



CLEAR HARBOR
ASSET MANAGEMENT, LLC

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Quarterly Market Update

Warren Buffet once warned that those investors who wait for the robins will miss the spring. That has certainly been the case so far in 2013: with less than a single week of the new season under our belts, we already find the major averages at new all-time records.

It would seem the long-awaited outperformance of equities over bonds has begun. The decline in the yen and rise in the Nikkei we anticipated are pronounced, as well. These and other significant themes of our 2013 Outlook have appeared on or ahead of schedule, including generally positive economic data that would seem to validate the United States as the top destination for global capital today.

Still, has Mr. Market gotten ahead of himself? With 99% of companies reporting, 2012 earnings for the S&P 500 stand at \$101.54, much closer to the initial Clear Harbor base-case assumption of \$100 than to the \$108 consensus estimate at the end of 2011. Yet in the past three months, investors have shrugged off this relative disappointment—to say nothing of Washington’s failure to avoid the sequester—and pushed the key average within 1 percentage point of our initial estimate of 1575 for all of 2013.

While these market developments have proved rewarding to client portfolios, they have arrived somewhat abruptly despite important caveats to underlying economic conditions. Moreover, unprecedented risks remain embedded in global monetary policy. We therefore begin the second quarter with a fresh look at these critical factors for signs that the tug-of-war between bulls and bears could shift.

Economic Update

The case to stay overweight U.S. equities finds a solid argument in economic data that has grown steadily more favorable, but it must be tempered by a candid appraisal of its limitations. Several trends will remain crucial to sustaining a balanced economic thesis for the remainder of 2013.

The housing recovery must remain intact. Sales levels, asset prices, inventories and permits all indicate a strengthening market for housing in the United States. We believe a long-awaited cyclical recovery is further supported by the structural force of renewed household creation, as well as an unusual backlog of twenty- and thirty-somethings—both single and married—who are still living with their parents.

Cautionary points remain: credit is still constrained, and an elevated 22% of transactions in February of this year were driven by speculation, particularly in those regions and product types that have seen the

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strongest rebounds. Nonetheless, we believe the stage is set for a move toward more normal supply/demand dynamics—and perhaps more normal returns—in this vital sector going forward, auguring well for payrolls, personal consumption, and consumer and investor confidence.

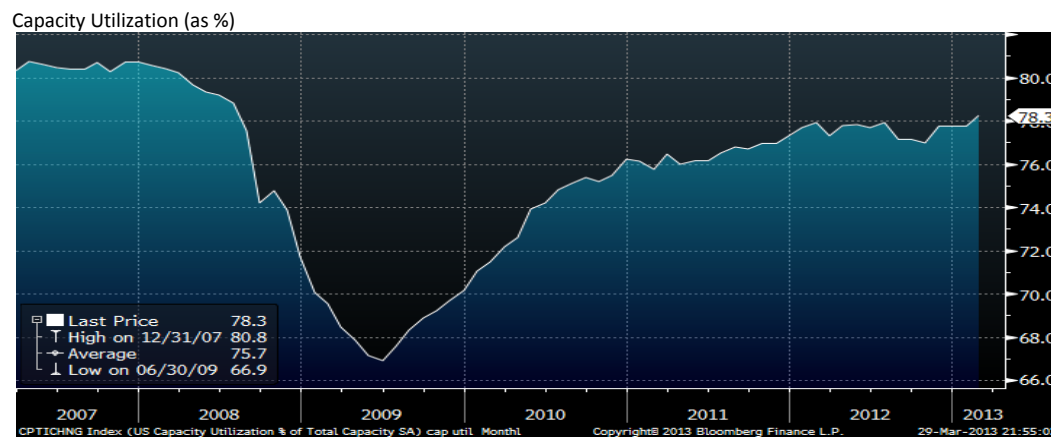
Retail must hang in there. With gains fluctuating and still generally low in the last three months, retail sales have squared with at best modest expectations of 2% GDP growth. It has yet to consistently match the gradual but steady improvement in payrolls and stabilization in housing.

Auto sales have been a bright spot as drivers replace the oldest car fleet on the road on record (11 years), suggesting that consumers are increasingly able to finance their higher-priority purchases where pent-up demand is strongest. We will be looking to see if this theme can translate into a more consistent upward-sloping recovery from one month to the next going forward in other areas during 2013.

Employment must stay on the mend. The continuation of these constructive trends will turn on employment. Monthly payroll gains have averaged 175,000 since 2010, with levels so far in 2013 closer to 200,000. Though well shy of the levels of past recoveries, this is sufficient for unemployment to edge lower over time, while giving credence to a “muddle forward” thesis in housing and sales data.

Manufacturing must keep gathering steam despite signs of continued dollar strength. Monthly ISM data and durable goods orders have both trended higher in recent months. After decades in decline, the U.S. manufacturing story today has been updated to include low prices from natural gas and other input costs for producers such as Dow Chemical; higher worker productivity, product reliability, and proximity to domestic supply chains; and the security of property rights compared with China, which also confers advantages on such regional competitors as Vietnam, Thailand, and Malaysia.

