March 31, 2021

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Chief Executive Officer & Chief Investment Officer

Friend of Clear Harbor,

As we pass the first anniversary of the lockdowns that rocked our nation and world, we at Clear Harbor are both astonished and grateful that many of you have received at least one dose of Covid-19 vaccine. Like you, we remain forever grateful to those in the scientific community who made it possible to look beyond the painful losses of the past year and make our way through 2021 with growing confidence.

We are also thankful to all of our clients who leveraged our work and professional resources during this period, including in ways that some had perhaps never imagined. At moments like this we realize the importance not only of family, but of strong partnerships across those other, larger communities—professional, civic, social—of which we are so fortunate to be a part.

Q1 Review

Here in the U.S., the first quarter of 2021 was marked by a massive acceleration in vaccine rollouts, the passage of a $1.9 trillion economic stimulus package, and consensus projections of economic growth the likes of which we have not seen in several decades. Market participants are struggling to predict not only how these trends will impact corporate earnings, consumption, employment, and other key data, but also central bank policy and the further evolution of major new federal spending initiatives.

In one undeniable and important shift, interest rate and inflation expectations rose quite markedly over the course of the quarter, paced by an increase in longer-maturity U.S. Treasury yields. 10-year yields ended the quarter at 1.71%,[1] after bottoming at 0.50% last August as pandemic-related economic fallout led the Federal Reserve to gobble up Treasuries and mortgages at a rate of $120 billion per month.

Sensing a post-pandemic rebound on the horizon, equity investors changed gears in the first quarter. They shifted incremental capital from secular growth sectors of the market, particularly technology, to economically sensitive sectors such as energy, financials and industrials. The global equity benchmark, the MSCI All-World Index, gained some 4.5% in the quarter, with the U.S.-centric S&P 500 higher by 5.8% and the MSCI Emerging Markets Index better by 2.4%.

[1] All market performance data is as of close of trading on March 30, 2021.

Economic Outlook

Without doubt, the economic picture is greatly brightened by our progress against the virus as well as government spending in developed economies. By early summer, a majority of adults in the U.S. will likely have been vaccinated; with passage of the American Rescue Plan, U.S. Covid-related relief will total $4.5 trillion—some 21% of GDP. The United Kingdom and Japan have each spent approximately 8.7% of their GDP on Covid relief, which are still staggering sums by any conventional measure. The global spree has sent not only deficits but central bank balance sheets to all-time highs.

All this more than justifies expectations of higher growth, as well as concerns about higher inflation, over the next several quarters. The average 2021 consensus GDP growth estimate is 5.7% for the U.S. and 5.6% globally—after a year in which both gauges fell by 3.5%.

We look for the rebound from last year's economic freefall to strengthen over the course of the coming year. While global growth was most likely already positive in Q1, we expect Q2 and Q3 to provide a great deal more fanfare both at home and abroad. Estimates for Q1 suggest annualized global growth of just 2.5%, with Europe weighing on the data. But projections are for stronger gains across the board in Q2, with estimated growth of as much as 7% in the U.S., 9% in Europe and 5% in China.

We are less sanguine that such a pace can be sustained for very long. By 2023, estimates call for U.S. and Global GDP growth to trend down to 2.5% and 3.5% respectively, as unprecedented fiscal stimulus wanes and the natural post-lockdown jump in consumer and business demand normalizes. We still anticipate long-term growth at or below 2% unless productivity surprises to the upside. Other key drivers of long-term growth—chiefly, increases in the population and workforce—will continue to decelerate both at home and abroad. These are gravitational forces that will bring growth back down to earth over time, notwithstanding the ebbs and flows of productivity and government stimulus.

- United States

Although the post-pandemic rebound took hold in Q1, poor weather throughout large swaths of the U.S. blunted it somewhat, as seen in decelerating retail sales and home building activity. Now that spring is upon us, we expect a re-acceleration in the data. We are also seeing a significant restoration of commuter travel across the country and think that by the end of the summer a large part of the American population that has been working from home will migrate back to an office environment.

