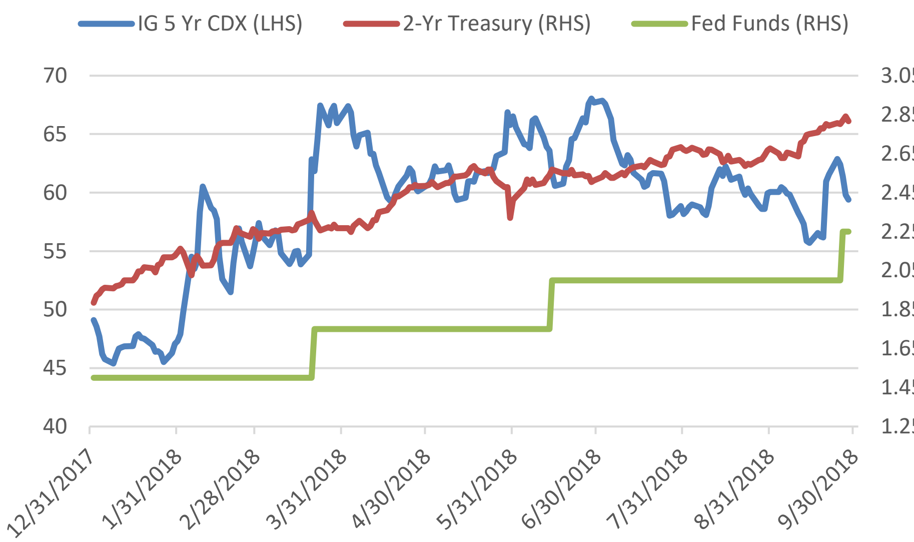
clearwater ADVISORS

MARKET Commentary

Onward and Upward

Fears of mounting global trade tensions and emerging market concerns (Turkey & Argentina) moderated amid renewed focus on the strength of the domestic economy. Risk assets rallied even as the Federal Reserve (Fed) raised rates near the end of September. Over the quarter, the yield curve bear flattened as front-end yields rose 25-30 basis points while longer maturities rose 20-25 basis points. Investment grade spreads tightened offsetting much of the widening experienced in the first half of the year (see Figure 1).

Figure 1: Fixed Income Markets



Source: Bloomberg

Geopolitical risk as well as contentious trade negotiations and tariffs have cast a shadow over synchronized global growth. These factors will contribute to higher volatility over the coming months. Additionally, the Eurozone, more specifically Italy or Brexit, is simmering in the background.

The Fed remains on course to hike for the fourth time in 2018 at their December meeting and has forecast a similar trajectory in 2019. The Treasury market has recently moved to price in less accommodative policy, decent domestic growth, modest inflation, etc. pushing yields to recent highs. Risk assets have shrugged off the move, but could come under pressure as the year closes.

SOFR So Good

Due to the scandals surrounding LIBOR manipulation, regulators recommended to find a replacement index and phase out LIBOR by 2021. The transition away from LIBOR isn't going to be easy as there is an estimated $200 trillion in securities and contracts that rely on the tarnished benchmark in the U.S. alone. LIBOR's U.S.

Fall 2018

US Treasuries

As of 28-Sept

Benchmark	Yield
3 Month	2.20%
6 Month	2.36%
1 Year	2.56%
2 Year	2.82%
5 Year	2.95%
10 Year	3.06%
30 Year	3.21%

Bank of America/Merrill Lynch Index Returns

Q3, 29-June to 28-Sept

Index	Return
1-3 Yr Gov/Corp ≥ A	0.30%
1-3 Yr Municipals	-0.01%
1-3 Yr Agencies	0.32%
0-3 Month UST	0.49%
S&P 500	7.71%

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

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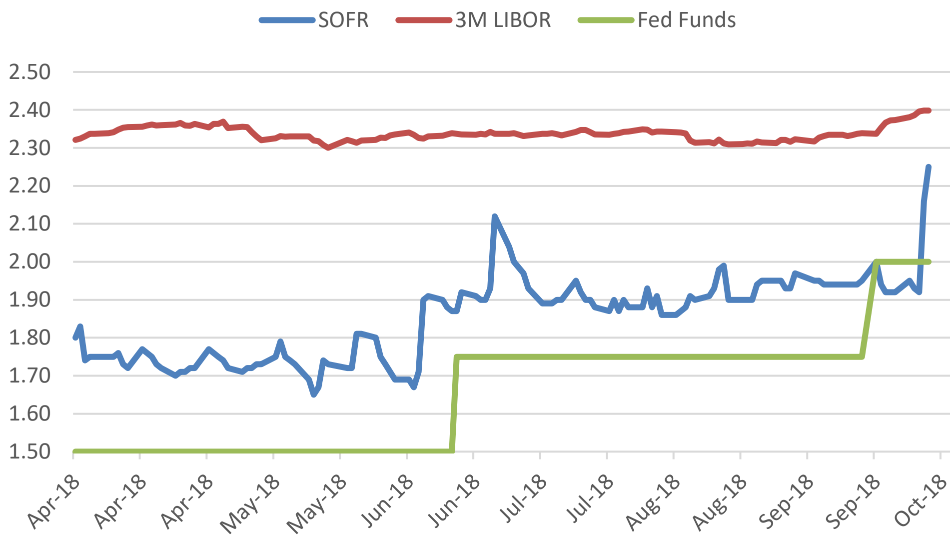
replacement, the Secured Overnight Financing Rate (SOFR), was rolled out in early April. SOFR is fully transaction based across multiple market segments – general tri-party repo, inter-dealer tri-party repo and FICC-cleared bilateral repo. As such, it is a risk-free index largely mirroring the fed funds rate while LIBOR continues to include an additional credit spread component (see Figure 2).

