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# MARKET Commentary

## Change You Can Believe In

The national election takes center stage this week and will remove one of the most significant uncertainties facing investors heading into 2013. The election outcome will set the stage for fiscal cliff politicking – clarifying a second major uncertainty. Unfortunately, $1 plus trillion annual federal deficits, $2.3 trillion in quantitative easing and $1.5 trillion of excess bank reserves have not translated into a robust economic recovery. Therefore, the U.S. is certain to face further economic headwinds, easy monetary policy and low rates. These factors will continue to create a challenging environment for fixed income investors. Further complicating matters for short-duration investors, traditional safe havens, money funds and bank deposits, are facing their own unknown certainty. Money market reform, once dead, now looks inevitable and the Transaction Account Guarantee (TAG) Program providing unlimited FDIC insurance will likely end in December at its scheduled expiration. Both events will add risk to assets that previously had little to none, and should motivate investors to seek prudent alternatives sooner rather than later.

## Money Market Reform is Coming

Money market reform that looked lost after the SEC shelved proposed reforms in August is gathering momentum now that the Financial Stability Oversight Council (FSOC) has threatened action. In late September, Treasury Secretary Geithner (who is chairman of the FSOC) sent a letter to members of the Council regarding the reform effort and urged the Council to move forward and use its authority to recommend that the SEC proceed with a money fund rules overhaul. The Treasury Secretary stated that he is hopeful to vote on a draft recommendation in November which will be followed by a 30 day public comment period and then a 90 day period for SEC adoption. Geithner's letter also urged FSOC members to prepare for more severe action on the money fund industry (i.e. declare money funds as systemically important thus subject to Fed oversight) should new regulations not come to pass.

Industry officials, many of whom had moved to successfully block earlier reform efforts, are now working with the SEC to seek an end to the impasse over new money fund rules. We've discussed the potential changes before (please see our June and July commentaries) which include a floating-rate NAV, capital buffers and shareholder redemption limits.

However, a plan submitted by BlackRock is garnering interest and may be gaining traction. This plan would allow money fund managers the ability to charge investors a fee for redemptions under certain circumstances like a liquidity event or a depressed mark-to-market share value. The fee would be injected back into the fund to increase liquidity for the remaining shareholders. Look for more details in the coming month and plan for change.

## A Temporary Guarantee Ends

The Transaction Account Guarantee (TAG) Program is set to expire at year-end, per the Dodd-Frank Act. Some have called for a tiered phase-out term supportive of smaller banks or a voluntary participation period owing to fears of instability as money rushes out of banks. The fear of bank destabilization seems overwrought; our concern is the effect of a massive deposit rush into money funds and other short-duration substitutes further compressing

*November 2012*

### US Treasuries

**As of 31-Oct**

| Benchmark | Yield |
|---|---|
| 3 Month | 0.09% |
| 6 Month | 0.15% |
| 1 Year | 0.17% |
| 2 Year | 0.28% |
| 5 Year | 0.72% |
| 10 Year | 1.70% |
| 30 Year | 2.87% |

### Bank of America/Merrill Lynch Indexes

**28-Sep to 31-Oct**

| Index | Return |
|---|---|
| 1-3 Yr Gov/Corp ≥ A | 0.00% |
| 1-3 Yr Municipals | 0.01% |
| 1-3 Yr Agencies | -0.01% |
| 0-3 Month UST | 0.01% |
| S&P 500 | -1.84% |

