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Friend of Clear Harbor,

As we approach the heart of summer, economic and geopolitical waves seem to be breaking almost nonstop, creating confusing crosscurrents for investors struggling to get their bearings on inflation, growth and market prospects. For its part, the U.S. Federal Reserve last week decided—reasonably enough—to take stock, holding the fed funds rate at 5.25% after hiking from near zero in a record-breaking 15 months. Yet the churn of news continues.

In the U.S., economic tea leaves are scrutinized in an effort to reconcile resilient stock and labor markets, disparate pricing data for various goods and services, and the future path of monetary policy. Across the pond, the Eurozone appears to have entered at least a mild recession amid stubborn inflation and wobbly business confidence, all complicated by the protracted war in Ukraine. Further east, Beijing has finally restarted China's economic engine after sunseting the world's most restrictive Covid policy, yet both domestic and export-related data suggest the recovery there remains underwhelming at best.

Against such a backdrop, stocks might well have continued last year's downward trend, joined by widening credit spreads and falling interest rates. Yet in the first half of 2023, none of that happened. Equity indexes instead rose, credit has remained firm, and interest rates are broadly where they were six months ago, with short-dated yields slightly higher and longer-dated yields a bit lower.

While most surveys of investors and Wall Street economists still highlight the risk of recession later this year, sentiment has grown less monolithic in recent weeks. Bulls point to employment levels and pockets of consumption that have remained unexpectedly resilient in the face of the Fed's tightening campaign. Yet evidence continues to mount that the U.S. consumer is more stretched today than many recognize, with revolving credit utilization and auto loan delinquencies both rising. Similar data is evident in Europe and China. Moreover, youth unemployment in China now exceeds 20%—most certainly a concern to the Chinese Communist Party. In fact, investors seem to expect Beijing to announce a broad economic stimulus package soon in an attempt to jump-start domestic demand.

Will the balance of 2023 see equity and credit markets rise further, or will the tide turn to favor more cautious investors? We of course cannot know the answer, but we will remain focused on economic data—particularly measures that can illuminate any softening in employment or further deceleration in

inflation pressures. Corporate earnings and insights from management will also provide critical perspective, especially across broad swaths of the equity market that have not shared in recent gains.

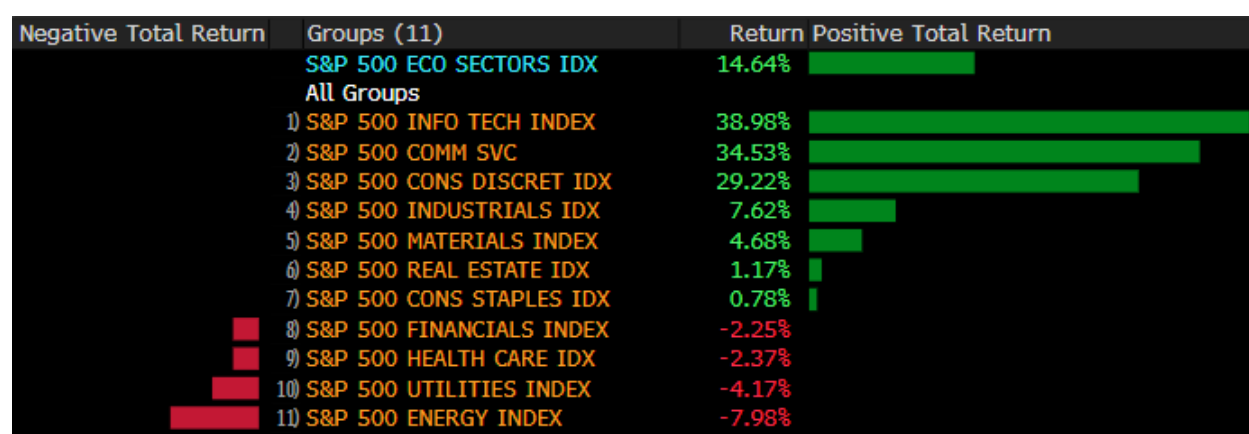
Equities: A Few Standouts Mask Tepid Performance

Some of the gains in major stock benchmarks may seem surprising. For example, the Euro Stoxx 50 has gained 15.8% year-to-date despite a raging war and inflation that is even more persistent than in the U.S.¹ These stocks have been helped in part by attractive valuations and an impressive degree of adaptation across European industry to manage shocks in Russian energy supply.

