CLEAR HARBOR
ASSET MANAGEMENT

June 28, 2018

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Friend of Clear Harbor,

Ah, July: another summer arrives bringing sun, temperate markets and rock-bottom volatility…

Not so fast.

We enter the third quarter of 2018 on the heels of significant geopolitical surprises. For the first time, a sitting U.S. president met with the dictator of North Korea, with open questions about the path ahead. Angela Merkel's hold on power appears weakened in Germany, while Italy has seen the rapid ascendance of new parties to the levers of power. In the UK, the government has less than 10 months left to break an impasse in negotiations to govern its formal departure from the European Union.

Aspects of the global business order seemed in flux, as well. Reaction to China's gains in sophisticated and politically and economically sensitive industries commanded the headlines just as a potent symbol of U.S. industrial might, General Electric, was booted from the Dow Jones Industrial Average. Another iconic American brand, Harley-Davidson, elected to move some production abroad as a pre-emptive move amid prospects for an escalating trade war—one that looms with our closest allies.

Partly in response to these developments, economic uncertainty has risen markedly in recent months. Currency volatility has increased, and several key global growth metrics have decelerated in both emerging and developed international markets. Although trends in the U.S. remain robust, the synchronous expansion witnessed in 2017 has given way to a more traditional global picture—one marked by increasingly divergent data and pockets of significant geopolitical risk.

In short: We enter the back half of 2018 with investors casting a nervous glance back at significant gains picked up along the mountain path so far. They are taking stock of the trail ahead, and trying to gauge how much further they can climb the wall of worry that they perceive through the fog.

Market Review

The first half of 2018 no doubt disappointed investors who expected a straight continuation of 2017, when key asset classes outpaced historical returns by a wide margin. So far this year, equity markets have traded in a mixed fashion throughout much of the world. Even in the U.S., which led its international peers, returns were concentrated in just two sectors: technology and consumer discretionary. This benefited the Russell 2000 small-cap benchmark, which has returned 8% year-to-date. Emerging Markets fared much worse, with equity benchmarks for China, Mexico, South Korea, Brazil, South Africa and Turkey falling 5%-35% in the period.[1]

Fixed income was lackluster at best. The major U.S. and global fixed income benchmarks both declined 1.5% year-to-date.[2] The European Central Bank may feel justified in its stubborn refusal to tighten last year now that retail sales, consumption, sentiment and manufacturing data have all recently decelerated in the Eurozone. And while Japan in recent years has escaped the deflationary experience of the 1990s and mid-2000s, Bank of Japan Governor Haruhiko Kuroda clearly intends to keep interest rates there near zero for the time being.

Economic Trends

The modesty of recent returns, as well as the divergence in central bank approaches, appear largely rational. While the global economy is on reasonable footing overall, some markets continue to show signs of acceleration while others seem to be hitting speed bumps.

- United States

While the economic expansion in the U.S. may well be in its middle innings or even later, it bears mention that cumulative growth since the bottom of the Great Recession has only been approximately 15%. The shallowness of the recovery has delivered little of the excessive inventory or capital investment that typically mark an overshoot and provoke recession. Indeed, recent improvements in GDP (now trending above 3%), unemployment (still trending near 4%), wages, retail sales, corporate earnings, sentiment indicators and dollar strength all bolster the case for extra innings of growth.

Some even believe the rising business output of the last few quarters may finally start to translate into meaningfully higher productivity. If this were to occur, the critical contributor to faster growth that has eluded us for so many years could return—just at the moment when GDP has come to seem capped by the age and limited growth of the U.S. working population.

The U.S. also has the advantage of being further along in its policy normalization journey. Having come off the zero bound, the Federal Reserve has restored a bullet or two to its monetary rifle should growth underwhelm. At the same time, capital remains priced at historically low levels, supporting M&A activity

[1] All first-half return figures are from Bloomberg LP as of close of trading on June 27, 2018.
[2] As of June 27, 2018, the Bloomberg Barclays Aggregate Bond Index returned -1.67% YTD and the Bloomberg Barclays Global Aggregate Bond Index returned -1.55%.

and debt-enabled growth in spending and capital expenditures. Other than public debt levels, most measures of economic health inspire reasonable confidence that this shallow recovery can continue.

- Europe

In Europe, the encouraging trends seen in 2017 and at the start of 2018 have decelerated as trade concerns with the U.S. and political uncertainty in Italy and Germany weighed on sentiment. Industrial production has trended lower, threatening the resiliency of the recovery and earnings momentum. This divergence has incrementally benefited U.S. equity markets over those across the proverbial pond.