While overcapacity remains a factor in some segments of the economy, utilization now stands at 78.3%, and is rising steadily from the lows of 2008-09. By historic measures, corporate America remains significantly under-invested over the past decade, and has record amounts of cash to fund capex needs as demand improves. The greater uncertainties over the intermediate term revolve around government policy: the regulatory impacts of Dodd-Frank, the direction of corporate taxes generally, and such industry-specific questions as the future deductibility of investments in energy production and natural resources.

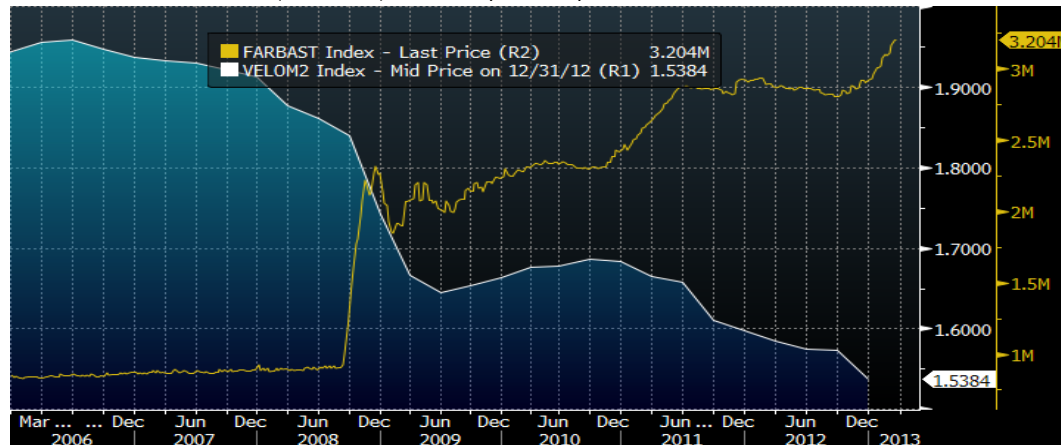


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The velocity of money remains low. Perhaps the greatest challenge to the bull thesis is that money is cycling through the economy less rapidly than at any time on record. Put another way: the relative health of individual parts of the economy have not yet translated into a self-reinforcing whole. Consumers seem to have agreed that a dollar will go so far, and no farther.

Federal Reserve Balance Sheet (in \$trillions) and Velocity of Money



Source: Bloomberg

Some of those dollars are still being used to pay down debt, rather than fuel spending. That augurs well for the balance sheets of households and small businesses over the longer term. But so long as confidence remains mixed, we should not be surprised to see the all-important consumer err on the side of prudence rather than exuberance, keeping overall growth in check—and providing precious little cushion against recession in the case of a major shock from Europe, the Middle East or elsewhere.

Monetary Policy: The United States

The rotation of cash through the economy appears particularly slow because it is measured against a total supply of money that has never been greater. By the end of 2013, the Federal Reserve is expected to have expanded its balance sheet to \$4 trillion in order to fund its unprecedented program of bidding Treasury prices up to keep yields down. Known as “quantitative easing” or simply “QE,” the Fed’s goal is to make borrowing more affordable throughout the economy, and thereby spur housing, retail purchases, and even employment.

With rates low across the yield curve, mortgage spreads at record lows, and the banking system and capital markets now awash in liquidity, credible arguments are now being heard that the Fed might start to tap the brakes on its QE programs earlier than expected. While we would welcome such restraint, we do not expect it in the near future. For purposes of portfolio construction, we look for the Fed’s current rate of asset purchases under QE—some \$85 billion per month—to continue for the balance of 2013, and perhaps well beyond.

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To be sure, the Fed has reserved the right to adjust its stance as the economy and employment improve. However, Chairman Ben Bernanke, Vice-Chair Janet Yellen, and New York Fed President Bill Dudley have all taken a wide range of opportunities in recent weeks to publicly reaffirm that a majority of the Fed's key Open Market Committee remain committed to extraordinary monetary stimulus, particularly in the absence of fiscal stimulus from Congress.

This is broadly consistent with the Fed's pledge to continue extraordinary measures until the specific, and elusive, goal of unemployment below 6.5% is achieved while inflation does not exceed a revised threshold of 2.5%. Bernanke and Yellen in particular have been quick to dismiss concerns about any negative impacts from their actions on credit growth, leverage buildup, or as Yellen recently put it, "significant asset bubbles that would clearly threaten financial stability."

This has three implications for investors. First, we can expect the dictum "don't fight the Fed" to remain Wall Street's mantra, further shepherding investors toward equities and other alternatives to low-yielding Treasuries. Second, the risks of the Fed's "damn the torpedoes" approach will continue to build. These include potential hits to the central bank's credibility should interest rates begin to rise, particularly if it leads to paper losses in its massive portfolio of Treasuries.

