Aaron J. Kennon
Chief Executive Officer & Chief Investment Officer

December 13, 2022

Friend of Clear Harbor,

2022 provided ample reminders that markets are driven by human forces, and can be just as mercurial. Indeed, those concerned with prospects for major asset classes in the new year must continue to scrutinize the ever-evolving steps in the monetary and economic dance as central bankers, corporate leaders and ordinary consumers—humans, all—strive to find their footing amidst various uncertainties.

Still, certain trends came into clearer focus over the course of the year. The pandemic and the war in Ukraine have created, highlighted or greatly accelerated changes that are structural in nature. In some cases, such as Europe's renewed urgency on clean energy or America's re-shoring of certain supply chains, they may prove nothing short of tectonic. With the cost of capital no longer virtually zero, such considerations carry great weight with us as we consider how consumers, businesses, and investors will behave not just in the next four quarters, but in the years that will follow.

2022: Market Review

2022 dealt a vicious brush-back pitch to investors conditioned to believe there was no crisis in nature or on Wall Street that could not be smoothed over with docile monetary policy. In the face of the highest inflation in 40 years, the U.S. Federal Reserve kick-started interest rates to levels that, while quite manageable by any historic standard, have nonetheless stunned an entire generation of younger market participants. This occurred even as economic conditions deteriorated amidst Zero-Covid policies in China, dwindling fiscal stimulus in the U.S., and the ongoing war in Ukraine—all of which weighed on consumer and industrial demand, and with a higher cost of capital, threatened corporate profit margins.

The sudden and sloppy reordering of markets that ensued has sent the broad measure of global equities down 15% year-to-date. Even after a recent bounce, the S&P 500 remains off by 16%, with value sectors and companies holding up better than growth.[1] Emerging Markets also buckled, with its key equity benchmark falling 21%. In a particularly unwelcome development, U.S. bond markets provided no consolation, with the Bloomberg Aggregate Bond Index declining a steep 12%—its worst calendar-year

[1] All data is per Bloomberg LLP as of close of markets on December 12, 2022.

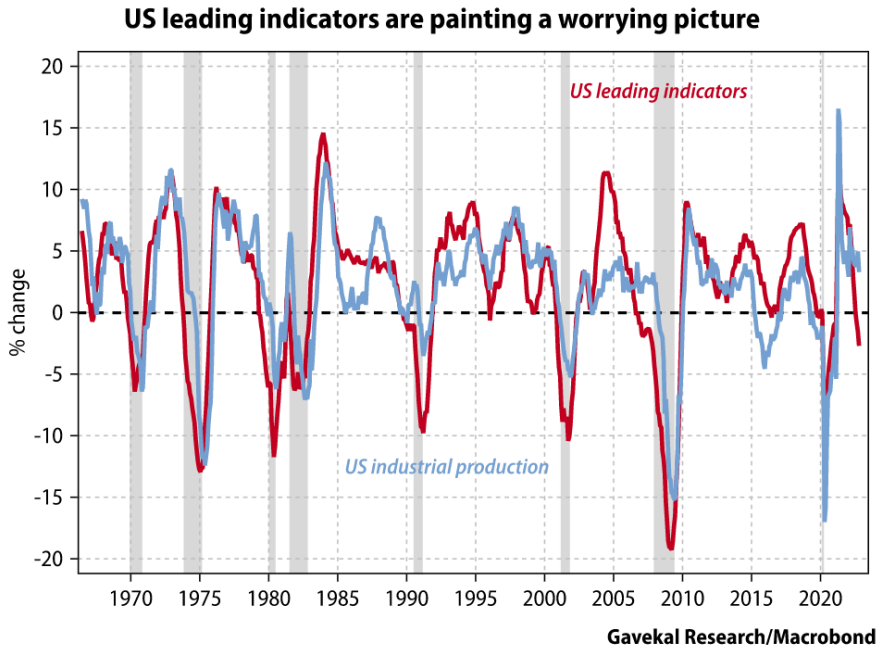
performance on record. Credit spreads widened as well, though not in proportion to the upward move in yields seen across Treasury maturities.

The broad commodities benchmark, the S&P GSCI, entered bear market territory this month after spiking in the spring. The index is now 30% off its peak, reflecting steep declines from spectacular highs in such key components as crude oil (-40%), copper (-21%), aluminum (-37%) and wheat (-40%). Gold remained under modest pressure throughout the year, declining 2%. The U.S. dollar maintained its strength relative to all major global currencies, though signs of toppiness have recently emerged.

