June 30, 2021

Aaron J. Kennon
Chief Executive Officer & Chief Investment Officer

Friend of Clear Harbor,

The second quarter saw a sharp spike in GDP growth and a well-advertised rise in inflationary pressures, as demand rose in the face of supply chain bottlenecks affecting everything from new cars to lumber. Employers, particularly in the hospitality sector, were caught in a similar vise, with a wave of pandemic-weary customers returning just as the supply of employees proved constrained by return-to-work fears, limited childcare options, and sustained unemployment bonus incentives.

Ongoing Covid-related stimulus, likely to be joined soon by some significant measure of infrastructure spending, will continue to boost economic growth well above sustainable levels in the coming quarters. In fact, the historically high 6.4% GDP growth rate seen in Q1 will most likely be followed by outright nosebleed levels of around 10% in Q2. Meanwhile, the Federal Reserve's preferred measure of inflation has risen to 3.4%—the highest rate of price acceleration witnessed since 1992.

There are already signs that, after some continued adjustment over the coming year or two, growth and inflation may stabilize nearer long-term trends once the bounce from unprecedented stimulus and a strong vaccination effort in the U.S. tapers off. Nevertheless, the ultimate direction of inflation remains unknown. A sustained increase would test the earnings momentum of many companies, the Fed's ability to maneuver in an environment of unprecedented debt—and, in all candor, the ability of allocators of client capital to maintain an even keel in a world of asset classes that remain stubbornly correlated.

Market Review

Equity markets have continued to rally both at home and abroad, with the MSCI ACWI Index better by 7.2% for the quarter and 12.4% year-to-date.[1] In fixed income, the overall benchmark, the Bloomberg Barclays Aggregate Bond Index, has declined in value by 1.6% YTD, despite a recovery of 1.7% in Q2. Within fixed income, investment grade and high yield credit markets have gained, while U.S. Treasuries have sold off a bit: the 10-year yield began the year at 0.91%, and now hovers around 1.45%.

[1] All market performance data is as of close of trading on June 30, 2021.

After a pandemic year in which both aggregate demand and production of metals and crude oil collapsed, major commodity markets have rebounded impressively. Brent crude is higher by half since the start of the year, while key metals such as copper, aluminum, and iron ore have all risen at least 20%. Agricultural commodities have also participated, with corn, coffee, cotton and sugar up between 8%-35%. One decliner was gold, which after last year's strong performance as "ballast" amidst broad market declines has taken a breather, off approximately 6% YTD.

Economic Outlook

Across the developed world, equity prices are currently supported by historically high rates of GDP growth at home and steady improvement abroad. However, the second half of the year will see some prominent spurs to growth subside. In the U.S., unemployment payments will decline significantly this fall, expectations for further stimulus from Congress should steadily abate, and the trajectory of GDP growth will most likely decelerate on its way toward trend growth of 2% within the next two years or so. While none of these factors seem likely to derail growth, their timing and degree may certainly alter investor perceptions of the health of the economy and opportunities across various major asset classes.

It is also worth noting that the economic reopening has been neither globally synchronous nor hiccup-free. Europe stumbled for months in sourcing and administering vaccines, but now seems to be making welcome strides. While the Continent seems poised to enjoy some measure of a summer vacation season, renewed quarantine restrictions aimed at the new "Delta" variant will keep most tourists from Asia, America and the UK away. From Portugal to Italy, hotels bookings are falling off a cliff: Bloomberg reported that one hotel has seen their occupancy drop from 90% four weeks ago to barely 30% today.

Indeed, though growth is improving almost everywhere, both developed and emerging economies across much of the globe appear to lag the U.S. by a quarter or more. We expect Europe, Southeast Asia and other regions to play catch-up in the back half of 2021—and with any luck, start to contribute more meaningfully just as the acceleration in U.S. growth seems likely to pass its peak.

Employment and Spending

Never has our society seen incomes increase in the midst of epic economic dislocation. Yet that is what occurred in 2020—by a whopping 7%, according to one measure. The unusual factors currently affecting income, employment and spending help explain much of the noise in recent economic data. On balance, I believe they also augur well for a return to more normal metrics as we peer toward 2022.

First, the Paycheck Protection Program and enhanced unemployment payments ensured substantial cashflow for households despite dramatic hits to employment. Even as money kept pouring in, much of it could not be spent during lockdown; it was instead stockpiled, sending the savings rate as high as 33.7% in April 2020. As the economy reopens, Americans thus have ample funds to spend on a wide range of pent-up demands. This both explains the tremendous economic burst we are seeing now, and helps us envision a glideslope back toward trend growth as consumer spending and savings rates both stabilize.

