clearwater ADVISORS

MARKET Commentary

Social Unrest

March 2011

Social unrest in several of the world's largest oil-producing nations in the Middle East and North Africa has the commodity markets on edge. While we do not claim to have any particular insight into the resolution of these conflicts, we ask what this widespread social uprising could mean to the United States economic recovery and interest rates going forward. We anticipate that continued unrest in North Africa and the Middle East will lead to further upward pressure on commodity prices and will sap strength from the U.S. economic recovery in the form of reduced profit margins for businesses and lowered consumer sentiment. These factors will strengthen the FOMC's stance of keeping interest rates low for an "extended period" despite inflationary headwinds as seen by recent shocks in the commodity markets.

The Effect of $100 Oil and $4.00 Gasoline

The most direct impact to Americans of the uprisings in North Africa and the Middle East can be seen in the rising price of crude oil. Part of the rise in oil is directly related to the countries in revolt—Libya, for example, is the 15th largest oil exporter in the world, contributing 2.0% of global oil exports—and the remaining part, which may be the larger contributor to rising prices, is attributed to the potential for further disruptions in larger oil-exporting countries like Algeria and Saudi Arabia. Algeria and Saudi Arabia are the 9th and 3rd largest exporters of oil into the U.S., respectively. While this is not to suggest that Saudi Arabia will endure the same fate as Libya where oil production has been curtailed, the charged environment in the region certainly presents serious risks that demand attention by U.S. policymakers.

Figure 1: U.S. Crude Oil Imports by Country in Thousand Barrels/Day

Country	Dec 2010	Nov 2010	YTD 2010	Dec 2009	YTD 2009
CANADA	2,064	1,975	1,972	2,104	1,943
MEXICO	1,223	1,229	1,140	1,063	1,092
SAUDI ARABIA	1,076	1,119	1,080	870	980
NIGERIA	1,024	806	986	1,020	776
VENEZUELA	825	884	912	772	951
IRAQ	336	340	414	325	449
ANGOLA	307	263	380	266	448
BRAZIL	271	188	254	181	295
ALGERIA	262	379	325	336	281
COLOMBIA	220	489	338	179	251
ECUADOR	192	188	195	86	181
RUSSIA	158	85	252	168	230
KUWAIT	125	170	195	160	180
UNITED KINGDOM	124	80	120	67	103
ARGENTINA	85	35	29	33	53

Source: U.S. Energy Information Administration

Higher oil prices will inevitably lead to reduced profit margins for businesses and lowered consumer sentiment, both of which will weigh on the economic recovery. A recent Deutsche Bank report estimates that every $10 rise in oil prices leads to a

US Treasuries

As of 28-Feb

Benchmark	Yield
3 Month	0.14%
6 Month	0.17%
1 Year	0.24%
2 Year	0.68%
5 Year	2.14%
10 Year	3.43%
30 Year	4.50%

Bank of America/Merrill Lynch Indexes

31-Jan to 28-Feb

Index	Return
1-3 Yr Gov/Corp ≥ A	0.03%
1-3 Yr Municipals	0.24%
1-3 Yr Agencies	-0.05%
0-3 Month UST	0.01%
S&P 500	3.43%

