MARKET Commentary

Making a List and Checking it Twice

The weeks leading up to year end can be a very hectic time: gifts must be purchased, party invitations sent, and accommodations for visiting family and friends prepared. As if people did not have enough to worry about, this end of year will demand special attention given a series of debates in Washington and abroad that will affect how investors view their investment portfolios and counterparty exposures going into 2013.

We have compiled a list of topics that investors should consider before the year is done. Evaluating these list items now will provide professionals with the flexibility to design the best response for potential adverse outcomes. And like any list made this holiday season, we recommend that investors take time to check it twice.

Clearwater Year-end Checklist

- ☐ **Prudent Counterparty Management**
  - *Portfolio and Business Risks*
    - ☐ Transaction Account Guarantee Program's Future (TAG)
    - ☐ Money Market Fund Reform
  - *Action Items*
    - ☐ Create Contingency Plans to Manage Potential Outcomes
- ☐ **U.S. Fiscal Situation**
  - *Portfolio and Business Risks*
    - ☐ Fiscal Cliff
    - ☐ Potential U.S. Downgrade
    - ☐ Debt Ceiling Debate
  - *Action Items*
    - ☐ Neutral Portfolio Positioning into Year End
- ☐ **Crisis in Europe**
  - *Portfolio and Business Risks*
    - ☐ Credible Plan for Debt Reduction
    - ☐ Economic Conditions
  - *Action Items*
    - ☐ Create Contingency Plan for Further Eurozone Problems
- ☐ **Portfolio Strategy for 2013**
  - *Portfolio and Business Risks*
    - ☐ Current Liquidity and Cash Needs
    - ☐ Market and Central Bank Outlook
  - *Action Items*
    - ☐ Evaluate Portfolio Strategy for 2013

November 2012

US Treasuries

As of 30-Nov

Benchmark	Yield
3 Month	0.08%
6 Month	0.13%
1 Year	0.17%
2 Year	0.25%
5 Year	0.62%
10 Year	1.62%
30 Year	2.81%

Bank of America/Merrill Lynch Indexes

31-Oct to 30-Nov

Index	Return
1-3 Yr Gov/Corp ≥ A	0.08%
1-3 Yr Municipals	0.09%
1-3 Yr Agencies	0.07%
0-3 Month UST	0.01%
S&P 500	0.58%

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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

Prudent Counterparty Risk Management

Portfolio and Business Risks

The fate of the FDIC's Transaction Account Guarantee (TAG) program and money market reform remains uncertain. Senator Harry Reid recently proposed a two-year extension of the TAG program in an attempt to protect the interest of small community banks which have greatly benefitted from the initiative. Whether or not enough support for the proposal can be obtained and legislation passed before the end of the year is in serious doubt. What remains clear, however, is that large banks and their high-powered lobbying effort oppose such an extension and will likely work to move away from offering such products even if the program is extended. The reason is simple: it is cost prohibitive and less lucrative than other investment products they offer.

The potential expiration of TAG could leave cash managers with large non-guaranteed deposit balances at partner banks and force them to address questions about prudent counterparty concentration limits. If TAG is not extended, we anticipate the flow of money out of unlimited FDIC-guaranteed accounts and into alternative investment options (i.e. money funds and separately managed accounts) will put significant strain on short-end rates. This will cause an already challenging market environment for short-duration investors to become increasingly difficult.

Recent comments from the Financial Stability Oversight Council (FSOC) indicate that change to the money market fund industry is inevitable. The Federal Reserve has recently published three proposals for money fund reform. These proposals are not mutually exclusive, and the final proposal sent to the SEC for amendment and approval could be a combination of one, two or all three of the proposals. The three proposals include a mix of capital buffers, holdbacks, additional regulations on holdings and reporting and variable net asset values.

Money Fund Proposal	Highlights
Proposal 1	• Floating NAV by moving away from amortized-cost accounting • Phase-out periods for existing funds over 5 years • Move fund share price to $100.00 • Eliminate sponsor support agreements and orderly liquidation requirements
Proposal 2	• Stable NAV • NAV Buffer of 1% required by fund sponsors to absorb daily market fluctuations • "Minimum Balance at Risk" of 3% above $100,000 which is the amount held back and subordinated by the fund for 30 days • In the case of losses in excess of NAV buffer, "minimum balance at risk" begins to take losses affecting investors who withdrew funds first to incent shareholders to remain in fund • These changes would not apply to Treasury money market funds
Proposal 3	• Stable NAV • NAV Buffer of 3% required by fund sponsors to absorb daily fluctuations and losses • More stringent diversification, liquidity and disclosure requirements • These changes would not apply to Treasury money market funds

Source: JP Morgan

Action Items

Investors should create a plan for a series of potential outcomes regarding the expiration of TAG and money market fund reform. These plans may include utilizing a combination of unsecured bank deposits over the FDIC-guaranteed limit, money market funds and separately managed accounts. We have helped several clients develop strategies to avoid the potential volatility surrounding these impending events. Please feel free to contact us to discuss your options.