Second, despite levels of available cash ordinarily associated with strong employment levels, many workers in fact remain on the sidelines. This has pressured employers and prices, especially in the service industries that are seeing strong demand from families eager to get out of the house. However, many potential employees who remain fearful of in-person work will likely reconsider as Covid case counts continue to decline; others may do so once extended unemployment bonus payments expire.

A related factor that deserves more attention is the reopening of schools. This will enable many who want to resume work to finally do so this fall, after more than a year at home with their children while teachers or caregivers were unavailable to assist. Temporary work visas should also ramp back up as embassies and consulates reopen, unlocking another source of much-needed labor.

Not every employment trend of the past year will necessarily reverse itself. For example, older workers have accelerated their retirement in droves, creating a dramatic drop in the labor participation rate relative to recent years. We also note that the federal rental eviction moratorium put in place last year will expire at the end of July, which could create new challenges for consumers and landlords alike. Other speed bumps will doubtless present themselves as well. But on balance, trends would seem positive for employment—and for the healthy spending it organically supports.

While we welcome the expected improvement in the employment picture, we are also mindful that the peak growth of ~10% we are experiencing now will decline quite noticeably over time. By 2023, we expect growth to trend toward a more historically average rate of roughly 2%. This could pose new challenges to both fiscal policymakers and the Fed, as debt-to-GDP will have soared—even as pressure to deliver government services persists in what may prove a less frothy employment environment.

The Inflation Equation

The great debate of late among market prognosticators has centered around inflation: How best to measure it, how long it will last, and whether we risk a 1970s-style wage-and-price spiral. The debate is hardly academic; if the Fed is right, current inflation signals will prove transitory. This would allow interest rates to stay low and earnings margins to expand, while providing a stable environment for credit, economic growth—and of course, potential gains across a range of asset classes and sectors.

Conversely, runaway inflation would crimp many corporate earnings, pressure the largest segments of the equity market and wreak havoc on credit and consumer confidence. At the risk of pontificating, I am also mindful of the risks sustained inflation would pose to the sustainability of our national balance sheet, and the political capacity of our republic.

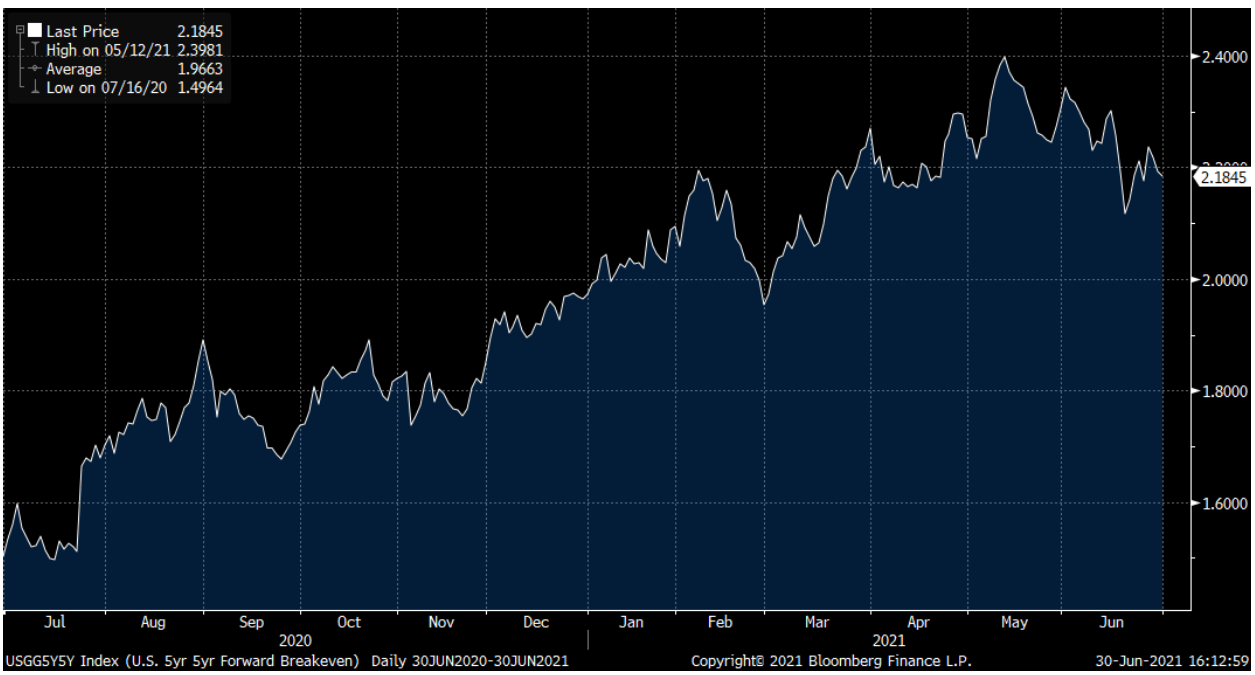
To be sure, one would be foolish—or living on Mars—to ignore recent signals of genuine inflation risk. The CPI is currently 5%, more than double the Fed's (arguably somewhat coy) target of 2%. Demand for semiconductors, oil and other commodities has skyrocketed; lumber prices spiked dramatically this spring, capturing headlines nationwide; used car prices stand at record levels; housing prices have climbed fiercely, with supply scarce and anecdotes of bidding wars common.

