clearwater ADVISORS

MARKET Commentary

Economic Remodel

January 2010

In 2009, the U.S. taxpayer began to pay for a remodel of the economy. The project is claimed to be a success following a slight downtick in the unemployment rate to 10%, the strong stock market rebound, and the above-consensus holiday retail sales data.

We, on the other hand, remain skeptical of the results that have been released: Do they represent fundamental improvements or are they just fancy coats of paint? We are concerned with the more inclusive unemployment rate of 17.3% and don't believe that taxpayers as an unlimited line of credit is a sustainable model. We welcome the effects of intervention to stabilize the financial system, but we remain concerned about the lingering effects of excessive stimulus spending and the markets' reactions as this spending begins to be withdrawn in 2010.

2009 Review

Many of the recommendations we made in 2009 have proven successful and are still in effect, although we deserve some negative marks for underestimating the markets' positive reactions to stimulus spending.

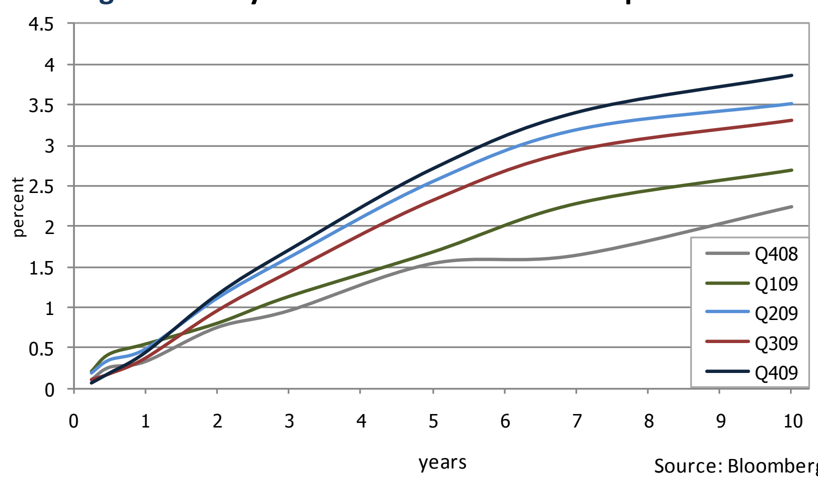
Our early recommendation that clients purchase paper issued in the 1-3 year space under the Temporary Liquidity Guarantee Program (TLGP)—as the guarantee was timely and direct—proved beneficial as TLGP spreads contracted quickly from UST+200 levels to trade closer to UST+20 today in three year paper. In addition to highlighting the U.S. government guarantee, we encouraged investors to purchase paper explicitly backed by certain fiscally responsible sovereigns, quasi sovereigns and multilateral institutions. For those whose policies and boards allowed, we also recommended a move into very high quality AA and A corporates, and even BBB credits in select cases. These credit trades were profitable as spreads tightened and are now left with limited upside.

Another opportunity we highlighted toward the middle of the year that proved successful was to extend from ultra-short 0-3 month portfolios into the 1-2 year space when purchasing Treasuries and Agencies. With front-end rates anchored by the Federal Reserve, along with our expectation that low rates will continue due to technical factors, we thought that extending into 1-2 year securities would provide a reasonable pick up in yield with minimal credit risk and little interest rate risk.

We were surprised by some effects of the stimulus spending and the confidence that seemed to be injected into the markets as program after program was rushed through Congress or agreed upon in closed-door, emergency meetings of the economic leaders of this country. The magnitude of the rebound in stocks and bonds was not anticipated.