Contact Us

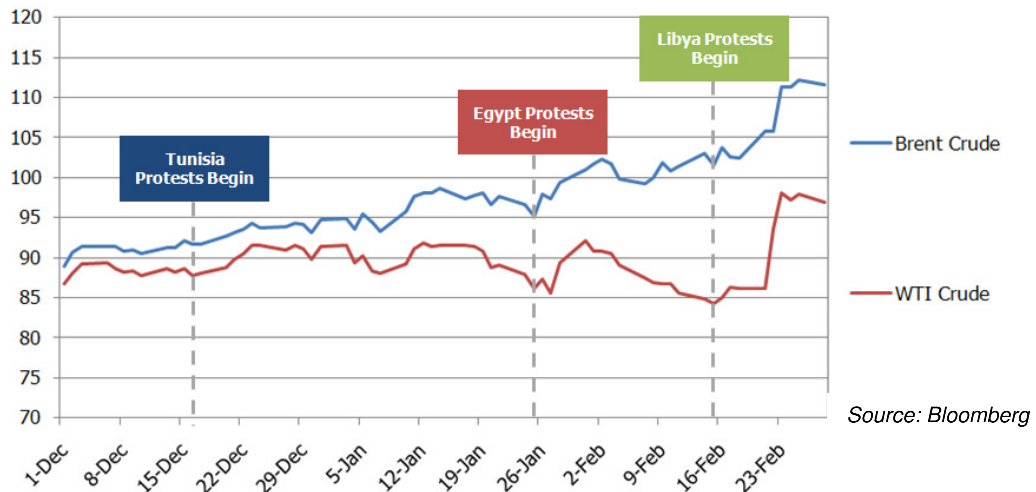
www.ClearwaterAdvisors.com

Trading@ClearwaterAdvisors.com

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

decline of 0.2% in future annual U.S. real GDP. In the recent past, businesses have been reluctant to attempt to pass on increasing commodity costs to price-sensitive consumers, as evidenced by companies' reaction to rising food prices that preceded the recent rise in oil prices. Businesses chose largely to absorb the rise in commodity prices rather than lose market share, attempting to squeeze out competitors with less robust profit margins.

Figure 2: Oil Prices Rise on Unrest in North Africa and the Middle East (as of 02.28.2011)

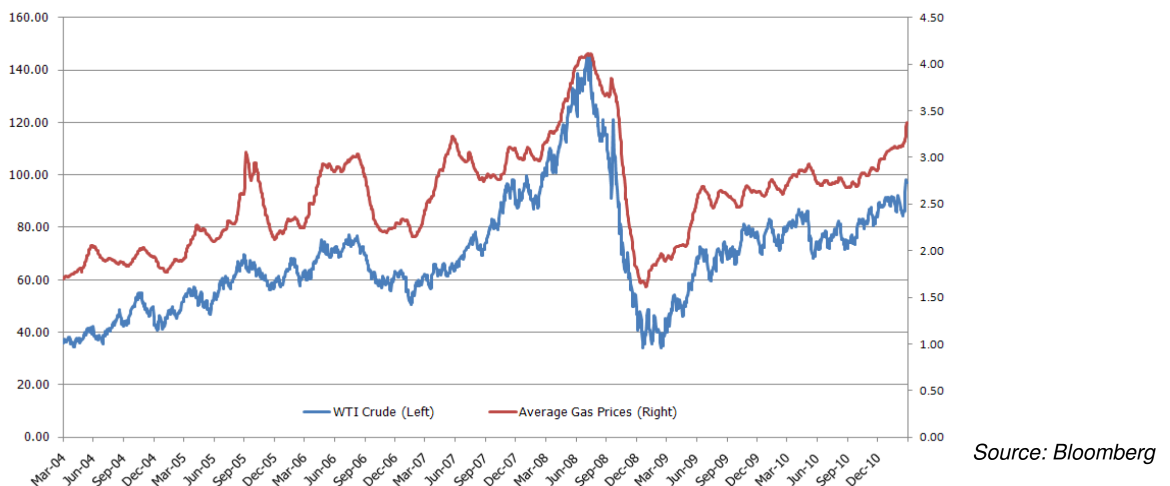


Source: Bloomberg

The sustained tough operating environment, however, suggests that businesses may not be able to continue this strategy. A New York Times article highlighted that airline carriers have already increased ticket prices four times this year in anticipation of higher fuel prices, compared with only three times in all of 2010. We expect this trend to continue and anticipate U.S. businesses and consumers to continue to feel the squeeze of rising oil prices.

In the same report, Deutsche Bank also forecasts that the same $10 rise in oil prices will lead to a 25 cent per gallon increase in retail gas prices. According to the Daily Fuel Gauge Report put out by AAA, national retail gas prices now average $3.387 per gallon, and this is before the peak driving season beginning Memorial Day weekend. The all-time high for retail gas prices was reached July 17th 2008 at $4.11 when WTI crude was $145 a barrel (oil is currently trading at $104).

