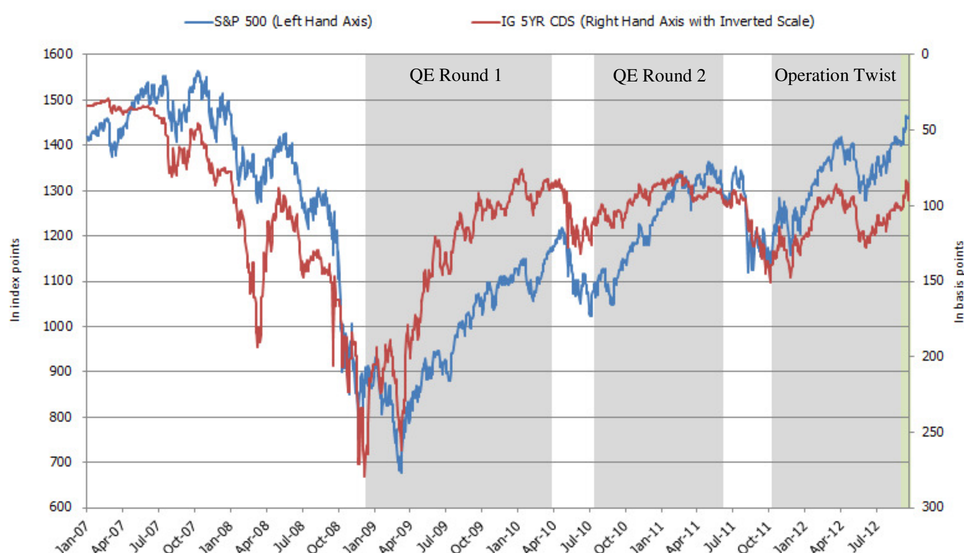
clearwater ADVISORS

MARKET Commentary

The Convexity of Credit Revisited

In our April 2012 market commentary entitled ***The Convexity of Credit,*** we outlined our thesis for the continued performance of risk assets in 2012 after recording exceptional gains in Q1. Central bank intervention and an extended period of exceptionally low interest rates underpinned our belief that short-duration investors should continue to take advantage of credits that displayed attractive carry and roll-down characteristics despite the potential for spread volatility caused by the ongoing debt crisis in Europe. While developed markets abroad have experienced exceptional volatility in 2012, this volatility has neither derailed the impressive performance of U.S. credit indices nor prevented the compression of credit spreads which are approaching year-to-date lows.

Figure 1: S&P 500, 5YR Investment Grade CDS & Quantitative Easing Rounds



The themes we outlined in April and in subsequent commentaries continue today. With the FOMC's most recent announcement of its intention to institute another round of quantitative easing (QE III), the markets now enter yet another period of sustained central bank intervention and monetary accommodation—a period that could be poised to be the FOMC's most aggressive to date. Yet, it is significant to note that the FOMC has never initiated a new round of quantitative easing with prices of risk assets at such lofty levels. The S&P 500 (near five year highs) is up 16.44% year to date and U.S. Treasury rates across the curve remain near all-time lows. The question on many investors' minds is why the Fed has chosen to act now, and what effect, if any, will this recent policy announcement have on the continued performance of risk assets for the remainder of the year?

The Convexity of Credit Explained

The "convexity of credit" as outlined in our April commentary is our view that credit assets in the current environment will perform as expected in a positive economic scenario and better than expected in a negative economic scenario due to central bank intervention. We

October 2012

US Treasuries

As of 28-Sep

Benchmark	Yield
3 Month	0.09%
6 Month	0.13%
1 Year	0.15%
2 Year	0.23%
5 Year	0.63%
10 Year	1.63%
30 Year	2.82%

Bank of America/Merrill Lynch Indexes

31-Aug to 28-Sep

Index	Return
1-3 Yr Gov/Corp ≥ A	0.08%
1-3 Yr Municipals	0.10%
1-3 Yr Agencies	0.04%
0-3 Month UST	0.01%
S&P 500	2.58%

