clearwater ADVISORS

MARKET Commentary

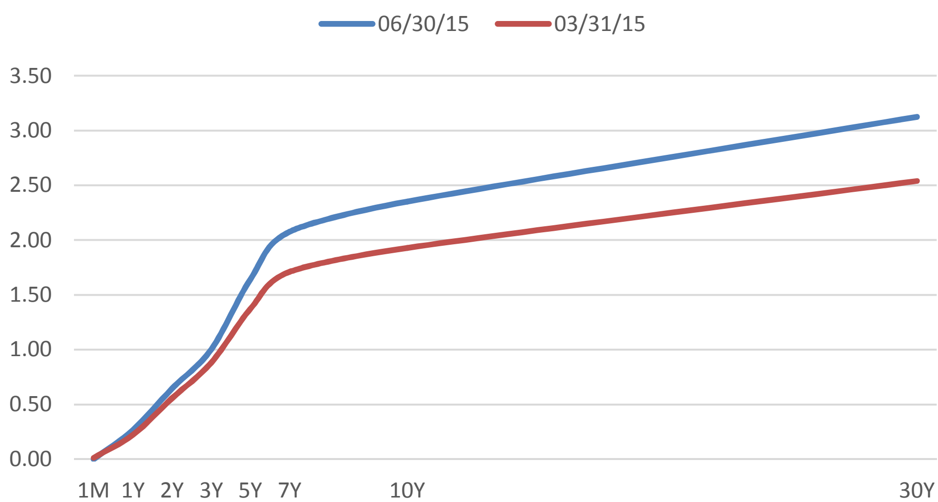
Are We There Yet?

Summer 2015

The U.S. economy regained momentum lost over the first quarter. The second quarter saw a significant increase in U.S. Treasury yields as investors refocused their attention on less accommodative monetary policy by the Federal Reserve (Fed). Risk assets delivered uneven results and U.S. Treasury yields were volatile as well. Fears of deflation in the Eurozone gave way to renewed concerns regarding Greece. On the quarter, performance rewarded short duration and the highest quality issuer exposure. Given the uncertainty surrounding Greece, China and Fed policy, expect more volatility in the intermediate term.

U.S. Treasury yields inside a year to maturity were basically unchanged while yields one year and beyond moved significantly higher on the quarter. The yield curve bear steepened (see Figure 1) as two-year Treasury yields increased 9bps while the thirty-year Treasury yield increased 59 bps.

Figure 1: U.S Treasury Yield Curve



Source: Bloomberg

Credit spreads widened over the quarter pressured by continued record high new issuance levels. Idiosyncratic credit risk remains elevated as issuers increase leverage to engage in shareholder friendly activity and mergers & acquisitions.

The Eurozone economy began to show signs of life as the European Central Bank's quantitative easing program found traction. The German ten-year Bund yield hit a low of 0.07% in April before rebounding to 0.76% at quarter-end further pressuring U.S. Treasury yields. The broader economic situation looks to have turned a corner, but growth remains weak. Further, ongoing negotiations regarding Greek bailout financing remain a wildcard.

US Treasuries

As of 30-June

Benchmark	Yield
3 Month	0.01%
6 Month	0.11%
1 Year	0.27%
2 Year	0.65%
5 Year	1.64%
10 Year	2.35%
30 Year	3.13%

Bank of America/Merrill Lynch Index Returns

Q2, 31-March to 30-June

Index	Return
1-3 Yr Gov/Corp ≥ A	0.13%
1-3 Yr Municipals	0.01%
1-3 Yr Agencies	0.16%
0-3 Month UST	0.00%
S&P 500	0.28%

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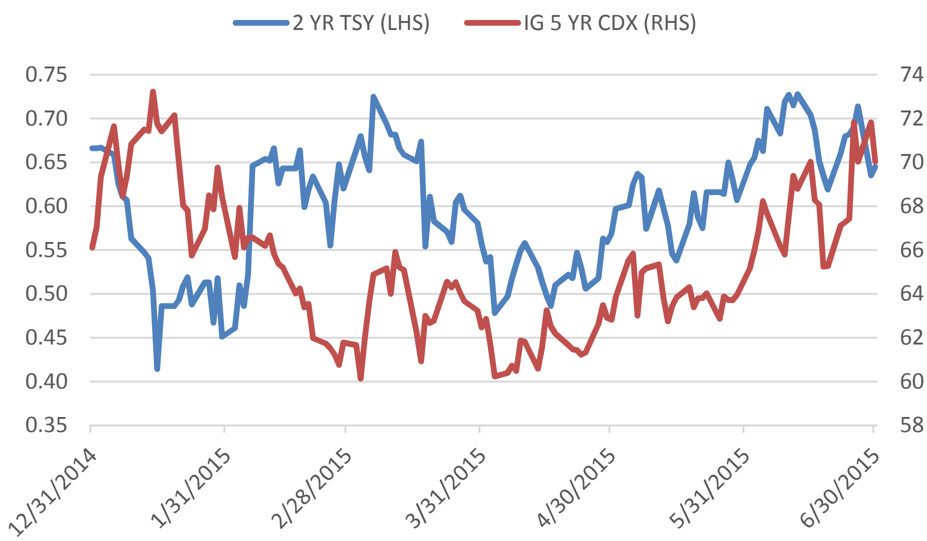
Source: British Bankers' Association, Federal Reserve, US Treasury, Bloomberg, Barclays, BofA/ML, and S&P

The Year the Music Stopped

Federal Reserve Chairwoman Yellen recently stated that "conditions are shaping up for a 2015 rate rise" during her semi-annual Humphrey-Hawkins testimony to Congress in mid-July. Other Fed officials have joined the chorus and the bond market is beginning to take notice. Futures markets that had priced the first rate hike in early 2016 are now pricing in a hike later this year. Treasury yields have taken notice as well moving higher into quarter-end (see Figure 2). The recent rise in rates reduces the risk of a potential "tantrum" when the Fed does decide to move and offers attractively steep curves for investors.

