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MARKET Commentary

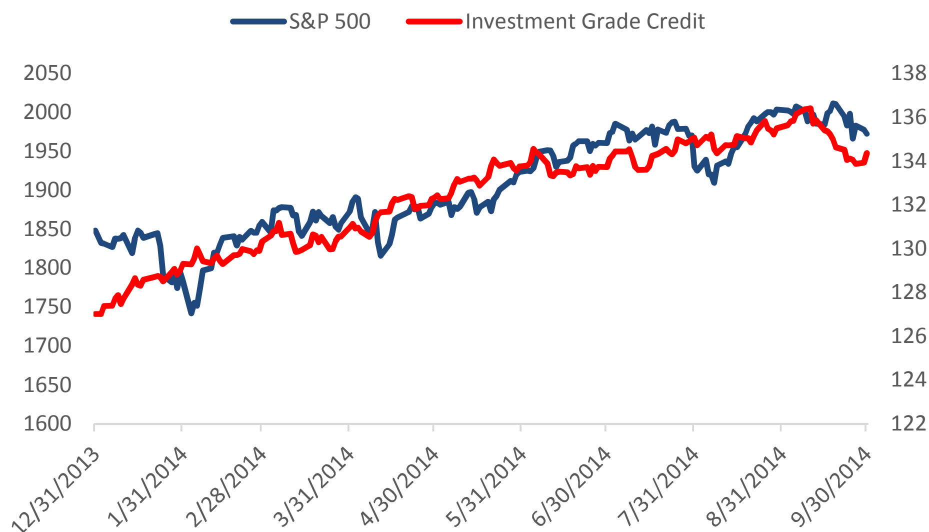
Fall 2014

The Home Stretch

The risk-on attitude that prevailed for most of the year faltered as the third quarter came to a close. Risk assets sold off and U.S. Treasury yields rose modestly on a combination of rising geopolitical risks and monetary policy uncertainty (See Figure 1). Still, year-to-date performance has rewarded duration and investment grade credit exposure. We expect credit to hold its advantage while duration could come under pressure as the year closes.

The Federal Reserve is on schedule to curtail its large-scale asset purchases after the October meeting thus ending a $3.5+ trillion expansion of its balance sheet that started in September 2008. The Fed then enters a transitory phase of managing market expectations into the first rate hike next year. This phase will likely introduce volatility as economic data comes in above/below expectations and Fed officials comment on future policy moves. In this quarter's commentary we will examine the Fed's exit policy and its effect on markets as well as providing updates on the GSE's and money market funds.

Figure 1: S&P 500 and Investment Grade Credit (Year-to-Date)



Source: Bloomberg

End of an Era

The rapid balance sheet expansion undertaken by the Federal Reserve will likely conclude at the end of October. The Fed has disclosed that it will continue to reinvest maturities

US Treasuries

As of 30-Sept

Benchmark	Yield
3 Month	0.01%
6 Month	0.03%
1 Year	0.10%
2 Year	0.59%
5 Year	1.77%
10 Year	2.50%
30 Year	3.21%

Bank of America/Merrill Lynch Indexes

Q3, 30-Jun to 30-Sept

Index	Return
1-3 Yr Gov/Corp ≥ A	0.03%
1-3 Yr Municipals	0.12%
1-3 Yr Agencies	0.07%
0-3 Month UST	0.01%
S&P 500	1.13%

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

and pay-downs maintaining its balance sheet size at least through the first rate hike. After which, it expects to allow its bloated balance sheet to organically shrink via maturities and principal payments to pre-crisis levels by the end of the decade. As the Fed begins the process to normalize monetary policy, it will utilize several tools to ensure control over short-term interest rates. The primary tools include:

- *Reverse Repo Program (RRP) Rate* – A temporary program for money funds and other non-banks to help set a floor on rates. The Fed pays interest on excess reserves held away from banks. Eligible institutions include money market funds and government sponsored entities.
- *Federal Funds* – The traditional tool for setting monetary policy. The Fed will likely hike rates gradually beginning around the third quarter of next year.
- *Interest on Excess Reserves (IOER)* – The rate the Fed pays to depository institutions on excess reserve balances. This rate will serve as the upper band for short-term rates. Given the massive amount of excess reserves, this rate will be the primary tool to set rates during policy normalization.

