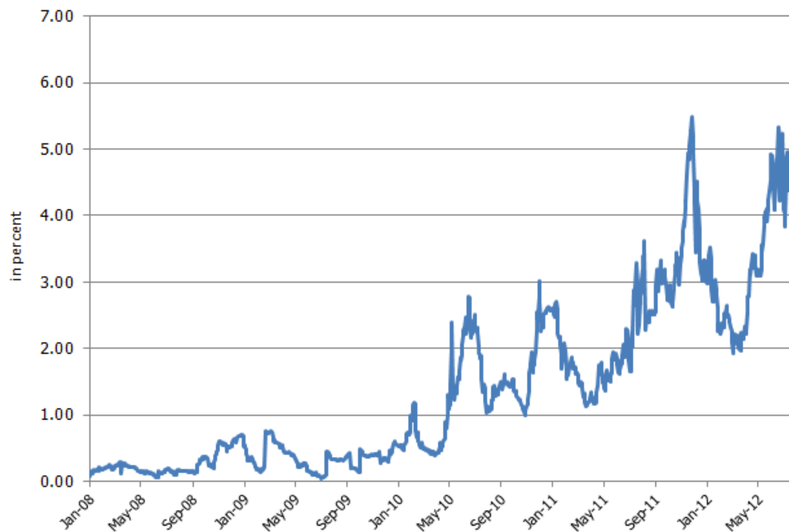
clearwater ADVISORS

MARKET Commentary

Waning Interest

The diverging path of global interest rates highlights the elevated risks to the global economy. Interest rates in so-called "core" countries have fallen precipitously as investors seek refuge from plummeting expectations for global growth and the deepening crisis in Europe. By contrast, interest rates in "peripheral" countries remain volatile and on a general upward trajectory as eurozone policymakers struggle to repair crippling structural imbalances in troubled member states and to contain market concerns of a near-term sovereign credit event.

Figure 1: Spanish 2-Year Borrowing Rates vs. German 2-Year Rates



Source: Bloomberg

The current environment creates a quandary for short-duration investors who bemoan the low-absolute interest rate environments in traditionally safe countries and express trepidation over the fate of countries embattled by ongoing debt crises and the spillover effects on corporate credit spreads. Given the low-absolute interest rate environment, however, we believe that portfolio returns for the remainder of the year will continue to be driven by the performance of high-grade credits which display attractive carry and roll-down characteristics. In an environment where credit premia make up a growing proportion of an investment portfolio's absolute yield and return, investors who marginalize the contribution of credit premia to an investment portfolio's performance must do so at their own risk.

The Misnomer of "Core" and "Peripheral" Countries

The notion that countries in the eurozone can be divided into "core" and "peripheral" countries is a farce. One need look no further than Greece, a country which was insignificant in almost every measurable way but whose eventual debt crisis roiled global markets and brought an entire continent to the brink of collapse. The ongoing and deepening European crisis attests to the fact that "peripheral" countries in the euro-zone do not exist; every country in the euro-currency bloc is essentially a "core" country.

August 2012

US Treasuries

As of 31-Jul

Benchmark	Yield
3 Month	0.10%
6 Month	0.14%
1 Year	0.16%
2 Year	0.21%
5 Year	0.59%
10 Year	1.47%
30 Year	2.55%

Bank of America/Merrill Lynch Indexes

29-Jun to 31-Jul

Index	Return
1-3 Yr Gov/Corp ≥ A	0.29%
1-3 Yr Municipals	0.17%
1-3 Yr Agencies	0.15%
0-3 Month UST	0.01%
S&P 500	1.39%

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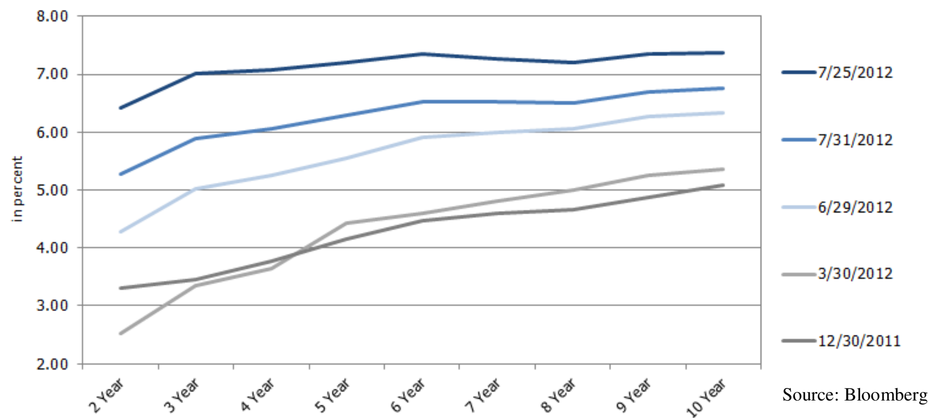
Source: British Bankers' Association, Federal Reserve, FDIC, US Treasury, Bloomberg, Barclays, Financial Times, JP Morgan, The Economist, S&P and Center on Budget and Policy Priorities, Wall Street Journal