The consumer's role will be crucial. Following a year of lockdowns, the term "pent-up demand" has never been more literal. The personal savings rate spiked dramatically last year amid the lockdowns and remains elevated. We look for a substantial increase in spending fueled by these savings, which will be bolstered further as the latest stimulus checks find their way into consumers' hands. In fact, anecdotal evidence even suggests that "the death of the mall" could be exaggerated, or at least delayed, as consumers seek a return to a more social, real-world shopping experience.

Air travel, hotel bookings, and even commuter vehicular data is all picking up robustly as well. However, we are mindful that as travel and leisure trends improve, some key sub-categories may remain under pressure from both delays and more permanent shifts in business travel and related conference activity.

As welcome as the anticipated rebound will be, the pandemic leaves significant damage in its wake, some of which will take a long time to repair. Approximately 9 million fewer Americans are employed today than one year ago; in addition to the human cost, this slack in the labor market may mitigate further increases in inflation expectations. We are keeping a watchful eye on rates of unemployment and underemployment to gauge the risks of wage inflation becoming pervasive.

In the coming months, some market prognosticators will surely highlight any jump in prices from the pandemic-depressed levels of spring and summer 2020. Such observations are fair game, but should be put into context. Temporary price adjustments arising from supply-demand imbalances as the global economy gurgles back to life are one thing; a true wage/price spiral characteristic of traditional inflationary pressures is quite another. We will be vigilant in discerning between the two—not just in the coming quarters, but in the coming decades, as unprecedented levels of government debt create unprecedented risks (see “Tidal Wave of Government Spending” below).

- Europe

While we believe the European recovery story is on track, the Continent appears to be lagging the U.S. This is due in part to supply bottlenecks and regulatory hiccups impeding the vaccine rollout in Europe, as well as to lower levels of fiscal stimulus. At the same time, policymakers in some countries, including highly indebted Italy, are responding to pressure to relax restrictions and allow citizens to book summer holidays, restaurants, and other activities that can generate critical revenue for government coffers.

- Emerging Asia

An acceleration in manufacturing tells a solid recovery story across much of Asia, which has helped support equity markets in the region. Nevertheless, a resilient U.S. dollar and unusually high levels of volatility in Hong Kong-listed equities have caused emerging market equities to trail developed markets.

We still believe that medium- and longer-term trends will accrue to the benefit of investors in emerging markets, with a fast-rising middle class and public-sector deficits that appear far more manageable than those in the developed world. Emerging Markets is also quite attractive from a fundamental perspective, with valuations the cheapest seen in well over a decade. Still, we are mindful that broad swaths of EM populations will wait longer for Covid-19 vaccinations than their “more developed” developing peers, with such nations as China, Korea, and Taiwan seeing rollouts closer to those in developed economies.

Market Trends

Unprecedented monetary and fiscal policy remain extraordinarily accommodative to economic acceleration and, by extension, financial market performance. Indeed, with hundreds of billions set to

enter the economy in the months and quarters ahead, and a multitrillion-dollar infrastructure deal perhaps not far behind that, some may wonder: "What could go wrong for equities and credit?"

The risks are, in short: a marked deceleration in growth and inflation expectations, coupled with newfound concerns about asset valuations. A key challenge for investors will be to gauge the moment when the stimulus-driven boom peaks, and a reversion toward secular growth trends begins. Market returns in 2020 "baked-in" significant growth in 2021. It is fair to ask: What is being discounted now?

- Equities

At home and abroad, the most salient change in equity markets so far this year is the flow of investment capital out of the extraordinarily high-growth components of the economy into more traditionally cyclical sectors. For example, technology companies with massive revenue growth yet little to show in earnings have corrected by approximately 17% from the February peak[2], while so-called "value" sectors such as energy, financials, materials and industrials have seen significant inflows. This is a nearly complete reversal from most of 2020, when growth appeared to trounce value at almost any price.

Many value sectors represent larger weightings in international benchmarks relative to the U.S.-dominated S&P 500. Indeed, the MSCI Eurozone Equity Index has outpaced the MSCI U.S. Equity Index by approximately 4 percentage points YTD (9.1% for Eurozone versus 4.9% for US) in large part for exactly this reason. Should the cyclical tailwinds favoring this "rotation into value" continue, it could help global benchmarks outperform U.S. equities for the full year—an outcome we have not seen since 2007.

