clearwater ADVISORS

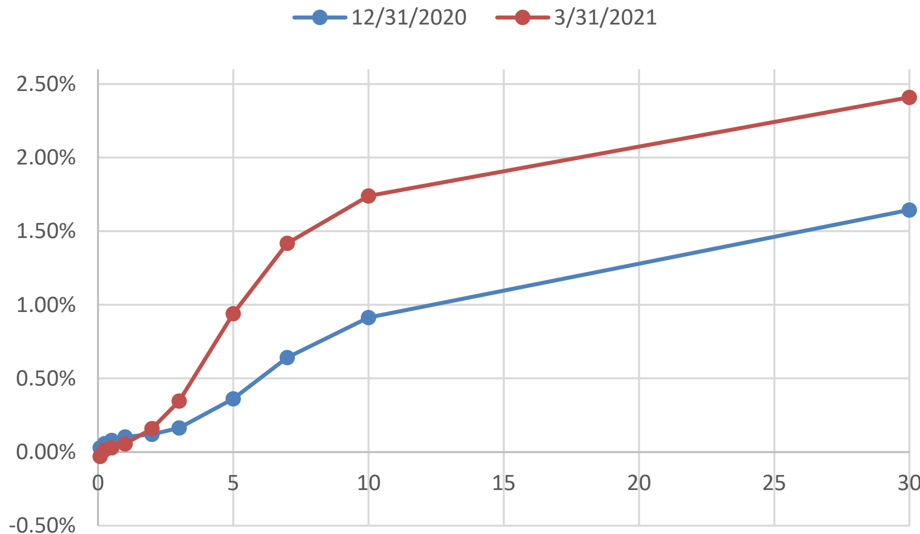
MARKET Commentary

Q1, 2021

Macro View

The January Georgia runoff election gave the Democratic Party a one-vote advantage in the Senate and the Biden Administration wasted no time pushing through a new round of massive fiscal spending. Meanwhile, the vaccine rollout continued to accelerate and states reopened or removed pandemic restrictions. All of the positive momentum contributed to new highs in equity prices and caused longer maturity treasury yields to rise materially. (see Figure 1).

Figure 1: Yields Surge



Source: Bloomberg

The yield curve steepened significantly with longer duration Treasury yields rising some 60-80 basis points as markets contemplated higher economic growth and large deficits. 2021 will likely see some of the greatest economic expansion metrics as the U.S. emerges from the pandemic in tandem with supercharged fiscal spending. Following up on the $1.9T American Rescue Plan passed in January, President Biden has laid out the framework for additional fiscal stimulus including a massive $2T infrastructure plan and a $1T family spending package.

Spread sector valuations largely reflect a return to economic normalcy supported by easy monetary policy and fiscal stimulus. The transition away from massive fiscal and monetary support as market guideposts to underlying economic fundamentals will be bumpy offering investment opportunities. The path forward continues to be driven by progress to tamp down the pandemic, but the outcome looks to be heavily tilted towards the upside.

Federal Funds Target

0.00-0.25%

U.S. Treasuries

As of 31-Mar

Benchmark	Yield
3 Month	0.02%
6 Month	0.03%
1 Year	0.06%
2 Year	0.16%
5 Year	0.94%
10 Year	1.74%
30 Year	2.41%

ICE BofAML Index Returns

YTD 2021 Return

Index	Return
0-3 Month UST	0.02%
1-3 Yr Gov/Corp ≥ A	-0.04%
1-3 Yr Municipals	0.19%
1-3 Yr Agencies	-0.02%
1-5 Yr Gov/Corp ≥ A	-0.53%
S&P 500	6.20%

