CLEAR HARBOR
ASSET MANAGEMENT

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Friend of Clear Harbor,

After years of advances, global equity markets ended 2018 with the stinging reminder that they can still reverse on a moment's notice. A year that began amidst historically low inflation, accelerating economic growth and expanding equity valuations ended with an eruption in volatility and the meaningful outperformance of broad fixed income benchmarks—precisely the reverse of what most strategists had predicted.

Record-breaking swings in December promise to make this the worst year for the S&P 500 since 2008, with a decline of 5.2% through December 28th.[1] Despite a rally into the fall, global equity markets neared year-end off 9.6%; largely in response to the relative strength of the U.S. dollar, gold faltered by 1.9%. In contrast, the broad benchmark for U.S. bonds ended the year off just 0.2%.

Investors are not without cause to fret. If 2017 was the year of synchronized global growth, 2018 came to be marked by economic deceleration. Trade tensions—particularly between the U.S. and China—hardly helped. And while U.S. tax cuts provided a degree of stimulus, the effect was blunted by the Federal Reserve, which moved to raise interest rates four times and to reduce monetary stimulus as part of the tricky process of unwinding its swollen balance sheet.

Even as holiday meals were prepared this month, investors thus lost their appetite to push "risk markets" such as equities and credit any higher. Instead, they sent P/E multiples in the U.S. from their September peak of approximately 17x to about 13x on Christmas Eve[2]—a decline that translates into approximately 600 points in the S&P 500. On a global basis, one Wall Street strategist notes that the breadth of market declines this year will likely prove the most significant since 1901.

It is against this backdrop that I present Clear Harbor's Outlook for 2019.

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[1] The data here represents data from November 2nd through December 24th, as equity markets at least temporarily bottomed on the 24th of this month.
[2] P/E multiples are based on current analyst estimates of $174 for 2019.

U.S. Economy

It is striking to experience the recent flight to the safety of long-dated Treasuries and defensive stocks even as corporate earnings and the economy itself continue to expand. Indeed, key economic variables in the U.S. remain strong. In particular, consumers appear healthy: They are saving more while benefiting from the strong dollar, a recent pause in interest rate increases, cratering energy prices, and unemployment just above 3.5%.

The strong consumer explains reasonably constructive growth expectations of 2.75% to 3% for the last quarter of 2018, and 1.75% to 2% in 2019. Decelerating growth, rather than outright recession, seems the most likely economic trend line for the new year.

Still, investors are not alone in voicing concern. Half of Chief Financial Officers recently surveyed expect a recession in 2019, with more than 80% predicting one no later than 2020. Such sentiment echoes skittish sentiment among investors and bodes ill for capital spending by corporate executives. What is weighing on minds as they peer into 2019?

We believe what is currently driving markets is the *rate of change* in growth indicators. While GDP, home sales, consumer confidence and a host of other data remains constructive, it has turned *less so* than expected—which in turn softens expectations further. Since the equity market is a mechanism for discounting expectations, even data points that remain positive are a recipe for volatility if they fall short of projections.

Furthermore, not all the recent data has been positive. Consumer net worth is essentially unchanged year-over-year, providing no additional catalyst to consumption at the moment. In addition, last week's Richmond Fed Manufacturing Index report showed a significant plunge from October to November—an unwelcome reading, albeit of an often-volatile measure.

We also expect the effects of U.S. tax cuts to wane in 2019. Even success brings its own limitations: Low unemployment means few workers are available to help businesses realize their expansion plans.

The banking sector raises unique considerations that warrant mention, because sluggish lenders will be less prepared to inject a jolt of economic optimism when needed. Though structurally sound and amply capitalized, U.S. banks face a flat yield curve and subdued loan growth as GDP growth slows, which will pressure profitability as deposit rates rise and net interest margins shrink.

Meanwhile, a rising Fed funds rate would crimp consumers through higher loan and mortgage costs, while increased spreads for high-yield and investment-grade credit would pressure corporations. All this fuels concern that the credit expansion of the last nine years could at last be coming to an end.

