CLEAR HARBOR
ASSET MANAGEMENT

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Friend of Clear Harbor,

As we embark upon the second quarter of 2020, the entire Clear Harbor team hopes this commentary finds you and your family both healthy and safe. We also reflect on those who are working on the front lines of this COVID-19 crisis, particularly the healthcare professionals who put themselves at risk so that they can tend to the seriously ill, which often requires painful sequestration from their own loved ones.

Indeed, as we all wade through this moment of historic uncertainty, I suspect we are all reminded of what is most dear and precious in our lives. We mourn with those who are suffering so much during this moment, even as we persist in our commitment as stewards of your hard-earned capital.

The Clear Harbor team is working remotely but communicating frequently throughout each day. As I mentioned in a previous note, we can still be reached at our usual phone numbers. We are also using Zoom, Skype and various social media channels to communicate with each another and with our clients in the most personal ways available. While our modus operandi may have shifted, the hours remain long as we communicate with healthcare experts about the anticipated duration and impact of this horrible virus, monitor and stress-test your portfolios, and make adjustments where appropriate.

It was scarcely two months ago that the world realized that the COVID-19 virus would wreak havoc far beyond China. It has since taken the lives of some 35,000 worldwide, and infected hundreds of thousands. As testing expands to more countries and broader population sets, we should expect millions more to become infected, with hundreds of thousands if not millions of total global deaths.

Governments are demanding that most residents work from home, school children from home, and embrace “social distancing”—a suddenly commonplace phrase. The purpose of such policies is to reduce the rate at which people are becoming infected, so as not to overwhelm the healthcare infrastructure with a surge in patients at once. We embrace this resolute public health response.

When the dust settles, the economic dislocation will prove extraordinary. Most estimates show U.S. and global growth declining more steeply in Q2 than at any time in modern economic history. Some well-regarded analysts believe that U.S. GDP could plunge more than 20% year-over-year, with global output falling more than 10%. This suggests a far sharper contraction than any experienced in even the worst moments of the financial crisis of 2008-2009.

COVID-19: Fiscal and Monetary Response

The fiscal and monetary response to this scourge has been quick and significant around the world, with central banks and governments pledging that they will do “whatever it takes” to maintain market order and prevent the worst-case scenarios for workers and employers. In the U.S., the Federal Reserve stepped in and provided unprecedented levels of liquidity to banks and other financial institutions, as well as supporting the short-term commercial paper markets. The central bank also cut the overnight funding rate twice in March—by a combined 1.50%—to nearly zero.

Recognizing that corporations with plummeting revenue would see their cost of funding skyrocket, the FED stepped in again on March 23rd with an announcement that they would immediately purchase longer-maturing investment grade corporate bonds and even municipal bonds. The firepower granted by Congress for these coordinated programs is some $4 trillion; support for credit in some instances already exceeds that seen in 2008-2009.

The explicit goals of these programs are to stabilize markets, ensure market liquidity, and promote confidence in the capital market system. Early signs have been constructive: credit spreads immediately contracted across both investment grade and high-yield markets, and Treasuries rallied significantly.

Congress, too, worked frantically to pass the most comprehensive and costly fiscal package in living memory. A first round, allocating $2.2 trillion, dwarfs past stimulus precedents. This morning, President Trump called for a separate $2 trillion infrastructure package as well. Both are aimed squarely at supporting middle-class and lower-spectrum wage earners and their employers at a time when unemployment—until recently at or near record lows—could easily hit 15% by midyear.

Such sweeping policy action in the U.S. reflects a near-global policy playbook of rate cuts, aggressive central bank interventions to reduce credit stresses, and massive fiscal stimulus. Europe and Canada are scrambling in similar fashion. It is clear that policymakers are determined to support growth today despite the massive increase in public debt that it requires. The separate challenges that are the inevitable byproduct of such largesse will have to wait.

The financial urgency of the moment is no illusion. Major stresses have formed around the globe. Australia is facing its first contraction in 30 years. In emerging markets, companies and countries that have relied on the issuance of U.S. dollar-denominated debt have been hit hard as the dollar has spiked. Balance sheets and healthcare systems in these regions remain under significant pressure, with major capital outflows despite indications of support from the International Monetary Fund, which in coordination with the G-20 nations is attempting to address the dollar funding crisis.

Nor is China necessarily emerging on the other side unscathed. Many observers distrust recently reported improvements in China’s COVID-19 data, let alone its economic numbers.

Market Reaction

The volatility of late in the major asset classes has, in many cases, easily matched the levels of the 2008-09 financial crisis. Not only bonds and equities, but oil have been savaged; even gold has not been immune to fluctuations. Non-correlated asset classes have been worth their weight in gold (see below).

- **Equities**

Both the speed and the scale of recent stock declines have been nothing short of stunning. It is hard to believe that only weeks ago the S&P 500 Index and the MSCI All World Index both struck all-time highs. Even after a rebound of at least 16% since the recent nadir on March 23rd, those two indexes remain approximately 22.5% below their mid-February peaks, and down 20% for the quarter as a whole.

