clearwater ADVISORS

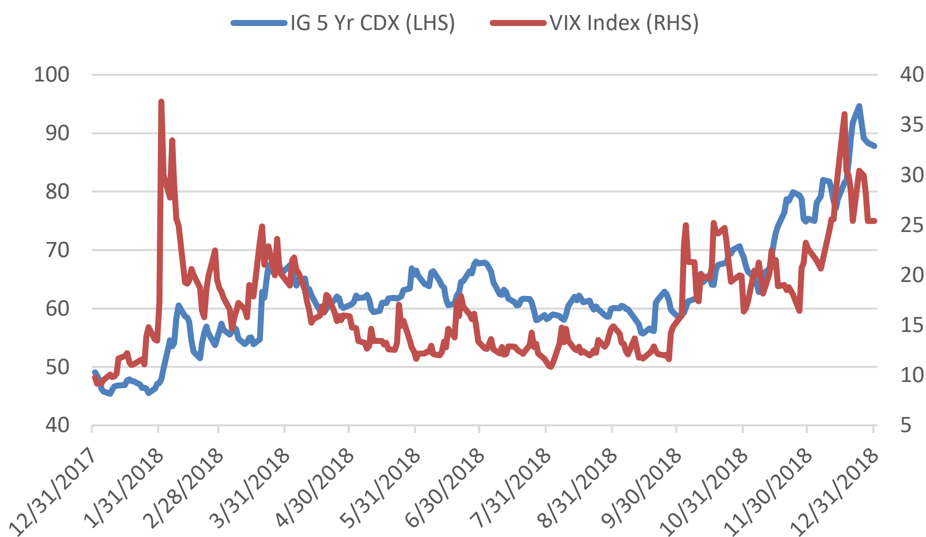
MARKET Commentary

Winter 2019

Volpocalypse Redux

Volatility surged as global markets wilted under increasing pressure as 2018 came to a close (see Figure 1). Risk assets, already on tenterhooks, did not interpret the December Federal Open Market Committee meeting and accompanying statement as dovish enough. This reaction coupled with data indicating slowing global growth, impending Brexit politics, trade wars, and domestic government strife amplified risk aversion already exacerbated by thinly staffed trading desks around the holidays.

Figure 1: Risk Aversion Returns



Source: Bloomberg

Consequently, over the quarter, the yield curve bull flattened as front-end yields rose modestly while longer maturities declined 20-40 basis points. Investment grade spreads materially widened pushing returns negative for the year. Portfolios benefited from exposure to very low-duration, high-quality sector exposure – cash was king in 2018.

The sell-off and corresponding rally in treasury yields seems overdone, especially if geopolitical risks are sorted in short order. U.S. economic growth will likely slow, but doesn't appear to be on the cusp of contracting. Therefore, we remain constructive on credit exposure and other select spread sectors, like asset-backed securities.

2018 – Year in Review

The calm that enveloped markets in 2017 gave way to a far more volatile year in 2018. President Trump sparked the first bout of instability in January by announcing tariffs on a range of goods. Risk assets sold off and credit spreads widened

US Treasuries

As of 31-Dec

Benchmark	Yield
3 Month	2.36%
6 Month	2.48%
1 Year	2.60%
2 Year	2.49%
5 Year	2.51%
10 Year	2.68%
30 Year	3.02%

ICE BofAML Index Returns

Q4, 28-Sept to 31-Dec

Index	Return
1-3 Yr Gov/Corp ≥ A	1.23%
1-3 Yr Municipals	0.88%
1-3 Yr Agencies	1.24%
0-3 Month UST	0.56%
S&P 500	-13.5%

Source: US Treasury, Bloomberg, ICE/BofAML, and S&P

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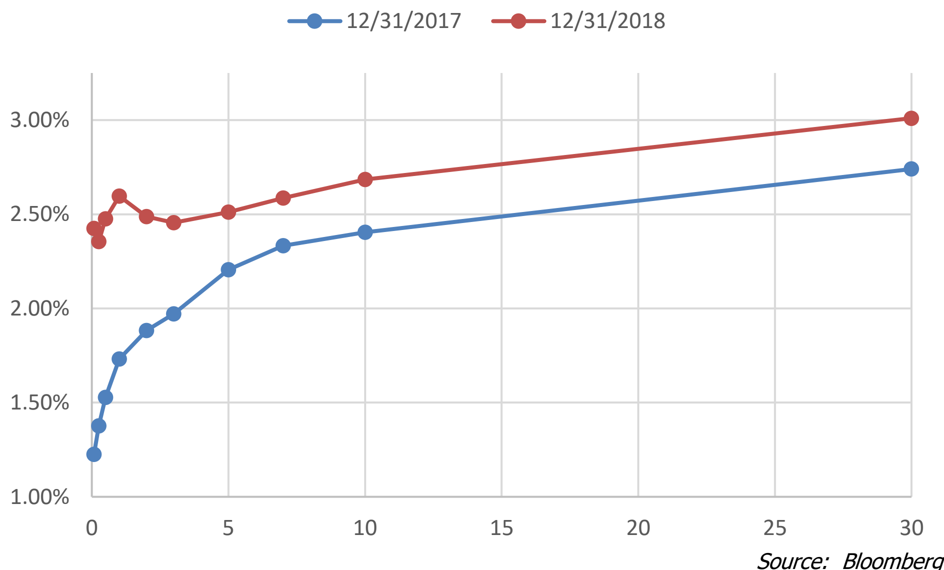
materially into the summer months. Investment grade spreads, which were hovering near post-recession lows, widened to levels not seen in over a year. Meanwhile, synchronized global growth conditions that were prevalent at the start of the year began to unravel mid-year. Domestic economic growth logged one of the best years in this expansion, but other developed and emerging market economies decelerated. Further, the waning boost from 2017's tax cuts, impacts from less accommodative monetary policy, trade tariffs and political uncertainty tempered growth expectations as the year closed.

