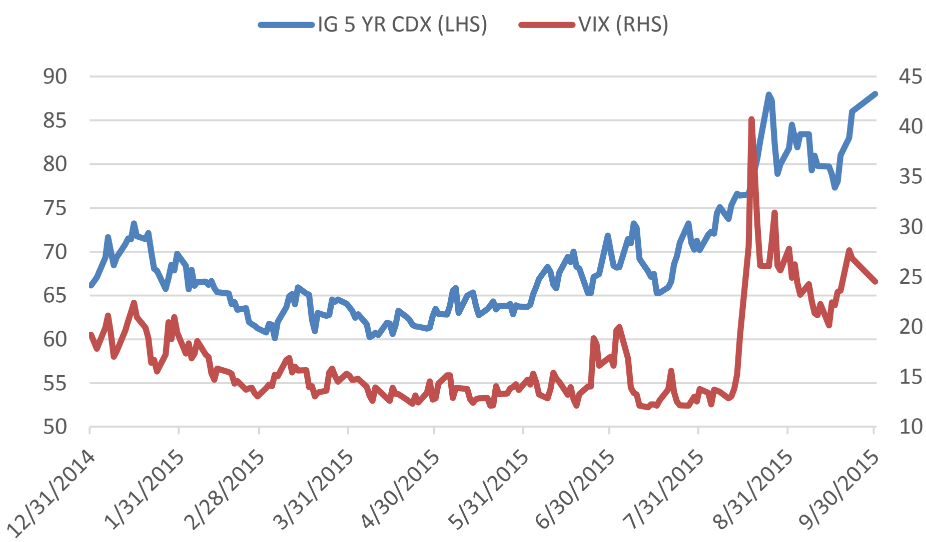
MARKET Commentary

Lower for Longer

Fall 2015

Global events shook markets testing the resolve of the Federal Reserve (Fed). Risk assets shuddered mid-quarter after China unexpectedly devalued their currency. Concerns over the strength of China's economy fueled a bout of risk aversion that spilled over into developed markets. The "Fear Index" or VIX spiked to levels not seen since 2011 when it looked like the Eurozone might fall apart (see Figure 1). Investment grade credit spreads widened in sympathy with the sell-off in equities closing the quarter at year-to-date highs. Commodity prices continued to come under pressure as well with oil declining 24% over the quarter (down 50% since 09/30/14). Energy and metals/mining sectors are stressed especially in the high yield space.

Figure 1: Risk Aversion Resurfaces



Source: Bloomberg

U.S. Treasury yields inside two years to maturity were basically unchanged while yields beyond moved significantly lower on the quarter. The yield curve bull-flattened as two-year Treasury yields decreased 1bp while the thirty-year Treasury yield declined 25 bps. On the quarter, performance rewarded long duration and the highest quality issuer exposure.

The U.S. economy gathered momentum heading into Q3 setting the stage for monetary policy normalization. However, the Fed passed citing "recent global economic and financial developments". Given U.S. monetary policy uncertainty and downside risks in the global economy, expect more volatility into year-end.

Monetary Policy Conundrum

Global events have complicated the case for the Federal Reserve. The September Federal Open Market Committee (FOMC) statement referenced global weakness and

US Treasuries

As of 30-September

Benchmark	Yield
3 Month	0.00%
6 Month	0.07%
1 Year	0.31%
2 Year	0.64%
5 Year	1.37%
10 Year	2.05%
30 Year	2.87%

Bank of America/Merrill Lynch Index Returns

Q3, 30-June to 30-September

Index	Return
1-3 Yr Gov/Corp ≥ A	0.33%
1-3 Yr Municipals	0.57%
1-3 Yr Agencies	0.36%
0-3 Month UST	0.01%
S&P 500	-6.43%

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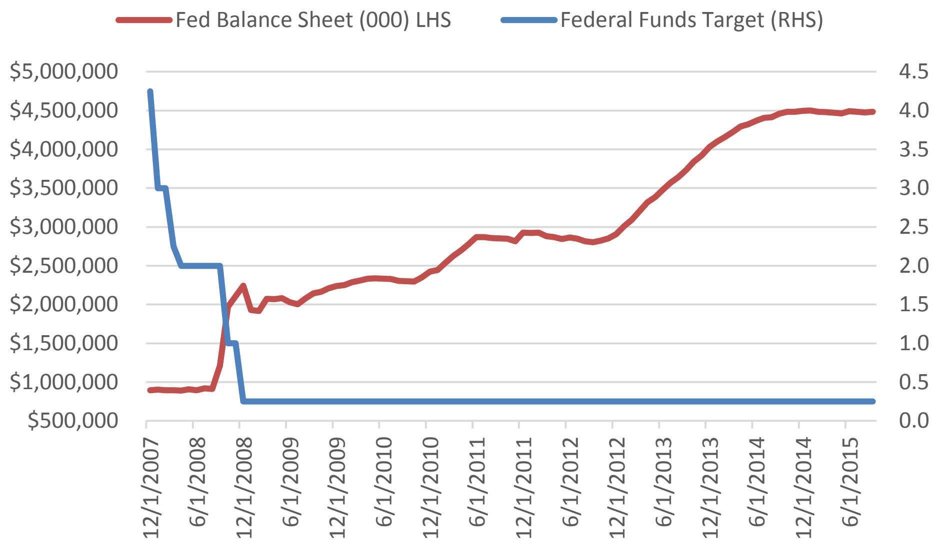
Source: British Bankers' Association, Federal Reserve, US Treasury, Bloomberg, Barclays, BofA/ML, and S&P