The Economic Seesaw

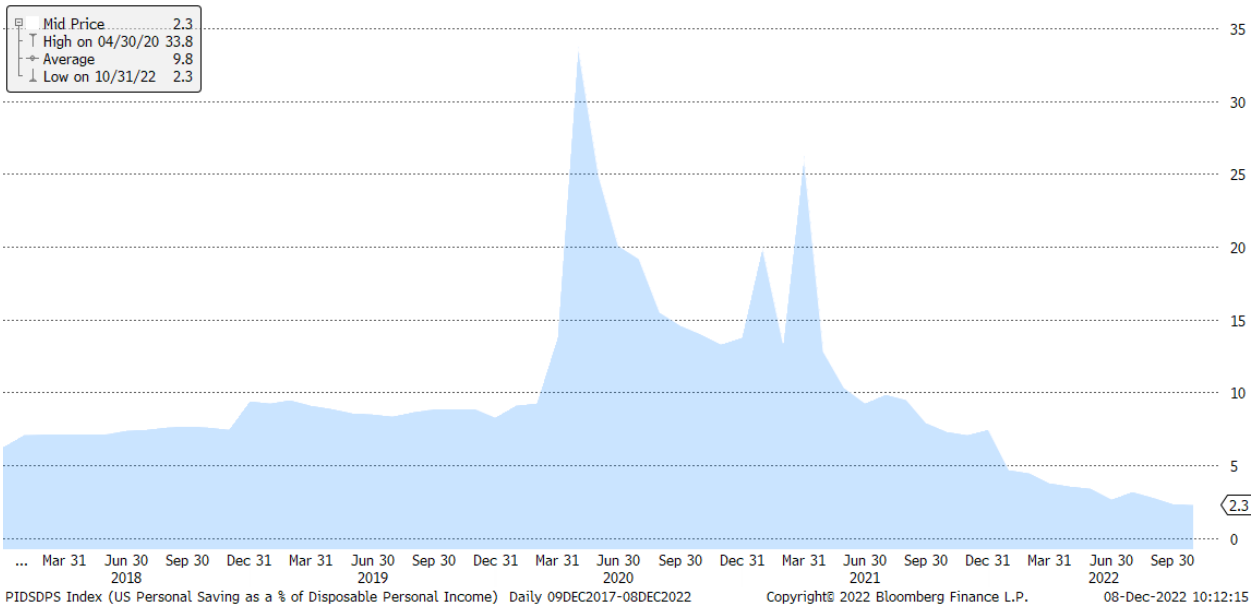
After a very robust pace in 2021, economic data decelerated both at home and abroad in 2022, with headline GDP in the U.S. straying modestly into negative territory in Q1 and Q2—a two-quarter decline that meets one formal definition of a recession. With that said, growth recovered to a 2.9% rate in Q3; full-year growth estimates now stand at 1.8% for the U.S., and 2.9% globally. In another twist, we now see evidence of economic deceleration returning in Q4, which we expect to bleed into full-year 2023 estimates soon. (The consensus for 2023 growth is currently 1.2% in the U.S. and 2.7% globally.)

In some respects, this see-saw in growth can be seen as a 21st-century take on the traditional boom-bust cycle of the 1950s and 1960s. As supply chains normalized, companies rebuilt inventories that had been severely depleted during Covid. This restocking activity contributed to growth in the back half of 2022, but we do not expect it to continue at a comparable rate in the year ahead. In some industries, such as retail apparel, inventories are already elevated; across many others, companies are beginning to "rein in" for an environment of higher wage and capital costs—all while their customers are adjusting to diminished savings accounts and 401(k) balances, softening home values, and fewer "help wanted" ads.



Demand for capital goods, housing permits, unemployment claims, and other indicators are clearly softening. Indeed, the broad series of U.S. Leading Economic Indicators as well as a recent downdraft in industrial production suggest that current 2023 consensus growth estimates may prove too optimistic—and that in fact we face an elevated probability of recession in the year ahead.

US Personal Savings Rate as a % of Disposable Income



Source: Bloomberg

To be sure, employment and wages remain strong, which should support consumer spending and help blunt the force of any downturn. Yet consumer credit balances have risen rapidly over the last several months, in tandem with an historically low household savings rate of 2.3%. This is a dramatic reversal from the significant excess savings Americans accumulated during the pandemic, and a sign of consumption headwinds and higher default risks in the year ahead.

