clearwater ADVISORS

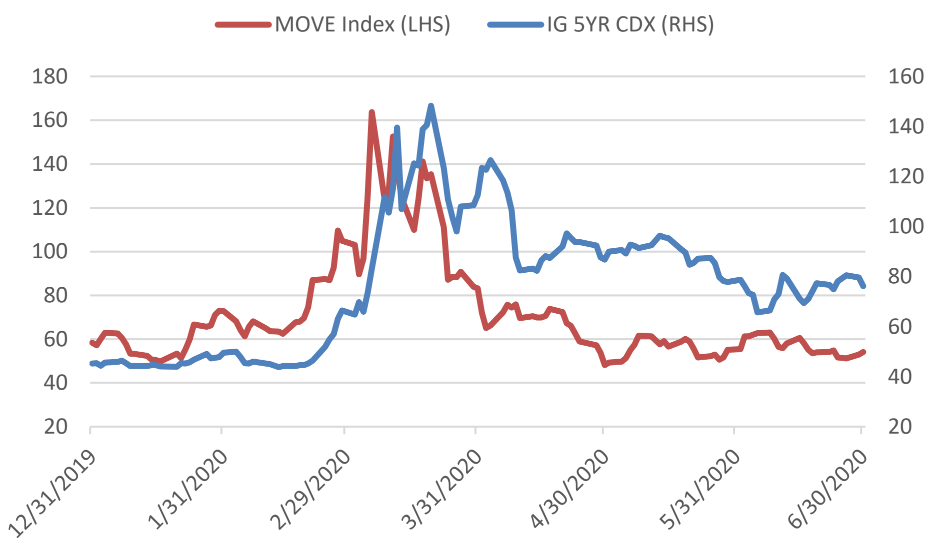
MARKET Commentary

Q2, 2020

Macro View

Markets continued to rally over the quarter as expansive monetary policy and fiscal stimulus offset the economic distress brought on by coronavirus (see Figure 1). Further, states slowly started reopening and economic data generally beat consensus by a wide margin supporting market sentiment.

Figure 1: The Market Recovery Continues



Source: Bloomberg

The euphoria started to wane late quarter as increased reopening activity led to a rise in new coronavirus cases dampening expectations of a relatively quick return to some form of normalcy. However, the Federal Reserve (Fed) staved off a broader market turn for the worse in mid-June with its corporate bond purchasing announcement.

With massive fiscal and monetary stimulus, the steeply negative Q1 market impact was largely offset by an equally impressive rally in Q2. The path forward will be more uneven as states endeavor to mitigate infections associated with reopening. Thus, the economic recovery may continue to surprise to the upside, but to a smaller degree than experienced over the last few months contributing to market volatility.

Monetary Policy

The Fed fine-tuned and launched many of the COVID response programs announced in March to support market stability. Further, at their June meeting,

Federal Funds Target

0.00-0.25%

U.S. Treasuries

As of 30-June

Benchmark	Yield
3 Month	0.13%
6 Month	0.13%
1 Year	0.15%
2 Year	0.15%
5 Year	0.29%
10 Year	0.66%
30 Year	1.41%

ICE BofAML Index Returns

2020 YTD Return

Index	Return
0-3 Month UST	0.48%
1-3 Yr Gov/Corp ≥ A	2.93%
1-3 Yr Municipals	1.49%
1-3 Yr Agencies	2.33%
1-5 Yr Gov/Corp ≥ A	4.03%
S&P 500	-3.09%

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

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Fed officials indicated dovish policies will continue until, at least, 2022 demonstrating the expected depth and breadth of the negative economic impact. The Fed stated that purchases of Treasury and agency mortgage-backed securities (MBS) will carry on at approximately $80B and $40B a month, respectively. Finally, the Fed reiterated that it is "committed to using its full range of tools to support the U.S. economy in this challenging time."