Technical factors, like high levels of deposits, high money market fund balances, and cheap financing while rates were held extremely low, provided capital that needed a home. Some of the money that was not responsible for driving down yields was

Figure 1: The yield curve continued to steepen in 2009



Source: Bloomberg

US Treasuries

As of 31-Dec

Benchmark	Yield
3 Month	0.05%
6 Month	0.19%
2 Yr	1.14%
5 Yr	2.68%
10 Yr	3.84%
30 Yr	4.64%

Merrill Lynch Indexes

30-Nov to 31-Dec

Index	Return
1-3 Yr Gov/Corp ≥ A	-0.67%
1-3 Yr Municipals	0.08%
1-3 Yr Agencies	-0.56%
0-3 Month Treasuries	0.00%
S&P 500	1.93%

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Source: British Bankers' Association, Federal Reserve, FDIC, US Treasury, Bloomberg, Barclays, Financial Times, JP Morgan used to purchase equities that were trading at depressed levels. The bounce off lows in March instilled confidence in the stock market and the buying continued, driven by hope and some initial signs of a quick recovery. We reiterate our concern that the fundamentals of the U.S. economy have not been adequately repaired and a withdrawal of stimulus spending, as well as other factors, will restrict growth.

Outlook for 2010

As we look forward to 2010 we continue to see opportunities in extending into 12-18 month Treasuries and other guaranteed paper due to curve roll-down, and selectively buying high grade corporates where allowed. We expect interest rates to rise modestly in the second half of the year, and we expect Agency spreads to widen. We anticipate economic constraints on growth stemming from a captive consumer, a slow recovery in jobs, and increasing deflationary pressure in the commercial real estate markets.

Opportunities

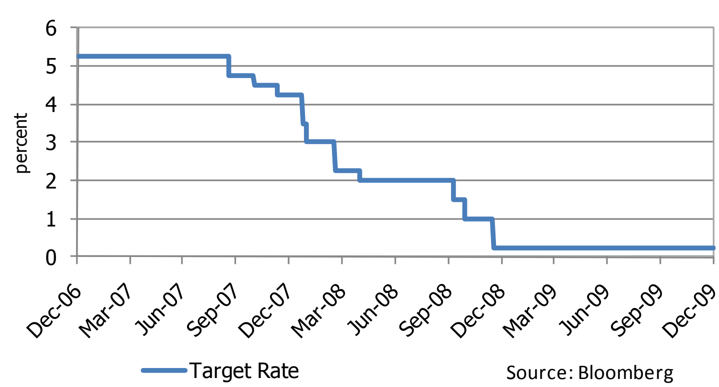
In looking at buying 12-18 month Treasuries we still see the chance to benefit from the steepness of the yield curve, though the trade has some timing dependency. The credit safety of government securities combined with roll-down characteristics help us remain confident that there is reasonable yield to be picked up that can buffer against a modest interest rate rise. Additionally, for portfolios with available cash cushions, the longer investments may be held to maturity to avoid recognizing losses should interest rates rise.

Just as the U.S. has done, other governments have stepped in to prop up financial markets through additional guarantees. Some nations' debt should be avoided regardless of an explicit guarantee, but other nations, such as Canada, France and Germany, provide the safety and liquidity that we require when buying sovereigns, quasi-sovereigns and multilateral institutions.

In the high grade corporate debt market, many balance sheets are in better shape now as uneasy equity and debt holders have demanded that companies increase their liquidity to higher levels. Companies have secured additional lines of credit and hoarded cash and equivalents since the liquidity crisis began. Though higher cash balances increase acquisition risk (on both sides of a deal), they also improve the ability of these companies to meet coupon and maturity payments. Investors must be picky, but opportunities to diversify away from Treasuries and Agencies and pick up some yield still exist in this market.

Rate Hike?

Figure 2: Federal funds rate



We will most likely see a hike in the federal funds rate this year after it flatlined in 2009, but not for at least 6 months. With the federal funds target range at an unsustainable 0% to 0.25%, the Fed will feel pressure to begin to curb growth as more convincing signs of recovery appear in the second half or later.

