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Friend of Clear Harbor,

After closing out a year in which returns were dented by decelerating economic data worldwide and a Federal Reserve seemingly bent on a steady pace of interest-rate hikes, markets gave investors some relief in the first quarter of 2019. The S&P 500 is better by 13.6% year-to-date, and 21.2% since the December 24th near-term bottom; international equities, as measured by the MSCI All-World Ex-U.S. Index, gained 10.4% in the quarter.[1] Fixed Income also fared well, with the Bloomberg Barclays Aggregate Bond Index improving 2.9% amid a rise in sovereign bond prices and a reasonably healthy credit environment.

The pivot in market performance came in January, when Fed Chairman Jerome Powell announced a return to a more neutral monetary policy, even as he voiced confidence in U.S. economic health. This somewhat realigned the U.S. with continued easy posturing from the European Central Bank, Bank of Japan and even the central bank of China. In fact, approximately $10 trillion of global government debt now offers negative returns to bondholders—an increase of nearly $2 trillion in the first quarter alone.

This shift created a more forgiving monetary environment than many had anticipated at year-end. Conventional wisdom held that solid domestic growth would ultimately outweigh the Fed's international concerns, thus warranting another hike or two in the new year. Nevertheless, some observers pointed to a wide range of data both at home and abroad—not least retail sales, inventories and surveys of purchasing managers—that suggested a more cautious consumer and argued for restraint.

In our Outlook for 2019, we highlighted our own belief that the Fed would soon reverse course, express a significantly more cautious view on the economy, and adopt a more neutral monetary posture:

> On December 19th, the Fed's FOMC Committee articulated a rather bullish case for the trajectory of the U.S. economy, saying that it anticipates two additional rate hikes next year… We shall see if they hold to that. While we certainly do not include a U.S. recession in our base case for 2019, we think future inflation and growth data may prove more tepid… and will therefore demand a somewhat more dovish response.… [P]rospects of a policy error are real,

[1] All data are from Bloomberg LP as of the close of trading on March 29, 2019.

and any intransigence in the face of deteriorating conditions could nudge an already-slowing U.S. into recession. That would be expensive proof indeed of the Fed's "independence."

The Fed's January shift in effect acknowledged such concerns. On March 20, Powell further signaled an intention not to raise rates in 2019, and to tolerate inflation above the Fed's longstanding 2% target. He also suggested a willingness to resume reinvesting its balance sheet holdings as they mature in September, which would restore at least temporarily one of the hallmarks of the institution's extraordinary response to the financial crisis—one that most observers believed was sunsetting.

We dwell on the Fed's retreat to more accommodative policy because we believe it has been a significant driver of the jump in the S&P 500 since December. Along with evidence of a surge in buybacks during Q1, it also factors strongly in our reasoning and assessment of capital flows.

It is tricky to evaluate the path ahead for risk assets in an inflation environment that continues to justify historically low sovereign yields. Now that slower growth in both earnings and GDP seems to be indeed upon us, attention to the trajectory of rates will be all the more important.

- Tea Leaves from the Treasury Market

Some have noted that the U.S. Treasury market foreshadowed the Fed's own rate pause, with Mr. Market sending yields well below those witnessed at the start of the year. In the same vein, many seek clues from the yield curve, which inverted last week when 3-month Treasury bills began yielding more than 10-year Treasuries. Moreover, the spread between 10-year and 2-year Treasuries remains extraordinarily flat, with 2-year issuance yielding 2.26% versus the 10-year at 2.40%.

Historically, such inversions have often boded ill for the economy. According to J.P. Morgan, they have heralded seven of the eight recessions since 1960. This makes sense: inversions imply that investors anticipate that monetary officials will soon lower short-term rates—which they often do when faced with weakening economic conditions.

