CLEAR HARBOR
ASSET MANAGEMENT

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Dear Friend of Clear Harbor,

The global economy remains marked by uncertainty over the trajectory of the global pandemic, yet the power of the virus to shock has diminished substantially. Even as U.S. deaths passed the grim milestone of 200,000, many schools resumed some fashion of in-person instruction; businesses are chomping at the bit to reopen. Markets have been buoyed by rock-bottom interest rates, better-than-expected corporate earnings, and meaningful rebounds in housing, employment and other economic data.

For students of human resilience and market optimism, it has been a dizzying year. For stewards of client capital, enormous challenges remain as we survey a landscape of elevated valuations across major asset classes, political disarray, and persistent questions about when and how we will tame this virus.

Covid-19: Clear Harbor Webinar

The cooler months present a new phase of uncertainty in the course of the pandemic, as many activities move indoors and the coronavirus is joined by the flu and other seasonal threats to human health. Just this past week, small outbreaks of the virus impacted pockets of New York City as well as the National Football League. Nevertheless, health experts continue to allocate extraordinary time and resources to both treatments and vaccine discovery. They are making impressive progress on both fronts.

In an ongoing effort to keep our clients informed on topics pertinent to the health of their families (and their portfolios), we are honored to have the head of the Mayo Clinic's Covid-19 research team, Dr. Andrew Badley, join us for a free webinar on October 6. Dr. Badley will discuss advances on the vaccine and treatment fronts, try to cut through some of the media and political fog, and provide facts and insights that can inform our everyday decisions in the months ahead. I encourage you to register here.

Fiscal and Monetary Considerations

The initial fiscal response to Covid here in the U.S. was large and swift, with trillions in stimulus falling directly into the hands of American consumers. Yet six month later, most of those funds have been allocated and enhanced unemployment benefits have run dry. Expectations of further stimulus—

generally thought to be well over $1 trillion—persisted over the summer, but brinksmanship on Capitol Hill has since turned investor attention back to the Federal Reserve for a sense of solace.

The Fed has signaled that it will keep its funds rate near zero until at least 2023, with its balance sheet expanding at a breakneck pace. In fact, we now expect the Fed to close this year with approximately $8 trillion in fixed income securities on its leger—a 90% annualized rate of growth. This amount is 2.5 times greater than the central bank's intervention over the entire course of the Great Recession. Our national debt has also skyrocketed this year, to approximately $20.5 trillion—$3.5 trillion higher than where we closed out 2019, and now reflecting a debt-to-GDP ratio of 106%. The proportions may vary, but central banks in Europe, Japan, and other developed and emerging economies are following a similar playbook.

U.S. Economy

The shutdown in March slashed U.S. GDP by a third overnight. But the economy has since bottomed and in fact regained a remarkable amount of ground, giving rise to discussion of a "checkmark recovery." We indeed expect that Q3 growth numbers will prove quite strong. Nevertheless, GDP, earnings and employment all remain well off the peaks of 2019, with significant obstacles ahead.

We believe the pace of the bounce-back to date will be difficult to maintain. For example, continuing unemployment claims ratcheted abruptly from 22 million down to to 13 million; future improvements are unlikely to be so dramatic. This is in part due to significant divergences across industry sectors, with some experiencing elements of structural decline even as others have seen demand accelerate.

With summer trips and business conferences no longer on the proverbial radar screen, demand for airplanes has cratered, and hotel and resort traffic remains shockingly low; overall bank loan demand is poor as well. On the other hand, demand has risen remarkably for home builders, RVs and automobiles, and the rollout of 5G networks remains on track. Moreover, the pandemic has only accelerated business adoption of cloud-based technologies, while railcar data suggests a robust trend for transport.

In short: certain industries are responding to new types of demand, some of which may prove durable. However, others that have snapped back rapidly may have already contributed much of what they can to any "checkmark" recovery. And others that have lagged to date still exhibit few signs of "green shoots," with quite a number of those now burdened by unsupportable debt.

I particularly want to highlight the structural damage to employment from the shutdown. While we all welcome the improvement in jobs data from the summer months, the reality is that continuing unemployment claims remain at levels that, viewed historically, most observers would deem incomprehensible if it were not for this pandemic. Moreover, as hard as it may seem, some of the best news may already be in the rear-view mirror. Jobless benefits last 26 weeks—and claims began to spike due to Covid-related closures just about 26 weeks ago. In addition, momentum has sagged of late: claims numbers have disappointed for the last three weeks. Market participants may not fully appreciate that once a worker's benefits eligibility has expired, he or she will not be able to access even the $300/week benefit from the current administration's recent executive actions.

Unless economic activity and hiring accelerates meaningfully into year-end, the tailwinds to consumption of the last few months could shift rather abruptly into headwinds. However, we believe the likeliest course in the years ahead is one of continued but tepid GDP growth, with some companies and sectors able to post significant growth amidst structural challenges facing the broader economy.