While we think the cyclical rotation has momentum for the time being, we remain mindful of the longer-term growth opportunities that will ultimately attract investors back into technology and consumer discretionary shares, as well as parts of the communications sector. Over the long haul, a combination of both growth and value equity strategies may prove the most prudent course. We adjust allocations as our assessments of relative value evolve, but we do not attempt to "time the market." We do not want to be caught flat-footed at the moment the current run in cyclicals once again gives way to growth.

- Bonds

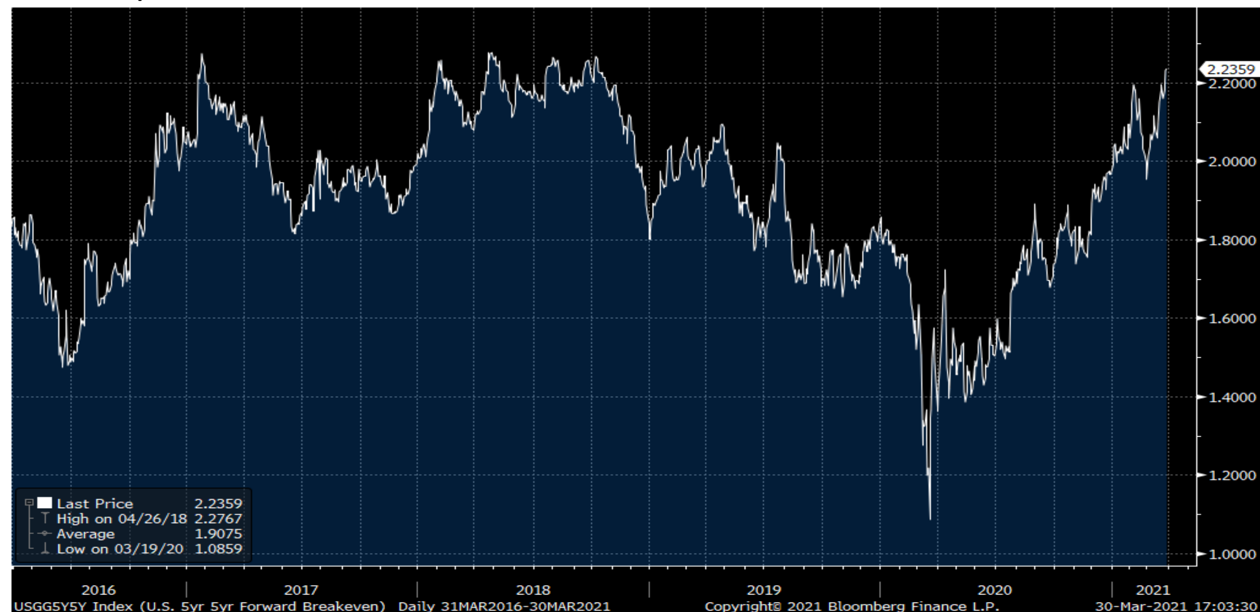
Interest rates have risen this year, especially for longer-maturity bonds. The primary U.S. fixed income benchmark, the Bloomberg Barclays Aggregate Bond Index, has declined by 3.4% YTD, as investors demanded higher yields to compensate for higher expected growth and inflation. Inflation expectations plummeted to 1.08% last March; they have now recovered, more than doubling to 2.23%.

Viewed historically, this rebound in inflation expectations appears less dramatic: it is just 33 basis points above the five-year average. However, continued acceleration in growth data would exert further incremental upward pressure on rates—as no doubt will the proverbial "helicopter money" that is now

[2] Russell 2000 Growth Index Technology

on full display from the U.S. Congress and parliaments around the world. The void that central bankers filled in response to the Great Recession of 2008-09 is now occupied by fiscal policymakers, as well.

Inflation Expectations, 2016-Present



Source: Bloomberg L.P.

- Metals, Mining and Gold

Even as we debate how long the current rotation into cyclical equities can last, we must keep sight of tailwinds arising from structural trends that are here to stay—and in fact only likely to accelerate. One such trend is decarbonization, as our society's commitment to address climate change grows ever more salient and enshrined in public policy. This will drive both a modernization of the electrical grid and a shift to less carbon-intensive sources of electricity generation and transportation.

