clearwater ADVISORS

MARKET Commentary

Where the Sidewalk Ends

May 2011

In a first in its long history as a rating agency, *Standard and Poor's* placed the credit rating of the United States and related Government Sponsored Enterprises (FNMA, FHLMC, FHLB and FFCB) on negative outlook on April 19th and 21st, respectively. While neither particularly insightful or enlightening, the rating actions were significant in that they formally validated the viewpoint of global investors that the fiscal position of the United States has become increasingly unsustainable.

Metaphorically speaking, we have arrived at that defining place where the sidewalk ends—the smoothly paved paths leading to economic prosperity are behind us, and fiscal and economic uncertainty have now become our traveling companions on the bumpy trails ahead. As Congressional leaders begin the heated battle to reconcile long-term structural imbalances, both parties agree that the resolution of the impending fiscal debate must secure the sustainability of the current economic recovery, the continued credibility of the U.S. as a global debtor and, most importantly, the long-term solvency of the U.S. sovereign. Indeed, we have quite the journey ahead of us.

Listening to George Strait

The U.S. remains one of the only large economic superpowers without a credible plan to address its large and problematic fiscal deficit. We are not confident that this will be remedied in the near future as history has shown that policymakers are often unwilling and unable to restructure entitlement programs like Social Security, Medicare and Medicaid, by far the largest drag on government spending. George Strait may have typified the attitude of policymakers best when he wrote in the song after which this commentary is named:

> ***Hide from the future, run from the past***
> ***I guess I'll stay here as long as I can last.***

Too often it seems that the conventional wisdom on Capitol Hill is to wait as long as one can last before addressing hot-button policy issues. This "look away" attitude, which deflects responsibility for inaction to the next generation, allows bad situations to get worse, reducing both policymaker's flexibility and resources to address the problem effectively and forcing suboptimal decisions in the long run. The current fiscal crisis, where the U.S. will be unable to meet all its obligations if a compromise by both parties is not reached by August, is a result of years of failing to acknowledge the mountain of debt on which we stand.

While we do not expect the current fiscal crisis ultimately to result in default (we expect a compromise to reach the bare minimum to avoid such an outcome), a shift in the perceived credit risk of U.S. government debt, as we have seen with the debt of so many other sovereign debtors who have fallen by the fiscal wayside, could lead to an increase in real long-term interest rates that will pose a threat to the current economic recovery and long-term competitiveness of U.S. debt financing.

US Treasuries

As of 31-Mar

Benchmark	Yield
3 Month	0.04%
6 Month	0.10%
1 Year	0.19%
2 Year	0.61%
5 Year	1.97%
10 Year	3.29%
30 Year	4.40%

Bank of America/Merrill Lynch Indexes

31-Mar to 29-Apr

Index	Return
1-3 Yr Gov/Corp ≥ A	0.48%
1-3 Yr Municipals	0.27%
1-3 Yr Agencies	0.43%
0-3 Month UST	0.01%
S&P 500	2.96%

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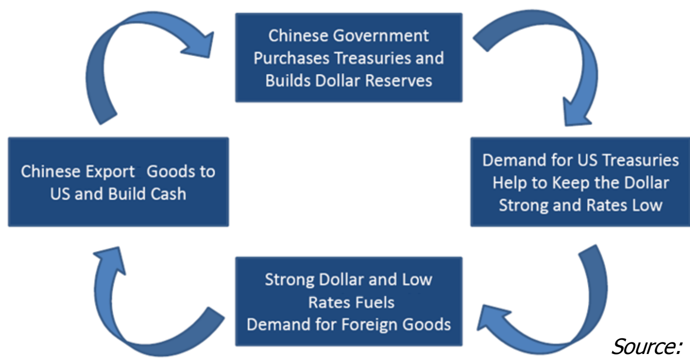
Source: British Bankers' Association, Federal Reserve, FDIC, US Treasury, Bloomberg, Barclays, Financial Times, JP Morgan, The Economist, S&P and Center on Budget and Policy Priorities

Running From the Past

Americans have long benefitted from strong global demand for U.S. dollars and dollar-denominated assets. In recent times, this demand for dollar reserves by global investors, particularly the Chinese, has resulted in a sustained period of low interest rates and increased purchasing power for U.S. consumers. This disequilibrium—something we have discussed in prior commentaries—has resulted in one of the largest transfers of wealth in history, from net importers to net exporters. This cycle has created a high dependency of U.S. consumers on foreign lenders of capital to maintain our current levels of spending and consumption.

Figure 1: Chinese demand for U.S. dollar-denominated assets have helped to keep interest rates low

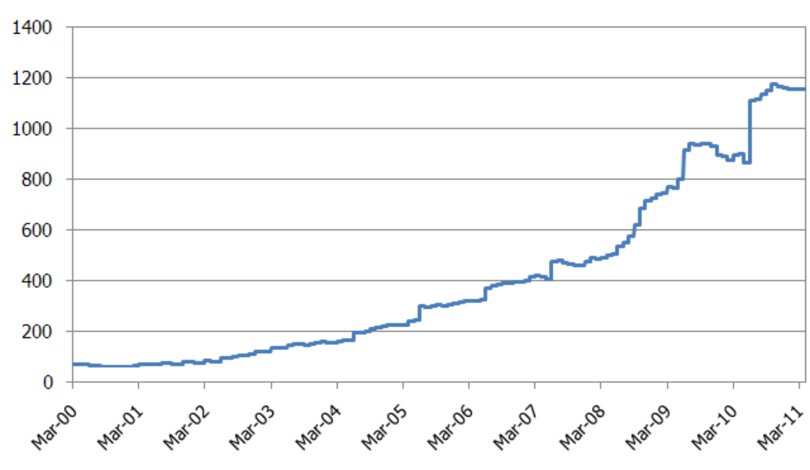


Source: Clearwater Advisors

Through this elaborate financing/exporting machine, the Chinese have grown to become the largest foreign creditor to the United States. Building a war chest of dollar reserves (calculated to exceed $3 trillion with over $1.15 trillion in Treasury holdings alone), however, has not been without significant risks. China has grown dependent on the U.S. to achieve its aggressive growth targets and has found that ending this mutually-beneficial, symbiotic relationship is not easy.

