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Friend of Clear Harbor,

Following a year in which Covid-19 steamrolled the economy and wrought havoc on lives around the world, 2021 brought a measure of long-awaited stabilization. Despite a still-rising death toll, new variants, and supply-chain problems pumping the brakes on the global reopening, the year is poised to end with significant economic momentum, backfilled in large part by record levels of debt-fueled fiscal stimulus. In the U.S., full-year GDP growth will likely register around 5.5% after contracting 3.5% in 2020.

As we peer into 2022, we expect to see further normalization of the economic picture as supply-chain bottlenecks are improved, vaccination rates increase, and fiscal stimulus and key measures of inflation in the U.S. both decelerate. These trends should give the U.S. Federal Reserve latitude to begin unwinding their extraordinary asset purchases sparked by Covid, even as they continue to ponder the timing and degree of actual hikes in the Fed Funds Rate. Our view is that while the Fed would prefer to bring rates back toward a more traditional relationship with inflation, speed bumps in the economy as well as political pressures from massive debt could inspire a dovish posture for longer than many expect.

While most other developed-market central banks face similar constraints, in many regions the inflation environment remains more benign, reducing the urgency to tighten. Both the European Central Bank and the Bank of Japan perceive more room to continue their ultraloose policies as they seek a more sustainable economic footing. Meanwhile in China, recent deceleration in GDP, paced by the credit-induced deleveraging of key swaths of their real estate market, has forced central planners to actually ease monetary policy. So while we would like to foretell a degree of economic synchronization for markets and the global economy next year, the reality is that a number of strong crosscurrents are likely to continue to influence outcomes in 2022 and beyond.

#### 2021: Market Review

2021 saw equity returns pop across developed markets, with the S&P 500 Index racing ahead 24.7% YTD and the broad global equity benchmark, the MSCI All-Country Index, jumping 15.8%.<sup>1</sup> Stocks were boosted by interest rates that remained well below historical measures of inflation, prodded by central

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<sup>1</sup> Equity, fixed income and commodity returns mentioned in this document are as of market close on December 17, 2021.

banks and other large natural buyers. This defied a long-suffering consensus that rates would surely rise markedly in the face of inflation, which this year approached levels not seen since the early 1980s.

In part due to sustained central bank action, bonds ended the year nearly unchanged—off by scarcely 1%. The accompanying strength of the dollar hurt emerging markets, where financial assets also suffered from a decelerating China and rocky efforts to vaccinate large, generally poorer populations.

#### 2022 Outlook: The Economic Backdrop

In the U.S., 2022 will likely see far less fiscal intervention as Covid-related shutdowns wane. For context, federal stimulus represented some 15% of U.S. economic activity in 2020, and a still-remarkable 5% in 2021. Not only did federal spending reach heights not seen since WW II, but a range of novel programs turned the spigot directly into the bank accounts of nearly every American. As this unprecedented gusher into household coffers slows to a dribble, we look for consumer spending to decelerate in the quarters ahead, ultimately bringing growth nearer its pre-Covid trend of 2% as early as 2023.

With that said, we see little risk of a reversal into recession. First, stimulus will not disappear entirely: even with Senator Manchin's recent blow to President Biden's "Build Back Better" plan, \$1 trillion in infrastructure spending will be spread over the next five years. Second, in a sign of economic health, consumers are transitioning back to more traditional consumption patterns, with evidence of a gradually normalizing balance between spending on services versus goods. This should help reduce the supply-demand imbalance for many goods that has been a significant cause of recent inflation headlines.

While we expect most reopening trends to continue in the U.S. despite the Omicron variant, much of the world faces renewed lockdown mandates and related reductions in consumer and business confidence. This is evident for instance in Europe, where Austria, Germany, and Holland are again experiencing significant Covid-related restrictions. European lawmakers may well lean more heavily on fiscal levers in response, even as stimulus funding runs its course in the U.S.

