clearwater ADVISORS

MARKET Commentary

Is This Time Different?

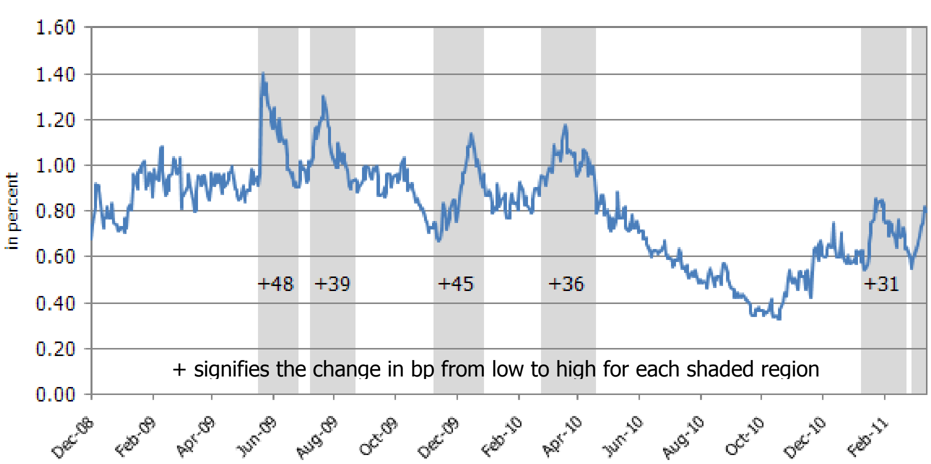
April 2011

Volatility in front-end interest rates has been a common theme since the FOMC lowered the Fed Funds target rate to a range of 0 to 25 basis points in December 2008. As we have pointed out in past commentaries, we viewed periods of rapidly rising interest rates as unsustainable. For the most part, we were right; the FOMC reaffirmed and even strengthened its commitment towards accommodative policy, leading rates to revert quickly back to levels consistent with policy goals. The education gained from these occurrences, however, has not prevented the market from becoming extremely jittery each time rates begin to creep upward. In the most recent chapter of this saga, nine consecutive sessions of rising Treasury benchmark rates (the longest consecutive period since 1990) in the second half of March has investors fearing higher inflation and monetary tightening on the near horizon. We ask the question: Is this most recent rise in interest rates different than previous interest rate shocks we have observed?

We've Seen This Before

Despite Chairman Bernanke's firm commitment throughout the crisis to keep the Fed Funds target rate "exceptionally low" for an "extended period," yields on the 2 year US Treasury—the interest rate most sensitive to changing expectations in the target rate—have been marked with severe volatility. These periods of heightened volatility have been opportunities to extend portfolio duration by buying high-grade credits further out the yield curve. We based our recommendations on our conviction that financial and economic conditions supported the Chairman's view. This strategy proved beneficial through 2009 and 2010 as a fragile economic recovery, quantitative easing (QE) and the European debt crisis caused interest rates to push lower, establishing a depressed trading range for front-end rates.

Figure 1: UST 2 Year Rate from the FOMC Date 12.17.2008 to Present



Source: Bloomberg

The advent of QE II and encouraging economic readings in the second half of 2010 caused the UST 2 year yield to rise from its lows as investor focus shifted from

US Treasuries

As of 31-Mar

Benchmark	Yield
3 Month	0.09%
6 Month	0.17%
1 Year	0.28%
2 Year	0.83%
5 Year	2.24%
10 Year	3.47%
30 Year	4.51%

Bank of America/Merrill Lynch Indexes

28-Feb to 31-Mar

Index	Return
1-3 Yr Gov/Corp ≥ A	-0.01%
1-3 Yr Municipals	0.23%
1-3 Yr Agencies	0.02%
0-3 Month UST	0.02%
S&P 500	0.40%

Contact Us

www.ClearwaterAdvisors.com

Trading@ClearwaterAdvisors.com

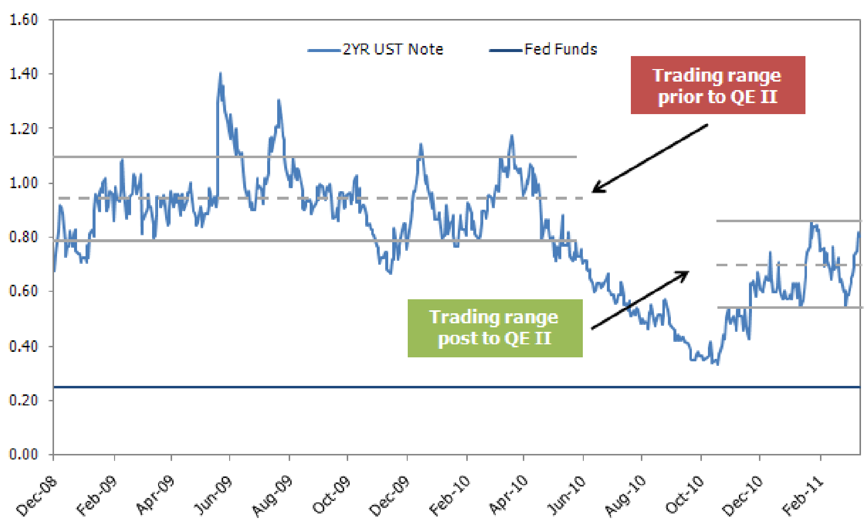
Source: British Bankers' Association, Federal Reserve, FDIC, US Treasury, Bloomberg, Barclays, Financial Times, JP Morgan, The Economist, S&P and Center on Budget and Policy Priorities deflation and economic weakness to inflation and sustained growth. Market interest rates have increased since that time, and the most recent rise in interest rates has resulted in increased speculation that the FOMC will take steps in the coming months to raise the target rate in the second half of 2011.

