MARKET Commentary

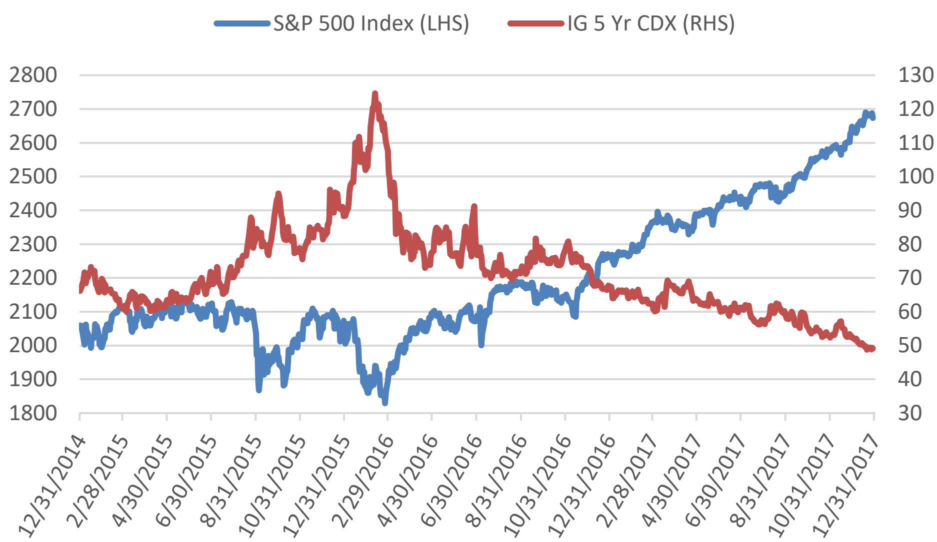
clearwater ADVISORS

Off and Running

Winter 2018

Risk assets rallied and credit spreads declined as markets were buoyed (see Figure 1) by strong economic data and tax reform as 2017 came to a close. The S&P 500 rose 6.6% in the quarter capping a stellar year for equity markets. The Federal Reserve (Fed) increased the federal funds rate by 25 basis points, as expected, at their December meeting. Further, Fed officials are forecasting three hikes in 2018 matching the 2017 pace.

Figure 1: Risk Assets Soar, Credit Spreads Tighten



Source: Bloomberg

Portfolios benefited from exposure to corporate issuers which topped all investment grade sectors on the quarter and for the year. A slow, steady rise in rates coupled with a supportive environment for credit exposure has delivered positive total returns alongside higher reinvestment yields. The yield curve flattened with short rates jumping to price in a December hike while longer maturities rose more modestly.

Global economic growth is expected to accelerate providing a constructive backdrop for less accommodative monetary policy as the New Year progresses. We look to take advantage of attractive relative value opportunities, but are selectively cautious of low-rated credits and agency mortgage-backed securities at current valuation levels.

2017 – Year in Review

The domestic economy gained strength in 2017 posting annualized GDP growth over 3% in the second and third quarters. The impacts of hurricanes were negligible

US Treasuries

As of 29-December

Benchmark	Yield
3 Month	1.38%
6 Month	1.53%
1 Year	1.73%
2 Year	1.88%
5 Year	2.21%
10 Year	2.41%
30 Year	2.74%

Bank of America/Merrill Lynch Index Returns

Q4, 29-Sept to 29-Dec

Index	Return
1-3 Yr Gov/Corp ≥ A	-0.20%
1-3 Yr Municipals	-0.58%
1-3 Yr Agencies	-0.19%
0-3 Month UST	0.26%
S&P 500	6.64%