Figure 3: Gasoline Prices are on the Rise on the Back of Higher Oil Prices



Source: Bloomberg

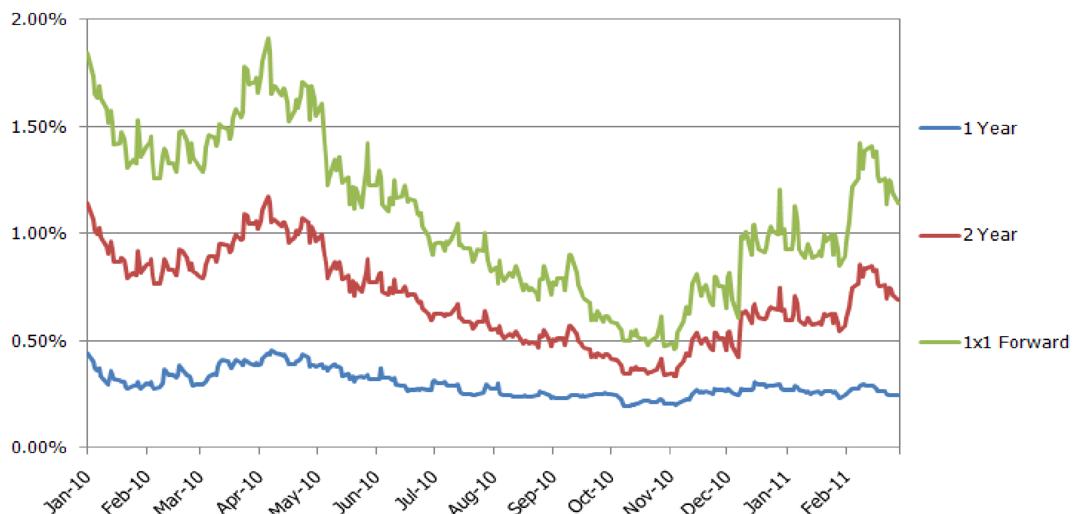
There is little that Americans are more sensitive to and passionate about than rising gas prices. Consumer sentiment, which is an indicator of consumers' outlook on the economy and attitude towards future spending, shows a strong negative correlation with gas prices. According to a recent study posted on *Roubini Global Economics*, a 10 cent per gallon increase in gasoline prices results in a half point decrease in consumer sentiment. With the large diversion of discretionary income away from durable goods and into fuel, the economic recovery will be dealt a blow if fuel costs continue to rise materially.

These recent events in North Africa and the Middle East and their possible adverse effect on the U.S. recovery strengthen our view, and the view articulated by Chairman Bernanke in recent Senate testimony, that interest rates will remain range-bound for much of 2011. Chairman Bernanke believes that despite recent commodity shocks in food, metals and oil, muted core inflation and a vulnerable economic recovery warrant rates to remain low for an extended period. We continue to look to extend client portfolios into the 18 month part of the yield curve where we see attractive relative value.

Extension Entry Point: Consider Forward Rates

We have found that many short-duration investors remain hesitant to invest in 2yr securities, choosing rather to position for an eventual rate rise despite the salient benefits of extension. Breaking down an investment of a 2yr security into two sequential investments—a 1yr note today and a 1yr note one year from today—helps to explain why extension into longer securities continues to make economic sense. The two strategies should theoretically result in identical returns. The investment in a 1yr note one year from now is known as a 1x1 forward rate. Forward rates help us determine the relative value of remaining short versus extending a portfolio duration when interest rates become volatile.

