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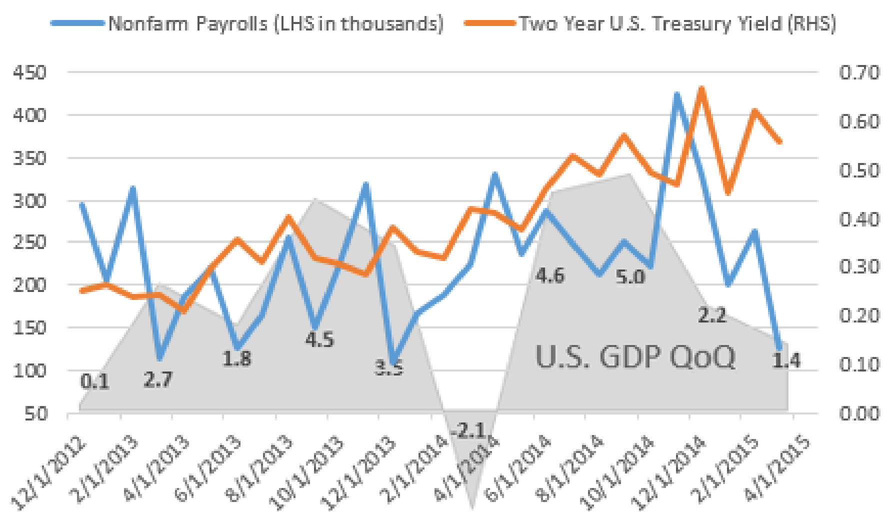
MARKET Commentary

The Waiting Game

April 2015

The U.S. economy lost momentum over the first quarter of 2015. Consensus analyst forecasts target 1.4% quarter-over-quarter growth with expectations for a lower print likely. Harsh winter weather and a major western port shut-down hampered economic activity while a strong dollar provided a stiff headwind as well. The string of robust employment numbers faltered pushing expectations for the first Federal Funds' rate hike into late 2015. Risk assets delivered uneven results and U.S. Treasury yields were volatile as well (see Figure 1). On the quarter, performance rewarded duration and U.S. Treasury exposure.

Figure 1: U.S. Economic & Market Indicators



Source: BEA, BLS and Bloomberg

U.S. Treasury yields inside two years to maturity were basically unchanged while yields two years and beyond moved significantly lower on the quarter. Credit spreads were modestly wider since year-end, but have performed reasonably well given the record level of new issuance. Idiosyncratic credit risk remains elevated as issuers look to engage in shareholder-friendly activity and pursue mergers and acquisitions. M&A activity to date is running at pre-Great Recession levels.

The European Central Bank launched a long-awaited quantitative easing program in March, subsequently driving sovereign yields lower. The German 10 year bund hit a low of 0.075% in April. The Eurozone economy is showing signs of life, but may hit a bump from the ongoing Greek saga. In this commentary, we'll discuss diverging monetary policy implications as well as briefly touch on money market reform developments that should refocus treasury staff efforts on reevaluating investment options.

US Treasuries
As of 31-March

Benchmark	Yield
3 Month	0.02%
6 Month	0.13%
1 Year	0.22%
2 Year	0.56%
5 Year	1.37%
10 Year	1.93%
30 Year	2.54%

Bank of America/Merrill Lynch Index Returns
Q1, 31-Dec to 31-March

Index	Return
1-3 Yr Gov/Corp ≥ A	0.56%
1-3 Yr Municipals	0.26%
1-3 Yr Agencies	0.54%
0-3 Month UST	0.00%
S&P 500	0.95%

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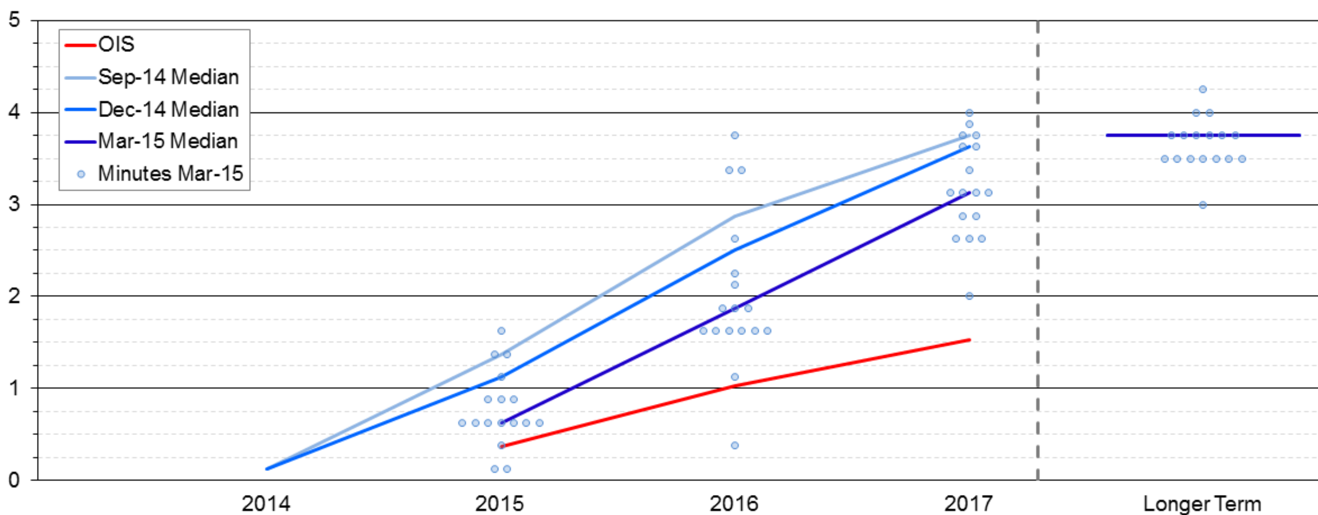
Source: British Bankers' Association, Federal Reserve, US Treasury, Bloomberg, Barclays, BofA/ML, and S&P

