clearwater ADVISORS

MARKET Commentary

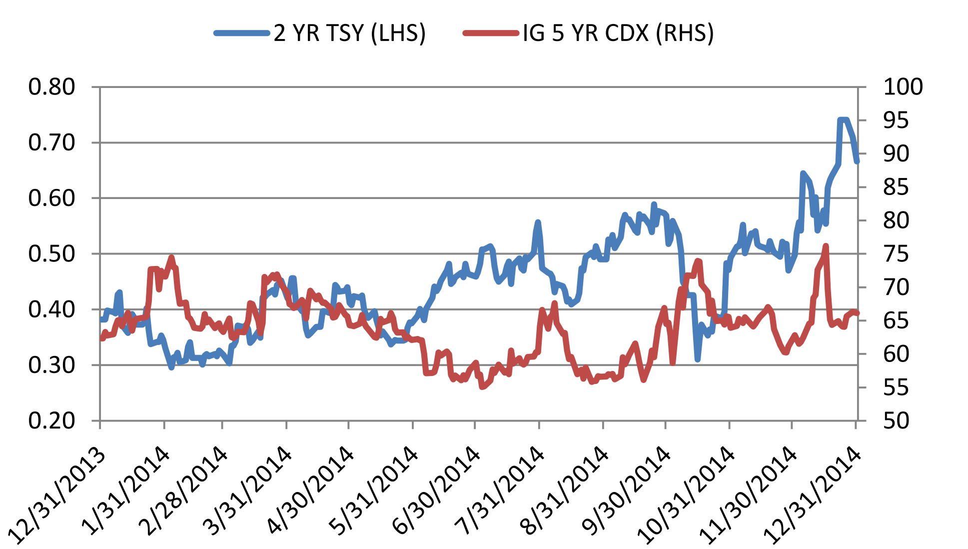
January 2015

Lost in Translation

The U.S. economy gained significant momentum as 2014 progressed. Economic activity, as measured by GDP, recovered from a dismal first quarter and the unemployment picture continued to improve. Overseas, growth faltered and fears of deflation became pervasive. The divergence between U.S. economic and monetary policy and the rest of the developed world increased. Credit spreads widened closing the year just outside of where they started 2014. U.S. Treasury yields inside 5 years to maturity rose in anticipation of higher Federal Funds (see Figure 1). Further, lower quality credit exposure lagged its higher quality counterparts while securitized sectors performed well.

Looking forward to 2015, the strength of the U.S. economy coupled with transitory Federal Reserve (Fed) policy is complicated by a gloomy economic picture abroad. The Fed is guiding to a mid-summer hike provided the economy maintains its current trajectory. Conversely, the market is pricing in a late 2015 hike. Let's hope their somewhat opaque communications aren't lost in translation. Yields are more attractive now and many spread sectors offer compelling value as well. The New Year is an opportune time to ensure your policy and investment choices are equipped to take advantage of the evolving opportunity set.

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



Source: Bloomberg

2014 – Year in Review

The year opened with new leadership at the Fed as Janet Yellen took over as Chairman from Ben Bernanke. The transition was relatively smooth save for a mistake during her first news conference when she provided a candid response to the meaning behind "a

US Treasuries
As of 31-Dec

Benchmark	Yield
3 Month	0.04%
6 Month	0.12%
1 Year	0.21%
2 Year	0.67%
5 Year	1.65%
10 Year	2.17%
30 Year	2.75%

Bank of America/Merrill Lynch Index Returns
Q4, 30-Sept to 31-Dec

Index	Return
1-3 Yr Gov/Corp ≥ A	0.18%
1-3 Yr Municipals	0.01%
1-3 Yr Agencies	0.22%
0-3 Month UST	0.01%
S&P 500	4.92%

Contact Us

www.ClearwaterAdvisors.com

Trading@ClearwaterAdvisors.com

Source: British Bankers' Association, Federal Reserve, US Treasury, Bloomberg, Barclays, BofA/ML, S&P and Wall Street Journal considerable time" in the FOMC statement, catching markets off guard. Since that time, she has deftly concluded large scale asset purchases (as of October 2014) and prepared markets for higher rates.