Nor are stubborn Covid uncertainties the only concern for international growth. China is witnessing the abrupt downward pressures in prices and possible bursting of a classic real estate bubble, which has dampened consumer activity and growth significantly just over the last few months. The degree of concern is reflected in recent action to cut reserve requirements, in hopes that looser borrowing can help stimulate the country's already overleveraged consumer economy. Even as these policy actions support demand for consumer goods and services within China, demand from Europe and U.S. should help the communist nation's export industries to recover, or at least to mitigate any recession.

Consensus growth expectations for 2022 in the U.S., the Eurozone, and China have all trended lower of late and are now at 3.9%, 4.2%, and 5.2% respectively. In fact, while economic activity may prove less than synchronous in 2022, a combination of continued monetary and fiscal accommodation in Europe, coupled with renewed stimulative policies in China and rising vaccination rates in emerging markets, could provide incremental growth to these otherwise diverse figures in the global economy.

## 2022 Outlook: Financial Markets

As we highlighted just one quarter ago, in the year ahead investors must grapple with an all-but-inevitable deceleration in growth, the timing and nature of monetary action, the scale of federal spending and deficits, and geopolitical tensions that too often fester unnoticed until they burst into the headlines. All these factors may impact outcomes for investors and entire economies—and leave markets poised for meaningful increases in volatility at a time of near-record valuations.

- Volatility and Valuations

Before wading into the details of individual asset classes, I want to note several reasons for volatility to manifest itself next year across the board. First, monetary support will almost certainly decline, yet consensus economic forecasts reflect a wide range of potential outcomes. Asset classes may well ebb and flow, and sector rotation become choppy, as investors scramble to adjust to shifting perceptions of how data and market prices will evolve over the medium to long term.

While a degree of volatility is a normal and healthy characteristic of properly functioning capital markets, it can dampen valuations, even if earnings growth (for equities) and default rates (for bonds) paint a rather positive economic picture. In the weeks and months ahead, we will monitor asset-class-level volatility in real time, recognizing that an environment of historically elevated valuations can invite outsize market reactions. This can be driven by investors nervous to protect long-held gains.

- U.S. Equities

2021 recorded unprecedented earnings growth in the U.S. after a violent decline in 2020, and equity markets rewarded this growth handsomely. However, the breadth of these trends diminished into year-end. While averages remain at or near records, approximately 10% of stocks in the broad U.S. equity market have recently corrected by more than 35% from their peak price levels.<sup>2</sup> Among growth stocks, we also note the stark performance difference between small-cap and large-cap this year, with the Russell 2000 Growth Index off by 0.2% against a leap of 27.9% in the S&P 500 Growth Index. Similar factor-level performance dispersion can be seen outside the U.S. equity markets as well.

We remain constructive on the long-term prospects for U.S. equities, yet recognize that valuations appear incrementally stretched relative to historical norms. The trouble is not earnings per se: for 2021, earnings look set to have grown approximately 50% on a year-over-year basis and 28% since the end of 2019, the last full pre-Covid year.<sup>3</sup> Moreover, consensus estimates point to further profit growth of about 5% in 2022—still healthy, albeit lacking the punch of the post-Covid snapback.<sup>4</sup>

The greater valuation risk is the price multiples applied to those earnings. While we believe that profits can continue to grow along these lines, we question the ability of multiples to expand. The prospect of greater and more frequent spikes in volatility could keep P/E ratios in check, and even compress them—

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<sup>2</sup> Broad U.S. equities as reflected in the Russell 3000 Index.

<sup>3</sup> JP Morgan

<sup>4</sup> Estimates compiled by Bloomberg LLP as of December 17, 2021.

even if the ultimate trajectory for earnings proves nicely higher over the course of 2022. With current P/Es for large cap U.S. stocks at 40x, room for error is scant.

In another measure of lofty valuations, the current dividend yield of the U.S. equity market is approximately 1.3%—the second-lowest level on record for the S&P 500, after a brief period before the Dot-Com crash in 2001. To be clear: we see none of the fundamental weakness that precipitated that historic correction. Still, it is a sobering yardstick to consider in the year ahead—particularly if yields within the safe haven of bonds increase substantially further, robbing equities of some of the comparative advantage they have enjoyed in recent years.