Global Monetary Policies Diverge

The European Central Bank (ECB) embarked on its maiden quantitative easing program during the quarter. Consequently, sovereign yields marched steadily lower. Close to 30% of European sovereign bonds trade with a negative yield presenting a dire environment for fixed income investors with assets abroad. The broader economic situation looks to have turned a corner, although growth remains tepid. Meanwhile, Greece represents a major unknown risk as negotiations continue regarding bailout restructuring. We expect contentious negotiations up to an eleventh-hour reprieve. If an agreement is not reached, be prepared for a bout of global risk aversion.

Central banks around the world have followed the ECB and Bank of Japan's lead on easy monetary policy. Year-to-date, thirty central banks have cut rates and taken additional easing measures according to Royal Bank of Scotland. The Fed, meanwhile, is attempting to step back from extremely accommodative policy to one that is slightly less so. The FOMC removed "patient" from the statement and indicated that a rate increase is data dependent. Additionally, the Fed recently released modestly weaker projections for the economy and forecast a slower pace to higher Federal Funds (see Figure 2). The FOMC ratcheted down their forecasts over the last year – note the decline in median forecasts over the last six months as indicated by the blue hued lines.

Figure 2: FOMC Rate Forecast - Dot Plot



Source: Federal Reserve, Bloomberg

Yields tumbled after this admission by Fed officials, but markets remain more pessimistic than the Fed and are pricing in the first hike at the end of the year (as indicated by the red line) and a much slower hiking pace. This disconnect will lead to volatility as these differing viewpoints are reconciled. However, the Fed has made it clear that they don't wish to upset the economic recovery and will gradually normalize policy. Therefore, duration exposure may pose less of a risk than many believe. This should provide an ideal environment for short-maturity investors 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 & Regulatory Impact

The compliance date for money market reform is over a year away (October 2016), but many fund complexes are announcing structural changes to their money fund offerings. JP Morgan, Fidelity, Blackrock and others have taken steps to revamp their money market fund offerings to ensure compliance with the upcoming rules changes. The

firms announced that some funds will be discontinued, others merged, and some converted to floating net asset value funds. Fidelity announced that it will be converting several of its prime funds, including the industry's largest, to government funds to avoid floating NAV pricing. Federated also announced measures to reduce the volatility of their prime funds including shortening the duration of the funds. Other asset managers have made similar announcements and more will come. If you have not heard from your fund complex, it may be time to inquire and begin assessing alternatives while planning for a very different money market fund investment profile. Many of the announced changes will limit the scope of investments for prime funds suppressing yield.

Complicating matters, bank deposits are becoming more punitive to hold from a regulatory standpoint. JP Morgan announced plans to reduce large, uninsured deposits by $100 billion due to new capital requirements – expect other banks to follow suit.

Investment Opportunity Set

We are often asked to review investment policies and make recommendations regarding appropriate opportunities that may be missing. There are two security types that are commonly avoided, but should be thoughtfully considered for inclusion: Tier-2 commercial paper (rated A2/P2) and prime, AAA-rated asset-backed securities (ABS). Both offer attractive yields with desirable risk profiles (see Figure 3). Tier-2 commercial paper offers attractive yields for limited duration exposure and a historically-high yield pick-up over higher rated securities of the same duration. AAA credit card and automobile ABS provide appealing yields at various points on the curve, especially for high rating. Further, ABS investors are immune from shareholder-friendly or M&A activity pursued at the expense of bondholders by corporate issuers.

Figure 3: Current Market Yields

Index	Quality	Duration	Yield
30 Day A1/P1 Commercial Paper	A	0.08 yrs	0.15%
30 Day A2/P2 Commercial Paper	BBB	0.08 yrs	0.50%
90 Day T-Bill	AAA	0.23 yrs	0.02%
90 Day A1/P1 Commercial Paper	A	0.25 yrs	0.25%
90 Day A2/P2 Commercial Paper	BBB	0.25 yrs	0.65%
2-Year U.S. Treasury	AAA	1.99 yrs	0.53%
AAA U.S. Asset-Backed Security	AAA	1.78 yrs	1.03%

Source: Clearwater Advisors

Adding either to an investment policy will be accretive to the current investment mix. However, thorough credit vetting is important for each security type to ensure the issuers are an appropriate risk for the portfolio and that commensurate yield is being earned. Further, if you're currently invested in subprime auto deals (a subsector we avoid) you should minimize exposure to the 2014 vintage which is exhibiting poor underlying credit performance across the three major areas: defaults, delinquencies and cumulative losses. After twelve months of seasoning, the 2014 vintage has the highest losses among post-crisis deals. Evidence that all asset-backed securities are not created equal, but that doesn't mean that the sector should be avoided altogether.

Looking Forward

The investment environment continues to be driven by global monetary policy. Domestically, a glacial shift to more normal policy will begin later in the year. The market is less confident than Federal Reserve officials regarding the U.S. economy, but is providing attractive opportunities across security type and duration. Overseas, policy is very

accommodative in an attempt to boost economic activity. Yields, unsurprisingly, have collapsed pushing investors to search for attractive alternatives which may provide a bid to U.S. markets. Money market and bank regulatory reform are reducing the attractiveness of commonly utilized investment options which should consequently push domestic investors to seek attractive alternatives.

Please contact the desk with questions or to discuss investment opportunities on how to best navigate today's market environment.

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