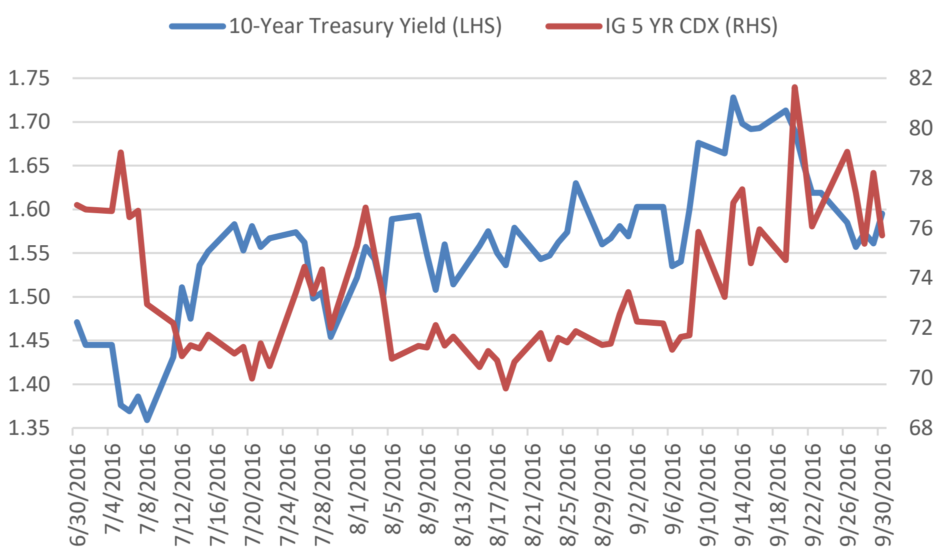
MARKET Commentary

Prime Time

Fall 2016

Markets spent much of the third quarter unwinding the risk-off move experienced post-Brexit vote while casting a wary eye on global central banks. The ten-year U.S Treasury yield touched an all-time low of 1.37% in early July on European Union break-up risk aversion and steadily rose into quarter-end briefly spiking to 1.73% ahead of the September Federal Reserve FOMC meeting before settling in at 1.60% to close the quarter (see Figure 1). Investment grade credit traded in a fairly narrow band finishing the quarter almost unchanged.

Figure 1: Markets Tread Water



Source: Bloomberg

Much of the quarter's market action was bookended around a quiet August that saw very little volatility across domestic markets. Investment grade corporations took advantage by issuing a record level of new debt ($112B) for the month.

Global central bank policy will be the dominant force for the balance of 2016. Easy policy overseas is countered by a potential hike domestically. Economic data and Fedspeak will weigh on markets contributing to volatility. Further, the U.S. presidential election should provide an entertaining backdrop to what could be a bumpy ride into year-end.

Money Market Reform Is Here

Money market reform rules go into effect on October 14th ending an era for yield-seeking money fund investors. Institutional prime funds will be required to transact

US Treasuries

As of 30-September

Benchmark	Yield
3 Month	0.27%
6 Month	0.43%
1 Year	0.59%
2 Year	0.76%
5 Year	1.15%
10 Year	1.59%
30 Year	2.32%

Bank of America/Merrill Lynch Index Returns

Q3, 30-June to 30-September

Index	Return
1-3 Yr Gov/Corp ≥ A	-0.04%
1-3 Yr Municipals	-0.18%
1-3 Yr Agencies	0.03%
0-3 Month UST	0.07%
S&P 500	3.85%

