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Friend of Clear Harbor,

Russia's unprovoked attack on Ukraine has dealt a blow to economic expectations and the confidence of consumers and investors around the world. Year-to-date, global equity indices are off approximately 8%, while broad measures of fixed income have shed 5.5%. Meanwhile oil has surged more than 40%, gold is higher by more than 6%, and soft commodities and industrial metals are nearly all measurably higher as well.[1]

While we hope that Russia will halt their invasion and that the West can address the humanitarian crisis in Ukraine, our fear and base case is that this war will continue, leaving thousands more dead. It has already steamrolled key economic assumptions. When I peered into 2022 at the end of 2021, I forecasted higher market volatility in the face of rapidly waning fiscal stimulus and an incremental ebb from historically accommodative monetary policy in the U.S. However, I also believed that these shifts, coupled with a transition toward Covid as an endemic but more manageable public health concern, would allow inflationary pressures—albeit still historically elevated—to wane significantly in 2022.

Q2 Outlook: Inflation

Like battle plans themselves, inflation expectations rarely survive contact with the enemy. Since Russia's incursion, inflation has jumped despite significant improvement in both Covid data and supply chain performance through major U.S. ports, which had been the root cause of shortages that sent prices of tradable goods higher last year. Key readings of inflation are now driven by surging prices for oil and natural gas, along with spikes in key agricultural commodities such as wheat, corn, and barley. Ukraine and Russia together produce approximately one-quarter of the world's wheat, and with the spring planting season around the corner, further spikes in soft commodities are distinctly possible.

The resolve that a unified NATO and other allied nations, including Japan, have shown in support of sanctions further supports expectations of stronger and longer-lasting inflationary pressures. Additional emerging variables that may prolong pricing uncertainties include new Covid-driven lockdowns in Shenzen, which have idled some key Chinese manufacturing facilities. Parts of Shanghai and Hong Kong are also shuttered, disrupting anew the flow of produce, manufactured goods, services and human

[1] All data is per Bloomberg LP as of the close of trading on March 21, 2022.

capital. Just a few days ago, the communist nation seemed poised to reverse course, recognizing that lockdowns may delay rather than prevent the inevitable spread of the virus while wreaking economic havoc on their own export-sensitive economy. So much is in flux during this moment of uncertainty.

While inflation may not crest until later in 2022 or even 2023 for these reasons, I still expect we will avoid a 1970s-style wage-and-price spiral—though due to a different and unencouraging cause: slower growth. Indeed, key metrics already point to a swift economic deceleration worldwide. From significant weakness in U.S. consumer confidence, to the collapse of several leading indicators in Europe, to ongoing growth challenges in China, we may already be in the midst of a synchronous global economic slowdown that few foresaw just one month ago.

A canary in the coal mine may be the Producer Price Index in the U.S., which showed that aside from energy and food, prices rose just 0.2% in February—well below average estimates of 0.6%. Similarly weak readings have emerged for overall retail sales as well. If these data points were to broaden into a trend, I would look for Treasury yields to stabilize, and for the shift from value to growth within equities to find a basis for reversing course. Until we see evidence of a more broad-based thawing of price pressures, we are respectful of the broader data set, which points to persistently high inflation readings. Evidence that this could prove stickier would certainly alter components of our economic and investment outlook in the quarters ahead.

Q2 Outlook: Equities

The potential for equity weakness in the near term should not be underestimated. On a technical basis, key indexes have seen lower highs and lower lows since late January. On a fundamental basis, investor caution toward equities could persist amid well-grounded fears that corporate profitability could underwhelm for full-year 2022 in the face of higher costs, rising interest rates and wavering consumer confidence. Indeed, while our base case for 2022 does not include a recession—i.e., two consecutive quarters of negative real economic growth—recent data does suggest that the odds of one this year have risen markedly. Labor statistics, equity valuations, energy prices, manufacturing health, consumer behavior, the shape of the Treasury yield curve, and central bank policy likewise argue for potential equity weakness amid continued volatility.

With all of this said, our approach to asset allocation reflects the individual risk tolerance and return objectives of each client over both the short and long term. We generally try not to “time” markets given overwhelming evidence that doing so is fraught with its own risks, including tax consequences and the real possibility of missing any eventual rebound. However, we do keep a keen eye on shifting fundamentals and the relative valuations of companies, sectors and entire asset classes, which can and do justify incremental tactical shifts in specific portfolios. Our ultimate commitment is to remain humble in the face of inherently unpredictable markets, and to stay grounded to longer-term expectations of asset class performance rather than short-term gyrations and ever-shifting analyst buy-and-sell ratings.