The Fed got markets back on track and financial conditions into a more normal state without having to use much program capacity (see Figure 2). Granted the Fed was not idle, having ballooned its balance sheet to $7T from just over $4T pre-COVID. But, much of that increase was from turbocharged Treasury and agency mortgage-backed security purchases. A few months ago, Fed strategists expected the balance sheet to reach $8-10T by the end of the year – barring further economic stress it looks like balance sheet size will come in around the low end.

Figure 2: Federal Reserve Market Support (as of 07/02/20)

Program	Size/Use	Description	Impact
CPFF Commercial Paper Funding Facility	$200bn/ $4bn	Purchases newly issued commercial paper from U.S. issuers when private sector normal market investment is not sufficient or absent	Improves liquidity in the short-term funding markets, primarily used by corporations for working capital
PMCCF Primary Market Corporate Credit Facility	$500bn/ $0bn	Purchases newly issued corporate debt from issuers	Increased confidence in corporate credit markets allowing corporations to borrow
SMCCF Secondary Market Corporate Credit Facility	$250bn/ $10bn	Purchases existing corporate debt or corporate debt exchange-traded funds on secondary markets	Increased confidence in corporate credit markets allowing corporations to borrow
Main Street Lending Programs	$600bn/ $6bn	Assists the flow of credit to small- and mid-sized businesses	Provides support to households and businesses of all sizes
PDCF Primary Dealer Credit Facility	$30bn/ $2bn	Provides overnight loans to primary dealers through their clearing banks in exchange for eligible collateral	Improves market liquidity and promotes the functioning of financial markets in general
TALF Term Asset-Backed Securities Loan Facility	$100bn/ $0bn	Facilitates the purchase of newly issued, highly rated ABS by providing non-recourse financing to investors	Ensures ABS market liquidity and function to facilitate consumer purchases (autos, credit card purchases, etc.)
MMLF Money Market Fund Liquidity Facility	$500bn/ $21bn	Provides non-recourse loans to financial institutions to purchase assets that money market funds are selling to meet redemptions	Reduces the probability of runs on money market funds which results in funds force selling assets for liquidity
MLF Municipal Liquidity Facility	$500bn/ $1bn	Purchases short-term notes from eligible states, cities, counties, and other issuers	Reduces the strains on municipalities' budgets and helps governments deliver critical services
PPP Paycheck Protection Program Liquidity Facility	NA/ $68bn	Lends to eligible borrowers, used to cover payroll costs, and most mortgage interest, rent, and utility costs	Reduces the financial strains on corporations while promoting employment

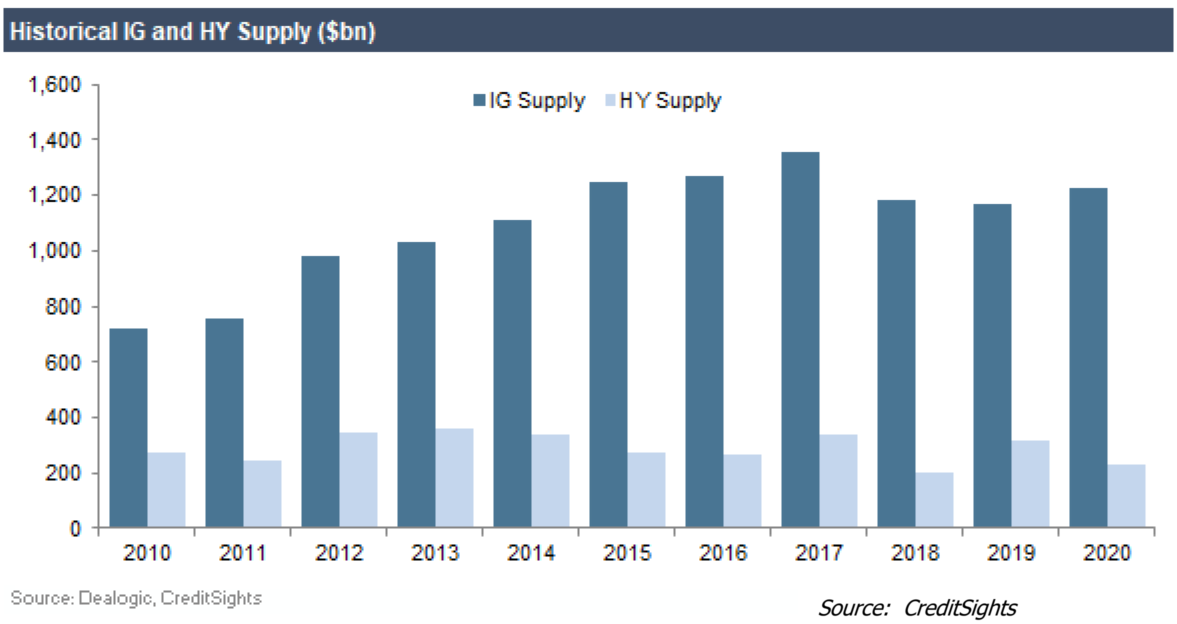
Source: Federal Reserve/Clearwater Advisors

