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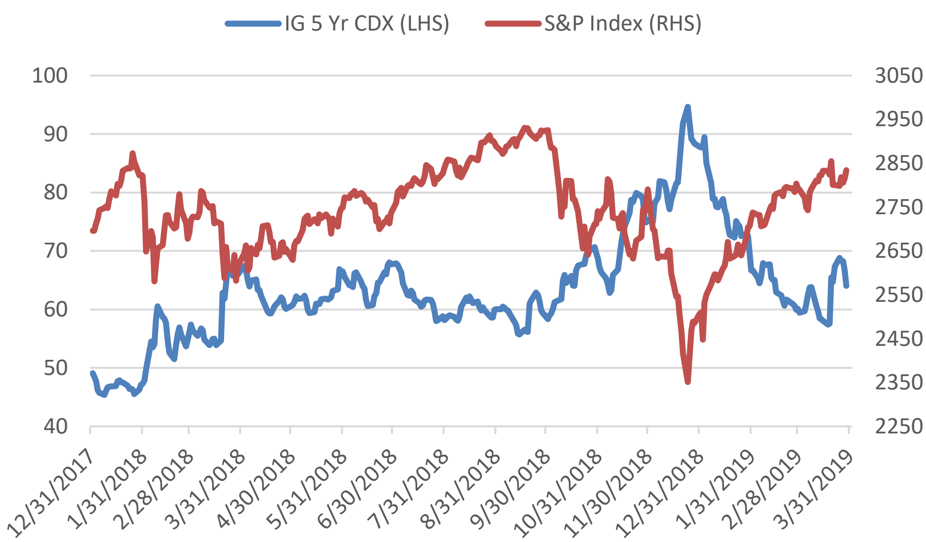
MARKET Commentary

That's All Folks

Risk assets rallied sharply to start 2019 (see Figure 1) as central bankers tempered expectations of further policy normalization and indicated that accommodative steps could be taken in the coming year. Domestically, the Federal Reserve's 180-degree policy pivot, a pause in rate hikes and possible adjustments to balance sheet rundown prior to the end of 2019, was cemented at the March meeting driving yields lower across the curve.

Figure 1: Risk Appetite Returns



Source: Bloomberg

Consequently, over the first quarter, the yield curve bull flattened as front-end yields declined modestly while yields for two year and beyond maturities plummeted some 25-30 bps. Investment grade spreads tightened materially offsetting much of the widening experienced as 2018 came to a close. Further, lower-rated credits outperformed their higher-rated counterparts.

Domestic monetary policy has shifted broadly which is supportive of risk assets. The change in policy coupled with reasonable underlying growth will allow spread sectors to continue to perform well. Geopolitical (Brexit, Italy and upcoming debt ceiling negotiations) and trade risks (China) remain, but for the intermediate-term, supportive monetary policy will allow markets to look past these issues.

The Powell Put

The Federal Reserve (Fed) raised rates four times in 2018 with the last at their

Spring 2019

US Treasuries

As of 29-Mar

Benchmark	Yield
3 Month	2.38%
6 Month	2.42%
1 Year	2.39%
2 Year	2.26%
5 Year	2.23%
10 Year	2.41%
30 Year	2.81%

ICE BofAML Index Returns

Q1, 31-Dec to 29-Mar

Index	Return
1-3 Yr Gov/Corp ≥ A	1.11%
1-3 Yr Municipals	1.03%
1-3 Yr Agencies	0.97%
0-3 Month UST	0.60%
S&P 500	13.6%

