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December 30, 2020

Friend of Clear Harbor,

As our *annus horribilis* draws to a close, the craving is palpable for an *annus mirabilis* next year to make up for it. Many prospects are indeed bright: the record-breaking development and initial distribution of coronavirus vaccines; a new aid package ultimately signed by the outgoing American president; the conventional manner of his successor. All promise that a return to some sort of "normal" is at hand.

We have paid a heavy price for such a return, in both human and financial terms. Yet much of what the pandemic changed will not revert so simply. In fact, some long-term shifts in how we live and work will likely accelerate further. And even as the rhythms of our personal and business dealings revive, certain structural headwinds to the U.S. economy will persist—and with them, a degree of secular stagnation.

In short: while we prize "normalcy," history finds it elusive. We certainly welcome the auspicious signals of a much better year ahead, but we must sift them carefully for a fuller picture. As allocators of client capital, we remain wary of false dawns, and mindful that the economic pendulum seldom rests.

2020 Review

- The Covid Economy

The losses in jobs and GDP caused by shutdowns in the face of Covid-19 were the most abrupt and significant in modern history. The U.S. economy had started 2020 off strong, with above-trend growth and the highest employment levels in a half-century—then within weeks, the unemployment rate spiked by more than 10 percentage points, followed by an annualized decline of more than 30% in Q2 GDP. Corporate earnings followed a similar roller coaster, striking an all-time high in Q1 before experiencing the most significant quarterly decline on record—then following GDP back up again in the second half.

Though Covid-19 shocked capital markets and our politics, it also spurred human ingenuity and spirit. Our frontline healthcare teams best exemplified these qualities, but they were also reflected in ordinary officer workers, and in the technologists who enabled them to "Zoom in" from sofas and kitchen tables.

The economic and human toll of this pandemic is still ravaging the globe, and its larger impacts on how we work, reside, travel, consume, celebrate, and communicate are still being measured. We will end the year with millions fewer jobs than we had at the start, and an annualized GDP decline of approximately 3.5%. Yet the ability of so many of us to keep working helped insulate broad sectors from truly crippling damage—and gave an outright boost to a few others. Such were the cruel twists of the Covid economy that demand spiked tremendously at lumber wholesalers, laptop makers and food banks alike.

- Fiscal & Monetary Response

That many companies had the chance to find their footing at all was due to the resolve of governments to respond. They largely followed the playbooks from the Great Recession, but on steroids—opening the fiscal floodgates at rates not even seen during WWII. In the U.S. and other mature economies, this included significant unemployment benefits and incentives for small businesses to retain employees. Though often dubbed "stimulus," it might better be described as "aid" or "support," with a goal of tiding over economies that governments had deliberately put in a state of suspended animation.

Central banks were as active as legislatures, printing money at a pace never seen before and buying fixed income assets across the sovereign, corporate and municipal segments of the debt markets. The Bank of Japan even expanded its purchasing mandate to include equities—an embrace of risk previously unknown amongst the world's major monetary authorities.

- Financial Markets

Skyrocketing liquidity from central banks helped keep markets aloft by renewing the confidence of market participants to buy equities, broad swaths of the fixed income market, gold, and residential real estate. As the scale of government aid and the resilience of the workforce in many sectors became apparent, those who stayed invested were rewarded for their fortitude. After cratering some 33% from its January peak to its pandemic trough in March, the S&P 500 rallied in staggering fashion and is now up approximately 17% year-to-date, to an all-time high. Developed-market equities around the world followed a similar pattern, with the MSCI All World Ex-U.S. Index gaining approximately 11% year-to-date.[1]

The timeless market cycle of fear, greed and euphoria was thus compressed within a period of just a few months. It got a further boost from new trading platforms such as Robinhood, which allows financial newcomers to trade stocks with little more than the three or four characters of a company's ticker symbol. In these emotionally driven quarters, TINA ("There Is No Alternative") and FOMO ("Fear Of Missing Out") returned to the investor and journalistic lexicon with a vengeance.

The impressive returns of the major indexes masked massive sector-level dispersion this year, with tech leading the charge and energy and financial stocks lagging significantly. Put another way: despite the giddy headlines, investors reserved their enthusiasm for the surest sources of growth—and paid handsome valuations for them. Whether this enthusiasm will rotate steadily into other, more attractively priced sectors, or instead retreat to today's well-known handful of technology giants (or some new basket of perceived "safe bets"), will be an important question for 2021.

[1] All return figures are as of the close of trading on December 30, 2020.

