixed Income Year-End Characteristics and Returns

Index	Quality	Yield	Duration	Annual Return
90 Day T-Bill	AAA	0.49%	0.24 yrs	0.33%
2-Year U.S. Treasury	AAA	1.19%	1.89 yrs	0.66%
1-3 Year AAA-A U.S. Corporate & Government	AAA	1.34%	1.89 yrs	1.07%
1-3 Year AAA-A U.S. Corporate	A1	1.89%	1.85 yrs	1.81%
AAA U.S. Asset-Backed Security	AAA	1.64%	1.60 yrs	1.79%
1-5 Year AAA-A U.S. Corporate & Government	AAA	1.51%	2.69 yrs	1.24%
0-3 Year U.S. Agency CMO (MBS)	AAA	2.16%	2.03 yrs	1.08%

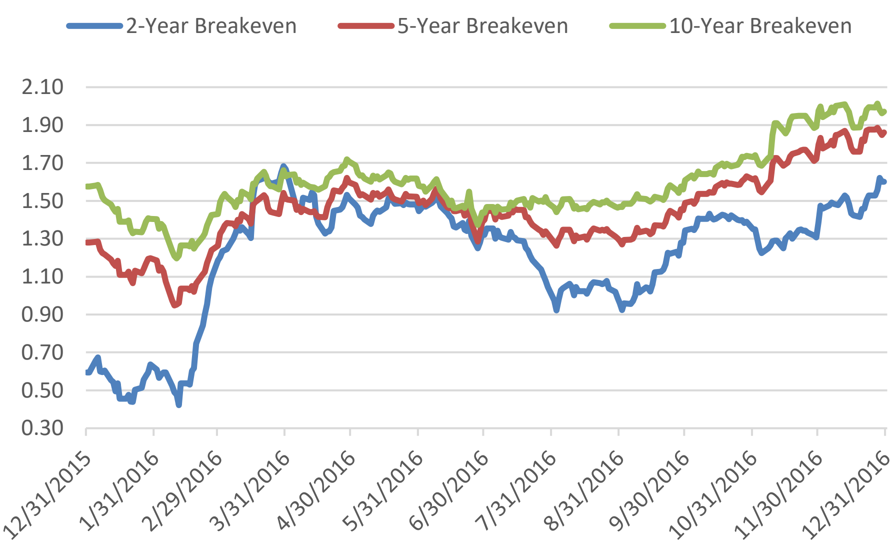
Source: BofA Merrill Lynch Indices

Money market reform pushed $1T out of prime funds. Institutional investors let their dislike for floating NAV's and redemption fees and gates known as they sought the refuge of government money funds. Money market rates rose as their largest buyer base materially contracted providing opportunities to investors with flexible investment policies.

Regime Change

The election of Donald Trump materially altered market expectations. Trump's reflationary policy proposals have led to expectations of greater fiscal spending, lower taxes and less regulation. Inflation expectations have jumped (see Figure 4) after a multi-year period of low inflation. Treasury yields have correspondingly increased as investors factor in potential higher inflation.

Figure 4: U.S. TIPS Breakeven Levels



Source: Bloomberg

In recent years, the Fed has had a great deal of flexibility in regard to normalizing policy due to low measures of inflation. Even as the employment picture recovered the Fed chose to keep rates exceptionally low to support the domestic economy. The absence of fiscal stimulus raising the importance of Fed policy in boosting economic activity.

Combine fiscal stimulus and requisite borrowing with higher inflation and the Fed's pace of hiking could quicken considerably in the near future. The market is pricing in two hikes in 2017 while the Fed is forecasting three. In the past, the market has been a better predictor of monetary policy. Both could be wrong if Washington delivers on its promises contributing to market volatility in the upcoming year.

2017 – Great Expectations

Markets are facing many of the same challenges in 2017 as in the past – divergent global monetary policy, emerging market (primarily China) economic concerns, EU uncertainty and geopolitical instability. However, there is a significant wildcard – domestic political uncertainty. The incoming administration's proposals should foster greater economic growth, but delivering on those promises will be difficult. Trump's rhetoric on trade and other major policy issues is worrisome as well.

However, assuming modest business-friendly policy execution and tempered protectionism, the domestic economy will continue to grow around 2.5% with potential to the upside supporting investment grade spread product exposure. Further, global geopolitical risk remains high as Brexit is ongoing and several core EU countries (France, Germany) have elections upcoming. Consequently, monetary policy will remain accommodative abroad squeezing yields and pushing investors to U.S. markets providing a technical bid further supporting credit and other fixed income sectors.

Therefore, we remain constructive on investment grade corporate exposure in portfolios with a critical eye on underlying balance sheets as the end of the credit cycle is nearing for many sectors. The domestic banking system looks attractive as strong balance sheets shaped by comprehensive regulation should be bolstered by earnings growth. For rating sensitive clients, AAA-rated asset-backed securities and commercial mortgage-backed securities continue to be a good fit as well as certain agency mortgage-backed securities. Rates across the curve are higher and money market investors enjoy a yield environment not seen since the Great Recession. The New Year offers an opportune time to revisit policy constraints to ensure your portfolio can take advantage of the appropriate opportunity set for your risk level.

Looking Forward

The outlook for fixed income markets is complicated by divergent developed central bank monetary policy amid an uncertain political environment. The U.S. will continue to grow modestly providing the Fed justification to gradually normalize policy. The ability and speed with which President Trump and the GOP-led Congress agree on tax reforms, deregulation and trade policies are key variables facing investors in 2017. If successful, economic growth and inflation could surprise to the upside posing a unique set of investment opportunities not experienced for some time.

Current markets present a favorable environment for Clearwater 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 best suited to navigate the challenges faced in 2017.

Clearwater Advisors · 101 South Capitol Boulevard · Suite 1201 · Boise, ID 83702

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