clearwater ADVISORS

MARKET Commentary

Cruel Summer

July 2011

In the current period of low interest rates and weakening credit conditions, avoiding potential pitfalls is becoming increasingly important to an investment portfolio's returns. Historically low interest rates offer little protection against adverse price movement from widening credit spreads or a credit event. The recent volatility in credit spreads due to contagion fears in Europe will likely intensify in the coming summer months as resolutions will need to be reached on the Greek debt crisis, U.S. fiscal debate and pending financial regulation to avoid further disruption in the financial markets. Rather than fighting against summer headwinds by remaining invested in risky credits (i.e., prime money funds, bank deposits and direct security holdings), we recommend investing further out the front-end curve in high-grade securities.

Timing the Market

We have seen many investors attempt to navigate the current period of low rates and deteriorating credit by trying to time the holding of riskier, higher-yielding securities. Many investors may not even be aware that they are employing this strategy, as they tend to do it indirectly via:

- Large balances in prime money market funds (which are some of the biggest holders of European bank paper)
- Large balances in non-guaranteed bank deposits held with at-risk institutions
- Direct security holdings of at-risk institutions, including short-term instruments

In past commentaries we have outlined the risks and exposures that prime money market funds have to European banks. As the Greek crisis has continued to escalate in recent weeks, the number of research reports and articles outlining prime fund exposures to European financials has increased exponentially. This is for good reason as the combined exposure of prime funds to European banks is substantial. JP Morgan estimates that prime money fund exposure to European banks stands at $764 billion, with $435 billion exclusive to Eurozone banks.

Prime fund investors undertake these credit risks—and other material risks, such as commingled risk—every day they choose to reinvest in the fund. The underlying assumption is that investors can exit the fund before a credit event adversely affects the fund and the ability for share redemption. Timing the market has never proven to be a prudent investment strategy for conservative investors, and a few basis points of additional yield do not adequately compensate for undertaking such serious risks.

A Troubled Timeline

Deepening credit concerns are largely attributed to sovereign governments that are becoming less willing and, more importantly, less able to support their struggling financial institutions. Greece and other European periphery countries are not the

US Treasuries

As of 30-Jun

Benchmark	Yield
3 Month	0.02%
6 Month	0.10%
1 Year	0.19%
2 Year	0.47%
5 Year	1.76%
10 Year	3.16%
30 Year	4.38%

Bank of America/Merrill Lynch Indexes

31-May to 30-Jun

Index	Return
1-3 Yr Gov/Corp ≥ A	0.03%
1-3 Yr Municipals	0.21%
1-3 Yr Agencies	0.06%
0-3 Month UST	0.00%
S&P 500	- .67%

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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 only culprits; the United States is also a prime example.

After buoying up the financial system for three years through capital injections, support programs and even explicit guarantees, the U.S has exhausted the resources and flexibility to address the residual problems that over $3 trillion could not solve. S&P has placed the U.S. on negative outlook because of the mounting deficits and the current impasse between parties in Congress over raising the debt ceiling, tax hikes and spending reductions. Moody's has all but done the same without an official credit action.

The U.S. government's reduced ability and willingness to support financial institutions led to recent credit actions against U.S. financial institutions—namely, Wells Fargo, Citigroup and Bank of America (there were similar reasons for the credit actions against 12 U.K. banks put on negative outlook and against select French banks).

Figure 1: Major Banks with Credit Actions against them in the Last 2 Months

Bank	Rating Action	Rationale
Abbey National	LT on Negative Watch	Reduced systemic support uplift
ANZ	LT Downgrade	High levels of wholesale funding
Bank of America	LT and ST on Negative Watch	Reduced systemic support uplift
Bank of Tokyo Mitsubishi	LT on Negative Watch	Reduced systemic support uplift
BNP Paribas	LT on Negative Watch	Greek exposure
CBA	LT Downgrade	High levels of wholesale funding
Citigroup	LT and ST on Negative Watch	Reduced systemic support uplift
Credit Agricole	LT on Negative Watch (Mdy), LT and ST downgrade (S&P)	Greek exposure
Danske Bank	LT Downgrade, Negative Outlook	Reduced systemic support uplift
Dexia Credit Local	LT and ST on Negative Watch	Greek exposure and acceleration of deleveraging
Intesa Sanpaolo	LT on Negative Watch (MDY), Negative Outlook (S&P)	Reduced systemic support uplift (MDY), weakened profitability and deterorated asset quality
Lloyds	LT on Negative Watch	Reduced systemic support uplift
Mitsubishi UFJ	LT on Negative Watch	Reduced systemic support uplift
Mizuho	LT on Negative Watch	Reduced systemic support uplift
NAB	LT Downgrade	High levels of wholesale funding
Nationwide	LT and ST on Negative Watch	Reduced systemic support uplift
RBS	LT on Negative Watch	Reduced systemic support uplift
Societe Generale	LT on Negative Watch	Greek exposure and reduced systemic support uplift
Sumitomo Mitsui	LT on Negative Watch	Reduced systemic support uplift
UniCredit	LT on Negative Watch	Weakened profitability and deteriorated asset quality
Wells Fargo	LT on Negative Watch	Reduced systemic support uplift
Westpac	LT Downgrade	High levels of wholesale funding

Source: JP Morgan

The view of U.S. policymakers being less willing to support the financial system going forward was outlined in the financial regulatory reform—otherwise known as Dodd-Frank—passed in 2010. Global policymakers have adopted the same mindset in the ongoing debate surrounding BASEL III capital rules, forcing global systemically-important institutions to hold additional capital buffers to protect against future market disruptions. While the additional capital buffer can be viewed in many ways as a credit positive, the uncertainty surrounding new and existing regulations will result in continued volatility in credit spreads into the summer months.

