CLEAR HARBOR
ASSET MANAGEMENT, LLC

April 16, 2012

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Clear Harbor Flash – Notes On The Market

The last few weeks have highlighted how quickly positive market sentiment can give way to pessimism in this age of turbulence. Equity indices in the U.S. have faltered three out of the last four weeks on the heels of weaker-than-expected employment data, ongoing Eurozone concerns, and a notable deceleration in Chinese growth. The U.S. Treasury market witnessed a sharp flight to quality with 10-year yields trending below 2.0% after many market strategists and economists warned earlier this year that yields were destined to trend sharply higher over the course of 2012. In our March outlook for this current quarter, we outlined why bond market bears would need to wait a while longer to see yields move higher and prices lower.

Meanwhile, we've seen first-quarter earnings results from about 7% of S&P 500 companies, and three-quarters of those have surpassed expectations on Wall Street. We still see some attractive investment opportunities in equity markets, but I suspect we're approaching a peak for margin expansion in the S&P 500 as a whole, and higher earnings multiples are now required to achieve markedly higher levels across the major indices. That could be a tall order as investors remain understandably cautious in an economic environment that is deeply troubling.

The most disconcerting story that is unfolding in the global economy remains the European debt crisis. Our March outlook outlined our concerns that this crisis remains far from resolved, and recent events seem to be confirming that. The Eurozone achieved some calm following the orderly default of Greece and the ECB's bold initiative to offer banks up to 3-years of extraordinarily inexpensive funding, but consumption is faltering, unemployment is skyrocketing, and growth is declining. Spain, the new epicenter of the crisis, is in a full-blown economic Depression, and its cost of capital has increased sharply. Italian bond yields are also creeping higher, and the Eurozone is forcing these countries to adopt strict deficit targets and austerity measures.

For their part, Eurozone banks are facing a mandate to meet strict capital requirements by the end of June, leaving them with two real options: 1) raise capital, a solution we view as highly unlikely. Or 2) they can liquidate segments of their balance sheet, a painful process that we

view as a realistic outcome. In fact, we believe this is already underway, which may explain why the European bond market is once again teetering.

All this adds urgency to our own fiscal and economic crisis here in the U.S. Without any congressional action this year, approximately $400 billion worth of tax hikes will impact Americans next spring. Despite our view that a manufacturing renaissance of sorts is positively impacting U.S. growth, domestic consumption is still responsible for approximately 70% of U.S. GDP. Therefore, tax increases could become a drag on economic growth in 2013.

Meanwhile, the U.S. debt ceiling debate will most likely heat up in the coming months as it appears that Congress will need to tackle this issue prior to Election Day. We believe that both parties missed an important opportunity to embrace the deficit reduction plan co-authored by former Senator Alan Simpson and Erskine Bowles. This plan was far from perfect, but it did address the structural deficit crisis that is a huge challenge today and an even more significant crisis over the course of this decade, and specifically, it dealt with the runaway costs of entitlement programs: Medicare, Medicaid, and Social Security.

How the Democrats and Republicans address these issues will provide fodder for 30-second campaign commercials and "gotcha" style debate formats, but it looks unlikely that a comprehensive solution to the nation's debt and tax crisis can be found prior to Election Day. Even after the election is over, arriving at a solution will remain elusive, and it may be that such a moment will not arrive until financial markets force the hands of our elected officials to make the tough decisions that are required.

Tonight, I fly to Argentina to visit several gold and silver mines where I will meet with operational people as well as management. Argentina is at a crossroads in so many important senses. They have the natural resources and human capital in place to provide for sustainable economic growth, but they lack the political will to embrace free-market policies and an independent monetary regime, both of which I view as necessary for the country to achieve positive change. This trip is bound to provide our firm with important insights that not only apply to Argentina but also to South America, the mining industry, and politics more generally. I expect to report on this when I return.

Next month, our firm will travel to Vietnam, Hong Kong, and China where we will meet with local companies from the financial, tech and energy sectors.

We do not know what the future holds. However, we attempt to position our thinking and our client's capital in a manner that incorporates our firm's collaborative thinking and idea generation. These travels will add valuable fuel to this ongoing process.

Please respond with any thoughts or questions.

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