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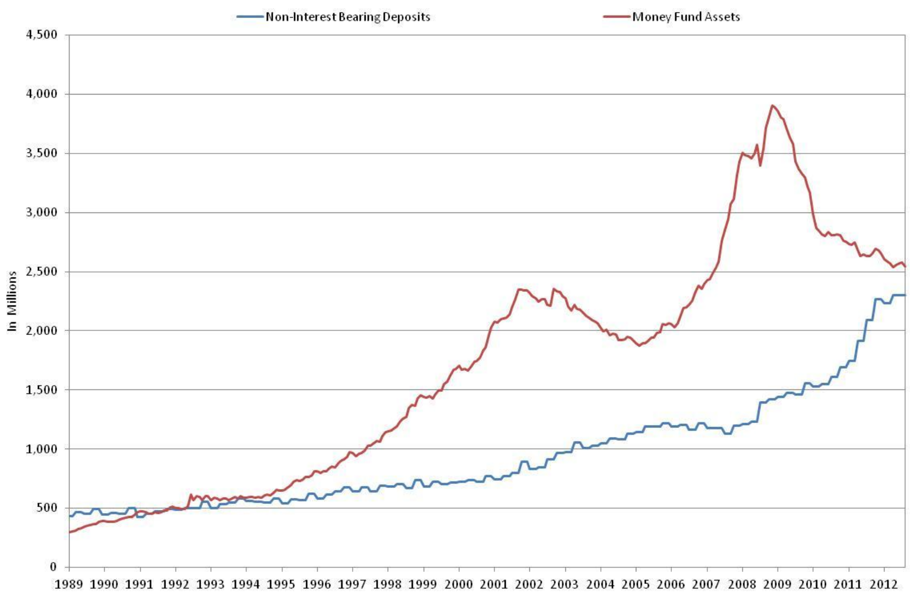
Source: British Bankers' Association, Federal Reserve, FDIC, US Treasury, Bloomberg, Barclays, Financial Times, JP Morgan, The Economist, S&P and Center on Budget and Policy Priorities, Wall Street Journal yields. Non-interest bearing, FDIC-guaranteed accounts have increased by $600 billion since the start of the most recent installment of the TAG Program. As we noted last month in the following chart (see Figure 1), $2.3 trillion sits in non-interest bearing accounts with the vast majority at large banks. We don't see an extension as likely because a lame-duck session of Congress would have to authorize it and currently there are no proposals up for consideration nor is there much sympathy for the banking industry.

**Figure 1: Bank Deposits vs. Money Fund Balances**




Source: Bloomberg, ICI

Similar to the changes in money fund regulation, TAG expiration will transform a riskless asset into a risky one. Consequently, Goldman Sachs forecasts $1.4 trillion will migrate away from formerly guaranteed accounts. A survey conducted by the Association of Financial Professionals found an almost even split between those that would move their balances out of banks versus those that plan to make "no significant change."

Either way, money is going to move. This means short-duration investors with bank deposits must either consider viable substitutes or ensure they are obtaining an appropriate yield for the concentrated credit risk they will assume on January 1st.

## Investor Options

As investors weigh alternatives they should carefully consider the following:

- How much liquidity is truly needed?
- How much credit exposure and duration is acceptable (inversely, what level of risk-free securities are appropriate)?
- What additional security types (e.g. asset-backed securities) and portfolio composition accomplishes your goals most effectively?

The low-yield environment exacts a high price when investing in ultra-short duration, risk-free assets. Therefore, it is critical to maintain prudent credit and duration exposure.

We have noted an increase in media coverage of TAG expiration and expect it to continue to escalate after the election is over and year-end closes in. Given the very large amount of assets that could flow out of bank deposits, we expect yields on

**Figure 2: The High Price of Liquidity (Current Market Yields)**

| | US Tsy | Agency | *FDIC | Corp AA | Corp A | Corp BBB | LIBOR |
|---|---|---|---|---|---|---|---|
| **0-1 mo** | 0.10% | 0.10% | 0.11% | 0.12% | 0.14% | 0.20% | 0.21% |
| **1-2 mo** | 0.11% | 0.11% | 0.15% | 0.17% | 0.18% | 0.25% | 0.26% |
| **2-3 mo** | 0.12% | 0.13% | | 0.19% | 0.26% | 0.34% | 0.31% |
| **3-6 mo** | 0.13% | 0.14% | | 0.23% | 0.29% | 0.43% | 0.43% |
| **6-9 mo** | 0.16% | 0.14% | | 0.28% | 0.36% | 0.54% | 0.63% |
| **9-12 mo** | 0.17% | 0.18% | | 0.35% | 0.45% | 0.64% | 0.80% |
| **1-1.5 yr** | 0.21% | 0.23% | | 0.44% | 0.54% | 0.75% | |
| **1.5-2 yr** | 0.27% | 0.31% | | 0.51% | 0.62% | 0.92% | |
| **2-2.5 yr** | 0.34% | 0.39% | | 0.59% | 0.71% | 1.22% | |
| **2.5-3 yr** | 0.40% | 0.48% | | 0.79% | 0.93% | 1.51% | |

Source: Clearwater

money market funds and the securities they buy, such as treasury bills and agency discount notes, to decline from current levels and, in some cases, possibly go negative. This dynamic favors proactive investors rather than those that wait.

## Looking Forward

The uncertain domestic landscape will begin to gain certainty next week. Immediately following the election, major decisions on taxes, sequestration, and the debt ceiling will have to be addressed. Investment outlooks will continue to evolve as opportunities are evaluated. The demise of TAG and pending money fund regulations are certain to have a material impact on investors' accounts and money market securities. Investors should act now to take advantage of the present opportunities and diversify credit risk.

Please contact the desk with questions or to discuss investment opportunities and how to best navigate the current market developments.



### 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 Brittany Pfister at 208-489-7550.*