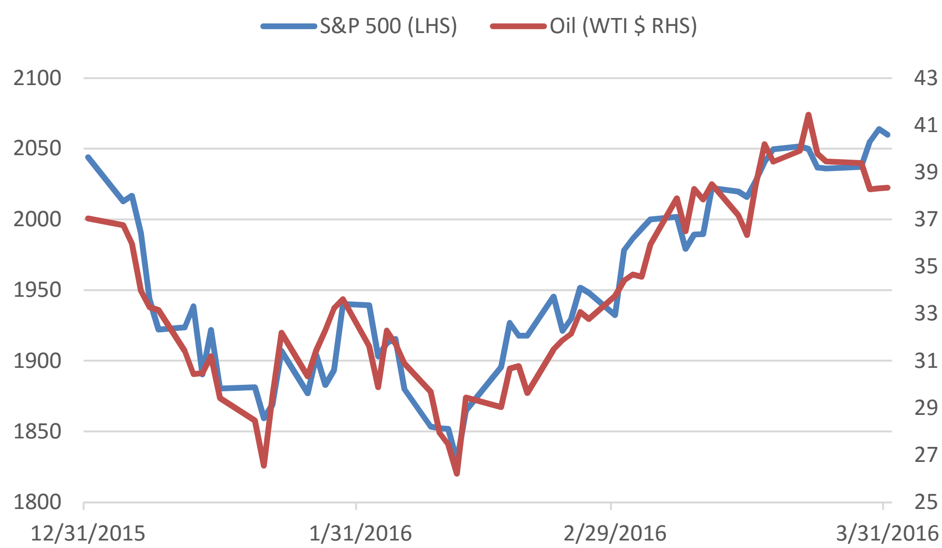
MARKET Commentary

Employment, Price Stability and Global Market Stability?

Spring 2016

The relative calm that enveloped markets at year-end gave way to renewed global growth concerns which led to a volatile sell-off in commodity prices and risk assets. Developed-country equity markets entered correction territory (-10%) while emerging markets touched bear market declines (-20%). Risk asset correlations to oil were close to one (see Figure 1). Investors handicapped recession probability and entertained the possibility of negative rates in the U.S. shrugging off modestly positive economic data and pulling yields close to twelve month lows. Credit spreads soared, especially for commodity related sectors.

Figure 1: Equity and Oil



Source: Bloomberg

The U.S. Treasury yield curve bull flattened – the two-year declined 32 bps over the quarter while the thirty-year Treasury yield fell 40 bps. Risk assets rebounded just as quickly as they sold off primarily due to further accommodative monetary policy and benign domestic economic data. Investment grade credit spreads recovered significantly, reversing the severe mid-quarter sell-off, boosting return in 2016 to the top of domestic markets masking the volatility over the quarter.

The Fed Blinks……Again

Federal Reserve (Fed) officials were forecasting four hikes in 2016 as of their December meeting and fixed income investors generally agreed. However, the weak global economic environment coupled with volatile financial markets weighed on the Fed and their updated March forecasts predicted just two hikes for 2016. Further, Fed Chair Yellen offered dovish commentary at her March press conference and reinforced it at a speaking engagement following the meeting. Yellen stated that it is appropriate for U.S.

US Treasuries

As of 31-March

Benchmark	Yield
3 Month	0.20%
6 Month	0.37%
1 Year	0.57%
2 Year	0.72%
5 Year	1.21%
10 Year	1.78%
30 Year	2.62%

Bank of America/Merrill Lynch Index Returns

Q1, 31-December to 31-March

Index	Return
1-3 Yr Gov/Corp ≥ A	0.94%
1-3 Yr Municipals	0.51%
1-3 Yr Agencies	0.86%
0-3 Month UST	0.06%
S&P 500	1.35%

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

Contact Us

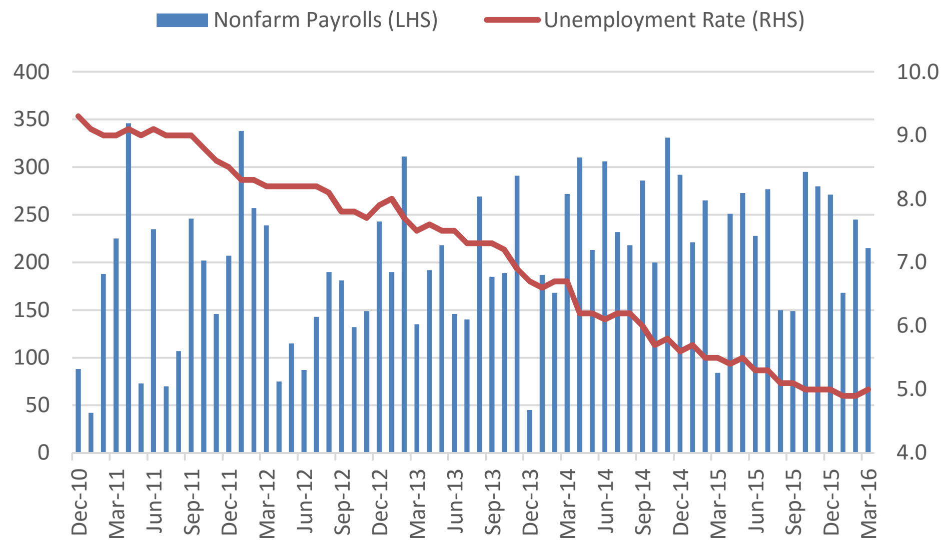
Sean Tierney
stierney@clearwateradvisors.com

