MARKET Commentary

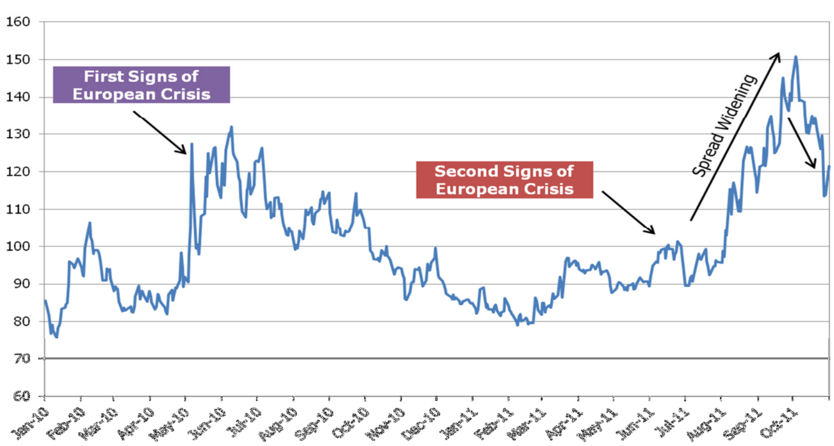
Jumping Over Dollars for Dimes

October's return for the S&P 500 of 10.93 percent—ranking among its best 10 months since 1950—would seem phenomenal if not preceded by one of the worst quarterly declines in recent memory. The market euphoria over the recent performance of risk assets, driven by optimism surrounding the resolution to the Greek debt crisis, seems strange when viewed in the context of the broader economic landscape (underlying macro- and micro-economic fundamentals point to continued weakness). In a market dominated by unpredictable volatility, investors should focus their efforts on identifying credit stories that provide both protection in bad times and participation in good times. A defensive credit overweight will allow investors to navigate future volatility as the European debt crisis continues to unfold in an exceptionally low interest rate environment expected to last well into 2013.

Remain Cautious on Europe

The appetite for risk assets in October has been driven primarily by encouraging headlines in Europe. Eurozone policymakers have scrambled to structure a rescue package to stave off a potential Greek default, the consequences of which have been forecast by analysts to range from financial Armageddon to a complete non-event. The most recent solution proposed by European policymakers to remedy the Greek drama involves offering leverage through the European Financial Stability Fund to purchase and provide guarantees on sovereign debt of troubled countries while forcing banks to "voluntarily" assume 50 percent losses on Greek sovereign debt.

Figure 1: 5YR IG Credit Spreads Have Not Returned to Pre-crisis Levels



Source: Bloomberg

To their detriment, global policymakers have shown a propensity to throw private capital under the bus to protect their own interest—we note that under the "voluntary" agreement by private banks to undertake debt losses on Greek debt, neither the European Central Bank (ECB) nor International Monetary Fund (IMF) will assume any losses on Greek debt they hold. In addition, since the act is "voluntary,"

November 2011

US Treasuries

As of 31-Oct

Benchmark	Yield
3 Month	-0.02%
6 Month	0.04%
1 Year	0.11%
2 Year	0.24%
5 Year	0.96%
10 Year	2.11%
30 Year	3.13%

Bank of America/Merrill Lynch Indexes

30-Sept to 31-Oct

Index	Return
1-3 Yr Gov/Corp ≥ A	0.19%
1-3 Yr Municipals	-0 10%
1-3 Yr Agencies	0.08%
0-3 Month UST	0.00%
S&P 500	10.92%

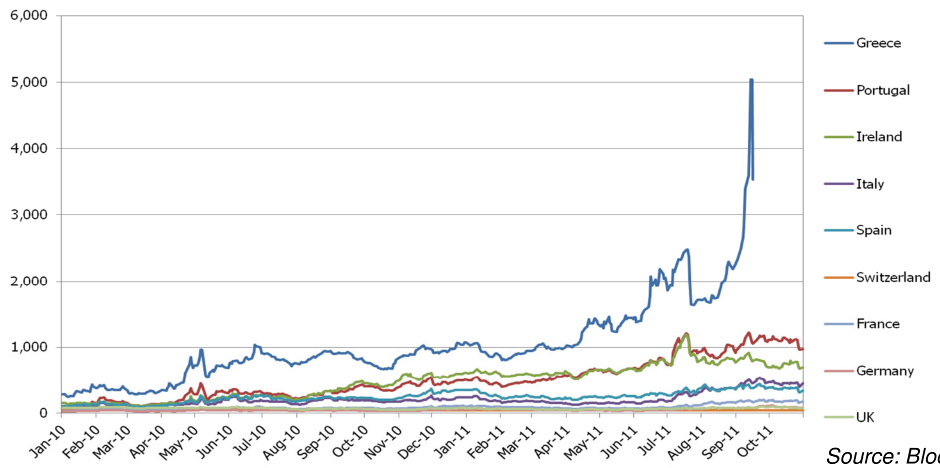
Contact Us

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 the triggers for credit default swaps are circumvented, punishing private investors who prudently hedged their risks in the case of such an event. This undermining of contract law will derail any effort to solve the Greek debt crisis effectively through the proposed rescue mechanisms. The actions of European officials have proven that legal provisions to protect private capital mean little when they choose to protect their own interests.