- Inflation and Earnings

If supply chain bottlenecks and accompanying inflation readings moderate in 2022 as I expect, look for interest rates to remain well anchored, helping to calm equity investors. However, a more stubbornly inflationary environment—particularly one driven by “sticky” jumps in housing and wages, as opposed to things like energy and metals costs, which can come back down once supply is restored—could dampen optimism for earnings growth. Too much inflation, or simply the wrong type, could in fact compress margins outright, and perhaps even constrain topline revenue growth for many companies.

We believe the direction and rate of change of inflation will have a rather significant impact on asset class level performance in 2022. Lower inflation could auger a return to a more “Goldilocks” picture, boosting equity markets and in particular growth-oriented sectors such as information technology, consumer discretionary, and communications. Conversely, more stubborn inflation, especially if coupled with reasonably strong growth, could push up sectors such as energy, materials, financials, and perhaps consumer staples and industrials.

- Could European Equities Outperform?

Earnings look set to notch a whopping 65% gain in the Eurozone for full year 2021, with nearby UK earnings surging 86% from the extraordinary lows of 2020. Consensus estimates are for earnings to trend higher by a further 20% in the Eurozone in 2022, along with improvement of approximately 12% in the UK.

A much-debated question for 2022 is how well corporations in Europe are poised to capitalize on opportunities to alter the world’s energy mix, embrace renewables, modernize electrical grids, and even overtake the U.S. in the longer race toward automobile electrification. Given the outsize presence of major industrial companies in European stock indexes, this question is of particular interest to investors considering allocations within the Continent.

One advantage for European firms is that parliaments in the region have enacted regulatory frameworks to strongly encourage decarbonization. The assurance that such investments will be more uniformly embraced and distributed can only help innovators there, irrespective of the experience and creativity of their management teams relative to their U.S. peers. (Imagine the political earthquake it would take for “green” initiatives and incentives to take hold across all 50 of these United States!) For these reasons

alone, U.S. companies competing for capital and business opportunities have a much longer road to travel within this high-growth segment of the global industrial economy.

Other reasons for optimism in Europe include superior prospects for fiscal stimulus to be sustained, and lower inflation. In addition to the other economic benefits, relatively stable prices should allow the European Central Bank to remain more accommodative relative to the U.S.

Lastly, valuations in Europe are historically low, both on an absolute basis and relative to U.S. equities. When viewed through the lens of a cyclically adjusted P/E ratio, U.S. large caps are approaching 40x versus just 18x in the Eurozone. While this divergence can be explained in part by the lower weighting of high-growth sectors in Europe, we consider this dispersion unusually pronounced at the moment.

When combined with tailwinds that appear stronger from both government spending and monetary policy, this makes a compelling case for incrementally higher equity returns in the year ahead. Japan also represents an economy with strong prospects for above-trend growth coupled with below-average inflation pressures; valuations there appear relatively attractive there as well.

- China & Emerging Markets

Emerging Markets underperformed significantly this year, with Chinese equities the principal drag on returns. Chinese equities are off by 22.1% so far this year, versus a stumble of just 3.8% for the entire MSCI Emerging Markets Index—a whopping 18.3% dispersion. Since China represents nearly one-third of the entire index, the components outside China actually held up reasonably well.

I have long sought to significantly underweight direct exposure to Chinese companies, and thus happily avoided a great deal of this year's carnage in the country's equities. As we wade into 2022, I recognize that earnings growth will likely rebound, which could increase prospects for P/E multiples to narrow the gap with developed markets. Nevertheless, the very investment opportunities that continue to exist in China still carry significant pitfalls. While the pop of a real estate bubble anywhere will have financial ripple effects, the havoc has been especially pronounced this year in China—an economy where policymakers were desperate to transition to a consumer-driven, demand-side model.

Other concerns about investing in China have not abated. How will recent regulatory crackdowns on sectors ranging from education to social media impact the global flow of capital in 2022? Will investors have short memories, conclude that the tone within the CCP has become more constructive, and dip their toes back into that market in 2022?