Richard Wehrmann
rwehrmann@clearwateradvisors.com

www.ClearwaterAdvisors.com

central bankers to "proceed cautiously" in raising interest rates because the global economy presents heightened risks. Further, caution is "especially warranted" given the low level of rates. Therefore, the Fed is factoring "global economic and financial developments" to weigh on policy decisions (similar to last August) while they appear to be fulfilling their dual mandate – employment and stable prices.

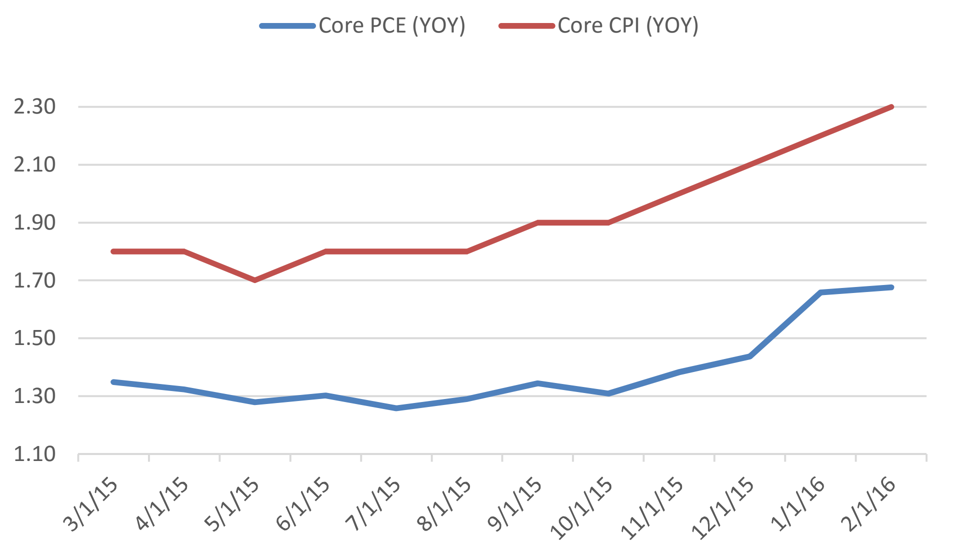
Figure 2: U.S. Employment



Source: Bloomberg

The U.S. employment picture looks fairly robust (see Figure 2). The U.S. has gained over 14 million jobs since the end of the recession after losing 8.8 million. Further, payrolls have posted healthy gains over the last several months even as markets fretted about a potential recession. There are data points, like productivity and the labor force participation rate, that are puzzlingly low; but, generally speaking, the U.S. is in the neighborhood of full employment.

Figure 3: U.S. Core Inflation



Source: Bloomberg

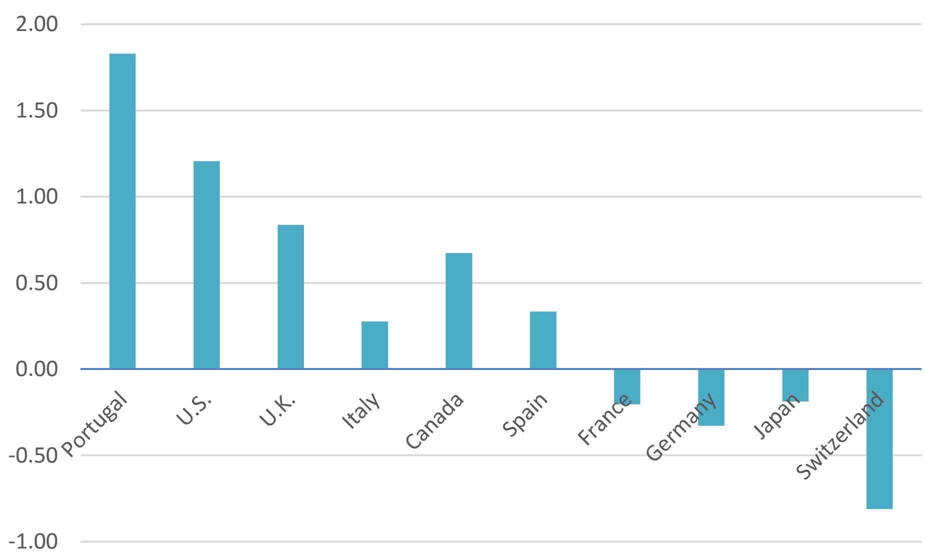
Inflation, both measured and expected, has run below the Fed's 2.0% target for some time. However, core inflation data (see Figure 3) looks to have turned a corner in late 2015 and wage pressures are beginning to materialize as average hourly earnings rose 2.3% from a year earlier. Recently, Yellen offered that she remains unconvinced that recent pace of inflation will prove durable. Fixed income markets share that sentiment pricing in negligible inflation. The data bears monitoring due to the implications for bondholders – higher yields. The Fed is willing to risk higher inflation over the longer term in order to reduce shorter term uncertainties.