Figure 2: Secured Overnight Funding Rate and LIBOR



Source: Bloomberg

Related markets and tenors will be built out around SOFR in the coming months and years. Earlier in the quarter, Fannie Mae and World Bank sold inaugural SOFR-based floating rate notes while MetLife broke ground for a corporate issuer in August. More recently, Wells Fargo and JP Morgan joined the "SOFR club" by issuing SOFR-based debt. Interestingly, JP Morgan's recently issued bank-level LIBOR floater was offered at a yield of 2.64% while the new SOFR debt came at +55 which equates to 2.76%. So, there was some concession for the less familiar SOFR benchmark and it makes sense to consider new SOFR deals when looking to add to floating rate exposure.

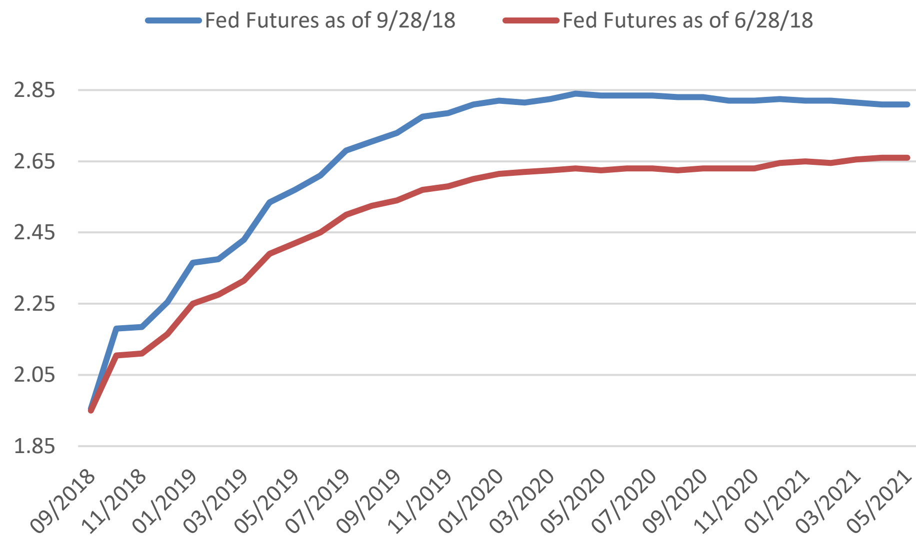
The Fed's Alternative Reference Rates Committee (ARRC) recently released two papers that create the discussion framework for fallback contract language on new LIBOR-benchmarked securities to provide a transition should it become extinct. Following the consultation period, the ARRC will publish its final recommendations which will provide a basis for the transition away from LIBOR to SOFR-related products during the phased transition through 2021. The Fed has stressed that LIBOR users quickly implement fallback language and accept that the benchmark will expire at the end of 2021. This final outline will provide a foundation for how to handle existing securities and regulators are starting to press banks, issuers and exchanges for their written transition plans. The initial steps are being made to move away from LIBOR and some analysts estimate domestic markets are ahead of schedule in meeting the 2021 deadline.

What Now?

The Federal Reserve hiked rates by 25bps, as expected, at their September meeting and looks on track to do so again in December. Of note, the Fed removed the observation that policy remains accommodative in the meeting statement and described the economy as "strong". Therefore, decisions will likely become more data dependent as policy passes neutral and becomes restrictive over the coming year or so.

Fed officials forecast three more hikes next year and one in 2020. Should the economic expansion continue and the Fed follow through on their forecasts, the fed funds rate would rise to 3.25-3.50% in a couple of years. Over the quarter, market expectations of Fed rate hikes rose (see Figure 3) as measured by fed funds futures. Markets are still skeptical that the Fed will maintain its predicted course as evidenced by lower peak rate (2.85%) that plateaus in April 2020, but are better positioned for policy tightening now than this summer.

Figure 3: Markets Reprice Fed Policy



Source: Bloomberg

The corresponding move higher in Treasury yields continues to bolster short-duration portfolio returns and create opportunities across the Clearwater Advisors investment universe. We remain constructive on investment grade corporate exposure in portfolios with a critical eye on underlying balance sheets and idiosyncratic risk. For rating sensitive clients, AAA-rated asset-backed securities and commercial mortgage-backed securities continue to offer value. Further, while 3.00% was an oft-discussed threshold for the 10-year Treasury note, it's now possible to purchase high-quality bank paper in the 14-16 month range above 3.10%. With another Fed hike coming in December, nimble portfolios will be rewarded as yields rise into year-end.

Looking Forward

The Fed is on track to hike at their December meeting. Domestic economic growth looks solid and inflation is trending modestly higher. The yield curve looks reasonably well-positioned to bear additional rate hikes while spreads continue to price in some uncertainty. Current markets present a favorable environment for Clearwater clients as money market rates trend higher and spread sectors cushion the impact of higher yields. For the near-term, duration positioning should be flexible as the Fed continues to hike. This strategy will evolve as 2019 unfolds and markets respond to Fed policy in light of economic activity.

Please contact the desk with questions or to discuss investment opportunities best suited to navigate the challenges facing market participants heading into year-end.

Form ADV Part 2

Clearwater Advisor's annual Form ADV Part 2 disclosure is available upon request. To make a request please email Compliance@ClearwaterAdvisors.com or call us at 208-433-1222.