CLEAR HARBOR
ASSET MANAGEMENT, LLC

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Clear Harbor Flash: Recalibrating Models—and Expectations

Fixed income is through the roof—and possibly nearing a ceiling. In recent years, a wave of cash has flowed out of money market and equity funds and into corporate and government bond funds. Momentum in the sector has built to the point where we must ask: is a bubble forming? And how should this affect portfolio positioning for our clients?

Consider the direction of the U.S. Treasury market, where absolute yields are now providing investors with a negative real return, and the lowest nominal return in half a century: 1.70 percent for the benchmark 10-year note, reflecting an average annualized return of nearly 9 percent over the last five years. For that pace to continue over the next twelve months, we would need to see 10-year Treasury yields decline to a yield of 0.75 percent —considerably less than most projected measures of inflation.

Some continue to allocate capital as if this trend will simply "continue to continue." Originally, this historic rally in Treasuries had its roots in understandable concerns over the global economy. But increasingly, financial planners have steered investors toward a wide range of fixed-income products, from investment grade to high yield, based on computer models that simply presume that recent inflation and interest rate trends will continue—and keep bringing uncommonly strong returns with them.

Models are only as good as the presumptions made in creating them. Could the rally in fixed income be sustained one more year? Of course it could: if we expand the risk/reward and shock the 10-year Treasury yield to 0.5 percent, investors would see an absolute return of 12 percent. If deflation surfaces or the global economy implodes, such a move might indeed occur as investors seek renewed safety.

But before embracing that projection, it is critically important to challenge the assumptions beneath it. We hasten to remind investors of one of the oldest axioms on Wall Street—and one of the most frequently ignored: *past performance is no guarantee of future results*.

The more things change…the more backward-looking models will fail. If one makes different assumptions about inflation and interest rates, the "all green" signals from computer models turn

quickly to red flags. Indeed, if rates on the 10-year Treasury rise to 3.25 percent, investors stand to lose approximately 9 percent in asset value. Another quarter-point rise, to 3.5 percent—where 3-month Treasury bills stood in the fall of 2007—would drive a 12 percent loss.

Which of these scenarios is more likely? Which direction represents a more fundamentally sound level for Treasuries based on economic growth, inflation, and a more normalized Fed funds rate? And what if recent extraordinary Federal Reserve policy—the subject of our third-quarter commentary—should begin to normalize as the U.S. economy revives, as some observers have recently suggested?

Those who presume that all momentum is irreversible may find themselves in harm's way should their models fail to take stock of our particular moment in economic or capital market super-cycles. The conditions that made recent yield moves possible—relatively low debt-to-GDP ratios and fear of a systemic global financial collapse among them—have receded. At some point, the motto "the trend is your friend" will give way to "the trend's at an end."

CHAM stress tests portfolios for alternative paths the market might take. At Clear Harbor, our goal is not to predict where U.S. interest rates will be a year from now. But as we approach zero yields, we believe that the downward trend over the last several decades is far closer to the end than the beginning. At a minimum, it is crucial to stress-test our investment ideas and portfolios not just for the possibility that recent trends will somehow be indefinitely sustained, but in recognition of the very real prospect that circumstances will change.

Rather than a simple distribution of capital among equities, fixed income, and commodities based on static or backward-looking models, we therefore ask:

- Although Treasury yields could compress further still, what might force them to rise?
- Contrary to conventional wisdom, could a significantly weaker economy actually catalyze higher interest rates, as investors seek compensation for added risk?
- How has Federal Reserve policy altered the intrinsic value of Treasuries? Is monetary policy about to shift? If not, is the current policy sustainable?
- Are high-yield bonds attractive at current yields, or do they merely appear so when compared with extraordinary low rates on Treasuries? How do they stand up against reasonable inflation expectations?
- When all is said and done, do their prices compensate adequately for the risk in a slow-growth environment?
- And how do bond prospects overall compare with potential expansion or contraction in equity market multiples?

A dynamic approach to diversification. Portfolio diversification is a very different process when such considerations are brought to the fore. No one can predict what will change, or when. But fixed-income markets today reflect fearful choices by many investors based on past correlations that might not hold

up much longer. After a multi-decade rally, it is now mathematically impossible for real returns in many corners of the fixed income universe to maintain this pace without rates entering negative territory.

This appreciation not only for past market behavior, but for future risk, distinguishes the Clear Harbor approach. We are committed to the continuous evaluation of market conditions; a dynamic approach to risk management; and forward-looking allocation strategies for potential environments that others haven't considered. Right now, that means asking the right questions about fixed income in particular.