I am skeptical of calls for Chinese equities to outperform the broader EM opportunity in the years ahead. However, it is obvious that investors have soured on China, and equities there could certainly rebound in response to an unexpected return of liquidity. We are often humbled by markets and their ability to behave in ways that fundamental and geopolitical analysis would likely not predict.

With all of that said, I still believe that demand-side trends in China can be captured through exposure to other EM and even developed market economies. Indeed, opportunity within EM does not just emanate from demand within China: to a great extent, it is a function of a rising middle class across

many key regions, with increasing domestic demand for goods and services going hand-in-hand with improved regulatory environments and policies that are more supportive of capital formation, economic growth, and healthy equity market conditions.

For example, we see this constructive thesis playing out in the largest democracy in the world: India. Many of our EM products and strategies allocate an overweight to India relative to China, a trend that we believe will bear further fruit in the years ahead.

- U.S. Dollar and Emerging Markets

For emerging markets outside China, the strength of the U.S. dollar will prove critical in the new year. Continued dollar strength would pose an incremental headwind to corporates and countries in the region that have seen their revenues decline and their cost of funding their debts rise.

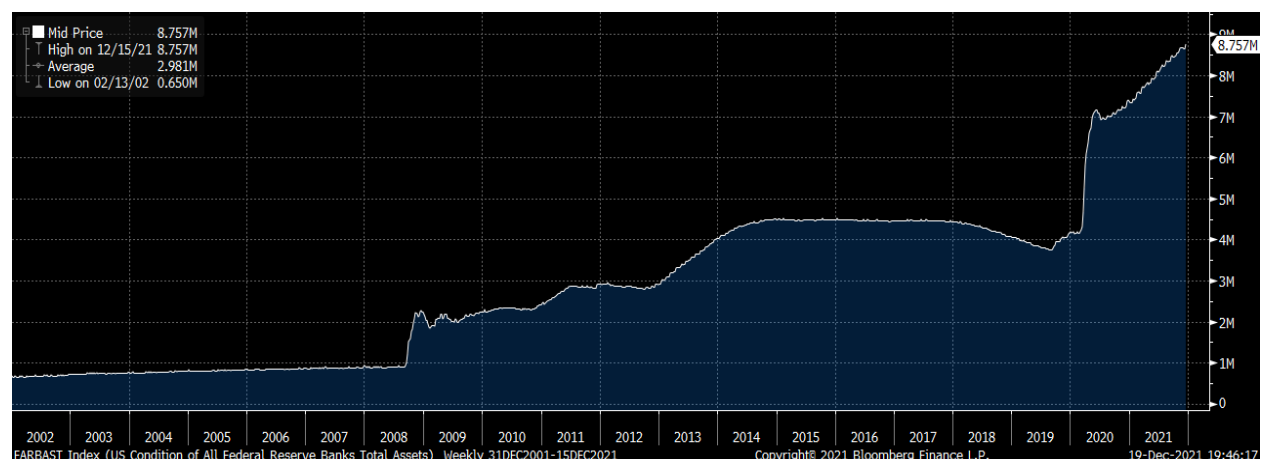
Like much else, the question of debt costs in emerging economies turns in large part on the evolution of interest rates in the U.S. Rate hikes here would attract investors around the world, depriving smaller and younger economies of capital. While we believe the Fed will taper its extraordinary asset purchases in 2022, my personal view is that raising rates will prove far more challenging. If this thesis evolves into market consensus, I expect the value of the U.S. dollar would peak and eventually decline, to the relief of indebted companies across the emerging world.

This may not be a Q1 2022 event. However, the latter part of 2022 should provide useful tea leaves regarding growth and inflation that will inform the Fed's thinking.