In the U.S., one surprise has been the very limited number of stocks driving the rally. While the S&P 500 has gained 14.6% this year, advances in just seven mega-cap names—Microsoft, Nvidia, Amazon, Tesla, Meta, Apple, and Alphabet—account for some 80% of that performance. This degree of concentration is highly unusual, and even greater than the 60% of gains that the top seven names represented in the index for all of 2021. It is a particular contrast to the Eurozone, where the top seven performers—ASML, LVMH, SAP, Siemens, Schneider Electric, L’Oréal, and Hermès—have only contributed about 23% of total market returns in 2023, albeit up from 16% in 2021. In Japan, the top seven stocks have contributed 30% of the 16% year-to-date return for the MSCI Japan Index—a decline from 44.8% in 2021.

While we welcome any rally, returns that are beholden to such a small group of companies representing such a narrow sector focus can mask a decidedly tepid broader market. Indeed, because the S&P 500 is “cap-weighted,” those who buy index funds are buying much larger proportions of those companies than the other 493 in the index. When viewed on an equal-weighted basis—i.e., as though you had allocated an equal dollar amount to each of the index’s 500 names—one finds the index better by just 4.7% year-to-date. Some 217 of these companies are in negative territory, and five of the S&P 500’s eleven sectors have generated flat or negative returns.

Year-to-Date S&P 500 Total Return by Sector



Source: Bloomberg LP

¹ Unless otherwise noted, all market data is per Bloomberg LP as of close of trading on June 21, 2023.

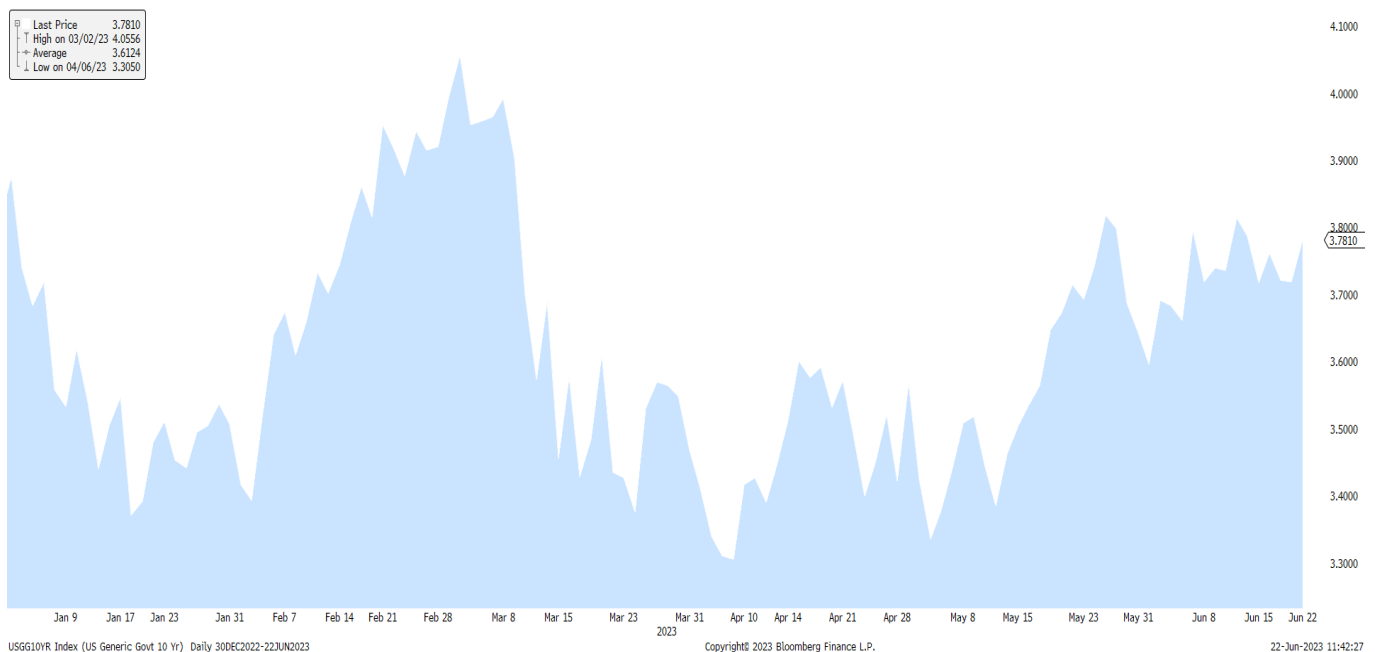
This extraordinary dispersion of performance can also frustrate those who rely on conventional index valuation measures. While the cap-weighted S&P 500 trades at a rather high P/E multiple of 20x for full-year 2023, the equal-weighted S&P 500 is trading at a more historically normal 16.5x. This disparity is largely because the growth-oriented Technology sector represents 28.2% of the market-cap weighted S&P 500, yet only 13.2% of its equal-weighted equivalent. Conversely, the cap-weighted index has just 8.4% of its holdings in the more value-oriented Industrials sector; the equal-weighted index has 15.4%.