Contact Us

www.ClearwaterAdvisors.com

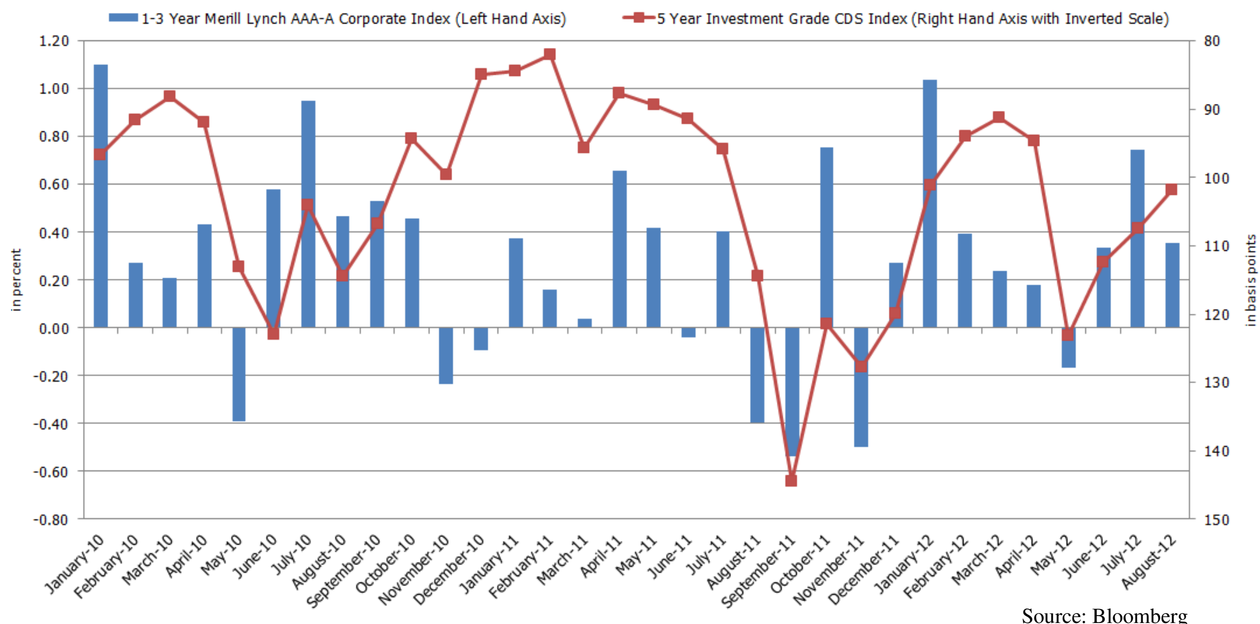
Trading@ClearwaterAdvisors.com

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

compared this idea to performance characteristics of a putable bond, where the holder of a bond benefits in market strength and has added protection (an option to "put back" the bond to the issuer when bond prices decrease in value) in times of market weakness.

Since April, we have observed that global central banks remain willing to provide monetary accommodation when credit conditions show signs of vulnerability. A prominent example is the European Central Bank's (ECB) recent proposal to initiate an unlimited sovereign-bond buying program for its Eurozone members. The aim of the program is to ease funding pressures on Eurozone sovereigns, such as Spain and Italy, which have been periodically locked out of the term funding markets. Rumors that such a program was being vetted by European monetary officials were the primary catalyst for the impressive rally in credit spreads this summer. The 0.75% monthly return in July for the *1-3 Year Merrill Lynch AAA-A Corporate Index* was the third best monthly return in two years.

Figure 2: Merrill Lynch 1-3 YR Corporate AAA-A Index vs. Investment Grade 5YR CDS Index



Source: Bloomberg

The practice of global central banks instituting "unlimited" and "indefinite" accommodative policies has become increasingly common. In addition to lengthening its pledge to keep the Fed Funds Target Rate exceptionally low into mid-2015, the Federal Reserve in its September policy statement committed to purchasing an additional $40 billion of mortgage-backed securities monthly to supplement the purchasing activities of "Operation Twist" and the reinvestment of maturities and pay downs of securities purchased under prior rounds of quantitative easing. The Federal Reserve has indicated—in a clear departure from prior rounds of asset purchases—that these new MBS purchases will continue indefinitely until the labor market "improves substantially." How long that will take is anyone's guess, even for the members of the FOMC.

Figure 3: Federal Reserve Rounds of Quantitative Easing

Policy Action	Monthly Commitment	Time Frame
Quantitative Easing Round 1	$100 Billion	2008-2009
Quantitative Easing Round 2	$75 Billion	2010-2011
Quantitative Easing Round 2.5 (a.k.a. "QE Lite")	$20-30 Billion	2010
"Operation Twist"	$45 Billion	2011
Quantitative Easing Round 3	$40 Billion	Indefinite

Source: Reuters

Ben Bernanke has long advocated that "central bankers alone cannot solve the world's economic problems." This belief, however, has not stopped Chairman Bernanke and his colleagues from trying to do so with increasing interventionism. The

law of diminishing returns tells us that global central banks' ever-aggressive strategy to spur economic growth should prove less effective with each passing action. The fact that the Federal Reserve now feels compelled to commit an indefinite amount of funds for an indefinite period of time confirms the fact that policy makers are acutely aware of their diminishing ability to buoy a sputtering economic recovery.

