CLEAR HARBOR
ASSET MANAGEMENT

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September 20, 2022

Friend of Clear Harbor,

Shifts in the economic, geopolitical and societal landscape have proved dizzying of late. The quarter about to end has seen a dramatic counteroffensive by Ukrainians against their Russian adversaries, "Zero Covid" policy thwarting growth in China, the passing of Queen Elizabeth II and a new sovereign and Prime Minster in the UK, and persistent inflation and climate-related dislocations around the world.

Many questions at the intersection of business and politics remain. Will China's coziness to Russia and other foes of democracy prod corporations to adjust supply chains and relocate production facilities to freer lands? If so, how will it impact profits and margins—the most significant long-term drivers of equity values? How much will the war in Ukraine exacerbate European energy shortages, fostering dangerous inflation and increasing recessionary pain on the Continent? On a global basis, will similar pressures usher in ever-more populist, and perhaps even undemocratic, political movements?

Mark Twain is believed to have remarked: "History never repeats, but it often does rhyme." While some of today's economic and political trends may echo what has come before, the confluence of considerations are unique. On a number of fronts, consensus thinking may well be in the midst of significant change, as one regime—whether literal, monetary or otherwise—ends and another begins.

Market Review

Major asset classes experienced their own tribulations and turning points in the third quarter as interest rates, the U.S. dollar, and volatility all marched higher. After a rough start to the year, the S&P 500 gained back some 6.5% following its June 16 low before dropping sharply again in the face of stubborn inflation readings. As of today, the U.S. equity benchmark is better by 3.4% for the quarter and off by 17.2% for the year; the MSCI All World Index has rallied 1% for the quarter and is off by 19.2% year-to-date.[1]

The leading fixed income benchmark, the Bloomberg Aggregate Bond Index, has faltered 2.4% for the quarter to date and 12.5% for the year to date, with prices for shorter-dated issuance falling the fastest—a traditional signal of economic weakness ahead. Declines during the quarter were more

[1]Data is as of market close on September 19, 2022.

welcome for a broad set of commodities, ranging from oil to lumber. From peak levels reached this year, copper has fallen by 27%, aluminum by 32%, lumber by 67%, and WTI crude oil by 31%. (In fact, given the headlines about recent price reversals for a panoply of goods, it is no wonder that many expected a more pronounced decline in the headline Consumer Price Index for August.)

U.S. Fiscal Policy: End of the Old Regime

History will record 2020 and 2021 as extraordinary in every way. Despite the profound uncertainty of a global pandemic, U.S. and global equity markets leapt. The reason: surging liquidity that carried equity multiples markedly higher, even in the face of unprecedented demand shifts and supply constraints that kept earnings growth in check for most sectors. Much of this liquidity came from Congress, which delivered the greatest fiscal stimulus in history—even more than was appropriated to wage World War II. American workers and families received direct deposits into household bank accounts, while the Payroll Protection Plan forced banks to issue forgivable loans to support salaries for employees of businesses shuttered by the pandemic. Put another way, Washington injected more stimulus during this period than the combined total economies of California, Texas and Florida.

This fiscal regime is now at an end. Although another large spending package was signed into law last month, it was of smaller size and narrower scope than the ones that lined individual bank accounts at the height of the pandemic. Still, it serves as additional tinder for inflation in an economy already straining to accommodate the return of consumers to more normal purchasing patterns.

Washington's response to the pandemic represents a significant contrast to the Great Recession and subsequent years, when Congress played a decided second fiddle to the U.S. Federal Reserve in attempting to rouse consumer spirits from their doldrums. Yet now, with Congressional stimulus effectively ended, the Fed is once again calling the tune—this time, in the more nuanced pursuit of engineering a "soft landing" that tames inflation without inflicting a deep and damaging recession.

Central Bank Policy: A Changing of the Guard

The Fed finds itself at a tricky point of transition. After spending more than a decade trying primarily to engineer growth in an environment of stable prices, they are now attempting to stamp out inflation without crushing jobs and growth unnecessarily. Such a changing of the guard is not easily achieved.

