clearwater ADVISORS

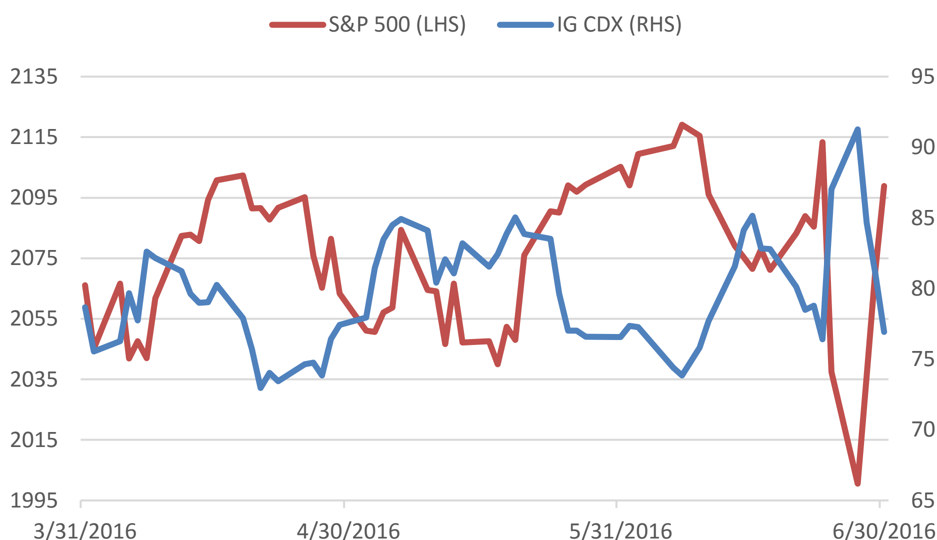
MARKET Commentary

Summer 2016

Much Ado about Nothing

Markets treaded water for most of the second quarter casting a wary eye on the British vote on whether to exit ("Brexit") the European Union lurking in late June. Investors were caught wrong-footed by the vote to leave, pushing safe-haven U.S. Treasury yields to record lows. Risk assets stumbled badly before recovering almost as quickly into month-end albeit on shaky ground (see Figure 1). The brief rout reversed on expectations of further easing by global central banks – a common elixir to economic malaise and market volatility these past several years.

Figure 1: Risk Assets Volatile



Source: Bloomberg

U.S. Treasury securities caught a bid late in the quarter fueled by a weak May employment report, a dovish June Federal Open Market Committee (FOMC) meeting and macroeconomic uncertainty surrounding the Brexit vote. Over the quarter, the U.S. Treasury yield curve bull flattened – the two-year declined 14 bps while the thirty-year Treasury yield fell 32 bps. In Q2 and on the year, fixed income returns rewarded duration and low-quality credit exposure.

The Brexit vote turmoil will keep global monetary policy accommodative and slow the Federal Reserve's path to more normal policy. Markets remain unconvinced that the Fed will act in the near term, pricing the next hike around the end of 2017, which will continue to contribute to volatility over the near term. Central bank policy will remain the dominant market force for the balance of the year.

US Treasuries

As of 30-June

Benchmark	Yield
3 Month	0.26%
6 Month	0.35%
1 Year	0.44%
2 Year	0.59%
5 Year	1.01%
10 Year	1.49%
30 Year	2.30%

Bank of America/Merrill Lynch Index Returns

Q2, 31-March to 30-June

Index	Return
1-3 Yr Gov/Corp ≥ A	0.59%
1-3 Yr Municipals	0.47%
1-3 Yr Agencies	0.41%
0-3 Month UST	0.05%
S&P 500	2.45%