noted that the Fed "is monitoring developments abroad". Diminished global economic growth prospects, centered on China, coupled with a weak inflation outlook prompted the Fed to remain on hold even as the U.S. employment picture firms. Fed Funds remains at 0-25bps and the Fed's bloated balance sheet continues to hold steady at $4.5 trillion (see Figure 2).

Figure 2: U.S. Monetary Policy



Source: Bloomberg

Further, the Fed released revised forecasts for several economic data points that showed less confidence in the strength of the U.S. economy in the future. Therefore, not only did the Fed pass but did so with dovish sentiment. Markets reacted quickly, pushing expectations for the first hike well into 2016 as indicated by fed funds futures. Fed officials, including Chairwoman Yellen, attempted to manage expectations the week following by stating that they still expected to hike in 2015. Investors were nonplussed.

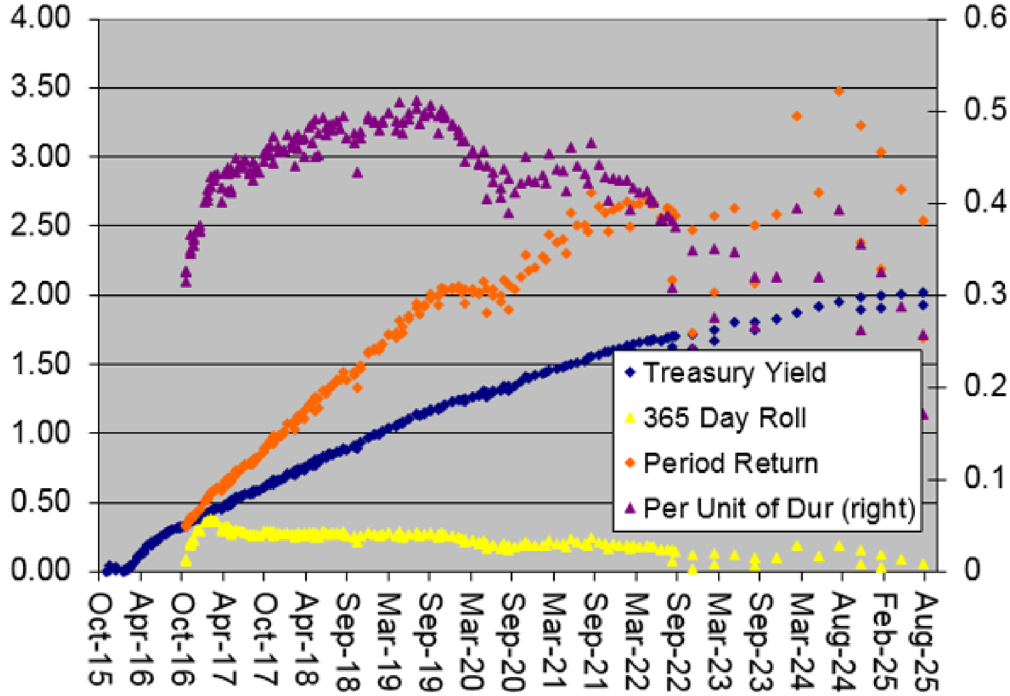
The October meeting is largely off the table with just an 8% chance – a sentiment with which we agree. The futures market shows just a 32% probability of a hike in December while we'd handicap the last meeting of 2015 at even odds. March 2016 is the first instance where the probability rises above 50% (currently, 55%). Needless to say, there is a significant disconnect between Fed and market expectations that will need to be reconciled in the coming months leading to heightened volatility. Additionally, the Fed's communication strategy and credibility is coming under pressure which only adds to the uncertainty.