- U.S. Fixed Income

At first blush, the trend is clear: 2-year U.S. Treasuries that began the year yielding 0.12% now hover at 0.64%; 10-years that started at 0.91% now trade at 1.40%. It would seem a clear case of interest rates finally rising as we near the end of the extraordinary economic crisis sparked by Covid-19—and the equally extraordinary response of the Federal Reserve, which more than doubled its balance sheet since the end of 2019 in an effort to keep credit spreads and bond yields low.

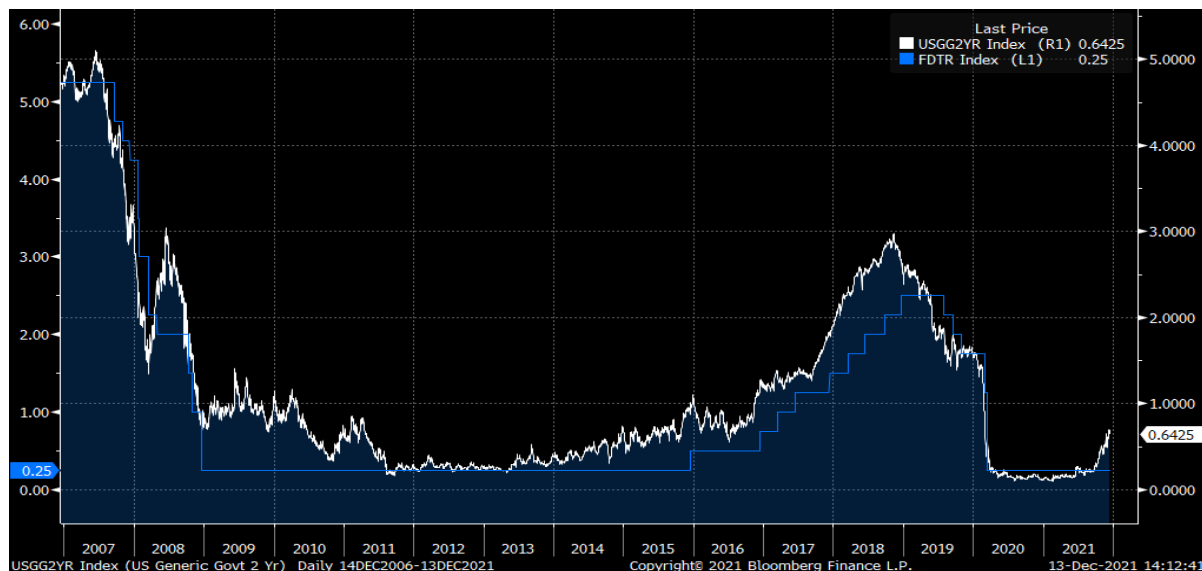
#### FED Balance Sheet—Last 20 Years



While true as far as it goes, this analysis is incomplete. The key missing fact is that while 2-year yields are near their high-water mark for the year, 10-year yields peaked in March. The two segments of the Treasury market have behaved quite differently since then.

Why is this? The answer is that shorter-maturing bonds are more sensitive to shifting expectations about changes in course at the Federal Reserve, whereas longer-dated bonds tend to reflect investor expectations for longer-term inflation and, to some extent, growth. The chart below illustrates just how smartly 2-year Treasuries tend to anticipate moves in the Fed Funds Rate.