While the impacts of this shift on hydrocarbon demand may be better-advertised, we also perceive a boon for the handful of elements in the periodic table that are critical to electrification. Such metals as lithium (+32% YTD) or aluminum (+13%) may receive attention for their role in powering electric vehicles or reducing their weight, but there will also be massive demand for electricity-conducting metals such as copper (+13%)—demand that will extend far beyond the automotive sector. Electrification will not occur without more of these elements; it is why I believe metals miners—unlike the carbon-intensive coal-mining industry—are entering a period of favorable supply-demand dynamics.

In contrast to the industrial metals mentioned above, we have always viewed gold as an alternative currency that tends to rise to the occasion at times of significant economic stress and outperform many fiat currencies—the U.S. dollar included. Last year was a rather pure example of this reassuring trait: with the U.S. and global economy in tatters, central banks printing money at a rate never before seen, uncertainty rampant about the future of work itself, and other markets plummeting…gold rallied 25%.

The yellow metal has since given back some of that gain, as the global economic picture improved and the U.S. dollar surprised many by trending a bit higher. But our goal is protection, not speculative gain. Under many possible negative scenarios—especially those involving profound and unanticipated economic shocks like those witnessed in 2008-2009 and 2020—gold retains protective characteristics worthy of continued modest allocations in thoughtfully constructed multi-asset class portfolios.

The Tidal Wave of Government Spending

The tendency of the U.S. government to outspend its resources is not unique to any one administration, Congress, or even party. Our national debt as a share of GDP has tripled since Ronald Reagan was president; the pace of the increase in debt has accelerated greatly of late, particularly in response to the 2008-09 financial crisis and the Covid-19 pandemic.

In fact, the Congressional Budget Office—the independent, nonpartisan accounting arm of Congress—has recently quantified some very troubling trends.[3] CBO projects that federal spending to cover commitments including Social Security, Medicare, Medicaid, and interest on our deficit will hit 32% of GDP by 2051, and grow eight times faster than revenues from 2025-2051. CBO further concludes that our nation's major trust funds will be insolvent within 14 years: the Highway Trust Fund next year, the Medicare Hospital Insurance Trust Fund by 2026, and the Social Security Trust Fund by 2035.

Even more troubling: the CBO's work only projects outlays based on current law. Neil Howe, a legendary demographer and author of *The Fourth Turning,* pointed out in a recent commentary that the CBO does not even include the impact of the $1.9 trillion American Rescue Plan, let alone the proposed $3.5 trillion infrastructure package now being negotiated. If additional deficits associated with these outlays are taken into account, Howe projects that discretionary spending will plummet to just 17% of all federal spending by 2050. "Autopilot spending" will consume the rest, crowding out most other programs.

The point in highlighting these looming challenges is not to suggest that they cannot be solved. But the most likely solutions involve rather significant increases in taxes and/or reductions in benefits.

One can also acknowledge the value of the rescues of the past dozen years and still be wary of the cost. For investors, the value is evident from the sustained rise in asset values since the generational bottom in 2009; the cost has been temporarily masked by the magic of ultralow interest rates.

Congress is still pouring the economic wine, but in time the hangover will come. Those who do not contemplate the impacts of debt burdens or an aging population may miss tectonic shifts that will ultimately affect financial markets—and perhaps sooner than previously believed. The value of the dollar, the rate of inflation, the shape of the yield curve, and the ability for corporate earnings to grow against a backdrop of higher tax burdens and slow economic growth could all weigh on asset prices.