Source: US Treasury, Bloomberg, BofA/ML, and S&P

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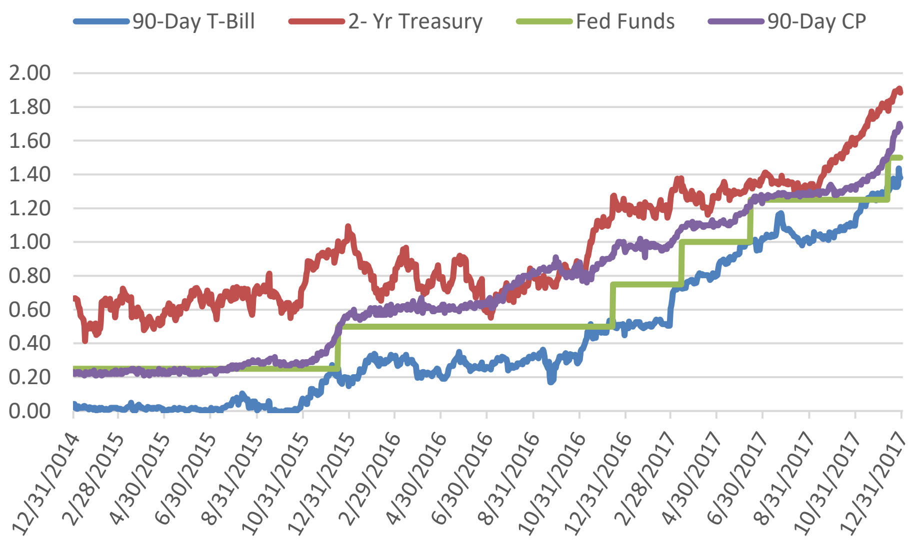
although growth slowed modestly in the fourth quarter. Synchronized global growth coupled with a domestic deregulatory push capped off by tax reform have investors optimistic about the coming year as evidenced by the record run in equity markets. This backdrop alongside low inflation, declining political uncertainty and broadly supportive monetary policy pulled volatility to record lows.

The Fed maintained its forecasted pace of hiking, raising the federal funds rate three times in 2017. Money markets followed in lockstep (see Figure 2) benefiting short-duration investors although not necessarily holders of bank deposits and prime funds which have tended to lag the rise in federal funds.

Figure 2: U.S. Money Markets



Source: Bloomberg

Also, this past October, Fed officials started passively reducing assets by $10B per month ($6B Treasury and $4B MBS) by not reinvesting proceeds. The run-off will increase by $10B every quarter until it reaches a maximum of $50B per month while maintaining the proportional 60/40 security-type split (max $30B Treasury and $20B MBS). Thus far, the market impact of balance sheet reduction has been inconsequential. Monetary policy fell into the shadow of political and fiscal policy as the year passed. Aside from tax reform, debt ceiling and budget politics were punted into 2018.

Overseas, questions on emerging market (primarily China) economic growth, EU uncertainty and geopolitical instability were largely overlooked. The recovery in commodity prices provided support for emerging markets and while geopolitical concerns flared (North Korea), they quickly faded. EU uncertainty was mainly focused on the path of monetary policy by the European Central Bank (ECB) which indulged markets by keeping policy very accommodative. Further, economic activity accelerated in developed and emerging market economies adding to global confidence and stoking animal spirits.

The clamor for risk assets has led to stretched valuations amid low volatility. Investment grade corporate issuers came to market with record issuance ($1.4T) surpassing last year's record level spurred on by post-recession lows in spreads. Across sectors, fairly full valuations provide little compensation for potential volatility.

2017 fixed income performance rewarded high-quality spread sector positioning while avoiding duration exposure. The annual return for the 90-Day T-bill was +0.86% while the 2-Year U.S. Treasury Index returned +0.19%. Further, the 1-3 Year AAA-A U.S. Corporate Index returned 1.67% illustrating the benefit of added income over a similar duration Treasury index (see Figure 3) and high-quality asset-backed securities provided a competitive return in the face of rising yields as well.