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

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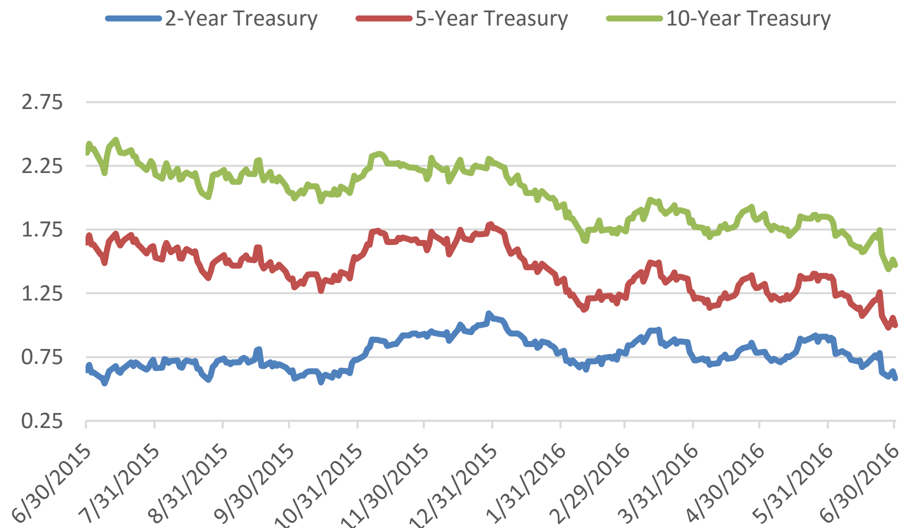
Lower for Longer

Geopolitical risk took center stage as the British voted to exit the European Union (EU) near the end of the quarter. The vote marks a significant shift away from the path toward social, political and economic unity over the prior decades. Global economic growth concerns reignited as significant uncertainty surrounds the second largest economy in the EU. The exit process will drag on for years, but already central banks are promising more stimulus. The Bank of England hinted at upcoming rate cuts and further quantitative easing as it hopes to cushion the impact of Brexit. Meanwhile, analysts expect the European Central Bank will loosen its bond purchase restrictions and possibly expand its quantitative easing efforts.

In Japan, there is talk of "helicopter money" as the Bank of Japan's (BoJ) foray into negative-rate policy hasn't been as effective as initially hoped. Recall, helicopter money is an unconventional monetary policy tool that involves printing money and distributing it to the public in an effort to stimulate an economy. Former Fed Chair Bernanke, a contemporary expert on the matter, recently visited with BoJ officials and Prime Minister Abe adding fuel to the fire although BoJ Chair Kuroda previously indicated that such measures were not a possibility. Nonetheless, markets are primed for more action driving the yen lower.

Global macroeconomic malaise, resulting in some $12T of global sovereign debt trading at negative yields, is pulling U.S. treasury yields lower especially in longer maturities resulting in a flatter yield curve (see Figure 2).

