MARKET Commentary

clearwater ADVISORS

December 2011

Money Markets Blues

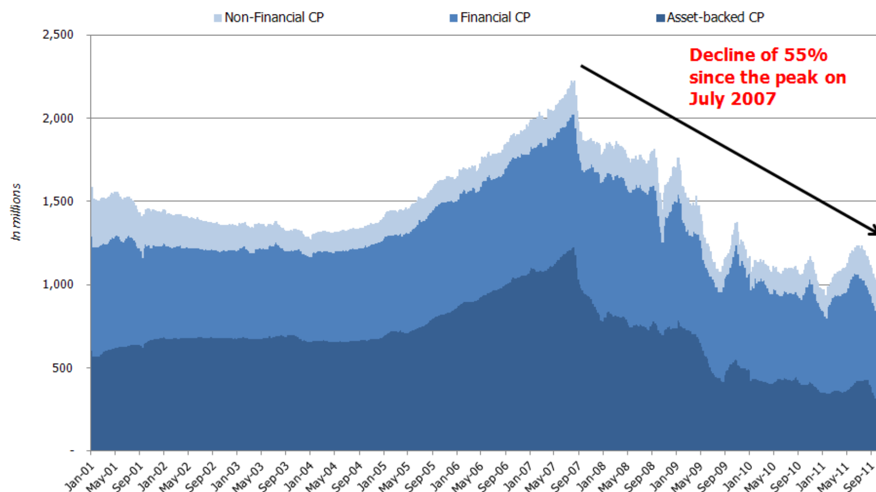
December 16, 2011 will mark the three-year anniversary of the Federal Open Market Committee (FOMC) instituting a zero interest rate policy (ZIRP) and lowering the Fed Funds Target Rate to a range of 0-25 basis points. The longevity of this low-rate environment has greatly dismayed short-duration investors. High-grade issuers have taken advantage of exceptionally low rates to finance in the term market, significantly decreasing the supply of short, high-grade paper. The money market is now plagued by less credit-worthy borrowers (e.g. European financials) who are dependent on wholesale financing and unable to fund in the term markets. Money markets investors are operating in a dangerous environment full of overpriced, risky assets.

With the FOMC telegraphing this low-rate environment will persist into 2013, short-duration investors should look to extend and diversify into an array of high-grade products to enhance portfolio returns and avoid potential pitfalls. Increased flexibility of investment policies and guidelines may be required to navigate the current and future environment successfully.

Supply Wanes

The supply of front-end product has been on a continued decline since the beginning of the credit crisis. This decline spans virtually all sectors (treasuries, agencies and corporate debt) as quality issuers have shored up their balance sheets to meet the demands of investors and regulators. The commercial paper market has declined 55% since its peak in July 2007, and the T-bill and Agency discount markets have experienced similar trends (the Treasury has moved to extend its maturity profile and the GSEs have shrunk their retained portfolios 10% per annum as part of their conservatorship).

Figure 1: Commercial Paper Market has Contracted Sharply from the Peak



Source: Bloomberg

US Treasuries

As of 30-Nov

Benchmark	Yield
3 Month	-0.01%
6 Month	0.02%
1 Year	0.08%
2 Year	0.23%
5 Year	0.90%
10 Year	2.04%
30 Year	3.10%

Bank of America/Merrill Lynch Indexes

31-Oct to 30-Nov

Index	Return
1-3 Yr Gov/Corp ≥ A	0.07%
1-3 Yr Municipals	-0.14%
1-3 Yr Agencies	0.05%
0-3 Month UST	0.00%
S&P 500	-0.22%