Global Economy

The international picture remains mixed as well. Some emerging markets economies (such as Brazil) are absolutely shuddering from the domestic impacts of the pandemic, while others (such as Russia) teeter precarious amid heightened currency volatility and acutely depressed demand for hydrocarbons. The most encouraging news may be the apparent degree of recovery in the Chinese economy, whose growth often augers improvement in global demand within three or four months.

In Europe, fiscal and monetary stimulus remains robust. However, a new wave of Covid positivity and hospitalizations has put speed bumps in the way of a more pronounced economic rebound, both in the UK and throughout continental Europe. In fact, the euro has recently stalled relative to other major currencies on weakening growth expectations, following what had been a nice rally into September.

Overall, the perception that the economic glass is half-full is bolstered by the implementation of nearly 600 monetary and fiscal stimulus packages over the last 12 months around the world. However, the picture in the years ahead is clouded by global debt loads among sovereign, municipal, and corporate borrowers—in no small part due directly to the costs of government stimulus in response to shutdowns.

For the U.S. and the broader developed world, even when the fallout from the pandemic clears, demographic challenges will remain. To be sure, population growth remains robust in key segments of the emerging markets—and higher in America than in, say, Italy. But in mature economies where new entrants to the workforce are limited, economic growth will turn on making the existing workforce more productive. We remain confident that key components of the technology landscape can continue to create efficiencies, thereby lifting productivity—and preserving corporate margins in the process.

Equity Markets

Amid all the chaos that 2020 has wrought so far, the innate resilience of private enterprise has in some respects prevailed. While most earnings results remain significantly below year-ago levels, a majority of S&P 500 companies exceeded consensus estimates for Q2. Equity markets rose on this news in Q3 and are up YTD, with strength reflected in both the S&P 500 (+4% YTD) and MSCI All World Index (+1% YTD).

Equity market volatility increased in September, but there is significant evidence that the positive earnings trends from Q2 2020 will accelerate in Q3. Recent data from such economic bellwethers as FedEx, Nike, General Mills and KB Homes suggests a potential surge in Q3 earnings per share for the S&P 500, from $112 in Q2 to as high as $145 in Q3.[i] Still $17/share below the peak EPS level of 2019, to be sure, but a marked improvement nonetheless from the levels investors feared just six months ago.

In a recent survey by Citigroup, 84% of family offices and wealthy individuals described their current view on equity markets and the economy as "cautious" or "extremely cautious." While plainly negative on their face, such surveys often provide a contrarian indicator that, if data should exceed expectations in the weeks and months ahead, some of these less-than-optimistic investors could allocate capital back into the market. These investors were, after all, among those who sent markets plummeting in March.

Where does Clear Harbor stand on this issue today? How "contrarian" are we willing to be?

We are not pumping cash under our mattresses, but we acknowledge any number of risks that could weigh on markets heading into year-end. These include, most notably, a contested U.S. presidential election; a rise in Covid cases and mortality coupled with a delayed vaccine timeline; weakness in economic data and overall credit conditions; a rise in U.S.-China tensions; a spike in the U.S. dollar (which creates negative impacts on exports and foreign-sourced earnings for U.S. corporations); and a lack of follow-through from the relatively strong Q2 earnings season.

Moreover, our observation in last quarter's Market Outlook remains fundamentally intact: asset prices are elevated. We expect investors in the broad equity market will have to wait until at least 2022 before earnings rise enough to justify current prices—at least at anything resembling historical valuations.

- Equity Sector Performance Dispersion

Even more this year than usual, "broad market" averages have masked huge variations in performance according to sector and size. Mega-cap technology companies have driven gains in the benchmark indexes, even as such historically influential sectors as Energy and Financials have plummeted (by 50% and 22% YTD, respectively). Though stark, this divergence appears supported by corresponding differences in earnings momentum. It is a powerful contrast with last year's market performance, in which every sector of the S&P 500 was positive. Global benchmarks reflect a similar story.

S&P 500 Sector Performance - Year-to-Date

S&P 500 INFO TECH INDEX	28.42%
S&P 500 CONS DISCRET IDX	23.76%
S&P 500 COMM SVC	8.36%
S&P 500 MATERIALS INDEX	3.76%
S&P 500 HEALTH CARE IDX	3.45%
S&P 500 CONS STAPLES IDX	1.77%
S&P 500 INDUSTRIALS IDX	-4.45%
S&P 500 UTILITIES INDEX	-8.23%
S&P 500 REAL ESTATE IDX	-8.51%
S&P 500 FINANCIALS INDEX	-21.79%
S&P 500 ENERGY INDEX	-49.91%

Source: Bloomberg

- Technology

Despite seemingly lofty valuations relative to other sectors, technology is one of the few that has seen both bottom line and top line (margin and revenue) growth relative to last year. While the success of consumer-facing companies is undeniable, demand is also broad and persistent from corporations, which look to technology to improve productivity and grow in the face of demographic headwinds. From the rollout of 5G and the expansion of cloud computing to the advancement of artificial intelligence, the benefits of technology are being felt across the economy.