We, however, retain our long-held view that the FOMC will keep the target rate exceptionally low through 2011, with the first rate hike likely to come in Q1 2012. While we expect the target rate to remain exceptionally low through 2011, we recognize that risks of higher market interest rates are certainly increasing. Several themes make this most recent rise in interest rates unique from past occurrences. In support of our view, we consider the following themes: 1) the end to quantitative easing, 2) recent hawkish comments from FOMC members and 3) increased inflationary trends and inflation expectations.

Quantitative Easing

Quantitative easing has been a powerful mechanism that the Federal Reserve has employed to carry out its goal of keeping long-term interest rates artificially low to spur in order economic growth. The first round of bond purchases of Treasuries, Agencies and Agency MBS instituted in November 2008 injected roughly $1.75 trillion worth of excess reserves into the system. In August 2010, the Federal Reserve announced that it would reinvest proceeds from its maturing mortgage portfolio and in November 2010 announced an additional $600 billion of Treasury purchases, otherwise known as QE II, to fight deflationary pressures and to support a fragile economic recovery.

Figure 2: Trading Range for the 2 year Note Pre- and Post- QE II



Source: Bloomberg

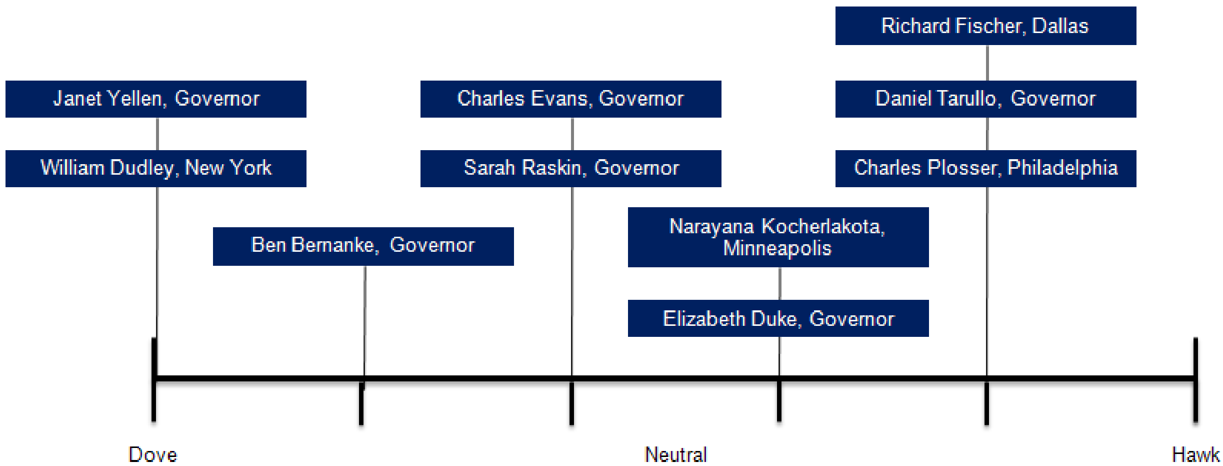
The expiration of quantitative easing, with little possibility of extension, signifies less accommodation going forward. The large bond-buying program contributed heavily to establishing a lowered trading range for short-end rates, and the program's end means a likely reversal of short-end rates to a more normalized level. Based on the historical relationship between the UST 2 year rate and Fed Funds target rate, this reversal could result in a further increase of 15 to 20 basis points in the UST 2 year rate in the coming months.

The end of QE is just the first of many events to remove accommodation that is likely to occur before the Federal Reserve raises the target rate from its current low levels. Interim steps could include moving from a range of 0 to 25 basis points to a firm level for the Fed Funds target rate, selling assets acquired during QE and engaging in reverse repurchase agreements to drain the system of excess liquidity. Each of these actions will reduce the artificial downward pressure on interest rates currently priced in.

Growing Dissent

Recently released FOMC minutes and speeches given by FOMC members (12 regional bank presidents and 5 board members) show growing dissent regarding current policy action. While Chairman Bernanke retains powerful dovish allies (Lockhart, Evans, Dudley and Yellen), the debate surrounding inflation and the accelerated removal of monetary stimulus is intensifying. Several Federal Reserve members have urged for an accelerated end to the current bond purchasing programs and even lobbied for an immediate interest rate hike. Other hawkish members have publicly stated that the Fed Funds rate could be as high as 75 basis points by the end of the year.