Nevertheless, the Fed may have this one more right than wrong. Several signs suggest that the most notorious recent price spikes are either already abating or poised to trend lower in the months ahead. For example: copper, a critical input to industrial production, auto manufacturing and housing, though still markedly higher on the year, has come well off levels seen just weeks ago. And lumber, a key input to housing costs, recently declined 60%, after rising nearly fourfold to a highwater mark last month.

Crucially, upward pressure on wages—the "wage" half of the "wage and price spiral" that economists dread—seems likely to moderate in the fall for the reasons noted above: continued progress against the virus; the reopening of schools and restoration of work visas; the end of enhanced jobless benefits.

Furthermore, it appears this consensus is somewhat broadly shared. One longer-term gauge of inflation expectations from the University of Michigan recently declined to 2.8%. While this level is still high—it is barely shy of the post-financial crisis record level seen in 2013, in fact—this inflection suggests that corporate executives and other market observers, like the Fed, see a trend toward cooler prices ahead.

U.S. Five-Year Forward Inflation Breakeven



Source: Bloomberg

Members of our firm have varying opinions on how inflation will evolve from here. This debate keeps all of us appropriately humble, on our toes, and attentive to the many nuances of this complex subject. Indeed, I recognize that price pressures seem likely to persist for months in several important areas of the economy, even if some of them weaken on the margin along the way. For example:

Semiconductors. Supply will rise to meet the sharp rise in demand for these linchpins of the modern economy more gradually than many had hoped, in part due to poor estimates of demand by industry leaders late last year. In fact, Intel's CEO last week projected that while the shortage may bottom later this year, full recovery to a normal supply-demand balance will likely not come until 2023.

Oil. While we believe enough hydrocarbon production will eventually come back on line to meet demand, we are less optimistic that prices will retreat as miles driven in the U.S. and abroad rise significantly this summer. While current crude prices appear broadly sustainable, the risks at this juncture appear geared more to a degree of overshoot than a meaningful correction.

Housing. Housing price data released this month suggests that the rate of change over the last several quarters may be taking a breather. However, this appears largely a function of running out of homes to sell, rather than diminishing demand—particularly with long-term interest rates still likely to stay "lower for longer." Housing prices weigh heavily on CPI and the deflator; they could well limit normalization in these key inflation measures for some time, no matter what happens to prices for used cars or crude.

Capacity utilization. In my view, this oft-consulted window into possible economic overheating seems unreliable at the moment. On the one hand, the drive to ramp up production has generated rising measures of capacity utilization in the U.S.—some 88% according to the most recent University of Michigan survey. However, current data appears muddied by several factors that appear temporary.

On balance, when viewed through a global prism, I perceive a healthy amount of slack in manufacturing capacity. As a result, I prefer for now to consider other indicators to glean cost pressures, margin expansion, prospects for capex, and other economic vital signs. Most of these support a base case of reasonably sustainable growth as transient factors fade and longer-term trends return to the fore—particularly outside of the U.S., where inflationary pressures appear more at bay overall.

<u>China and the Global Supply Chain</u>

After years spent encouraging and building intricate and hyper-efficient global supply chains, policymakers and corporate executives in the West are undertaking a serious reappraisal of their approach to globalization. China's autocratic approach to governance, and the dependency that many democratic nations felt on the communist nation for a wide range of products during the pandemic, have rapidly come to overshadow the once-universal priority of "more goods at a lower price."