The Greeks, however, through an on-again, off-again referendum vote to the proposed EU rescue plan, may very well provide finality to the crisis in an expedited manner. Plans to move forward with the referendum vote would threaten the payment schedule (the next installment is €9 billion due November) under the original rescue plan and trigger a good old-fashion default—as opposed to the pseudo-default structured by European officials. A referendum vote to reject the rescue package may also be the catalyst to push Greece out of the Euro and back to its former currency, the Drachma. Rescue package or not, the Greece drama will end as a tragedy for bond holders, and the EU should focus its efforts on structuring a rescue plan for more systemically important countries like Italy and Spain so as to avoid a larger global financial crisis.

Figure 2: The Widening Trend Among European Sovereigns Continues



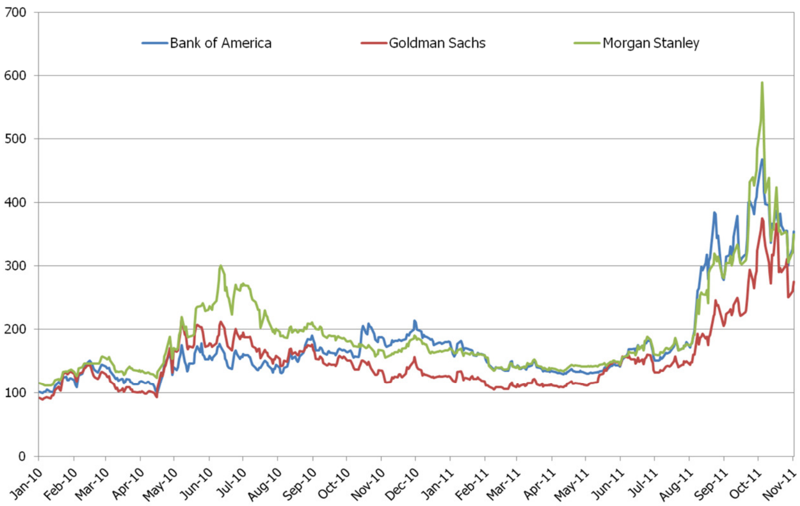
Source: Bloomberg

The fundamental issue, which we have highlighted in past commentaries, lies in the inability of sovereign governments and financial institutions to stabilize and support both themselves and each other simultaneously. This challenge cannot be overcome with midnight rescue packages aimed to provide sovereigns and banks with funding to survive the next day, week or month. The solution requires long-term plans for deficit reduction, deleveraging and structural rebalancing. A debt forgiveness plan like that proposed for Greece is not feasible for the other troubled sovereigns (Italy and Spain) given the current lack of resources. The resolve of governmental policymakers and financial institutions to undertake the steps necessary to accepting the immediate pain to shore up fiscal houses and balance sheets remains questionable at best. "Pretend and extend" continues to be in vogue in Europe; for this reason, we remain extremely cautious of European sovereign and bank debt.

Risk-On, Risk-Off

Since the risk-on trade began in earnest in the beginning of October, we find little evidence to support the market sentiment that credit conditions have improved fundamentally. Financial institutions have been able to book quarterly profits largely attributed to extraordinary items and accounting gimmickry. The most egregious is the provision for Credit Valuation Adjustments (CVAs), which allows banks to book profits when the value of their liabilities declines due to market volatility and rising funding costs. As a recent Wall Street Journal article highlighted regarding this practice, "since banks book them [CVA gains] as their own debt loses value, a firm would theoretically mint money while going bankrupt."

Figure 3: 5YR CDS of High-beta Names (Bank of America, Goldman and Morgan Stanley)



Source: Bloomberg

Weak top line earnings and the first rise in over two years in the percentage of delinquent loans on banks' balance sheets have not stopped the domestic banks from significant outperformance in October. Feeling satisfied about the recent gains in high-beta names, however, is comparable to jumping over dollars to pick up dimes. The outperformance in financials only makes sense if you consider the huge underperformance incurred to capture it.

In the medium term, we believe the trend will continue to be credit spread widening as banks face numerous challenges including increased regulation, declining margins, market volatility, reduced client activity and increased capital requirements. Perhaps the largest of the challenges banks will face is the decreased willingness and ability of governments to support the industry.

The idea of a "double A" bank is dead, in our opinion, as rating agencies attempt to reflect the difficult environment in which banks will be forced to operate over the coming years. Recent rating actions by Standard and Poor's and Moody's include downgrades of Australian, Italian, Spanish, French and U.S. banks. There is only a handful of global banks at the holding company level, primarily in Canada and Australia, with "double A" ratings at both rating agencies. New rating methodologies by the rating agencies due out this quarter, which are expected to be more punitive than current standards, will continue to reduce the number of highly-rated banks in existence. Clients with specific rating requirements for banking institutions and counterparties should consider reevaluating their investment policies to reflect the new reality of a world with only "single A" banks (see appendix for a selective list of ratings for global bank holding companies).

