clearwater ADVISORS

MARKET Commentary

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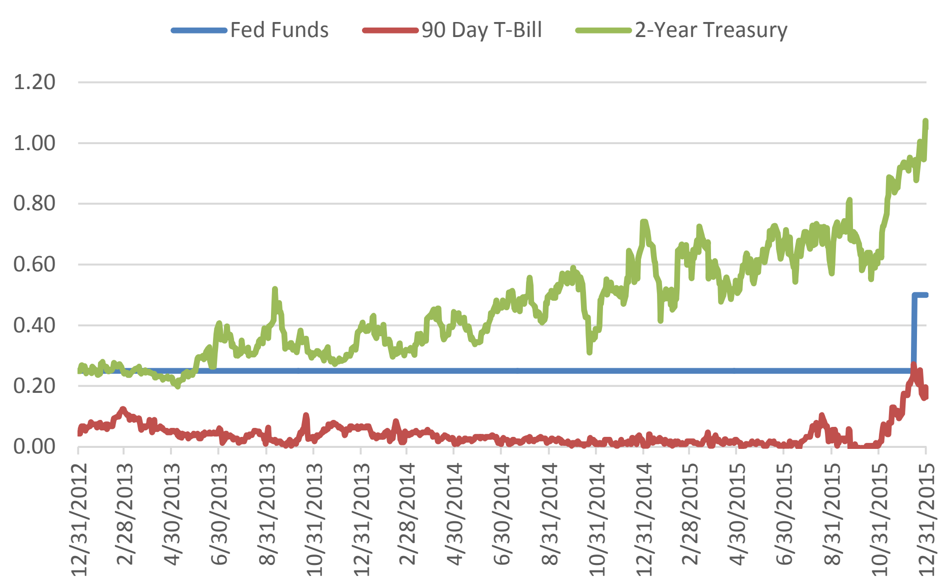
Winter 2016

Global economic and financial developments stabilized enough late in the fourth quarter to provide a window for a change in U.S. monetary policy. The Federal Reserve (Fed) closed the book on zero interest rate policy (ZIRP) seven years after the policy began when it moved the fed funds target higher by 25bps at their December meeting. While the hike was expected, risk assets stumbled into year-end as market participants confronted less accommodative domestic monetary policy amidst continued global economic weakness.

Investment grade credit spreads widened over the course of the year as corporations brought a record high $1.3 trillion to market and fundamentals weakened. Idiosyncratic risk remains high in the corporate sector highlighting the importance of credit selection. Commodity prices continued to come under pressure as well with oil declining 30% on the year.

Figure 1: December Fed Hike



Source: Bloomberg

U.S. Treasury yields across the curve shifted modestly higher with the brunt of the increase felt by the front-end of the curve (see Figure 1). The two-year rose 38 bps from the end of 2014 and the thirty-year Treasury yield increased 27 bps. Markets are now focused on the path of future rate hikes with a keen eye on global growth challenges. The Federal Reserve has repeatedly stressed that the upward trajectory of the funds rate will be gradual, but still forecasts a more aggressive hiking path than the market.

The U.S. economy will continue to grow modestly pressuring domestic monetary policy while overseas turmoil will contribute to another challenging investment environment in the year ahead.

US Treasuries

As of 31-December

Benchmark	Yield
3 Month	0.16%
6 Month	0.48%
1 Year	0.60%
2 Year	1.05%
5 Year	1.76%
10 Year	2.27%
30 Year	3.02%

Bank of America/Merrill Lynch Index Returns

Q4, 30-September to 31-December

Index	Return
1-3 Yr Gov/Corp ≥ A	-0.36%
1-3 Yr Municipals	-0.08%
1-3 Yr Agencies	-0.37%
0-3 Month UST	0.01%
S&P 500	7.03%

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

2015 – Year in Review

The past year opened with concerns over the growth in developed economies specifically the Eurozone. Those fears were assuaged due to expanded central bank intervention. The European Central Bank launched its own quantitative easing program (almost $70 billion a month) in Q1 pulling sovereign yields lower in an effort to stimulate a moribund economy. Greek concerns resurfaced briefly as the anti-austerity party, Syriza, won control culminating in a threatened mid-summer "Grexit" amid negotiations for their third bailout. Chinese equity markets swooned in June after soaring leading Chinese officials scrambling to prop up their economy and markets. A surprise, late August, devaluation of their currency fueled a significant bout of risk aversion that spilled over into developed markets delaying a possible September rate hike with the Fed concerned about "global economic and financial developments".

