clearwater ADVISORS

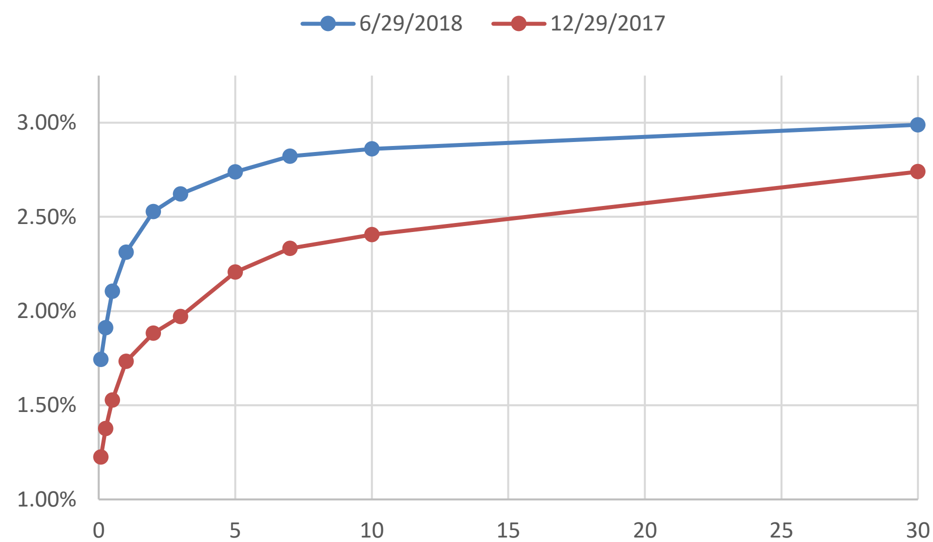
MARKET Commentary

Monetary Mayhem and Geopolitics

Summer 2018

Geopolitical tensions continued to weigh on markets heading into summer. The underlying domestic economy looks reasonably strong, but trade war fears, Eurozone politics and emerging market woes have investors spooked. The European Central Bank (ECB) presented a fairly dovish outlook while the Federal Reserve (Fed) increased rates by 25 bps in June and signaled two more hikes this year. Consequently, the yield curve flattened as front-end yields rose while longer maturities increased more modestly (see Figure 1).

Figure 1: U.S. Treasury Yield Curve



Source: Bloomberg

June's primary market activity for corporate issuers was the highest for that month since 2014, driven primarily from acquisition-related deals, pressuring spreads. Similarly, global mergers and acquisitions activity totaled $2.5T in the first half of 2018, marking the strongest start of a year since records began in 1980, according to Reuters. Animal spirits are stoked even as geopolitical risk casts a shadow over synchronized global growth.

Monetary policy will continue its gradual, less accommodative shift further complicating matters. Contentious trade negotiations and tariffs pose a threat to global economic activity. These factors will contribute to higher volatility over the coming months.

Trade, Tariffs and Trump

The Trump administration increasingly ratcheted up the rhetoric on trade as the quarter came to a close. With tariffs and tweets targeting most of our trading

US Treasuries
As of 29-June

Benchmark	Yield
3 Month	1.91%
6 Month	2.11%
1 Year	2.31%
2 Year	2.53%
5 Year	2.74%
10 Year	2.86%
30 Year	2.99%

Bank of America/Merrill Lynch Index Returns
Q2, 29-Mar to 29-June

Index	Return
1-3 Yr Gov/Corp ≥ A	0.27%
1-3 Yr Municipals	0.59%
1-3 Yr Agencies	0.23%
0-3 Month UST	0.44%
S&P 500	3.43%

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

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partners, the era of globalization seems to be coming to a close. However, the Trump Administration would argue that they are simply trying to level the playing field. Markets are struggling to appropriately price the uncertainty the President's negotiating tactics bring. Immediate impacts are being seen in certain corners of the economy like autos and agriculture, but $35-$50B in tariffs seem a bit underwhelming against an almost $20T domestic economy. Investment grade credit spreads have widened for most of 2018 offsetting all of last year's move tighter with the initial gap wider coming after tariffs were first announced this past spring. Credit curves have steepened as well providing investors with reasonable compensation for much of the uncertainty.

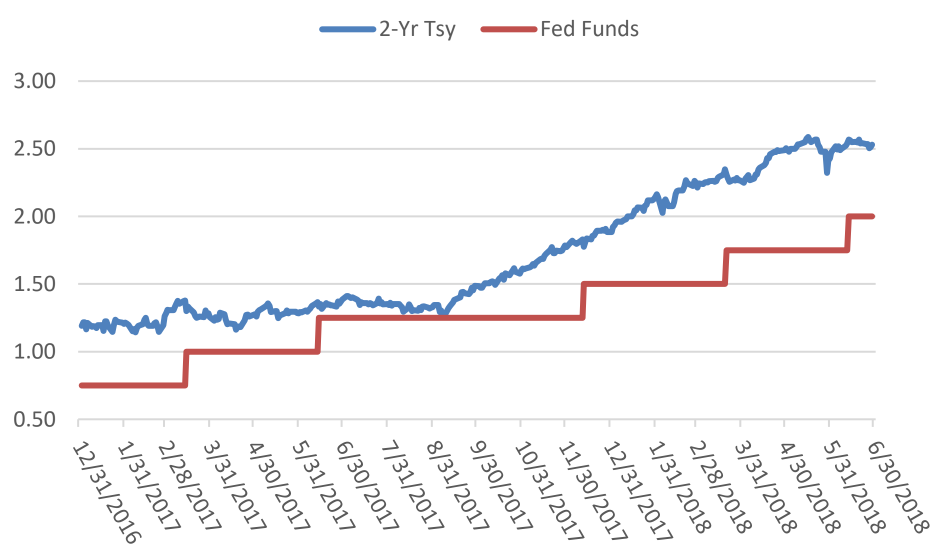
The path the Administration is trudging down is rife with risks should opposing parties continue to ramp up rhetoric and countermeasures. The President recently announced he is ready to go all the way with China by putting tariffs on every single import that comes into the U.S. This would represent a major escalation that China would not ignore. Soft economic data (like consumer sentiment) are already starting to show some weakness due to the increased rhetoric and initial tariffs while the hard data (like durable goods orders) indicate a resilient economy. Negotiations must begin to make headway or the underlying economy will be impacted and market volatility will react in kind.

