MARKET Commentary

clearwater ADVISORS

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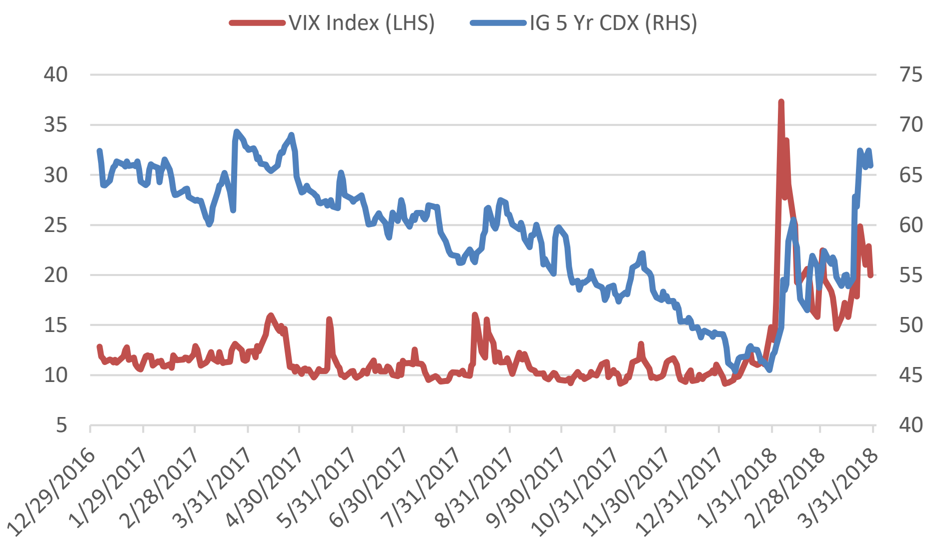
Trade Talk Tantrum

Volatility swept across markets in March (see Figure 1) as geopolitical risk ramped up on trade war rhetoric and the technology sector came under fire due to Facebook's poor data protection protocols. Economic activity lost some momentum from the fourth quarter, but remained healthy.

Figure 1: Volatility Returns



Source: Bloomberg

The Federal Reserve (Fed) hiked its target rate by 25 basis points (bps) in March, lifting the fed funds target range to 1.50-1.75%, and maintained their expectation to do so twice more this year. Further, their outlook for the economy strengthened balanced by the possible impact of trade uncertainties. The yield curve flattened with short and intermediate rates jumping 30-40 bps while longer maturities rose more modestly.

The corporate primary market shrugged off a slow start to the year as investment grade issuers brought $111 billion to market in March which included the blockbuster $40 billion CVS deal. This backdrop pressured corporate spreads and rewarded risk aversion.

LIBOR Stress?

LIBOR's U.S. replacement was recently rolled out. Due to the scandal surrounding LIBOR manipulation, a recommendation to find a replacement was announced last summer. Britain's Financial Services Authority advocated phasing out the index by 2021. The Secured Overnight Financing Rate (SOFR) has been chosen domestically. It is fully transaction based on multiple market segments – general tri-party repo,

US Treasuries

As of 29-March

Benchmark	Yield
3 Month	1.70%
6 Month	1.91%
1 Year	2.08%
2 Year	2.27%
5 Year	2.56%
10 Year	2.74%
30 Year	2.97%

Bank of America/Merrill Lynch Index Returns

Q1, 29-Dec to 29-Mar

Index	Return
1-3 Yr Gov/Corp ≥ A	-0.17%
1-3 Yr Municipals	0.29%
1-3 Yr Agencies	-0.02%
0-3 Month UST	0.34%
S&P 500	-0.76%

Source: US Treasury, Bloomberg, BofA/ML, and S&P

Contact Us

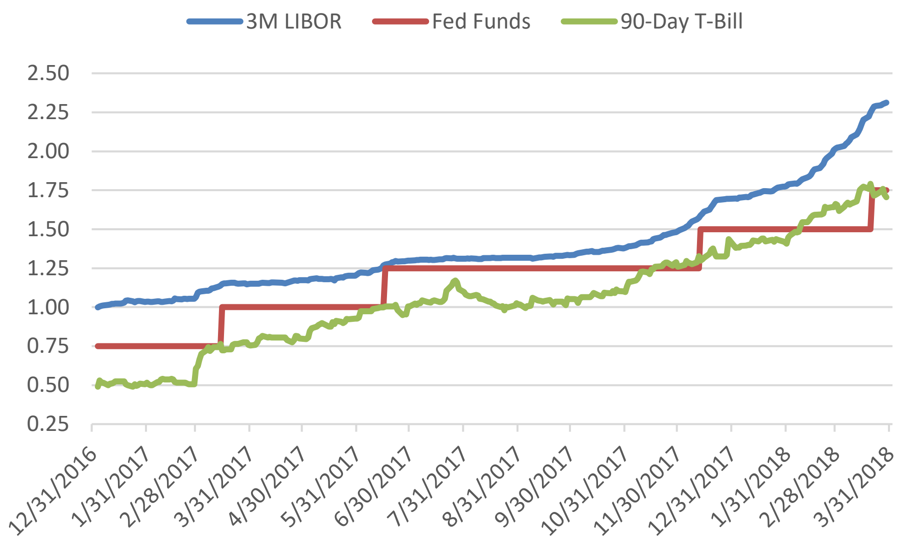
Matt Peterson
mpeterson@clearwateradvisors.com

www.ClearwaterAdvisors.com

inter-dealer tri-party repo and FICC-cleared bilateral repo. Related markets and tenors will be built out around it in the coming months and years. The transition away from LIBOR won't be easy as there is an estimated $200 trillion in securities and contracts that rely on the tarnished benchmark in the U.S. alone.