Any reduction in commercial interdependency with China will not be fast, simple, or politically and economically frictionless. The U.S. is far more commercially and logistically entwined with China than two great powers have ever been in living memory. The economic rivalry is also stronger than with past adversaries: Russia, for all its missiles, was never an economic threat to market economies. In contrast, China's geopolitical chest-thumping is matched by a footprint in trade and technology that already compares formidably in important respects to those of the U.S. and key European powers—who still look upon China as an irresistible export market and financier. Objections do not always come readily.

Nevertheless, governments and to some degree consumers have clearly awoken to China's economic and military aspirations, both in its hemisphere and on a global basis. U.S. and European companies appear to be decoupling from the once-conventional wisdom that the natural way to source manufacturing is in (or through) China. There is new priority in Western nations to repatriate production capacity, especially for sensitive or essential products. Moreover, corporate and diplomatic frustration with Chinese hacking, intellectual property theft, and technology transfer demands has increased.

This subject will develop over years, not just months and quarters. I highlight it now because China's central place in the global supply chain—from semiconductors to rare earths, airplane manufacturing to artificial intelligence—is already linked intimately to the flow of global capital, the character of emerging geopolitical risks, and the evolution of the Middle Kingdom's military, political and economic influence.

Renewable Energy Marches On

While the arrival of the Biden administration increased the cohesion of international decarbonization efforts and accelerated the policy prerogative within the U.S., consumers and corporations have been marching in this direction for a while now. To take but one barometer of consumer interest: Ernst & Young estimates that electric vehicle sales in the U.S., China, and Europe will outpace all other engine sales by 2033, while non-electric vehicle sales will represent less than 1% of total sales by 2045.

Renewable energy is experiencing renewed growth as well. According to the International Energy Agency, wind and solar capacity grew in 2020 at the fastest rate in two decades. Nonetheless, coal use as a percentage of global energy consumption is also on the rise, due to the growth of electricity demand in China—a sad irony for the world's dominant producer of solar panels.

Another irony of the massive growth in global renewable demand is the related rise in demand for copper, cobalt, nickel, lithium, aluminum, and rare earths. Though crucial to the manufacture of solar panels, wind turbines and electric vehicle batteries, mining these elements is not without its own environmental impacts. Moreover, the carbon intensity of producing these vehicles extends the carbon "break-even" point in an automobile's life cycle substantially.

Nevertheless, broader adoption and steady improvement of these technologies are both essential to bending back the curve of climate change. And they present significant opportunities for investment, not only in the final products themselves but in the broader ecosystem of their essential inputs.

Market Outlook

With the exception of the defensive utilities sector, every major component of both the S&P 500 and the MSCI ACWI Index is positive for the year. It is encouraging that these moves appear, broadly speaking, to be supported by earnings recoveries that meet or exceed already-high analyst expectations.

We see earnings continuing to grow nicely into year-end and throughout 2022, even as economic growth necessarily decelerates from its recent historically high levels. Meanwhile, technical indicators suggest that stocks are not overbought; market breadth has also improved markedly when compared with six months ago, when gains were concentrated in a handful of mega-growth names.

As economic momentum ebbs back to within normal parameters and market participants regain their bearings, simple bets based on economic momentum should increasingly give way to more conventional comparisons of stock value to analyst expectations. This has implications for allocation strategies at a sector and regional level.

The cyclical components of the market—most notably energy, materials, financials, and industrials—are currently leading the way, as one would expect in a period of higher inflation and robust growth. As growth peaks and reduces its upward pressure on inflation, I see an increased likelihood that capital will rotate to other sectors, including growth areas within technology, communications, and consumer discretionary.

At a very macro level, a particular challenge in analyzing equity markets at the moment is that one can perceive tail winds for stocks in both a higher-growth scenario *and* a more accommodative monetary scenario. Even if earnings should falter amid unexpected economic weakness, the "Powell put" seems alive and well. While this is no replacement for healthy fundamentals as the basis for stock valuations, the knowledge that the Fed's monetary bazooka remains trained on asset purchases can still give a measure of comfort and support to financial markets.

From an investing standpoint, this isn't the worst challenge to have; but it does invite complacency. Indeed, one key metric of complacency is the Volatility Index, which rests at the lowest level since the onset of Covid in Q1 2020. However, by the same token, a low level of market volatility can create conditions for positive flows into equities.

For their part, bond investors seem to be expressing the conviction that growth and inflation will soon peak. They have sent longer-dated yields steadily lower from the cyclical highs seen at the end of March, even as short-term yields—the part of the curve most sensitive to economic news—have risen.

<u>The Fed, the Data, and Portfolio Construction</u>

While I find myself, for once, embracing aspects of today's conventional wisdom about the economic outlook, my optimism is not unfettered. The underlying tone of markets can turn on a dime in response to news; sectors or entire asset classes can correct for any reason, or for no clear reason at all.