In fact, just since June of 2022, fully one-third of household expenditures and 100% of retail sales can be attributed to higher household borrowing.[2] Such borrowing is not sustainable as a major basis for consumer spending, particularly in an environment of rising interest rates. On that point, of course, homebuyers have been hit particularly hard: the average 30-year fixed-rate mortgage has more than doubled since this time last year, from 3.2% to 6.5%.[3] Even if chronically constrained supply helps support home prices, residential sales volume will likely continue to slow—and with it, revenue for the furniture retailers and many other businesses that depend on new homeowners for growth.

[2] Rosenberg Research
[3] Bankrate.com and Bloomberg

- China

The world's second-largest economy, China, is a potentially powerful contributor to global growth, but it continues to bear several economic burdens, many of them self-imposed. First, the Communist Party's Zero-Covid policy and its stubborn shunning of western vaccines, which are more potent than China's home-grown varieties, have reduced growth to a trickle all by themselves. It will be interesting to see what more comes of the modest concessions the government has made in response to the extraordinary anti-lockdown protests seen in recent weeks in a smattering of Chinese cities.

Second, Chinese real estate continues to decline precipitously, accompanied by a significant credit and liquidity crisis in the industry. The rise of real estate has been highly correlated with higher investor and consumer sentiment in China; its fall dampens hopes for a buoyant economic or market recovery.

Third, Chairman Xi Jinping has continued a regulatory crackdown that he undertook earlier in this decade, with particular scrutiny of technology and education-related firms weighing on business activity. While this could lighten as Xi and the CCP scramble to restart growth, evidence of such a shift to date remains scant.

Other important societal and economic shifts in China demand attention. These include an aging population, which is an outlier among large developing nations and a long-term drag on China's growth; shifts in global oil and commodity demand, which have repercussions for consumers around the world; and the rise of household and commercial debt, which could constrain GDP in 2023 and beyond.

All told, consensus estimates call for 4.8% growth in China for full-year 2023—up from 3.2% in 2022, but still a far cry from the high single-digit rates seen over the last decade. Even 4.8% may prove too optimistic given the headwinds noted above. Yet we are mindful of the potential for shifts in economic policies that could increase Chinese output for some products and commodities, and demand for others. For example: China's Zero Covid policy has taken an estimated 1.5 million barrels of oil demand per day offline; any move away from that policy will mean higher oil consumption alongside higher growth.

- Oil, Gas and Europe

The divergent stories of crude oil and natural gas warrant mention. Prices for crude, the archetypal global commodity, have retreated with the broader GSCI and are currently down about 2% versus the start of the year; they seem to have found technical support around this level. While natural gas prices have also corrected somewhat from their summer highs, regional price disparities are substantial and shifts in supply have been massive. Hardest hit has been Europe, where expensive-to-ship U.S. liquified natural gas has increasingly replaced cheaper Russian pipeline volumes since the invasion of Ukraine.

The natural gas story is thus not just about global prices staying higher for longer than for other commodities, but specifically about Europe coming to terms with its strategic blunder of relying for so long on cheap Russian energy. Until the Continent establishes reliable alternative sources for both gas and oil, along with an accelerated strategy for home-grown renewables, European industrial companies will flounder amid uncompetitive costs to produce everything from chemicals to trucks.