Commodity prices continued to fall to the lows of the decade. Low prices continue to squeeze oil producing countries, like Russia and Venezuela, and the U.S. energy industry, pressuring high yield credits.

The U.S. economy shrugged off a weak, snowpocalyptic start to the year and weathered a Western port strike to post reasonably strong economic numbers through Q2 and Q3 allowing the Fed to maintain course towards normalizing policy. Yields rose unevenly throughout the year in anticipation of upcoming Fed Funds hikes while the dollar strengthened.

2015 fixed income performance rewarded high-quality spread sector and modest duration exposure. The annual return for the 90-Day T-bill was +0.05% while the 2-Year U.S. Treasury Index returned +0.46%, even though the 2-year note's yield rose from 0.67% to 1.06%, illustrating the power of relatively short-duration and reinvesting at higher yields. Additionally, as illustrated in Figure 2, higher quality spread product outperformed Treasuries even as spreads widened over the year.

Figure 2: 2015 Fixed Income Year-End Characteristics and Returns

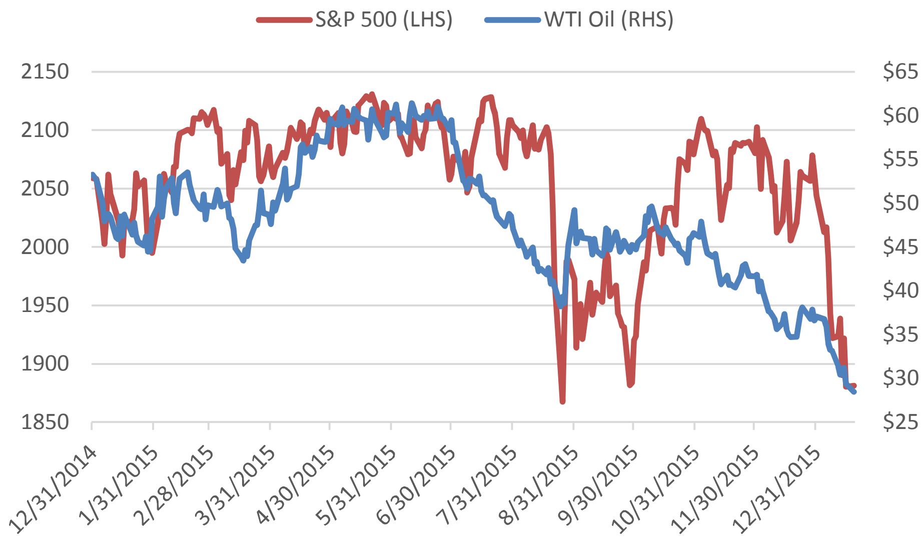
Index	Quality	Yield	Duration	Annual Return
90 Day T-Bill	AAA	0.17%	0.23 yrs	0.05%
2-Year U.S. Treasury	AAA	1.06%	1.98 yrs	0.46%
1-3 Year AAA-A U.S. Corporate & Government	AAA	1.22%	1.87 yrs	0.66%
1-3 Year AAA-A U.S. Corporate	A1	1.82%	1.90 yrs	1.16%
AAA U.S. Asset-Backed Security	AAA	1.67%	1.74 yrs	0.97%
1-5 Year AAA-A U.S. Corporate & Government	AAA	1.47%	2.67 yrs	1.07%
0-3 Year U.S. Agency CMO (MBS)	AAA	1.86%	2.14 yrs	1.57%

Source: BofA Merrill Lynch Indices

2016 – Risk Aversion Returns

Domestic equity markets are off to their worst start of any year on record. Major indices are flirting with correction declines (down 10%) while overseas most have breached those metrics and are closing in on bear market territory (down 20%) with just twelve trading days in the book. Oil prices have plummeted as well, declining 28% as measured by West Texas Intermediate (WTI) prices (see Figure 3). Oil is now trading at levels last seen in 2003 as supplies remain elevated and global demand trends weaker.