Contact Us

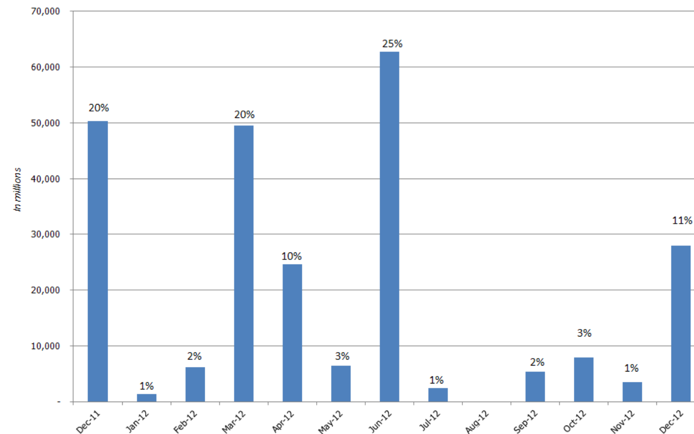
www.ClearwaterAdvisors.com

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, Wall Street Journal

Paper issued under the FDIC's Temporary Liquidity Guaranteed Program (TLGP), in particular, will experience significant contraction over the coming months. Over 20% of the $250 billion outstanding paper under the program will mature in December 2011, and an additional 62% of the balance is scheduled to mature between January and June 2012. TLGP paper has been a favorite among short-duration investors as a proxy for lower-yielding agency debt. The decline of TLGP debt outstanding, however, has driven TLGP spreads in-line with agencies, making the asset class less attractive.

Figure 2: Remaining TLGP Maturity Schedule through December 2012



Source: Bloomberg

Investors looking to replace maturing paper in the face of diminishing supply will find themselves between a rock and a hard place. On one side, demand for high-grade product has driven short yields to record lows. The 6-month and 12-month T-bills are currently trading at a paltry 4 and 9 basis points, respectively. On the other side, investors looking for yield are forced to resort to less-creditworthy borrowers, which are increasingly dominating the market. Financial and Asset-backed commercial paper now comprise 80.1% of the total commercial paper market. In addition, the share of financial paper attributed to non-domestic financials has increased from 11.7% in 2001 to over 36.3% today. This figure was as high as 47% before the second advent of the European debt crisis. European banks found it less expensive to fund in dollars and swap back into Euros, indicating a mispricing of risks by USD investors, primarily by money market funds which were the largest buyer base.

Figure 3: Risk-Return Profile for Differing Asset Classes and Products

	Low Yield	High Yield
Low Risk	- Treasuries - Agencies - FDIC-guaranteed TLGP debt - Industrial Commercial Paper	- High Grade Industrials (>1 Year) - Low Beta Finance - Consumer ABS - Agency MBS
High Risk	- Time Deposits - Financial Commercial Paper - Financial Certificates of Deposit	- High Yield Debt (<BBB-) - High Beta Financials - Equities

Source: Clearwater Advisors

Investors choosing to remain exclusively in the money markets are exposing their portfolio to a higher risk profile without being properly compensated (i.e. higher risk, lower yield). This is the complete opposite of what investors usually aim to accomplish in their investment portfolio (lower risk, higher yield). The best case scenario for these captive investors is that principal is returned at historically low yields. The worst case scenario is that riskier credits pose principal risk without compensatory income to offset potential losses. For investors who must operate in this challenging environment, we encourage reevaluating investment policies and guidelines in order to adapt to this new reality (see below).

Cash Back Rewards: Extending Credit Pays

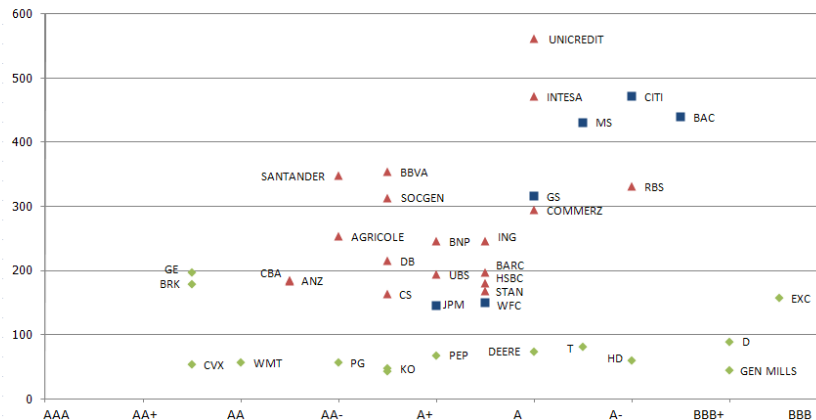
While it may seem counterintuitive, we see less risk of principal loss for short-duration investors by extending and diversifying into an array of high-grade products. Reworking investment guidelines to allow for a greater allocation outside the money markets introduces a variety of attractive opportunities in products that are higher yielding and lower risk than money market alternatives.