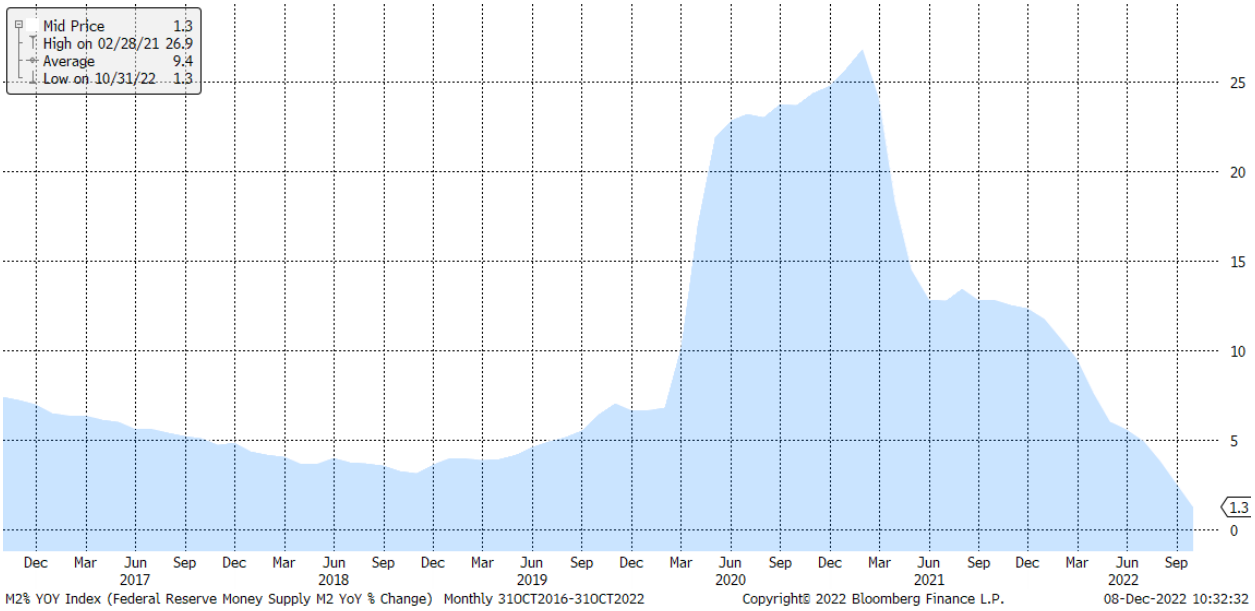
- All Eyes on Inflation

As of today, the biggest economic challenge in the U.S. is not jobs, consumer spending or overall GDP growth. It remains inflation—and the big question is how messy the Fed will be in striving to rein it in.

On balance, we accept the consensus view that the Fed will succeed. To be sure, inflation has been not only pronounced but unexpectedly stubborn, with the latest Consumer Price Index reading just marginally below the cyclical peak recorded a few months ago. And wages, which are stickier than fuel or corn, have registered gains this year.

Yet many key inflation drivers—such as the cost of commodities, the value of housing and rent, and the state of the employment market—are all showing signs of cooling off, especially in the United States. Money supply growth has also collapsed, after surging at a record pace during the heart of Covid in 2020 and 2021: less money being forced into the system means less money pushing prices higher.[4] In fact, money-supply data for November may indicate a pace of decline not seen since the 1930s. All this bodes well for, at long last, a deceleration in inflation trends next year.

M2 Money Supply Growth (rate of change year-over-year):



Source: Bloomberg and Federal Reserve

The million-dollar questions now are how quickly inflation can retreat, and at what economic cost if the Fed should overshoot the mark in its tightening process. The market's collective assessment of long-term inflation—expectations of where inflation will be in, say, 10 years—remain well anchored below 2.5%. But even if these estimates prove reasonably accurate, what path will inflation take between now

[4] See pp. 4-5 of Clear Harbor's Q4 2022 Outlook for more perspective on why we believe the growth of the money supply was an important factor in the acceleration of headline and core inflation.