Covered Bonds

In an environment where investors are at the mercy of event-driven volatility, we reemphasize the importance of credit discipline. One sector we feel will provide protection in bad times while allowing participation in good is the developing market for dollar-denominated covered bonds. While the dollar-denominated covered bond market is just in its infancy, the market has long existed in Europe and has developed into an important funding mechanism for European banks.

Given the secured nature of covered bonds by a pool of mortgage assets, many people incorrectly categorize covered bonds as mortgage-backed securities. In many respects, covered bonds are similar to unsecured bonds (i.e. bullet maturity, semi-annual coupon, quoted to Treasuries). They differ, however, in many material ways as outlined by the associated table.

Figure 4: Covered Bonds vs. Traditional Asset-backed Securities

	Covered Bonds	ABS and RMBS
Assets	Cover assets remain on the balance sheet of the issuer but are legally separated ('ring-fenced')	Cover assets are transferred to a SPV
Collateral Pool	Dynamic collateral pool, i.e., non-performing loans must be replaced	Usually static pool which amortizes through repayments
Recourse to Issuer	Investor has a full recourse to the issuer in case of claims not being fully met by cover assets	No legal recourse to issuer
Asset Eligibility Criteria	As defined in the respective covered bond legislations	Defined on a transaction-by-transaction basis only
Liquidity	Highly standardized, liquid debt instrument, often issued in benchmark size	Highly fragmented, less liquid debt instruments
Prepayment Risk	Remains with the issuer	Remains with the investor

Source: Morgan Stanley

The key feature of covered bonds is their dual recourse nature. Dual recourse means that in the case of a default by the issuer, the bond holders have a secured claim on the assets in the covered pool and an unsecured claim to the ultimate issuer for the remainder not satisfied by the covered pool. From a credit perspective, covered bonds are superior to unsecured bonds in every way. They are better isolated from credit events and perform well in markets where risk is in favor. However, not all covered bond programs are created equal (covered bond legislation is different in every country) and vigilant credit work must be performed to ensure that the covered pool, bond structure, and risk monitoring are appropriate for a particular investors' risk appetite.

Looking Forward

The low interest rate environment warrants that investors consider alternatives to enhance portfolio yield, while protecting against the volatility surrounding unpredictable events in Europe. We anticipate the volatility to continue as problems intensify in larger sovereigns like Italy and Spain.

We continue to view high-grade credits as the best way to earn an attractive rate of return while remaining defensive. As the Federal Reserve remains committed to accommodative monetary policy and low front-end rates, we encourage short-duration investors to consider the 2-3 year part of the credit curve to identify value.

If you have any questions regarding opportunities in this market, please feel free to contact the desk.

Appendix: Long-Term Credit Ratings of Select Global Banks

Name	S&P Long-Term Ratings	Moody's Long-Term Ratings	S&P Outlook	Moody's Outlook
American Express	BBB+	A3	STABLE	STABLE
Autralian & New Zealand Banking Group	AA	Aa2	STABLE	STABLE
Banco Santander	AA-	Aa3	NEG	NEG
Bank of America	A	Baa1	NEG	NEG
Bank of Montreal	A+	Aa2	STABLE	STABLE
Bank of Nova Scotia	AA-	Aa1	STABLE	STABLE
Barclays	A+	A1	NEG	NEG
BBVA	AA-	Aa3	NEG	NEG
BNP Paribas	AA-	Aa2	STABLE	STABLE
CIBC	A+	Aa2	STABLE	STABLE
Citigroup	A	A3	NEG	NEG
Commerzbank	A	A2	NEG	NEG
Commwealth Bank of Australia	AA	Aa2	STABLE	STABLE
Credit Agricole	A+	Aa2	STABLE	STABLE
Credit Suisse	A	Aa2	STABLE	STABLE
Deutsche Bank	A+	Aa3	STABLE	STABLE
Goldman	A	A1	NEG	NEG
HSBC Bank PLC	AA-	Aa2	STABLE	STABLE
ING	A	A1	STABLE	STABLE
Intesa Sanpaolo SpA	A	A2	NEG	NEG
JPMorgan	A+	Aa3	STABLE	STABLE
Lloyds TSB	A	A2	STABLE	STABLE
Macquarie Bank Ltd	A	A1	STABLE	STABLE
Mizuho Corporate Bank Ltd	A+	A1	STABLE	STABLE
Morgan Stanley	A	A2	NEG	NEG
National Australia Bank	AA	Aa2	STABLE	STABLE
Nomura	BBB+	Baa2	STABLE	STABLE
RBS	A	A3	STABLE	STABLE
Royal Bank of Canada	AA-	Aa1	STABLE	STABLE
Royal Bank of Canada	AA-	Aa1	STABLE	STABLE
Soc Gen	A+	Aa3	STABLE	STABLE
Standard Chartered PLC	A	A2	STABLE	STABLE
Toronto Dominion	AA-	Aaa	STABLE	STABLE
UniCredit SpA	A	A2	NEG	NEG
Wells Fargo	AA-	A2	NEG	NEG
Westpac Banking Corporation	AA	Aa2	STABLE	STABLE

Source: Moody's and S&P

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