clearwater ADVISORS

MARKET Commentary

Happy "New Normal" Year

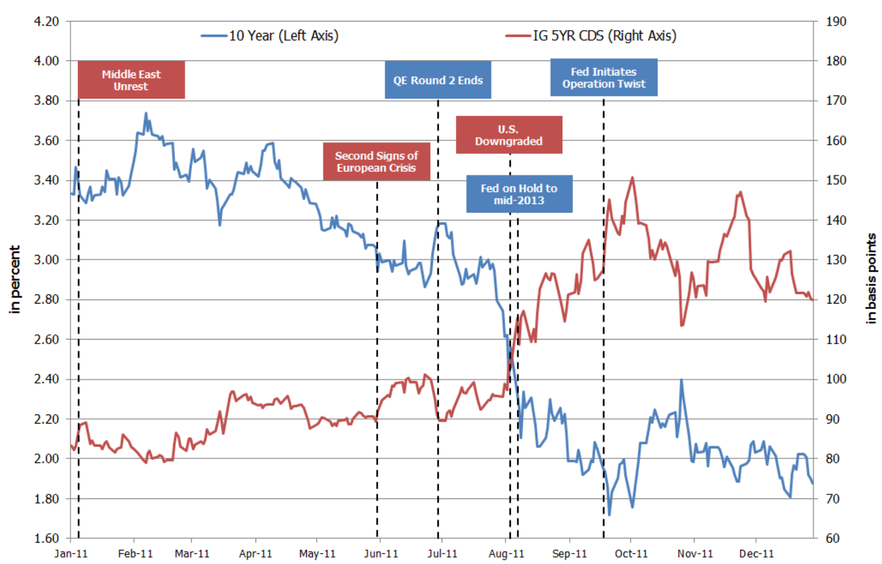
January 2012

2011 will go down as anything but a normal year. The year burst forth with renewed optimism but then stumbled badly as economic, political and natural forces turned against it. Our recommendations for the past year focused on extending in high-quality sectors (treasuries, agencies, TLGP and select high-grade corporate securities) to take advantage of opportunities presented by the "new normal" - weak economic growth, high unemployment and, consequently, continued easy Fed policy. We maintain this stance in 2012, while also highlighting additional opportunities in high-quality structured product as well as the need to consider moving lower on the credit rating spectrum, but not necessarily lowering credit quality (for example, American Express at BBB+ versus BNP Paribas at AA-). We continue to face a challenging investment environment as front-end supply diminishes, rates remain low, highly-rated credit remains suspect and risks of a global shock remain elevated.

The Year in Review

2011 emerged with positive expectations of economic renewal and an aggressive search for yield. However, investors quickly shifted to a defensive flight to quality as a variety of factors weighed on markets. Overseas, tensions in the Middle East boiled over, the European sovereign debt crisis resurfaced with a vengeance, and Japan endured a catastrophic earthquake. Domestically, fears of a double dip recession had markets clamoring for additional quantitative easing as QE2 came to a close mid-summer. The Fed moved quickly to ease concerns, stating that rates would remain "exceptionally low" "through mid-2013." The Fed also maintained easy policy via Operation Twist, aggressively driving rates lower. Along the way, the U.S. lost its AAA rating as our political class bickered.

Figure 1: U.S. Treasury Yields (10 Year Note) vs. Investment Grade CDS



Source: Bloomberg

US Treasuries

As of 30-Dec

Benchmark	Yield
3 Month	0.01%
6 Month	0.06%
1 Year	0.10%
2 Year	0.24%
5 Year	0.83%
10 Year	1.88%
30 Year	2.90%

Bank of America/Merrill Lynch Indexes

30-Nov to 30-Dec

Index	Return
1-3 Yr Gov/Corp ≥ A	0.09%
1-3 Yr Municipals	0.28%
1-3 Yr Agencies	0.07%
0-3 Month UST	0.00%
S&P 500	1.02%