Throughout this process, timing has been a significant X factor. As GDP and inflation both rebounded in 2021, some economists criticized the Fed (among other developed-market central banks), arguing that they should have started raising interest rates—after many quarters spent near zero—much sooner. This spring, the Fed began making up for lost time, hiking rates at a seldom-seen clip in belated recognition of persistent and broadening inflationary pressures. Indeed, with the U.S. already in a technical recession following two quarters of modestly negative GDP growth, some believe it is in fact time to reverse course again and *reduce* rates—or at least shift into neutral.

- Hawks vs. Doves

Looking to what the Fed should do next, both hawks and doves have data to support their case. On the one hand, notwithstanding sluggish GDP, unemployment remains at 3.7% and the Consumer Price Index is stuck at four-decade highs—8.5% in July and 8.3% in August. Inflation has broadened to affect more goods and services, despite visible declines at the pump. All this suggests consumption will continue to stoke inflation unless the Fed continues to tighten policy.

Yet prices are already markedly lower not only for gasoline but for copper, iron ore, lumber, aluminum and other key commodities. Once-hot real estate sales—which are particularly responsive to interest rate changes—have stalled. Moreover, the Fed is well aware that many pricing trends only show up in official inflation data with a meaningful lag. Indeed, most worries about price increases are limited to the coming months and quarters; in recent sentiment surveys, longer-term inflation expectations remain anchored.

In fact, some of the stickiest inflation is currently found in housing costs, which are rising due to insufficient home construction—which higher interest rates only discourage further. Given this, it would not be unreasonable to give this year's interest rate increases—already totaling 2.5%, with expectations of another 0.75% this week—time to work their way into the economy before hiking any more.

Nevertheless, the Fed has repeatedly telegraphed its intent to return inflation nearer its traditional 2% target before downshifting back toward lower rates, even at the cost of "some pain to households and businesses," as Chairman Jerome Powell put it last month. Given the market's ugly reaction to last week's inflation data, it seems other investors are coming to accept this prospect. The fear now is that, just as the central bank was late to begin raising rates in the back half of 2021 and early 2022, it could now persist in tightening for too long, even as many inflationary trends turn out to be rolling over.

- Base Case for the Fed Funds Rate

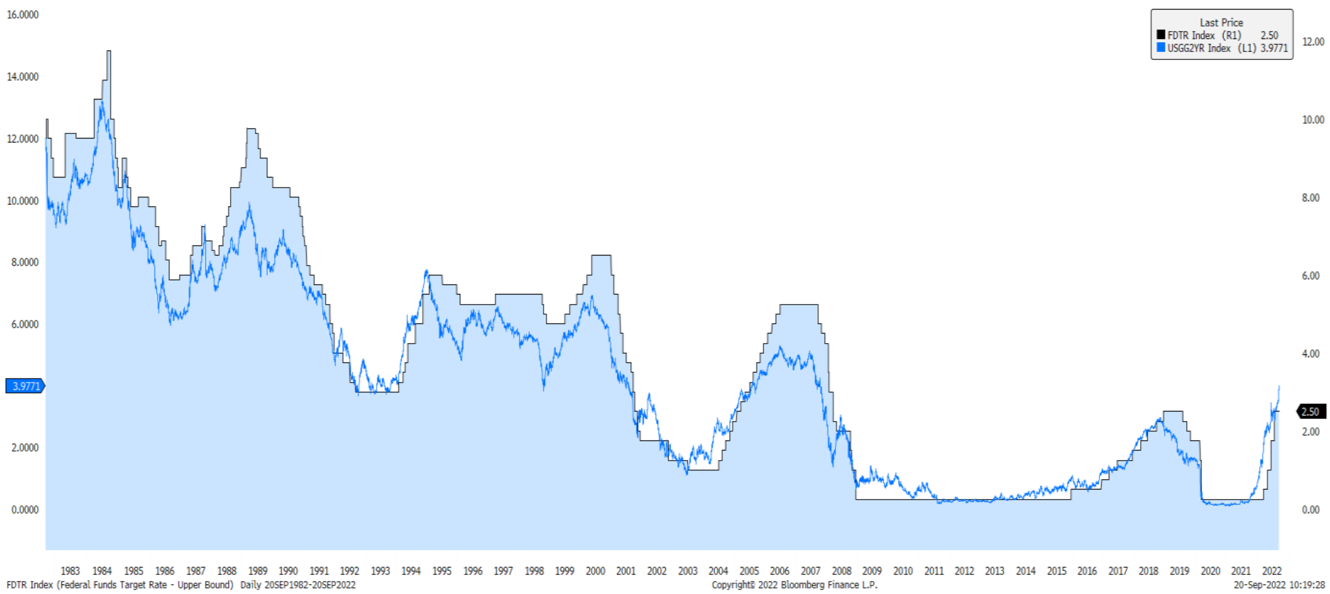
Clear Harbor's base case for the Fed Funds rate remains another 75bp bump at this week's meeting. Moreover, though markets continue to price in 50bp hikes in November and December, the odds of a 75bp increase at one or both of those meetings have increased as well. This would take the Fed Funds rate from 1.75% today to approximately 4.25% by year-end, at which point the Fed might yet be inclined to pause and assess the impacts of their work to date.