The Fed’s Predicament

The persistence of inflation and Covid flare-ups in key global manufacturing regions amid otherwise slowing global growth presents a conundrum for the U.S. Federal Reserve. Keeping policy extremely loose would seem to court further inflation; yet, tightening now might choke off a fragile recovery.

At the moment, the Fed is committed to begin the tightening campaign that many have been waiting for since before the pandemic. Last week the Fed increased the overnight lending rate for the first time in more than three years, bringing it off the zero bound to 0.25%. Even more important, members of the Fed's Open Market Committee have signaled seven such hikes in 2022, and three or four more in 2023.

This course of increases is intended to slow the economy to allow inflation to subside, but doing so without tipping into recession will require the Fed to walk a knife's edge. The current Wall Street consensus calls for 3.3% growth in the U.S. and 4.0% globally this year; looking ahead to 2023, the FOMC's membership has converged on forecasts of 2.2% GDP growth, 2.4% inflation, and 3.5% unemployment. Given the trajectory of recent data, I find these projections too rosy to serve as a base case for investors. If so, the Fed may be forced to reconsider the pace of its tightening campaign.

Of course, the Fed is free to change tack at any time. Indeed, the current Fed leadership emphasizes its responsiveness to data, and returned quickly to an accommodative posture in the face of slowing growth in July 2019—months before the pandemic provoked an all-out cut to zero percent. So, while we expect the Fed to raise rates more than once this year, the nine hikes that a few leading Wall Street economists predicted just a few weeks ago now appear aggressive. Even within the Fed, the dispersion of opinion is quite wide on this question, with FOMC members' projections of the Fed Funds Rate at year-end ranging from 1.25% to 3% for 2022, and 2% to 3.5% in 2023. And just yesterday, Fed Chairman Powell gave a speech indicating that "there is an obvious need to move expeditiously to return the stance of monetary policy to a more neutral level, and then to move to more restrictive levels if that is what is required to restore price stability." This shift in policy posture just five days following the FOMC meeting where the Fed raised rates 0.25% seems to suggest that a more aggressive rate hike path could take shape as soon as the May Fed meeting where perhaps we see one or more 0.5% rate hikes by midyear is now possible.

Failing to raise rates in the face of rising inflation carries significant risks and the Fed seems to be coming around to this reality. However, recent surveys still reflect market expectations that after a few more months at elevated or even somewhat increasing levels, inflation will start to wane in the back half of the year or early in 2023. If so, the Fed's potential shift to 0.5% rate hikes later this Spring could prove temporary if pricing pressures subside and growth estimates continue to ratchet downward in the quarters ahead. Future data will certainly continue to dictate the slope and pace of Fed actions in the months ahead.

<u>Q2 Outlook: A Deeper Dive</u>

- Oil, Gas, and Consumer Spending

The war in Ukraine is certainly impacting consumer sentiment and behavior. Rising oil prices are pushing up gasoline prices somewhat dramatically here in the U.S. and around the world, which is putting a dent

in recent high savings rates and crowding out spending on other purchases. This can have a direct impact on corporate revenue and earnings.

While motorists everywhere share in recent pain at the pump, Europe is uniquely vulnerable to reductions in Russian energy supply. While the Continent has storage in place to hold out for months, some form of energy rationing is a distinct possibility while seeking alternatives to Russian supply. Securing such alternatives could take many years. For example, while efforts are already underway to accelerate implementation of liquified natural gas terminals in Europe, these will take years to build.

Any beneficiaries from rising demand for natural gas, including companies with natural gas resources in basins close to LNG terminals in the U.S., must likewise be viewed in the context of a multi-year trend rather than offering an overnight solution to a sudden supply shock. In the meantime, the question will not be whether consumers will feel the pinch, but rather, how painfully and for how long.

- Volatility and Equity Multiples

Despite their recent retreat, broad U.S. equity markets are still valued near the top quartile of the 20-year average of forward P/E multiples. Given this, market volatility should remain high as monetary and fiscal liquidity begins to drain from markets amid economic jitters. Multiples could be at risk of contracting further before reaching levels more comfortably aligned with the range of expected returns in a less certain economic environment. With that said, components of the U.S. equity market that have already corrected significantly could provide higher expected returns, and several have our attention.