Global Economy

Caution appears to be gaining ground across the world's largest economies, premised largely on poor choices by national governments. Trade wars, tumultuous U.S. policy (and a strong U.S. dollar), Brexit chaos, Italian populism, Indian elections and reform concerns, uncertainty over China's continued growth—all these pose roadblocks to business spending, investing plans, and ultimately consumer confidence.

We especially fear that trade friction between the U.S. and China may not subside in 2019. Despite an apparent thaw in negotiations recently, which saw China reducing auto tariffs by 25% for 90 days, each side may perceive political benefit in continuing the skirmish. President Trump may see a continued fight as an asset in his reelection bid ahead of 2020, and Premier Xi might assume a similar posture to convey a sense of strength and determination to both the Communist leadership and the Chinese people.

While factors vary from one region to another, the resulting data is remarkably similar around the world. Indices of manufacturing and consumption are declining; yield curves are flattening. Daily market gyrations are an apt reflection of investor uncertainty over the degree to which the economy will continue to decelerate.

Monetary Policy

Like many market participants, we were disturbed by recent suggestions that the White House was exploring the President's legal options for firing Fed Chairman Jerome Powell. While officials were quick to walk back speculation about such a move, the mere consideration of direct political interference into central bank policy sends shivers down the spines of investors who have witnessed the disastrous impacts of such behavior in countries such as Argentina, Venezuela, and Turkey.

The coming year may test the Fed's independence not only of the executive branch, but of its own public commitments to continue its projected course of tightening. On December 19th, the Fed's FOMC Committee articulated a rather bullish case for the trajectory of the U.S. economy, saying that it anticipates two additional rate hikes next year based on its assessment of growth and risks. They also predicated this view on an expectation that "inflation will remain right near our target" of 2%.

We shall see if they hold to that. While we certainly do not include a U.S. recession in our base case for 2019, we think future inflation and growth data may prove more tepid than the Fed expects, and will therefore demand a somewhat more dovish response. In fact, just since Powell's statement, readings both at home and abroad suggest that inflation may trend further below the Fed's 2% target rate.

It is rather unprecedented to see the Fed raise rates into a decelerating economy. We expect the Fed to prove more cautious than their dot plot now suggests, and to reassert their "data dependency" should future data confirm further economic deceleration. That would result in a single rate hike next year, or even an outright pause. However, prospects of a policy error are real, and any intransigence in the face of deteriorating conditions could nudge an already-slowing U.S. into recession. That would be expensive proof indeed of the Fed's "independence."

Fixed Income

2018 was an interesting year for fixed income investors, as inflation expectations rose early in the year only to trend below the Fed's 2% target by the final quarter. The deceleration in growth and the related decline in credit and equities reminded investors of all stripes that when "risk" markets become challenging, one of the few historic ballasts to a portfolio remains longer-dated U.S. sovereign debt.

Indeed, the 20+ year segment of the Treasury market has rallied nearly 9% since 30-year bond yields peaked on November 2nd, while the S&P 500 declined 12% over the same period. For the year, the major U.S. fixed income benchmark, the Bloomberg Barclays Aggregate Bond Index, is essentially unchanged, representing outperformance of approximately 5% over stocks.

Market observers who determined at the start of 2018 that a Fed "on the march" would require investors to shun fixed income were doubtless surprised to witness such relative strength in the asset class by year-end. Looking ahead to 2019, we maintain our view that broad swaths of U.S. Treasuries and mortgages offer diversification for clients seeking to mitigate portfolio volatility, a measure of secure income—and perhaps even a touch of price appreciation where few are looking for it.

U.S. Equity Markets

While fixed income has a vital role to play in many strategies, our long-term total return assumptions certainly continue to favor equities. Historically, sharp declines in equities have increased the likelihood of outsize returns in the future. Since the current market has already priced in an economic slowdown, equities stand to rise if the economy finds a base level of traction in 2019 and the Fed proves reasonably dovish. Having already corrected by some 20% in 2018[3], stocks could very well rebound with returns above nominal GDP growth as it trends back nearer its 20-year average of 2%.