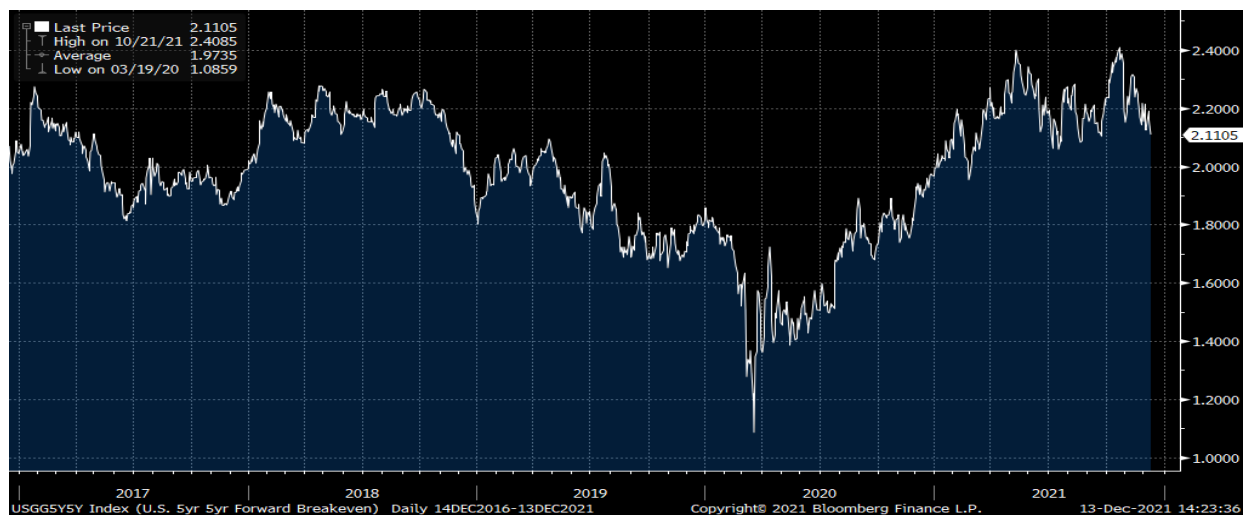
#### U.S. 2-Year Treasury Graphed Against Fed Funds Rate—Last 15 Years



In today's market, the rise in shorter-maturity interest rates seems to reflect the growing recognition that the Fed plans to reduce its unconventional, Covid-induced asset purchases soon, and to start raising interest rates at some point during 2022. Based on the current pricing of Fed Funds futures contracts, market participants in the aggregate expect the first quarter-point rate hike in the spring, with a second in the summer or early fall. Markets do not expect a third until early 2023.

What about looking further down the road, where investors are more concerned with the path of inflation? Market participants are clearly unwilling to allow a rate of return anywhere near the long-term expected inflation rate of 2.11%, let alone the most recent Consumer Price Index reading of 6.9%. On the contrary: 10-year interest rates have *fallen* some 0.35% since peaking back in March.

## Market Indication of Longer-Term Inflation—Last 5 years



Another reassuring point: current market metrics point to a rate of long-term inflation that is scarcely 0.14% higher than the five-year average—hardly cause for panic. To be sure, market prognosticators continue to voice a range of opinions on this topic. But on the whole, those who are putting their money where their mouths are seem to think that Covid-induced supply bottlenecks and demand spikes will pass without spurring a 1970s-style inflation spiral.

These reflections of bond-buyer sentiment are not infallible, but they are important tea leaves. Unlike a prediction from an individual analyst or investor, they represent the expectations of all market participants allocating to the segment. On balance, those expectations are for Fed Funds rates, at long last, to rise a bit in the coming quarters, but with inflation moderating in the ensuing years—leaving less room for the Fed to raise rates on the way up than many currently anticipate.

- Gold

A strong dollar and surging cryptocurrency landscape provided a headwind to gold in 2021, leaving the yellow metal off approximately 5.5% YTD after an extremely strong 2020. While higher interest rates in 2022 will likely keep the dollar more appealing than, say, the euro, we also see dampers on the dollar from a meaningful deceleration in the rate of economic growth. We also believe that while crypto could continue trending skyward in 2022, high volatility within this still-emerging asset class could send incremental dollars back into gold. I maintain my conviction that the world's single most iconic store of value continues to behave like an alternative to other currencies that may come, stay or go, and that it can merit a modest allocation to help mitigate risk in multi-asset class portfolios designed for positive overall returns.

### 2022 Outlook: A Deeper Dive

The thoughts I put forth each quarter do not emerge from a vacuum. It is a privilege, a joy, and at times quite a workout to exchange views within Clear Harbor's investment committee and our larger network.



This diversity of experience and opinion helps keep all of us humble in the face of volatile markets, and perhaps a bit readier for the unexpected than any individual might be if limited to our own perspective.