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

Contact Us

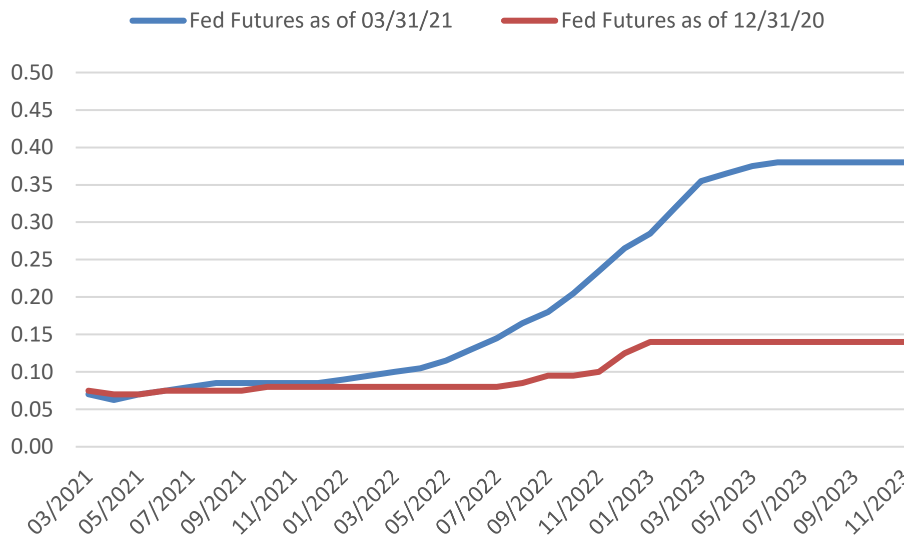
Dan Bates
dbates@clearwateradvisors.com

www.ClearwaterAdvisors.com

Monetary Policy

The Federal Reserve (Fed) met twice in the first quarter, most recently in March, leaving policy unchanged while upgrading their growth and employment forecasts. The Fed maintained course on asset purchases – $80B of Treasury and $40B of agency mortgage-backed securities a month. More importantly, Fed officials stressed that any conclusion to the current accommodative policy stance is well in the future after inflation and employment data recover to levels acceptable to the Fed. Markets were firmly in the Fed's camp at the start of the year as the pandemic flared and political uncertainty was high. Yet, with the decline in COVID cases and widespread vaccine rollout, markets have pulled forward expectations for the first hike to late 2022 (see Figure 2).

Figure 2: Fed Funds Futures



Source: Bloomberg

Chairman Powell acknowledged "the economy is a long way" from the Fed's employment and inflation goals. Further, while he expects inflation to rise above 2% this year, it is expected to be transitory and not enough to require a monetary policy response. Subsequent appearances by Powell and other Fed officials replayed the theme of patience even as economic data surprised significantly above expectations. The end result has money markets anchored by zero interest rate policy while the belly of the yield curve exhibits some volatility as markets anticipate lift-off.

Markets

Risk assets continued to build on their year-end surge as the Biden Administration pressed forward with massive fiscal stimulus, vaccine distribution increased markedly and states reopened their economies. Major risk asset classes zoomed to new highs while the Treasury curve bear steepened. Longer-duration Treasury yields increased 60-80 basis points contributing to deeply negative fixed income returns for the quarter. The Fed has reiterated its lower for longer mantra capping the recent rise in yields.

The pace of investment grade new issuance slowed as the quarter progressed as most corporate issuers have taken advantage of market conditions over the last ten or so months. However, high yield

companies issued a record level of bonds in the quarter easing financing concerns and tightening credit spreads. Financial conditions are at their easiest on record by many measures supporting credit markets while spreads have returned to pre-pandemic levels increasing the importance of selective sector and security decisions as the year progresses.

The Fed's Vice Chair for Supervision and current Chair of the Financial Stability Board (FSB) put money funds on notice for further regulatory reform during a recent speech. He specifically mentioned the strain money market funds exhibited during the COVID crisis noting that institutional investors pulled 30% of money funds' assets during a two week mid-March 2020 period stressing money markets and forcing the Fed to step in and provide market support. He noted that it was a faster run than during the September 2008 market turmoil. Therefore, the FSB will publish a report for consultation in July on policy proposals to improve money market fund resilience as the recent set of reforms proved insufficient.

The SEC comment period recently closed on the President's Working Group on Financial Markets list of proposed measures to improve money market fund resiliency. Unsurprisingly, the structural proposals that would increase costs and reduce yields found the most opposition (like implementing capital buffers or a minimum balance at risk where some of each shareholders' balance would be subject to a redemption delay). If enacted, those changes would effectively drive prime money funds out of business. The U.S. Treasury is also reviewing market vulnerabilities. Therefore, over the summer, regulators, the Fed and Treasury will work towards definitive policy and we should have a good idea of what the next round of MMF reform looks like later this year.

Looking Forward

The worst of the pandemic has passed and the U.S. is now quickly pivoting to a fully open economy amid massive fiscal and monetary stimulus. Sector and security decisions should drive performance going forward as markets have priced in much of the return to pre-pandemic economic activity. We believe the Fed will stay the course holding money market rates low, but will have a difficult time managing market expectations should the economy grow too strongly.

Money market reform is coming once more likely impacting prime funds more so than their government counterparts. It is an opportune time to begin the process of a prime fund alternative separately managed account. Changes are coming and, according to Crane Data, prime funds are offering yields just a handful of basis points over the risk-free alternative.

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

This material is for your private information, and we are not soliciting any action based upon it. Certain investments, including those involving futures, options and other derivative products give rise to substantial risk and are not suitable for all investors. The risks inherent in these investments may lead to material loss of capital. Past performance may not be indicative of future results. Results portrayed, including those of indices, reflect the reinvestment of dividends, as well as the effects of material market and economic conditions. Different market and economic conditions could have a material impact on performance. Index results are used for comparison purposes only and have been unaltered from their original state as received from independent sources. Historical results reflect returns that a typical investor would have received based on stated fees and do not necessarily reflect returns that actual investors received. Opinions expressed are our present opinions only. The material is based upon information that we consider reliable, but we do not represent that it is accurate or complete, and it should not be relied upon as such. This document is intended for your internal use only and may not be distributed outside your organization. This is neither an offer to sell nor a solicitation of an offer to buy an investment product.

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.