No part of the equity market is protected from this moment of uncertainty. Even the two brightest spots in the U.S. market for the year to date, utilities and technology, have given up 12% and 13% respectively. The worst-hit sectors, financials and energy, have swooned by 32% and 50% respectively.

We see few technical signals that a bottom has formed. Moreover, on a fundamental basis, we believe the coming earnings season will be extraordinarily ugly, and a catalyst for reorienting investors and repricing markets. We therefore eye rallies primarily for any opportunities they might present to rebalance portfolios between asset classes, rather than as a "green light" for increasing target allocations for equity and credit.

The equity market has always been dubbed a "discounting mechanism" that peers into the future, weighing future expectations rather than reflecting on current conditions. This moment lacks key data on which to predicate insights into the future—in particular, the duration of our economic freeze.

It is a most peculiar moment. On the one hand, this freeze has been implemented by policymakers: it is in some sense, then, of our own choosing in a way that other downturns have historically never been. On the other hand, it is the course of the virus that will guide future decisions on when, and by how much, to relax the restrictions that are currently depressing economic activity. As NIAID Director Anthony Fauci put it: "You don't make the timeline; the virus makes the timeline."

The data that will most likely drive these decisions should emerge steadily in the coming months. Most important will be identifying the peak and subsequent decline in new COVID-19 cases for each country. Only when confidence grows that the turning of the tide is in sight can we accept the assumptions behind the models, and apply them to equities, high-yield bonds and other risk assets.

Perhaps the current program of social distancing will bend the curve more in the U.S. than in some other Western nations; perhaps innovation will speed tests and vaccines to market more quickly than most analysts project. These will provide the foundation for the restoration of public health. Perhaps they will even justify recovery in financial markets and the underlying economy within the second half of 2020.

At present, though, we can say with assurance only that the worst of the human cost remains ahead of us even in the New York region— by far the largest epicenter of infection in America, and one of the earliest to confront the threat. Much of the nation has not yet begun.

- **Fixed Income**

Fixed income, too, saw significant volatility this quarter. Nevertheless, the broad U.S. benchmark, the Bloomberg Barclays Aggregate Bond Index, has returned 3.2% year-to-date. Yields have declined in lockstep, with 10-year Treasury yields going from 1.91% at the start of the year to just 0.67% today.

It was not long ago that owning Treasuries over corporate credit was deemed "irresponsibly conservative," a "return-free risk" instead of the traditional "risk-free return." However, in this unprecedented moment—and even at such low absolute yields—Treasuries have indeed delivered the "ballast" advertised: 7- to 10-year maturing Treasuries are better by more than 10% year-to-date, while 20+ year maturing Treasuries have returned more than 23%. For balanced portfolios that have seen equity holdings whipsawed, such a cushion to performance from fixed income is welcome indeed.

On the other hand, credit has fared more in tandem with equity markets. Even investment-grade bonds are worse by an average 3.5% year-to-date; high-yield bonds have fallen 11%, preferred stocks 14%, and mortgage REITs demolished by a whopping 55% or more.

This divergence in returns overwhelmingly is the result not only the perceived state of the economy but also of choices made by the Federal Reserve. Their buying programs and lending facilities have clearly benefited Treasuries, mortgages, municipal bonds, and investment-grade credit; high-yield bonds, preferred equities, and non-U.S. agency mortgages have experienced a swoon akin to that seen in the financial crisis. Without direct central bank action to support their prices, recovery must turn on individual credit fundamentals—and that will turn on overall economic stability. As with stocks, the inputs required for those assessments is still changing daily.

- **Oil and Gold**

Energy prices absolutely collapsed this past quarter. In addition to the swift evaporation of global demand, Saudi Arabia and Russia chose this moment to begin a production war. The result was a decline of 65% in the quarter for Brent Crude. Nor are lower prices the unmixed blessing for consumers that they once were. In a world of enforced quarantines, benefits from lower gas prices are harder to reap; in a world in which the U.S. is a net energy exporter, the harm to employment is direct.

The story was much more encouraging for holders of gold, which trended higher by 4% in the quarter, bolstered by its ancient stature as the world's strongest non-fiat currency. As central banks around the world slash rates and expand their balance sheets, gold's allure as an alternative currency and fundamental store of value has clearly grown. Looking ahead, strength in the U.S. dollar relative to other major global currencies could dull some of gold's shine. However, we believe it is well positioned to stand its ground in price, if not continue its incremental advance in the months ahead.

