Aaron J. Kennon April 2, 2018

Chief Executive Officer & Chief Investment Officer

Friend of Clear Harbor,

I'm pleased to share our firm's outlook for the second quarter.

Many of the macro trends we have highlighted in recent years seemed to move to the forefront of investors' minds in recent weeks. The path toward monetary normalization after a decade of unprecedented and unconventional easing continued to frame investor considerations throughout the first quarter, even as geopolitical risks reclaimed their place atop the news flow on several occasions. The spotlight on technology shifted from long-running perceptions of invincibility to the sort of highly public missteps that invariably accompany disruption.

Such developments helped drive higher volatility and an abrupt correction in global equity markets from the highs of late January, along with incremental pressure on bonds. Oddly, emerging markets seemed more quiescent, with benchmarks outperforming most key global indices across both equities and fixed income by reasonable margins.

Economic fundamentals are more encouraging. Despite continued employment and wage gains, the global trend still seems one of longer-term disinflation. In the final weeks of the quarter, inflation fears appeared to subside as economic data suggested a deceleration in price momentum. It is an enticing prospect for those seeking a Goldilocks scenario of "just enough" monetary tightening coupled with economic growth and insignificant levels of inflation. We shall see.

Market Review

U.S. equity markets posted mixed results for Q1 2018, with small-cap companies represented by the Russell 2000 falling just -0.07% while large cap names represented by the S&P 500 ended the quarter off by -0.76%%. The broadest indicator of international equities, the MSCI All World Index ex US, declined -1.09%, while the MSCI Emerging Markets index rose 1.37%. We continued to see growth outperform value, and technology lead on a sector basis.

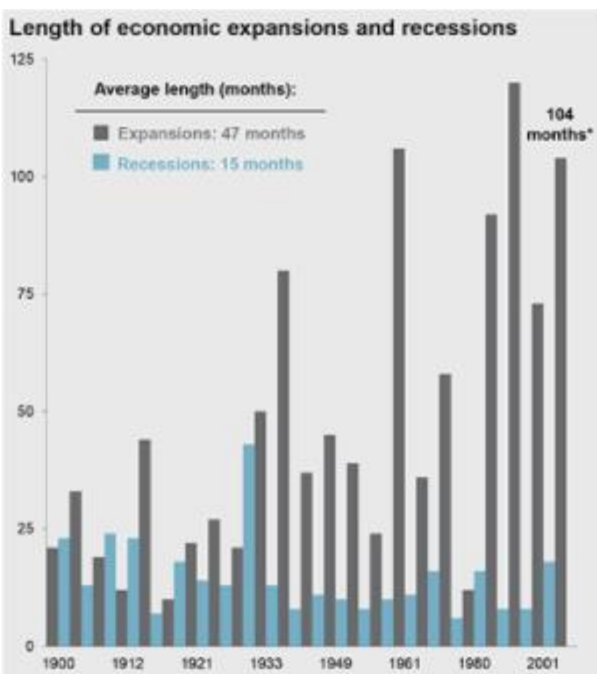
In fixed income, international bonds outperformed domestic by a small margin, with the Bloomberg Barclays Aggregate Bond Index off -1.46% while the global benchmark managed a 1.36% gain. Gold bullion ticked up 1.75%, while Brent crude rose 5.55% in response to higher demand, tightening supply, a weaker dollar, and emerging signs of labor shortages in key basins in the U.S.

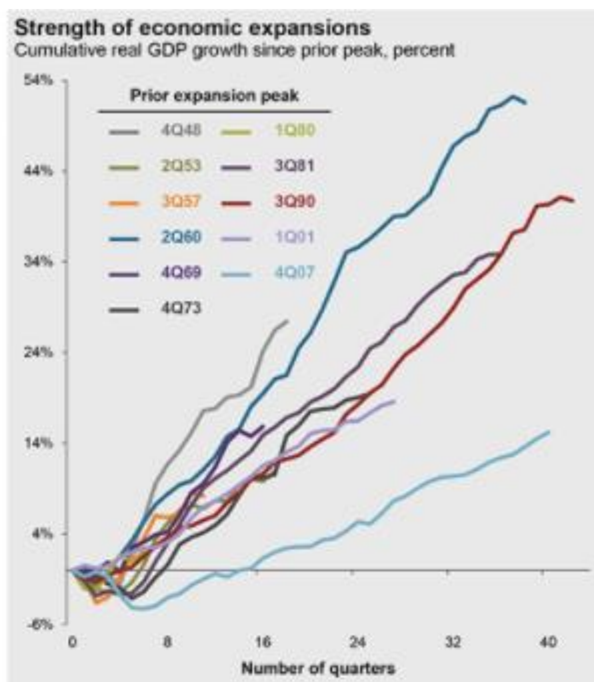
Economic Cycle

Some observers maintain that a recession may well be around the corner—perhaps just a few quarters away. They point out, quite reasonably, that the current U.S. expansion is the longest in modern history; that public debt loads are poised to explode on the heels of significant deficit spending; that interest rates remain low enough to invite overheating, especially given tight employment markets across key segments of the economy; that the U.S. Federal Reserve might nonetheless raise rates too quickly, choking off the recovery; and that market valuations appear expensive relative to recent history.

