clearwater ADVISORS

MARKET Commentary

Quantitative Easing is a Market's Best Friend

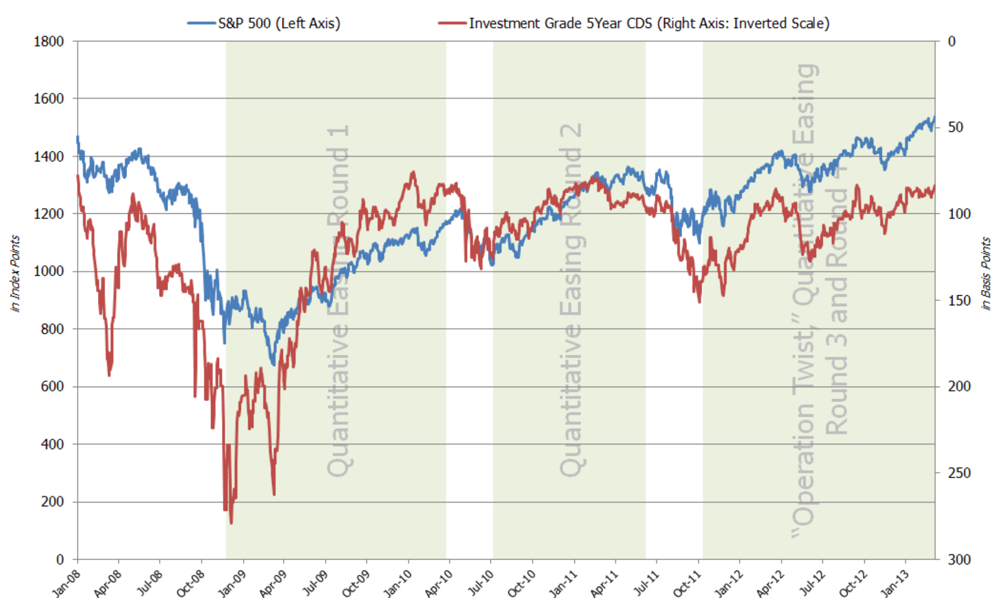
March 2013

He's your guy when stocks are high, but beware when they start to descend.
It's then that those louses go back to their spouses. Diamonds are a girl's best friend.

Marilyn Monroe, Gentlemen Prefer Blondes (1953)

Marilyn Monroe never met Ben Bernanke, but she would have *adored* him. Contrary to Ms. Monroe's characterization of the often capricious nature of men, Ben Bernanke and his crowning policy tool, Quantitative Easing (QE), appears to have less in common with the typical man and much more in common with the luxurious diamonds of which she speaks. Like diamonds, QE incites joyous reactions from its respective benefactors and carries the perception, right or wrong, of lasting forever.

Figure 1: Monetary Accommodation and Prices of Select Risk Assets



Source: Bloomberg, Federal Reserve, Clearwater Advisors

Chairman Bernanke: Like a Rock

In each instance in the past five years when prices of risk assets have shown sustained periods of vulnerability, Chairman Bernanke has mobilized the Federal Open Market Committee (FOMC), the body that officially sets monetary policy, to drive risk asset prices higher through increasingly aggressive monetary action. One can only imagine the size of the diamond Chairman Bernanke might have deployed if Ms. Monroe had begun to show even the slightest signs of waning interest in the Chairman's advances.

US Treasuries

As of 28-February

Benchmark	Yield
3 Month	0.10%
6 Month	0.12%
1 Year	0.16%
2 Year	0.24%
5 Year	0.76%
10 Year	1.88%
30 Year	3.09%

Bank of America/Merrill Lynch Indexes

31-Jan to 28-Feb

Index	Return
1-3 Yr Gov/Corp ≥ A	0.10%
1-3 Yr Municipals	0.19%
1-3 Yr Agencies	0.03%
0-3 Month UST	0.00%
S&P 500	1.36%

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, Wall Street Journal

The broad market has enjoyed the liquidity provided through FOMC's generous monetary programs. QE 1 (2008-2010), QE 2 (2010-2011), QE 2.5 a.k.a. "Operation Twist" (2011-2012), QE 3 (2012-Present) and QE 4 (2012-Present) have injected nearly $3 trillion of additional reserves into the system. This easy money has been put to good use driving prices of risk assets higher, and in a market that continues to be engulfed in persistent uncertainty (i.e. Europe, fiscal challenges, domestic growth questions, etc.), Chairman Bernanke has been the one constant, providing investors with a reason to cheer.

Figure 2: A Summary of FOMC Quantitative Easing Rounds

FOMC Action	Start Date	Finish Date	Committed Funds
Quantitative Easing Round 1	December 2008	March 2010	$1.650 trillion through the purchase of Agency MBS, Agency debentures and U.S. Treasuries.
Quantitative Easing Round 2	November 2010	June 2011	$600 billion through the purchase of U.S. Treasuries.
Quantitative Easing Round 2.5 a.k.a. "Operation Twist"	September 2011	December 2012	$267 billion through the sale of shorter-dated U.S. Treasuries to purchase longer-dated U.S. Treasuries.
Quantitative Easing Round 3	September 2012	Ongoing Operation	$40bn of Agency MBS purchases a month until the labor market improves "substantially."
Quantitative Easing Round 4	December 2012	Ongoing Operation	Expanded QE3 to include purchases of an additional $45 billion of Treasuries a month until unemployment reaches 6.5 percent.

