clearwater ADVISORS

MARKET Commentary

United We Stand, Divided We Fall

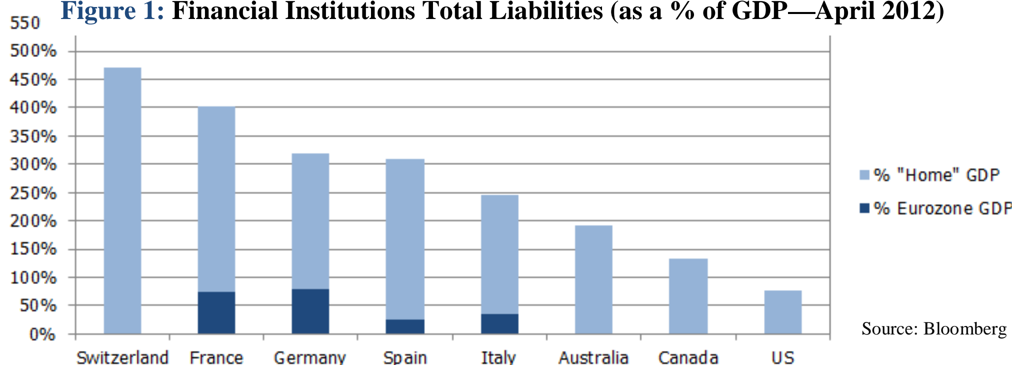
July 2012

The European Union (EU) is finding out how difficult it is to live up to its motto, “United in Diversity”. In a prolonged crisis that demands the cooperation of the collective body, individual member states have been loath to place national interests below that of the union. It is extremely difficult, however, to address the economic and structural issues that plague the EU without leaning towards more federalism. The requisite capital to buoy up distressed banking sectors and cash-strapped governments is too large for each country to bear on its own, and burden sharing among EU members is difficult to stomach without coordinated oversight and reform. As core member countries (Spain and Italy) come under increasing pressure, EU decision makers seem to have acknowledged reluctantly that the time for half-measures has passed. The recent EU announcement to create a single regulator to monitor the region’s banking sector marks significant progress towards a united front. While we will reserve judgment on the recent policy actions until additional details emerge, we anticipate further consolidation of monetary, fiscal and regulatory efforts among EU member states as the debt crisis wages on.

A Banking Union

It took the United States over a hundred years to establish the framework of our banking system. The Europeans have tried to accomplish a similar feat over a single weekend. While comparatively this may seem remarkably fast, their efforts have and continue to feel achingly slow given the severity of the debt and banking crisis engulfing the union.

Figure 1: Financial Institutions Total Liabilities (as a % of GDP—April 2012)



Recently, EU leaders have vowed to establish a central eurozone financial regulator and allow bailout funds to be directly injected into ailing banks. This is a decisive departure from the status quo where individual nations had been called upon to support their own ailing financial institutions and bailout funding flowed through the national government rather than directly to select institutions. A centralized regulator should ultimately lead to further regulation and oversight, which we view as long overdue. These decisions represent a significant step towards more financial and political consolidation, and while not a panacea, it is progress, nonetheless.

French and German banking system liabilities already total 400% and 300% of their nation’s GDP, respectively, with the combined bank liabilities of the two countries exceeding

US Treasuries

As of 29-Jun

Benchmark	Yield
3 Month	0.08%
6 Month	0.15%
1 Year	0.15%
2 Year	0.30%
5 Year	0.72%
10 Year	1.65%
30 Year	2.75%

Bank of America/Merrill Lynch Indexes

31-May to 29-Jun

Index	Return
1-3 Yr Gov/Corp ≥ A	0.04%
1-3 Yr Municipals	0.07%
1-3 Yr Agencies	0.03%
0-3 Month UST	0.01%
S&P 500	4.12%

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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

Eurozone GDP. Shoring up the collective banking system is important, but heavily leveraged economies can only support so much debt. With French and German taxpayers now on the hook for the poor decisions made by Italian and Spanish bankers, one is left to wonder who will be there to bail out France and Germany if the economic weakness persists for longer than anticipated. By giving clearance for collective EU bailout funds to be appropriated to select institutions directly, the Germans and French are effectively saying they are comfortable with the credit risk of their neighbors. We would not be so brave, but the Germans and French may have little choice. If further policy consolidation among EU member states is truly inevitable, it would not be wise to fight the trend and prolong a potential solution.