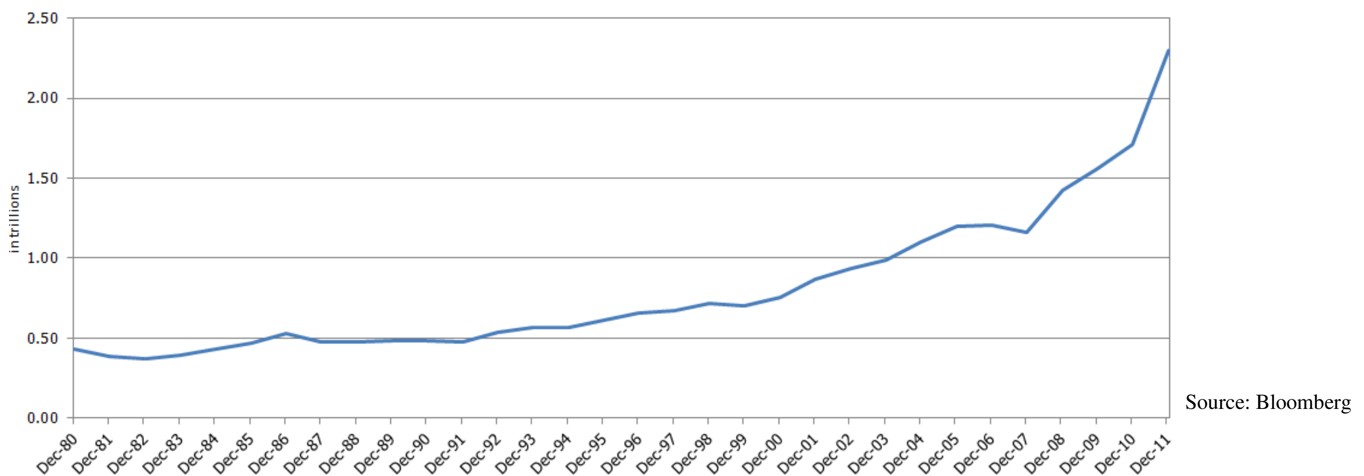
While it is true that each progressive policy action by the FOMC appears to be accompanied with diminishing returns in achieving the Fed's stated goal of improving the labor market, it has been wildly successful in driving the prices of risk assets to new highs. Even with the prices of risk assets at current lofty levels, investors should not lose faith in the continued ability of Chairman Bernanke to drive asset prices higher. If we are to deduce one thing from our four-year experience in operating in an unprecedented period of central bank intervention it is this: Don't Fight the Fed.

In each instance of Fed interventionism relating to asset purchases, equity prices have risen and credit spreads have compressed. We have no reason to believe that this round—which has no limit on the amount of money the Fed could inject to buoy asset prices—will result in a different outcome. As a result, we recommend that short-duration investors continue to seek high-grade credits with attractive carry and roll-down characteristics with the anticipation that credit continues to perform admirably despite recent gains. The opportunity cost of being underweight credit in this absolute low-rate environment warrants that investors stay the course despite the potential for short-term credit spread volatility.

Expiration of the TAG Program

Central bank intervention (including periods of non-intervention) has been the main driver of asset prices in 2012, but it has not been the only driver. Exceptionally low interest rates and the supply and demand imbalance of short high-quality paper have investors unabashedly reaching for yield. Another key driver of short money market rates could occur in the coming months with the scheduled expiration at the end of 2012 of the FDIC's Transaction Account Guarantee (TAG) Program. While this issue does not seem to garner as much attention as money market fund reform has in past months, the TAG program's expiration has the potential to affect nearly the same amount of assets as money market reform ($2.2 trillion for non-interest bank deposits vs. $2.6 trillion for money funds). We believe that the implications on the money markets could prove significant, and investors should look now to employ strategies to capitalize on the coming announcements of the program's future.

Figure 4: Growth of Non-interest Bearing Demand Deposit Accounts at U.S. Commercial Banks