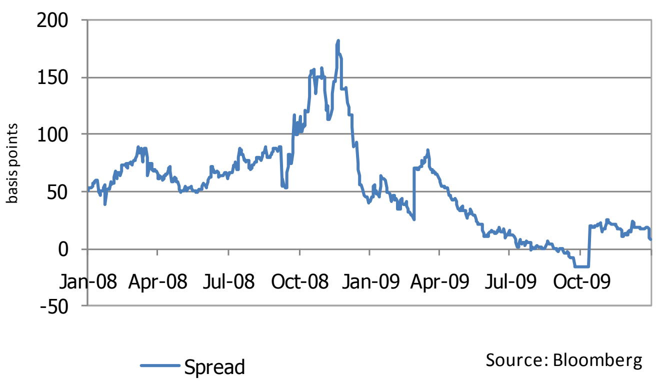
The Federal Reserve has indicated that it is closely watching three key indicators in determining when to raise the federal funds rate: inflationary expectations, actual inflationary trends, and resource utilization. All signs point to limited inflation in the near term and the Federal Reserve has indicated that inflation is not a major concern at the present. Despite recent improvements in the labor market, we expect that unemployment will remain elevated throughout 2010. Fed officials have indicated that there must be strong signs of job recovery before action to raise the federal funds rate will be taken.

While the federal funds rate is a major determinant of the level of short-term interest rates, other policy actions by the Federal Reserve could lead to rising interest rates. Some of these actions include withdrawing liquidity and excess reserves from the system (e.g., term deposit at the Fed, Fed debt issuance, expiration of asset-purchase programs, selling purchased assets back into the market, reverse repurchase agreements), and continuing the large issuance of Treasury notes and bonds to fund rescue programs. Other factors include an expanding deficit and policy action in Congress that could push rates higher due to uncertainty surrounding potential legislation (e.g., health care, climate change, and tax legislation). These factors will lead to greater volatility in the near term, presenting opportunities to take advantage of attractive yields in the money markets.

Look for Widening in Agencies amid Restructuring

Another development in 2010 that will have large implications for the U.S. economy and broad financial markets will be the government's actions in regard to the Government Sponsored Enterprises (GSEs) Fannie Mae and Freddie Mac. The Obama administration is scheduled to present a plan for the future of these agencies in February 2010. Fannie and Freddie own or guarantee about $5.5 trillion of mortgages, roughly half of the U.S. mortgage market. Their role as financier of mortgage origination is crucial to the current administration's plan to prop up the housing market.

Figure 3: 2-yr Agency Spread over Treasuries

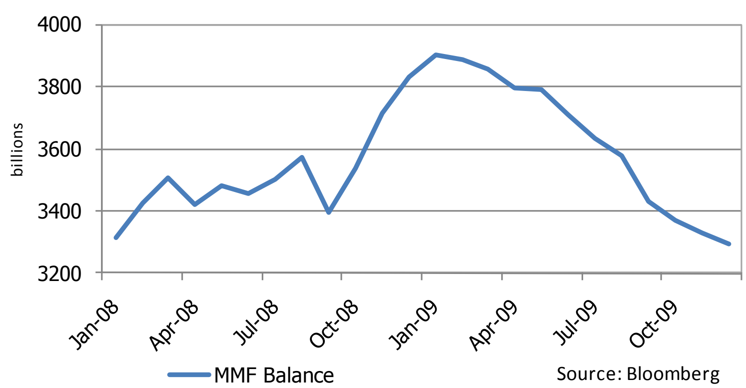


At the height of the credit crisis, Fannie Mae and Freddie Mac were vilified as significant contributors to the economic crisis. Policy makers in 2008 mandated that the GSEs delever their balance sheets at a rate of 10% per year beginning in 2010 as a condition to receiving government support. This and other restrictions on support were recently lifted, as explained in a Christmas Eve 2009 announcement. The prior agreement had limited the Treasury to offering a combined $400 billion in aid to ensure both institutions' solvency (GSEs have collectively received $111 billion to date). Fannie Mae and Freddie Mac will now be allowed to grow their balance sheets in 2010 to provide additional funding to the struggling housing market. The GSEs will be able to accomplish this through expansion of their retained portfolios; i.e., the mortgages that they hold on their balance sheets.