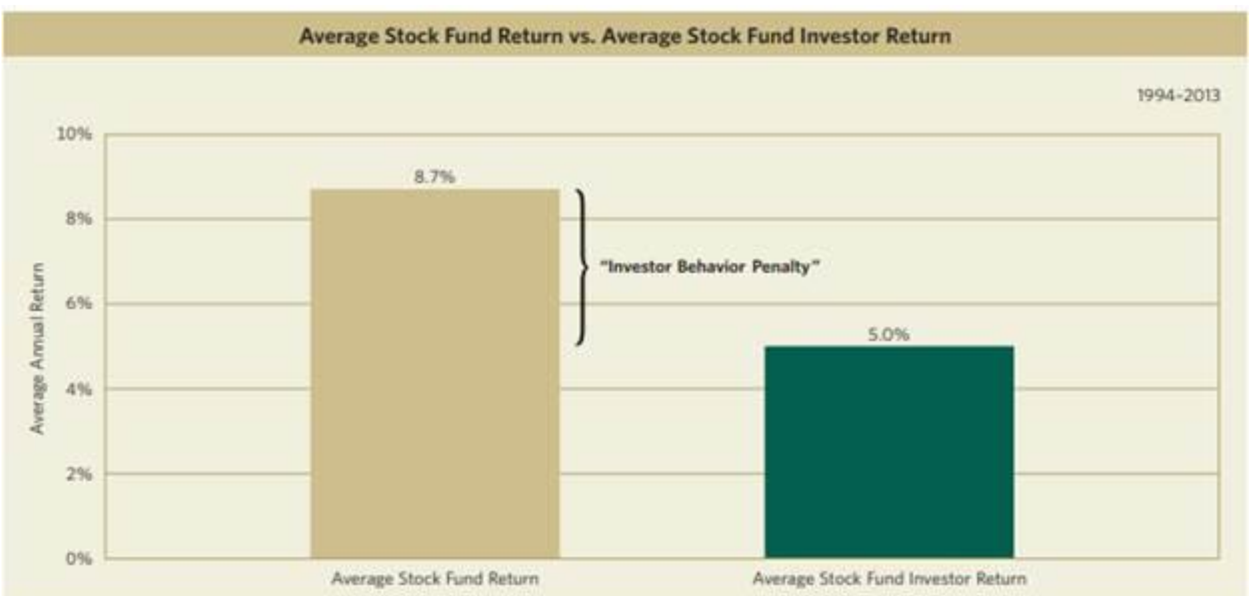
What Has Worked During This Crisis?

In short: diversification has worked. This is not uniformly the case at moments of extreme market stress; particularly when the markets themselves seem to malfunction, as they did during the financial crisis, all bets are off. But during the current swoon, exposure to a variety of asset classes with differentiated correlations to one another has proved beneficial, with flat or gaining asset classes helping to buffer against some of the worst short-term declines in other components of the portfolio.

To be sure, the value of such buffers at moments like this must be weighed against the drive for higher returns, which are generally correlated to greater risk. Given a long enough horizon, a portfolio of 100% equities stands an excellent chance of achieving long-term wealth objectives for many investors—and perhaps more rapidly than a portfolio with significant components of Treasury bonds or gold.

However, the vicissitudes of such a portfolio are likely to test one's stoicism during periods of market tumult, luring investors to sell equities at precisely the wrong moment in a cycle. That describes both this particular moment, as well as the emotional reality for many investors confronting it.

In fact, several academic studies have established the outperformance of diversified portfolios over the long haul—not in the abstract, ***but when taking into account how human emotions alter investing decisions in volatile markets.*** It is for this reason that we urge most of our clients to accept some measure of diversification, even in portfolios designed primarily for long-term appreciation. Recognizing that volatility affects emotions, and emotions affect decisions, we have welcomed our many conversations with clients in recent weeks about the current state of the market, and how thoughts about individual life goals and the allocation process have shifted during this most disconcerting period.



Source: Davis Advisors and Dalbar, Inc. (March 2014)

Revisiting Our Investment Thesis

Although the Clear Harbor team is not gathering around a physical table at the moment, we have never been more collaborative. We are stress testing portfolios in order to maintain appropriate risk levels for individual clients, and scrutinizing company balance sheets and debt coverage ratios rigorously.

Thinking outside the proverbial box and testing our assumptions are warranted now more than ever. For example, we are assessing how business closures and bottlenecks are constraining cash flows and stressing balance sheets in ways that we had not previously imagined. While this exercise has discovered some unanticipated risks, it has also shed light on many opportunities across different sectors and asset classes, with some securities trading at deep discounts to intrinsic value.

How will historians ultimately document the days and weeks we are living through? In the near term, what policy lessons—both healthcare and economic—can we learn quickly to address our challenges?

The medium-term questions—those looking out several years—may prove to be of the greatest interest to investors. How will the world’s interconnectedness and interdependence change? What will our relationship with China look like in a few years? How will the current experience of online learning and remote work alter how individuals and corporations structure their time and their human resources? Will recent experience open a transformative door for telemedicine in aging nations that have long struggled with rising healthcare costs? What are the investment ramifications for it all?

We have not lost sight of these questions, and I will return to them in future communications. For now, we remain conscious of a global investing environment in which growth has been slowing, and debt rising, since 2018 even before the meteor hit from COVID-19. We will continue to adapt together.

Above all, we remain committed to your long-term financial health. We wish to hear your concerns, respond to your questions, receive updates on your financial life, and advise on any adjustments to your wealth roadmap assumptions. Whether by telephone, video conference or even Facebook, our priority is to ensure clear lines of communication. We look forward to hearing from each of you.

We all hope that Q2 2020 marks a peak and ebb of COVID-19 infections in our nation and across the world. We also hope and believe that when this happens, the deep decline in economic activity and employment will end, and the rebuilding of lives, businesses and economies can begin.

Sincerely,

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