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September 29, 2023

Friend of Clear Harbor,

As we close out the third quarter, we find markets still struggling to digest the economic and financial cross-currents triggered by global inflation and the efforts of central banks to combat it. Growth continues to trend downward almost everywhere, prompting European equities to soften and China-dominated emerging markets indexes to decline more steeply. In the U.S., too, stocks gave back some of the year's gains as the Federal Reserve's record-setting rate-hike campaign helped to cut both inflation and growth roughly in half. Yet U.S. markets are faring better than most others on a year-to-date basis, supported by remarkable resilience in consumption and employment. In cap-weighted indexes, a handful of high-fliers have even kept returns solidly positive—the S&P 500 remains up 13.3% so far this year—despite more modest gains in average earnings.¹

Much of the regional dispersal makes sense. For example, Chinese equities have sputtered as the world's second-largest economy grapples with real estate debt, lackluster export demand, and a sluggish consumer. Stagflation has beset Europe as the Ukraine war drags on. Yet even in the U.S., profit growth in particular sectors seems vulnerable as consumers exhaust pandemic benefits and other savings amid costs that remain elevated. Parsing the relative strength and probable impact of these economic forces is part of the necessary spadework of portfolio construction as we peer into Q4 and beyond.

U.S. Economic Outlook

A key question for market participants is how much of the Fed's aggressive tightening over the last 18 months remains to be felt. Key parts of the economy, such as commercial real estate, must confront higher rates because they are dominated by floating-rate loans that reset regularly, or else have short-maturity loans that must roll over at new rates every several years. However, the largest category of consumer debt—residential mortgages—is significantly insulated from rate hikes. In fact, the average outstanding mortgage still carries a rate between 3% and 4%; fewer than 10% of outstanding mortgages are at 6% or higher. So even though rates for new 30-year fixed-rate mortgages have leapt to more than 7.8%, the vast majority of American mortgage holders will be shielded from these dramatic increases until they move.

¹ All market data is per Bloomberg LP as of close of business on September 28, 2023.

Make no mistake: households are feeling the pinch in other ways, many of which only stand to increase in 2024. Revolving credit is at an all-time high (and at higher rates), and delinquencies for car loans are edging up from historically low levels. In addition, in accordance with a Supreme Court ruling, federal student loan payments will resume in October. This will constrain consumption for two economically critical age cohorts: Millennials (age 25 to 40), who owe 47% of outstanding student debt; and Generation Xers (age 41 to 56), who owe approximately 30%. On average, monthly loan payments are expected to jump by at least \$200 per borrower. Meanwhile, gas prices have resumed their climb.

As these factors in financial anxiety increase, we could see the savings rate increase as consumers tighten their belts after years of freer spending fueled by rock-bottom borrowing costs and generous federal stimulus. Indeed, even though overall spending is still robust, cracks are appearing in some discretionary areas. For example, back-to-school spending this year has been weak, with many clothing, footwear, and sportswear companies reporting disappointing Q3 earnings and projecting tepid results for the remainder of the year. Sales are also declining in response to the end of the Covid-19 emergency, with patterns normalizing for autos, airline tickets, durable goods and healthcare diagnostics.

An important variable in the months and quarters ahead will be the employment picture. Nominal wage growth trends have remained above historical levels, offering some support for continued consumption. Job openings have recently begun to decline from their highs but still remain reasonably strong, and the overall unemployment rate remains at levels not seen in more than half a century. Yet manufacturing data has been weakening, and the impact of the UAW strike has yet to hit the numbers.

Many observers see these cross-currents as effectively balancing each other out, and are optimistic that inflation can decelerate while employment and economic growth remain reasonably healthy. Whether such a “soft landing”—some may remember the phrase “Goldilocks” from past cycles—is achievable will depend on many factors. Not least of them is the ability of policymakers to break the back of inflation, and then pivot smartly to cut rates aggressively before growth is seriously impaired—and indeed sooner than many investors and members of the Fed’s Open Markets Committee currently project.

