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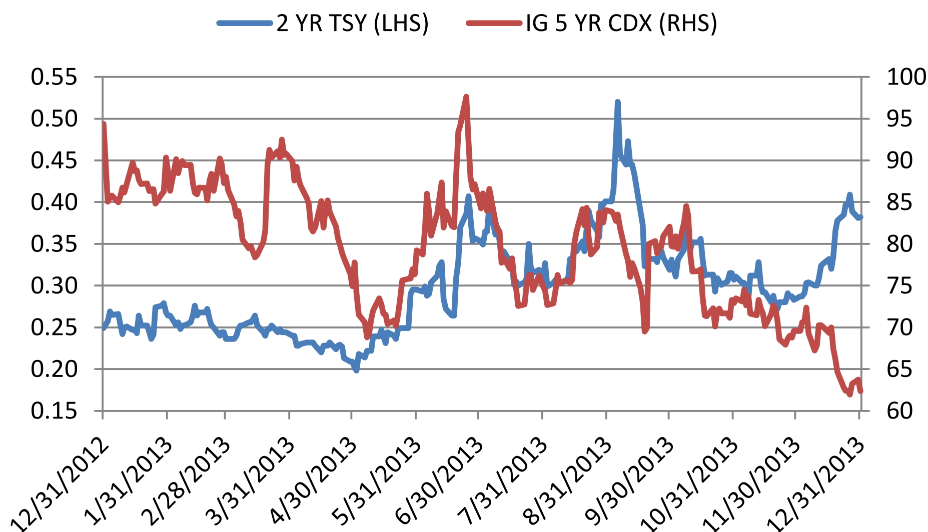
MARKET Commentary

The Year of the Taper

January 2014

The power of accommodative central bank policy dominated financial markets in 2013. The domestic economy continued to grow below capacity while Europe managed to be less bad than the year prior. Risk assets rallied strongly into year-end on the belief that easy monetary policy will finally lead to stronger economic activity, and recent economic data seems to support this optimism. Our recommendations for the past year to maintain credit exposure via select corporate issuers and high-quality structured product (credit cards and autos), as well as migrate to lower-rated issuers served us well as credit rallied (see Figure 1). Our call to extend duration constraints also proved beneficial for short-maturity investors even as Treasury yields rose (see Figure 1). Looking forward to 2014, credit will still play an integral portfolio role, but given modestly attractive valuations, corporate issuer and sector preference will be more critical. Asset-backed securities (credit cards and autos) still look attractive, especially in comparison to other AAA-rated, short-duration alternatives. Meanwhile, central bank policy will continue to have a significant impact as the Fed carefully exits its high-octane policy.

Figure 1: 2-Year Treasury Yield and Investment Grade Spread (5 Yr CDX)



Source: Bloomberg

2013 – Year in Review

The year started off with a last-second fiscal cliff resolution by Congress. Risk assets performed well buoyed by better-than-expected U.S. economic data and easy monetary policy. Europe tried to take center stage by badly handling the Cypriot banking crisis. However, a bailout was arranged and the E.U. promised to develop a central banking

US Treasuries

As of 31-Dec

Benchmark	Yield
3 Month	0.06%
6 Month	0.09%
1 Year	0.11%
2 Year	0.38%
5 Year	1.74%
10 Year	3.03%
30 Year	3.97%

Bank of America/Merrill Lynch Indexes

30-Nov to 31-Dec

Index	Return
1-3 Yr Gov/Corp ≥ A	-0.13%
1-3 Yr Municipals	0.03%
1-3 Yr Agencies	-0.10%
0-3 Month UST	0.01%
S&P 500	2.52%

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

regulator and handle future banking crisis more uniformly. Markets quickly moved on. The euphoria turned into a full blown "taper tantrum" in May when Fed Chairman Bernanke broached the topic of reducing asset purchases possibly as soon as September. Markets shuddered globally, selling off significantly, at the thought of less punch in the bowl. Fed officials spent the rest of the summer talking markets off the ledge, stressing that any change in monetary policy was data dependent. The Fed backed up this talk with no "Septaper" just in time for Congress to shutdown the government while toying with the idea of default over debt ceiling negotiations. With a temporary solution negotiated and the economy showing signs of life, risk assets rallied into year-end.

2013 fixed income performance rewarded credit exposure and modest duration extension in the front-end of the yield curve. The annual return for the 90-Day T-bill was +0.07% while the 2-Year U.S. Treasury Index returned +0.31%, even though the 2-year note's yield rose from 0.25% to 0.38%, illustrating the power of relatively short-duration and reinvesting at higher yields. Additionally, as illustrated in Figure 2, the added yield of credit and short agency mortgage-backed securities proved beneficial as well.