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

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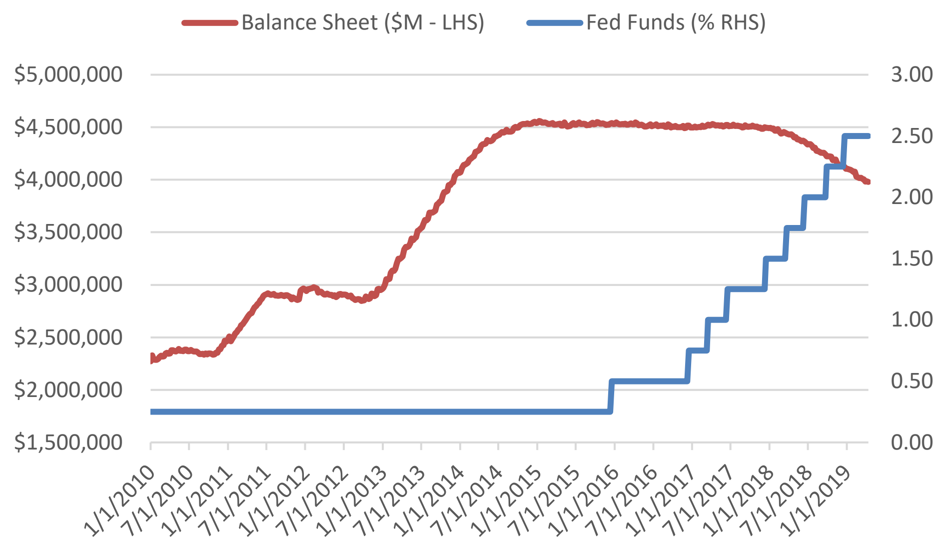
December meeting. At the time, markets were deeply unsettled by the Fed's insistence on normalizing policy into the coming year and volatility surged. Amid this back-drop, Chairman Powell pledged that the central bank would be patient and the Fed followed that proclamation with dovish policy statements at their January and March meetings. The Fed now forecasts no hikes in 2019, down from the two expected at their December meeting, and just one in 2020. Further, during the Q&A session after January's meeting, Powell indicated that the next policy move could be a cut or a hike depending on economic data, a marked departure from the Fed's stance a month earlier. Therefore, the fed funds rate is not likely to move in 2019 and the current target range of 2.25-2.50% may mark the high point of this hiking cycle (see Figure 2).

Figure 2: Fed Balance Sheet and Target Rate

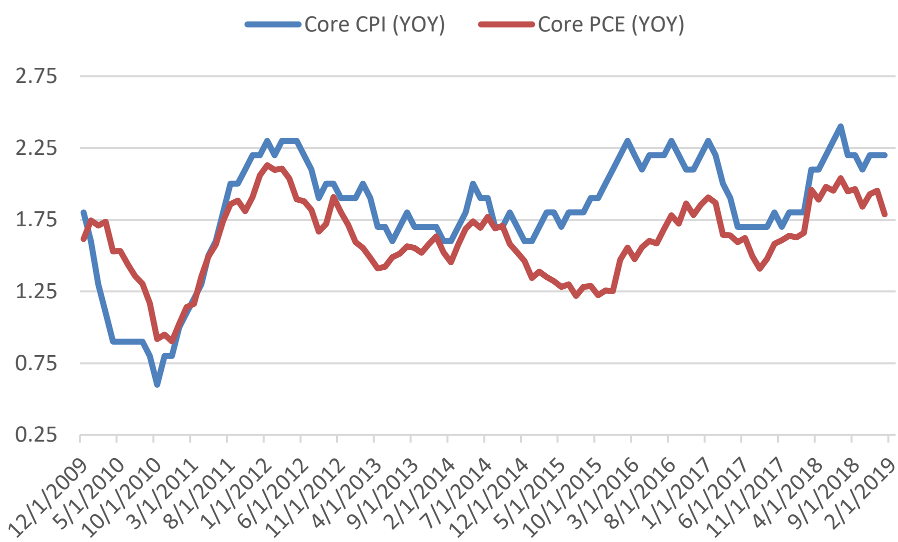


Source: Bloomberg

The Fed also outlined a roadmap for ending its balance sheet reduction program which had been on autopilot since October 2017. Beginning in May, the Fed will taper the amount of proceeds it allows to roll off its balance sheet each month. Currently, $30B in Treasury proceeds and $20B in agency mortgage-backed securities roll off. The Treasury monthly roll-off cap will decline to $15B in May while mortgages remain unchanged. Balance sheet run-off will end completely in September and the bulk of the maturing proceeds will be reinvested across the Treasury curve. It is expected that the size of the Fed's portfolio will stabilize around $3.8T when the dust settles. The Fed is expected to provide more clarity on that subject over the coming months.

