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Friend of Clear Harbor,

As we race toward the final quarter of 2019, markets are defying widespread narratives of decelerating global growth and accelerating geopolitical uncertainty as much as they have at any time over the last decade. Equity benchmarks for U.S. and global developed markets are better by 10-20% so far this year, while emerging markets have notched an average 5.5%.[1]

These gains have occurred despite little progress on the trade, intellectual property and cyber-theft concerns that prompted the current tariff spat between the U.S. and China, while Britain remains unprepared for a negotiated break from the European Union ahead of the October 31st deadline. Iran's brazen bombing of Saudi Arabia's energy infrastructure represents a recent high-water mark in tensions between the two countries, and North Korea continues its saber-rattling with occasional "conventional missile" tests in an apparent bid for the attention of the Trump administration and global observers.

On the economic front, U.S. and especially international growth expectations ratcheted downward over the course of the summer while corporate earnings lost steam. This prompted renewed dovishness on the part of monetary policymakers around the world, from a pair of rate cuts at the U.S. Federal Reserve to the expansion of quantitative easing in the eurozone. The breadth of these easing decisions also reflects a widespread desire to avoid the sort of multi-decade battle with deflation that befell Japan.

The monetary medicine does appear to be helping. The return of lower rates across the maturity spectrum has spurred a recent rise in home sales and refinancings, and helped the American consumer stay focused on solid wage growth rather than global trade uncertainties. All this has supported the retail sales sector, which powers 70% of the U.S. economy and until now has helped insulate it from rapidly deteriorating data in such places as China and Germany. In fact, the growth profile of the U.S. today remains similar to that throughout the last decade, with GDP continuing to run a bit above 2%.

The question is how U.S. optimism will weather the storms clearly brewing elsewhere, to say nothing of the toll an impeachment inquiry might take on confidence at home. We are mindful of how quickly the vector of economic activity can shift, yet we must also remain objective and alert to the prospects for economic "green shoots" and their implications for investment. A willingness to hear what the data is

[1] All prices are as of September 27, 2019.

telling us—and the discipline to know what to listen for—will remain critical as we evaluate market volatility, determine asset allocations, and construct specific portfolios for each client of Clear Harbor.

The Continuing Case for Equities

In the face of concerns like those noted above, some observers question an S&P 500 that stands within 2% of its all-time high. However, investors who have bid markets to current levels have a strong case as well. In addition to seeing prospects for sunnier skies ahead, they point to other factors that are providing support for equities at present.

Three bullish arguments warrant particular mention for their impact on markets today:

1. "There Is No Alternative." With U.S. 10-year Treasuries yielding a mere 1.68% and nearly $17 trillion of global sovereign debt offering negative yields, some types of investor find the risk of equities to be well worth taking. The same can be said for high-yield bonds, whose equity-like risk profile has helped them surge more than 11% year-to-date, even as economic conditions have softened. Institutional money flows, such as those from endowments and pension funds, continue to provide important and durable support to risk assets for exactly this reason.

2. "Fear of Missing Out." Particularly among smaller investors, many of those who stayed gun-shy following the generational market bottom in March 2009 have begun to look back on a decade of extraordinary gains with regret, and may be inclined to rejoin markets without much of a focus on current-day fundamentals. And truth be told, institutional fund managers—who are tasked with attempting to outperform a given benchmark, and may have excess cash weighing on portfolio returns from time to time—can also find themselves acting on this "fear of missing out."

There are old-fashioned terms for this attitude, including "chasing returns," "momentum plays" and the "bandwagon effect." By whatever name, it can be a powerful psychological driver of investor behavior and a meaningful contributor to market moves. But we caution that it can be susceptible to reversing rapidly when markets turn.

3. "Don't Fight the Fed." While policymakers traditionally set interest rates to achieve targets for price stability and employment levels, the persistence of extraordinary policy dovishness around the world has become a direct and critical factor driving up asset prices. In fact, what started a generation ago as the "Greenspan Put" has evolved through successive Federal Reserve chairs into an ever-clearer embrace of market performance as an informal "third mandate" for policymakers.

Just last fall, the specter of potential rate hikes wrought fear in the market, sending the S&P 500 lower by nearly 20%; the downtrend subsided when Fed Chair Jerome Powell signaled a willingness to pause the tightening. A year later, we have seen the Fed cut rates twice and reverse its long-awaited progress toward reducing its balance sheet. As it happens, markets have since moved notably higher—and the U.S. economy has continued to percolate.

Some have come to view such an unstated mandate as justified. Equity markets do represent a significant economic leading indicator, and the "wealth effect" of higher account balances can inspire consumer spending and overall economic activity. Some central banks are even purchasing equities outright: although the Fed does not, the Bank of Japan and others do, often acting on an explicit mandate to lift asset prices—and presumably investor, consumer and corporate spirits along the way.