Over the past two years, Chinese policymakers have threatened several times to reduce their holdings of dollar reserves, citing a continued decline in the dollar and extreme monetary policy actions (i.e. quantitative easing). These threats have, at times, sent shock waves through the global rate and currency markets, but have subsided quickly as the global economic slowdown persisted longer than anticipated and a lack of safe alternatives forced investors' hands.

Figure 2: Growth of Chinese Holdings of U.S. Treasuries from 2000-2011



Source: Bloomberg

While the demand for U.S. debt has continued to remain strong in recent weeks (in light of ongoing crises in Europe, the Middle East and North Africa, continued support to keep short-term and long-term interest rates exceptionally low and the tempered expectations for global growth), we do not expect this trend to continue in perpetuity. The S&P action is yet another reason urging the Chinese and other large holders of U.S debt to consider further diversification of their dollar reserves. Comments from Chinese officials following the S&P rating action have suggested a large reduction of dollar reserves—targeting a range of $800 billion to $1.3 trillion—through an increase in state-owned capital, strategic resources, investments abroad, issuance of foreign bonds and national education and health welfare programs.

Figure 3: Actual and Projected Federal Budget Deficits from 2006-2013

	Federal Deficit as a % of GDP	Federal Deficit in Nominal Terms ($billon)
***12/2013**	4.30	704.00
***12/2012**	7.00	1,100.00
***12/2011**	9.80	1,480.00
12/2010	8.82	1,293.49
12/2009	10.01	1,412.69
12/2008	3.18	458.55
12/2007	1.14	160.96
12/2006	1.86	248.57

*Source: Bloomberg and the CBO. *Signifies a projection by the CBO.*

Increased hesitancy on the part of large buyers of U.S. debt could put moderate upward pressure on long-term interest rates in the second half of 2011 and create additional headwinds to domestic growth. The extent to which foreign central banks and investors will continue to buy U.S. debt at these extraordinarily low rates will hinge on the introduction of credible plans by U.S. policymakers to address long-term structural imbalances. S&P cited high uncertainty surrounding the elimination of large projected budget deficits, the debate surrounding raising the debt ceiling and the future of Fannie Mae and Freddie Mac (which the government estimates will eventually cost taxpayers a total of $259 billion) as key risks to the outlook of the U.S.

Hiding from the Future

The GSEs and government's involvement in housing policy are prime examples of the reluctance of policymakers to address politically-sensitive issues in a timely matter, forgoing the necessary medicine today in hopes that the underlying problem will resolve itself tomorrow. It has been nearly three years since Fannie Mae and Freddie Mac were taken into conservatorship, and their ultimate survival is as dependent on government support as ever before. Fannie Mae and Freddie Mac have already received approximately $154 billion of capital from an unlimited credit line extended by the Treasury. This credit line expires December 31, 2012, after which Fannie Mae and Freddie Mac will be able to draw up to a combined $274 billion in order to keep a net positive worth under GAAP standards.

Optimistically, the extraordinary support by the U.S. taxpayer will ensure that both mortgage giants, which own and guarantee roughly half the entire U.S. mortgage market, will survive long enough to clean up their balance sheets and ultimately repay taxpayers. Realistically, we think that neither is likely, and we anticipate that the rescue of Fannie Mae and Freddie Mac will be the most costly venture to taxpayers stemming from the credit crisis and subsequent recession.

While mandating the GSEs reduce their retained portfolio by 10% a year, policymakers have simultaneously given another mandate to support new issuance of mortgages to homeowners, being responsible for 90% of all new issuance this year. We see these conflicting mandates as further indication that policymakers are delaying the decisions necessary to shift the burden of housing policy (with the exception of low-income borrowers which we agree the government should retain) away from government sponsorship.

Some policymakers believe that maintaining a monopoly on mortgage guarantees may be the critical element to helping the GSEs earn their way out of their predicament. We strongly disagree and argue that expanding the guaranteed mortgage book of these lenders in a market that is artificially inflated due to government subsidies could pose significant risks if housing prices continue their downward slide faster or for longer than anticipated.

Looking Forward

The business model of the GSEs, level of entitlements and deficit spending is clearly not sustainable, but this has not stopped policymakers from contributing further to the underlying problems. We extrapolate this behavior to the impending fiscal debate, and we anticipate that it will be a drawn out, contentious process as fundamental ideologies collide.

We retain our view that short-term interest rates will remain exceptionally low into 2012, and see risk to marginally higher long-term interest rates in the second half of 2011 as round II of Quantitative Easing expires and hard lines begin to be drawn in the battle to reduce mounting budget deficits.

Please feel free to contact the desk with any questions.

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