We are mindful of these concerns and take them into account in our scenario planning. However, an equally persuasive swath of data supports a more balanced view.

First, the shallowness of the current expansion itself allows greater room for it to continue: there has been no unsustainable “boom” from which a “bust” must result. Indeed, cumulative growth over the last eight years is still well below the average expansion witnessed over the last several cycles. Such a view is reinforced by global manufacturing and developed market leading economic indicators, which continue to point in a very healthy direction.





Source: JP Morgan Asset Management, BEA, NBER. The Chart assumes that the current expansion started in July 2009

In addition, economic stimulus from the 2017 tax cuts will be meaningful in both 2018 and 2019, auguring a further boost to earnings this year and beyond. In other encouraging readings, capital remains relatively inexpensive, credit spreads remain at healthy levels, merger and acquisition activity is robust, and global liquidity continues to provide incremental fuel to the world economy.

We believe these factors augur for continued growth—even if hiccups along the way keep things interesting, and maintain volatility at higher levels than investors have come to expect in recent years. On balance, we consider this market a "wall of worry" worth climbing further.

Monetary Policy

The new Fed Chair, Jerome Powell, appears committed to maintaining the data-dependent succession of rate hikes that began in 2017. While some fear that "too much, too soon" could suppress the expansion, the Fed just last week made noises about allowing inflation to rise above their long-stated 2% target.

While this should placate some fearful doves, the more important takeaway is the conviction that the Fed remains committed to an incrementally more conventional policy stance. This is welcome, as it invites investors to step back from the white-knuckled obsession over monetary concerns that has defined the last decade and embrace more traditional indicators of economic and corporate health.

Geopolitical Considerations

In February of 2017, we articulated in a Clear Harbor Flash that geopolitical uncertainties would become markedly more pronounced within the developed world. Our view was a function of the loosely defined, but demonstrably more aggressive, approach to trade and foreign policy outlined by the incoming Trump administration in the U.S., coupled with unknowables surrounding Brexit and the future of the European Union.

While market participants looked past these points at the time, events have since demanded their attention, particularly around trade. Debate and policy action from the Trump administration on tariffs for steel, aluminum and some consumer products, as well as broader free-trade agreements with allies in North America and across the Pacific, have introduced potential new fragilities into the global economy. The most concerned observers perceive in Trump's saber-rattling a symbolic shift from free-market capitalism to greater state control—something with echoes of the authoritarian governance that wrought horror both economically and politically in the 1930s around the world.

While we accept that protracted limits on growth and widening wealth disparities represent long-term challenges for Western democracies, we also think Commerce Secretary Wilbur Ross has a point that investors to some degree may be confusing political bark with economic and geopolitical bite. The appointments of Larry Kudlow as the president's chief economic advisor and John Bolton, a foreign policy hawk, as Secretary of State are not the dire developments that their most vocal critics presume.

Both men have relevant prior experience—itself a reassurance in an administration plagued by staffing scandals and shortages. Rhetorical flourishes notwithstanding, neither is an isolationist in economic or foreign policy. They support strong dollar policies and free trade, and share a willingness to confront China's companies and government over widespread patterns of technology theft and breaches of international trade and patent law that gravely disadvantage American competitors. This suits them well to carry forward themes established in the most recent quarter, in which Trump blocked the acquisition of U.S. technology titan Qualcomm by Broadcom—a Singapore-based company with strong ties to China—on national security grounds.

Legitimate concerns remain. The President has publicly accused our closest allies of unfair practices, and made a fetish of trade deficits to the neglect of their necessary counterpart, the country's large capital surplus. This picks an unnecessary fight in a heedless fashion. The U.S. has a trade deficit and capital surplus with most major countries at the moment—as indeed our nation has had since before its founding, including through periods of great prosperity. We also enjoy a comparative advantage in services, which Trump neglects in his emphasis on trade in goods.

We are hopeful the administration's actions, if not its rhetoric, will be tempered by Mr. Kudlow's arrival, and that he will find internal support from Treasury Secretary Steven Mnuchin. We take heart from this past week's reports that the U.S. and China already are "quietly" seeking trade concessions, possibly around U.S.-made semiconductors.

Mr. Kudlow and his allies nonetheless will have their work cut out for them. The President's decision to exit the Trans-Pacific Partnership ("TPP") undermined America's economic and military stature and position in the Pacific, and set an early precedent that more rational minds must avoid repeating as negotiations proceed to update NAFTA. We have already destroyed a critical mechanism for banding our allies and democratic nations in one region together to signals strength and resolve to China and Russia. To do so in our own geopolitical back yard could very well prove inexplicably self-destructive.