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Source: British Bankers' Association, Federal Reserve, FDIC, US Treasury, Bloomberg, Barclays, Financial Times, JP Morgan, The Economist, S&P and Center on Budget and Policy Priorities, Wall Street Journal

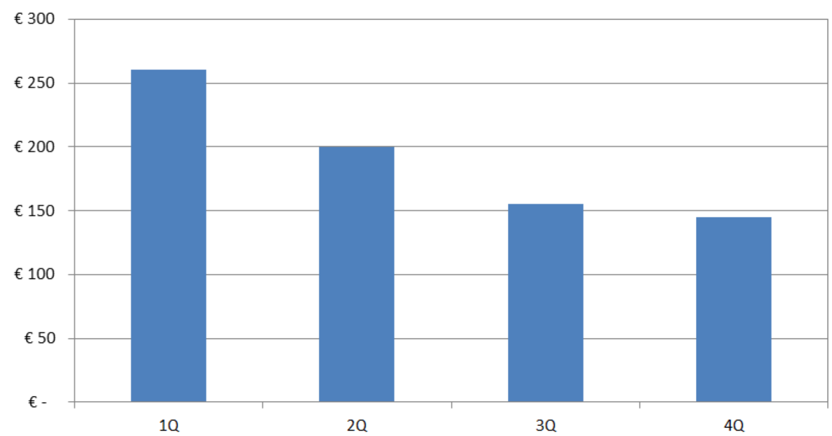
Fixed income returns rewarded duration and selective credit exposure during 2011. T-bills returned just 0.07% on the year while the 2 year U.S. Treasury note was up 1.45% as its yield fell from 0.59% to 0.26% over the course of the year. Corporates fared better with 1-3 AAA Corporates up 1.71% while 1-3 year U.S. Treasuries returned 1.55% (all return data from Bank of America/Merrill Lynch). Industrials outperformed financials as the industrial premium hit its highest level since mid-2009, with Bank of America, Goldman Sachs and Morgan Stanley among the weakest performers.

Given the weak macro-economic environment and expectations of continued Fed easing, throughout the year we focused on high-quality corporate securities and encouraged clients to extend portfolio duration. We stressed that the Federal Reserve would err on the side of caution, economic growth would be muted as leverage exited the system and unemployment would remain stubbornly high.

The Year Ahead

Political risks loom large in 2012. The U.S. faces gridlock heading into a presidential election while Europe is still struggling to cobble together a viable mechanism with which to confront its debt crisis. Complicating matters, EU governments and banks have large (over €1.7 trillion) front-loaded refunding needs in 2012. Italy, France and Spain lead the funding morass with €319 billion, €269 billion and €126 billion coming due respectively. We expect volatility to remain high as Europe continues its uneven march towards the inevitable: a Greek EU departure, massive ECB quantitative easing, or worse.

Figure 2: 2012 Euro-zone Bank Debt Maturity Schedule

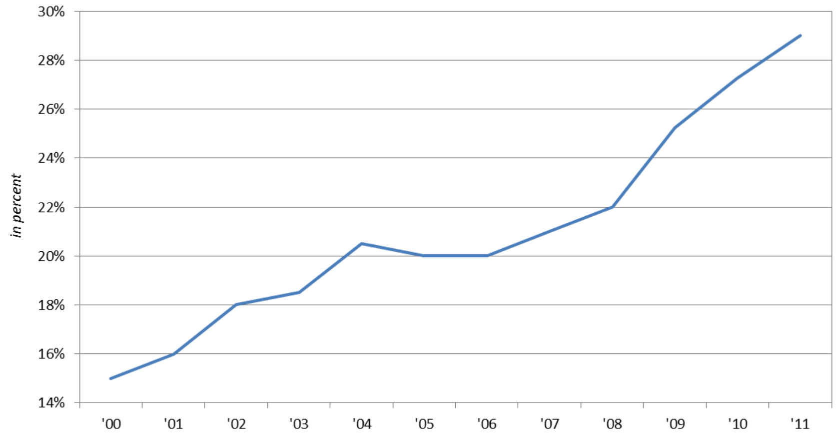


Source: Bloomberg

The European Central Bank (ECB) seems finally to have grasped the gravity of the matter with the recent launch of their Long Term Refinancing Operation, but remains constrained by German reluctance for loose policy. Needless to say, we remain extremely wary of European issuers and worry about possible spillover effects should European policy makers fail to contain the contagion – a position readers of our commentary are long familiar with.