Figure 3: 2017 Fixed Income Year-End Characteristics and Returns

Index	Quality	Yield	Duration	Annual Return
90 Day T-Bill	AAA	1.36%	0.24 yrs	0.86%
2-Year U.S. Treasury	AAA	1.88%	1.87 yrs	0.19%
1-3 Year AAA-A U.S. Corporate & Government	AAA	1.99%	1.86 yrs	0.70%
1-3 Year AAA-A U.S. Corporate	A1	2.30%	1.88 yrs	1.67%
AAA U.S. Asset-Backed Security	AAA	2.17%	1.61 yrs	1.47%
1-5 Year AAA-A U.S. Corporate & Government	AAA	2.04%	2.64 yrs	1.02%
0-3 Year U.S. Agency CMO (MBS)	AAA	2.63%	2.21 yrs	1.07%

Source: BofA Merrill Lynch Indices

2018 – What Next?

Markets are optimistic about the coming year. Conditions that were prevalent this past year (broad economic growth, modest inflation, accommodative monetary policy) will largely carryover. The U.S. economic recovery is now one of the longest in history. However, old age isn't a precursor for recession – material systemic imbalances, global macro shocks or restrictive monetary policy generally set the stage. The threat of each seems low and the pace of growth has been one of the slowest coming out of the Great Recession, supporting continued growth. Consequently, Goldman Sachs places the probability of a recession at 17.6% over the next two years. Further, tax reform should provide a tailwind to the U.S. economy. Analysts see growth exceeding that experienced last year in the U.S. and Eurozone.

Unemployment (4.1%) is likely close to "full-employment" which is finally leading to a modest rise in wages. Commodity prices have rebounded and stabilized as well. Inflation could be the wildcard of 2018. Inflation expectations have surged recently signaling the return of the Trump reflationary trade and bond yields have started to price that in.

Monetary policy will continue its less accommodative shift in 2018. The Fed's balance sheet normalization may challenge markets as the pace of reduction starts to reach a material level around the middle of the year. Diminished Fed purchases coupled with increased issuance due to a growing federal deficit should pressure long maturity Treasury yields higher. Overseas efforts to reverse stimulative monetary policy will test markets as well. The European Central Bank reduced its bond-buying program for 2018 which is set to expire in September. ECB officials have stated they plan a gradual exit and will start communicating expectations for future policy mid-summer. However, given the sizable impact its program is having on yields and spreads in Europe (which has spilled over into our markets) even a small communication mistake or surprise shift away from easing will cause reverberations.

Domestic fiscal issues will remain front and center. Debt ceiling and budget negotiations must be revisited in short order. Congress has yet to reach an agreement on a budget for 2018 and has used a series of continuing resolutions to keep the federal government open. The current resolution expires on February 8th amid contentious immigration negotiations. Additionally, the debt ceiling suspension has not been addressed since it expired December 8th. The U.S. Treasury is using extraordinary measures to fund the government in the interim. Those measures will be exhausted in late February-early March, necessitating Congress to act. Early March T-bills are starting to show some dislocation which will be exacerbated should Congress dawdle.

The tax package signed into law has corporations reassessing strategy given the significant changes in policy (please see our recent Insights article "Tax Reform and Repatriation" for more). The $1.5T tax cut should bolster consumer confidence and encourage spending and expectations are that corporations will boost capex investment from low levels.

Therefore, we remain constructive on investment grade corporate exposure in portfolios with a critical eye on underlying balance sheets as the end of the credit cycle is nearing for many sectors. For rating sensitive clients, AAA-rated asset-backed securities continue to be a good fit as well as certain agency mortgage-backed securities. Rates across the curve are higher and money market investors enjoy an attractive yield environment.

Looking Forward

Accelerating global growth has investors seeking risk assets pushing equity prices higher and spreads lower. Supportive conditions will persist, but much has already been priced in. Monetary policy will continue its gradual less accommodative shift while there are fiscal challenges that should be resolved in the first quarter. A slow transition to more normal policy should prove to be a favorable environment for Clearwater Advisors' clients as reinvestment rates increase and spread sectors cushion the impact of higher yields. Further, the environment remains constructive for credit and select asset-backed security exposure provided diligent credit research is undertaken. Volatility will return providing opportunities to investors with flexible investment policies.

Please contact the desk with questions or to discuss investment opportunities best suited to navigate the challenges faced in 2018.

Form ADV Part II

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