My own view is that we are hovering close to peak inflation levels as money supply decelerates (see below) and prices decline for shipping and key industrial metals, which should give the Fed cover to temper its hawkish posture by then. But the stronger the employment and inflation data, the more the Fed will be inclined to keep tightening financial conditions, potentially into the new year.

A larger question is how resolute the Fed will stay if inflation persists, but economic data deteriorates. Indeed, how long before aggressive tightening meaningfully threatens growth, as well as the bottoming process for equity and credit prices that many believed was over and done with back in June?

On balance, I accept the consensus that the Fed Funds rate will not much exceed 4.25%, which would mark a near-term end to the march higher in yields across the broader fixed income universe. In fact, the Fed Funds rate and 2-year Treasuries tend to peak in tandem; if ~4.25% proves to be the correct high bound for Fed Funds, then 2-year Treasuries, which now yield 3.94%, have already priced in most of their move. Both bond and equity investors should welcome yields that stabilized at such levels; the evolution of data over the course of Q4 will be the proof in the pudding.

Fed Funds Rate vs. 2-Year Treasury Yield—1982-Present



Source: Bloomberg

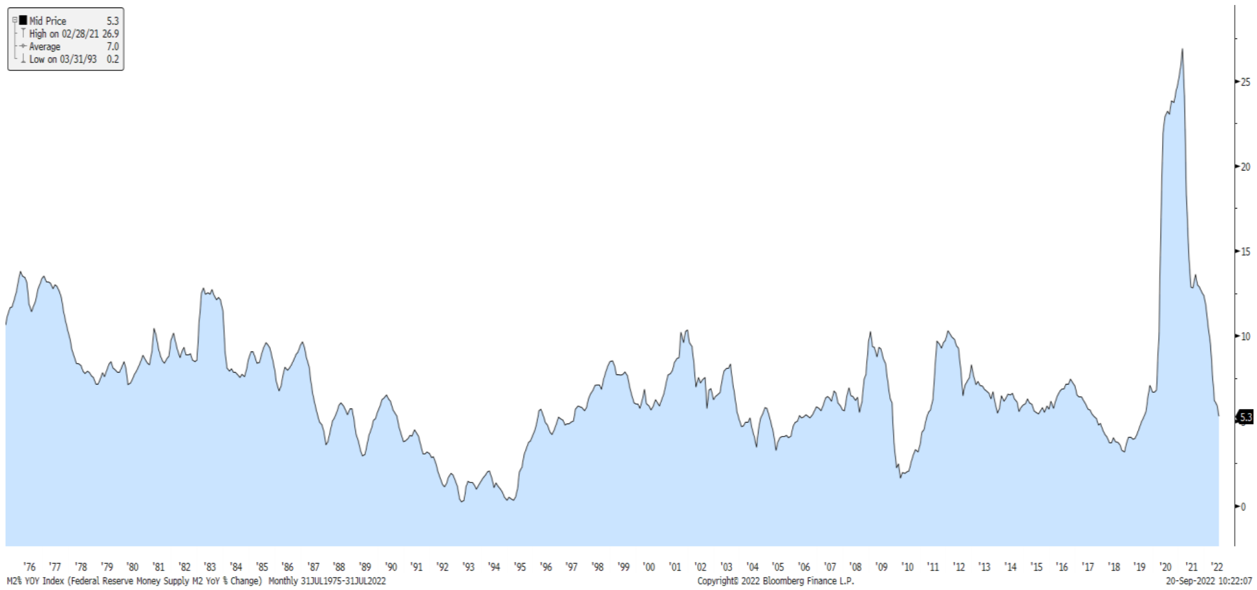
- The Fed's Blind Spot: The Money Supply