Figure 2: Timeline of Important Events over the Coming Summer Months

June	Jun 29	Greece: Parliamentary vote on austerity program.
	Jun 30	Greece: Drop dead deadline for passage of austerity program/End of QE2.
July	Jul 3	Euro Fin Ministers meet to discuss: 5th tranche disbursement from EU to Greece.
	Jul 8	IMF Board meeting to disburse 5th Tranche to Greece in lock step with EU.
	Jul 11	Euro Fin Ministers expected to approve disbursement of 5th tranche disbursement from EU to Greece.
	Jul 13	Speculated release of European Banking Authority bank stress test results.
	Jul 15	Euro 2.4bn Greek 3 month T-bill redemption.
	Mid-July	Heated discussions about debt ceiling and budget deficit expected to pick up and extend into early August.
	Jul 16-21	Various Dodd-Frank implementation deadlines.
	Jul 22	Euro 2.0bn Greek 6 month T-bill redemption.
August	Aug 2	U.S. debt ceiling deadline.
	Aug 4	First US T-bill matures triggering default.
	Aug 12	Euro 0.5bn Greek 6 month T-bill redemption.
	Aug 15	$25bn of coupon payments and $27bn T-notes payable: 10% of the marketable Treasury debt exposed to default.
	Aug 19	Euro 2.0bn Greek 3 month T-bill redemption.
	Aug 20	Euro 5.9bn Greek 5 year bond redemption.
September	Beg-Sep	Moody's expected to complete review for downgrade of BAC, C, and WFC.
	Sep 12	Expect details of ring-fencing reforms for UK banks.

Source: Clearwater Advisors

Key summer events include further resolution of the Greek debt crisis and associated European bank stress tests, potential rating actions on U.S. and other global financial institutions and intense U.S. fiscal debates regarding the debt ceiling, federal spending and taxes. While the passage of Greek austerity measures opens the way for additional aid by European and global monetary institutions to meet current obligations, the drama in Europe is by no means over.

European banks now have a brief work-out period to clean up their balance sheets, but we can envision several scenarios in which Europe's financial condition continues to deteriorate. The problems in periphery Eurozone countries could materially disrupt the funding markets of the major Eurozone countries like France, Germany, Spain and Italy and also non-Eurozone regions like the UK, Australia and Scandinavia, which are seen as strong, fiscally responsible credits but at the mercy of the wholesale funding markets. This was the main reasoning for the recent downgrades of Australian banks. We have only seen a fraction of the crisis that would ensue if the larger and more prominent regions around the world suffer a funding crisis like Greece in the near future.

In the U.S., we expect a last-minute deal to be reached by Congress to raise the debt ceiling. What is truly at risk is the global perception of the United States as a credible debtor. An extended period of low interest rates cannot continue to bailout a fiscally irresponsible Congress.

A recent op-ed in the Wall Street Journal on June 28, 2011 presented that normalization in interest rates—at present the average rate on U.S. Treasury debt is 2.5% versus the average over the past two decades of 5.7%—would increase debt service obligations by $4.9 trillion over a ten year period. Whether the rise in interest rates comes from improving economic conditions or from a global loss of confidence in the U.S. government's willingness to honor its obligations is irrelevant. However, in a period of a global economic slowdown and weakening credit conditions, the latter seems to be the more likely culprit to lead interest rates higher in the near term if Congress mishandles the fiscal debate, which it has been prone to do.

Rates Will Remain Low

Investors may be able to avoid the summer volatility by investing further out the front-end curve in high-grade securities. While 2-year U.S. Treasury yields recently reached all-time lows, the shape of the front-end curve is much more attractive than the last time yields reached comparable levels (i.e., the start of the Quantitative Easing Round II in November 2010). The roll down from 2-year UST yields to 12-month UST yields currently stands at 29 basis points. In November 2010, the same roll down was a mere 13 basis points.

Yields and roll down in industrials and proven financials are even more attractive. We would rather hold a diversified portfolio of select high-grade, highly-liquid credits in the 1-2 years space than take chances in direct security holdings and investment vehicles which utilize risky European bank credits to buoy yield. This type of portfolio would be better isolated against potential credit events and interest rate shocks, while remaining very liquid and higher yielding due to increased duration. We are convinced that the best way to avoid the potential headwinds that the summer could bring is to avoid it entirely.

Please feel free to call the desk with questions.

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