Figure 2: 2013 Fixed Income Returns

Index	Quality	Duration	Annual Return
90 Day T-Bill	AAA	0.22 yrs	0.07%
2-Year U.S. Treasury	AAA	1.98 yrs	0.31%
1-3 Year AAA-A U.S. Corporate & Government	AAA	1.89 yrs	0.55%
1-3 Year AAA-A U.S. Corporate	A2	1.85 yrs	1.41%
AAA U.S. Asset-Backed Security	AAA	1.86 yrs	0.12%
0-3 Year U.S. Agency CMO (MBS)	AAA	4.13 yrs	1.02%

Source: BofA Merrill Lynch Indices

Federal Reserve Policy – The Fed in Transition

The Federal Reserve celebrated its 100th anniversary with a decision to taper asset purchases at its December 18th FOMC meeting. Starting in January, monthly purchases of U.S. Treasury and agency mortgage-backed securities will be reduced by $5 billion each to $40 billion and $35 billion respectively. Chairman Bernanke stressed that tapering remains data-dependent and further decreases will be "measured". We expect the Fed to continue to pull back at a similar rate at each meeting going forward provided the economy does not falter and the employment picture continues to improve. The FOMC also strengthened forward guidance promising to keep rates low "well past the time that the unemployment rate declines below 6.5%", especially if projected inflation continues to run below the Fed's 2% goal.

The Fed has fine-tuned its message to stress that Fed Funds and tapering are separate monetary levers. The market has heeded this communication by forecasting the first rate hike to occur in late 2015. This will temper rate increases in the front-end of the yield curve (3 years and in) and lay the path for an orderly transition to higher rates should the economy grow more strongly. This should provide short-maturity investors an ideal environment to take advantage of steep yield curves while utilizing higher yielding sectors, like corporate, asset-backed, and agency mortgage-backed securities, to cushion against unanticipated rate increases.

Janet Yellen takes over as Fed Chairman at the end of January ensuring continuity in policy. However, she won't preside over her first FOMC meeting until March as there is no February meeting. The Fed will remain front-and-center in 2014 and will continue to have an outsized influence on markets.

Looking Forward

Congress presents the first hurdle of the year for investors as the debt ceiling suspension ends on February 7th. Yields on Treasury-bills (T-bills) maturing in March have started to rise as participants try to avoid those securities that mature in the expected timeframe of when the U.S. Treasury exhausts extraordinary measures. If the recent debt ceiling debacle serves as a guide, those yields will continue to rise significantly should Congress delay resolution of the issue.

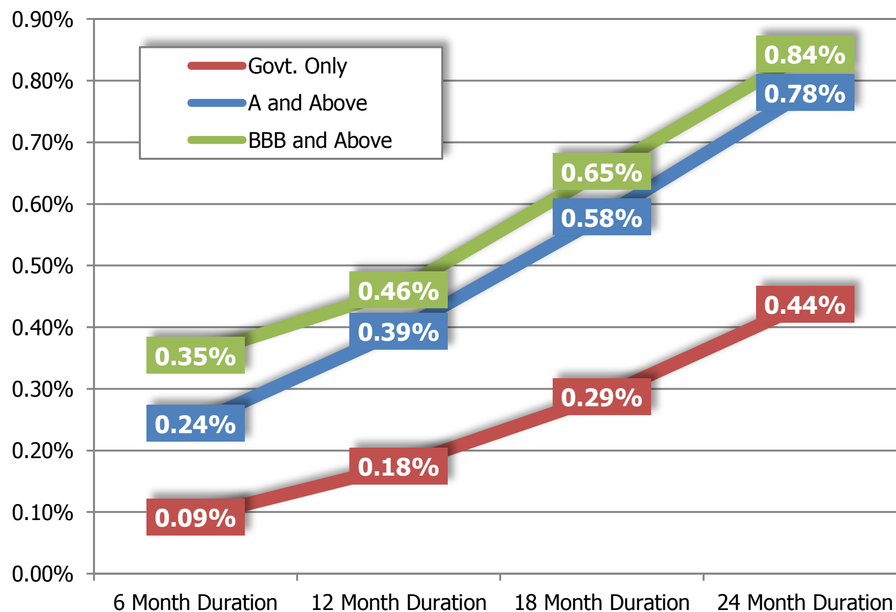
The final rule on money market reform is targeted to be released in early 2014. As you may recall, the Securities and Exchange Commission (SEC) has proposed a floating net asset value or liquidity fees and redemption limits (or some combination thereof). Implementation is expected to take one to two years, but expect institutional money markets to have a very different look in the near future.

The U.S. Treasury will launch a floating rate note on January 29th. Auctions will be held monthly and will offer an alternative to Treasury-bills. The final maturity on the notes will be two years while the coupon will reset daily based upon the most recent 13-week T-bill auction rate. Therefore, the security will offer very low duration with a yield pick-up to T-bills. This new security is attractive for those investors unable to assume credit exposure or held captive by low-yielding government money funds.

The New Year often serves as a catalyst for assessment and change. Revisit policy constraints to ensure your portfolio can take advantage of the proper opportunity set for your risk level. Duration and credit provide meaningful contribution to portfolio composition (see Figure 3).

Figure 3: Indicative Portfolio Yields

Govt. Only consists of 50% Tsy and 50% Agcy Securities
Non-Govt. portfolios consist of 75% credit, 10% Tsy, 10% Agcy and 5% Quasi



Source: Clearwater

Selectively choosing corporate issuer exposure in the upcoming year will be more important as valuations appear fair while credit fundamentals will likely weaken. Europe still faces challenges and is far behind the U.S. in rebuilding the health of its financial institutions. The E.U. looks to make progress on that front with bank stress

tests while consolidating oversight. Asset-backed securities and agency mortgage-backed securities offer value as well.

Please contact the desk with questions or to discuss investment opportunities and how to best navigate this challenging environment.

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