Figure 3: Hawkish/Dovish Stance of Current FOMC Voters



Source: Credit Suisse, Clearwater

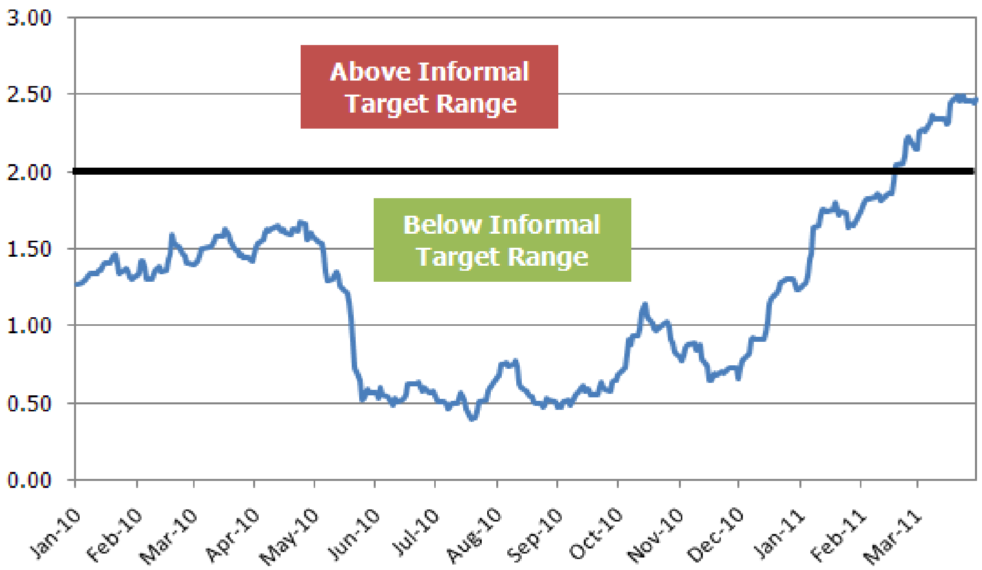
The rapidly growing discord among FOMC members' attitudes towards future monetary policy is unlike anything we have observed in the past two years. During 2010, only one voting member of the FOMC, Kansas City's Thomas Hoenig, officially dissented from policy action taken in 2010. The minutes of recent FOMC meetings show that there is a growing coalition of voters (Fischer, Plosser and Kocherlakota) who are increasingly public in their hawkish views. While their influence will not override the dovish sentiment which prevails among other FOMC voters, vocal and public dissent shows that the risks of less accommodation and higher market rates are increasing.

Inflation Expectations

One reason the hawkish tone of several Federal Reserve governors has increased over the past weeks has been heightened inflationary trends and inflation expectations, two of the three key indicators the Federal Reserve is watching to guide policy action. While core inflation remains muted, a closer look at the CPI index highlights some trends. Inflation diffusion indices—indices that negate the weightings built into an index and focus on the collective trend of its components—show that inflation is starting to spread outside of food and energy. A recent report by Deutsche Bank shows that their inflation diffusion index, made up of 23 sub-components of the CPI index, has recorded notable gains in the past months.

At the same time, the two-year inflation breakeven rate has continued its upward trend and predicts inflation averaging 2.49 percent yearly over that same period. This is materially above the informal 2 percent target that the Federal Reserve has outlined as optimal inflation for economic growth. With economic conditions on firmer footing, hawks argue that the Federal Reserve must act to stave off an inflationary crisis.

Figure 4: 2 YR Breakeven Spreads Show Increased Inflation Expectations



Source: Bloomberg

Chairman Bernanke and other doves see the inflationary pressures, mainly in food and energy, as transitory and not likely to affect the economic recovery adversely. This outlook warrants that the FOMC consider risks to growth over risks of near-term inflationary pressures. These doves also cite that the purpose of QE I & II was to increase inflation to levels more consistent with the FOMC's mandate and spur economic growth, goals which they think their actions have helped to accomplish. As president of the New York Federal Reserve Bank William Dudley remarked recently, "A stronger recovery with more rapid progress toward our dual mandate objectives is what we have been seeking. This is welcome and not a reason to reverse course."

Looking Forward

The scheduled end of monetary stimulus, growing dissent among Federal Reserve policy makers and heightened inflationary trends and inflation expectations make this most recent period of rising rates different from past occurrences. While we do not expect a change in the Fed Funds target rate in 2011, the combination of these three recent developments introduces risks of higher market rates in the near term. We expect that short-end rates revert to more normalized levels relative to the underlying target rate, and we could see a 15-20 basis point rise in the trading range of the 2 year rate as QE II winds down.

We are also closely monitoring other developing issues that could contribute to marginally higher interest rates in the coming months. The largest of these issues are the growing budget deficit and debt ceiling limit. A credible plan to address the budget deficit will be a sign of our country's willingness and ability to address this growing problem. A prolonged budget impasse will lead to reduced confidence by large foreign investors in US Treasury debt. These two issues have the potential to be very disturbing to interest rates markets if not addressed soon.

Please feel free to contact the desk with any questions.

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.