Despite the reminder of government support we see widening risk in Agency spreads due to currently tight spreads and the potential for increased supply as the GSEs expand their balance sheets. Fannie Mae and Freddie Mac will become the backstop to purchase qualifying MBS as the Fed program for MBS purchases is set to expire in Q1 2010. Any increase in the GSEs' balance sheets will likely be accompanied by increased debt issuance, which could cause spreads to widen.

The demand story for Agency debentures also points to widening. This is primarily driven by the expiration of the Federal Reserve's program to purchase Agency debentures. The amount of Agency purchases under the Asset Purchase Program was originally scheduled at $200 billion when announced and was revised to $175 billion in November. With such a big buyer leaving the market, investors will see support for Agency debentures challenged. Demand will also fall as investors rotate out of safer investments such as money market funds (money market funds are large purchasers of Agencies). Competing demand will come from over $300 billion of expected non-US-government-guaranteed supranational and sovereign issuance in 2010.

Figure 4: Money Market Fund Balance Index



Pressures

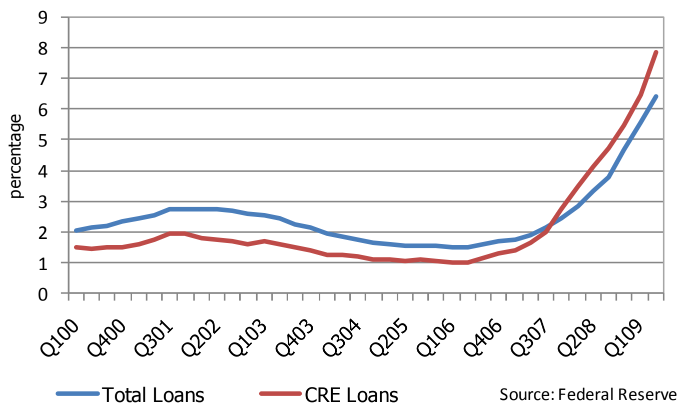
We see significant pressure on the economic recovery as consumers continue to struggle, unemployment rates remain high, and commercial real estate prices continue to fall.

The U.S. economy is primarily driven by consumption, with 70% of GDP coming from consumer spending (much of which is discretionary). Economic recoveries in the past have been driven by consumers and we don't believe that the U.S. consumer is currently able or willing to lift the economy out of this hole. The greatest pressures on the consumer are joblessness and lack of credit—in addition to stricter lending standards, we lost the ability to use our houses as ATMs.

Banks blame the consumer for not wanting to borrow, and Congress on behalf of the consumer blames the banks for not wanting to lend. We think both sides are correct, though it is less a lack of desire from the consumer and more a lack of ability. As lending standards have rightfully been tightened, overlevered consumers are failing to meet the requirements to borrow money, and when they do, lenders are requiring higher interest rates to compensate for the added risk in this economic environment.

Consumers will have their hands tied until jobs are created at an encouraging rate. The Federal Reserve says it could be 2012 before the U.S. sees an unemployment rate of 7.6% and could take an additional two to three years for it to return to levels closer to 5% the market has come to expect over the past decade. Ongoing depressed levels of spending by the consumer will hurt businesses, which in turn puts pressure on commercial real estate (CRE) values. As more businesses cannot make lease payments, more employees must be laid off. This is a cycle that will eventually be reversed, but not until we see significant stability in the fundamentals of the economy. Some believe that the CRE cycle can be sidestepped as lenders scramble to get these loans off their balance sheets through workout programs, but we expect that additional pain will be felt in this market. The question that remains is whether the lenders or the taxpayers get the brunt of it. Either way, we see it as a significant drag on the economy in the near future.

Figure 5: Delinquency rates (all commercial banks)



Remodeling Delays and Cost Overruns

The U.S. economic remodel is well underway as government intervention has kept the structure standing and intact. But with any remodeling or construction project, when the work is done hastily at first, both delays and extra costs must be added to estimates after the issues have been adequately addressed. We look forward to further stability in the financial markets and see opportunities to position portfolios to achieve higher returns while maintaining safety and liquidity. However, we remain skeptical that the taxpayer-funded remodel has solved the underlying fundamental problems that the economy faces.

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