The Federal Reserve (Fed) hiked rates four times in 2018 with the last at their December meeting. Fed officials now expect to hike twice in 2019, down from three projected in the September meeting. Further, amid the volatile back-drop, Chairman Powell pledged that the central bank will be patient and that "there is no preset path for policy". We expect monetary policy decisions will become more data dependent as policy passes neutral and becomes restrictive over the coming year or so.

Geopolitical risks weighed on markets for much of the year including the close as a partial government shutdown carried into 2019. Brexit negotiations ground to a standstill and the March 2019 exit date is approaching quickly with material issues unresolved. It's difficult to see an orderly outcome – we expect more headlines and volatility. The Trump Administration's trade policies weighed on markets for the first half of 2018. Quick progress on the revised NAFTA agreement helped calm some of the worry, but negotiations with China continue to be a concern. While negotiations are ongoing, tariffs are expected to increase from 10% to 25% by March 2nd if talks fail. However, economic weakness seems to be spreading across China, increasing the odds that progress will be made in our opinion.

Treasury yields moved higher on the year (see Figure 2). Much of the move came early in the year followed by months of range-bound trading. The 10-year treasury peaked at 3.25% in October and fell over the quarter to close the year at 2.68%. The flat nature of the curve signals market participants' belief that we're close to the end of this long economic growth phase.

Figure 2: Yield Curve Shift in 2018



Source: Bloomberg

2018's final outcome looked significantly different than year-to-date performance through Q3 which rewarded credit exposure at the expense of high-quality duration. Credit spreads widened materially in the later part of the fourth quarter and treasury yields plummeted from their 2018 highs in a volatile close to the year that

upended returns. Further, yields compressed towards fed funds and treasury maturities yielding around 2.50% in the belly of the curve complicate curve positioning going forward.

2018 fixed income performance rewarded low risk and low duration exposure as evidenced by the return of the 90-Day T-bill and short agency mortgage-backed securities (see Figure 3). Additionally, AAA-rated asset-backed securities held their own as corporate spreads widened and rates moved higher.

Figure 3: 2018 Fixed Income Year-End Characteristics and Returns

Index	Quality	Yield	Duration	Annual Return
90 Day T-Bill	AAA	2.38%	0.23 yrs	1.87%
2-Year U.S. Treasury	AAA	2.50%	1.94 yrs	1.48%
1-3 Year AAA-A U.S. Corporate & Government	AAA	2.66%	1.86 yrs	1.64%
1-3 Year AAA-A U.S. Corporate	A1	3.22%	1.84 yrs	1.64%
AAA U.S. Asset-Backed Security	AAA	3.09%	1.60 yrs	1.85%
1-5 Year AAA-A U.S. Corporate & Government	AAA	2.69%	2.48 yrs	1.49%
0-3 Year U.S. Agency CMO (MBS)	AAA	3.14%	2.39 yrs	2.15%
5-Year U.S. Treasury	AAA	2.51%	4.66 yrs	1.46%

Source: ICE BofAML Indices

2019 – Looking Forward

Markets enter the year focused on monetary policy and politics. While growth is expected to slow, an outright recession does not seem likely over the coming year. Inflation measures shouldn't be a concern giving the Fed flexibility in the face of uncertainty. Risk assets have recovered somewhat from depressed levels experienced at year-end. Domestically, ongoing government funding negotiations and an upcoming debt ceiling limit will test the patience of market participants, but shouldn't derail the economy.

Monetary policy has likely passed its peak tightening phase. Fed officials forecast just two hikes in 2019, but recent rhetoric has been firmly dovish causing many to wonder if hiking is done. The January FOMC meeting outcome has been accurately described as an "aggressively dovish pause". The FOMC "will be patient as it determines what future adjustments" for federal funds may be appropriate and dropped language from its statement calling for "some further gradual increases". Additionally, the Fed released a statement indicating that its balance sheet reduction strategy could be adjusted in light of economic and financial developments. Therefore, domestic policy, which markets had feared being too aggressive, capitulated and should be supportive of risk assets.

However, should the U.S. and China make material progress on a trade agreement and Congress resolve the government funding deadlock, the Fed may have to resume the modest hiking path they forecast just a month ago. The exceedingly dovish nature of their recent meeting will make communicating this shift problematic. Overseas, the European Central Bank (ECB) is no longer expanding its balance sheet choosing simply to maintain its current level. Officials don't see hiking rates until mid-year, at the earliest. Given the Brexit mess and slowing growth, the ECB may never get around to raising rates this cycle. Other major economy central banks are likely in pause mode as well, especially for the first half of the year. This backdrop is supportive of select credit exposure and flexible policy to take advantage of shifting policy and market sentiment.

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 offer value as well as agency mortgage-backed securities. It's rare for cash to outperform all major asset classes and is unlikely to do so again.

Please contact the desk with questions or to discuss investment opportunities best suited for the challenges facing market participants in 2019.

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