While interest rates are right to receive substantial scrutiny, another factor in inflation seldom does, even from the Fed and many economists: the money supply. Without wading too far into the weeds, it is worth noting that when the flow of money through the economy accelerates, inflation typically does too. During the pandemic, one broad measure of money supply (dubbed "M2") jumped 40%; higher prices were bound to follow.

To be clear, other factors driving inflation deserve the attention they receive. Covid-related supply chain dislocations, for example, clearly sent prices higher by constraining supplies of a wide range of consumer goods. But Congress added fuel to the fire by passing extraordinary stimulus (see "U.S. Fiscal Policy" above), and the Fed bought up much of the debt the Treasury issued to fund it. These actions greatly accelerated growth in the money supply at precisely the moment demand had collapsed. The result was too much money chasing too few goods in a locked-down world, inevitably bidding prices higher.

Criticism is mounting that Fed policy seems to disregard this important contributor to inflation dynamics. I emphasize again: it was Congress, not the Fed, whose fiscal injections kick-started the money supply. Yet by ignoring a spike not seen since the early 1940s, the central bank risks misreading a key component of the problem. In fact, at an interview at the Cato Institute this month, Chairman Powell seemed to dismiss the role of money supply in the evolution of inflation altogether.

Change in USD Money Supply Growth—1978-Present



Source: Bloomberg

I believe this is a great and avoidable mistake. As the late legendary economist Milton Friedman once said: “Inflation is always and everywhere a monetary phenomenon, in the sense that it is and can be produced only by a more rapid increase in the quantity of money than in output.” Indeed, while the central bank has understandably focused in recent years on such exotica as quantitative easing, the traditional obligation of monetary officials to monitor the relationship between money supply growth and inflation has not been repealed.

We are deeply focused on this subject at Clear Harbor, as we expect current money supply trends to show up in inflation data in the months ahead—*and those trends have recently reversed*. Pandemic-era fiscal programs, particularly the forgivable Payroll Protection Plan loans, were significant drivers of the money-supply spike in 2020-21. Now that they are over, M2 measures have plummeted back to Earth.

If the Fed continues to ignore signals from the money supply, they may raise rates too quickly and too aggressively at just the moment inflation is poised to correct significantly—a mirror-image of their error in underestimating inflation in the first place. Unfortunately, perhaps as a matter of credibility, they seem intent on seeing the whites of the eyes of disinflation before declaring victory and shifting gears.

For many, these thoughts are perhaps new and even a bit confusing. Indeed, the Fed’s levers for modulating money flows are highly technical, and many pressures—not least, Congressional action—are beyond its control. As such, I do not envy Chairman Powell and other Fed Governors their task. My hope is that as they seek a soft landing, they will come to acknowledge the impacts of the speed and direction of money supply growth. The alternative is to merely continue to raise rates in an explicit effort to reduce GDP and employment—a path that may prove needless.