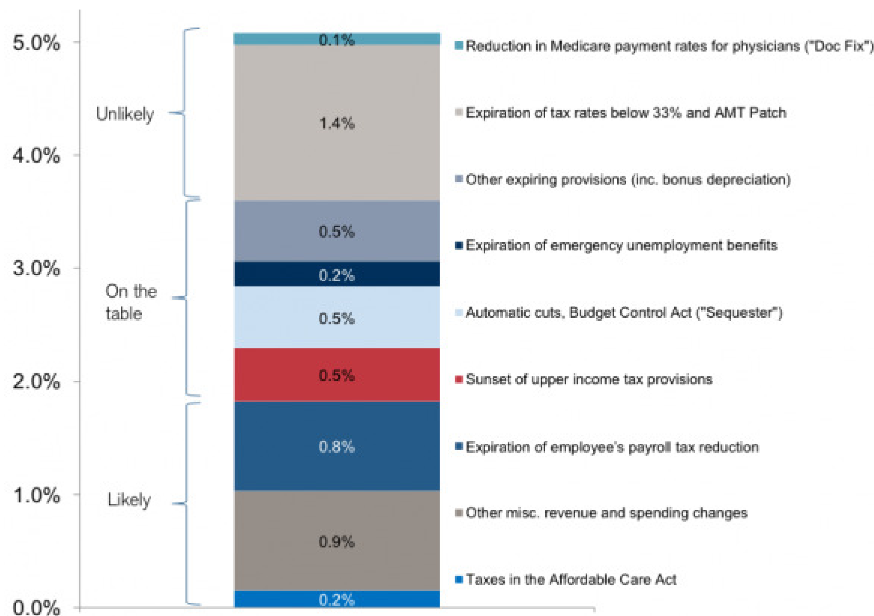
U.S. Fiscal Situation

Portfolio and Business Risks

Investors should remember the last time Congress was forced to reach a major fiscal compromise by a firm drop-dead date. The debt ceiling debacle of the summer of 2011 resulted in a U.S. downgrade and a significant sell-off in risky assets with the S&P 500 declining 16% and credit spreads gapping wider over the following two weeks. Markets are currently giving Congress the benefit of the doubt on the "fiscal cliff" resolution, but significant risk remains as the deadline closes and post-election accommodative discussions give way to partisanship.

The "fiscal cliff" refers to the $600 billion in tax increases and spending cuts that will automatically take place if a compromise by Congress is not reached by year end. The tax increase portion of the fiscal cliff is largely attributable to the expirations of the Bush-era tax cuts and other stimulus initiatives, such as the temporary exemption of payroll taxes for employers. The automatic and mandatory spending cuts are a product of the aforementioned debt ceiling debacle and the tendency of Congress to push problems down the road instead of addressing them in their proper time and place.

Figure 1: Cost (as a share of GDP) of the Fiscal Cliff



Source: CBO, Credit Suisse

We've reached the end of the road yet again, and the outlook is not good. Analysts estimate that if no action is taken by Congress the "fiscal cliff" could result in a reduction of $200 billion in consumer spending, 1.4% decrease in real GDP next year, and a rise to 9.1% unemployment by the end of 2013. There is little debate that the cumulative effect would drive the economy towards another recession. Indeed, Congressional delay to address "fiscal cliff" concerns until after the Presidential election has likely already contributed to slower growth in Q4 2012 as corporations prepare for year-end fiscal uncertainty.

In addition to these considerations, the U.S. is once again expected to hit the debt ceiling sometime in January or February 2013—something that is getting far too little attention in our view. If this issue is not also resolved in the current "fiscal cliff" negotiations, we expect to see the market's attention turn to this issue immediately following the turn of the calendar. Given the historical precedent of debt-ceiling negotiations, the market would be grateful if Congress would act sooner than later on this issue—but we are not holding our breath.

Congress need not solve all of the country's fiscal woes in this current round of budget negotiations, but they must do something—and quickly. A credible plan to reduce the nation's chronic budget deficit will go a long way in appeasing investors who are growing increasingly concerned about the absolute level of U.S. indebtedness.

Action Items

Past history and current uncertainty surrounding these likely market-moving events suggest that investors should err on the side of conservatism and position portfolios toward benchmark neutrality. In this way, investors are appropriately positioned for either a risk-on or risk-off scenario. To discuss effective portfolio positioning heading into year end, please feel free to contact the desk.

Crisis in Europe

Portfolio and Business Risks

The ongoing debt and economic crisis in Europe will remain a key risk to investors in 2013. Moody's' negative outlook on Germany and recent downgrade of France on November 19th indicates that rating agencies are quickly losing confidence in the ability of the strongest Eurozone countries to support their weaker counterparts. Greece continues to be the angst of technocrats and policymakers alike who demand that the country live up to its obligations following two rounds of bailout funding. These austerity measures have driven the Greek economy into a deep recession.

This is a trend that appears to be spreading across the continent. Spain and Italy are now 5 quarters deep into recession, and German leading indicators point to further contraction in Q4 of an already anemic sub-1% Q3 growth rate. The structural deleveraging of the continent is painful, but is an important catalyst for future growth. As with the U.S., what matters most is that policymakers outline a credible plan for responsible deleveraging, not necessarily attempting to solve all Europe's fiscal troubles overnight. So far, given the complex nature of the problem and competing interest of the Eurozone member-nations, policymakers have left much to be desired.

Action Items

We have long advocated that investors take a defensive approach when evaluating investment opportunities in issuers with large exposures to Europe, particularly European financials. We continue to recommend this approach going into 2013, and any significant exposure to the region should be accompanied by a game plan in case the conditions in Europe deteriorate more rapidly and violently than anticipated.

Portfolio Strategy for 2013

Portfolio and Business Risks

Global central banks will continue to dictate the interest rate environment and market sentiment in 2013. Continued monetary accommodation by the Federal Reserve will support asset prices and foster an interest rate environment that favors borrowers at the expense of lenders. While compressed credit spreads and lower interest rates should lead to reduced expectations for portfolio returns in 2013, strong statements by monetary officials should provide investors with a level of comfort that interest rates will not rise precipitously in the immediate future. Even in this extended low-rate environment, a constructive strategy addressing portfolio duration, sector and ratings allocation should provide investors with the tools to generate competitive returns.

Action Items

The extended low interest rate environment will force investors to reevaluate their risk tolerance and investment guidelines to meet expected portfolio returns. For consultation on portfolio strategy or investment guidelines and policies, please feel free to contact the desk.

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