Commodity prices tumbled over the course of the year with oil declining over 55% from its mid-summer high. The bulk of the fall came after the Saudi's Thanksgiving Day OPEC decision declining to cut production. Low prices have pressured oil producing countries, like Russia and Venezuela, and the U.S. shale oil industry, which are predominantly high yield credits. Ultimately, lower oil prices are a positive for the global economy overcoming regional weakness.

Stronger economic numbers allowed the Fed to maintain course on normalizing policy. Front-end yields rose in anticipation of upcoming Fed Funds hikes. In December, the one year Treasury yield topped 0.25% for the first time in over three years. Commensurately, other sectors within the corporate cash investment universe experienced modestly higher yields as well.

2014 fixed income performance rewarded high-quality spread sector and duration exposure. The annual return for the 90-Day T-bill was +0.04% while the 2-Year U.S. Treasury Index returned +0.69%, even though the 2-year note's yield rose from 0.38% to 0.67%, illustrating the power of relatively short-duration and reinvesting at higher yields. Additionally, as illustrated in Figure 2, AAA asset-backed securities delivered solid returns without the volatility experienced in other fixed income sectors, a trend that will likely continue in 2015.

Figure 2: 2014 Fixed Income Returns

Index	Quality	Duration	Annual Return
90 Day T-Bill	AAA	0.23 yrs	0.04%
2-Year U.S. Treasury	AAA	1.99 yrs	0.69%
1-3 Year AAA-A U.S. Corporate & Government	AAA	1.90 yrs	0.72%
1-3 Year AAA-A U.S. Corporate	A2	1.98 yrs	1.08%
AAA U.S. Asset-Backed Security	AAA	1.78 yrs	1.29%
1-5 Year AAA-A U.S. Corporate & Government	AAA	2.68 yrs	1.42%
0-3 Year U.S. Agency CMO (MBS)	AAA	2.44 yrs	2.76%

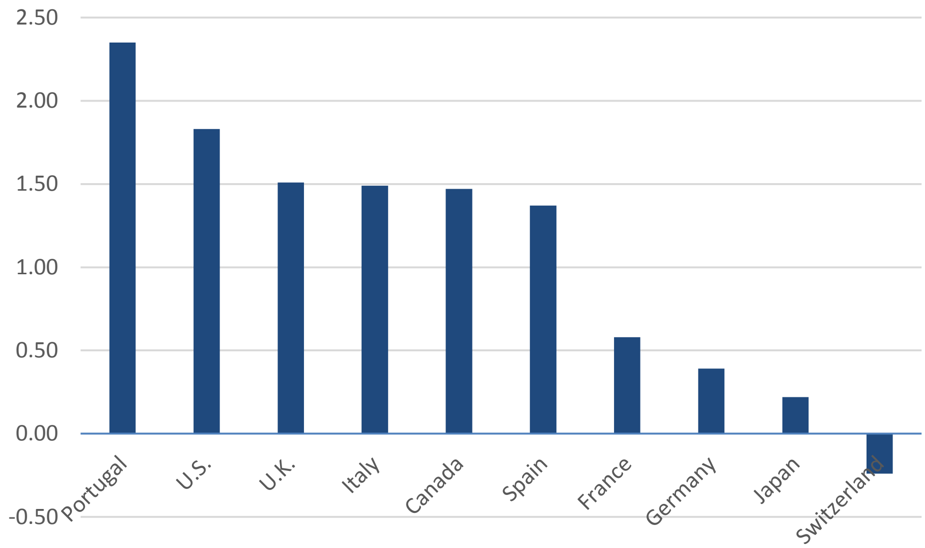
Source: BofA Merrill Lynch Indices

The Year Ahead

The European Central Bank (ECB) kicked off 2015 by launching a long-anticipated quantitative easing program targeting sovereign debt. The plan is to purchase almost $70 billion (€60 billion) of Eurozone sovereign, agency and supranational debt a month inclusive of the prior ABS and covered bond program. The program will commence in March and run through September 2016 unless there isn't a meaningful movement in inflation at which point the deadline will be extended. This will grow their balance sheet by just over $1 trillion reversing almost two years of decline. Purchases will be distributed by country according to each country's capital contribution to the ECB. Therefore, almost 76% of purchases will be directed to German, French, Italian and Spanish debt. Further, all purchases will be limited to investment grade securities thereby excluding debt of Greece, Portugal and Cyprus.