With that said, we do not expect this economic divergence to persist, and indeed hope that converging forces will ultimately trend upwards. Recent Purchasing Managers Index data point to the possibility of a more positive direction for the euro area. We await future data to confirm such a trend reversal.

- Emerging Markets

We see lower prospects for such a trend reversal in emerging markets. The largest emerging economy, China, has seen retail and factory data slip of late. From Turkey to Venezuela and Argentina, political hotspots threaten further economic divergence within the emerging market universe, as well as between emerging markets as a whole and the developed world.

These economies are poised for additional challenges. As we entered Q2, many emerging nations tightened policy in an attempt to keep investment from flowing abroad, particularly to the stronger dollar, economy and safety of the U.S. While higher rates may help retain investment capital, it will tend to slow consumption and spending.

Nonetheless, it is in these regions that millions are transitioning from poverty to the ranks of middle class consumers. In the world's second most populated country—India—the middle class has expanded exponentially since 1990, from 2.5 million to more than 50 million today. Similar trends are underway in other countries in Asia and South America. We remain alert to the opportunities and attendant challenges of investing on the basis of these and related regional trends.

- Return to Synchrony?

Emerging markets interact within an incredibly connected world. Despite important points of differentiation among markets, the simultaneous cooling of China and Germany, two export-led nations seemingly at opposite ends of the economic ladder, speaks to why we see a degree of synchrony returning to global growth.

While we highlight these recent signs of economic deceleration, other trends around the world remain positive. These include benign inflation, noticeable employment gains, and accommodative central bank policy. The Clear Harbor team sees ample reason to maintain long-term allocations to major asset classes, while acknowledging clear near-term flashpoints and the risks of significant policy missteps.

Market Outlook

In this mixed environment, we remain watchfully positive on equities, particularly in the U.S. In fixed income, we are particularly constructive on the virtues of U.S. issuance over international opportunities. We also note the importance of considering commodities, cash and alternative investments, which may help reduce risk or achieve other specific priorities in some investor portfolios.

- Equities

U.S. equities have become a story of increasingly attractive valuations on the one hand, versus rising fundamental concerns and stronger competition from fixed income on the other. The good news: Earnings acceleration in Q1 exceeded 20%, and this pace may well continue in Q2. With prices stuck in a tight (and nervous) trading range, this has unwound (and justified) some of the P/E expansion that supported last year's impressive gains, making for a more appealing entry point for investors.

However, investors toeing the brakes on stock prices have understandable reasons. For one, multinational companies domiciled in the U.S. could face earnings pressure as global growth decelerates and the dollar strengthens. This is of particular importance to companies and sectors that rely on international markets for profit growth, even as some domestically focused firms could benefit.

Furthermore, history has not favored equities when rates rise. Six of the last six tightening cycles put downward pressure on equity returns and P/E multiples. The current environment illustrates some reasons why: with inflation tame, stocks treading water of late and 10-year Treasuries now offering near 3%, bonds have taken on an appealing risk-return profile even though yields remain quite low by historic standards.

- Commodities

Gold has been under pressure (-3.8% YTD) as the dollar has strengthened (+3.4%). We consider that a reasonable reaction in what we view as an alternative "hard" currency. Meanwhile, crude oil has seen persistent demand set against supply bottlenecks in key producing areas such as the Permian Basin in the U.S., as well as OPEC's recent decision to keep production increases modest. Furthermore, crude inventories continue to fall somewhat rapidly, suggesting that oil is well supported at current levels.

Brent Crude prices are better by 15% on the year on the heels of tighter supply and rising demand. While that sector of the U.S. equity market has not matched the performance of the underlying commodity, it is trending positive so far this year: the energy segment of the S&P 500 is better by approximately 3.3% YTD, even as the majority of equity sectors have flagged.

- Fixed Income

While cash has a role to play for many investors, we believe the fixed income asset class today continues to offer a compelling contribution to balanced portfolios on both a relative and absolute basis, and in pursuit of both return and safety. Although Treasury yields will likely continue heading higher over time (as we've anticipated since the start of 2017), this core piece of the fixed income market still stands to benefit from any short or longer-lasting "flight to quality" that may emerge.

It is for this reason that we believe the asset class provides a critically important ballast or “hedge” within a diversified portfolio. Indeed, if economic data were to materially decelerate or a recession were to ensue, we would expect monetary policy to shift markedly, sending sovereign yields the U.S. back down, and bond prices higher.

A critical factor in this analysis is inflation. We have commented on the lack of inflation in recent quarters, and conventional wisdom appears to be trending toward this view. While we are not tactical with our core allocations, benign expectations for inflation bolster confidence in the role fixed income can play in portfolios, even as we agree that the 35-year bull market in bonds is over.[3] As the paradigm shifts from inflation concerns to questions about growth, we also grow more comfortable with nudging our allocations closer toward benchmark durations.