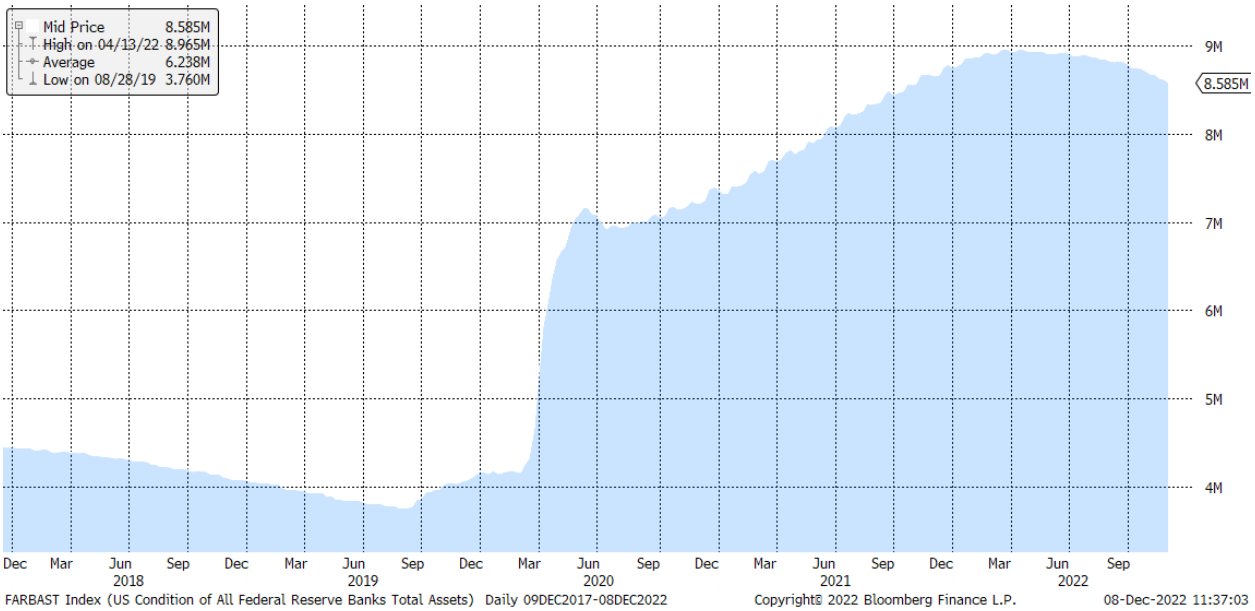
and then? In the nearer term, how will central banks wade into 2023, given that hikes to date will keep impacting the economy with what even Fed Chair Jerome Powell acknowledges as a "variable lag"?

2023 Outlook: Fed Policy

While some central banks (e.g., the Bank of England) began their rate-hike campaigns earlier and others (e.g., the European Central Bank) a bit later, none matched the audacious pace seen in the U.S., where inflation combined with comparatively strong economic signals this past year pushed the Federal Reserve to ratchet the Fed Funds Rate from 0% to 4% in record time. This sent nominal interest rates markedly higher across the maturity curve: two-year Treasuries leapt from 0.21% in January to 4.25% today, while 10-year Treasuries moved from 1.51% to 3.5%. In 2023, eyes will doubtless—and rightly—remain glued to the path of inflation and central bank response, most likely through a deceleration in rate hikes. (We accept the consensus that this deceleration will begin this month, with a 0.5% increase rather than 0.75% hikes witnessed four times earlier this year.)

But a second form of tightening is also afoot with less fanfare. The Fed continues to reduce its balance sheet, which it is currently doing at a pace of some $95 billion per month simply by allowing its holdings of Treasuries and mortgages to mature without reinvesting the proceeds.

Federal Reserve Balance Sheet ($Trillions)



Source: Federal Reserve, Bloomberg

If other bidders do not step in where the Fed is stepping away, prices for these securities will fall and their rates will necessarily rise. Though less conspicuous than the headline rates that receive coverage after each Fed meeting, balance-sheet runoff is another very real way liquidity is ebbing from markets. In fact, this "double barrel" policy response reflects a dramatic shift in U.S. and global liquidity—and it is hardly a tailwind for credit, equities, or anyone currently seeking a mortgage.

2023 Outlook: Fixed Income

As allocators of client capital, we cannot ignore the fact that interest rates now stand at levels not seen since 2007, prior to the global financial crisis. While we do not celebrate the price declines that bondholders have witnessed to get to this point, at current yields the asset class can provide more balance to portfolios than at any time in the last decade. This is true in terms of both absolute rates and real rates, i.e., relative to long-term inflation. For example, real yields on 10-year Treasuries have swung from a *negative* 1.1% one year ago to a decidedly *positive* 1.2% today.

In fact, the real 10-year rate exceeded 1.5% earlier this quarter, and it could again in the coming weeks and months. Yet Fed policymakers are well aware that high levels of federal debt relative to GDP will make markedly higher nominal rates unbearable over the longer term. This makes the Fed's job even more challenging: if they ease too soon, pain from inflation may persist; yet if they hike too high for too long, skyrocketing interest expense will act as a straitjacket on federal spending of every kind.

A real yield in the 1.0-2.0% range is much closer to the norm that predominated prior to the explosion in the Fed's balance sheet that began in 2008. Again, for those who could hang on through the nominal declines while holding their bonds to maturity, proceeds reinvested into the fixed income component of a 60/40 portfolio today is far better positioned relative to just 12 months ago—and indeed relative to any time in nearly a decade and a half. For context: since 1980, there have been eight years in which the S&P 500 ended lower than it began. Out of those, there was just one in which the bond market did not provide an absolute positive return: 2022. We believe this traditional virtue of fixed income—providing a measure of security when equity markets falter—will be restored in 2023.