This will require both a dramatic improvement in the Fed’s track record, and the compliance of many economic forces that lie beyond their control. For our part, we at Clear Harbor continue to anticipate decelerating economic growth as we enter year-end and wade into 2024. We will watch the interplay of growth, employment, inflationary pressures, the response of Fed policy, and implications for the relative value of key segments of the investment landscape.

International Economic Outlook

The economic picture outside the U.S. is in some respects simpler: key regions continue to struggle, with fewer mitigating factors to weigh than exist stateside. In Europe, inflation remains higher and growth more restrained as the war in Ukraine pushes food and energy costs higher, inflexible labor policies crimp businesses, and Covid-era fiscal stimulus offers a much smaller buffer of support. (The U.S. spent a whopping 27% of GDP on such measures, versus 10% across the Eurozone.) This poses a conundrum for the European Central Bank, which must pick its poison: fan still-rising inflation further by keeping rate raises modest, or smother growth outright by hiking more aggressively.

In China, many observers expected the country's long-awaited reopening from Covid to boost global growth. Instead, almost the opposite has happened: from retail sales to industrial production data, most economic measures have proved lackluster at best. Government actions to nudge consumers to open their wallets have failed, and the real estate sector has plummeted amid defaults by major development companies. While Chinese authorities will likely introduce further incentives for consumers to spend, youth unemployment remains quite high, and the outlook is somewhere between uncertain and bleak.

Much of this post-Covid disappointment is a function not only of China's particularly strict pandemic lockdowns, but a mass dislocation of workers that was unique to the country. In effect, a generation of Chinese laborers—tens of millions—that had come to large cities over the last two decades returned to the countryside. Their return to urban factory work in 2023 was sudden, flooding local labor markets and depressing their own wages and purchasing power.

China's woes and Europe's share some direct links. As Chinese buyers retreated, exporters of cars and luxury goods on the Continent suffered: ISM manufacturing surveys this past quarter reached lows not seen in Europe since German reunification. Conversely, China's own manufacturing pain has been exacerbated by slowing demand for a wide range of consumer products from the developed world, as well as a weak domestic consumer. So, while pockets of strength do exist outside the U.S. (see "Investment Themes" below), the U.S. consumer remains the strongest cylinder still firing—for now.

Generally speaking, equity markets today reasonably reflect the different growth prospects in various regions. China has underperformed all major markets so far this year, with its major benchmark off by 4.7%. Since China represents nearly 30% of the MSCI Emerging Markets Index, investors allocating to this broader universe have faced headwinds relative to developed market performance.

Asset Allocation in Q4 and Beyond

The marketplace continues to adjust to a world in which bond yields offer strong competition to equities. To be sure, we still prize the superior return profile of equities for the long run, and therefore do not propose to dramatically reduce exposure to stocks in most portfolios. Nevertheless, I continue to urge caution before increasing target weights for equities in light of falling economic activity and valuations that are well above historical averages.

- Testing the Limits of Stocks

The fact is that advances in U.S. stock indexes this year have been driven almost completely by the expansion of P/E multiples, not earnings growth. To a degree, this is justified by the increased prominence of the technology and communication services sectors over time. After all, these two sectors tend to exhibit higher growth and margin characteristics than all others; they are also overrepresented in U.S. indexes relative to most other major markets, and so will tend to nudge overall multiples higher. But the pace of returns in these sectors year to date, and the extent to which only a handful of companies—just seven names—have dominated returns, has masked the nearly flat performance of the vast majority of stocks on a year-to-date basis.

Consider: the equal-weighted S&P 500 Index is essentially unchanged so far this year, even as the traditional cap-weighted S&P 500 has advanced by more than 13%—a remarkable dispersion. A portfolio that can rise so far on such a small number of securities might very well fall just as far when sentiment shifts.

The current reluctance of investors to bid up broad swaths of equities does seem rational given tepid earnings growth, expectations for decelerating economic growth, and the potential for inflation to crimp margins in the coming quarters. One hopes that any broadening in the equity rally might be equally rational—which is to say, that valuation advances will be justified by improving prospects for business performance in the real economy. Time will tell.