Investment Environment

The undetermined monetary policy backdrop and global turmoil has created investment opportunities. High grade corporate securities trade at some of the widest spreads since the financial crisis. However, leverage is increasing and idiosyncratic risk (M&A, shareholder rewards, corporate structure shake-ups, etc.) is high warranting careful credit selection. AAA-rated asset-backed securities trade at historically attractive levels as well. Credit card and automobile sub-sectors offer a significant yield pick-up to other highly rated alternatives. Further, the primary market is expected to be robust leading into the Thanksgiving holiday providing ample opportunity to take advantage of new issue concessions in each space.

In rates, it pays to be selective. The following graph (Figure 3) illustrates the U.S. Treasury yield curve out to ten years to maturity (blue diamonds). The one-year roll (yellow diamonds) peaks just beyond one year to maturity due to the steepness of the curve in the money market space. However, examining total return (income and roll) per unit of duration (purple triangles), the curve between two and four years to maturity looks fairly attractive.

Figure 3: U.S. Treasury Yield Curve



Source: Clearwater Advisors

This chart is one of the many tools we use to screen for value offered by the market. As the Fed looks to move off of zero, each economic data point and FOMC meeting/communication impacts the market differently creating new opportunities, requiring constant vigilance. Each portfolio manager then looks to position client portfolios to take advantage of these opportunities within their policy limits.

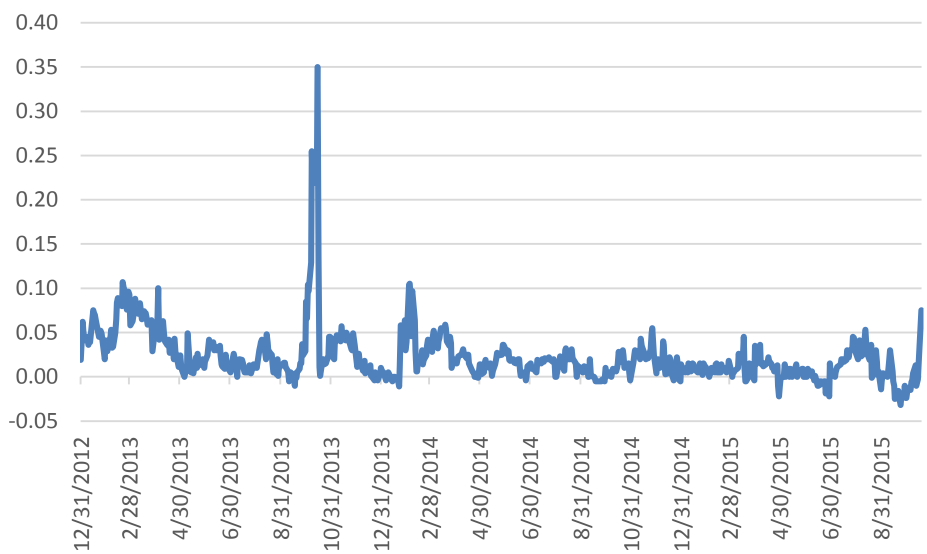
Finally, as we enter the final quarter of the year, it's a good time to revisit policy constraints to ensure your portfolio can take advantage of the proper opportunity set for your firm's risk level.

The Debt Ceiling

On the domestic front, the debt ceiling is quickly becoming an issue again. The U.S. Treasury is currently undertaking "extraordinary measures" to fund the government. According to U.S. Treasury Secretary Lew, these actions will be exhausted on November 3rd, leaving the government unable to pay its bills after that date and introducing the possibility of a government shutdown and/or technical default.

Money markets haven't hit the panic button just yet. Treasury yields on securities maturing in November are beginning to rise from close to zero, but are not indicative of the significant stress last seen during the government shutdown surrounding the most recent debt ceiling debate in October, 2013 (Figure 4). Outgoing House Speaker Boehner has indicated a desire to pass a straightforward bill to address the debt ceiling and has given up on a broader budget compromise.

Figure 4: U.S. 1-Month T-Bill Yield



Source: Bloomberg

The political rhetoric is beginning to heat up as conservative leaders stress the need for significant spending reform as part of any debt ceiling agreement. However, we expect cooler heads will prevail and resolve the situation, but are closely monitoring the politically-charged situation.

Looking Forward

The outlook for domestic monetary policy is highly uncertain as we enter the final months of 2015. Further complicating matters, year-end liquidity is usually poor and markets thin due to seasonal holidays. Once the Fed decides to move, rate increases will be slow and steady as they do not wish to derail growth. A slow transition to more normal policy should prove to be a favorable environment for Clearwater clients as reinvestment rates increase and spread sectors cushion the impact. Further, as the deadline to money market reform (October, 2016) quickly approaches we expect to see market dislocations from money fund changes that will prove advantageous as well.

Please contact the desk with questions or to discuss investment opportunities on how to best navigate today's ever-evolving market environment.

Form ADV Part II

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