CLEAR HARBOR
ASSET MANAGEMENT

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Friend of Clear Harbor,

I am delighted to share with you the Clear Harbor Outlook for the third quarter.

In the second quarter, major asset classes held onto the first quarter's impressive gains despite decelerating corporate earnings, a seemingly abrupt turn in U.S. monetary policy, and significantly heightened tensions between the world's two largest economies. Beyond the U.S.-China trade spat, other geopolitical disturbances erupted: In the Straits of Hormuz, Iran was implicated in attacks on oil tankers; in Hong Kong, residents turned out to support the island territory's unique legal protections in the largest demonstrations since its handover from Britain to China in 1997. The UK's exit from the European Union remained constipated, costing Prime Minister Theresa May her post and spreading further heartburn across the Continent.

Against this backdrop, U.S. and international fixed income benchmarks gained 5.8% and 5.3%, respectively, in Q2.[1] These price gains sent 2-year and 10-year Treasury yields decisively below the Federal Reserve's fed funds overnight target range of 2.25-2.50%. Recall that just six months ago, the Fed was still signaling that successive rate hikes were in store for 2019; last week, the Fed voiced its readiness to cut rates should economic conditions and trade uncertainties weigh on the economy. This July may mark the formal shift into the more dovish policy that investors first started demanding at the end of 2018, when bond yields first began to decline, credit spreads widened, and equities faltered 20%.

While the "Fed put" thus appears alive and well, the U.S. dollar has nonetheless maintained its relative strength, modestly buttressed by the global "uncertainty factor." If the dollar were to take a breather, perhaps abetted by a formal rate cut, we could envision gold—already up nearly 10% YTD—benefiting further.

Equities also improved in the quarter, with the S&P 500 notching 3.7% and the MSCI All-World returning 3.3% and year-to-date advances of 17.8% and 16.0% respectively.[2] Near-term risks to any of these asset classes include a recession in the U.S. or abroad, further geopolitical surprises in China or elsewhere,

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[1] Indices referenced are the Bloomberg Barclays Aggregate Bond Index and the Bloomberg Barclays Aggregate Global Bond Index. Prices are as of end of day June 27, 2019.
[2] Equity data referenced is as of end of day June 27, 2019.

and the response from global central banks. These remain key considerations as we construct client portfolios for long-term financial health.

U.S. Economy

While it is foolhardy to guess at the timing of recessions, markets do tend to peak a good 6-12 months beforehand. If we were convinced of a likely recession in, say, the first quarter of 2020, we might be much more cautious about overweighting equities and credit today. At a minimum, advisors would do well to rebalance client holdings after the spectacular march higher in asset prices over the past decade.

For now, actual economic signals suggest a U.S. economy that, while decelerating, remains on reasonably solid footing. GDP growth may have ebbed from the strong 3.1% rate recorded in Q1, but expectations remain nearly at trend—about 2%—for full-year 2019. Consumer spending has remained resilient, up 3.9% at the most recent reading, supported by low inflation, attractive mortgage rates, and unemployment at its lowest point in 60 years. Employment growth appears to have slowed, yet job openings remain robust; wages are rising, helped by long-elusive signs of life in worker productivity.

The data is not without its share of noise. Credit spreads have widened across the investment and high yield landscape, but we do not perceive red-flag conditions. Housing starts fell in May, but were revised higher for the prior two months. Business sentiment and spending plans trended lower over the course of the second quarter, with purchasing managers recently reporting the weakest rate of expansion in 9 years. To be sure, businesses are better situated to perceive certain headwinds—for example, those presented by threatened tariffs—before individual consumers do. At the same time, restrained corporate investments today may well reduce prospects for bloated inventories (and resulting pullbacks) tomorrow—perhaps helping prolong the current, already historic, expansion.

We may be seeing a “tale of two economies” as the consumer remains resilient even as corporate earnings advances have grown muted. Moreover, the lion’s share of increased demand from the 2017 tax cuts has already registered in earnings growth, as well as broader GDP. Even if the bear case is vulnerable, much of the bull thesis is already reflected in equity prices.

Global Economy

Growth appears to be slowing on a global basis. The World Bank has lowered its estimate for full-year 2019 from 2.9% to 2.6%. A great deal of this variability appears driven by the seemingly intractable disputes over trade and intellectual property between the U.S. and China, along with uncertainty over the political and economic relationship between the UK and the European Union.

Despite these factors, global monetary and fiscal policy is still simulative. Dovish policy posturing from the European Central Bank, infrastructure spending and forthcoming incentives to support the auto market in China, and expectations of a rate cut in India all speak to the willingness of political and monetary authorities to sustain growth.