Given the current steepness of the credit curve, we see value in lower-beta finance names, strong industrial credits and select structured products such as consumer asset-backed and agency mortgage-backed securities (ABS and MBS). In past commentaries we extolled the benefits of considering front-paying, short CMOs on seasoned mortgage collateral and Canadian covered bonds, the structure of which allows investors seniority on the capital structure and attractive yields versus bank unsecured debt. For investors who are captive in the money markets we suggest A-2/P-2 industrials borrowers who have access and proven ability to issue the term funding markets.

"Double A" Banks: A Dying Breed

Many investors balk at allocating a greater portion of their portfolio in the category of "riskier" credits previously mentioned, and instead opt to keep a majority of their investment funds in time deposits or short certificates of deposits. Unless these deposits are explicitly guaranteed by the FDIC, we encourage investors to limit this practice, which may prove convenient operationally, but often makes little sense from a risk perspective.

Figure 4: CDS vs. Credit Ratings of European Financials (Red), U.S. Financials (Blue) and Industrials (Green)



Source: Bloomberg

We have been relentless with our negative outlook of the banking industry. As we mentioned in our last commentary, **"Jumping over Dollars for Dimes,"** the idea of a "Double A" bank is dead in our opinion. Banks face formidable regulatory changes, onerous capital requirements and a challenging economic recovery. Since our last commentary, S&P has downgraded or revised the outlook on 37 global banks in one action and additional institutions in follow-up actions. S&P has recently announced a review of all the members of the Euro zone, which would put further downward pressure on European bank ratings.

In our opinion, the idea that a bank deposit—money held at a bank facing a number of potentially fatal business, regulatory and ratings risks—is superior to a strong industrial credit with a healthy balance sheet that generates consistent cash flow is flawed. This particularly holds true when looking at the value of "Triple B" credits, such as regulated utilities and consumer names.

The rating agencies have done nothing to regain credibility, therefore, we independently monitor trading levels, balance sheet health and earnings power of credits in determining suitability for client investment portfolios. Market perception as measured by CDS (one generic metric) shows that the market currently perceives prominent U.S. and foreign financials as exponentially riskier than lower-rated industrial credits. We expect the downgrades in the sovereign and financial sector to continue and we encourage short-duration investors to take the necessary steps to ensure contingency plans for their investments and banking relationships in such an event.

Looking Forward

We expect the volatility in credit, particularly in high-beta finance names, to continue in the near term. To protect against this volatility, we encourage short-duration investors to consider expanding investment guidelines and policies to allow for greater flexibility. Preemptively doing so will allow investors the nimbleness to deal effectively with potential outcomes (e.g. further ratings downgrades or credit events) without sacrificing preservation of capital, liquidity or yield.

Please feel free to contact the desk to review or gain ideas in formulating new or revised investment guidelines or policies.

This material is for your private information, and we are not soliciting any action based upon it. Certain investments, including those involving futures, options and other derivative products give rise to substantial risk and are not suitable for all investors. The risks inherent in these investments may lead to material loss of capital. Past performance may not be indicative of future results. Results portrayed, including those of indices, reflect the reinvestment of dividends, as well as the effects of material market and economic conditions. Different market and economic conditions could have a material impact on performance. Index results are used for comparison purposes only and have been unaltered from their original state as received from independent sources. Historical results reflect returns that a typical investor would have received based on stated fees and do not necessarily reflect returns that actual investors received. Opinions expressed are our present opinions only. The material is based upon information that we consider reliable, but we do not represent that it is accurate or complete, and it should not be relied upon as such. This document is intended for your internal use only and may not be distributed outside your organization. This is neither an offer to sell nor a solicitation of an offer to buy an investment product.

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.