Factors such as these of course do not fully explain the recent outperformance of equities. We also caution against the assumption that they will be enough to sustain such outperformance in an incrementally more expensive market. But these arguments are becoming conventional wisdom. They represent an increasingly important context for understanding why fund flows into U.S. equities have recently reached a six-month high—and why a degree of support may well remain behind them, even as traditional questions of economic and investment fundamentals demand renewed attention.

Economic Considerations

While we at Clear Harbor try to refrain from attempting to “time the market”—a feat that academic studies suggest is a fool’s errand—or to guess at the start and end points of the next recession, we do monitor changes in economic activity closely. We are particularly attuned to shifts that inform our assessment of how much risk we are taking for each point of anticipated return in a client portfolio.

With this philosophy in mind, the current backdrop for the global economy clearly presents a mixed bag of risks. Consumer components of the U.S., including employment, wages and most retail sales figures, have maintained their momentum, helped in part by a strong dollar and low inflation. But broader data sets continue to deteriorate both domestically and around the world. Global gauges of manufacturing failed to stabilize this summer, and in fact appear to suggest a broader slowdown in key areas such as new orders and manufacturing employment.

Even in the U.S., manufacturing indexes have weakened close to recessionary levels, with business confidence falling. A challenge to continued 2% GDP growth cannot be ruled out. And outside the U.S., key economies are signaling that a recession is either already underway or likely imminent.

- Europe

Germany, Europe’s largest economy, is undoubtedly on the verge of recession, with business confidence and manufacturing data in the doldrums. Both the German Purchasing Managers Index and the Ifo Business Expectations Index have trended to levels not seen in many years. While few see a major downturn on the horizon, it is difficult to imagine a rapid reversal on the Continent without its largest economic engine pulling its weight.

The United Kingdom has likewise experienced a sharp decline in manufacturing, which now hovers at levels not seen since 2009. Should a further deterioration in the global economic picture ensue, we would expect to see a meaningful decline in British consumer sentiment and related spending. This is hardly a welcome trend for a nation at risk of a further economic shock should Brexit come and go at the end of October without an agreement in place to manage the transition.

- China

China continues to shudder under the weight of excess global manufacturing capacity and ongoing disagreements with the U.S. over trade. We do not see closure to the latter issue in the near term, and doubt that one of the Trump administration's fundamental grievances with China—sustained and systematic intellectual property theft—will ever be resolved.

Though these stubborn conflicts are regrettable for many reasons, other considerations loom larger in our view of global economic and investment prospects. While the trade spat has the potential to negatively impact consumer and investor behavior and ultimately drag a bit on economic growth, at this juncture we view it chiefly as a red herring cited by prognosticators who would envision a sunny economic environment "if only" differences between the two nations could be resolved.

- India

In an encouraging move that surprised many casual observers, India this month passed a $20 billion corporate tax cut that lowered the rate companies pay on earnings from 30% to 22%. In addition, the government has lowered corporate taxes for companies established in the future to an effective tax rate of 17%. With these measures, India has leveled the playing field with some of Asia's lowest-taxed countries, such as Singapore. We expect India's economy and equity market to benefit as incremental foreign capital is drawn to the world's second most populous nation.

India is also a demographic bright spot on a globe that is dominated in many regions by aging populations, rising demands to support the retired, and sluggish economic prospects arising from these trends. In contrast, India's nearly 1.3 billion people are, on average, younger than the global cohort by a wide margin. This population is expected to exceed that of China within five years. It remains an area that warrants interest from clients with the risk tolerance and time horizon for seeing this economy work through its undeniable issues with infrastructure, corruption and workforce transformation.

- Iran & Saudi Arabia

We are also mindful that the recent attack by Iran on Saudi oil infrastructure marks a troubling acceleration in friction between two Middle East heavyweight countries. Some 5% of global oil production has been disrupted. However, after spiking approximately $8/barrel on the day of the attack, oil prices have since settled to within approximately $1/barrel of pre-attack levels. While this has surprised some observers, several mitigating factors exist in 2019 that did not at the time of the First or Second Gulf Wars. Perhaps the most notable is the newfound ability for other oil-producing countries, particularly the U.S., to increase drilling quickly to help meet global demand.

An outstanding question is how quickly Saudi Arabia can restore its own lost production. In the short term, the ability for governments to release strategic reserves of petroleum can preserve the supply/demand balance, particularly in light of encouraging resilience in other producing countries. However, a sustained loss of Saudi production would be difficult to mask; it would certainly raise the specter of higher oil prices.

The somewhat quiescent response to date suggests that "Mr. Market" expects a return to nearly full production within several weeks. Any potential disappointment warrants careful consideration for its economic impact well beyond the Persian Gulf region.