Once rates stabilize or even start to fall and the Fed's balance sheet reductions begin to trail off, we could very well mark a bottom in equity prices and credit distress. Whether this occurs gently or chaotically, such a bottoming process is a very plausible story within the next several calendar quarters.

- Quantitative Tightening

A final note on the Fed: in a long-awaited reversal of the quantitative easing policy that began in response to the financial crisis, the central bank is currently reducing its balance sheet at a rate of $95 billion per month. Though this has made few headlines, it does serve to tighten financial conditions, as it effectively takes the world's largest buyer of Treasuries and U.S. mortgages out of the market. The impacts of this "quantitative tightening" are particularly salient for mortgage rates, which this week reached a cyclical high-water mark of 6% for a conventional 30-year fixed-rate mortgage.

<u>King Dollar</u>

The strength of the U.S. dollar, up 17.5% over the last 12 months versus a basked of global currencies, is a significant story as we enter the final quarter of 2022. The greenback has surged as the Fed has raised rates far more aggressively than the European Central Bank, which commenced tightening only this month with a 0.75% hike. Japan, still scarred by a three-decade battle against deflationary pressures, remains stubbornly committed to a near-zero policy. Against such weak alternatives, the higher rates and incrementally stronger growth in the U.S. have drawn global capital, pushing the dollar higher.

Currency fluctuations are notoriously difficult to forecast. But for now, the strong dollar makes imported goods less costly for American consumers, while making U.S. goods and services less competitive to international buyers and blunting the foreign earnings of U.S. companies. A stronger dollar also typically tempers commodity prices, but drought across segments of America's breadbasket and the ongoing European food and energy crisis have mitigated this dynamic, complicating the equation for investors.

The current hawkish posture of the Federal Reserve would tend to support the dollar in the months ahead. However, any signal that the pace of tightening might fall short of current market expectations could reduce that support. Should evidence mount that the dollar may be topping, a key beneficiary could be not only U.S. Treasuries but gold, the world's leading and longest-standing non-fiat currency. We also could see Emerging Market equities and credit rallying, as key segments of these markets are currently burdened by the strong dollar. At Clear Harbor, our investment framework continues to anticipate currency volatility in the months ahead, as investors assess the path of inflation and related actions from central banks and fiscal authorities at home and abroad.

<u>Bonds: Restoring the Traditional Order</u>

Parts of the fixed income market have grown dramatically more appealing in the last few weeks. Even accounting for recent near-term surprises on inflation, real yields have risen for many bonds as longer-term inflation expectations remain anchored. After many years being disadvantaged by a risk-free rate near zero percent, the asset class is suddenly a much more viable destination for capital allocators.

I do not mean to convey outsized bullishness on fixed income markets: any number of surprises on the growth and inflation front could change the narrative further. Still, a page has undeniably been turned as interest rates provide a nicely positive spread to long-term inflation expectations for the first time in many years. At a minimum, seeing Treasury notes—the foundation for pricing fixed-income securities of all kinds—in positive real territory again restores a traditional frame to the wider investment landscape. And should rates prove to be in a process of finding a top, it will go a long way towards forming a foundation from which equities, credit and other risk assets can rally.

At present, my own fixed income allocation is still focused on U.S. Treasuries, mortgage-backed securities and investment grade credit. I continue to underweight high yield, because in my view, spreads—currently offering less than 500bps above Treasury yields—are not attractive on an historical basis. (This could change in the months ahead; we remain nimble, and alert to the constant ebb and flow of risks and opportunities.)

Equities: Finding a New Footing

In part due to increased competition from newly attractive bond yields, and in part due to concerns over inflation and growth, stocks are experiencing their own period of transition and adjustment. Both in the U.S. and internationally, major indexes remain above the lows of the year seen in mid-June, but market technicals do not inspire confidence. On a fundamental basis, equity valuations have contracted, but without undue panic; P/E multiples currently percolate close to 25-year averages, and prices have not fallen to levels that typically mark a bottom and clearly define attractive entry points. But investors are clearly on edge about the vector of inflation and the response of monetary officials, knowing that stocks often bottom only after the Fed Funds rate has peaked and begun to trend lower again.