Figure 2: 2-Year Treasury Yield and Investment Grade Spread (5 Yr CDX)



Source: Bloomberg

While the U.S. economy has rebounded from weak Q1 growth, the Fed does not want to derail growth and has repeatedly stated that it will gradually normalize policy. The Fed is committed to a very slow and gradual pace of hiking which coupled with global economic headwinds should keep yields in the U.S. relatively low.

Revisiting a table we published in a prior commentary (02/2013) – during past periods of rising interest rates, short-duration mandates have held up admirably, striking the proper balance between higher carry and frequent portfolio turnover. The short nature of these portfolios has allowed investors to reinvest at higher rates faster than portfolios further out the yield curve in periods of rising rates. The higher carry associated with spread product has also protected the portfolio from unexpected negative price movements.

Figure 3: Historical Index Performance during Sustained Periods of Rising Rates

Index	2009	1999	1994
Current 10-Year Index	-9.71%	-8.25%	-8.29%
U.S 1-3 Credit ≥A Index	11.57%	3.66%	1.06%
U.S. Broad Market	6.12%	-0.87%	-2.75%
U.S. Corporate Index	19.76%	-1.89%	-3.34%

Source: Bank of America/Merrill Lynch

Diversified investors with mandates in the 1-5 year space should not be overly concerned about the implications for rising rates—the fact that long-duration investors are looking to place an increasing amount of funds in this space should provide some solace. Further, modest inflation expectations and a cautious Fed should warrant a gradual rise in rates, rather than a sudden shift higher.

Other Concerns

Investment grade credit spreads have leaked wider on the quarter (as seen in Figure 2 above). Questions surrounding the Fed haven't helped risk assets, but high grade credit has also experienced record levels of new issue supply which has weighed on the market. Corporate issuers are rushing to take advantage of low yields prior to Fed lift-off. Thus far, 2015 has had the first (May at $153bn) and third (March at $140bn) highest monthly levels of investment grade issuance on record and is well ahead of pace to set a new annual record as well according to BofA/ML data. This constant barrage of primary market activity has pressured spreads that were already widening on heightened shareholder friendly activity and M&A. We expect supply to continue to come at a high rate in the first half of the upcoming quarter before slowing into September. We will continue to take advantage of the new issue market as appropriate to capture new issue concessions in credits we have fully vetted.

Overseas, the recent Greek bailout drama is likely to resurface, but should not present significant risk to the market now that a framework for a deal has been agreed upon. The Chinese equity market's precipitous decline has rekindled fears about the underlying economy. However, the Shanghai Composite was up 60% year-to-date prior to the sell-off and arguably wasn't connected to fundamentals. Headline risk remains and will weigh on risk assets.

On the domestic front, the debt ceiling will become an issue once again. The U.S. Treasury is currently undertaking "extraordinary measures" to fund the government. These actions should last until October or November, at which point, Congress will have to act. Our expectation is that Congress will handle a debt ceiling resolution in a civil manner and it looks like corporate tax reform may be on the table as well, but we remain wary. Expect the political rhetoric to pick up.

Puerto Rico's economic struggles have highlighted the need for sweeping restructuring of its $72bn debt pile. In June, the island's Governor admitted that its debts are "unpayable". If default does occur, it would be the third largest behind Greece and Argentina. If you've heard that it's simply a liquidity issue, recall that Puerto Rico has debt per capita of $15,637 (the next highest state is Connecticut at $5,491) and the debt-to-GDP ratio in Puerto Rico is 66% while the average U.S. state is 7%. The triple tax exemption (tax-free at the federal, state and local level) has made it a favorite investment in many municipal bond portfolios. Large holders include Oppenheimer and Franklin Templeton according to Bloomberg. Clearwater has none. The commonwealth cannot declare bankruptcy unless Congress grants it the ability. So, it is pushing for a restructuring. We don't expect Puerto Rico to represent a meaningful risk of negative contagion save for those who have exposure.

Looking Forward

The long-awaited transition to higher federal funds is likely to come later this year almost seven years after the Fed implemented zero interest-rate policy in the midst of the Great Recession. Rate increases will be slow and steady as the Fed does not wish to derail growth. Additionally, global economic weakness and deflationary forces will temper yield increases. Short-duration mandates have held up well in prior rate hiking cycles especially those with a prudent allocation to investment grade credit and other high-quality spread sectors (like asset-backed securities). Additionally, there are a variety of other factors that will take a back seat to monetary policy developments, but bear monitoring as well.

Please contact the desk with questions or to discuss investment opportunities on how to best navigate today's market environment.

Form ADV Part II

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