The U.S. enters a major election year with ballooning fiscal imbalances, major tax policy expiring at the end of the year (Bush tax cuts), and dysfunction in Washington. The Fed will maintain exceptionally low rates through mid-2013 and potentially longer as they maintain loose policy beyond what may be warranted. The FOMC membership will become more centrist so there should be less dissent. Additionally, the Fed will be releasing additional information after its policy meetings, so we expect some market hiccups as participants digest their relevance. The economy should continue to muddle along and we expect high-quality credit to outperform. Profitability is at an all-time high due to aggressive "right-sizing" strategies. Additionally, most high-quality industrials have termed out maturities while maintaining healthy balance sheets with very high levels of cash.

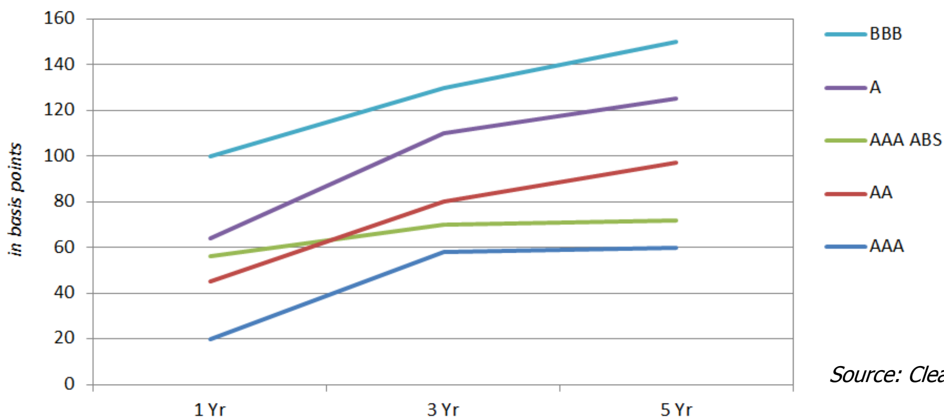
Figure 3: Corporate Cash as a % of Current Assets



Source: JP Morgan

Select financials have bolstered deposits and now have limited issuance needs. Therefore, we continue to advocate for credit exposure and where appropriate look for additional yield opportunities in lower rated, high-quality bonds like General Mills and American Express.

Figure 4: Short Duration Credit Spreads over Treasuries by Rating



Source: Clearwater Advisors

The "New Normal" Portfolio

Many of the central themes and challenges that were present entering 2011 remain in place for 2012. Portfolio constraints established prior to the Great Recession (or possibly in reaction to it) should be reexamined to take advantage of investment opportunities that will arise in 2012. Specifically, look to:

- Add select credit exposure (including a move down in ratings quality) – the credit ratings agencies have had a poor track record, so don't constrain your portfolio to their definition of "higher-rated" credit.
- Allow investment in high-quality sovereign securities as a substitute for GSE debt (for example, Canadian provinces) – the GSE's unlimited Treasury support ends in 2012; expect volatility until a clearer resolution comes forward.
- Add high-quality structured product – there is attractive yield pick-up versus other short, high-quality assets.

- Increase the flexibility of duration limitations – a steep yield curve provides opportunity in a Fed-on-hold environment.

Finally, with bank deposits paying low, or in some cases negative yields, and money market fund yields continuing to compress, it is a good time to consider a custom separately managed account that is tailored to your investment guidelines and prudently maximizes your yield.

Please contact the desk with questions or to discuss investment opportunities.

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