clearwater ADVISORS

MARKET Commentary

A Call to Action

January 2013

Over the past three years markets have ebbed and flowed with early-year optimism giving way to the reality of unsustainable sovereign debt levels, inept political policy, and weak economic activity. Central banks around the globe, forced to combat fiscal and economic headwinds, remained extremely active with easy policy buoying risky assets. Our recommendations for the past year focused on adding credit exposure through select corporate issuers and high-quality structured product (credit cards and autos) as well as migrating to lower-rated issuers. We also asked clients to extend duration constraints to take advantage of steep curves. We reiterate this view in 2013 with a cautious eye on underlying credit fundamentals. Fixed income investors continue to face a challenging investment environment as interest rates remain anchored by Fed policy, political risk abounds, and high-quality bond supply diminishes. But, against this backdrop, investors should not idly sit back and wait for higher rates. The dawn of a New Year coupled with the expiration of the much-utilized FDIC Transaction Account Guarantee (TAG) Program and pending money fund regulation should serve as a catalyst to prudently optimize the utility of your short-term investments.

Figure 1: Investment Grade Spreads (5 Yr CDS) and 2 Yr Treasury Yields

Source: Bloomberg

2012 - Central Banks to the Rescue

2012 dawned with investor angst over the European sovereign debt crisis subsiding due to the European Central Bank's (ECB) Long-Term Refinancing Operation which provided a $1.3 trillion band-aid to euro-zone banks. The implosion of the European Union that was feared in late 2011 was effectively snuffed out by exceptionally accommodative central bank policy. Markets rallied and interest rates rose through Q1 2012. However, the euphoria was short-lived as there was a whale sighting at JP Morgan and Greco-euro-zone relations deteriorated pulling Spain and Italy into the mire. The Fed continued to pursue easy policy (Operation Twist and unlimited MBS purchases) alongside the ECB which pledged to do "whatever it takes" to protect the euro-zone. The ECB backed up that pledge with an unlimited

US Treasuries

As of 31-Dec

Benchmark	Yield
3 Month	0.04%
6 Month	0.11%
1 Year	0.14%
2 Year	0.25%
5 Year	0.72%
10 Year	1.76%
30 Year	2.95%

Bank of America/Merrill Lynch Indexes

30-Nov to 31-Dec

Index	Return
1-3 Yr Gov/Corp ≥ A	0.06%
1-3 Yr Municipals	-0.07%
1-3 Yr Agencies	0.06%
0-3 Month UST	0.01%
S&P 500	0.01%

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Source: British Bankers' Association, Federal Reserve, FDIC, US Treasury, Bloomberg, Barclays, Financial Times, JP Morgan, The Economist, S&P and Center on Budget and Policy Priorities, Wall Street Journal government bond purchase program soothing market angst. Additionally, the Bank of England and the Bank of Japan joined in efforts to stimulate economic growth in their respective countries. Collectively, these actions spurred investor demand for risky assets even as the underlying economic conditions were little improved into year-end.

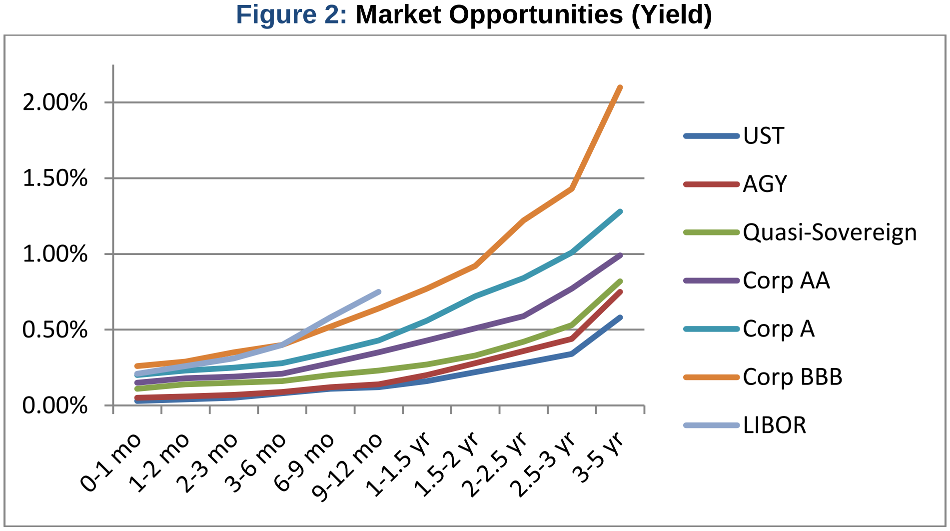
2012 fixed income performance rewarded duration and credit exposure. The 90-Day T-Bill Index was up 0.11% on the year while the 2-Year U.S. Treasury Index was up 0.28% with the 2-year note's yield little changed from the beginning of the year. Corporate bonds fared far better with the 1-3 Year A-AAA Corporate Index up 4.02% while the 1-3 Year U.S. Treasury Index was up just 0.43% (all return data is based Bank of America/Merrill Lynch Indices). Interestingly, the Corporate Index provided twice the income of the Treasury Index (1.40% vs. 0.63%) and three times the price return (2.62% vs. 0.85%). Meanwhile, financials outperformed their industrial counterparts on the year. In a year dominated by central bank policy, the market rewarded exposure to credit.