Headline numbers seldom tell the whole story. Depending on the selected measure, the same basket of companies can project a very different valuation picture—and an equally different investment profile.

Fixed Income: Nailing Down Skittish Yields

Like the equity market, bond performance this year has been out of whack in ways that top-level comparisons might obscure. For example, many bond yields now stand close to where they started the year, which at first blush suggests relative stability. But along the way, they recorded EKG-like gyrations as investors changed their assessment of inflation risks and the future of central bank policies both at home and abroad. For example, the 2-year Treasury yield was 4.10% in early February, only to rise to 5.07% in early March, dive to 3.76% a few weeks later, then trend back to 4.75% today.

Year-to-Date 10-Year U.S. Treasury Yields



Source: Bloomberg LP

As with the incredible concentration of equity returns in a handful of stocks so far this year, these vicissitudes in sovereign U.S. yields are not normal. Like a tailgating driver shifting rapidly between the gas pedal and the brakes, investors are struggling to assess the future of monetary policy at a perceived inflection point as an historic tightening cycle likely nears its end. Every economic report is therefore

examined for signs the Fed might raise rates a bit further—or instead be forced to pivot and cut rates if employment and growth seem poised to reverse course and trend markedly lower.

Our view is that inflation has already fallen meaningfully, and that its future direction will remain downward without further rate hikes. However, we also recognize that the Fed will not likely get all the way to its 2% target without engineering weaker employment and growth numbers. If that scenario materializes (and it may), I suspect markets will be pleasantly surprised by the speed with which the Fed reduces the fed funds rate and the degree to which rates drop across the maturity curve in response.

To be sure, outright economic contraction would dent credit conditions and widen spreads across both investment grade and high yield segments of the bond market. But in such a situation, we would expect a nice price bounce for Treasuries; the degree of underperformance in high yield and/or investment grade credit would likely be proportional to the severity of any slowdown or outright recession.

This highlights a simple but enduring truth: key components of the sovereign and investment-grade bond market can provide ballast to portfolios during periods of economic weakness and equity market correction. The chief risk to this approach is a “stagflationary” environment in which both asset classes suffer: stocks from the stagnation, bonds from the inflation. In such circumstances, short-term money market funds would likely outperform all else as the Fed prioritizes price stability over growth, and chooses an interest rate posture of “higher for longer.” But stagflation seems unlikely as a 15-month, 500-basis point (5.0%) rate hike campaign nears its end amid declining inflation and emerging signs of weakness across key components of the economy.

“Rolling Recession” and the Post-Covid Economy

A mild slowdown may be a small price to pay to regain price stability. In fact, for more than a year now we have been in a kind of “rolling recession” in which different sectors experience significant fluctuations at different times. This conflicts with the conventional sense of a recession as a singular event for markets, but it may go a long way to reconcile conflicts in the data that have confounded so many economists and market strategists of late.