Of course, an economy where inflation appears in check can also benefit stocks. Moreover, history reminds us that over the long term, equities provide higher anticipated returns than fixed income and the broad swath of “alternative” investments. In the short term, our conviction on returns is always tempered by the many factors that shape the investment landscape, and tested as we build portfolios appropriate to each client we serve.

The Trillion-Dollar Question: Trade Wars

The most prominent risk today is that trade disagreements that seem a matter of temporary posturing could explode into major challenges for the global economy and for the earnings of companies that drive and benefit from it. This concern fluctuates with the daily, often conflicting statements by senior U.S. officials, and leaders around the world attempting to come to grips with it all.

This week’s announcement of restrictions on Chinese investment in key U.S. technologies and related companies is an important development. It is a constructive move insofar it addresses legitimate concerns of long-running IP and cyber theft directly on security grounds, rather than through the cloudy lens of trade deficits that President Trump has emphasized. This shift in focus may at long last help to rally our allies, rather than alienate them as tariffs have done. However, it raises the temperature with China considerably—and with it, the odds that a tit-for-tat trade spat may escalate into a true trade war.

In such a case, global risk assets will doubtless suffer in the near term, especially in the U.S. and China. A trade spat may take a tenth of a point off of growth, but a trade war could lead to a contraction of perhaps 0.5% or more in GDP expectations. Interestingly, and perhaps counterintuitively, select emerging market equities could outperform as Chinese demand, discouraged or barred from seeking products and materials in the U.S., incrementally shifts to these regions.

Whatever happens on the security front between the U.S. and China, the rise of trade tensions between the U.S. and other key economies remains an important risk. Our tariffs on steel and aluminum have already invited retaliation on cars and other imports not just from China, but from the EU and our allies

[3] The 10-year US Treasury yield bottomed on July 8, 2016 at a yield of 1.35%. At the time of this commentary 10-year US Treasury yields are approximately 2.85%.

to the north and south. The path forward on trade will help determine whether the U.S. and global economy harmonize in a constructive fashion, or decamp to separate corners in a weakened state.

Clear Harbor's base case remains one in which trade skirmishes remain somewhat contained, delivering limited impacts on the growth of key global economies. However, the risk of meaningful dislocations remains real and is frankly rising. As investors process these risks, it is no accident that for the first time in many years, cash has outperformed several asset classes so far in 2018—some by significant margins.

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We are mindful that, particularly in the short term, markets move not just on political headlines but on shifts in the yield curve, monetary policy, equity valuations and growth prospects. We also acknowledge that benign inflation and accommodative central banks can both soothe jittery markets. In the U.S., the Greenspan, Bernanke and Yellen "Put" might be rebooted as "the Powell Put" if needed; in Europe, the ECB could resume its bond-buying program.[4] Such facts no doubt have helped bring volatility back well within historical norms, after a spike in February.

Yet at Clear Harbor, we take great care not to allow tactical considerations to cloud the larger picture. Even as the Fed slowly normalizes policy, the ghost of the Great Recession lingers: Despite the U.S. now well off the zero bound, the balance sheets of major global central banks remain near their combined peak of almost $12 trillion. Europe has yet to raise rates, and Japan is still purchasing assets.

We have come a long way across the tightrope, away from a potential second Great Depression and toward a global growth paradigm. But we're still walking, and while our trajectory appears positive, risks are never far in one's investment journey. Should recession strike, some might learn just how little central banks have done to reload their monetary cannons, and how much public debt weighs on the next recovery.

These are more reasons our focus remains on customizing portfolios based on an in-depth knowledge of our clients: your life and financial goals, risk tolerance, and unique personal, professional, and family considerations. Some readily accept that "time in the market is more important than timing the market." For others, peace of mind is the highest consideration.

Financial planning must also encompass a range of objectives. Whether you are planning for a stress-free retirement, working to shelter your assets from litigation, wish to establish a 401k for your employees, seek efficient charitable and philanthropic strategies, or simply need guidance on how to manage withdrawals from retirement and taxable accounts to optimize income in your later years, the team at Clear Harbor is equipped to work with you and your family members each step of the way.

[4] The notion of a "put" named for a Fed chief dates back to Chairman Alan Greenspan. It captured the belief of market participants that the Fed would be willing to lower interest rates to maintain equity valuations. It was perceived under successive Fed chiefs as inducing greater risk-taking among investors even as valuations proved lofty.

What matters in each case is maintaining a partnership grounded in trust and competence. We thank you for granting us the former, and pledge our continued diligent efforts to provide the latter.

We hope that you and your family have an enjoyable and safe summer season.

Sincerely,

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