Redefining Liquidity in 2013

Looking forward, front-end yields will remain low as accommodative central bank policy will continue to drive market action. The Federal Reserve is pursuing open-ended purchases of Treasury and agency mortgage-backed securities with a focus on lowering unemployment provided inflation remains in line with expectations. These actions combined with zero interest-rate policy demonstrate the Fed's market-bending commitment to low yields which will continue to motivate investors to buy assets they wouldn't normally purchase. Rather than fight the Fed, it's best to reevaluate the purpose of your fixed income investments and strive to optimize the available opportunity set. Further, with the expiration of the FDIC Transaction Account Guarantee (TAG) and pending money market reform, now is an opportune time to shake off inertia and take control of your fixed income investments. Traditional short-term options are evolving and so should your portfolio.

If policy duration is constrained or at its maximum, consider adding credit flexibility to include A2/P2 commercial paper issuers and pick up 15-20 bps over higher rated issuers within 30 days until maturity. Similarly, there are attractive Single A and BBB issuers available further out the curve for longer duration mandates. These issuers are generally industrial in nature with stable credit profiles aiding in diversification away from financials. If portfolio credit must be constrained by ratings, look to loosen duration parameters to take advantage of steep yield curves and/or include other high-quality sectors like credit card and automobile asset-backed securities (ABS). The stable structure of these ABS securities is proven and they continue to offer value in the context of other AAA or AA alternatives.

Figure 2: Market Opportunities (Yield)



Source: Clearwater

We realize liquidity is a primary focus of our existing and potential clients. However, liquidity should not be defined, as it has been traditionally, as short duration (for example, maximum one year security duration). It is important to note that the market for high-quality corporate and ABS sectors is very deep and liquid, which might strike some participants as counterintuitive. A properly constructed portfolio with an average duration of one or two years, inclusive of all of the sectors in Figure 2, will provide ample liquidity for most front-end investors while adding valuable yield in the current environment. Additionally, creating a custom separately managed account tailored to your investment guidelines and profile will provide an ideal balance of liquidity and yield that pooled investments and banks cannot provide.

Looking Forward

The debt ceiling debate will provide the first test of market optimism post fiscal cliff. We expect volatility to increase as politicians dig in their heels and turn up the rhetoric. Another downgrade for the U.S. looms if there is a delay in its resolution or further fiscal degradation. For the time being, Europe will likely continue to lurk in the background as Spain debates a formal request for aid. Earnings will come under pressure as the U.S. economy muddles along. Corporate fundamentals are beginning to weaken, albeit from historically strong levels, which we will monitor as the year progresses. We continue to advocate an overweight to corporate bonds and opportunities in select lower quality issuers, but 2013 will demand more selectivity in the exposure as valuations are not as favorable as a year ago. The challenges of 2013 look less daunting than those faced in 2012 largely due to central bank action. However, risks do remain and having a policy that allows for nimble investment will allow your portfolio to be best positioned when opportunties arise.

Take Action

Use the start of a New Year as a catalyst to review your firm's fixed income needs and investment options. As we've discussed in prior commentaries, reevaluate the following:

- How much liquidity is truly needed?
- How much credit exposure and duration is acceptable?
- What additional security types and portfolio composition accomplishes your goals most effectively?
- How can my firm take advantage of the opportunities present in the marketplace?

Revisit policy constraints to ensure that opportunities can be sought and realized. Take action; look for avenues to optimize the utility of your investment.

Please contact the desk with questions or to discuss investment opportunities and how to best navigate the current market developments.

Form ADV Part II

Clearwater Advisor's annual Form ADV Part II disclosure is available to clients upon request. To make a request please email Compliance@ClearwaterAdvisors.com or call Brittany Pfister at 208-489-7550.