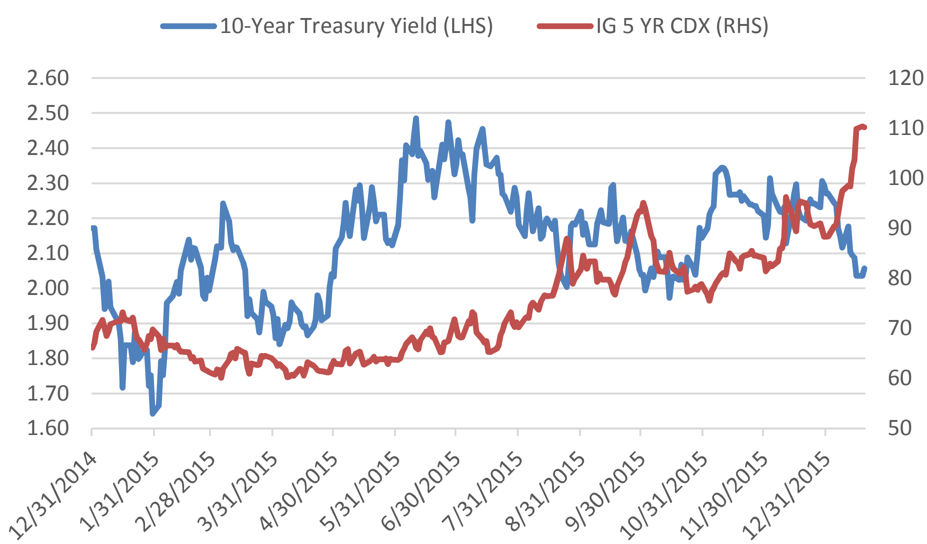
Figure 3: Oil and Equity
(As of 01/20/16)



Source: Bloomberg

The sell-off in risk assets has provided a bid to U.S. Treasury securities boosting prices and pulling yields 20-30 bps lower since the end of 2015. Investment grade credit spreads have widened (see Figure 4) in sympathy with other risk assets. However, even with the heightened volatility, the tone of the high grade market remains reasonably good. Anheuser-Busch InBev brought the second largest corporate deal in history during the first full week of the year – a $46 billion, seven-part deal at the tight-end of price guidance with over $100 billion in interest.

Figure 4: Bond Market Impact
(As of 01/20/16)



Source: Bloomberg

The Fed meets on January 27th and while no change in policy is expected markets will glean the Federal Open Market Committee (FOMC) statement for any hint about future policy decisions. We then move on to March which has long been viewed as the first "live" meeting. Markets remain skeptical about the future path of Fed funds pricing in one hike this year. Fed officials were forecasting four hikes in 2016 as of their December meeting. Those hikes seems unlikely given the weak inflation outlook and modest economic growth expectation (around 2.0%). We expect two rate hikes as a base case, but will monitor closely as the data comes in.

Looking forward, the uncertainty that has dominated daily market activity will only be overcome with time, improving economic data and less volatile markets.

Money Market Reform Reminder

The major deadline in 2016 for short duration investors is money market reform. Securities Exchange Committee (SEC) rules go into effect in October.

Recall, the 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.

Prime fund investors will have to assess whether the yield they are earning is high enough to compensate for the floating NAV, liquidity fees and redemption gates. Currently, the highest yielding institutional prime funds yield 0.19% more than their stable value, government counterparts.

Investors have few options to preserve same day liquidity at par – bank deposits and government-only money funds. Bank deposit offerings are less prevalent due to regulatory pressures while government-only money funds offer meager yield – the top 10 institutional funds average 0.20% according to iMoneyNet.

The following months give market participants a window to evaluate and execute suitably attractive alternative investments as the compliance date for the floating NAV and redemption limits is quickly approaching.

Looking Forward

The outlook for fixed income markets is complicated by divergent developed central bank monetary policy amid uneven economic growth. The U.S. will continue to grow modestly providing the Fed ammunition to gradually normalize policy. A slow transition to more normal policy should prove to be a favorable environment for Clearwater clients as reinvestment rates increase and spread sectors cushion the impact of higher yields setting the stage for performance similar to the year past. Further, as the deadline to money market reform (October 2016) quickly approaches, we expect to see market dislocations from money fund changes that will prove advantageous as well.

Please contact the desk with questions or to discuss investment opportunities best suited to navigate this year's volatile market environment.

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