As we look toward 2022, I want to highlight three areas of continuing inquiry and debate: the trajectory of inflation, the “glass half full” vs. “glass half empty” arguments on the U.S. economy, and supply chain and inventory management in the post-Covid world. All are consequential for my thesis around equities, which remains generally constructive, albeit more moderately so in the wake of this year’s large gains.

- The Trajectory of Inflation

It may still be the minority view on Wall Street, but my view on inflation remains that its recent rise is driven by Covid-related supply chain shocks and temporary spikes in demand, both of which should normalize in the coming quarters. Despite some arguably overdue gains in recent months for lower-end workers in such industries as retail and hospitality, overall wage growth has yet to accelerate meaningfully now that enhanced unemployment benefits are no longer competing with employers for the attention of workers. Employment in general seems on track for a reasonably strong recovery in the year ahead, which should benefit workers, businesses and consumers alike.

If the labor market tightens more widely, worker demands for higher pay could indeed go beyond “anecdotal and incremental” to become more widespread, helping to broaden and possibly entrench inflation trends. But I am skeptical of such a wage-price spiral taking hold for several reasons. Chief among them are advances in productivity, especially through technology, which can increase a company’s output without increasing its costs; prospects for improvement in the U.S. labor participation rate, which I believe has room left to normalize toward pre-Covid levels; and an anticipated rise of supply of goods and services to meet current demand.

Again, there is considerable discussion of this subject within our firm, and indeed heated disagreement about it across the larger financial community. Should I prove materially wrong, it could present an important challenge to my constructive equity thesis. Indeed, I believe that normalized inflation is essential to an upward sloping equity market in the new year.

If this thesis proves out for 2022, we could see declining inflationary pressures despite above-trend GDP growth (though lower than 2021’s “snapback” numbers), and a Federal Reserve still able to persuade markets of its power to calm the capital markets should new economic fissures appear. Conversely, if inflation remains stubbornly high in 2022, investors may feel uneasy that the central bank’s “monetary put” has lost its magic, leaving few wands up its sleeve with which to entrance market participants.

- A GDP Half Full: Money Supply, Interest Rates and the Fed

In what I consider a welcome bid to preserve its credibility and restore its “dry powder,” the Fed is starting to reduce their Covid-sparked asset purchase program, which could well be completed within 4-6 months. It feels urgent to me that they do so. In less than two years, the Fed’s balance sheet has increased more than \$4 trillion, to approximately \$9 trillion—including an increase of 20% within the

past 12 months, even as vaccines rolled out and the economy boomed back to life. This has created unprecedented growth in the money supply (M2) which now stands at approximately \$21 trillion.

Furthermore, interest rates are not merely at rock-bottom from an historical standpoint: they are decisively negative on an inflation-adjusted basis. And whereas certain types of fiscal policy from Congress can impact the economy very quickly, the full impacts of any tightening in monetary policy tends to lag for about a year. Which is to say: it is in some regards easier to turn the fiscal spigot on than to cut the monetary taps entirely.

Because of this lag factor, even aggressive action by the Fed might not be felt much until 2023. In fact, some economists, including the #1 *Institutional Investor*-ranked Ed Hyman, suggest that real GDP growth will remain well above 4% in 2022, with nominal growth as high as an estimated 7.5%.

- A GDP Half Empty: Consumer Exhaustion, the Savings Rate and Public Debt

On the other hand, other thoughtful economists see evidence of consumer exhaustion in the U.S. They point to savings rates that, while certainly off the historic highs during the lockdowns of 2020, remain somewhat elevated. In fact, recent data from the University of Michigan portrays a consumer who has had their fill of durable goods (washing machines, refrigerators, gas grills). With that said, consumers are now displaying greater interest in dining, travel and entertainment—a welcome rebalancing of spending patterns that should help ease inflation in key goods. So while the Omicron variant will surely have a say in how reopening trends proceed, we still believe they will prove generally positive for full-year 2022.