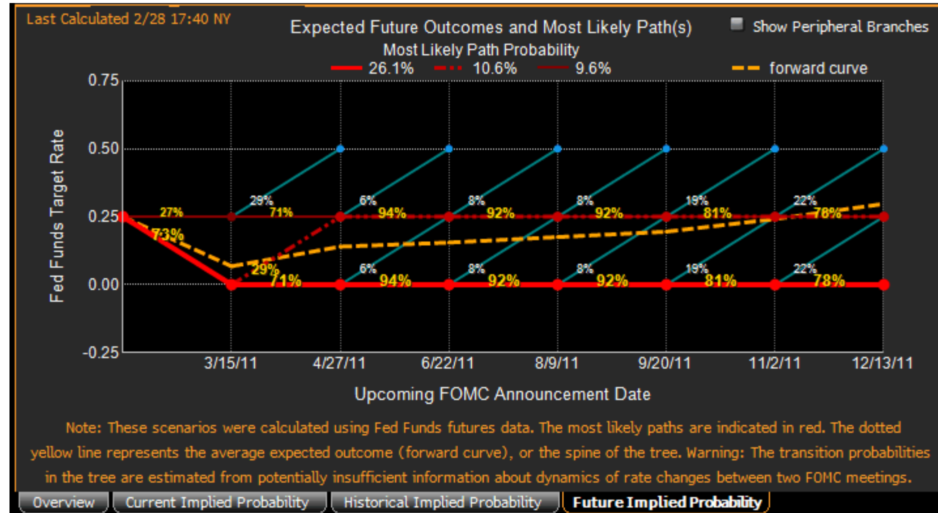
Figure 4: 1x1 Forward Rates Indicate When the 2YR Rate Looks Attractive



Source: Bloomberg & Clearwater Advisors

Figure 4 depicts the 1yr spot rate, 2yr spot rate and the 1x1 forward rate from the beginning of 2010. The first thing to point out is that the 1x1 forward rate is higher than the current 2yr rate. This makes mathematical sense as the average of the 1yr spot rate and the 1x1 forward rate should roughly equal the 2yr spot rate. Given that short-end rates are heavily pegged to the Fed Funds rate, a 1x1 forward rate higher than the current 2yr rate indicates that the market expects that interest rates will be higher one year from now. In a period of economic expansion, this is normal and largely explains why the yield curve is traditionally positively sloped.

Figure 5: Fed Funds Indicate that the FOMC Will Remain on Hold throughout 2011



Source: Bloomberg

The real question is whether the pricing of the 1x1 forward rate is justified. When the 2yr rate reached 85 basis points on February 14, 2011, the 1x1 forward rate indicated that the market expected the 1yr rate one year from now to be 1.41%. Could we justify a scenario one year from now that would result in the 1yr rate being that high? The short answer was no. Elevated unemployment, dovish rhetoric from voting members of the FOMC, muted Fed Funds futures and turmoil in North Africa, the Middle East and Europe pointed to a low-rate environment persisting throughout 2011. Based on this analysis of the 1x1 forward rate, the 2yr rate at 85 basis points looked like a screaming deal. The 2yr rate has fallen 18 basis points since that time, and those who purchased the 2yr at 85 basis points are now in the money.

We have consistently recommended buying spikes in the 2yr note on the back of over-exuberance in the bond market centered on positive economic data. When the 1x1 forward rate looks unreasonably high, the 2yr note and bonds priced off the 2yr note provide attractive relative value; when the 1x1 forward looks unreasonably low, we approach the 2yr note and bonds priced off the 2yr note with caution.

Looking Forward

The unrest in North Africa and the Middle East is another example of the populist uprising that has spread around the globe in recent months. While the rally cries of the conflicts and revolutions in Asia, Europe, Africa and the Middle East differ as greatly as the regions in which they occur, these conflicts have created geopolitical risks that can only be described as combustible and dangerous to the long-term stability of these regions and the broad global economic recovery. The ongoing conflicts point to a low rate environment in the United States persisting for much of 2011.

While much of the attention remains on North Africa and the Middle East, we have not forgotten about Europe and the fiscal troubles that continue to plague high-risk countries. We feel that the events in North Africa and the Middle East only intensify the economic risks in Europe, whose banks are large financiers to countries in the region and whose countries are among the largest importers of regional oil exports. Libya, for example, constitutes 24%, 14% and 10% of Italian, German and French oil imports, respectively. This is not immaterial. We continue to approach the region and bank credits with caution.

As the situation is very fluid, please feel free to call the desk with additional questions.

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