clearwater ADVISORS

MARKET Commentary

August 2011

Deficits, Defaults and Downgrades: Update

The markets were volatile in the days surrounding the events of the S&P downgrades, additional support measures in Europe, and continued weakness in the U.S. and global economy. We have outlined some of the key events and market movers (and non-movers) below. Please feel free to call the desk with any additional questions or comments.

Topics discussed

- Downgrade of the U.S. sovereign and related entities
- Downgrade of the insurance industry
- Rationale for non-downgrade of U.S. financial institutions and select corporates
- FOMC reaction
- Lowered expectations for U.S. growth

Downgrade of the U.S. sovereign and related entities

In the past two business days, S&P took rating actions on the following government entities and related securities:

Issuer	Rating Metric	Prior Rating	Current Rating	Comments
U.S. Sovereign	Long-term Sovereign Credit Rating	AAA	AA+	Remains on negative outlook (1/3 chance of further downgrades in the next two years).
Federal National Mortgage Association (Fannie Mae)	Senior Issue Rating	AAA	AA+	Does not affect discount notes. Remains on negative outlook.
Federal Home Loan Mortgage Corporation (Freddie Mac)	Senior Issue Rating	AAA	AA+	Does not affect discount notes. Remains on negative outlook.
Federal Home Loan Bank System	Senior Debt	AAA	AA+	10 of the 12 Home Loan Banks were also downgraded, and all 12 now have either a AA+ or AA stand-alone rating. Does not affect discount notes. Remains on negative outlook.
Federal Farm Credit Banks	Senior Debt	AAA	AA+	Remains on negative outlook.
126 Issues of the Temporary Liquidity Guarantee Program (TLGP, a.k.a., FDIC-guaranteed issuance)	Bond Ratings	AAA	AA+	Does not affect the 30 issuers of TLGP debt, just the debt issued under the program. Remains on negative outlook.
4 National Credit Union Association-guaranteed Debt (Issued under the Temporary Corporate Credit Union Guarantee Program)	Bond Ratings	AAA	AA+	Does not affect the 2 issuers of TCCUGP debt, just the debt issued under the program. Remains on negative outlook.
Tennessee Valley Authority	Senior Issue Rating	AAA	AA+	Remains on negative outlook

Downgrade of the insurance industry

In addition to these sovereigns and related entities, the following insurance companies also suffered a ratings downgrade. This was telegraphed by the rating agencies (who, in a move related to their estimation of the U.S. sovereign, put the insurance industry on credit watch negative) as a possible consequence of a sovereign downgrade. Per S&P's criteria, the financial strength ratings on insurers were constrained by the sovereign rating. Other factors that go into the analysis of an insurer's financial strength as a result of the U.S. sovereign downgrade include large concentration of Treasury holdings, macroeconomic volatility, currency devaluation, asset impairments and portfolio deterioration.

Issuer	Rating Metric	Prior Rating	Current Rating	Comments
Knights of Columbus	Counterparty Credit and Financial Strength Rating	AAA	AA+	Outlook on Negative.
New York Life	Counterparty Credit and Financial Strength Rating	AAA	AA+	Outlook on Negative.
Northwestern Mutual	Counterparty Credit and Financial Strength Rating	AAA	AA+	Outlook on Negative.
Teachers Insurance & Annuity of America	Counterparty Credit and Financial Strength Rating	AAA	AA+	Outlook on Negative.
United Services Automobile Association (USAA)	Counterparty Credit and Financial Strength Rating	AAA	AA+	Outlook on Negative.
Assured Guaranty	Outlook	Stable	Negative	No change in counterparty credit and financial strength ratings
Berkshire Hathaway	Outlook	Stable	Negative	No change in counterparty credit and financial strength ratings
Guardian	Outlook	Stable	Negative	No change in counterparty credit and financial strength ratings
Massachusetts Mutual	Outlook	Stable	Negative	No change in counterparty credit and financial strength ratings
Western and Southern	Outlook	Stable	Negative	No change in counterparty credit and financial strength ratings

Rationale for non-downgrade of the U.S. banks and financial institutions and select corporates

Investors wondered what impact a downgrade of the U.S. Sovereign would have on banks and financial institutions. S&P answered that concern shortly after its announcement of the downgrade to the U.S., *"Standard & Poor's Ratings Services said today that the Aug. 5, 2011, lowering of the United States of America sovereign credit rating to 'AA+' from 'AAA' does not have an immediate or direct impact on our ratings on U.S. banks. None of the banks we rate in the U.S. has an issuer credit rating higher than the U.S. sovereign rating. The sovereign downgrade does not alter the government support assumptions that we factor into our ratings on four banks."*

While U.S. institutions may have dodged a bullet this time, we still view significant ratings and spread risk in the near term. Spreads on financials widened significantly on Monday. While traditional funding metrics like LIBOR and SWAP spreads were relatively muted, we think that significant volatility among financials will persist and that funding markets will become increasingly soft. We retain our view that investors should approach the financial sector with caution and should look to build banking relationships and place investments with only the strongest institutions.

On the heels of the downgrade and other events, the KBW index (an index of large U.S. banks) declined 10.70%. The losses were most significant at Bank of America (-20.32%, -51.2% YTD), Citigroup (-16.42%, -40.9% YTD) and Morgan Stanley (-14.49%, -37.1% YTD).

We think that it is highly probable that U.S. banks suffer downgrades. Weakening economic conditions will find their way into asset quality, funding markets will experience increased volatility, and increased capital rules and regulations will force banks to delever and become less profitable. With significant implied uplift in many U.S. financials and a sovereign less willing to lend its support, we would not be surprised to see increased rating actions in the coming months.

On another note, S&P also commented that the most highly-rated corporations (JNJ, Microsoft, GE, ADP, WW Grainger) would not suffer a downgrade as a result of the U.S. sovereign downgrade. This reinforces our point that investors should take advantage of high-grade credits to insulate their portfolios from ratings and price volatility.

FOMC Comment

After its scheduled meeting, the Federal Open Market Committee released a statement saying that "*Economic growth so far this year has been considerably slower than the committee had expected*" and that "*economic conditions…are likely to warrant exceptionally low levels for the federal funds rate at least through mid-2013*." Bonds rallied significantly on the news.

Treasury 10-year rates are approaching lows reached in the height of the credit crisis in 2009, and the 2 year rate is a whopping 17 basis points at the time of this writing. The relatively recent change in market expectations for 'exceptionally low rates' for an extended period – combined with large buyers of UST and AGY paper reluctantly expressing their continued support to buy Treasuries in the future, the US dollar retaining its position as the reserve currency, and the scarcity of alternative AAA-rated investments – lends strength to the US Treasury market. How long this strength remains will be one of the main drivers of interest rates going forward.

Lowered expectations for U.S. growth

Leading up to the FOMC meeting, Goldman Sachs became the most recent brokerage house to downgrade the prospect for U.S. growth. Goldman now predicts that the U.S. economy will only grow at a clip of 2% in 2012 and 2.5% thereafter, well below the run rate for periods following the end of a recession. Prior estimates projected 2.5% in 2012 and 3% thereafter. Goldman also sees a 1/3 chance that the U.S. dips into another recession, a probability we think may be optimistic.

US Treasuries

Tenor	Yield *
2 year	0.19%
3 year	0.34%
5 year	0.95%
10 year	2.21%
30 year	3.61%

*Source: Bloomberg

Please feel free to call the desk with questions.

Form ADV Part II

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