Monetary Policy

The Federal Reserve hiked rates by 25bps, as expected, at their June meeting moving the target range for the federal funds rate to 1.75% to 2.00%. The Fed also released updated forecasts that moved slightly more hawkish signaling two more hikes in 2018 and three in 2019. Solid economic data seemed to bolster the Fed's confidence in its path toward normalizing monetary policy. Fed Chairman Powell echoed that sentiment during recent testimony before Congress. He maintained the narrative that economic growth looks strong warranting a gradual pace of continued hikes "for now". When asked about the escalation of trade rhetoric with China and the G-7 he warned that the situation could weigh on the economy should it deteriorate or continue for a long time period.

The current economic environment should allow the Fed to remain on a gradual policy course (see Figure 2), avoiding the kind of sudden or large rate hikes that might cause the yield curve to invert in the near term.

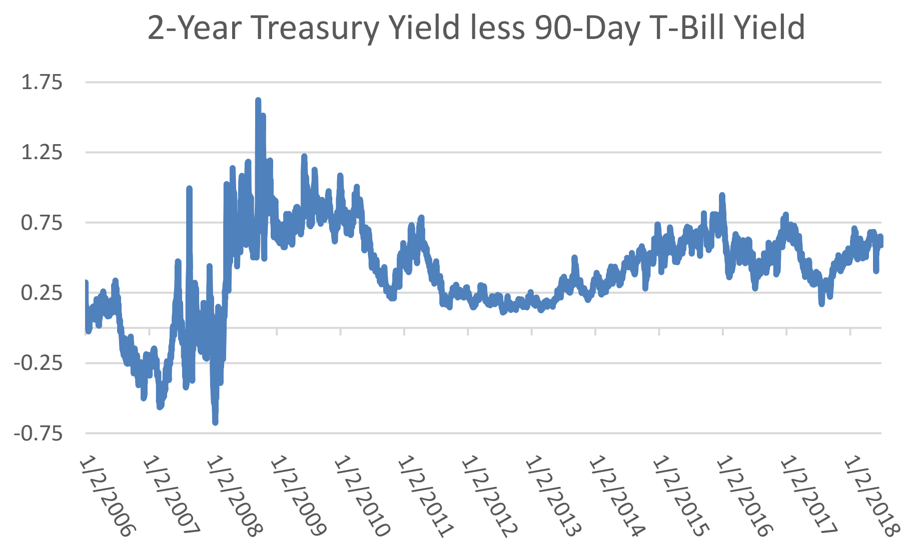
Figure 2: The Path Higher



Source: Bloomberg

Much has been written about the flattening of the yield curve and potential inversion, even Fed officials are getting in on the game. While it's true the broader yield curve is flattening, the front-end looks reasonably steep (see Figure 3). Further, this short maturity yield curve differential will move negative and possibly significantly so (-175 bps in 2006) in recessionary periods. Therefore, for those clients with mandates within these maturity parameters, don't get too caught up in the curve flattening headlines.

Figure 3: Short Maturity Yield Curve



Source: Bloomberg

Further, according to ICE BofAML Index data the two-year Treasury has never posted an annual loss since the inception of the index in 1987. For additional historical context with a broader index maturity, the ICE BofAML 1-3 year Treasury Index hasn't posted an annual loss since the inception of the index in 1976 which includes several bouts of Fed tightening.

Overseas, the ECB announced at its June meeting that it will cut its bond purchases in half in October and end the asset purchase program by December. The ECB's statement also signaled that policymakers don't plan to begin raising rates until the end of next summer, at the earliest. Both of these measures were viewed as dovish and reassured investors that the ECB would be very gradual in transitioning towards less easy policy. Further, the European Central Bank will continue reinvesting the proceeds from maturing debt, focusing on longer-maturity bonds in an effort to hold down long-term rates. Recall, the ECB came to the quantitative easing party late and looks to be willing to be the last to exit.

Looking Forward

The Fed is on pace to raise rates twice more this year. Domestic economic growth looks solid and inflation is trending modestly higher. Front-end rates look reasonably well positioned to bear additional rate hikes. Contentious trade negotiations and tariffs pose a threat to global economic activity and will likely contribute to higher volatility over the coming months. Investment grade credit spreads have priced in a reasonable level of uncertainty allowing for opportunistic positioning. Additionally, monetary policy will continue its gradual, less accommodative shift especially as the ECB shifts to neutral by year-end.

Please contact the desk with questions or to discuss investment opportunities best suited to navigate the challenges facing market participants heading into the second half of 2018.

Form ADV Part II

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