Sovereign yields across the European Union (see Figure 3) reflect diminished economic activity and very low/negative inflation. Approximately 25% of outstanding Eurozone sovereign debt, largely inside three years to maturity, is priced at negative yields (investors are paying sovereign issuers to invest in their debt) – a depressing reality for front-end investors in Europe. Sovereign debt purchases will keep yields low, forcing investors to seek out attractive alternatives tempering yield increases in U.S. Treasury securities. While the ECB may be pushing on a string, it is sending a message to markets that it is determined to rekindle inflation. Further, its policies are no longer acting like an anchor to economic activity.

Figure 3: 10 Year Sovereign Bond Yields (%)
(As of 01/23/15)



Source: Bloomberg

Greece may rain on the ECB's parade as a radical-leftist anti-austerity party, Syriza, won enough seats this past weekend to lead a coalition government. Look for the new government to push to renegotiate bailout terms emboldening other populist parties opposed to austerity across Europe. There will be posturing on both sides introducing headline risk in the days and months ahead.

On the domestic front, the debt ceiling suspension ends on March 15, 2015, after which, the U.S. Treasury can take extraordinary measures to fund the government for 4-6 months beyond that point. Our expectation is that Congress will handle a debt ceiling resolution in a civil manner especially since 2016 is a presidential election year, but we remain wary.

The U.S. will likely become the primary driver of global economic activity, allowing the Fed to slowly normalize policy by moving Fed Funds modestly higher. The FOMC added new language to its December statement explaining it can be "patient in beginning to normalize" policy. Given the global economic uncertainty from other developed and emerging markets (mainly Europe, Japan and China), we do not forecast Fed Funds hikes until the latter half of 2015. With inflation very low and U.S. yields attractive to other major markets, the belly of the curve (3-10 year maturities) will bear the brunt of rate hikes.

U.S. banks will continue to build capital ahead of the implementation of tougher requirements set to fully phased-in by 2019. The eight largest banks will be required by the Federal Reserve to have higher capital buffers than their smaller counterparts. It is estimated that JP Morgan will be subject to the most stringent capital requirements and need to raise more than $20 billion in additional capital as a result. Additionally, the annual Fed stress tests will be released in Q1 and may offer further color on banks' capital plans. As we have stated in the past, U.S. banks are in a very strong position from a bondholder standpoint as capital is built at the expense of stockholder return.

The Fed has been targeting June 2015 for its first rate hike while the market is less convinced, forecasting the first rate hike to occur in late 2015. This disconnect will lead to further volatility as these differing viewpoints are reconciled. 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 select agency mortgage-backed securities, to cushion against unanticipated rate increases.

Money Market Reform Reminder

The major development in 2014 for short duration investors was money market reform. Less than two years remain before the Securities Exchange Committee (SEC) reforms go into effect. Additionally, due to regulatory pressures, deposit rates will decline as banks try to curb that offering, eliminating another attractive option from the corporate treasury investment arsenal.

This next year gives market participants a window to evaluate and execute suitably attractive alternative investments.

Recall, the transformative rule changes include:

- *Floating Net Asset Value (NAV)* – Prime institutional, including tax-exempt, money market funds will be required to transact at a floating, market-based net asset value. Government and retail funds will continue to utilize a stable $1.00 NAV.
- *Redemption Limits* – All non-government money market funds will be able to use liquidity fees (up to a 2% fee on redemptions) and redemption gates (a temporary suspension of redemptions) when a fund's liquidity falls below a certain level (15% of its total assets). Government money market funds could voluntarily utilize these limits, if previously disclosed to investors.

The compliance date for the floating NAV and fees and gates amendments is October 2016.

Looking Forward

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, credit, and other spread sectors like AAA-rated asset-backed securities provide a meaningful contribution to portfolio composition.

Weaker growth abroad (specifically in Europe and China) bears monitoring and may temper the rise in rates here in the U.S. Furthermore, the Federal Reserve enters a new phase of managing market expectations into the first rate hike which will likely introduce volatility as the domestic economy improves against a weak global backdrop. The Fed will normalize at a measured pace, eager not to disrupt economic growth. Low inflation provides some leeway to policy adjustments.

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

Form ADV Part II

Clearwater Advisor's annual Form ADV Part II disclosure is available to clients upon request. To make a request please email Compliance@ClearwaterAdvisors.com or call Brittany Pfister at 208-489-7550.