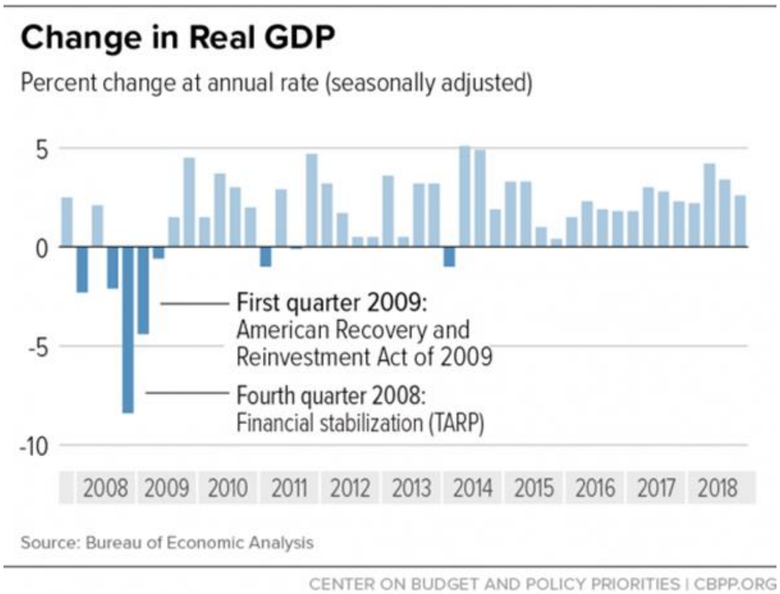
We see additional factors at play in today's inversion story. One is the continuing disruption from unconventional monetary policies around the world, even a decade after the financial crisis. Faced with zero or negative yields on sovereign debt in Germany or Japan, many institutional investors opt for the additional 2.5% available in longer-dated U.S. Treasuries. At the same time, U.S. investors see "lower inflation for longer," which would tend to put greater pressure on 10-year yields than on 2-year yields.

These factors push down rates in ways that reveal as much about global monetary policy and inflation expectations as they do about U.S. economic strength. Nevertheless, we will watch the vector of these moves carefully—particularly in a domestic economy that is without question less spry than a year ago.

- Reading the Fed's Signals

Some welcome the Fed's recent "rate-hike freeze," taking heart that the central bank is reacting nimbly to real-time shifts in economic and political conditions. However, others simply see it as validating economic weakness. Indeed, U.S. GDP growth of 3.1% in Q4 2018 appears likely to decline significantly in Q1 2019—and not only due to the 34-day government shutdown and ebbing fiscal stimulus.

At Clear Harbor, we appreciate both sides of this coin. To be sure, it is good for the Fed to acknowledge and respond to changing economic circumstances. However, we believe the more salient point right now concerns those circumstances themselves. Ever since the Great Recession, the economy has been marked by low inflation expectations amidst steady but lackluster growth. In fact, 2018 may yet prove an historical outlier—a year in which stimulus from tax reform helped GDP briefly outstrip this baseline.



- U.S. Economy

While we constantly scrutinize capital flows and the trajectory of economic activity, it is extraordinarily difficult—if not impossible—to precisely time economic inflection points. Consider this month's survey of institutional investors attending the Global Markets Conference in Paris this month: Just 6% expect the U.S. to tip into recession by Q4 2019, and only 24% consider one likely by Q4 2020.

Is this realistic? It very well may be. However, such optimism seems at odds with recent moves in Treasury yields and weakness in data—particularly consumer buying trends, from autos to homes.

We believe some of this tension can be explained by the "great moderation"—a term coined by James Stock and Mark Watson to describe how technology-enabled supply chains, independent monetary authorities, and other features of the modern economy tend to reduce data fluctuations and resulting policy conflicts. While this trend can reduce the prevalence and severity of recessions—at least those that aren't caused by a major shock, such as a financial collapse—it also limits the capital spending and overproduction that delivered the "boom" part of the traditional boom-bust cycle.

Secular forces are at work, too. The pace of potential entrants to the work force and recent estimates on productivity suggest that U.S. growth for full-year 2019 will trend closer to the post-Great Recession average of approximately 2.3%, with even weaker data points for the first half of the year. This also allows us to consider that any economic decline we might experience this year may be shallow enough to permit a recovery, rather than outright recession, looking ahead to 2020.

