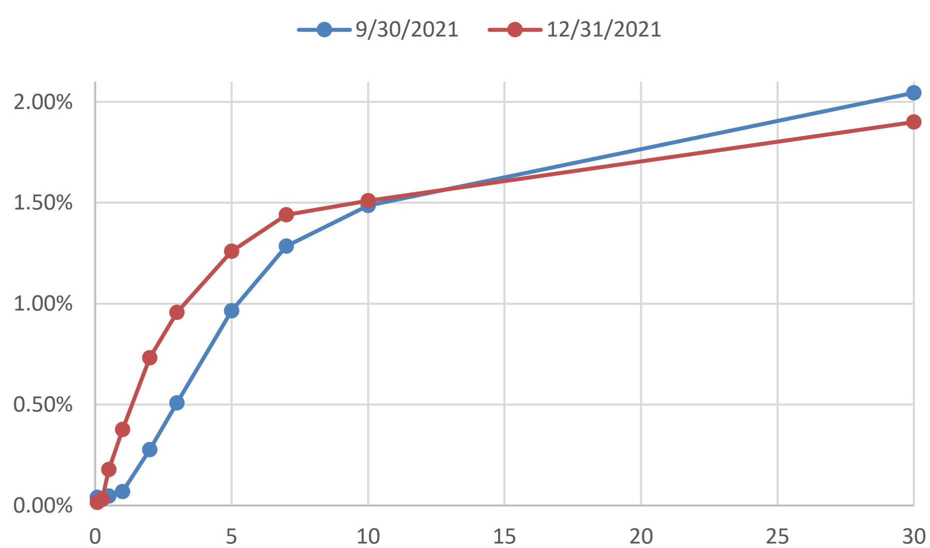
MARKET Commentary

Winter 2021

Macro View

Risk assets recovered from Omicron fears and a Fed pivot away from accommodative policy to close the year near record high price levels. The Federal Reserve continued along its path away from ultra-accommodative policy as the quarter progressed. The central bank doubled its asset purchase tapering pace and indicated that interest rate hikes will soon follow (possibly as soon as March). Consequently, the yield curve bear flattened as short rates rose 30-50 basis points and longer maturity yields actually fell slightly (see Figure 1).

Figure 1: Preparing for a Hike



Source: Bloomberg

The pivot towards less accommodation is accelerating even as the Omicron wave disrupts economic activity. Risk assets will likely experience volatility as markets grapple with the impact of less monetary policy stimulus. The first hike may come near the end of the quarter as the job market is tight and inflation stubbornly high. Short and intermediate yields have risen and will continue to do so as the Fed normalizes policy.

Monetary Policy

The Federal Reserve significantly shifted policy direction over the fourth quarter. Chairman Powell officially retired the word "transitory" as inflation accelerated to multi-decade highs. Further, the Fed started tapering its asset purchases

Federal Funds Target
0.00-0.25%

U.S. Treasuries
As of 31-Dec

Benchmark	Yield
3 Month	0.03%
6 Month	0.18%
1 Year	0.38%
2 Year	0.73%
5 Year	1.26%
10 Year	1.51%
30 Year	1.90%

ICE BofAML Index Returns
2021 Return

Index	Return
0-3 Month UST	0.04%
1-3 Yr Gov/Corp ≥ A	-0.49%
1-3 Yr Municipals	0.34%
1-3 Yr Agencies	-0.43%
1-5 Yr Gov/Corp ≥ A	-1.00%
S&P 500	28.7%

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

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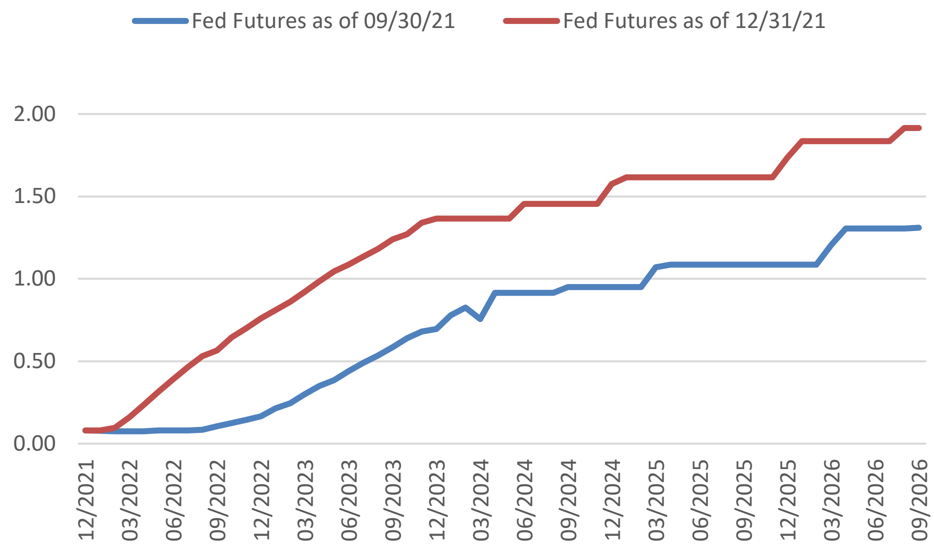
mid-quarter and soon decided to double the pace in December. Fed officials hinted that rate hikes were necessary and see three hikes in 2022 as a base case after forecasting just one as recently as September.