Monetary Policy

Economic factors will weigh on central banks as they craft monetary policy in July and beyond. However, so will their starting point for setting rates: never in modern economic history have they been so low during a period of economic expansion. In Japan and parts of the European Union, yields are already below zero, and—as in the U.S.—are flat or inverted. A prolonged period of inversion has historically correlated with increased odds of recession.

Some argue that extraordinarily low rates abroad mean that an inverted Treasury curve no longer signals recession for the U.S. Indeed, with nearly $12 trillion in negative-yielding sovereign debt around the world, capital is pushing into U.S. Treasuries, which still offer more yield than German Bunds or JGBs. This risks distorting shape of the Treasury curve—and its value as an economic predictor.

Nevertheless, inflation remains below the Fed's 2% target rate; in fact, consumer expectations of future inflation declined to a record low in June. This has prompted both market participants and the Fed to worry more about economic deterioration than overheating. Moreover, fed fund yields are now some 50-75bp higher than 2-year Treasuries. Historically, these conditions, too, tend to augur recession. This suggests that the Fed is (all but literally) behind the curve and must reduce its target rate just to reflect the reality of growth and inflation expectations already embedded within financial markets.

However, another school of thought holds that the Fed is balancing the relative strength of recent data against the potential disruption from any escalation in the trade wars. Indeed, language in their June 19th statement indicated a renewed willingness to reduce rates if conditions should deteriorate further. One point in favor of early action is that the current economic expansion, while long by historical standards, has proved quite shallow. Since no one knows what the economic future holds, officials may find erring on the side of economic stimulus offers the better risk/reward proposition.

Mr. Market certainly seems to be pleading with the Fed to ignore what it sees in the rear-view mirror, and focus instead on the future trajectory of U.S. economic activity. To be sure, low inflation—and nominally positive rates—give the Fed more room to maneuver than other monetary authorities, even if the primary impact may turn out to be to support equity prices. Perhaps this is why on June 15th *Barron's* ran this headline: "The Rate Cut the Economy Doesn't Need — but the Markets Do."

Long-Term Factors

A number of factors in economic and market performance are of a long-term nature. Some tend to elude scrutiny altogether; others may seize the headlines just long enough to be misunderstood. Here are some that we believe bear watching not just in the coming quarters, but in the coming years.

- U.S. Deficits

While the U.S. national debt attracts little attention at present, it is expanding mightily. It is particularly worrisome to see it increase during a period of reasonably strong economic growth, when deficit-driven stimulus spending is harder to justify than in sluggish periods. Furthermore, as non-discretionary commitments continue to skyrocket, the deficit impact from cuts to discretionary programs will decline.

The Congressional Budget Office now reports that the federal government will spend “more on interest in 2020 than on Medicaid, and more in 2025 than on national defense.”[3] The first of these thresholds is quarters away, not years. Both may spring devastating traps should we cross them with higher interest rates than we’ve grown accustomed to.

- The U.S.-China Relationship

Friction between the U.S. and China clearly rose in recent weeks as President Trump maintained existing tariffs on Chinese goods, added new ones, and demanded that China recognize property rights and prohibit IP and cyber theft. The Administration made a particular example of denying semiconductor sales to Huawei, a Chinese company associated with leadership in 5G technology (and reported ties to Chinese intelligence). But the wider policies are already hampering trade with the communist nation.

Is a new Cold War upon us, driven as much by technology leadership as by traditional military considerations? Is the current trade spat merely part of this larger war, and if so, how far-reaching will the impacts be on global growth? Will tariffs become a more common tool of foreign policy objectives for this and future administrations, or will this heated moment end with the tenure of this president? To what extent do such actions undermine the Communist Party’s perceived ability to govern China? These questions may demand attention for years to come.

- Other Geopolitical Shifts

While recent attacks on shipping recall isolated incidents from previous decades, they may be part of a larger, decidedly murky power shift in the Middle East today. While Iran has long been a dominant power in the region, seldom have hawks in the U.S. made calls for direct conflict; those murmurs are growing. At the same time, criticism has grown more vocal of our longstanding ally and counterweight to Iran, Saudi Arabia, as well as Turkey. Both Muslim nations are recipients of significant U.S. military support. Any break in these alliances will have implications for global energy markets, despite important strides in U.S. energy production in recent years.

Putin’s Russia has grown more adventurous of late, too, rattling its sabers in the Pacific to the point of a near-collision with a U.S. aircraft carrier earlier this month. In the Americas, beyond the humanitarian and political crisis at the U.S. border with Mexico (and Mexico’s relationships with its own southern neighbors), uncertainty over Venezuela’s future at a time of U.S. isolationism puts control of the Western Hemisphere into question. And with Theresa May and, in the near future, Angela Merkel set to leave the stage, the future leadership of the UK and Europe is an open question. Forms of nationalism similar to the populism that swept Trump into office are gaining ground across the Continent.

