THE HARBOR VIEW

A QUARTERLY INVESTORS REPORT FROM **THE HARBOR GROUP AT MORGAN STANLEY**

Q4 2021

EXECUTIVE SUMMARY

2021 has been another impressive year for equity markets as corporate earnings have continued to power through despite uncertainty over the path of inflation, rates, and the ongoing pandemic. Supply disruptions caused by labor shortages and post-lockdown demand spikes have caused inflation to sharply increase. While many expected these factors to cause a demand deterioration, consumers have remained resilient and have continued to spend despite higher prices. However, there have been clear winners and losers as proven by the drastic dispersion of returns for individual stocks. This has contributed to constant leadership changes between cyclicals and growth stocks. We continue to believe that 2022 will see the same pattern as pockets of opportunities shift and the macro environment becomes increasingly more fluid and uncertain. In addition, the Fed has finally acknowledged that inflation has not been so "transitory" and has announced that it will double the pace of its tapering and open the door to faster rates hikes next year. As monetary conditions begin to tighten, we acknowledge that higher returns will become more difficult to come by. Nevertheless, we remain optimistic for 2022 as supply chain bottlenecks begin to clear, unemployment continues to decline, and companies continue to invest in productivity and efficiency to offset higher costs. We expect economic growth to remain strong as demand ultimately shifts from goods to services once we get past the colder winter months and make it to the other side of another COVID variant wave.

A Tough Act to Follow

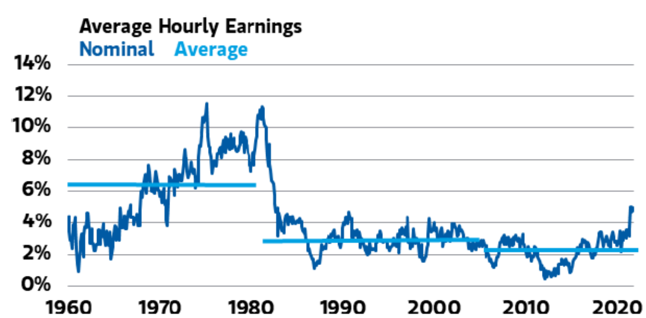
- After two strong years of policy induced support, we believe that market returns will likely be lower in comparison as the Fed dials down on easy monetary policy and fiscal support fades.
- Market leadership changes will continue to be frequent and dispersion among individual stocks will remain high as pockets of opportunities shift.
- We expect the U.S. to continue to outperform in the near term as the recovery overseas remains uneven due to the more stringent and restrictive measures used to contain COVID cases.
- We believe that inflation will ease towards the end of 2022 as the worst of supply chain bottlenecks is behind us and unemployment continues to fall. It may, however, remain higher than in previous cycles as wage and rent increases are unlikely to reverse.
- Corporate profits are expected to remain strong as companies have displayed a high degree of pricing power amidst high consumer and enterprise demand.
- We continue to prefer credit and shorter duration assets within fixed income as investors are not getting paid to take on duration risk.
- We continue to like private real estate and other alternative investments as a source of yield and diversification.

Markets

Despite what feels like a never-ending pandemic and the highest inflation we've seen in 30 years, markets continued to be supported by strong economic growth, plentiful liquidity, excess savings, strong retail spending, and higher wages. While markets were initially rattled when the Federal Reserve dropped the term "transitory" from its inflation outlook, we believe that tightening monetary policy has been unavoidable. After all, the Fed has provided extremely accommodative policy for over a year and a half. With the Producers Price Index (PPI) coming in at 9.6% vs the expected 9.2% and the Consumer Price Index (CPI) reaching its highest level in nearly 40 years, it is no surprise to us that the Fed pivoted to a more hawkish tone. The majority of Fed members are now forecasting three interest rate hikes in 2022, which is up from at least one hike in the September forecast. In addition, the Fed has doubled down on its tapering from $15 billion a month to $30 billion a month, which we expect to be complete by March 2022. While we have not yet reached "full employment," unemployment fell to 4.2% as COVID relief programs expired. It has become increasingly more difficult for the Fed to maintain ultra-dovish policies as inflationary pressures have continued to surprise to the upside while many have argued that such policies have been inflating asset prices and contributing to income inequality. Even if the Fed does as it says, monetary policy will still be far from restrictive. On the COVID front, it appears that while the new Omicron variant seems to spread more easily, hospitalizations and deaths remain much lower as the infected population is experiencing much milder symptoms. Our Morgan Stanley & Co. biotech analysts believe the worst will peak much faster than the previous Delta variant. In addition, U.S. equity markets are relieved to see that the government has made it clear that lockdowns are no longer an option. There have been no forced closures at the federal level and even states with high infection rates have remained open. While the uptick in Omicron cases has forced cancellations in flights, shows, sporting events and other areas, they have been short term in nature and have been at the individual business level. In fact, the Centers for Disease Control and Prevention have shortened its guidelines on isolation for asymptomatic people who test positive to five days from ten. This will allow employees who feel well to resume their work faster. Ultimately, we have learned to live with and adapt to the virus. In addition, the FDA's recent approval of Pfizer's COVID pill gives us another tool against the virus. This seems to be a pivotal point in the pandemic that the worst may finally be behind us.