Overall GDP data may not yet depict an economic contraction in the U.S., but many important sectors, including transportation and retail, have been in recession since mid-2022. Other segments of the economy—from technology to advertising to components of commercial real estate—have seen their own recessionary periods in the last two years, even as the broader economy has stayed mostly positive.

Much of this differentiation is a direct result of the post-Covid environment. Stung by the sudden freeze of supply chains in 2020-2021, retail businesses—and the transportation networks that serve them—shifted priorities from the efficiency of “just-in-time delivery” to the security of “just-in-case inventory.” The economy needs time to work through the large amounts of excess inventory that resulted, giving a breather to industries in those sectors. In other sectors, pandemic-related headwinds have faded or even become tailwinds for margins as raw materials, freight and employment costs normalize. While these adjustments are no longer in their early innings, second-order impacts are still being felt on GDP growth, employment, and corporate profits.

Covid also disrupted the ability of many economists and corporate executives to accurately forecast consumer demand. Past economic cycles provided scant useful guidance at a time of sudden spikes in demand for diagnostic healthcare and remote communication, the ping-ponging from services to goods and back again, and the monumental monetary and fiscal stimulus that funded these trends. While many seek a “reversion to the mean” for demand trends and ultimately corporate profit, great companies adapt quickly to new circumstances, embrace fresh thinking, and innovate new paths toward operational efficiency and increased profitability. In this respect, the pandemic only highlighted what has always been an ever-changing economy and investment opportunity set.

Finally, today’s mixed economic bag is also contributing to the confusing signals from stock benchmarks. Many retail and transport stocks have been clobbered, but their small representation in major cap-weighted indexes has blunted their impact on overall market valuations. In contrast, perceptions of Consumer Discretionary performance have been somewhat inflated by Tesla, whose stock has more than doubled so far this year. Yet Tesla is hardly a bellwether for the U.S. consumer, let alone the thousands of other companies in this sector. If Tesla misses by a penny and the stock tanks, it will take down the entire equity sector—yet for the vast majority of Consumer Discretionary companies, little in their business will actually change as a result. Either way, those relying on S&P 500 headlines for clues to the near future of the U.S. economy must be prepared for surprises lurking under the hood.

Current Investment Themesⁱ

Clear Harbor seldom makes wholesale changes to basic asset class allocations. Yet investment themes do shift and evolve. Here are some worth highlighting as we peer into Q3.

- **Smaller Stocks**

The concentration of year-to-date gains in a handful of the very largest companies has fed speculation that the back half of the year will see a broadening that will lift other components of the S&P 500. I would point out that U.S. small cap stocks have been neglected as well, with the Russell 2000 Index better by just 6.5% YTD. Opportunities also exist within midcap equities, especially for those who believe the U.S. economy will avoid a recession in the near term.

- **Sovereign and Investment-Grade Bonds**

The opportunity to capture meaningful income from investment grade corporates or even U.S. Treasuries is back for the first time in 15 years, a development that represents a profound shift in the appeal of these segments of fixed income. The current yield-to-maturity of the broad U.S. fixed income benchmark, the Bloomberg U.S. Aggregate Bond Index, is approximately 4.7%. (This represents the average annualized return of the index’s components to its approximately 8-year weighted average maturity.) Investment grade corporate bonds of similar maturities currently yield approximately 5.3%.

While we continue to espouse a significant allocation to equities for clients who can embrace a medium- to long-term investment timeline, these bond yields are quite attractive, both on an absolute basis and relative to long-term return expectations for equities. And with inflation trending lower and long-term

inflation expectations still well anchored at approximately 2.25%, we believe the opportunity for price appreciation for bonds over the next few years is real as well.

For those willing to take even more risk, a broad basket of high yield bonds may promise a yield-to-maturity of 8.5% or even higher. While attractive on the surface, such yields reflect the increase in interest rates for the entire bond market, rather than newfound additional premium over Treasuries. In other words, investors are not necessarily receiving much more extra income versus Treasuries than they would have a year ago, despite the greater default risk that high-yielding companies represent at this increasingly tenuous point in the credit cycle. During recessions, it is not uncommon for high-yield spreads to gap to more than 8% over Treasury yields of the same maturity. The current spread for the broader U.S. high yield market is scarcely half that level—just 4.25%, hardly a generous margin of safety.