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

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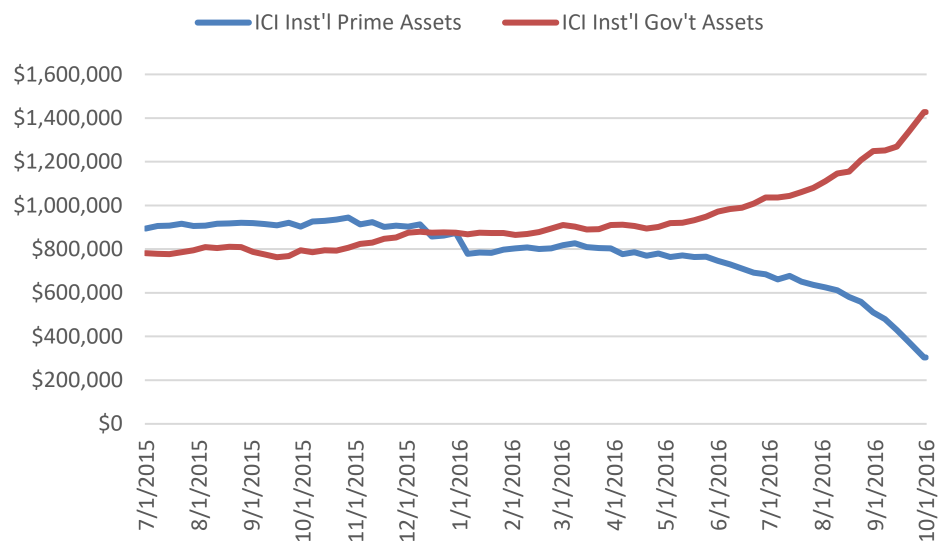
at a floating, market-based net asset value (NAV) while all non-government money market funds will be able to use liquidity fees (up to a 2% fee on redemptions) and redemption gates (a temporary suspension of redemptions) in certain market circumstances. Due to the material regulatory impact, institutional prime funds continue to experience outflows with government funds being the primary beneficiary (see Figure 2).

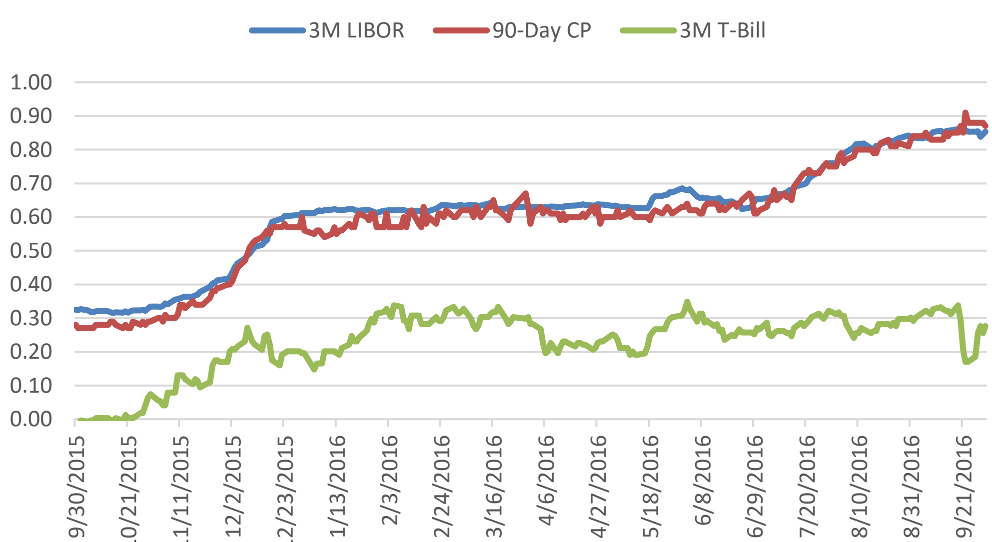
Figure 2: Money Market Fund Balances ($ Mil)



Source: Bloomberg

Given the exodus of clients, prime money fund managers are maintaining exceptional liquidity with weighted average maturities touching nine days at quarter-end (according to Wells Fargo). The conservative portfolio positioning coupled with the significant decline in prime assets (down from about $900 billion at the beginning of the year) have created dislocations in the money markets. LIBOR measures and commercial paper yields have risen appreciably (see Figure 3) offering attractive opportunities for investors with modest investment policy flexibility.

Figure 3: Money Market Dislocation



Source: Bloomberg

Government funds may be the best interim stable-NAV option to park funds, but the opportunity cost (inst'l government funds yield around 0.26%, according to iMoneyNet data) over the intermediate-term should incentivize investors to seek alternatives. Further, meager prime fund yields offer little compensation given the material changes to their structure adding further value to the added flexibility and transparency of a separately managed account (SMA).

