clearwater ADVISORS

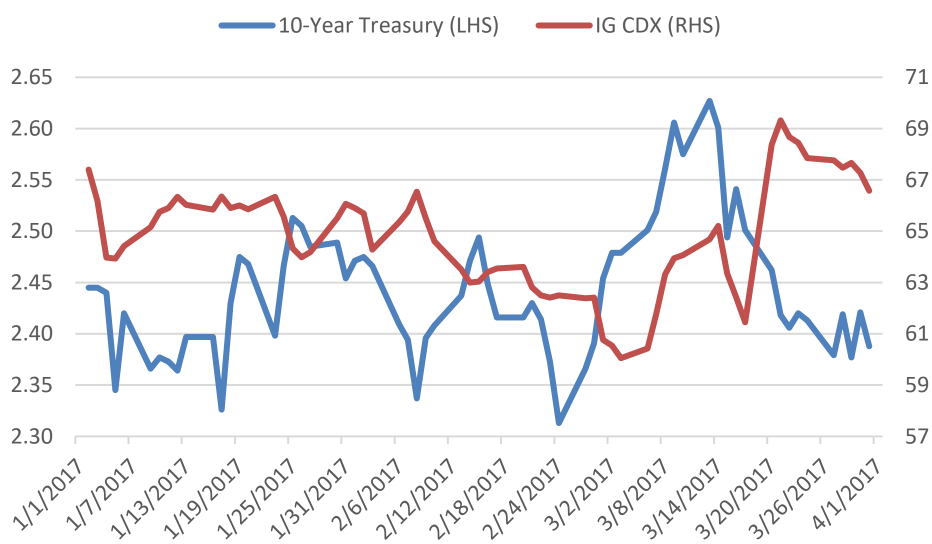
MARKET Commentary

Onward and Upward

Spring 2017

Monetary policy stole the show from the White House and Congress as the Federal Reserve (Fed) unexpectedly boosted the federal funds rate mid-March but soothed markets with a less-hawkish statement. U.S. Treasury yields were largely unchanged on the quarter save for very short maturities (one year and in) which rose on the back of the move higher in the federal funds rate, now 75-100 basis points. Investment grade credit spreads (see Figure 1) were also unchanged even as corporations issued a record $400 billion during the quarter.

Figure 1: Bond Market Unchanged



Source: Bloomberg

Portfolio returns benefited from exposure to corporate issuers which topped all investment grade sectors over the quarter. Further, returns across credit quality favored lower-rated issuers over their higher-rated counterparts as the additional income carried the day in a stable to modestly higher rate environment.

The tone out of Washington continues to drive markets even as policy execution falls short of the rhetoric. Domestic monetary policy will become less accommodative over the upcoming year and the focus may shift to winding down its balance sheet as the year progresses. We look to take advantage of attractive relative value opportunities mindful of evolving fiscal and monetary policy impacts.

US Treasuries
As of 31-March

Benchmark	Yield
3 Month	0.75%
6 Month	0.90%
1 Year	1.02%
2 Year	1.25%
5 Year	1.92%
10 Year	2.39%
30 Year	3.01%

Bank of America/Merrill Lynch Index Returns
Q1, 31-December to 31-March

Index	Return
1-3 Yr Gov/Corp ≥ A	0.34%
1-3 Yr Municipals	0.82%
1-3 Yr Agencies	0.31%
0-3 Month UST	0.10%
S&P 500	6.07%

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

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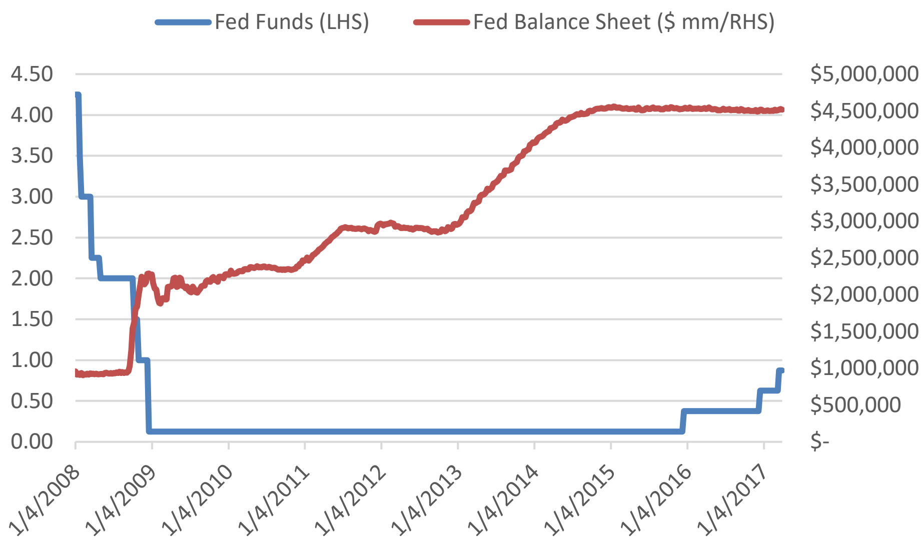
U.S. Monetary Policy – Less Accommodative

The Federal Reserve jolted the market out of its dovish stupor when several officials signaled in late February that a March rate hike was on the table. At the time, markets were pricing in two hikes for 2017, one around June and the other near end of the year, but quickly repriced as Fed rhetoric brought March into play. U.S. Treasury yields jumped 20-30 basis points across the curve as markets fretted about what the Fed might do. Those fears were eased after the mid-March FOMC meeting at which the Fed did indeed hike by 25 basis points (see Figure 2), but followed with no changes to their economic forecasts. Fed Chair Yellen noted that while the economy is "going nicely" the Fed would "gradually" withdraw accommodative policy. Therefore, expect two more hikes in 2017 provided the economy performs as expected and there are no major global risk flare-ups.

