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MARKET Commentary

December 2019

Macro View

Trade news primarily drove market sentiment as 2019 came to a close. Progress towards a "Phase 1" trade agreement with China continued with both countries signing the accord in January. Further, Congress approved the new trade agreement with Mexico and Canada providing another boost to the domestic economy. Consequently, risk assets continued their tremendous fourth quarter rally into year-end.

Economic data weakness moderated signaling that the slowing experienced mid-year likely bottomed in the quarter. The outlook for manufacturing is weak, but may be turning. Looking forward, the U.S. goldilocks economy persists with moderate growth, solid employment picture, and subdued inflation in the forecast for 2020. Politics will take center stage for much of the year, but is not expected to derail economic prospects.

Overseas, Boris Johnson solidified power as the Conservative party took a sweeping general election victory mid-December. Prime Minister Johnson sees this landslide victory as a clear mandate to deliver on Brexit over three years after the public voted to leave the European Union.

The trade détente has markets primed for 2020. Many risks remain, but markets are looking past them for the time being.

Monetary Policy

The Federal Reserve (Fed) followed its September rate cut with another two at successive meetings. At its December meeting, the Fed reiterated its stance that monetary policy was appropriate and expects to remain on hold through 2020. Consequently, the yield curve steepened as the front-end was anchored by Fed policy and longer maturity yields rose some 10-15 basis points.

The European Central Bank (ECB) will undertake a strategic policy review as President Lagarde takes over. The review is expected to take most of the year with little policy deviation expected during the interim. With little to show economically after five-plus years of negative rates, some expect the ECB to reconsider that stance. Of note, Sweden's Riksbank (the world's first central bank) was the first to cut its policy rate below zero in 2009. The Riksbank raised its benchmark rate to zero at their December meeting signaling and end to negative rates for the coming years. This first step may signal that negative interest rate policy (NIRP) may be coming to close on the continent.

Federal Funds Target

1.50-1.75%

US Treasuries

As of 31-Dec

Benchmark	Yield
3 Month	1.54%
6 Month	1.58%
1 Year	1.57%
2 Year	1.57%
5 Year	1.69%
10 Year	1.92%
30 Year	2.39%

ICE BofAML Index Returns

2019 Return

Index	Return
0-3 Month UST	2.21%
1-3 Yr Gov/Corp ≥ A	3.83%
1-3 Yr Municipals	2.88%
1-3 Yr Agencies	3.48%
1-5 Yr Gov/Corp ≥ A	4.61%
S&P 500	32.6%

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

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Most developed market central banks have meetings scheduled for January. Little near-term change is expected and a majority have slightly more optimistic forecasts for 2020, but remain ready to act should economic activity disappoint.

Markets

Risk assets closed the year on a tear posting some of the best annual returns on record. Investment grade credit spreads closed December at post-crisis tights after putting up historically strong returns on the year. BBB-rated issuers outperformed their higher-rated counterparts over the month and for all of 2019. Looking at 2019 returns across the Clearwater Advisors' client universe, duration and credit exposure were prominent drivers of performance (see Figure 1).

Figure 1: 2019 Fixed Income Year-End Characteristics and Returns

Index	Quality	Yield	Duration	Annual Return
90 Day T-Bill	AAA	1.52%	0.23 yrs	2.28%
2-Year U.S. Treasury	AAA	1.56%	1.96 yrs	3.49%
1-3 Year AAA-A U.S. Corporate & Government	AAA	1.67%	1.85 yrs	3.83%
1-3 Year AAA-A U.S. Corporate	A1	1.96%	1.82 yrs	4.99%
AAA U.S. Asset-Backed Security	AAA	2.11%	1.66 yrs	3.95%
1-5 Year AAA-A U.S. Corporate & Government	AAA	1.71%	2.59 yrs	4.61%
0-3 Year U.S. Agency CMO (MBS)	AAA	2.24%	1.46 yrs	3.50%
5-Year U.S. Treasury	AAA	1.68%	4.78 yrs	5.91%

Source: ICE BofAML Indices

The decline in treasury yields (some 75-100 bps) as the Fed reversed course in 2019 contributed to a very good year for bonds even as the U.S. government issued a record $2.6 trillion in debt. Further, the marked sell-off in credit spreads in late 2018 set the stage for strong performance this past year. High grade credit outperformed at all points across the curve.

Money funds were a popular investment in 2018 as the Fed hiked and continued to be in early 2019 when the yield curve inverted. By comparison, the Crane institutional government money fund index closed 2019 yielding 1.40% while its prime money fund index counterpart yielded 1.56%. A year earlier, those yields were 2.15% and 2.23% respectively. Neither beat the return of the 90 Day T-bill (2.28%) in 2019.

The Secured Overnight Financing Rate (SOFR) continued to make strides toward market acceptance as the SOFR futures market added options late in the year. Further, while SOFR-based floating rate note issuance for corporate and agency issuers continued, Freddie Mac issued the first commercial-mortgage securitization to contain a class of bonds indexed to SOFR in December. Both Freddie Mac and Fannie Mae have SOFR-linked residential adjustable-rate mortgage products in the works too. Further, the New York Fed is proposing to publish 30, 90 and 180 day SOFR benchmarks in early 2020. LIBOR's days may be numbered.

Looking Forward

Monetary policy has regained prominence globally as developed central bank policy shifted from a short pause to accommodative over the first half of 2019 broadly supporting markets. Domestic growth slowed but seems to have stabilized. The Fed has paused after cutting three times and the path for future rate cuts will be determined by macro risks and incoming economic data. Markets are pricing in another cut in late 2020.

Investment grade credit spreads closed the year at post-crisis tights prompting an assessment of portfolio exposure. After a stellar year of credit performance, agency mortgage-backed securities, commercial mortgage-backed securities and asset-backed securities look more attractive from a relative value standpoint. However, if volatility surges, selloffs will serve as opportunities to selectively add exposure to spread product.

Please contact the desk with questions or to discuss investment opportunities in the coming year.

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.

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