2021 Outlook: Economic Backdrop

Economists expect the new year to prove far more robust than the old. In fact, they generally anticipate 2020's negative growth trends to flip: they see U.S. GDP ending 2020 with a decline of 3.5%, but gaining perhaps 4% in 2021; globally, the expectation is for a decline of 4% this year, but a 5% pop in 2021.

- Pent-up demand is real…

With widespread predictions that most of the developed world will be inoculated against Covid-19 by fall 2021, even bears must consider the likely scenario of a normalizing economic picture over the course of the coming year. Low interest rates continue to boost demand for homes and refinancing. Many also point to pent-up demand after a year of little travel and other spending—and considerable savings on hand to fuel a rebound in GDP and earnings growth as pandemic restrictions yield to the vaccine.

We largely embrace these observations. We do expect employment to improve once case counts abate, as it did this summer after the first wave of lockdowns ended. We are also hopeful that growth will broaden, supported by the likely return of consumer and corporate demand for services—a welcome complement to the heavy goods and staples purchases that dominated buying behavior in 2020.

- …but the recovery's pace is still vulnerable…

There are, of course, caveats to our optimism. Principally, we acknowledge many more months of uncertainty regarding the pace of vaccine distribution; the risk that new, potentially vaccine-resistant, strains of the virus will emerge; and associated impacts on investor, consumer, and business sentiment.

The last few weeks illustrate the point. Vaccine distribution commenced to great fanfare—but in the midst of the largest spike in cases and deaths since the pandemic began. Then came fears of a new and more transmissible strain of the virus in the UK, shuttering cross-border travel once again just as the Christmas season was to finally allow millions to visit loved ones. Optimism for a European economic acceleration early in the new year of course waned quickly and significantly.

On a global basis, key gauges of manufacturing and home sales still point to significant momentum in the U.S., China and even Europe. However, other metrics such as retail sales, consumer confidence and employment metrics appear to have decelerated recently in the U.S. and Europe. While Q4 2020 may see a continuation of above-trend GDP, the timing of global vaccine distribution could delay the more robust swaths of growth in 2021 until the back half of the year.

- …and structural limitations remain

Another caveat concerns fundamental limitations to the ultimate magnitude of the rebound. Unlike some, we do not expect 2021 to usher in a repeat of the "roaring '20s" that followed the 1917-18 pandemic. That period was not restrained by the today's massive national deficits; its working-age cohort was also considerably younger. Perhaps most of all, the burden of leverage is far more pronounced today. This can potentially magnify the risks from any error in monetary policy—or even from a simple rise in interest rates—to business confidence, consumer behavior and investor sentiment.

I have long voiced my concerns about rising corporate debt loads, and about a U.S. fiscal deficit that seems to rise inexorably at a pace of approximately 5% per year. But when I did so at this time last year, America stood on the shoulders of its longest economic expansion since 1900. Today, we stand somewhat nervously at a hoped-for inflection point—with as much new debt on the national credit card from just this year as we would ordinarily expect over four or five.

Despite these caveats, we agree with relief that the worst is, or soon will be, behind us. As Dr. Anthony Fauci told us in March: “You don’t set the timeline; the virus sets the timeline.” Thanks to the vaccine, that timeline does now seem to have an end in sight. Large swaths of consumers are eager to once again book flights and hotels, dine in restaurants, attend concerts and take cruises. Even if economic gains are concentrated in the back half of 2021, investors have proved patient: absent some fresh cause, those who have not run for the exits yet seem unlikely to do so now.

2021 Outlook: U.S. Financial Markets

Bears may find it difficult to prevail outright in 2021, as earnings re-accelerate across the post-pandemic economy. Still, we recognize that markets have already discounted a great deal of future uncertainty, and pulled forward a considerable portion of anticipated returns. As a result, investors should anticipate a lower base-case return profile than they have enjoyed in recent years, whether in a long-only equity portfolio or across a multi-asset class diversified, or “balanced,” portfolio.

This is not to reflect a negative view on core asset classes over the medium and longer term, or to suggest that we see few opportunities to thoughtfully allocate capital to them. The only alternative to putting cash to work is to hold it—which is an investment decision in itself, and one that accepts the steady deterioration in buying power of cash over time. While some level of cash does have a role to play in many portfolios, we continue to see appealing destinations for client capital across a range of asset classes and sectors in 2021, reflecting a spectrum of risk tolerances and investment horizons.

- U.S. Equities: From “Up” to “Out”?

It is clear that equity investors are content to peer through the current turmoil, and to pay prices today that reflect much better days ahead. In the U.S., full-year 2020 earnings for the S&P 500 are slated at approximately $137/share—approximately $30/share, or 18%, lower than for full-year 2019. Yet, the S&P 500 Index rose by 17% in 2020. Put another way: the value of the broad market rose considerably to new heights this year, even as the earnings power of its constituent companies fell even faster.