Media headlines have recently noted the sharp rise in LIBOR in relation to other money market rates (see Figure 2). In the past, such a rise would be indicative of stress in the financial markets or a bank funding crisis. However, that is not the case currently. There are several conditions that are contributing to the rise that, as discussed below, should abate as we progress through the next quarter.

Figure 2: LIBOR Moves Higher



Source: Bloomberg

U.S. T-bill issuance has soared following the debt ceiling suspension resolution early this year. Over $325B in supply was marketed since early February into quarter-end, easily the most over the last six years, pressuring bill yields higher. Additionally, the impact from repatriation is reverberating through money markets. As corporations adjust to the updated tax regime, there has been a vacuum of demand for short duration securities as investment strategy adjusts to business plans moving forward. Finally, bank liquidity pools were reluctant to shift balances away from the Federal Reserve.

These conditions should settle as we head into Q2 arresting the recent LIBOR rise. The U.S. T-bill supply should fall over the coming months as tax receipts come in. Repatriation impacts seem to be stabilizing and money markets have largely adjusted. Foreign bank funding impacts remain a bit of a wildcard, but adjust fairly quickly to market conditions. In the meantime, we are a buyer of floating-rate notes at these elevated LIBOR levels.

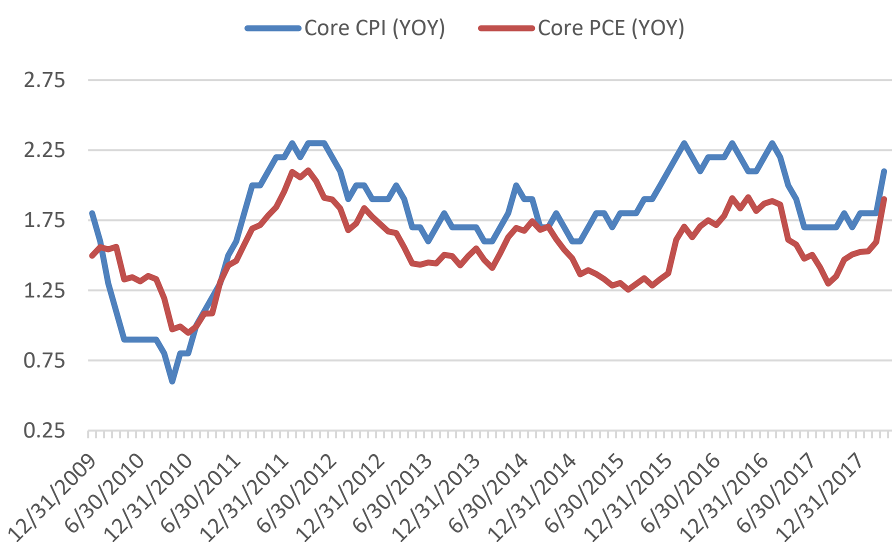
Fixed Income Dynamics

The long period of calm that enveloped markets was broken early in the quarter. Risk assets sold off and credit spreads widened materially. Investment grade spreads, which were hovering near post-recession lows, widened to levels not seen in over a year. Money markets, including commercial paper and CD's, were choppy as clearing levels rapidly rose without the buying power of corporate treasury groups. Concerns over trade wars and fears of Middle East unrest added to the unsteady environment.

As the quarter came to a close, trade issues faded a bit and markets tended to focus less on geopolitical risks than had been the case for most of Q1. Those risks will likely ebb and flow as the Trump administration negotiates with involved parties. Underlying global economic activity appears to have slowed somewhat in the quarter, but still remains reasonably strong. The Fed reiterated its commitment to raising rates two more times this year and three in 2019. Further, its balance sheet reduction plan continues on autopilot for the foreseeable future. Markets are fairly well-positioned for domestic monetary policy with the two-year Treasury yielding 2.27% as of March 29th.

However, fixed income investors are largely overlooking a couple of factors that could increase rate volatility materially in the near future – inflation and yawning deficits. For much of 2017, core measures of inflation (Figure 3) were printing well below the Fed's 2% target. The Fed dismissed the decline as "transitory" and maintained their 2017 hiking pace even as they introduced balance sheet reduction. Markets spent most of the year unconvinced of the "transitory" nature until late in the year when TIPS markets repriced higher. Nominal yields, especially further out the curve, could come under pressure as inflation data prints higher in the coming months. The yield curve is flat as investors are questioning the durability of the current economic cycle and whether inflation will continue this trend.

Figure 3: Inflation Firming



Source: Bloomberg

Tax reform was lauded by markets. However, lower taxes against even modestly rising fiscal spending are a recipe for increased Treasury issuance. Further complicating matters, entitlement spending, like Social Security and Medicare, is not forecast to rise modestly, but exponentially. The Congressional Budget Office forecasts the federal deficit will top $1 trillion in the coming years. Those deficits grow even as we enter the later stages of this most recent economic expansion and when unemployment is near its lowest levels in decades – this pattern is counter to deficit spending that historically rose in times of economic distress. The U.S. Treasury will begin to increase government bond issuance as the European Central Bank ends quantitative easing and the Fed continues to pare back its balance sheet. This dynamic could create volatile markets as we head into Q3 alongside firming inflation.

Looking Forward

Global monetary policy will continue its gradual, less accommodative shift. The broad global economic growth backdrop remains, but appears to be slowing somewhat. Treasury markets look to have domestic monetary policy priced fairly while inflation and significant deficits will likely impact longer maturities. Select investment grade floating-rate credits, commercial paper and AAA-rated credit card and autos are attractive given the current environment.

Please contact the desk with questions or to discuss investment opportunities best suited to navigate the challenges facing market participants in the near term.

Form ADV Part II

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