We are also mindful that a generational reversal in the direction of interest rates will have a meaningful impact on investor psychology, to say nothing of the real cost of funding nearly every aspect of the economic life of an individual, family or business. A decade of effectively free borrowing has greatly buttressed sales of cars, homes, and other goods and services, and spurred aggressive moves in public and private equity markets, housing, and government bond issuance. It is hard to ignore the downward pressure that markedly higher rates could apply to valuations across all of these asset classes.

However, the widespread fear of such pressure is the strongest argument against it coming fully to fruition any time soon. As debt-to-GDP ratios skyrocket both at home and across many developed and emerging market economies, the economic and government imperative to keep rates at historic lows is more apparent than at any point in our lifetimes. When policymakers argued for a balanced budget amendment during Ronald Reagan's presidency, U.S. national debt as a percentage of GDP was less than 40%; today it is 130%. Should rates rise against such a backdrop, the constraints on budgets for everything from national defense to Medicare and Social Security could quickly become severe.

- Global Supply Chains and The Future of Inventory "Management"

The last element in my cautiously constructive equity market perspective—and an admitted risk to it—turns on meaningful improvements in supply chains. As I write, the number of container ships at the Port of Long Beach—the nation's largest—is at a record high. I believe that some of the employment

gains in 2022 will accrue to those working on the docks, in the trucks and on the short rail lines that are currently in desperate need of additional labor to finally normalize our nation's logistics.

Furthermore, clearing the logistical clogs here in the U.S. may well coincide with increasing the supply of semiconductors, a global commodity that continues to experience levels of unmet demand that are crippling a range of industries. From handheld mobile phones to automobiles, a thawing in this supply/demand challenge could bode well for both sales growth and price stability for a wide range of goods currently in short, and therefore expensive, supply. While real progress may be delayed until late 2022 or even 2023, I believe strongly that normalization is still a question of "when" rather than "if."

With that said, I acknowledge that with every passing quarter, high prices arising from these "temporary" bottlenecks may encourage more permanent gains in wages and prices overall. Should such trends develop, my own view that inflation will trend back below ~3% could prove optimistic. Clear Harbor's investment committee is keeping several global price trends on our radar as we assess prospects for inflation to remain above its historical trend of approximately 2% in 2022 and beyond.

It is also possible that our "short-term" supply chain problems may have a long-term solution: deglobalization. As political and trade frictions increase between China, developed nations in Asia and much of the West, global companies may incrementally shift manufacturing away from China and toward alternative countries in the region, or even "reshore" aspects of production nearer the home office in, say, Stuttgart or Chicago. Either course likely promises better supply reliability and corporate security. However, such decisions likely incur higher wages, and sometime higher transportation costs as well. They also run the risk of angering the world's most populous and promising consumer base: China.

Realistically, how much can companies shift from "just in time" delivery, leveraging the efficiencies of meticulously crafted global supply chains, to a "just in case" model, which is in some respects a throwback to traditional practices of maintaining excess inventory as a buffer against future supply bottlenecks? The challenges will vary from industry to industry, and priorities will vary from company to company. But any meaningful shift in the aggregate will have significant ramifications for how economists assess the course of economic cycles. And it will require greater investment and advancements in technology than the ones we saw in the low-cost, high-efficiency decades that preceded the earthquake known as Covid-19.

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While I am increasingly confident that the economy will make its way forward as our society learns to live with the virus, on a personal level we face a second holiday season amid renewed risks to health. Accordingly, I recognize that in the new year it may be prudent for much of our connecting with our clients and partners to remain, for a while longer, remote.

Regardless of the method used, the Clear Harbor team is looking forward to seeing as many of our clients as possible in the year ahead. I am grateful to my colleagues for being such a diverse, thoughtful and compelling resource about markets and the economy. On behalf of all of us at the firm, I thank our

clients for the continuing opportunity to bring our consultative approach to the construction of investment portfolios and overall wealth strategies that fit your individual life and financial goals.

I wish you the very best of health and happiness for this holiday season and in the new year.

Sincerely,

A handwritten signature in dark ink, appearing to read "Aaron Kennon", with a long horizontal flourish extending to the right.

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