It is one thing for investors to perceive even a global pandemic as a fundamentally limited-term event, and look with *sangfroid* to an eventual return of consumer and business optimism. But it is another thing to bid up asset prices well above levels seen during the prior earnings peak, knowing that some as-yet-undetermined swath of the economy is likely changed for good. How does one account for a P/E for the S&P 500 that has risen from 19X one year ago, to 27X today—and will still be nearly 24X if analyst average projections of approximately $158/share are met by this time next year?

One explanation is simple: there is too much capital chasing too few investment options. Indeed, trillions of dollars in fiscal stimulus and central bank liquidity have forced investors to pump capital into assets with the hopes of achieving reasonable returns—which was, after all, an important goal of those liquidity programs. With interest rates negative on an inflation-adjusted basis, cash yielding near zero, and corporate credit spreads at historically tight levels, capital is pushing up prices for a wide range of risk assets, creating valuations that are challenging to justify by any traditional metric.

If investors tire of nosebleed pricing and the economy gains traction as expected, the next move in a market still drenched in liquidity may be less "up" than "out." That is to say: gains that in 2020 were concentrated in an elite cadre of mega-growth stocks could be rebalanced into a comparatively neglected, much larger array of sectors and asset classes.

I do not mean to suggest that we are making wholesale shifts in client portfolios. In the year ahead, many forces—some predictable, others unforeseen—will surely push and pull at portfolio valuations. Nevertheless, we are contemplating several themes that could provide the basis for incremental adjustments to certain Clear Harbor strategies as we peer into 2021. A few examples follow.

- Growth and Value

Prospects for renewed growth, meaningful infrastructure spending, and perhaps even incremental inflation could benefit a number of sectors that were under pressure in 2020. These include industrials, materials, energy, and financials. A number of companies in these sectors are often characterized as "value" stocks; they could nonetheless stand to perform better next year versus the more historically growth-oriented sectors, such technology and consumer discretionary, that drove index returns in 2020.

- Fixed Income

10-year Treasuries returned nearly 10% in 2020 as yields dropped from 1.91% at the start of the year to 0.93**%** today. We do not anticipate this pace to continue unabated in 2021: both at home and abroad, the sovereign bond markets offer investors little besides security.

In fact, some $18 trillion of global issuance now carries a negative yield. While U.S. Treasuries retain a yield advantage over their European or Japanese peers, it narrowed when the Federal Reserve cut rates in response to the pandemic. Inflation could dent it further: in a bid to boost growth and employment, the Fed has made plain their willingness to let inflation exceed its traditional 2% target.

Indeed, the Fed continues to buy $80 billion of Treasuries and $40 billion of mortgage-backed securities each month, with the goal of maintaining negative real (inflation-adjusted) interest rates on the "risk-free" segment of the bond market. This policy could very well continue even as inflation accelerates above their target. These remain far from normal times.

Meanwhile, corporate bond spreads are at historically low levels, even as expectations of defaults among the nearly "junk"-rated companies appears elevated. Caution is certainly warranted for those who would "chase yield"; the price for every increment of additional return could be dear.

With all of that said, we continue to view Treasuries as the “flight-to-quality” asset of choice for those seeking shelter during times of economic uncertainty. As such, we still see a role for these assets as a “shock absorber” in balanced portfolios—a function that it performed effectively during the savage, if mercifully brief, equity and credit corrections last spring.

- Equities + Bonds = Best Friends Forever?

The extraordinarily low yields that central banks have fostered do not just affect bond value: they have changed how investors perceive riskier asset classes as well. In fact, this is by design. In response to the Great Recession of 2008-09, the Federal Reserve embraced a program of massive balance sheet expansion dubbed “quantitative easing”; its goal was to prod investors to buy up equities and credit by compressing Treasury yields to unattractive levels. Ever since, any sign that the central bank might shrink its balance sheet has given pause to this “risk on” posture among market participants.

Such a pause occurred during the spring of 2013, when the Fed signaled that it was preparing for the day when it could reduce its then-$3 trillion balance sheet. Bond yields jumped and equity markets proved volatile until the Fed shifted gears, signaled a more accommodative stance, and resumed its purchases with a new $1.5 trillion round of Treasuries and mortgages.

I recount this history because many equity bulls have recently taken to jeering the historically low rates on Treasuries. Some have even called for a return to higher interest rates more broadly, as though stock valuations would prove immune to a tightening in Fed policy.