Until the Fed begins to raise rates, yields on securities maturing inside one year will remain very low. Quarter-end and year-end will continue to see negative T-bill rates as demand outstrips supply. Therefore, having duration and credit-constraint flexibility will continue to offer meaningful value (see Figure 2). We recommend select lower-rated corporate issuers as well as taking advantage of the very steep yield curve as both offer buffers to a potential rise in rates.

Figure 2: Quarter-End Market Yields

	U.S. Treasury	A-Rated Credit	BBB-Rated Credit
90 Day	0.01%	0.12%	0.25%
1 Year	0.11%	0.33%	0.55%
2 Year	0.50%	0.82%	1.15%
3 Year	0.98%	1.45%	1.84%

Source: Clearwater & Bloomberg

The Global View

Domestic economic activity should continue to improve while overseas developed markets, specifically Europe and Japan, and emerging markets look to be on uncertain footing heading into the closing quarter. The U.S. will become the primary driver of global economic activity moving forward while the Eurozone teeters on the edge of a recession and disinflation. The European Central Bank (ECB) announced purchases of asset-backed securities and covered bonds, but those efforts don't appear up to task given the weak economic picture. Furthermore, markets are questioning the ECB's commitment and Eurozone sovereign yields continue to fall reflective of diminished economic and low to negative inflation expectations. This dynamic will play out against U.S monetary policy that is becoming gradually less accommodative.

While uneven economic data and geopolitical risk increase market volatility, global disinflationary forces and low domestic inflation give the Fed ample runway until Fed Funds liftoff.

Fannie and Freddie Update

Fannie Mae and Freddie Mac's status as wards of the federal government is unlikely to change anytime soon. Recently, two shareholder activist lawsuits have been dismissed or decided in the favor of the U.S. Treasury and

the Federal Housing Finance Agency thwarting equity-holder attempts to return capital to the entities. Both stocks cratered on the news. As we have stated in past commentaries, even lacking an explicit guarantee we do not expect any fundamental credit degradation in either firm. Furthermore, headline risks have declined materially which should be further supportive of low spreads to Treasuries.

Money Market Reform Reminder

The Securities Exchange Committee (SEC) approved rules aimed at reducing the susceptibility of institutional money funds to runs during periods of financial stress and increasing the transparency of risk in money market funds. 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.
- Additional disclosure requirements for money market funds such as daily holdings reports, historic instances of sponsor support, and new material events.
- Amendments to enhance fund diversification, stress testing and reporting requirements to improve the risk profile of money funds.

Treasury Solutions found that 79% of treasurers would either decrease or discontinue their investments in money funds with a floating NAV leading to a 61% decline in money fund assets. Similarly, Barclays has estimated that 40% of prime institutional fund assets will exit into other options. Investors have started to move. Since August, according to JP Morgan, government money market fund assets are up almost 7% even as yields on those funds are barely positive. The compliance date for the floating NAV and fees and gates amendments is October 2016. This timeline gives Treasury staff a window to evaluate and execute suitably attractive alternative investments.

Looking Forward

Domestic economic activity should continue to improve. Coupled with evolving accommodative global central bank policy, we remain overweight select spread sectors. Weaker growth abroad (specifically in Europe) bears monitoring and may temper the rise in rates here in the U.S. Furthermore, with large-scale asset purchases winding down, the Federal Reserve enters a new phase of managing market expectations into the first rate hike which will likely introduce volatility as economic data exceeds and/or falls short of expectations. Major dislocations should be viewed opportunistically.

Please contact the desk with questions or to discuss investment opportunities and how to best navigate today's investment environment.

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