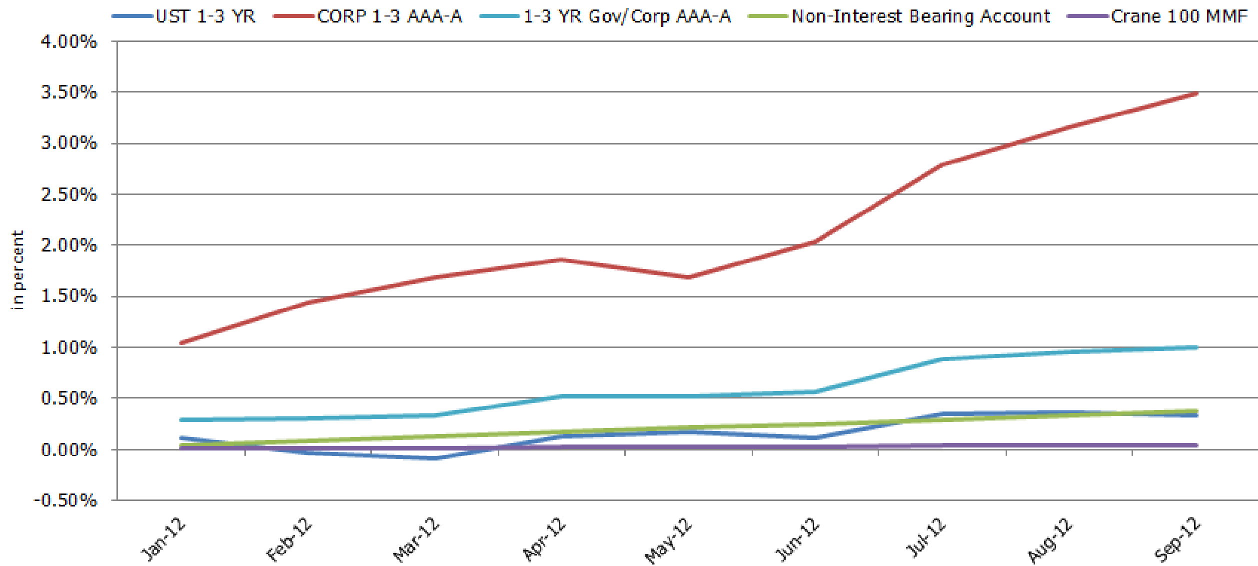


Source: Bloomberg

The TAG program was instituted by the FDIC in 2009 at the height of the U.S. credit crisis to allow corporations access to unlimited FDIC insurance on funds sitting in non-interest bearing demand deposit accounts. The growth of these accounts—which has been at the expense of other stable NAV products like money market funds—shows that corporations remain hesitant to seek higher yielding, non-stable alternatives given headlines in Europe.

Investors parked in non-interest bearing accounts place an inordinate premium on FDIC insurance in an environment where the probability of domestic bank defaults are near five year lows. They have missed the duration boom on the back of the Federal Reserve's massive asset purchase programs, the carry and roll-down performance or credit assets due to favorable supply and demand dynamics and attractive relative value versus alternative sectors and investment vehicles (Refer to Figure 5 for comparison of year-to-date investment returns assuming a generous 50 bp earned credit on non-interest bearing demand accounts).

Figure 5: Cumulative Returns of Various Investment Vehicles and Indices



Source: Bloomberg

Attractive investing opportunities in the short-duration universe still exist, but the trade could become increasingly crowded if the TAG program is not extended as many analysts anticipate. With over $2.2 trillion dollars currently in non-interest bearing accounts, a complete or systematic expiration—allowing an opt-out period for banks—of the program will likely cause money to flow en masse into commercial paper, certificates of deposits, treasury, agency and repo putting immense downward pressure on short-end rates. The yields of money market funds will not be immune to this pressure as funds are the largest purchasers of these short-duration products.

Investors should seek to wean off their dependence of bank deposits lest they are forced to seek investment alternatives at the most inopportune time. The likelihood that banks will opt out of the TAG program if given the option is very high given the onerous cost to pay the FDIC deposit insurance on these large balances. Non-interest bearing deposits hold little benefit of return-potential and marginal benefits of liquidity when compared with alternative investment vehicles such as index-benchmarked, separately-managed portfolios. As a stable-NAV vehicle with an FDIC guarantee, principal preservation in bank deposits is unquestioned, but fares poorly against the hidden cost of inflation. Over a longer period of 2-3 years where credit has continued to remain in favor, this give up in performance has been very costly.

Looking Forward

Past rounds of quantitative easing and periods of imbalanced supply and demand for high-grade paper have proven a boon to investors who are willing to be proactive. Quantitative Easing III will be a catalyst to drive asset prices even higher despite recent impressive gains in credit assets. The indefinite nature of the Fed's recent announcement shows a strong willingness and ability to support markets in times of vulnerability. Despite diminishing returns with each progressive action, the market has not yet experienced fatigue over the Federal Reserve's policies, and investors would be wise to not "Fight the Fed." The "carry and roll" strategy in high-grade credits, as we outlined in past commentaries, will continue to be the primary driver for portfolio performance for the remainder of the year.

Uncertainty concerning the TAG program's expiration also presents opportunities for short-duration investors to be proactive by exiting low-yielding (as measured by earned credits) bank deposits and migrate into higher yielding alternatives. Sustained central bank intervention and the FDIC's willingness to let the program expire gradually or entirely is strong evidence that credit conditions have improved immensely from when the program was first initiated in 2009.

For strategies on how to best take advantage of these recent and coming market developments, please feel free to contact the desk.

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