I believe they are mistaken. As the experience in 2013 illustrates, not just bonds but equities are sensitive to monetary actions; this past year likewise proved that both asset classes are quite capable of moving in tandem. To be sure, bonds have gained in part because inflation has proved elusive, shielding bonds from a perennial threat to their value. But it is also because central banks throughout much of the developed world have doubled down on the quantitative easing approach and embraced negative real rates outright. Just in the U.S., our central bank has expanded its balance sheet by approximately $3 trillion since the onset of the pandemic in March. It now stands at approximately $7.3 trillion.

Taken together, these factors have kept bond yields low and their prices high, notwithstanding simultaneous growth in stock values. In fact, I believe that the equity market has been listening intently to the bond market’s music, and has concluded that low rates will remain in place for a while.

Notwithstanding the critics, I see today’s low rates as directly supportive of equity strength. The less risk-free yield one can expect from bonds, the easier it is to justify paying higher multiples for the primary alternative—i.e., stocks. Should fixed income yields return to more normal levels relative to inflation, then—all other economic factors being equal—the risk premium that investors are willing to pay for equities will normalize, and price-to-earnings multiples would need to contract.

Since a return to positive real interest rates would most likely challenge equities and credit alike, stock investors today may want to stand shoulder-to-shoulder with their bond-buying brethren in cheering low interest rates. The question is what happens when inflation finally returns, central banks reduce their asset purchases, or capital markets perhaps even question the integrity of the currency—a consideration not easily dismissed, given the extraordinary magnitude of public sector deficits.

2020 Outlook: Monetary Policy

If my attention to monetary policy in these missives seems to have grown steadily since the Financial Crisis, it has only been to keep pace with its ever-expanding role in financial market performance. During the pandemic, the Federal Reserve further accelerated its purchases of U.S. Treasuries, agency securities, mortgages, and even corporate bonds. This year, the Fed and European Central Bank increased their combined balance sheets by 78%**;** the Bank of England and Bank of Japan have not been far behind.

- Quantifying the Monetary Policy-Equity Market Link

The following chart helps to qualify the apparent reliance of U.S. equity markets on the Fed's expanding balance sheet. In short, what was initially intended to provide a short-term liquidity boost to address market turmoil and spur growth has become a central fixture in the valuations of entire asset classes.

Should investors expect asset prices to keep rising even if central bank balance sheets wane over the medium-to-long term, as occurred in much of 2019? Or will rates rise in the next crisis, punishing equities and credit alike, if the Fed proves unable to repeat its feats of 2020? We will continue to ponder these questions and their implications for client portfolios, ever alert to the possibility of a reckoning.

FED BALANCE SHEET VS. S&P 500

Source: Bloomberg

- Modern Monetary Theory: Is It Already Here?

While the absolute growth in the Fed's assets is staggering, a complementary measure is equally noteworthy: the degree to which government has run deficits as a percentage of GDP. For several years prior to the pandemic, the U.S. had already run deficits of approximately 5% of GDP; in response to Covid-19, that figure jumped this year to more than 15%.

While conventional economic theory holds that this approach to debt and spending is inherently unsustainable, Modern Monetary Theory deems it prudent, citing extraordinarily low interest rates. Years of low inflation and societal crises have inspired political figures from both parties to court higher spending on social welfare, as the recent debate over the dollar amount of stimulus checks illustrates.

Yet few seem to ponder: What happens should the outlook for inflation change, and interest rates trend back to more historically normal levels? If this were to occur, the future cost of funding our deficit could rise significantly, abruptly blunting both future government spending and private sector growth.

Modern theorists might point—as I often do myself—to limits on inflationary growth, such as declining birth rates and aging populations. Yet interest rates are currently also kept low by monetary ammunition that might one day run out, due not to the will of the central bank but to declining faith in the currency. Moreover, our debt as a share of GDP is already at previously unseen levels. Should the cost of servicing it jump, the impacts would be unprecedented as well—and could include a generational diminishment in the U.S. dollar's many advantages as the world's reserve currency.

2021 Outlook: The Dollar, Commodities, and Global Investment

While Clear Harbor has maintained a U.S. bias in our equity exposures since our founding, we have not been shy to allocate capital to international developed and emerging markets where opportunity and client interest aligned. Our macro view for 2021 is more constructive on incremental allocations abroad for several reasons. These include the extremely rich valuations across U.S. markets; the potential repatriation of international capital from assets denominated in a weakening dollar; and near-term prospects for institutional capital to follow these opportunities, particularly in emerging markets.

- Dollar Weakness; Global Opportunity?

For many institutions and individuals around the world, allocating capital to the U.S. is often predicated on the stability and strength of the dollar relative to their home currencies. In addition to diversification, buying dollar assets creates exposure to "carry trades" that a strong currency can offer.