Markets, long accustomed to a heavy dose of accommodative policy, reassessed how quickly the Fed may have to act given the stubbornly high inflation data and economic backdrop (see Figure 2). Market expectations of the first rate hike were pulled forward to early 2022. Further, the trajectory of hikes increased as the Fed seeks to reassert its inflation fighting credentials amid a tight labor market.

Figure 2: Expectations Pulled Forward



Source: Bloomberg

The accelerated taper will end asset purchases by March 2022. Rate hikes are expected to commence at that point in 25 basis point increments at a quarterly clip. Federal Reserve balance sheet contraction (via maturities) could come in the summer as Fed officials stress this economic cycle is unlike the previous. Thus, the Fed begins the difficult task of guiding the economy to a soft landing.

Markets

Risk assets surged into year-end. Major asset classes, led by commodities, delivered strong annual returns fueled by easy monetary policy, massive fiscal stimulus and strong economic activity. Within fixed income, U.S. treasury inflation-protected securities and cash posted positive returns as inflation printed high and rates materially rose. Lower quality credit (junk) trumped higher quality (investment grade). Investment grade credit spreads widened modestly on omicron fears before reversing course as the year came to a close. Financial markets are opening 2022 with an outlook for good economic growth, stabilizing inflation and tighter monetary policy.

Within the Clearwater Advisors' client universe, duration and credit exposure were prominent drivers of performance (see Figure 3). The additional spread pick-up provided by credit offset some of the impact of higher yields while asset-backed securities provided a good combination of low duration and spread for a very high-quality sector. For much of the year, returns mirrored coupon levels which eroded in the last quarter as the Fed began to change their message and reduce monetary policy support pushing Treasury yields higher. The broad U.S. Treasury Index returned -2.5% on the year and received some attention as it has never posted two negative return years in a row (since index inception in 1974). Many strategists, however, see 2022 as challenging for treasury securities with high inflation and upcoming Fed hikes.

Figure 3: 2021 Fixed Income Year-End Characteristics and Returns

Index	Quality	Yield	Duration	Annual Return
90 Day T-Bill	AAA	0.05%	0.25 yrs	0.05%
2-Year U.S. Treasury	AAA	0.73%	1.98 yrs	-0.53%
1-3 Year AAA-A U.S. Corporate & Government	AAA	0.75%	1.88 yrs	-0.49%
1-3 Year AAA-A U.S. Corporate	A2	1.04%	1.84 yrs	-0.24%
AAA U.S. Asset-Backed Security	AAA	0.99%	1.62 yrs	-0.23%
1-5 Year AAA-A U.S. Corporate & Government	AAA	0.95%	2.66 yrs	-1.00%
0-3 Year U.S. Agency CMO (MBS)	AAA	1.69%	2.55 yrs	-0.33%
5-Year U.S. Treasury	AAA	1.26%	4.86 yrs	-2.82%

Source: ICE BofAML Indices

The agency mortgage-backed securities sector has recently come under pressure as the Fed backs away from asset purchases and should be an area to add exposure over the next few months. Selective high grade credit and AAA-rated asset-backed securities continue to look reasonably attractive as fundamentals look good even as the technical environment weakens slightly. Agency securities are an opportunistic add during bouts of volatility.

As the Federal Reserve normalizes policy, 2022 returns will likely benefit nimble duration and sector exposure. Further, money market yields (13 months and in by maturity) should move substantially higher as the year progresses.

Looking Forward

Soaring inflation and a robust employment situation has driven the Fed's recent shift on monetary policy. Therefore, in the coming year, monetary policy pivots away from being a volatility dampening factor for markets to potentially inducing it. Sector and security decisions will be more selective as we move forward amid less accommodative policy. Fundamentals for most sectors in the Clearwater Advisors' universe are in decent shape and portfolios should take advantage of risk-off market moves to add exposure to most spread sectors.

Money market regulation should be finalized this year with a compliance timeline of a year or two following. Swing pricing (a form of cost bearing for redeeming investors in times of stress) may be a part of the final prime fund rules and should lead to further outflows near the end of this year. Ultimately, prime fund net costs will likely rise as the March 2020 "dash for cash" centered on these funds. It is an opportune time to begin the process of implementing a separately managed prime fund alternative 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 on policy reviews or to discuss investment opportunities.

Form ADV Part 2

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