Although this fundamental narrative has helped make technology the largest segment of the U.S. equity market, growth in the sector remains highly dependent on global demand and the willingness of some of our less-than-friendly trading partners—in particular China—to allow U.S. companies to sell and manufacture within their borders. One prominent example, Apple Computer, continues to manufacture 100% of the iPhone for the global marketplace in China. If the communist nation were to shut down Apple tomorrow, the world's largest company by market cap could very well experience significant manufacturing and supply chain dislocations for many quarters if not years.

Is such a prospect central to our "base case" assumptions? No. However, we believe the risks have risen that whether for reasons of trade advantage, perceived security, geopolitics or internal politics, China may one day take abrupt and generally unexpected actions. President Xi may determine that flexing his country's economic muscle in highly selective ways offers greater influence over its rivals, with less risk, than more traditional forms of conflict between rising and established global powers.

Fixed Income

It has been a welcome reassurance this year to see core components of the U.S. bond market—principally Treasuries and mortgage-backed securities—function as we would hope and expect amid so much market turmoil and economic dislocation. As the equity-market tide abruptly ebbed in late February into March, Treasuries rallied in a classic "flight-to-quality" among investors. Even as equities have rebounded, Treasury prices have stayed at relative high-water marks, helped by subdued inflation and clear signals that rates would stay lower for longer from the Federal Reserve.

As such, investors with balanced portfolios—for example, a healthy mix of sovereign fixed income, mortgages, investment-grade-corporate bonds, and equities—were able to significantly mitigate volatility this year without sacrificing returns. In fact, this year has proven a historical anomaly: fixed income benchmarks have outperformed the vast majority of equities, with the Bloomberg Barclays Aggregate Bond Index better by approximately 7% YTD, while the S&P 500 and MSCI All World Index are better by 4% and 1% respectively.

While we welcome stable returns in unstable times, we are mindful that even this core asset class is trading at levels dislocated from key metrics, such as inflation. For example, the 10-year Treasury yield has historically traded at least 1% above the rate of anticipated inflation. In today's market, that would suggest a 10-year yield closer to 2.5%, versus the current rate of 0.68%. However, given the Fed's significant Treasury asset purchases and the relative attractiveness of U.S. Treasuries to other developed market sovereign debt, the seemingly abnormally low rate environment appears more justified.

Gold

Another asset class that has provided useful ballast to diversified portfolios this year has been gold, advancing approximately 24% YTD. Economic uncertainty, a weaker dollar, an unprecedented expansion of central bank balance sheets, and federal spending at levels not seen since World War II have all given the yellow metal an opportunity to shine this year. I maintain the view that a modest allocation to gold is warranted in many well-diversified portfolios.

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I recognize that the proverbial elephant in the room—any room in America today, it seems—is the U.S. election. Laws and policies affecting taxes, business regulation, foreign affairs, and coronavirus response could shift dramatically depending on the outcome, not only for president but in several pivotal races in the U.S. Senate. (We are closely watching razor-tight races in states that could tilt the balance in the upper chamber, including Montana, Maine, Michigan and South Carolina.) Since the passing of Justice Ruth Bader Ginsburg, the Supreme Court has been drawn again into the political limelight of a nomination battle, too. There is never a dull moment.

While I appreciate the significance of these contests for the health of our body politic and our economy, the likeliest outcomes augur against an abrupt and broadly destructive assault on American business. The greatest change to near-term forecasts from a change at 1600 Pennsylvania Avenue could be an economic boost from a large new round of recovery spending, and/or support for cities which could relieve stress on segments of the muni bond market. (With that said, we recognize that a further massive expansion of the federal deficit would most likely raise longer-term questions about sovereign credit and the stability of the dollar. Again: never a dull moment.)

I believe that odds of a deal for additional stimulus may be higher than many expect even before the election, should the incumbent president perceive them as an opportunity to tighten his polling gaps. Of course, any president's best-laid plans can be stalled in Congress, and both the Senate Majority Leader and that body's Finance Committee Chair have voiced caution on sustaining the extraordinary federal largesse witnessed in 2020.

What if voters return a divided government to Washington? Historically, this has created a difficult environment for raising taxes. The makeup of the Senate next year may therefore decide the fate of any such initiative, as well as influencing layoff decisions by corporations in still-challenged sectors, regulatory levels, and by extension, risk appetite in equity markets. We also have an eye on the likelihood of inflation or further disinflationary forces, and the incremental pressure that deficit spending and high debt will have on the shape and directionality of the yield curve.

Most important in my view is that the so-called "novel" coronavirus has proved novel not only to the clinicians on the front lines of the disease, but across our culture and our economy. Some of the divergences it has created may be here to stay; others, given time, may give way to a more familiar life. All represent the risks and the opportunities of our era. And we at Clear Harbor stand ready to seek out, to understand, and to act upon them together.

Lastly, I thank each of our clients and friends for your expressions of support and confidence in our work during this most uncertain moment. Earning and maintaining your trust is why we do what we do.

Sincerely,

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[i] Estimate from Ed Hyman at Evercore ISI. Ed is a highly regarded and top-rated Institutional Investors economist. Estimates as of September 22, 2020.