Figure 2: Monetary Policy



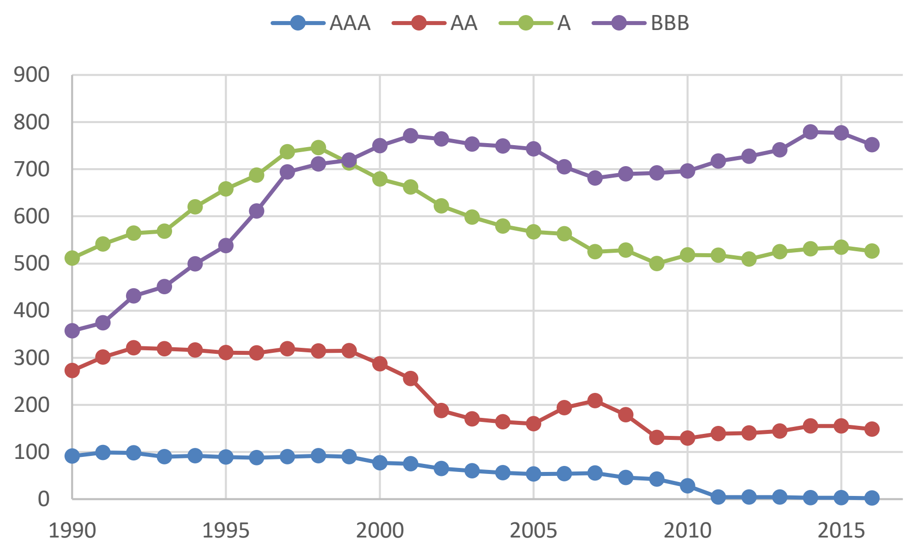
Source: Bloomberg

While neither Yellen nor the FOMC statement mentioned the balance sheet, minutes recently released from the March meeting indicate that Fed officials believe balance sheet reduction could start later this year. The Fed has maintained its balance sheet at $4.5 trillion by reinvesting maturities and paydowns over the last few years. Fed officials emphasized that reductions should be conducted in a passive, predictable way and will likely start by phasing out reinvestments. Outright sales of Treasuries or mortgage-backed securities are unlikely. We expect the Fed to outline their plans further in the upcoming meetings which will impact the mortgage-backed security market more so than the U.S. Treasury or Agency market.

High "Quality" Universe Shrinking

The universe of highly-rated corporate and sovereign issuers continues to contract. Long-time Clearwater clients have heard our proclamation that ratings agency-based exposure limits while helpful and easy to monitor should take a back seat to solid credit research. Further, having strict policy limits related to credit ratings significantly restricts a portfolio's investment opportunity set. Highly-rated corporate issuers are nearly extinct while the number of BBB-rated issuers has grown significantly (see Figure 3). In 1990 there were ninety-one AAA-rated corporate issuers, now there are two. Similarly, there are only twelve countries with a AAA-rating (representing 40% of global sovereign debt outstanding) down from nineteen as recently as 2008, according to S&P.

Figure 3: Corporate Issuer Ratings Migration
Issuer Count



Source: Standard & Poor's

AA-rated corporate issuers have declined materially from 273 to 148 over that same period while BBB-rated corporations have doubled. Interestingly, A-rated issuers have had a fairly consistent population after a brief explosion in the late-90's.

Therefore, when reviewing policy constraints it's important to provide asset managers leeway on credit ratings. Further, if high ratings quality is important to stakeholders, be sure to consider other highly-rated fixed income sectors like AAA-rated asset-backed securities to ensure a reasonable opportunity set for your portfolio. Otherwise, investment options are limited to an ever-diminishing asset pool.

Geopolitical Pressures

Global geopolitical risks are rising. The French will hold national elections shortly followed by the Germans in late fall. Markets do not want populist, anti-Eurozone politicians to gain ground. Meanwhile, the British have invoked Article 50 beginning the two-year negotiation period to withdraw from the European Union. The Middle East remains a hotspot with Russia raising the stakes in the Syrian situation while North Korea represents a volatile wildcard. The Trump administration is taking a harder line than its predecessor worrying markets.

Domestically, campaign promises are proving difficult to execute. Health care reform was pulled, causing many to doubt the Trump Administration's ability to enact its major initiatives like infrastructure investment and tax reform this year. In the near term, the current spending bill expires on April 28th requiring Congress to pass another continuing resolution to kick the can down the road or a new budget to prevent a government shutdown. Additionally, the debt ceiling suspension ended in March requiring the U.S. Treasury to undertake "extraordinary measures" to fund the government until Congress takes action. Those efforts will be exhausted near the end of the third quarter forcing a showdown. Markets and businesses are waiting anxiously for certainty on what policies will be put in place so they can invest and plan for the future. Further missteps will lead to market volatility.

Looking Forward

A period of unprecedented, global monetary stimulus has led to firmer growth and inflation in major economies stirring the spirits of investors and consumers. Risk assets have rallied to new highs while the bond market has been more circumspect. Against this backdrop, the Federal Reserve will quicken its glacial hiking pace while revisiting its balance sheet policy. Geopolitical risk remains high, but we view market disruptions as potential opportunities to add exposure to select credit and securitized sectors.

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 the coming months.

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