clearwater ADVISORS

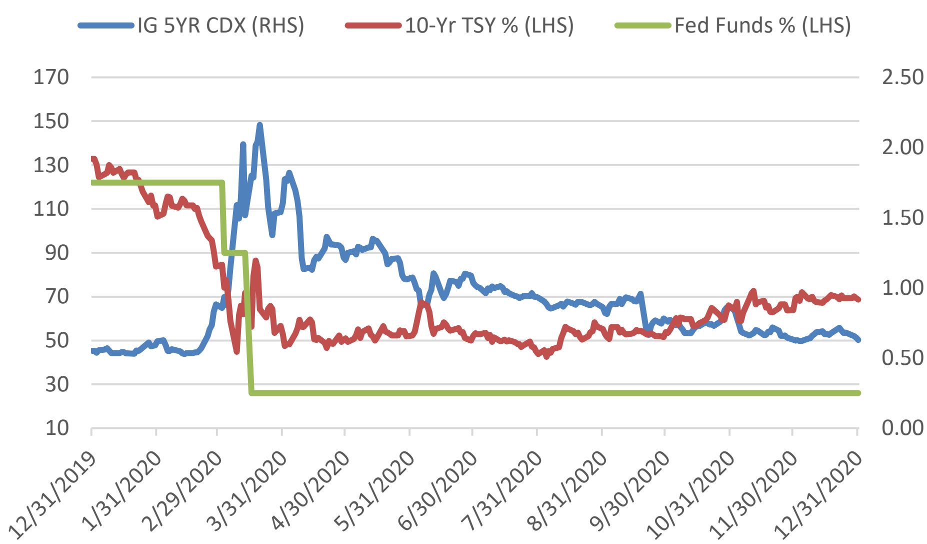
MARKET Commentary

Q4, 2020

Macro View

Risk assets rallied to new highs as 2020 came to a close. Expectations of further fiscal stimulus and optimism that vaccines will curb the economic impact of the pandemic buoyed market sentiment. Political turmoil was largely overlooked as President Biden is expected to usher in a return to more conventional governing. The yield curve bear steepened with short rates anchored by accommodative monetary policy and longer maturity yields rising on greater deficit spending. Further, credit spreads recovered close to pre-pandemic levels (see Figure 1).

Figure 1: What a Year



Source: Bloomberg

The Federal Reserve (Fed) maintained course on zero interest rate policy as well as asset purchases, $80B of Treasury and $40B of agency mortgage-backed securities a month. Little change is expected in the first half of 2021, but depending on the success of vaccine distribution and pandemic dynamics the Fed could start tapering later in the year. However, the path to higher rates is still likely a couple of years away.

Spread sector valuations largely reflect a return to economic normalcy supported by easy monetary policy and fiscal stimulus. The recovery path will be uneven which should leads to bouts of volatility and opportunities to add selectively to spread product. However, it will be difficult to replicate the easy monetary policy-charged fixed income returns from the past year.

Federal Funds Target

0.00-0.25%

U.S. Treasuries

As of 31-Dec

Benchmark	Yield
3 Month	0.06%
6 Month	0.08%
1 Year	0.10%
2 Year	0.12%
5 Year	0.36%
10 Year	0.91%
30 Year	1.65%

ICE BofAML Index Returns

2020 Return

Index	Return
0-3 Month UST	0.46%
1-3 Yr Gov/Corp ≥ A	3.24%
1-3 Yr Municipals	2.16%
1-3 Yr Agencies	2.67%
1-5 Yr Gov/Corp ≥ A	4.36%
S&P 500	18.4%

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

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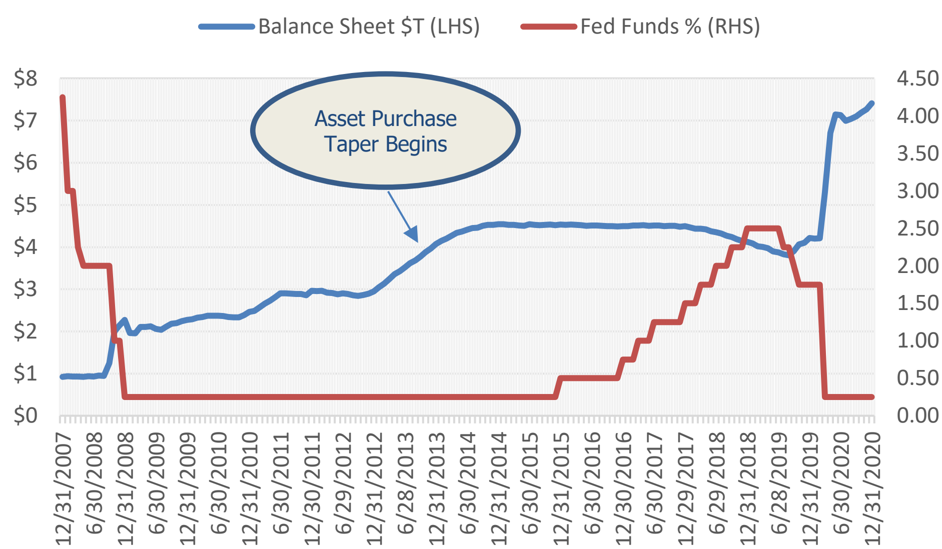
Monetary Policy

