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**Clear Harbor Flash – Market Update**

Friend of Clear Harbor,

When I penned our preceding Outlook just three months ago, the equity market had collapsed so rapidly as to make the multi-quarter pace of the financial crisis seem almost leisurely. Despite many differences between the two periods, one thing is the same: Now as then, those who stuck to a disciplined approach to asset allocation—including rebalancing where appropriate—were able to incrementally benefit from this moment of extreme market dislocation.

The team at Clear Harbor believes strongly that discipline is the surest defense against many blunders in wealth management. We are grateful to our clients for trusting our process, and for working with us to ensure that our strategies for achieving your short- and long-term objectives remain aligned with your own tolerance for risk.

Sadly, the need for extreme vigilance remains. While markets have rebounded powerfully, the pandemic that prompted the historic shutdown of the global economy continues. Since my last report to you, the death toll from COVID-19 in the U.S. has grown from 35,000 to more than 125,000; the South and West now seem to be repeating, rather than avoiding, New York's woeful experience from March and April. Global deaths now exceed 500,000, with large swaths of the planet still seeing accelerating case growth.

We at Clear Harbor mourn those lost to this terrible virus, including the tens of thousands in the greater New York region that most of us call home. We applaud those in government, business, and especially healthcare institutions and the other front lines of this fight. We all want to reopen in ways that keep them and indeed all of us safe.

**The Fed's Market Rebound**

The reopening of America may be marked by stalls or reversals in many states, but the rebound in financial markets through the second quarter has been almost unrelenting. The S&P 500 has rallied 37% off the March 23rd low, an extraordinary development against the backdrop of an economic standstill. Meanwhile, at the other end of the risk spectrum, "flight-to-quality" bonds—notably U.S. Treasuries and government-sponsored mortgage-backed securities have also rallied, gaining approximately 5%.

How can such a diverse range of assets rally in this way with an economy that remains largely dire and hard to predict? Within equities, how can one justify forward P/E multiples charitably estimated at 24X 12-month forward earnings—versus a 25-year average of just 15.5X, even in better times? In fact, based on current estimates, today's prices would still hover just above that average *two years from now*.

The answer in both cases is that financial markets, like the comatose economy itself, are being propped up by monetary and fiscal stimulus to a degree that is not sustainable in the long term. In particular, global central banks have greatly increased the money supply, injecting trillions of dollars into nearly every major corner of the capital markets: commercial paper, investment grade bonds, high-yield bonds, equities (e.g., the Bank of Japan's purchases of Nikkei-listed equities) and even municipal bonds.

These actions dwarf the response to the financial crisis, and they are being taken within a much more compressed timeframe. Although we worry about moral hazard, these moves have clearly boosted asset prices. This has provided a sense of relief to many investors that while the real economy continues to shudder, at least one visible leading indicator—the stock market—remains a beacon of encouragement, shining directly through to the account balances of consumers and business owners around the world.

Gold, perhaps the ultimate safe haven, is better by some 13% over the course of the second quarter. The yellow metal is behaving as expected: though recently correlated w/equities, its bullish trend stems from the widespread view that over the medium to longer term, fiscal and monetary largesse will create uncertainties. Gold's historic role is to hedge against such concerns, making it an appealing component in many balanced portfolios.

**Economic Prospects**

At some point, to borrow from Herbert Stein, the unsustainable will stop, and recent stimulus levels will subside. At that point, equity prices and corporate credit must find support from a more traditional source: earnings. To justify current nosebleed pricing, we will need to see a nearly perfect V-shaped economic recovery. Anything less will prove inadequate to power us back to the prior earnings peak of 2019.

We seem unlikely to recapture that level for a while, quite possibly not until 2022 or beyond. Most GDP estimates for full-year 2020 top out at a decline of roughly 5.6%. Several points of concern across the economy help to validate this pessimism: fundamental factors such as corporate revenues, employment and the consumer remain severely depressed. Growth estimates do improve for 2021, with average economists predicting growth of 4.1% for the year—still leaving us shy of pre-pandemic levels.

To be sure, fiscal stimulus and generous unemployment benefits have softened the blow to consumers considerably. However, to date these payments have fueled a spike to an eye-popping 32% savings rate, not a spending spree. The months and quarters ahead will tell whether this reflects the impact of shelter-in-place restrictions, which would ultimately unleash pent-up demand as the country reopens—or a more entrenched "fear factor" that will only prolong the downturn.

We do expect the gradual reopening of businesses across the developed world to continue, while emerging markets will see a more scattered approach. Even as COVID-related impediments fall away, however, other pre-existing financial conditions will continue to cloud the prognosis for business.

In our Outlook for 2020, we highlighted one such area of concern for corporate America: the rise of debt loads. These burdens have been particularly acute in the bottom strata of the investment grade market and the broader swath of the high yield ("junk bond") market. While the Fed's strong words and actions since mid-March have succeeded in pushing down the cost of capital for the average public corporation, many so-called "fallen angels"—firms whose debt was investment grade as of March 22, but faltered during the pandemic—still face insolvency. Simply flooding debt markets with liquidity will not, by itself, prevent insolvency.

**The Great Divergence(s)**

As suggested above, the S&P 500 remains above fair value by any traditional metric. Indeed, the stock market as a whole has clearly diverged from the reality of the underlying economy. I would go further and suggest that the following additional important divergences are worth pondering as we assess the present market and peer ahead.