- The Undeniable Appeal of Treasuries

For clients whose mandates allow us to allocate to fixed income, the risk-reward of Treasuries remains appealing, and the comparative value to equities is the best we have seen in some 15 years. For context, the earnings yield on the S&P 500 is currently 5.1%—dead even with the guaranteed coupon for the 2-year Treasury, and not far from 4.55% for the 10-year Treasury. Equities seem expensive when this measure of earnings comes so close to the risk-free yield available in U.S. sovereign bonds.

Treasuries also look good when compared against long-term inflation expectations. For this we look at the 10-year breakeven inflation expectation data published on Bloomberg LLP, which reflects market expectations of inflation in 10 years. Despite meaningful debates over the variables that will influence inflation in the coming years, expectations are that it will ultimately trend down to roughly 2.35% in the long run. This level is not far from the Fed's 2% target rate. If the market is right, current rates on Treasuries are quite attractive; if the market is wrong, the current trend toward higher rates could remain in place as long-term inflation exceeds expectations.

In some important sense, this is the essence of the current debate about the bond market. Those who contend that markets currently underestimate future rates have plausible arguments. For example, runaway federal debt issuance may coincide with a decline in foreign buyers for it, particularly as international rates normalize and pull institutional and personal capital from the U.S. back home. As noted in our discussion about the Bank of Japan (see below), we see evidence of this already occurring.

Nevertheless, by any contemporary metric, Treasuries are more attractive today than they have been in many years. Furthermore, history suggests that when the Fed does pivot, it is usually far more abrupt and aggressive in lowering rates than during the tightening cycle that preceded it. Should the Fed indeed find cause in future data to abandon its “soft landing” narrative next year, I suspect it will correct course more or less as markets currently expect. If not, we may see large cracks form in the commercial real estate market, with default rates rising and valuations faltering.

Without either a rapid decline in rates within the next twelve months, or enough economic strength to significantly revive leasing demand, this important and massively leveraged segment of our economy will only see the risks grow—which would itself provide good reason to consider the safety of Treasuries.

Investment Themes for a Decelerating World

Even amid economic deceleration across most of the globe, new opportunities and context around investments present themselves. Here are some trends that bear watching for their potential impacts on economic outcomes, investor sentiment and market performance.

- Oil

While crude oil is already trading at or near its highs of the year, it would not surprise the Clear Harbor team to see it register still higher prices amid further volatility into 2024. In addition to the possibility that OPEC+ may show reasonable discipline in restricting production, we also note the intention of the U.S. to refill its Strategic Petroleum Reserve, and the need for net importers—particularly in emerging economies—to purchase energy whenever prices decline. Both factors help provide a floor for prices.

Finally, we acknowledge the potential for Russia—the world’s second-largest oil exporter, after Saudi Arabia—to further weaponize energy as it continues the Ukraine war. Vladimir Putin has already exploited a reliance on natural gas as a pressure point in an attempt to divide Western Europe, and shown the world that bombing and blocking grain shipments is part of his strategic plan.

While he appears to have miscalculated in these actions, there is little to stop him from cutting off energy exports to increase pain for allies of the Ukrainian war effort. And if Russia’s 8 million barrels per day were to disappear from the market, there is no guarantee that another producer such as UAE or Saudi Arabia would step into the breach. Prices could leap, mitigating the revenue Russia loses from reduced exports and rewarding the rogue nation. If done amidst a cold winter, the U.S. elections or a time of low oil reserves, the impacts would be significant for the U.S. and Western Europe.

- Re-shoring, “Friend-shoring” and the Emerging Market Opportunity

Reshoring and “friend-shoring,” trends in which companies and countries source key components from closer or more reliable providers, offer to increase security of supply for developed nations and opportunities for domestic manufacturers and well-positioned export partners. One prominent company changing its supply chains is Apple, which in a pivot from China is reportedly expanding its production of iPhones in India from \$7 billion last year to approximately \$40 billion within five years, according to recent news reports. India is encouraging such moves with market-friendly initiatives as the world’s second-most populous nation tries to balance its relationships with China, Russia and the U.S.