For example, a German institution buying a 10-year Treasury might gain, say, 150 points in yield relative to their native Bunds, which is attractive; but if the dollar strengthens over the euro in the meantime, that gain is magnified when redeemed for euros. The relative strength of the dollar is thus a traditional premise for allocations to the U.S. among investors the world over.

This premise faded in 2020 as the U.S. dollar weakened amidst America's poor pandemic management, deficit spending and other factors. Should dollar weakness persist in 2021, I suspect that international capital will feel even less compelled to allocate to U.S. debt, equity, or even currency markets. While these funds are likely insufficient to overcome the much more significant flows of domestic capital and asset purchases by the Fed, they could very well provide tailwinds elsewhere around the globe.

- Emerging Markets

A flat to weaker dollar could particularly lift emerging markets, and perhaps even help end a 13-year stretch of underperformance in EM equities. EM also appears to be poised for a multi-year rally relative to U.S. equities on a technical basis, and valuations have become significantly more attractive since the sector last matched the performance of the S&P 500 more than a dozen years ago. In fact, EM stocks are trading at approximately 2x book value, versus 4x for the S&P 500—a divergence in relative value not seen since the dot-com bubble peaked in 2001.

To be sure, sector, style and momentum factors capture dispersions within the EM universe, just as they do within developed markets. But if the dollar remains weak, more capital will find reasons to flow to the attractive demographic and long-term growth trends that emerging economies offer.

We recognize that considerable uncertainty remains in the global economic outlook, and that recent dollar weakness could reverse abruptly. We also emphasize that emerging markets carry inherently greater risks than developed markets, including heightened opacity and uncertainty around capital controls, regulatory structures, and currency volatility.

Many of these risks can be mitigated by owning U.S.-domiciled companies with significant revenue originating in emerging economies. On the other hand, some investors prefer to own companies that are on the ground, with direct exposure to the trends unique to these higher-growth regions.

Of course, many clients prefer to avoid these risks altogether. Never hesitate to reach out to your financial advisor; regular communication is the best way to ensure that your investment mandate is clear, current, and in line with your changing priorities.

- Commodities

So long as the dollar remains weak and central banks keep interest rates lower than inflation would historically dictate, commodity prices should also benefit—as many in fact did this past year. To the extent that extraction industries are often concentrated in developing markets, this thesis can seem to complement our broader observations about emerging markets.

At the same time, we urge against buying, say, miners or oil and natural gas producers indiscriminately: for many companies, the increase in business costs stands to offset or even erase any price gains for their products. With that said, we do expect a boost for certain energy and similar equities in 2021 and beyond, and we will continue to allocate selectively within the sector for clients seeking such exposure.

2021 Outlook: Setting Expectations

For now, the pendulum is swinging toward optimism and perhaps even euphoria. While we believe the current cycle will likely carry portfolio valuations higher in 2021 as the threat of Covid-19 is finally tamed, we systematically consider and stress-test the potential outcomes should our market assumptions prove wrong. We do not want to be caught looking for a chair when the music stops.

Clearly that time has not yet arrived: a majority of Wall Street strategists continue to call for double-digit returns in 2021, which now represents the “base case” rather than the “bull case” within our industry. We recognize the logic of this case—but also the risks should current expectations of economic acceleration, efficient vaccine distribution, and continued fiscal and monetary stimulus go unmet.

While ultralow interest rates provide a rational basis for higher P/E multiples than investors would otherwise accept, we also question how much further equities can rise without either meaningful gains in earnings or a degree of exasperation from market participants. We also think that, in the coming years, market participants will come to recognize that secular growth trends will be weighed down by demography and debt, and that considerable future returns have already been claimed by prior benchmark gains.

Yet we also continue to believe that certain segments of the global economy will outpace others, and that great companies with talented management teams will keep taking market share and delivering shareholder value. After all my years in this business—and more than a decade after forming Clear Harbor—I am still excited by the capacity of capitalism to surprise, to achieve, and to overcome. I am particularly honored to identify and pursue these opportunities each day in partnership with the entire Clear Harbor team, and the clients that we are privileged to serve.

We will forever remember 2020 as our “Covid year”—the year in which we lost so many, the year when so much of daily life changed without warning. Yet it was also the year that previously unsung heroes made extraordinary sacrifices to serve and save others in our hospitals. The year ahead will likewise be one in which the advances of our scientific community will save millions of lives around the world.

Such stories testify to our civilization’s ever-burning belief that tomorrow can be better than today. For that, and for your own confidence and trust, I am thankful.

Sincerely,

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