An outright recession would change the calculus, sending earnings, forward multiples and equity prices all lower. However, moderate economic deceleration after a long period of growth is simply part of the ebb and flow of healthy and functioning capital markets. Prudent long-term investors able to tolerate this risk are right to perceive opportunity in the asset class at this juncture.

Our approach to portfolio construction and rebalancing is strongly informed by fundamental analysis. For example, the 25-year average forward P/E level of the S&P 500 is 16.1x; today it is about 14.3x, assuming $174 in 2019 operating earnings. While Clear Harbor's base case for 2019 earnings is actually lower than $174, this apples-to-apples comparison of analyst estimates over time suggests the equity market is at least at fair value—particularly if the economy avoids recession over the next 12-24 months.

To be clear, we do not believe P/E multiples can march back to the most recent highs until there is clarity on both the direction of the economy and the intentions of the central bank. Nor do we expect earnings growth alone to carry stocks meaningfully higher during an economic cooling-off period.

[3] Approximate "peak to trough" change in the S&P 500.

Indeed, important standard-bearers of corporate America are currently guiding down investor expectations for revenue and earnings growth. From the global-trade-sensitive FedEx to the all-important semiconductor segment of the technology supply chain represented by Micron Technologies, anecdotal evidence suggests that corporate guidance is now reason for caution.

In any case, attempting to predict near term direction of any asset class over the short term is always challenging and often foolhardy. It is over the medium and long term that past behavior holds insights for future performance.

Emerging Markets

While developed markets received more attention, emerging markets were also noticeably weak in 2018, correcting a good eight months before developed markets did. One reason is that friction between the U.S. and China presented hurdles to global trade. Another is that rising U.S. interest rates drew capital away from these economies, which were pressured by dollar-denominated debts that grew more burdensome as U.S. rates increased. As in the U.S., the result was a significant contraction in forward equity multiples, which trended from their peak of 13x in late January to approximately 10x today.

We continue to look favorably on emerging market equities, both for their long-term return potential and for the increasing diversification that they offer investors who can tolerate the anticipated associated volatility. With recent declines in mind, we also see potential catalysts to improved investor sentiment in 2019, as significant pessimism appears embedded in current equity prices.

First, fundamentals provide a basis for cautious optimism: Average analyst estimates for 2019 earnings growth in emerging markets are in excess of 10%. Second, should U.S. monetary policy indeed be entering a more dovish stage, we would expect an incrementally weaker U.S. dollar to create room for emerging market currencies—and their economies—to find traction.

In addition, the very purpose of owning emerging markets has evolved in recent years. Investors now seek to capture the potential of rapidly growing middle classes, which have created significant domestic demand for goods and services from technology to healthcare, travel and tourism.

Finally, this shift means that owning a broad representation of emerging market equities is no longer synonymous with a heavy weighting in energy and materials: “diversifying into emerging markets” has never been more diversified. Whether through externally managed funds or ETFs, individual emerging market stocks, or companies domiciled in more established nations that derive significant revenue in emerging regions, we believe most investors can benefit from some form of exposure to these regions.

Geopolitics

Many of the global hot-button issues we addressed back in February 2017 have yet to come to any clear conclusion, while others have been added with disconcerting regularity. Brexit, Italian populism and Euroskepticism, riots and political instability in France, and the future of leadership in Germany as

Angela Merkel departs the scene in 2021: In all these case, politics and economics are converging on multiple fronts in the world's most developed nations.

Nor can we exclude the U.S. from the list, as the 2018 midterm elections upended the House GOP majority. This has weakened President Trump's policy agenda for the balance of his term, and suggests a collision course with both Democratic Congressional leadership and presidential challengers already looking toward 2020. Democrats already have six primary debates on tap for 2019; one or more Republicans may mount a challenge to the sitting president as well.