U-S-A, U-S-A, U-S-A

Here in the U.S., it is easy to look at the problems abroad with detached amusement. This year, however, will prove equally challenging and contentious as we face a fiscal cliff of our own. Policy makers have delayed critical decisions regarding our growing deficit. In 2008, the percentage of total publically-held marketable debt to GDP was a mere 40%. Currently, the ratio stands at 70% (according to the Congressional Budget Office). Research by Reinhart and Rogoff, co-authors of “This Time is Different: Eight Centuries of Financial Folly”, has shown that once a country reaches a ratio of 90%, long-term growth and stability are threatened. The CBO projects that if current tax and spending policies are extended, we’ll hit 200% in 25 years, putting the U.S. in Japan’s zip code. Conversely, if the Bush tax cuts are allowed to expire as scheduled, the CBO estimates this ratio would fall to 53% by 2037.

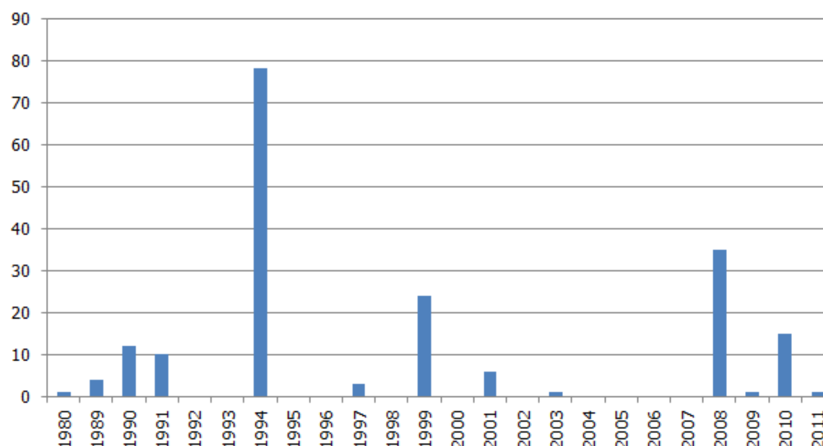
The uncertainty surrounding the potential fiscal cliff at year end is cause for concern. The longer policy makers delay decisions to address chronic fiscal deficits and the ballooning cost of entitlement programs (i.e. Medicare, Medicaid, and Social Security), the less ability and room for error policy makers will have to address these issues effectively. It was just over a year ago that the White House and Congress bungled the debt ceiling debate leading up to the S&P downgrade of the U.S. to AA+. Unfortunately, Washington may be lulled into a false sense of security with U.S. Treasury yields close to all-time lows and may continue to kick the can down the road.

Money Market Fund Reform Update

As an update to our last month’s commentary, “Money Market Reform,” SEC commisioners are now reviewing an internal draft proposal for money market reform. The commissioners have 30 days to review the draft. The proposal contains two potential options for money market funds:

- A combination of a fund capital buffer and redemption limits for money market fund investors in times of market distress
- Floating rate NAV pricing

Figure 2: Number of Funds Receiving Sponsor Support



Source: Bloomberg

Both options significantly alter the nature of money market fund investments. SEC Chairman Schapiro continues to argue for tougher oversight, a sentiment echoed by the Federal Reserve and supported by internal research. According to a recent study by the SEC, money market funds have been rescued by their parent companies more than 300 times since industry inception in the '70's. Chairman Schapiro also highlighted in her recent testimony to the Senate that during the three week period beginning June 14, 2011, prime funds saw redemptions equal to 6% of their assets while one fund lost 23% of its assets, illustrating the risks still present. Similarly, Moody's conducted its own research and found that between 1980 and 2011 at least 201 U.S. money funds received sponsor support, including 80 during 1994 (Orange County bankruptcy) and 15 in 2010, nearly two years after Lehman Brother's bankruptcy. The number of funds receiving support in 2008 would certainly have been higher had the administration and Federal Reserve not provided the extraordinary support they did. Clearly, this is not an isolated or defunct issue.

Looking Forward

The second half of 2012 is shaping up to be just as action-packed as the first. The EU looks to continue to lurch from crisis to crisis, serving as cacophonous background music to events here in the U.S. – namely, a presidential election, expansive tax increases, mandatory spending cuts, expiring deposit guarantees, tepid economic activity and requisite Fed-watching. The debt ceiling shouldn't be an issue until 2013, but it will certainly become a hot topic as the year winds down, especially given how poorly it was handled the last go-around.

With the ratings agency actions on banks finished for the near-term and the Federal Reserve extending Operation Twist until year-end, the environment for high-quality credit looks modestly constructive for the second half of the year. Within our portfolios expect to see a continued overweight to Clearwater-approved credit (including BBB-rated issuers, when permitted) and exposure to high-quality structured product, like the upper tranches of credit card and auto asset-backed securities and GSE-guaranteed mortgage-backed securities.

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