- Fixed Income

As one would expect at a moment of geopolitical shock, bonds have recently outperformed equities, but so far this year they have fallen well short of positive returns as markets assess the duration of current inflationary pressures. The U.S. bond market as captured in the Bloomberg Aggregate Index is off by approximately 5% YTD, versus a decline of more than 8% in the MSCI All Country Index of global equities. Within the asset class, inflation coupled with prospects for a decelerating economy have pushed credit spreads higher, reflecting a renewed perception of risk in corporate issuance compared with risk-free U.S. sovereign debt. We are monitoring the evolution of this trend quite closely.

We are also attentive to shifts in the relative appeal of Treasuries of different durations. Two-year yields are now approaching 2.20%, with 10-year and 30-year Treasuries offering only 0.15% and 0.40% of additional yield, respectively, in exchange for their much longer durations. For many fixed-income portfolios we thus see merit in keeping overall maturity characteristics incrementally below the market average.

- Gold

Gold has performed its role as a “shock absorber” within portfolios admirably during this moment of geopolitical uncertainty, gaining more than 6% YTD even as most major asset classes have declined. It has risen despite a surging U.S. dollar and should benefit from an environment in which consensus

remains dispersed on the near-term return prospects for other major asset classes such as equities and fixed income.

Internal Dialogue at Clear Harbor

While much of the analysis above concerns trends rooted in existing data, the nature of wealth management—and especially the formulation of client portfolios—requires us to ask important questions about how the market might evolve in the quarters and years ahead. Some examples of subjects we are discussing internally here at Clear Harbor at the moment:

- Have equity and credit markets priced in as much negative geopolitical sentiment as we can expect? Or is the spread widening of late more a function of dimming prospects for growth and corporate profitability, with room for considerable further declines in response to global events?

- At a moment of elevated inflation and slowing growth, should we favor traditional growth stocks over cyclical sectors such as industrials and financials—particularly as many growth equities have corrected by more than 50% from recent highs?

- How do traditionally defensive segments such as consumer staples fit into portfolios at a moment when surging food and energy costs are expected to impact profit margins?

- What adjustments are advisable in fixed income portfolios when rates are trending higher well in advance of actual Fed actions? Do we expect the curve to steepen from here, or continue flattening as growth slows—perhaps even into recession? At what point should certain portfolios begin to wade further out the maturity curve as rates trend higher?

- If the interest rate curve should invert, would it signal recession risk as investors would traditionally perceive—or have the Fed's purchases of Treasuries and mortgage securities over the last several years complicated the meaning of such a signal?

- How is China responding to its own rather significant economic deceleration? To what extent do we see value in the Emerging Markets more generally?

- How does the China's current posture with Russia impact its own long-term prospects with crucial Western trading partners?

- How do current sanctions on Russia affect how other autocratic nations—including China—perceive the safety of their own central bank reserves following Russia's isolation from SWIFT?

- In the event of a Russian sovereign bond default, what are the risks of financial contagion?

- How do alternative investments fit into client portfolios, and under what circumstances? Where does one extract non-correlating returns when equity and fixed income have converged?

- How might elevated commodity prices alter the sentiment of voters both at home and abroad? Will they have patience with politicians given the war in Ukraine, or will elections reflect the growing anxiety that many feel about rising costs of living, and lower real wage growth?

- While the trend toward renewables appears inevitable, how have current understandings of national energy security either accelerated, altered, or negatively impacted this trend?

- While market observers and citizens around the world are understandably keen to put Covid restrictions to bed, what will be the potential range of government responses, supply chain impacts, and broader economic consequences in the event that a more virulent strain emerges?

While such questions as these inform our firm's day-to-day thinking and decisions within asset management, we are extraordinarily mindful that your own thinking about your financial life must take into account the daily ebbs and flows of your portfolio value; the inflation you see at the pump, the grocery store, and for a range of goods and services; and the ordinary changes that come in the life of a family over time. In many cases, this may be a good time for us to schedule time together and reassess your own wealth roadmap.

So whether you have concerns about the risks of this particular moment in markets for your own investments, or there has been a change in your life that we should consider, please feel free to reach out so we can incorporate these insights into our approach to your wealth. The partnership and communication between Clear Harbor and each of you is the bedrock of not only our firm's philosophy and culture, but our structured process for crafting individual strategies in pursuit of specific client goals.

Sincerely,

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