Figure 2: U.S. Treasury Yields

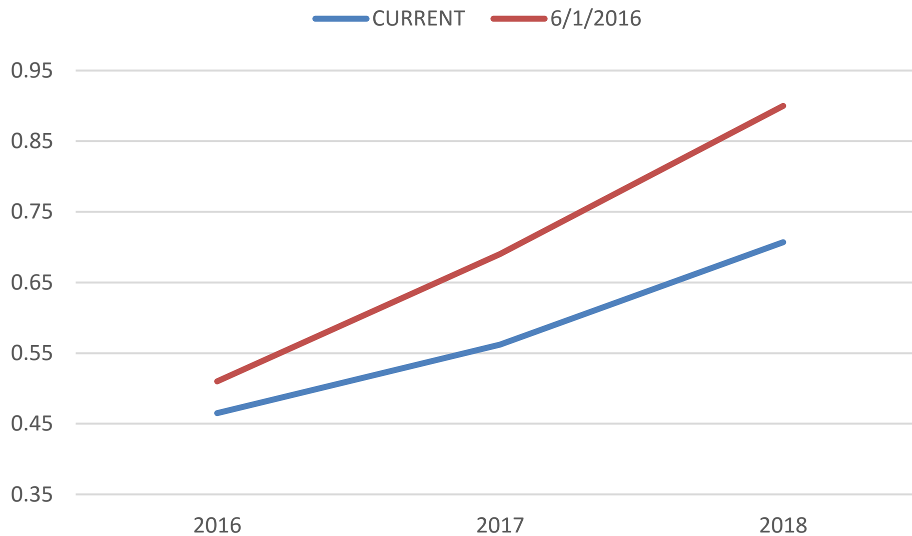


Source: Bloomberg

Further, following a dovish June FOMC message, markets have become exceedingly so. Certainly the Fed will continue its cautious path to more normal policy given their heightened focus on global uncertainty, but there is just one hike a year priced into the market over the next two years. The overnight indexed swap market is pricing the next hike around the beginning of 2018 and barely another before the end of that year (see Figure 3). This is significantly lower than just a month earlier illustrating the Brexit impact on monetary policy expectations.

Fed fund futures indicate just a 42% probability of a hike in December, significantly better than the 8% likelihood we saw immediately after the Brexit vote, but still fairly low.

Figure 3: Market Implied Fed Funds (OIS)



Source: Bloomberg

Within Clearwater portfolios, we look to maintain a yield buffer via spread product (specifically, select investment grade corporate and asset-backed securities) to cushion against sudden Treasury yield increases should market sentiment shift or the Fed's message become less dovish. The investment grade credit market has remained resilient. Oracle sold $14B worth of bonds, the third-largest deal of the year, in the primary market less than a week after the Brexit vote. Additionally, with European credit investors getting squeezed out of their home market as the ECB continues to buy non-financial corporate bonds, technical factors look favorable as well.

Money Market Reform Countdown

One quarter to go – money market reform rules go into effect in October. Prime funds suffered redemptions of $118B this past June according to iMoneyNet and estimates vary on how much more will move ahead of the reform deadline. Barclays estimates $350 billion (33% of assets) could leave those funds while Citigroup estimates $100B-$200B will shift away from the floating NAV of the next generation prime fund.

Prime money fund managers are concerned as noted by the yield-sapping, historically low weighted average maturity (22 days) of their portfolios, holding nearly 30% of assets in overnight maturities (according to Barclays).

Currently, investors in the highest yielding institutional prime funds earn, on average, 0.18% more than the top government funds. This yield pick-up seems inadequate given the changes that are coming and is likely exacerbated by the high level of liquidity prime fund managers are maintaining ahead of the conversion date.

Recall, the rule changes include:

- *Floating Net Asset Value (NAV)* – Prime institutional, including tax-exempt, money market funds will be required to transact at a floating, market-based net asset value. Government and retail funds will continue to utilize a stable $1.00 NAV.
- *Redemption Limits* – All non-government money market funds will be able to use liquidity fees (up to a 2% fee on redemptions) and redemption gates (a temporary suspension of redemptions) when a fund's liquidity falls below a certain level (15% of its total assets). Government money market funds could voluntarily utilize these limits, if previously disclosed to investors.

The following months give market participants a rapidly closing window to evaluate and execute suitably attractive alternative investments including separately managed accounts (SMAs). The added flexibility and transparency of a SMA provides control that is lacking in a pooled investment. And, with the appropriate investment policy and asset manager, money market investors can position their portfolios to prudently maximize yield while ensuring adequate liquidity is maintained.

Looking Forward

The annual Eurozone-induced summer sell-off was short lived due to expectations of further accommodative central bank policy. Central banks remain at the ready, but will likely underwhelm expectations. Domestically, the Fed may be looking to accomplish another hike before year-end (historical note: in past hiking cycles, once the Fed hikes and pauses for six months the next move is usually a rate cut) which would lead to some volatility against the backdrop of an entertaining U.S. presidential election season.

We are on the doorstep of new money market rules and are beginning to see market impacts as prime funds position for redemptions. LIBOR is rising and financial commercial paper yields have risen from earlier in the year. SMAs can take advantage of these market dislocations without many of the negative characteristics of a money fund.

If you are planning on attending the 2016 Clearwater User Conference here in Boise this September, please reach out to your portfolio manager or sales contact. We'd like to set aside some time to visit with folks.

Please contact the desk with questions or to discuss investment opportunities best suited to navigate this year's uncertain and volatile market environment.

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