- International Markets

For investors open to equities of companies domiciled outside the U.S., international valuations in both developed and emerging markets have become significantly more attractive lately, relative to both historical valuations and current U.S. markets. Some of this is because, as noted earlier, U.S. indexes include more companies in higher-growth sectors such as Technology, which represents 28.2% of the S&P 500 vs. 11.8% for the ACWI Ex-U.S. Such sectors do tend to trade at higher valuations, but this factor alone does not seem sufficient to explain the disparity. Clear Harbor's investment team continues to identify other factors that may point to opportunities that carry acceptable risk and appealing value.

- Europe

In some cases, “known unknown” catalysts can help define an investment thesis. For example, a conclusion to the war in Ukraine could spark consumer and investor spirits in Europe. The Continent's industrial behemoths—particularly in Germany—will undoubtedly be central to the eventual rebuilding of Ukraine. Since one cannot know how or when this horrific war might end, such factors are to a degree inherently speculative, rather than core to our investment base case in Europe. Yet over some indefinite horizon, the prospects for rebuilding should prove both real and substantial.

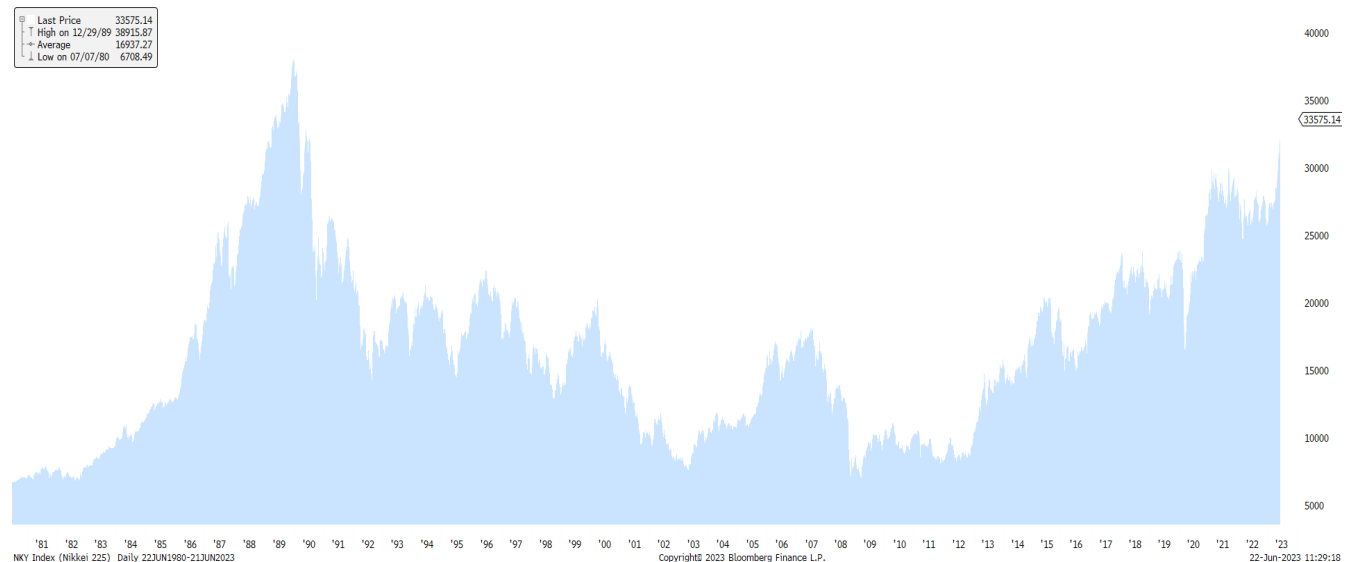
- Japan

One segment of the developed international market where the risk/reward balance appears compelling is Japan. To be sure, the island nation has been dubbed “the widow maker” for its effect on investors since its equity market peaked in 1989. But while we respect this daunting history, several fundamental reasons suggest that change may be afoot in Japan's economy and equity markets.