Presidential Race

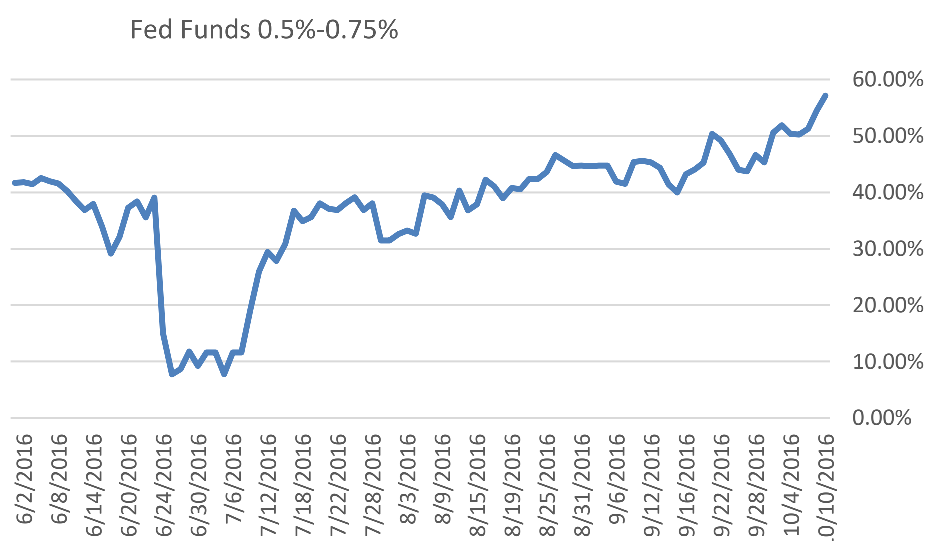
Geopolitical risk took center stage early this past quarter as the British voted to exit the European Union and will rise again in less than a month as U.S. voters head to the polls on November 8th to elect our next president. A Trump win would roil markets given his Federal Reserve ranting and the "unknown quantity" aspect his presidency would bring while a Clinton win would represent greater policy continuity. Either way, the rhetoric will only increase over the last few weeks of a sadly entertaining election season.

In addition, there are 34 Senate seats and all of the House up for grabs with a disenfranchised electorate that have led to volatile polls presenting difficulty handicapping races. Split control of Congress and the White House is the most likely scenario offered by political pundits – an outcome closest to the status quo placating markets. We are closely monitoring the results and will look to position portfolios accordingly and take advantage of any market dislocations that may occur.

Central Bank Risk

Fed fund futures indicate close to a 60% probability of a hike in December, significantly better than the 8% likelihood we saw immediately after the Brexit vote. Federal Reserve officials will look to maintain an implied probability around or above 50% heading into their December meeting.

Figure 3: Fed Funds Futures (Implied Probability)
December FOMC Meeting



Source: Bloomberg

The November 2nd FOMC meeting, while considered "live", is pretty much a non-contender as it falls the week before Election Day. Therefore, a hike in December looks likely provided markets don't riot in the meantime and the economic data continues to come in as expected. Further, unlike last year's December hike, expect the Fed to communicate a modest hiking pace, possibly two hikes in 2017, rather than last year's aggressive four hike forecast. Modest economic growth coupled with a reluctant Fed should lead to an orderly rise in rates which shouldn't lead to market tantrums. Therefore, fixed income investors will have the opportunity to reinvest at higher yields while risk assets continue to enjoy monetary policy support.

Overseas, central banks in the UK, Japan and Europe will spend a combined $506B on asset purchases over the final three months of the year. Questions about the efficacy and potential harm of asset purchase programs are beginning to increase in tandem with market dependency on further accommodative policy in those markets. Any hint at a policy pull back will pressure global yields as little downside risk is priced into markets.

Looking Forward

The journey to close 2016 faces several hurdles – a contentious U.S.national election, the prospect of a Fed rate increase, underwhelming central bank policy action overseas, renewed Brexit headline risk, to highlight a few. Further, European bank health questions resurfaced recently as Deutsche Bank was hit by headlines that the Department of Justice (DOJ) was initially seeking penalties around $14B for the bank's role in the residential mortgage lending meltdown. The bank is in the midst of restructuring its business amid a difficult operating environment and media headlines drew comparisons to Lehman (an unfair assertion, in our opinion). The most severe market pressure has passed, but until an agreement is reached with the DOJ we expect continued volatility. European banks are several years behind the U.S. in balance sheet repair, but are in far better shape than in 2008.

Money market rules are here and market impacts are providing opportunities for investors that have even modest policy flexibility. LIBOR is rising and commercial paper yields have risen from earlier in the year. SMAs can take advantage of these market dislocations without many of the negative characteristics of a money fund. Further, if you have excess liquidity in a government fund or bank deposit, there are attractive investments within three months to maturity that bear consideration.

Please contact the desk with questions or to discuss investment opportunities best suited to navigate the rest of this year's uncertain and volatile market environment.

Form ADV Part II

Clearwater Advisor's annual Form ADV Part II disclosure is available to clients upon request. To make a request please email Compliance@ClearwaterAdvisors.com or call Tim Dunn at 208-433-1222.

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