Whether the near- and intermediate-term challenge proves to be an outright recession or simply growth so weak that it feels like one, the good news is that pullbacks are historically brief periods—typically lasting less than a year—while expansions have averaged approximately five years since WWII.

On a global basis, complications to the economic picture are easy to find. They include Brexit; fiscal policy and the resulting long-term trajectory of public debt in developed markets, particularly the U.S.; and prospects for U.S.-China tariffs and trade negotiations.

- Brexit

It has now been two years since the British government invoked Article 50 of the Lisbon Treasury, trumpeting its intention to withdraw from the European Union. However, the House of Commons has now rejected the withdrawal agreement that Prime Minister Theresa May negotiated with the EU for a third time. The constant display of political incoherence has provided fodder for comedians worldwide.

While oddsmakers continue to dismiss any strong probability of a "hard Brexit" with no agreement at all, negotiations become more fraught each time the deadline for a deal—originally this month, then April 12, now likely an extension as late as May—is kicked down the road. While some path may yet emerge to at least keep Britain in a customs union with the EU, the ultimate fate of this significant player in European commerce and global finance remains entirely unknown.

- Global Fiscal Policy

Even as Britain attempts to redefine its trading relationship to Europe, the Continent itself wrestles with appropriate ways to stimulate growth. Despite already quite high and rising levels of public debt, sluggish GDP has sparked interest in renewed fiscal stimulus across Europe. This year, several major economies stand to implement what may be their most significant stimulus in a decade, led by Berlin.

What is disheartening is that much of the planned spending appears heavily allocated to increased social payments in Germany and the gradual implementation of a novel universal basic income scheme—"UBI" to the *cognoscenti*—in Italy. While economists expect such programs to boost German GDP by 0.9% in 2019 and perhaps by an even 1% in 2020, we doubt they will create the lasting impact on consumption and investment required to sustain longer-term improvement across the economy. However, we recognize that extraordinarily weak manufacturing, investor and consumer sentiment data points of late may leave policymakers grasping at straws, with little sign animal spirits will rouse themselves this year.

Meanwhile, a reminder: Closer to home, the U.S. federal debt clock has now surpassed $22 trillion.

- Global Monetary Policy

Like the Federal Reserve, the European Central Bank became more dovish this past quarter, and from an exceedingly dovish starting point. This posture stands to incrementally benefit risk assets, just as it seemed to be a primary catalyst for the significant rise in European sovereign bond prices in Q1.

In fact, broad European, U.S. and Emerging Market equity benchmarks have tracked each another quite closely year-to-date. When this happened in 2017, major regions were enjoying synchronous growth; in contrast, the world today is experiencing a diversity of economic conditions and vectors. We most likely have the world's central bank doves to thank for eliciting similar returns from such disparate situations.

While asset prices may benefit today, the longer-term repercussions from embedding negative rates in an economy are less salutary. For one, they have long hampered European bank earnings, and therefore bank recapitalization efforts. (Supporters of the proposed Commerzbank-Deutsche Bank merger in part tout it as a means to address undercapitalization that has lingered since the financial crisis.) Even if justified by persistently low inflation, ultra-dovish policy risks feeding a feedback loop of extraordinarily compressed interest margins, weak lending—and economies ever in need of more stimulus.

- U.S.-China Relations

The messy and opaque contest between the U.S. and China continues over such long-simmering issues as IP theft, forced technology transfer, domestic subsidies for favored industries, and national security claims—and the blunt force of tariffs that to date has been the Trump administration's weapon of choice in these arenas. While signals from both U.S. and Chinese officials have been mixed and somewhat volatile, it does appear some progress is being made. The Attorney General's summary of the Mueller Report has recently provided Mr. Trump with a political boost, perhaps nudging Chairman Xi Jinping to consider the prospect of another six years, not just two, across the table from this President.

In China as elsewhere, central bank officials are trying to counter economic uncertainties with monetary and fiscal accommodation. Lower financing rates have been joined with new plans to reduce taxes (in, for example, the VAT) with a goal of adding as much as 2% to GDP. Expectations are adjusting smartly: After several years of significant underperformance, major equity indices in the communist nation are now outpacing most other global benchmarks.

