CLEAR HARBOR
ASSET MANAGEMENT, LLC

February 1, 2013

Aaron J. Kennon
Chief Executive Officer

Clear Harbor Flash: Consequences of a Weaker Yen

In the Clear Harbor Outlook for 2013, I outlined our view that the Japanese yen would weaken versus the U.S. dollar in 2013, providing investors with an opportunity to invest in Japanese equities that benefit from an acceleration in exports. Just this month, the yen declined in value by 6.7% percent, and the Nikkei closed the month the top performer relative to all major national indices.

We are pleased with this result from an investment perspective, as our firm's team strategies were positioned for this trend. However, we also believe that a continuation of this trend will provide challenges to investors and policy makers in the U.S. and around the world. What is the basis for this view?

The currency market is a zero sum market: when one becomes cheaper, another must become more expensive. When the yen declines against the dollar, goods and services offered by Japan become incrementally more attractive relative to those offered by U.S. corporations. And so on the margin, we would expect to see U.S. companies fighting harder for their share of revenue growth, even as an expanding global economy provides some level of relief across the board.

In addition to the revenue challenge, U.S. corporations report their earnings in dollars, which has the effect of lowering earnings from their operations in countries with less expensive currencies. For example, the most recent earnings release from Hawaiian Holdings disappointed on several fronts, including currency impacts. However, the most striking impact from the weaker yen was not on the company's customer traffic—i.e., their ability to attract customers—but rather, their adjusted revenue and earnings once sales were booked. The management team at Hawaiian has now indicated that they will hedge their currency exposure going forward. But hedging is not free, and further weakening in the yen will carry significant risk of currency volatility and earnings uncertainty.

What is driving this volatility amongst currencies? The Japanese government and Bank of Japan have simply joined the Eurozone, the U.K., the U.S. and other major players in a bid to devalue currencies and stoke domestic inflation. This "race to the bottom" among global currencies will bring both intended and unintended consequences. The goals are to reduce the value of debt and encourage growth. However, global currency wars can lead to significant foreign policy friction, international mistrust, and at times even war. I believe that the risk of at least some of these negative outcomes is now real and growing, with currency and geopolitical volatility liable to heighten capital markets risk—most notably in the equity markets—in the coming months and quarters.

This is not a warning sign to avoid equities in this or that particular region, but rather to revisit portfolios, review exposures, determine one's ability to withstand portfolio volatility, and understand the consequences of exiting positions at market lows. At Clear Harbor, we continue to overweight equities (including U.S. equities) relative to U.S. credit, but recognize the risks of headwinds should currency volatility continue to grow. While our main focus remains on company fundamentals, we will keep one eye on the global currency horse race, and remain alert to both the opportunities and risks it presents as we march through 2013 and beyond.