- High Yield

While high yield bonds are categorized as a component of the fixed income asset class, their correlation to the equity market is historically quite high—so much so that we do not rely on them to provide the ballast that higher-quality bonds traditionally serve in a balanced portfolio. Indeed, high yield default rates tend to spike during recessions, and we are mindful that credit spreads could gap significantly higher as growth likely retreats in the year ahead.

So long as this higher risk is acknowledged, we do see incremental value in pockets of high yield today after years of relative abstinence. In fact, we see diversified, short-maturity segments of high yield as substantially more attractive than many of the high-income loan-fund products of the last few years.

For example: a basket of BB-rated bonds maturing in roughly one year can be accessed through a liquid, publicly traded fund, offering a yield-to-maturity of approximately 7.5%—some 3.25% more than a Treasury of similar duration. We believe most BB companies will be able to meet their bond obligations over that term, and may represent acceptable risk for inclusion in client portfolios where appropriate to individual mandates.

2023 Outlook: Equities

The sudden emergence of meaningful real yields from risk-free government bonds means, among other things, the end of investors pushing into equities simply because "there is no alternative." But to be clear, we remain committed to the view that a sizeable commitment to equities remains central to a well-diversified strategy for clients with a long-term horizon and tolerance for equity gyrations. I would also submit that while returns in the next several years could prove paltry compared with the annual averages over the last decade, the long-term return profile of equities still exceeds those of corporate bonds, Treasuries and cash. With that said, here are some considerations that may take on greater weight in 2023 as investors ponder prospects for stocks.

- The History of Equity Market Bottoms

While equity markets have recently shown renewed strength, it is an open question whether their momentum will continue into the new year or fade anew as sluggish GDP, thinner profit margins, and competition from safe, juicy bond yields all become harder to ignore. For at least the past half-century, bear markets that feature a Federal Reserve bent on raising rates have only bottomed after the central bank has reversed course and begun cutting rates. If this pattern holds, equities have further to fall.

Other historical metrics similarly counsel caution. For example, when viewed in relationship to recessionary trends, equity markets tend to bottom about three-quarters of the way through the contraction. By this measure, if a recession were to start in Q1 2023 and end in, say, Q1 2024, markets would most likely bottom sometime in mid-to-late 2023. Of course, if the U.S. and world avoid a recession in 2023, then such a comparison may not have much relevance. But most data suggests that the profit margin cycle peaked sometime in 2021, in line with economic growth trends. If so, the drag on corporate performance will bleed into earnings and asset prices in the year ahead, serving as a headwind to asset prices.

- The Real "E" in P/Es

It is somewhat surprising that so few analysts have lowered their expectations for next year's earnings yet, given the economic headwinds we already know about. At the time of this writing, the average full-year 2023 S&P 500 per-share estimate from major investment banks is still a lofty $233. While Clear Harbor's entire investment committee would welcome such a result (which would reflect earnings growth of some 5% over 2022), it may prove optimistic in the face of margin contraction; dollar strength; higher capital, labor and input costs; vanishing federal stimulus and lower consumer savings levels; and generally lackluster global demand as we wade into 2023.

Over the last 25 years, analyst estimates as of December 31st of the prior year tend to overshoot actual full-year results more than two-thirds of the time, by an average of 7%.[5] If 2023 were to follow those averages, actual earnings would come in at approximately $217—and current valuations would appear considerably more stretched than they currently do.

[5] Fact Set data published December 2, 2022.

- The Right "P" for P/Es

In addition to the level of earnings per share, one must ponder the multiple that should be applied to those earnings in order to determine fair value. Sustained volatility, higher nominal and real yields, and wider credit spreads will tend to weigh on multiples, while a reversal of these trends could tempt investors back to equities and push multiples higher.

Where things stand today depends on your confidence in current earnings projections. If you accept the projected per-share figure of $233, the S&P 500 forward multiple is currently 17.5x, hardly a bargain level. Should earnings indeed trend to $217 or perhaps lower in the coming quarters, today's forward multiple would rise to at least 18.8x, versus a 25-year forward average of approximately 15.5x. The risk of price retrenchment from such levels could be significant if corporate profit margins have in fact peaked.