Fed officials must be pleased that markets are in a reasonably good spot while they still have ample program capacity left should the situation deteriorate. As it stands currently, most programs expire at the end of Q3, but we expect them to be extended unless the COVID pandemic suddenly abates.

Markets

Market performance over the quarter was a mirror image of the prior. West Texas Intermediate crude oil, which was deeply battered, rose 92% on the quarter. However, it's still down 36% YTD. Equity indices rallied as did fixed income spread product. Investment grade credit outperformed high yield over the quarter following up one of the worst quarter's performance ever, likely due to the jump start provided by monetary policy support. The extremely active primary investment grade market dynamic continued with $730B in bonds printing in Q2. This brings investment grade issuance in the first half of 2020 to just over $1.2T, surpassing the prior annual totals of 2018 and 2019 (see Figure 3). In comparison, the high yield market was slower out of the gate, but still managed to print a record $56B in June and is on pace to surpass last year's total in Q3.

Figure 3: Blockbuster Supply



Source: CreditSights

The Fed commenced purchases of investment grade and high yield exchange traded funds followed shortly thereafter by purchases of corporate bonds on the secondary market – all totaled about $160M a day. As of the end of Q2, just over 50% of the corporate bond purchases were in BBB-rated securities and almost 60% were within the 1-3 year maturity bucket. The top five issuer exposures were AT&T, Comcast, VW, Apple and Verizon. Ford fell just outside of the top five. The expected decline in issuance over the later part of the year combined with Fed purchases provides a strong technical backdrop for credit into the second half of 2020, especially inside five years to maturity.

The yield curve was little changed save for a modest decline in the belly as markets priced in a possibility of negative Fed Funds over the next year or so. However, Fed officials have repeatedly stressed that negative rates aren't an attractive option for U.S. monetary policy. Treasury yield curve management looks to be the next unconventional tool to be deployed. Either way, low rates are here for the foreseeable future.

Looking Forward

Massive doses of fiscal and monetary stimulus buoyed risk assets and restored market function. Another round of fiscal stimulus (end of July is targeted) is expected to help cushion further economic weakness as we head into a politically charged election season. The path forward will be uneven as the trajectory of the coronavirus and economy recovery take shape.

The Fed will continue to maintain liquidity and support credit availability for the foreseeable future and fed funds will be at zero for the next year or two. In such an environment, investors should maximize spread product limits within policy. Investment grade credit looks reasonably valued given the uncertainty faced while agency mortgage-backed securities look attractive. AAA-rated asset-backed securities are a good source of incremental yield over similarly rated alternatives. If volatility surges, selloffs will serve as opportunities to selectively add exposure to certain fixed income sectors.

For risk averse investors, government money market fund yields continue to fall towards zero – a low cost separately management account rolling treasury bills and agency discount notes may be an attractive alternative while the Fed remains on hold.

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

Form ADV Part 2

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