Figure 2: Spanish Sovereign Curve Continues to Flatten Indicating Credit Concerns



Source: Bloomberg

Spain, whom European policymakers vehemently defended not too long ago as fiscally sound, is now entering a full-blown funding crisis. The unfolding saga in Spain has a certain Hellenic feel to it. The bear flattening (rise in short-term rates relative to long-term rates) of the Spanish yield curve signals that investors are losing confidence in policymakers' ability to contain the crisis effectively. A Spanish debt default is not just a distant possibility; market participants are now deploying significant money betting that it could occur, and soon.

The deepening crisis in Spain has caused investors in Europe to flock to traditional safe haven countries en masse. Several European countries now boast negative nominal interest rates out to two years, with Denmark and Switzerland posting negative interest rates out to three and five years, respectively. Negative interest rates mean that investors are willing to pay respective governments to hold their money for them. This unprecedented flight to quality reflects heightened fears of a near-term sovereign credit event, strong deflationary pressures and prolonged economic contraction.

Figure 3: Yield Curve in Safe Haven Countries Reflect Market Concern

	Denmark	France	Germany	Netherlands	Switzerland	U.K.	U.S.
2 Year	-0.36%	0.10%	-0.07%	-0.03%	-0.63%	0.10%	0.21%
3 Year	-0.17%	0.23%	0.00%	0.03%	-0.28%	0.16%	0.29%
5 Year	0.30%	0.86%	0.30%	0.64%	-0.10%	0.54%	0.61%

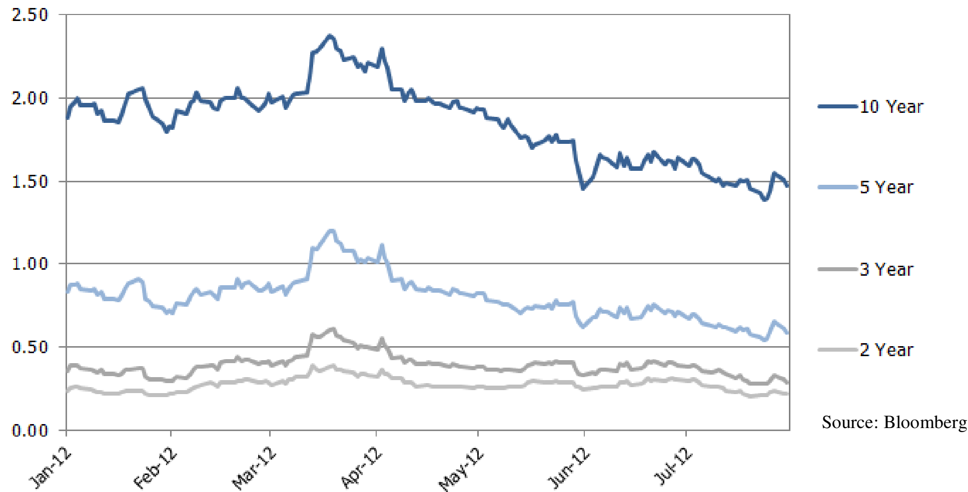
Source: Bloomberg

The compression in short-end rates also reflects the policy actions of monetary authorities who are desperately attempting to compensate for the ineptitude of fiscal authorities. The ECB recently cut their overnight deposit rate to zero (comparable to the Federal Reserve's Interest on Excess Reserves which currently stands at 25 basis points), putting further downward pressure on front-end rates. The Federal Reserve has openly floated similar policy actions, with recent comments by Chairman Bernanke indicating that the FOMC is exploring "new tools" to support growth. The high likelihood of further policy accommodation domestically supports our long-held view that interest rates will remain exceptionally low for an extended period.

Carry and Roll-Down Remains Core to Portfolio Returns

In our February market commentary ***The Diffusion of Innovation,*** we emphasized that "short-end interest rates have reached such low absolute levels that investors will find it increasingly difficult to generate meaningful returns by extending portfolio duration in rate products (i.e. Treasuries and Agencies), exclusively."