Most of the crises of the last half-century have arisen in emerging markets such as Thailand, Mexico, Russia, and Argentina. The fact that we must even discuss such risks emanating from America represents a dramatic departure from the relative stability our nation has cultivated since World War II. While global growth is healthy and synchronous at present, we have entered a multi-decade period of demographic change that could give a second wind to isolationist impulses in the West. We look for the market calculus in the coming years to be no more assured than the political one.

Technology: Autopilot on Pause?

- Social Media

This month we saw yet again how technology companies are able to extract and leverage consumer data for considerable profit. The revelation is not new: indeed, selling data is intrinsic to the business model of every major social media platform. However, the scale of the most recent revelations has inflamed concerns that our personal lives are being exploited and manipulated for political and economic gain.

Historically it is government, in its ever-expanding largesse and accompanying tentacles, that has provoked the greater fear over loss of private space and personal thoughts. In a relatively short span of years, prospects of similar exploitation in the private sector have won equal billing.

This development has been aided and abetted by a Congress that, starting with the Communications Decency Act of 1996, granted liability relief to private companies (eventually to include Facebook) for what users do on these public platforms. Such measures helped create the environment that made the U.S. the origination for so many of the world's dominant Internet companies, which continue to lower prices across wide swaths of the consumer economy.

Attention is now being paid to the amount and kind of data that is helping to underwrite those lower costs, as well as new services. In an understandable backlash, cries are growing for greater regulation of these latter-day monopolies. However, technology has historically outpaced regulators. While Europe may find ways to enforce its "right to be forgotten"—a concept as yet unfamiliar to many Americans—the dominant reality is that the degree of privacy our grandparents took for granted will prove nearly impossible for most consumers of technology.

The bottom line is that personal data is intrinsic to the personalized services today's consumer demands. We are mindful of the historically outsized representation that the sector has assumed in major indexes, and recognize that volatility may prove even more elevated here than across the broader market. Nevertheless, we expect that over the longer term investors will continue to reward those companies that can walk the fine line between their users' outrage and their addiction—and do so profitably.

- Artificial Intelligence

Recent advancements in storage, semiconductor capacity and data science have enabled the emergence of artificial intelligence in ways that seem fated to transform our lives. This presents an opportunity and a conundrum. Both are of historic proportions; neither is likely to be resolved soon.

Machines can now write certain types of code, recognize objects, translate speech, and ultimately synthesize fast quantities of data quickly and more accurately than humans. Machines can extract insights that we cannot from impossibly large data sets, and sell those insights to companies in the position to monetize them—a process known as "deep learning." This is the conundrum for those who fear, as many have in prior technological upheavals, for those workers who are ill-adapted to change.

I believe that the uncertainty, even the chaos, of this moment this will spark a yearning for human interaction, human perspective, and more meaningful forms of connectivity that will force important features of the global employment landscape to dramatically shift rather than disappear outright. Perhaps I am wrong, and—for the first time since the Luddites—our entrepreneurs will cease to create new avenues for human effort. But perhaps, as has historically been the case, we simply have yet to fully comprehend a future that we have only begun to create.

We have already glimpsed the potential of AI. Doctors may be able to hand over parts of the diagnostic process to robots with superior data-synthesis abilities, freeing time to counsel patients. Even in the wealth management industry, advisors are already leveraging new technologies to provide better analytics to advance client objectives. Such professionals are not rendered obsolete: they become more effective, and freer to address the personal needs and behavioral realities that determine client priorities and influence investment outcomes.

Portfolio Considerations

The second quarter of 2018, like the second year of the Trump presidency, presents intractable tensions: between rhetoric and reality, action and backlash, chaos and progress, greed and fear. How should such tensions be reflected and addressed in client portfolios?

As advisors, we must focus more on what is in our control than not. While price-to-earnings multiples can vacillate and quarterly earnings may prove fickle, fidelity to an appropriate asset allocation can help protect investors during times of market turbulence.

Such fidelity is greatly enhanced by a portfolio that accurately reflects an individual's tolerance for risk. If recent intraday swings of 1-3% have cost you sleep, what impact would one or more corrections of greater than 10% in the next year have on your sense of financial well-being?

Our base case anticipates exactly this sort of elevated asset class volatility to remain with us. It is one that makes sense in the face of tightening monetary policy, expanded market multiples and a range of domestic and geopolitical uncertainties. In some important sense, we should welcome it, as it indicates a return to a normalized market where complacency is replaced by a vigorous competition for price discovery among market participants. What we must not do is attempt to "pretend it away."

A further challenge, after a 300% run in U.S. equities over the since the March 2009 bottom, is to recalibrate return expectations. Those who see large returns with little risk in their rear view mirror may find the view ahead very different—and be tempted to reach for more than is realistic or prudent.

In balancing these priorities, the key is to craft portfolios that mitigate these risks where desired, while creating exposure to the opportunities they represent where appropriate. We at Clear Harbor remain honored to guide you in finding the right balance—one that marks steady progress toward defined goals without inviting excessive heartburn from the many disruptions that remain on the horizon.

Sincerely,

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