- Supply Chain Shuffle

While historical and financial analysis is crucial to our work, it is also important to step back and view the larger backdrop of corporate performance. At times, a myopic focus on numbers alone can miss variables that allow companies to display surprising resilience in profit margins.

Unfortunately, a key part of today's backdrop is also negative for near-term margins: the restructuring of global supply chains. While supply chain performance has improved substantially since Covid peaked, multinationals are putting a new priority on supply chain security, reliability and control. As several recent news articles have highlighted, firms from Apple to Honeywell are reconsidering where they make their products and how they distribute them to customers around the world.[6] In part, this is in direct response to the experience of Covid-era bottlenecks and rising U.S.-China and Europe-China geopolitical frictions.

However, other trends have lent in this direction for some time, including rising wages that reduce the economic cost/benefit of siting manufacturing facilities in China. Not all of these shifts can be defined as "de-globalization" or "reshoring production" as a matter of national security or reducing transportation complexity. In fact, in many instances—with Apple perhaps the most notable—production will remain in Asia but shift to countries such as India and Vietnam, which remain cost-competitive.

Though costly for many manufacturers, such changes will create incremental growth opportunities for supply chain management companies, specialty manufacturing companies, related service providers, and Asia markets ex-China. We are keeping a keen eye on these trends to identify how they may impact margins and overall corporate profits, and create specific pockets of opportunity in the years ahead.

The Hunt for Opportunity and Value

In some sense, our rigorous and collaborative investment process is more important than our global macroeconomic outlook. Put another way: while no one can reliably project the depth or duration of a

[6] E.g., *Wall Street Journal,* December 3, 2022: Apple Makes Plans to Move Production Out of China - WSJ

recession, well-managed companies will always use downturns to expand market share at the expense of more highly indebted or less nimble competitors. Still, we do emphasize broad structural economic shifts that we believe will provide investors with opportunities for many years to come.

A few examples of how our macro perspective is merging with our bottom-up fundamental equity work at Clear Harbor in the current investment environment:

- While recognizing that future returns may not match those of the recent past, we maintain heavy exposure to U.S. equities in most client portfolios. The market has corrected significantly, and in our view, many companies offer meaningful future return prospects, particularly those with strong free cash flow and predictable growth fundamentals.
- We favor incremental exposure to emerging markets given corporate strategic priorities and global demographic shifts, particularly outside China.
- We are wary of European large cap exposure, which is heavily focused on industrials and financials at a moment of surging manufacturing costs and rising interest rates, which may hit many European mortgages hard due to high exposures to short-term floating rates.

We also note that each cycle brings different equity themes to the fore. During the 1970s, energy stocks rose; in the 1980s, inflation finally normalized and growth become more predictable, sending industrial and technology giants roaring higher. Japanese equities took a turn leading global indexes on the back of skyrocketing wealth in the island nation, followed by the first generation of Internet speculation. As we moved into the 2000s, globalization accelerated and a more mature phase in the Internet story catapulted major technology and retail firms to new heights. After the financial crisis, rapidly accelerating cellphone adoption and cloud computing were top market stories.

My point is that while no asset allocator can guarantee how each new economic era and market cycle will impact your portfolio, we strive to understand the forces acting on portfolios today, weigh the opportunity set as we see it for tomorrow, and reconsider asset allocations and portfolio balance on an ongoing basis. To that end, some themes we believe have multi-year momentum at the sector level:

- Healthcare continues to see rapid growth, both in per capita spending as the U.S. population ages, and driven by the evolution of new technologies and molecules to treat disease. We see no abatement in this trend, though we remain mindful of regulatory and competitive risks.
- Energy security will remain a priority for many nations. We see the opportunity for U.S. natural gas producers to export through LNG terminals continuing to expand in the years ahead.
- On a global basis, specialty manufacturers will continue to see new greenfield opportunities as companies large and small shift their production to friendlier nations.
- As poverty abates and middle classes grow in Emerging Markets, we think the human desire to consume, travel, and socialize will benefit travel and social networking providers among others.
- We think companies that develop defense products and capabilities will continue to benefit from rising defense budgets and reliable government partners in the U.S. and around the world.
- The technologies and services that support the ongoing expansion of miles driven around the world—whether electric, hybrid, or combustion engine—will benefit in the years ahead.