- U.S. Politics

What a difference a phone call makes. After more than a year spent trying to keep her fellow Democrats from initiating impeachment proceedings against President Trump for actions outlined in the Mueller Report and elsewhere, House Speaker Nancy Pelosi has given ground and acceded to an "impeachment inquiry." The shift occurred after reports surfaced that a whistleblower—now understood to be a C.I.A. officer—claimed that in a phone conversation with the leader of Ukraine, President Trump predicated aid to that country on its willingness to deliver negative information on former Vice President Joseph Biden and his son.

The details are still emerging at this date, and I do not highlight this episode to suggest that a formal impeachment process will take place or that the President will be forced from office. However, neither of those outcomes is necessary for the economy to suffer from what will be, at a minimum, yet one more political firefight with the potential to distract from constructive policy development.

Of course, to the extent that any impeachment process dims President Trump's political stars as he seeks re-election in 2020, it also elevates the possibility that Senator Elizabeth Warren might become President Warren. Such an outcome would significantly raise the odds for increased regulation and taxes in the years ahead, even if her most dramatic agenda items—such as the elimination of the private healthcare insurance market—seem unlikely to become law.

<u>Monetary Policy</u>

While monetary policy around the world remains broadly supportive of growth, important differences in approach remain. The outgoing president of the European Central Bank, Mario Draghi, has continued to ease monetary policy aggressively and perhaps even irrationally, putting the overnight bank lending rate in negative territory. In contrast, Fed Chairman Powell took the opportunity of a recent Q&A session to emphasize that the U.S. central bank has no intention of adopting such a negative interest rate policy. Indeed, he signaled the clear view that he grasps the significant risks of such a policy approach.

Nevertheless, U.S. rates still have room to fall as the Fed's Open Market Committee contemplates potential shifts in inflation and economic data. We also note that while negative rates appear off the table, a return to quantitative easing may not be. In any event, we also recognize significant disagreement within the Fed on these points. We will be monitoring the evolution of both U.S. and global monetary policy very carefully in the coming months.

<u>Portfolio Considerations: Tools for Staying Invested</u>

While certain technical indicators—as well as the bullish arguments that I acknowledged at the start of this letter—point to still-higher prices for equities on the horizon, we continue to believe that both equities and fixed-income securities offer lower return profiles today than they have at any time for several years. Even if institutional demand or a dearth of compelling alternatives manage to keep a floor under equities, rising valuations and decelerating earnings growth may impose a near-term ceiling.

We also heed the wisdom that “time in the market” is far more important than “timing the market.” We are particularly keen on strategies that can help clients stay invested—even through inevitable fluctuations—in core asset classes that can produce attractive long-term returns. As such, even as we outline what we consider some of the underpinnings of today’s market optimism, the team at Clear Harbor believes that asset allocation must begin with attention to each individual’s tolerance for risk.

While some investors’ attitudes remain shaped by their experience of the financial crisis, others feel ready to accept the volatility inherent in equities in exchange for the superior prospects of that asset class over time. However, we like to challenge that confidence: after all, it has now been more than a decade since most investors have been forced to ponder a sudden correction of 30% or 40%, much less the 55% seen during the Great Recession.

We certainly do not predict such an outcome to recur in the near term, but the discussion can be very productive. Many clients with long investing horizons nevertheless elect to have some allocation to sovereign and investment-grade fixed income—an asset class with a lower return profile than equities, but reassuring qualities as a proverbial “air bag” to the portfolio under many scenarios in which equities might falter. For clients who allow us to allocate across multiple asset classes, portfolio volatility can be further mitigated with allocations to broader components of the fixed income market, and even to gold.

Even within an equity allocation, it is both possible and prudent to find securities that offer some exposure to economic expansion while also providing more ballast during times of uncertainty. For example, when the S&P 500 fell nearly 20% last fall, Utilities were off just 1.6%; Consumer Staples fell 10.7%. While the broader market has since recovered smartly, those with overweight allocations to these two sectors may have slept better along the way.

Make no mistake: Clear Harbor remains committed to identifying compelling opportunities for those with the tolerance for security-specific allocations, and to always parse the relative value of asset classes and sectors. Some current investment topics can be inferred from the discussion above: Is a rotation from growth to value underway? Do select energy stocks present good prospects on the heels of the supply shocks emanating from the Persian Gulf? What is the best risk-adjusted way to find exposure to growth in India? These are important conversations, with real impacts on client portfolios.

The key is to remain disciplined in our work, with not only a keen eye on market fundamentals but a sustained commitment to partner with each client to achieve specific financial and life goals. To borrow a phrase from former U.S. Defense Secretary Donald Rumsfeld, we try to spend at least as much time on “known knowns” that are in our control as stewards of client wealth—i.e., individual risk tolerance and wealth objectives—as we do on the “known unknowns” of the direction and timing of future market outcomes.

This is where the science and the art of asset allocation and investing merge to create what we believe are thoughtfully constructed portfolios. I thank you for your trust in Clear Harbor, and ask that you share with us any change in your outlook or circumstances—the “known knowns”—that will help us face the unknowable future together.

Sincerely,

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