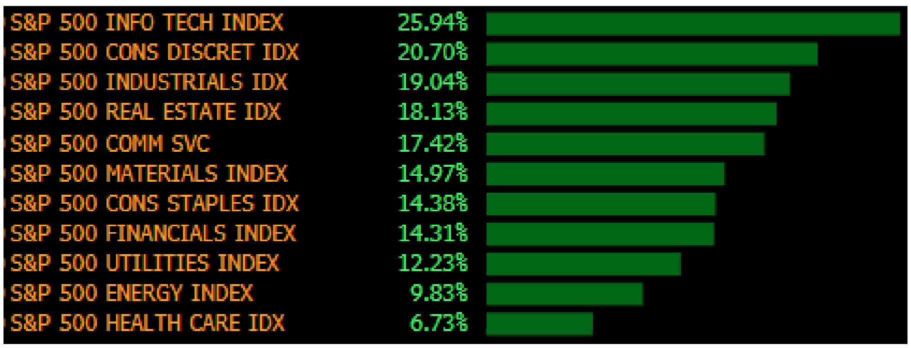
[3] See, e.g., Tory Newmyer, “The Finance 202,” *Washington Post,* June 14, 2019.

Market Considerations

To date, our posture has been to overweight U.S. equities relative to international and emerging markets (EM), which has proved beneficial for client portfolios so far this year. Having recorded significant year-to-date gains even in the face of global economic deceleration, we look to the second half of 2019 as a time to recalibrate and reassess the fundamental outlook for major asset classes.

- Equity Sectors

On the corporate side, more than a third of S&P earnings growth last year can be attributed to the tax cut; profits are unlikely to find a comparable catalyst in the coming quarters. At the sector level, technology—while certainly volatile—has outpaced all others this year. We also note the strong performance of utilities, whose solid yields have drawn interest amid lower interest rates, subdued inflation and slowing growth. With that said, it is worth noting that as of June 27th all major sectors of the U.S. equity market are positive on the year.



While few seem unreasonably valued in the context of available yields in fixed income or other asset classes, we continually evaluate investments at the security, sector and asset class levels for relative value and relevance to specific client objectives.

- Emerging Markets

EM may present interesting pockets of value for some investors at this juncture. Though the sector has underperformed U.S. and developed International equities this year, this can be attributed largely to continued dollar strength and broader economic deceleration, as opposed to poor business performance and lack of absolute economic growth. For those clients allocated to Emerging Markets, we prefer to own segments that benefit from the tailwinds that are born from the rapid growth of the rising middle class.

- Fixed Income

The rise in equity market volatility in both late 2018 and May of this year sparked a flight-to-quality in U.S. Treasuries, providing a smoother year-to-date ride to balanced investors than to those concentrated in equities. Decent corporate fundamentals also buttressed investment grade and high yield gains. In fact, high yield corporate bonds and long-dated Treasuries have both returned nearly 10%

year-to-date with the Treasury and Mortgage-heavy fixed income benchmark[i] better by nearly 6%. Still, for those who seek an allocation to fixed income as a proverbial “air bag” to cushion portfolios against volatility, we remind clients that while investment-grade and high-yield bonds may at times offer strong relative value, they remain more correlation to equities than is often recognized.

- Commodities

On the commodity front, crude oil has trended higher this year—albeit in volatile fashion—with Brent up approximately 23%, even as natural gas fell by more than 20%. Aside from gold, metals have proved mixed; so have soft commodities.

<u>The Markets and Your Financial Life</u>

Amid economic uncertainty and market vacillations, we remain anchored in the conviction that timing the market is nearly impossible; that without the unknown, expected returns would be zero; and that patience through periods of volatility is required to capture the benefits of an appropriately allocated investment strategy. We also recognize that different asset classes react differently to uncertainty, and that clients vary in their embrace and tolerance of risk.

Central to our work is thus to understand not only the inputs that drive markets, but the variables that inform client priorities and concerns. Many find that a balanced approach provides a level of comfort during moments of geopolitical and market stress, which makes it easier to stay the course en route to achieving their objectives. Others are better able to withstand elevated volatility in pursuit of higher anticipated long-term returns. In each case, our asset allocation process is not geared toward predicting the future: it is intended to provide a framework for maneuvering toward long-term goals in a way that respects what each client needs to come out the other side in healthy financial shape.

The team at Clear Harbor not only monitors portfolio positions, but seeks to add value through thoughtful advice on each client’s holistic wealth picture. Whether you are planning for retirement, saving for college, moving to a new employment opportunity that involves restricted stock, pondering a move to another state, managing a divorce, or simply contemplating alternatives for your portfolio allocations, we are prepared to help guide your decision making every step of the way.

On behalf of the Clear Harbor team, I wish you a pleasant and safe summer.

Sincerely,

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[i] Bloomberg Barclays Aggregate Bond Index