Third, by pledging to indefinitely suppress rates at unnatural levels, the Fed risks suppressing animal spirits as well. Why rush to lock in that low rate today for a house, car or vacation—or for that matter, corporate expansion—if it is likely to be just as cheap tomorrow? History may ultimately deem QE to have been well-intentioned, but counterproductive to organic growth as overall conditions normalized.

There may be other impacts we do not yet anticipate. We do know this: when Senator Corker (R-TN) asked about the Fed's exit strategy from QE, Bernanke's response appeared improvised, and limited to the idea of simply letting its horde of securities mature—a process that would take a decade given current durations, while risking inflation through the current \$1.7 trillion of excess reserves in the banking system.

Nor will the Fed attempt its exit from QE in a global monetary vacuum. After significant declines from mid-2010 until mid-2011, the dollar has gained strength against a basket of currencies; future moves will be influenced by how and when the Bank of Japan and European Central Bank manage their own accommodative policies. Japan's new monetary easing program was only announced this quarter, and can be expected to continue for some time. So while competitive pressures on the currency may be secondary considerations, they do represent additional incentives for the Fed to keep the foot on the gas throughout the course of 2013.

Monetary Policy: The Eurozone

More immediate than the potential risks of Fed policy are those presented by Cyprus and the Eurozone generally. While Cyprus is tiny in both economic and financial terms, the precedent of capital restrictions

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and proposed “haircuts” for depositors establishes the prospect that a euro in one troubled nation might end up worth less than a euro in a more secure jurisdiction.

Could such a fate befall the larger countries in the European periphery? The possibility cannot be dismissed. At present, the Vatican may have a new pope, but Italy doesn’t even have a government; Spain and Portugal have their own combinations of economic, social and/or political weaknesses that could render them vulnerable to their own sorts of currency risk. In the face of proposed, or even rumored, capital controls, would depositors in these nations transfer their euros to banks in Germany or other nations deemed safe? Could one blame them, in the face of certain devaluation of their life’s savings should their home country in fact exit the euro? And while none actively seek such an outcome, is a self-fulfilling prophecy truly out of the question?

In our view, the potential of further deposit flight from peripheral Eurozone nations remains a legitimate threat to the near-term stability of the euro. We continue to believe—as we have stated since 2011—that so long as the Eurozone continues without a shared banking and regulatory structure, the long-term viability of the common currency will be subject to question at the slightest provocation. Indeed, a euro exit and immediate devaluation might well be in the best interests of certain nations facing prolonged austerity and economic depression.

While each twist in the Eurozone story helps revive the fear trade in Treasuries, the impacts on other aspects of the dominant U.S. investment thesis will be harder to predict.

Market Implications

Our initial estimate of 1575 for the S&P 500 for purposes of portfolio construction was predicated on 5% earnings growth and a 14.5x multiple. With the average already within six points of that target, what can we expect next? Have the positive trends we forecast in December so exceeded expectations as to justify a continued straight line higher?

With so much reward already in hand for the risk assumed, we are wary of the potential for near-term corrections, even as we are attentive to strong arguments for further upside over the course of the year. We note that Q1 earnings have yet to be reported, and could disappoint—even if disappointment results from higher spending by more optimistic companies.

At the same time, the chase for quality income continues. Global funds—exceeding \$70 billion last quarter, the most in seven years—continues to flow to U.S. equities for their blend of safety, current yield and growth potential; it is not hard to envision multiples expanding to 16-17x, helping bump prices further even in a disappointing earnings environment. Accordingly, we maintain a modestly more favorable view of equities relative to sovereign, investment grade or even high-yield credit.

With that said, flows into fixed income credit funds also remains positive. In light of the Eurozone and monetary risks outlined above, along with the ever-present possibility of shocks from the Middle East, a

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flight to quality could occur even in the face of a strengthening U.S. economy. And while U.S. Treasuries may not seem attractive on an inflation-adjusted basis, they represent compelling value relative to other large and liquid sovereign nations such as Japan (at less than 0.60%) and Germany (at less than 1.30%)—this despite recent revisions of 2013 German GDP growth down to just 0.3% by Deutsche Bank and Morgan Stanley.

Conclusion

Despite a lackluster finale to the 2012 earnings season and a troubling economic and political picture in Europe, we believe in the fundamentals of the U.S. private sector growth story. Coupled with “bottom up” evaluations of specific sectors and companies and a tailored approach to client risk profiles, volatility tolerance and cash flow needs, this allows for the continued construction of client portfolios with excellence risk-reward characteristics over the medium to longer term.

I look forward to sharing updates to these and other major themes as they develop, as well as examples of the “bottom-up” aspect of our process in upcoming Clear Harbor Flashes. Whatever speed bumps we may feel over the next several quarters, I thank you for your trust in Clear Harbor as we continue the search on your behalf to preserve and grow wealth for years and generations to come.

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