Other countries benefiting from Apple’s shift away from China include Vietnam and Malaysia, where the technology leader is manufacturing AirPods and other accessories. Other emerging economies are worth considering as well. For example, Mexico last month surpassed China as the largest exporter of goods and services into the U.S.—quite a feat for a country once consigned to the economic ash heap following the Mexican Peso Crisis of the 1990s.

To be sure, China remains the dominant trading partner for products across both the developed and emerging world, from Germany and the U.S. to Brazil and throughout Africa. Still, these shifts are real and appear to be accelerating. Covid, the war in Ukraine, and geopolitical friction between China and

the developed world have amplified this trend; aspects of it have even been codified in the CHIPS Act and other actions by governments with national security concerns. We look for this to increase costs for some buyers, but create new opportunities for shippers, logistics companies and specialty manufacturers, among others. All these trends are promising for selective investment, provided individual risk tolerances are met.

- The Slow Fade of Dollar Dominance

Recent moves by western governments to reduce their reliance on Chinese manufacturing, and to sanction Russia in part by restricting its access to the U.S. dollar, have had a side effect: they have accelerated the decline in the greenback's pre-eminence in global trade, and may even have ramifications for its unique status as the global reserve currency.

According to the IMF, 59% of total foreign exchange holdings are in U.S. dollars today, off from approximately 85% fifty years ago. In India, Russia is now selling coal and oil in Rupees; across the countries targeted in its "Belt and Road" initiative, China is selling infrastructure products in local currencies. The fact that emerging economies from Thailand and Indonesia to Malaysia and Cuba can pay for Russian and Chinese products in their own currencies reduces their exposure to the dollar—and their need for it. To a lesser degree, the euro has begun to experience a similar kind of decline.

We see this shift as likely to continue in the coming decades. It is part and parcel of the world's progression from a bipolar world during the Cold War, to a unipolar one after the fall of the Berlin Wall, to an increasingly multipolar one. Countries such as India are careful not to embrace any one side exclusively, and instead prioritize open trade relationships and high optionality. If Russia has oil to sell on good terms, such countries are willing to buy it regardless of what sanctions the U.S. may be championing.

Over time, these trends could influence fixed income markets. To the extent that these regions are stepping away from buying dollars and euros, American and European buyers must fill the breach in order to keep their own sovereign bond markets from losing value. While fund flows of this type are difficult to track, and foreign purchases of U.S. and European sovereign debt have hardly fallen off a cliff, we are mindful of the potential impacts de-dollarization could have on bond prices over time. De-dollarization may already help explain why U.S. and European sovereign yields have moved as high as they have this year, despite clear declines in regional inflationary trends and growth expectations.

- Artificial Intelligence

As we highlighted in more depth last quarter, the application of artificial intelligence (AI) will continue to create efficiencies and open the door to a new wave of productivity gains after many years of lackluster advancements. However, the evolution of generative AI will be a source of friction between workers and employers—something exemplified in recent labor actions. The strike that the Writers Guild of America settled this week and the ongoing walkout by the United Auto Workers both highlighted AI as a threat to job security. This reflects the difficult balance our society will need to find in the coming years between the opportunity AI represents and the very real concerns it raises in many sectors.

Central Bank Policy

Compared with quantitative easing and other extraordinary measures the Fed took in the decade following the financial crisis (and then again immediately after Covid), the central bank's current charge is almost quaint: persuade market participants that they're going to get interest rates right. As of their last policy meeting on September 20th, that seems to mean keeping rates steady for now, while insisting—largely through a set of internal estimates affectionately dubbed the “dot plot”—that they no longer expect to cut rates by 0.5% in 2024. Chair Powell posits that this is a reasonable course now that average real GDP for 2024 is projected at 1.5%, up smartly from the prior 1.1% estimate.

Such hopes for continued strength seem at odds with rapidly decelerating trends in inflation and measures of economic activity in recent months. Indeed, while bond yields have risen since the September meeting, markets continue to price in 0.75% of easing in 2024. But given the historical tendency of inflation to bite hardest when monetary authorities declare victory prematurely, the Fed's prerogative to “jawbone” investors on the continuing need for hawkish vigilance is understandable. Detering investors from front-running future cuts—potentially in an aggressive manner—is essential to avoid easing in market rates and real economic conditions while tightening is still warranted.