Within the asset class, the recent outperformance of value stocks gives some pause. To be sure, the more inflation persists, the more market participants will tend to stick with the relative safety of slow-and-steady sectors. Yet growth-oriented equities have been battered of late, and now stand nearly 26% below last fall's levels.[2] Peering into 2023 and beyond, growth stocks may well hold the greater promise. This could prove particularly true if inflation subsides, markets reflect the reality of below-trend economic growth in developed markets, and investors again prize companies that can demonstrate a capacity for long-term profit growth.

Earnings reports for Q3 and Q4 will reveal much about which companies can continue to prosper even as economies slow and interest rates rise, and which will see their bottom lines dented by these and other factors. In one discouraging signal for markets and the global economy, FedEx last week withdrew its full-year forecast, citing rising labor and fuel costs and declining demand worldwide in recent weeks.

Certain crosscurrents in today's markets create intriguing questions. For example: Are energy stocks the new "anti-fragile" haven, whose prospects will hold up even as broad equity, credit, and even sovereign bond prices sputter? Perhaps an uncomfortable thought as global policymakers struggle to transition to

[2]As reflected in the S&P 500 Growth Index.

a lower-carbon economy, and large numbers of institutional and individual investors have embraced ESG and other socially conscious investing priorities.

Europe

In Europe, the inflation and growth story remains dominated by the war in Ukraine and Russia's decision to weaponize its flow of oil and natural gas to the Continent's major economies. Liquified natural gas from other sources, including the U.S., has proved extraordinarily helpful, albeit at significant cost. Germany in particular has aggressively replenished gas storage facilities, reducing the risk and impacts of any rationing this winter. Yet Europe is likely already in recession, with little relief in sight—and interest rates starting to rise, in part to stem the flow of capital to higher-yielding countries such as the U.S.

Continued success from Ukrainian counteroffensives may provoke false declarations of "victory" from the Kremlin, which may show the nearest path out of this horrific war. While a swift and just peace is hardly our base case, the restoration of any degree of normal life in Ukraine, and indeed across Eastern Europe, is better than most dared to envision at the war's outset. Such an outcome would surely spur a relief rally for equities and credit and help reduce inflation readings around the world.

China

Year-to-date, stocks in China have fallen by nearly twice as hard as Europe, with the MSCI China Index off approximately 25%. The communist nation's zero-Covid policy has clearly limited travel and constrained consumption, while significant deterioration in their real estate market has been a blow to consumer sentiment and spending. Consensus GDP growth expectations have been ratcheted down to 3% for full-year 2022, and many economists believe even that figure could prove rosy. Even if growth were to accelerate, many observers fear that Chinese leadership would leverage any newfound confidence to return to the regulatory tightening that impacted key economic sectors in past years. Such concerns have led large and influential allocators of international capital to curtail or even abandon direct investment in China.

Contrarians cite historically low investor sentiment as precisely the reason to seize opportunities in Chinese companies. But any rebound in China will likely mirror a general rebound in global economic activity, opening up literally a world of ways in which to capture tailwinds for the Chinese consumer beyond the exchanges and corporations controlled by the Chinese Communist Party. For this reason, I am inclined to remain underweight Chinese equities relative to the rest of the global equity market.

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We are mindful that this is an unsettling moment for markets, the economy, and investors. Indeed, we have long cautioned that the end of a longstanding regime of unprecedented easy money would bring turbulence. But keeping a keen eye on these transitional dynamics should not distract us from the larger journey that most of us are on. Maintaining quality of life, pursuing long-term financial goals, and creating and preserving wealth are the work of years, during which short-term gyrations are inevitable.

The Clear Harbor team does not shrink from this reality. We welcome conversations with each of you whenever aspects of your financial life evolve, new concerns emerge, or you simply wish to touch base on the status of your overall wealth picture in a changing investment landscape.

On behalf of the firm: We are grateful for your trust in partnering with us and wish you and your families a healthy and pleasant autumn.

Sincerely,

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