- Odds are rising that inflation will abate more quickly in the U.S. than in other regions, opening the door to a weaker U.S. dollar while benefiting gold, gold miners, and gold royalty companies.
- The U.S. labor participation rate has fallen from 68% 15 years ago to almost 62% today. In an aging world with a smaller share of the population in the workforce, the economy will need to deliver more products and services with fewer people. Software, products, and services that address this structural challenge will prosper in this new age.

Finally: in the near term, much still turns on the Federal Reserve. If interest rates reverse their climb next year, equity investors will likely rediscover their appetite for higher-risk growth opportunities. But if rates remain stubbornly elevated—a prospect that few seem eager to acknowledge—investors may seek refuge for longer than they had hoped in stocks that are slower, steadier, and income-producing.

2023 Outlook: Liquidity Trends

Liquidity trends tend to be predictors of equity and credit market direction, and right now those trends are bearish. The Federal Reserve is raising rates and reducing its balance sheet, and the cash that the federal government placed in the bank accounts of nearly every American during the pandemic has dried up—all pointing to less money being pumped through the economy. Meanwhile, inflation is still here and unemployment might soon tick up from its current historically low levels, giving consumers cause to tighten their own purse strings in the year ahead as well.

I suspect that 2023 will be a year of transition in which liquidity reaches a low-water mark, then begins to rise again. Key factors will include when and how the Fed ends its tightening campaign and returns to easier policy, and whether the Bank of China turns its own liquidity spigots back on, expanding the money supply just as Zero Covid policies start to fade. Evidence of either trend should spark a return to risk in financial markets. Should a year of liquidity transition in 2023 end with rising flow, it would be welcome after a decidedly dry 2022.

*

In important respects, asset allocators can finally feel the ground beneath their feet again. The return of a positive real interest rate from Treasury bonds means, first and foremost, that clients can pursue aspects of their return goals with considerably lower risk than at any time in recent memory. Second, the return of a viable sovereign bond alternative provides a standard by which to judge equity value. These developments are welcome steps back toward basics—literally the fundamentals of investing.

By exactly the same token, a guaranteed 4% or 5% from bonds makes it harder to envision—and harder for investors to justify—giddy returns for stocks in the coming years. Indeed, with so many “known unknowns” on the horizon, risk management discipline remains at the forefront of our work.

Yet I reiterate: over any meaningful horizon, equities remain the engine of higher returns and indeed economic progress in our world, and are still core to our research process and to most client holdings. On behalf of the entire Clear Harbor team, I thank you for your confidence in us as we craft portfolios to help you reach your specific goals. And as ever, I invite you to reach out to make sure we have struck the

right balance between risk and reward to allow you to commit comfortably to the long-term success of your investments, while respecting other priorities within your overall wealth picture as they evolve.

I wish you and your family every happiness over the holidays, and look forward to our work together in the new year.

Sincerely,

Disclosure:

Clear Harbor Asset Management, LLC ("Clear Harbor") is an SEC registered investment adviser with its principal place of business in the State of Connecticut. Registration does not imply any level of skill or training. Clear Harbor and its representatives are in compliance with the current notice filing requirements imposed upon registered investment advisers by those states in which Clear Harbor maintains clients. Clear Harbor may only transact business in those states in which it is notice filed, or qualifies for an exemption or exclusion from notice filing requirements.

The material contained herein is intended as a general market commentary. The commentary may contain general information and views that are not directly relevant to your particular account. Opinions expressed herein are those of Aaron Kennon and may differ from those of other employees and affiliates of Clear Harbor Asset Management LLC. The information contained herein should not be construed as personalized investment advice. Past performance is no guarantee of future results. Information presented herein is subject to change without notice and should not be considered as a solicitation to buy or sell any security. Any comparison to an index, including the S&P 500 and Russell 2000, is for comparative purposes only. An investment cannot be made directly into an index, which are unmanaged and do not reflect the deduction of advisory fees. This brochure is limited to the dissemination of general information pertaining to its investment advisory services. The current account composition is intended for informational purposes and allocations are subject to change.

For information pertaining to the registration status of Clear Harbor, please contact Clear Harbor or refer to the Investment Adviser Public Disclosure web site (www.adviserinfo.sec.gov). For additional information about Clear Harbor, including fees and services, send for our disclosure statement as set forth on Form ADV from Clear Harbor using the contact information herein. Please read the disclosure statement carefully before you invest or send money.