While such sustained and widespread upheaval is a valid argument in favor of allocating to high-quality fixed income, there is no iron-clad rule that equities can't rise in the face of trade wars, global economic deceleration and a tightening Fed. In fact, while it is hard to see P/E multiples expanding to recent highs, there is a great deal of room to rise from the current level of 14.3x to the historical mean nearer 15.5x. Investors must simply accept the likelihood that any upside will be capped unless and until we see some clarity on the most important unresolved issues—both political and economic.

U.S. Government Debt

After years of ignoring it in the name of crisis intervention, investors again may start to concern themselves with the long-term outlook for government debt. Annual new debt as a percentage of U.S. GDP will most likely have neared 6% by year-end once "off-balance sheet" items—chiefly, unfunded promises to pay Social Security and Medicare benefits—are included.

This level of deficit growth is startlingly high, particularly as it is occurring during a more robust part of the economic cycle. While household debt as a percentage of disposable income has dropped from 13.2% in Q4 2007 to 9.9% in Q3 2018, it is runaway public balance sheets that investors may take note of in the coming years.

It is impossible to know when debt will come home to roost. Though kicking the can down the road merely adds to the final tally, experience suggests it may continue indefinitely. Even Italy—albeit with an abundance of drama—has staved off a full reckoning for years, under a greater burden relative to GDP than America's.

Nor must a debt "crisis" resemble a financial panic: High debt, by itself, need not cause banks to fail or the ATMs to cease functioning. Still, a hike of just a few percentage points in sovereign yields would significantly constrain appropriators in Washington, hamstring many state budgets, and crowd out large swaths of private-sector financing. And should an inflationary cycle take hold, prompting the Fed to undertake a rapid series of rate hikes to stabilize prices, it could all occur with unexpected suddenness.

Portfolio Positioning

As we peer into 2019, we remain humbled by the uncertainty markets bring, but confident in the value and importance of addressing the unique wealth picture of each client. Understanding the financial life of an individual or a family means homing in on emotional risk tolerance as well as financial risk tolerance. Only then can we craft a responsible portfolio that addresses short- and long-term investment objectives as part of a holistic wealth management mandate.

In allocating client capital, our priority is to create portfolios that provide the most conservative approach to achieving clearly articulated, long-term financial goals. We periodically rebalance portfolios to maintain target allocations across major asset classes.

After a thorough conversation with us, some clients elect to pursue more upside in exchange for higher portfolio volatility and risk. Our approach to investment management regularly uncovers opportunities for doing so, as we relentlessly assess relative value at the asset class level in search of discounts relative to expected appreciation. We also scrutinize opportunities on a regional, sector and individual company basis. We are happy to discuss the full range of opportunities that markets present at any given time, and whether they align with your goals.

What we advise strongly against—in this market environment as in any other—is to attempt an exercise in market timing. While one might guess right on a 1,000-point move on any given Tuesday, I do not know of any investor who has timed the market successfully over the medium or longer term. Such effort is much better spent revisiting your fundamental strategies with us to ensure that they remain aligned as your own financial life, not the market, evolves.

Clear Harbor enters its tenth year in business in 2019. Some of our clients were with us at the firm's creation, following decades of work with our investment managers elsewhere; others have joined more recently, including some for whom Clear Harbor has been their first and only home for financial advice. Some represent institutional wealth; others, family legacies; still others, a new generation in the creation and stewardship of prosperity.

In each case, we are honored by your confidence in us, and by the responsibility you have entrusted to us. While our clients are diverse, our passion is the same: For creating better outcomes across a panoply of topics related to your wealth picture, and a sense of assurance for your financial future grounded in partnership and discipline.

Whether you will celebrate the new year in Anchorage or Miami, San Diego or Manhattan: On behalf of Clear Harbor, I wish you the best of the season. We look forward to working with you in 2019.

Sincerely,

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