The Fed is attempting to balance the needs of the global economy with those of the domestic economy indirectly adding a third mandate – overseas economic/market stability. With intertwined global markets, it is difficult for the Fed to focus solely on the domestic economy and financial conditions. This complicates their message and introduces policy uncertainty as risk appetite and global economic data ebbs and flows. Risk assets prefer low rates – how does the Fed prepare them for modestly higher levels without creating dislocations that then require further hints of accommodative policy? It's a balancing act that will contribute to volatility over the coming quarters. Further, it increases the risk of a policy mistake which has more significant consequences, such as falling behind the curve and having to hike more aggressively than anticipated.

Global Fixed Income Environment

Global bond markets are awash in accommodative monetary policy. The European Central Bank (ECB) recently boosted its quantitative easing efforts from €60B to €80B a month while broadening eligible securities for purchase to include non-financial corporate bonds. The ECB also launched targeted longer-term refinancing operations to provide attractive financing options to Eurozone banks in an attempt to boost lending activity. Further, the ECB joined Japan and other developed countries by implementing NIRP (negative interest rate policy) drawing sovereign bond yields lower (see Figure 3). German yields are negative out to seven years to maturity while French yields are negative out to five years. 81% of Swiss sovereign bonds and 65% of Japanese sovereign bonds trade at negative yields. Even basket-case countries like Italy and Spain are trading negative out to two years.

Figure 3: Global Sovereign Yields (5 Year)
As of March 31, 2016



Source: Bloomberg

Negative yields abroad temper the rise in longer-term yields in the U.S. and provide a technical bid for many domestic asset classes. This dynamic gives the Fed further leeway as U.S. yields and/or spreads may not rise as quickly or as high as anticipated, but it clouds many traditional fixed income relationships and alters economic decisions in unconventional ways. Therefore, it is important to allow flexibility within your investment policy for different sector, rating's quality and duration allowances.

Money Market Reform Reminder

Six months remain until money market reform is a reality. Securities Exchange Committee rules go into effect in October. At quarter-end, prime fund assets totaled just over $1.1 trillion (according to Crane's Data) and Barclays estimates $300 billion (25% of assets) could leave those funds ahead of the deadline, possibly abruptly.

The following months give market participants a window to evaluate and execute suitably attractive alternative investments as the compliance date for the floating NAV and redemption limits approaches. Further, the added flexibility and transparency of a separately managed account provides control that is lacking in a pooled investment. And, with the appropriate investment policy and asset manager, money market investors can position their portfolios to insulate or benefit from any market disruptions that may occur.

Looking Forward

The annual Eurozone induced summer sell-off will likely arrive in June when the British vote on whether to exit ("Brexit") the European Union or not. Polls currently indicate that Britain will stay, but headline risk will rise as the quarter progresses up to the June 23rd vote. Meanwhile, the U.S. presidential election circus continues ahead at full steam guaranteeing no shortage of entertaining rhetoric.

The outlook for fixed income markets is complicated by divergent developed central bank monetary policy amid uneven economic growth. The transition to more normal policy may be more gradual than originally anticipated as the Fed appears sensitive to global headwinds. The market is pricing in one hike this year with just a 20% probability of a hike occurring at the June meeting. Within Clearwater portfolios, we look to maintain a yield buffer via spread product (specifically, select investment grade corporate and asset-backed securities) to cushion against sudden Treasury yield increases. Given the dovish market stance, portfolios are modestly short duration as current low yields have historically proven difficult to hold.

Please contact the desk with questions or to discuss investment opportunities best suited to navigate this year's uncertain and volatile market environment.

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.