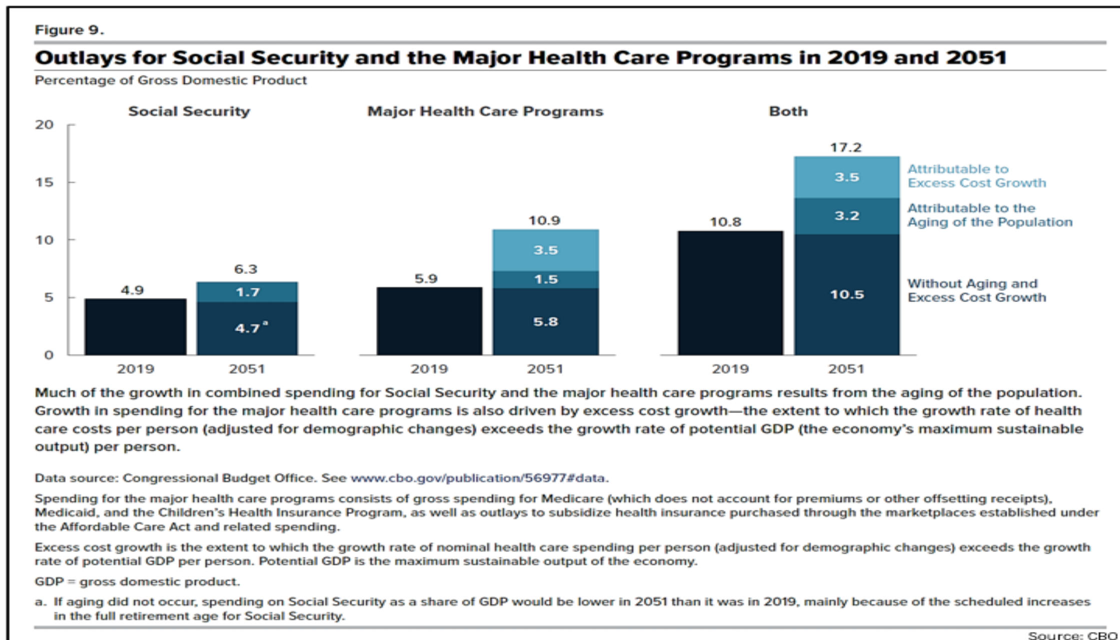
Massive government spending has no doubt helped spare us massive economic disruption. However, the debt it continues to create will force central banks to keep the cost of funding skyrocketing deficits as low as possible. We will all be contending with the resulting structural impediments to growth and

[3] https://www.crfb.org/papers/analysis-cbos-march-2021-long-term-budget-outlook

other risks, some of which are still impossible to assess, for decades to come.

Figure 9.

Outlays for Social Security and the Major Health Care Programs in 2019 and 2051



Much of the growth in combined spending for Social Security and the major health care programs results from the aging of the population. Growth in spending for the major health care programs is also driven by excess cost growth—the extent to which the growth rate of health care costs per person (adjusted for demographic changes) exceeds the growth rate of potential GDP (the economy's maximum sustainable output) per person.

Data source: Congressional Budget Office. See www.cbo.gov/publication/56977#data.

Spending for the major health care programs consists of gross spending for Medicare (which does not account for premiums or other offsetting receipts), Medicaid, and the Children's Health Insurance Program, as well as outlays to subsidize health insurance purchased through the marketplaces established under the Affordable Care Act and related spending.

Excess cost growth is the extent to which the growth rate of nominal health care spending per person (adjusted for demographic changes) exceeds the growth rate of potential GDP per person. Potential GDP is the maximum sustainable output of the economy.

GDP = gross domestic product.

a. If aging did not occur, spending on Social Security as a share of GDP would be lower in 2051 than it was in 2019, mainly because of the scheduled increases in the full retirement age for Social Security.

Source: CBO

As advisors and asset allocators, we must reconcile the natural evolution of each client's financial needs, risk tolerances, and objectives to fast-changing economic and market currents. The interplay of these forces requires constant and careful assessment, both in the initial development of a wealth plan and in keeping that plan current. This involves creating a personal balance sheet and income statement, as well as making assumptions about long-term asset class level returns and inflation expectations.

In the years ahead, we expect the latter to figure more prominently in client conversations than they have in a generation. The variability of inflation has significant ramifications for consumers, governments (especially highly indebted ones), and of course for your own holistic wealth plan. While we are intensely focused on present market conditions, we maintain a watchful eye on longer-term secular trends, with the resolute approach to risk management they demand at this extraordinary time.

Above all, we are grateful for your trust and partnership. Please know the entire resources of our firm are available to ensure your wealth strategies stay aligned with changing needs and market realities. On behalf of the firm, I look forward to our work together as we stride toward a safer, more normal world.

Sincerely,

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