Figure 4: Short-end Rates Have Remained Resilient, while Intermediate and Long-end Rates Have Rallied

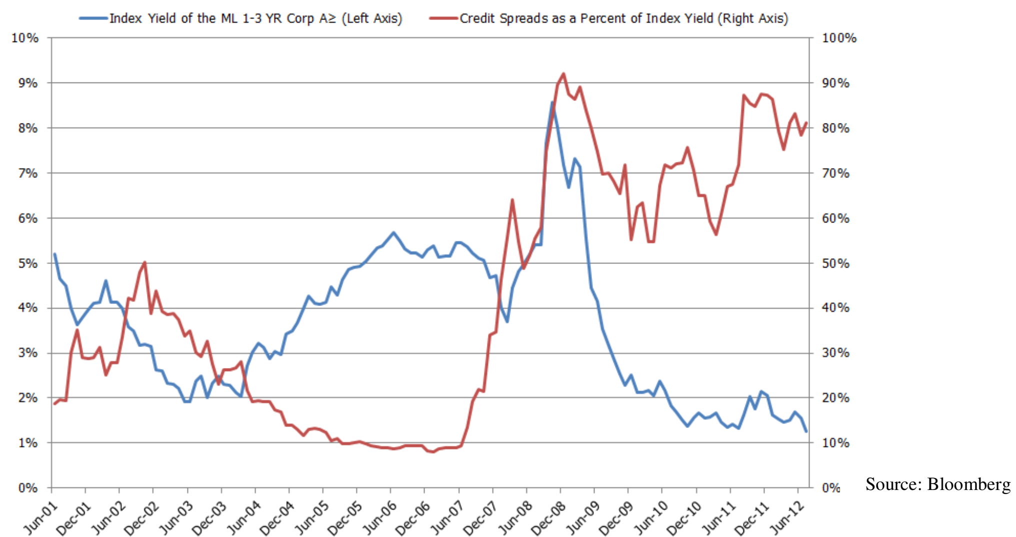


Source: Bloomberg

We highlighted how the "easy money" in risk-free assets for short-duration investors was gone. The two-year and three-year Treasury note rates, which we believed at the time had "hit a performance ceiling," are effectively unchanged from when the commentary was published (see Note 1). We also commented on how "opportunities to capture relatively attractive returns in the coming years will require identifying and investing in high-quality credits." We are convinced this theme will continue to hold true for the remainder of 2012.

Given the low-absolute level of rates, credit premia are becoming a larger contributor to a portfolio's overall yield and return than it has been historically. An analysis of the Merrill Lynch 1-3 Year Corp ≥ A shows that the ratio of an index's imbedded credit premium to its overall yield is near all-time highs. The only period which produced a higher ratio is the period directly following the Lehman bankruptcy in September 2008, when credit spreads widened and Treasury rates plummeted. Not surprisingly, the months following this period produced some of the absolute best returns for credit in a decade.

Figure 5: Merrill Lynch 1-3 Year Corp ≥ A Credit Premia as a Percentage of Index Yield



Source: Bloomberg

Note: For a list of our past commentaries, please visit our web site www. clearwateradvisors.com

We feel that the current environment lends well to investors who are willing to undertake incremental risk by extending into high-grade credit. Credit spreads at their current levels have a high likelihood of continued performance through 2012, contributing to portfolios through attractive carry in an historically low-rate environment and price appreciation through spread compression and roll-down potential. Despite the volatility of 2012, credit has performed remarkably well. Improving balance sheets and technicals surrounding the massive flow of funds into the front-end cash market will continue to support credit going forward.

Looking Forward

The deepening crisis in Europe and monetary actions by central banks continue to drive asset prices. The resolution in Europe will be long and arduous and require as much political capital among European policymakers as real capital to support struggling sovereigns and insolvent banks. With Europe moving towards fiscal union, short-duration investors should pay close attention to how policymakers will respond to the markets' insatiable demands for more coordinated actions.

On the domestic front, all eyes will be on the Federal Reserve and FOMC meeting today. If the Federal Reserve expresses a willingness to continue to support a struggling market through more aggressive accommodation, we could see increased volatility in the long-end of the yield curve. On the short-end, the fate of money market rates will be determined by whether the FOMC enacts new policy action on the interest on excess reserves (IOER) similar to what Europe initiated weeks ago.

Please feel free to contact the desk with any questions.

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