This leaves the central bank and market participants in a delicate dance—one in which the official narrative is one of a soft economic landing that brings only modest pain in employment despite growing evidence to the contrary. This narrative is intended to support a hawkish interest rate posture that in truth seems better suited to levels of inflation and growth that are long past. As we peer into the 2024, we suspect that preserving hopes of such a happy economic outcome will require the seemingly restrictive Fed to pivot rapidly to policy accommodation next year after all—and with a sense of urgency that conspicuously eluded them when inflation was much hotter than it looks today.

- An Inflection Point for the Bank of Japan?

In Japan, recent inflation has proved more of a “feature” than a “bug.” Indeed, the central bank appears to be seizing on domestic inflation and growth data as an opportunity to work its way out of its multi-decade fight against disinflationary pressures. Among other measures, Bank of Japan Governor Ueda has begun to gradually unwind its bond-buying program. This program was intended to keep a lid on domestic rates and incentivize borrowing to stimulate the economy. But as Japanese growth remained paltry, many chose to borrow in yen—only to park that capital overseas in higher-yielding bond and equity markets. As the BoJ reverses gears, Japanese interest rates should continue to rise, which should help to repatriate some domestic capital back to the island nation.

As when the BoJ's ultra-loose policy began, the exact balance of benefits and potential disruptions from ending it may prove hard to predict, both within and beyond Japan. An incrementally normalized yield curve should, as expected, benefit Japanese banks who fund long-term loans with short-term deposits. But the reshoring of Japanese capital could also pressure yields in the U.S., Germany, New Zealand, Australia—any market that for years has benefited from Mr. and Mrs. Watanabe's export of capital.

Signs of this policy shift have increased since I first floated the prospect in these pages. The Bank of Japan took the first meaningful step in July, moving to allow 10-year rates to rise to a ceiling of 1% versus the previous 0.5%. Just weeks ago, Governor Ueda indicated that yield curve control could loosen further—and that the Bank’s zero-interest rate policy could even end altogether—if inflation rose to its long-elusive 2% policy target.

We expect these shifts to complement other moves afoot in Japan to attract more foreign investment—specifically, their continued efforts to reform their regulatory structures and corporate cultures. As I discussed in last quarter’s outlook, the Tokyo Stock Exchange has strongly encouraged companies to increase dividends and share buybacks, and even embrace restructuring and M&A as ways to improve return on equity for investors. We remain intrigued by the long-term opportunities in Japan where appropriate to individual client risk tolerances and return objectives, and will keep a watchful eye as Japanese policy actions, economic realities, business performance and financial markets evolve.

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As I write, newspaper editors are preparing headlines ahead of the federal shutdown expected to begin this weekend. Like many observers, I hope we will avert a protracted interruption, just as we have in the past; in that case, the economic impacts should be fleeting. Yet this moment does feel more unstable, as the conflicts behind the current impasse are emanating not from the leaders of two parties representing large swaths of the electorate, but from rogue representatives wielding undue influence with impunity.

It is sad to see. With debt-to-GDP at 120% and growing, hard decisions need to be made across defense, healthcare, and broader social welfare. Time is no longer on our side, and it is imperative that elected leaders restore our government’s ability to function.

Many other important developments are underway further from the headlines, including demographic change, geopolitical shifts, and technological progress that consumers don’t often see. As stewards of generational capital for many clients, as well as the interests of institutions with lengthy horizons, the Clear Harbor team remains attentive to such changes, whether in or out of the spotlight.

In the nearer term, uncertainty and volatility look set to remain fixtures of markets. Now is a good time to confer with your wealth manager and make sure we have an accurate picture of your current risk tolerance and anticipated cash needs, as well as any major changes in your family or financial situation. A steady flow of communication remains essential to maintaining the trust you have placed in us, for which we remain grateful.

Sincerely,

A handwritten signature in dark ink, appearing to read "Dan J. Hansen", written in a cursive style.

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