In a year of exceptional turbulence, the Federal Reserve served as a major counterbalancing force to economic and market volatility. The Fed aggressively expanded its balance sheet and launched myriad programs to restore market function as the pandemic gripped the domestic economy last spring. More recently, no changes to policy were announced while forecasts updated at the December policy meeting, indicate a flat Federal funds rate through 2023. Further, in its December statement, the Fed modified guidance to note asset purchases would continue at the current pace until "substantial further progress has been made toward the Committee's maximum employment and price stability goals."

Following the meeting, several Fed officials spoke publically about a possible timeline to taper asset purchases stirring markets and indicated that the process could generally follow the post-Great Recession sequence. Looking back, the Fed tapered purchases for all of 2014 and then reinvested maturities to maintain a stable balance sheet size for three years before finally allowing the balance sheet to passively shrink starting in 2018 (see Figure 2). The path to higher Fed funds commenced two years after the Fed tapered asset purchases.

Figure 2: Fed Policy Transition



Source: Bloomberg

While we certainly won't see a change in Fed funds rate this year, the vaccine impact and pandemic trajectory will influence the pace of asset purchases. The Fed will do its best to communicate its taper plan, but market volatility will likely arise as the Fed attempts to decelerate its highly accommodative stance which will lead to investment opportunities as sectors react.

Markets

Risk assets surged into year-end on calls for additional fiscal stimulus and as the vaccine rollout began. Major asset classes delivered strong annual returns as unprecedented fiscal and monetary stimulus restored market confidence. Lower quality credit (junk) trumped higher quality (investment grade) even as defaults rose above long-term averages. Investment grade credit spreads recovered to near pre-pandemic levels as easy financial conditions provided a dynamic environment to access capital and/or refinance debt.

Within the Clearwater Advisors' client universe, duration and credit exposure were prominent drivers of performance (see Figure 3). The bulk of the returns were recognized earlier in the year as the Fed cut rates to zero and launched quantitative easing. As a result, given the Fed's accommodative stance and current yield levels, 2021 returns will likely mirror the income of a particular fixed income sector.

Figure 3: 2020 Fixed Income Year-End Characteristics and Returns

Index	Quality	Yield	Duration	Annual Return
90 Day T-Bill	AAA	0.08%	0.25 yrs	0.67%
2-Year U.S. Treasury	AAA	0.12%	1.99 yrs	3.03%
1-3 Year AAA-A U.S. Corporate & Government	AAA	0.19%	1.88 yrs	3.24%
1-3 Year AAA-A U.S. Corporate	A2	0.53%	1.81 yrs	3.98%
AAA U.S. Asset-Backed Security	AAA	0.54%	1.62 yrs	3.48%
1-5 Year AAA-A U.S. Corporate & Government	AAA	0.26%	2.66 yrs	4.43%
0-3 Year U.S. Agency CMO (MBS)	AAA	0.86%	2.15 yrs	2.21%
5-Year U.S. Treasury	AAA	0.36%	4.97 yrs	7.20%

Source: ICE BofAML Indices

Looking across the indices in the table above, agency mortgage-backed securities are a sector that has lagged a bit in the subsequent rally and look reasonable attractive within the investment grade universe. However, the current stance on monetary policy and technical environment is broadly supportive for high grade spread product. Therefore, we'd maintain credit and high quality asset-backed security exposure away from treasury and agency securities in portfolios.

The Treasury curve bear steepened into year-end as yields rose some 15-35 bps for maturities of five years and beyond. Further, TIPS break evens widened as the Democratic Party swept the Georgia Senate run-off in early January stoking the reflationary trade. Looking forward, front-end yields will continue to be little changed for the foreseeable future while longer rates will key off of measurable economic and pandemic progress. Therefore, we're comfortable taking advantage of yield curve steepness when available inside 3-4 years.

Looking Forward

A tumultuous year has come to a close. Expectations for pandemic, economic and political improvement are high for 2021. With the recovery in fixed income markets, sector and security decisions will be more selective as we move forward. Further, investors should look to take advantage of current policy flexibility to extend duration and maximize prudent spread product exposure with the Fed expected to remain on hold for a while.

Please contact the desk with questions on policy reviews or to discuss investment opportunities.

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