First, the market remains cheap at 1.3x book value, with 60% of companies trading below book value outright. Second, at the urging of The Tokyo Stock Exchange earlier this year, Japanese companies are sharpening their focus on return on invested capital as a measure of value to shareholders. It is not yet clear when relevant disclosures will become mandatory, but the cultural shift toward greater transparency on these metrics is a significant step toward developed-market norms for corporate Japan.

Third, the weak yen and improving export performance suggest that Japan's stock market benchmark, the Nikkei 225, could be on pace to recapture its 1989 peak of about 39,000. That would be an impressive return from today's levels around 33,000. While a downward move in global equities would thwart such an outcome in the near term, the same factors would still position Japan well to outperform many of its global peers.

Nikkei 225 Index—1980-Present



Source: Bloomberg LP

Finally, a possible “cherry on top” would be any move by the Bank of Japan to begin gradually lifting interest rates. Though certainly not my base case in the coming year, any increase would shore up the yen, and encourage domestic savers to buy Japanese sovereign debt and equities after decades of preferring foreign markets with higher interest rates and stronger currencies. For U.S. investors, the prospect of both rebounding financial markets and an incrementally improving yen make some allocation to Japan a tantalizing proposition.

Artificial Intelligence (AI) and the Fickleness of Mr. Market

A recurring topic at Clear Harbor is the fickleness of the financial media as they pursue the latest market narrative. For example, Nvidia was a poster child for the crypto implosion last year, only to surge in 2023 after blowing analyst expectations out of the water, in part on the heels of AI-related demand growth.

AI was certainly a factor in Nvidia's change of fortunes, and speculation around the potential for AI fueled stock gains for the other large companies that have driven the S&P 500's climb this year. But Nvidia is certainly not alone in experiencing a narrative whipsaw. Earlier this year, Microsoft's announcement of its investment in ChatGPT led many investors to incorrectly speculate that Alphabet was dead on its back and unable to meet earnings growth expectations. The story was that Microsoft was eating Alphabet's lunch. After a brief market correction in the stock price, cooler heads prevailed: recognition finally grew that Alphabet has been working on AI for years, and will likely remain a

dominant player in the space. Such reversals of reputational fortune illustrate the folly of accepting “conventional wisdom” uncritically.

Portfolio Considerations

My thoughts this quarter are particularly suited to highlight an enduring investing principle: the value of thoughtful diversification. A commitment to diversification remains central to our asset allocation philosophy, and is the primary context for our hunt for relative value between and within asset classes.

Because bonds appear attractive at current levels, they will tend to contribute more of a typical balanced portfolio’s return in the quarters and perhaps even years ahead. But we will also respect another principle: remaining invested with core allocations, even as we seize incremental opportunities to benefit from market dislocations and valuation shifts.

Other commitments continue to guide us as well. We will not attempt to “time” markets; we will remove emotion from our own allocation decisions as best we can, while recognizing that times of excessive optimism or pessimism in markets can create opportunity for patient and disciplined investors. We strive to read widely, remain curious, and stay humble.

One particular lesson learned over decades of experience: do not try to apply geopolitics to market valuations. Do not try to trade around a war, a debt ceiling deadline, a presidential election outcome, or even the prediction of a recession. Two Gulf Wars, 9/11, the Asian Financial Crisis, the Mexican peso debacle, the collapses of Enron and Long Term Capital, the Great Recession of ‘08-09, the Covid Pandemic, the war in Ukraine: after each of these, companies and entire nations adapted, and markets rebounded. But those who lacked portfolio management discipline too often sold into chaos, rebought in frenzies, and went headlong into cash at precisely the wrong time in a market cycle.

The right investment process does not render us immune to emotion or error. But as we wade into the back half of 2023 our focus, as always, will be on the specific course for portfolios and broader wealth management priorities we have charted for each of our clients—whether individuals, families, charitable organizations, or corporations. I hope that the summer treats you and your families well, and welcome you to reach out to us at any time.

Sincerely,

A handwritten signature in dark ink, appearing to read "Paul J. Huns". The signature is fluid and cursive, with a long horizontal stroke extending to the right.

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