The Fed has repeatedly emphasized a patient policy stance for 2019 and a strong desire to allow inflation to run above target as they seek to sustain the current economic expansion. Recent inflation indicators (see Figure 3) have rolled over giving policymakers pause and latitude to go on hold. Further, even if economic growth were to accelerate, the Fed would want to see core inflation metrics printing consistently above 2.0% before another hike would be considered, further reinforcing expectations of an extended pause.

Figure 3: Inflation Softens



Source: Bloomberg

Upcoming Fed meetings are expected to be uneventful as the bulk of the policy transition occurred in the first quarter. Markets are currently pricing in just over a 60% probability of a cut before 2019 comes to a close. This viewpoint seems accurate given the Fed rarely hikes after pausing.

Market Opportunities

The pivot in monetary policy led to some of the best returns in fixed income since the June 2016 Brexit vote. With the Fed on pause, we look to past monetary policy transitions as guideposts to what portfolio exposure will benefit late in the cycle with a flat Treasury yield curve. Looking at the mid-to-late 90's and early 2000 (see Figure 4) periods, after the Fed pauses it has been advantageous to maintain exposure to duration and spread product, like credit or, more recently, asset-backed securities.

Figure 4: 1 Year Return after Fed Rate Pause

Index	Feb – 1995	April – 1997	May – 2000
90 Day T-Bill	5.98%	5.34%	6.22%
2-Year U.S. Treasury	10.68%	7.30%	9.14%
1-3 Year U.S. Treasury	10.60%	7.44%	9.63%
1-3 Year U.S. Corporate	11.28%	7.87%	10.17%
AAA U.S. Asset-Backed Security	-	-	10.77%
1-5 Year Corporate	13.76%	8.79%	11.45%
0-3 Year U.S. Agency CMO (MBS)	-	9.07%	9.50%
5-Year U.S. Treasury	16.42%	10.43%	12.76%

Source: ICE BAML Indices

Market strategists, including Fed Vice Chair Clarida, recently pointed to 1995 and 1998 as two instances where the central bank reduced rates as insurance against a weakening economy. Most focus on 1995 as a more appropriate template given the 1998 cuts were in response to a crisis brought on by the Russian debt default and subsequent implosion of Long Term Capital Management. Additionally, the 1995 transition may offer worthwhile clues as labor conditions were fairly tight and the stock market buoyant mirroring conditions present today.

Unfortunately, money market returns won't be as high as in past cycles since the Fed has paused around 2.50% as opposed to 5-6% in those instances. However, selectively adding exposure to duration and credit should prove beneficial, if history serves as a guide.

Looking Forward

Monetary policy has regained prominence globally as developed central bank policy shifted dovish in the opening months of 2019. While domestic growth is expected to slow, an outright recession does not seem likely over the coming year. Inflation measures have softened giving the Fed additional support for a pause. Markets are balancing expectations of easier monetary policy against tentative signs of global growth stabilization. Upcoming Fed meetings should be uneventful, but markets will be looking for clues as to what the next policy step will be in light of incoming economic data. Macro risks remain, but if volatility surges, selloffs will serve as opportunities to add exposure to risk assets.

We remain constructive on investment grade corporate exposure in portfolios with a critical eye on underlying balance sheets and durability of cash flows. For rating sensitive clients, AAA-rated asset-backed securities offer value as well as agency mortgage-backed securities especially in the context of performance during similar historical monetary policy instances.

Please contact the desk with questions or to discuss investment opportunities in today's market.

Form ADV Part 2

Clearwater Advisor's annual Form ADV Part 2 disclosure is available upon request. To make a request please email Compliance@ClearwaterAdvisors.com or call us at 208-433-1222.