- Equity divergence

One is the divergence that has emerged within the equity market. Technology shares continue to power forward, rising 13% year-to-date; meanwhile, the bank sector, for example, is mired in a bear market, off 35% YTD. Some of this is understandable: technology is an asset-light sector that has enabled many of us to work remotely during the pandemic, and it will play a key role in restoring productivity across many sectors as supply chains de-globalize. In contrast, banks currently struggle under low loan growth, collapsing interest spreads, and a hazy credit picture clouded further by new regulatory limits on company dividends and share repurchase prerogatives.

We do not challenge these factors; the big question concerns valuations. Prices have grown quite lofty in tech across the board, even accounting for relative growth, while financial companies are much better capitalized than they were when the financial crisis hit. The degree of repricing warrants skepticism.

As we look to sectors and individual companies going forward, further divergences have our attention. We think growth companies with fortress balance sheets will continue to outperform the more asset-heavy companies such as industrials. We expect that utilities (including water utilities) will maintain cash flow during this period of uncertainty and see reasonable returns on equity. Meanwhile, prominent global industrial companies are feeling the headwinds from the sharp anticipated decline in global GDP expected for full-year 2020. Across sectors, companies with strong balance sheets and good records as capital allocators generally have captured market share; we expect that trend to continue.

Finally, the consumer still holds the keys to a sustainable recovery. Within the consumer discretionary sector, products and services that entertain families in their homes have seen tailwinds from historically low levels of travel and summer camps on hold for the year. While some consumer staples could be stretched following a massive spike in demand during the initial peak of the COVID crisis in March and April, others could still see a reasonable tailwind in the months and quarters ahead as the economy slowly reopens and consumers start to return to restaurants, bars and other social venues.

Divergences can also be seen across the geographical spectrum. Even as U.S. markets trade just a few percent below their levels in January, Emerging Markets are struggling—held back, in part, by the strength of the world's reserve currency, the U.S. dollar.

- Societal divergence

The scenes of protest from American streets this past month, some violent, may have been sparked by a single killing, but their potency speaks to fractures in our society that have been deepening for some time. Moreover, while questions of race currently dominate the political conversation, economic inequality is a closely linked subject that may again come to the fore during the fall campaign season.

The pandemic has thrown new light onto the persistent and growing income disparities in the U.S. Low-income workers have been significantly more impacted by the pandemic than higher income workers: a recent study by the Becker Friedman Institute found that those in the bottom fifth have seen incomes drop by 35%, while the upper fifth have seen their incomes ebb just 9%.

The economic fallout from COVID-19 has only exacerbated a decades-long trend of stagnant real wages for lower- and middle-income consumers. Our friends at macro research firm Hedgeye recently argued that while a crisis such as a pandemic has a tendency to strike the lower-income workers first, the impacts eventually spread broadly as elected officials attempt to apply populist solutions in the face of civil unrest. That such policies can augur poor outcomes for the long-term economic health and vibrancy of the whole society, including those they are intended to help, is a point few politicians care to make.

Ultimately, the continued fracturing of American politics has global implications. As we have highlighted several times in recent years, geopolitical instability in the past has often arisen in smaller economies; of late, it has been rising among the very nations that since World War II had fostered prosperity around the world. The coming years, not quarters, will tell how far, how fast and how peacefully we shall retreat from globalization and other postwar norms.

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The stories that dominated the spring will clearly carry through the summer. How the South and West handle COVID-19 will say much about whether the East experiences a second wave, and determine the slope of the economic recovery in the U.S. While the Fed clearly risks creating new bubbles—some already forming, others easily foreseeable—they remain caught between a rock and a hard place, and they are choosing any initiative with the potential to create growth, ensure liquidity, and thereby rein in insolvency rates. In this election year, we also expect the Congress to pass Stimulus 4.0, and for the President to sign it into law.

This is a moment for humility. Past is hardly prologue in a period so unconventional and unique. After a fall, markets typically take 2.5 years to recover their previous highs; we have nearly done so in as many months, after an equally abrupt bottoming. Nor can we safely conclude that the bloodletting is over. Economists, strategists and investors are engaged in an unprecedented debate over the use to which unprecedented cash on the sidelines will be put.

Finally, for all of America's troubles and political preoccupations, we must remember: the public health crisis that COVID-19 created remains a global one, and so is the economic damage left in its wake.

**Clear Harbor Offices Are Moving**

An administrative update to all our clients: Clear Harbor Asset Management will move our offices from Midtown Manhattan to Stamford, Connecticut as of August 1, 2020. We made this decision after careful consideration of many factors, including peace of mind for the members of our firm. This move will allow us to return more safely to an in-person work environment, as all of us desire, while dramatically reducing our exposure to crowded forms of public transportation such as subways and trains.

We believe in the long-term future of New York City and look forward to its resurgence. However, we believe that the resources we were leveraging in such a vibrant location will also take some time to return. A combination of efficacious vaccines and/or eventual herd immunity will most likely give life back to New York so that conferences, analyst and company meetings, and of course time with our New York-based clients can return to normal in due course. Unfortunately, that time is not now.

While our address will change, our email addresses and telephone numbers, our internal processes, and our approach to your wealth picture will not. It is with great pride that I work with such a devoted, thoughtful, and hard-working team here at the firm. In fact, we are all eager to find a way to return to a live work environment and work in the same location so that our longstanding "open door policy," lately relegated to virtual means, can again take physical form.

Each of our wealth managers continues to communicate with clients about changes in their financial life, estate planning and retirement strategies, as well as shifts in their perception and reaction to market and portfolio volatility. We also are eager to communicate with all of you via Zoom, telephone, or other virtual platforms. We recognize the importance of outreach and responsiveness during these uncertain times, and look forward to our ongoing dialogue with each of you.

Sincerely,

Aaron J. Kennon

Disclosure:

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