Source: Federal Reserve, Wall Street Journal

Chairman Bernanke's quest to support a weak recovery with unlimited monetary stimulus, however, has not been without its detractors—and the opposition appears to be growing in number. The minutes from the FOMC's most recent policy meeting revealed that several Federal Reserve Governors (most notably, Fisher, Lacker, Plosser, George and Bullard) believe that encouraging economic statistics warrant the FOMC reconsider its unlimited monetary support aimed at achieving its explicit goal of reducing the unemployment rate to 6.5 percent. Policy hawks have raised questions concerning the benefits and the costs of the FOMC's most recent round of bond purchases. The balance between promoting job creation today and controlling inflation, asset bubbles and excessive risk taking in the future is an extremely delicate one, and it is growing increasingly hard to argue that the FOMC has taken anything less than the sledgehammer approach to address structural imbalances.

Figure 3: A Tough Balancing Act for the Federal Reserve

- Job Creation
- Economic Growth
- Bank Recapitalization
- Consumer Debt Refinancing
- Corporate Access to Capital

- Elevated Levels of Inflation
- Risk Asset Bubbles
- Excessive Risk Taking
- Rampant Leverage
- Economic Overheating

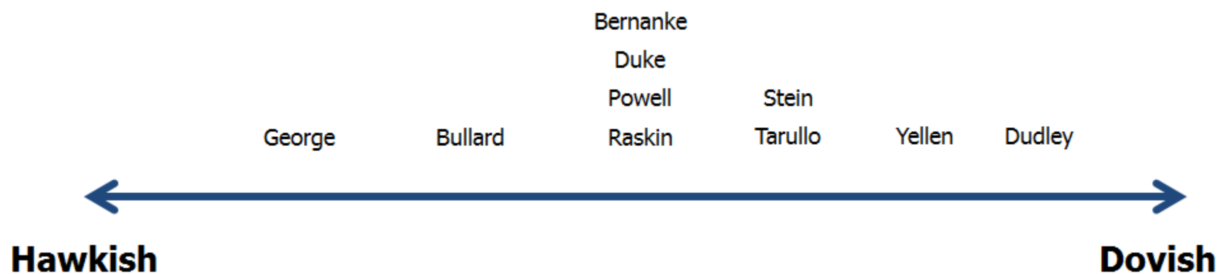
Source: Clearwater Advisors

Recent history has shown that in periods of economic uncertainty the Federal Reserve has erred on the side of caution, appeasing short-term economic interests at the expense of laying the underpinnings of larger future crises. The Federal Reserve remains between a rock and a hard place, particularly given the lack of substantive measures by fiscal policy makers to address chronic deficits, which remains the single largest cause of market uncertainty. This has left the FOMC with little choice but to escalate policy actions towards exceptional accommodation far longer than is considered prudent and neglect to deal with the consequences until a future date.

The release of the Fed minutes indicates that several committee members are making efforts to reverse the FOMC's long-standing accommodative mindset. A number of Governors (some of which are non-voting members in 2013) verbally opposed the FOMC's current policy stance, cautioning investors that the perception of "indefinite" accommodation associated with QE 3 and QE 4 should not be interpreted as an extended period of time, but rather a state of policy uncertainty which could change sooner than generally anticipated based on economic conditions, even if the unemployment rate remains above 6.5 percent.

This growing hawkish sentiment caught many investors by surprise and sent ripples through both the bond and equity markets in the latter half of February. Bond investors grew even more wary of holding long-duration securities (i.e. 10-30 year bonds) which offered little protection against price movements associated with rising rates, and equity holders paused to question whether the tailwinds which had driven stocks to euphoric highs were in the midst of changing direction. Taking their cues from the past five years, investors understand that the future of risk assets prices in 2013 will largely depend on the amount of accommodation the FOMC is willing to provide the market, and the release of the Fed minutes was not an encouraging sign.

Figure 4: Federal Reserve Voters Hawk-Dove Spectrum



Source: Bank of America/Merrill Lynch

The Anti-Louse

The key to reconciling the perceived divergence between policy doves (those who support monetary accommodation) and policy hawks (those who support monetary tightening) is to determine Chairman Bernanke's continued level of influence over the FOMC's members. While several Federal Reserve Governors have grown more public in their disapproval of the current state of monetary policy, increased dissension may be a product of Chairman Bernanke's own design. Chairman Bernanke has taken measured steps over the past several years to increase transparency into the FOMC's policy-setting process, shedding light on contrarian opinions that may have in the past been subdued. In our opinion, despite the growing fears among investors, there is little to indicate that Chairman Bernanke has lost the ability to dictate policy decisions.

Chairman Bernanke continues to have several macro factors supporting his decision to keep monetary policy exceptionally accommodative. Domestic growth concerns in the U.S. persist as political ineptitude concerning the sequester and budget ceiling loom over the market. Recent weeks have seen downward revisions to global and U.S. domestic growth from the IMF and National Bureau of Economic Research, the official body that determines

domestic recessions. Problems in Europe have not subsided, and recent elections in peripheral countries have seen opponents of austerity measures grow in influence, stoking fears of spillover effects into the broad markets. Perhaps most importantly by FOMC standards, the unemployment rate remains stubbornly high at 7.9 percent. All of these key unknowns provide Chairman Bernanke with the ammunition to maintain the unprecedented course of monetary accommodation.

Looking Forward

We expect that the Chairman Bernanke's FOMC will continue its exceptionally accommodative policy stance, which will be the biggest driver of risk assets in 2013. As we have mentioned in past commentaries, short-duration investors should seek attractive credit curves that will provide protection from the prospect of rising interest rates and benefit from investors looking for yield in a historically low-rate environment. While uncertainty abounds, Chairman Bernanke has proven that he will not abandon the market in difficult times. Investors should have the confidence to stay the course in risk assets given that Chairman Bernanke also maintains ample credibility to follow through with his plans for further monetary accommodation.

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