As always, I am keeping a keen eye on the Fed. In concrete terms, the test of its mettle may not come at their meeting in September as many market observers seem to believe. While the FOMC plainly believes that current inflationary pressures will prove transitory, we won't have conclusive data on that question until Q4, and indeed into Q1 of 2022. It will take at least that long to gauge with any confidence the impact of school reopenings, the end of enhanced unemployment top-offs and other factors.

As a result, come September the central bank might insist that it simply isn't yet in position to take its foot off the accelerator. And while economic data would seem to justify at least a tapering of asset purchases, every move to tighten carries implications for the structure of interest rates throughout the economy, as well as how we fund large government deficits that are only slated to continue.

I am hopeful that the largest of these deficits are baked into expectations. If majorities in Congress pushed for more, no one could claim to be entirely surprised, and an additional couple trillion more would certainly change the trajectory of GDP going forward. But time is short before the 2022 midterms, and doubling down on recent largesse would test the patience of America's remaining swing districts.

Other risks loom. The Fed isn't the only actor attempting to make sense of an unusually fluid data environment: Investors, too, lack the level of clarity they usually rely on to inform their decisions, which increases the potential for asset prices to become distorted and bubbles to form. Indeed, the Fed's policy of negative real yields all but invites bubble creation; any reluctance to tighten promptly even if conditions should continue to heat up will only extend the invitation. We've seen that cycle before.

*

All this is to say: We at Clear Harbor are mindful that we can be wrong, and that poor decisions can deeply impact client portfolios. So, though our views of the markets may differ—and benefit from being freely exchanged—we share the central conviction that humility serves the client interest.

This philosophy supports our disciplined approach to multi-asset class portfolio construction, which is admittedly a balance of investment science and art. It also respects the diversity of economic conditions and monetary moments, and how they can affect markets: in some, equity and fixed income performance tends to diverge; in others, higher levels of correlation prevail.

We often see convergences and divergences within asset classes. For example, at times of economic stress or uncertainty, Treasury prices tend to rally while high-yield bonds ("junk bonds") will likely falter. Yet at the moment, both segments remain elevated, reflecting not only real economic strength but also perceived insurance in the form of central banks commitments across the developed world.

The interplay of all of these forces is often challenging to assess, yet important to ponder in portfolio construction. While it is always easier when assets seem to rise in tandem, it raises the question of what might happen if such a high correlation should persist when the economic moment turns south.

I am grateful to the team at Clear Harbor for the dedication and diversity of thought that each member brings to the table. I am proud of the professional resources we have assembled, which we leverage every day as we contemplate, analyze, question, and debate economic trends, investment opportunities, and the mandates and priorities for individual client portfolios.

Most of all, we value our client relationships, and I thank you for your trust in us. With hope that the progress seen on the health and economic front will continue to trend positively in the quarter ahead, on behalf of the entire Clear Harbor team, I wish you a safe, healthy, and pleasant summer.

Sincerely,

Disclosure:

Clear Harbor Asset Management, LLC (“Clear Harbor”) is an SEC registered investment adviser with its principal place of business in the State of Connecticut. Clear Harbor and its representatives are in compliance with the current notice filing requirements imposed upon registered investment advisers by those states in which Clear Harbor maintains clients. Clear Harbor may only transact business in those states in which it is notice filed, or qualifies for an exemption or exclusion from notice filing requirements.

The material contained herein is intended as a general market commentary. The commentary may contain general information and views that are not directly relevant to your particular account. Opinions expressed herein are those of Aaron Kennon and may differ from those of other employees and affiliates of Clear Harbor Asset Management LLC. The information contained herein should not be construed as personalized investment advice. Past performance is no guarantee of future results. Information presented herein is subject to change without notice and should not be considered as a solicitation to buy or sell any security. Any comparison to an index, including the S&P 500 and Russell 2000, is for comparative purposes only. An investment cannot be made directly into an index, which are unmanaged and do not reflect the deduction of advisory fees. This brochure is limited to the dissemination of general information pertaining to its investment advisory services. The current account composition is intended for informational purposes and allocations are subject to change.

For information pertaining to the registration status of Clear Harbor, please contact Clear Harbor or refer to the Investment Adviser Public Disclosure web site (www.adviserinfo.sec.gov). For additional information about Clear Harbor, including fees and services, send for our disclosure statement as set forth on Form ADV from Clear Harbor using the contact information herein. Please read the disclosure statement carefully before you invest or send money.