- Investment Considerations

After all the tumult of recent months, global equity markets now stand 3% above their level of one year ago. Mr. Market has digested global politics, slowing earnings and tepid GDP growth, and deemed it all worth little better or worse than a round-trip in major asset classes.

This leads many observers to ponder whether recent "gains"—particularly in credit—are sustainable, or merely testing a familiar ceiling. Skeptics point to the overall vector of economic data both home and abroad, which they believe mark a downward trajectory rather than a bottoming process. Residential real estate and consumer retail sales, rising inventories, and deteriorating manufacturing data make it difficult for them to envision capital flows rising from current depressed levels any time in 2019.

Nor do they see the U.S. as insulated from an international slowdown. If these global trends become more entrenched within the U.S., they believe the Fed may well set aside the narrative that their "dot-plot" of economic data currently suggests for 2020, and ease policy. In fact, just this past week Chicago Fed President Charles Evans told an industry gathering in Hong Kong that "the risks from the downside scenarios loom larger than those from the upside ones." He added that "if activity softens more than expected or… inflation expectations run too low, then policy may have to be left on hold—or perhaps even loosened—to provide the appropriate accommodation to obtain our objectives."

But optimists have a great deal to point to as well—most importantly, that the breadth of leading economic indicators (LEI) are in their favor. After all, markets follow investor expectations of what's to come, not past economic performance. And the LEI Index has not yet peaked, as it did in advance of the dot-com bust, the financial crisis and other postwar recessions.

Let's consider estimates for S&P 500 earnings; analysts currently project approximately $168/share in operating earnings in 2019, which with a forward P/E multiple of 16.7x would put the S&P 500 at 2800 by year-end. That implies year-over-year earnings growth of approximately 3.5%, supporting the YTD gain in the index but little more for the remainder of the year. Looking ahead to 2020, analysts see $188/share, with a forward multiple of 14.9x and earnings growth of 12% over 2019.

These are not troubling multiples to allocate capital to for the long haul. Of course, if the economy indeed enters a recession within the next two years, these estimates would seem overly optimistic—and if earnings are not there to support price gains directly, they seem unlikely to justify expanded multiples that might prop up values, either. However, these estimates already presume less-than-massive EPS growth; the risk that there has been too much contraction in earnings expectations cannot be ignored either. There may well be room for earnings to surprise to the upside, rather than to the downside.

Consider this snapshot of current investor sentiment: some of our favorite utilities holdings now trade at a nearly 30x multiple of earnings that are expected to grow just 8% this year; Apple commands just 16x (including their massive cash stockpile) and despite expected earnings growth of 13%! While Apple is always its own story, this comparison illustrates a larger truth: Slow & steady is not necessarily the end of the world. Not in stock selection, and not in evaluating investment performance.

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Ultimately, the greatest influence on the trajectory of major asset classes is the rate and vector of change *relative to expectations.* The evolution of data coupled with expectations on the FED's "reaction function" are to be assessed and reviewed in the coming weeks and months with great attention.

Would possible Fed action to cut rates in 2020 spook the market, or spark another round of investor enthusiasm for equities and credit? Would discussion of the revival of "unconventional" policy tools to buttress the markets and excite animal spirits, or signal desperation and backfire? While we believe long-term earnings growth will drive equity markets higher over time, the near-term gyrations of economic data and asset markets invite hubris and error from the unprepared and the unwary.

We believe our work is most valuable when taking into account a full panoply of wealth considerations in our clients' lives. Portfolio construction is at its most relevant and disciplined when it addresses carefully identified risk tolerances and objectives across a holistic picture of client financial concerns.

While the recently concluded quarter certainly suggests that global capital markets are off to a great start in 2019, we remain mindful of the many clouds hovering, and both the risks and the benefits of the ever-expanding toolset central banks and fiscal policymakers have at their disposal. Their macro impacts are challenging enough to assess in this still-fragile global economic environment; but even more crucial is for financial advisors to vet their implications for each client portfolio in their care.

On behalf of Clear Harbor, I again thank you for placing your confidence in us as stewards of your investment capital, and indeed all aspects of your financial journey.

Sincerely,

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