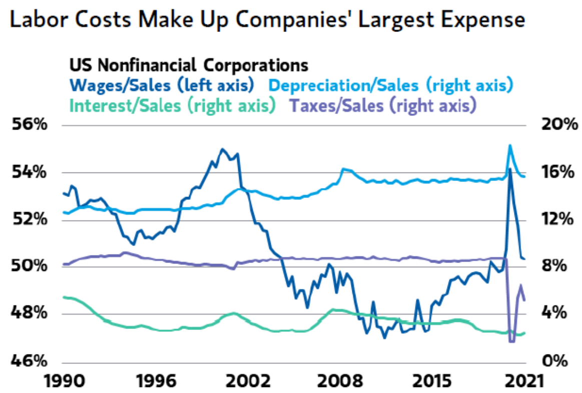
Despite the challenges that COVID has presented this year, earnings growth has continued to be strong as many companies have been able to increase margins by aggressively cutting costs during the pandemic. The companies that invested in their technologies and manufacturing capabilities beforehand were able to benefit and gain market share as revenues bounced back once the economy re-opened. Many have been forced to go digital and innovate well before COVID to withstand disruptors. While we expect earnings growth to remain strong, we do expect multiples to compress in the face of rising rates and an overall more difficult operating environment. Resolving the remaining labor issues will have major implications for whether the services sector finally recovers this time around. Many of those who continued to work throughout the pandemic have experienced burnout. After being forced to take on uncompensated risks, they have started to demand better wages and benefits. Companies across various sectors have dealt with pressures from unions and strikes, making wage growth and attracting talent important factors in addressing heightened demand.

Wage Growth Above 5% for First Time in 40 Years



Source: Federal Reserve Bank of St. Louis as of Oct. 31, 2021

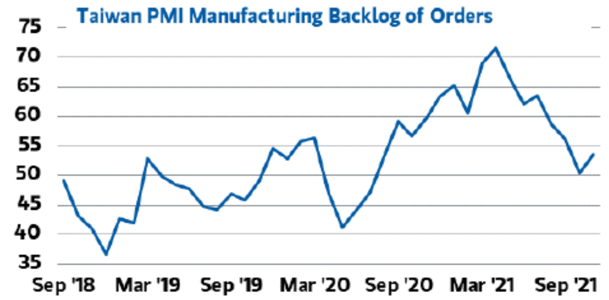
Labor is still the largest cost for most companies. In fact, in accounts for more than 50% of expenses for the S&P 500 Index in aggregate. While earnings in aggregate has been strong, there are still many companies that have struggled with the high costs of materials and labor and have even missed out of fulfilling customer demand altogether due to supply shortages. This has led to a major dispersion between winners and losers.



Source: BCA Research as of June 30, 2021

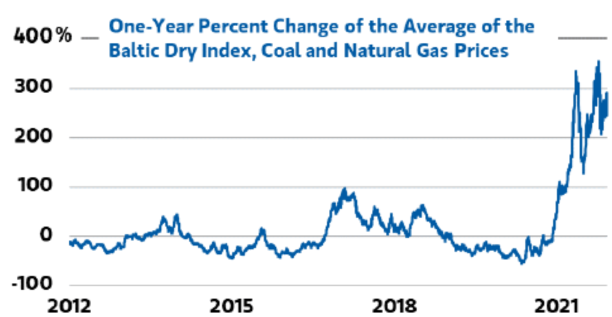
This has forced many companies to invest in productivity and efficiency. We have seen increased spending and intentions to spend on things like automation and data analytics across many sectors to better match supply and demand while offsetting labor costs. An uptick in COVID cases and labor shortages have also forced companies to turn to robotics. Therefore, we don't think the argument of growth versus value is as relevant as it used to be in the past. Many companies that have once been considered value oriented blue chips have more exposure to technology than ever in order to stay relevant. We believe that such investments have set companies up for greater efficiencies going forward. The companies that have been successful so far have been able to pass along higher costs to consumers. Those that can continue to navigate the uncertainties of unpredictable supply and demand best will be the ultimate victors, regardless of style or sector.

While the impact of higher wages on inflation is unlikely to fade, the impact from supply chain issues will. We expect the bulk of this year's deferred demand to be captured next year as supply chains ease. There have already been signs of improvement with backlogs at ports easing and more truck drivers getting hired. This can be seen through manufacturers also chipping away at their order backlogs.



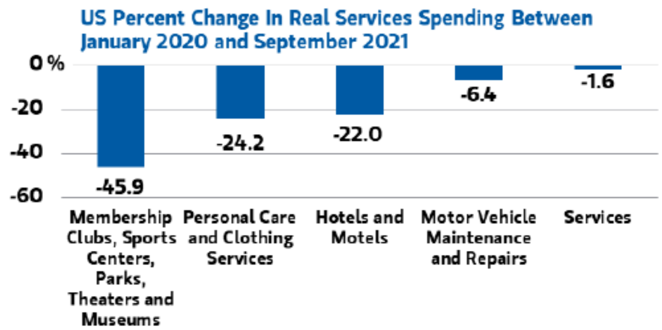
Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of Nov. 30, 2021

If labor starts to improve on the services side, we can see a major pick up from pent up demand. As the impact from new variants appears to decline, a shift from spending on durable goods to services will also allow for inflationary pressures to moderate as inventories get the opportunity to rebuild. We do not believe the Fed will be as aggressive as the market is pricing in if we are right in our call that inflation will simmer down at some point next year. While housing prices and wage growth are expected to remain high, disruptive technologies and pandemic-related digitization of services will continue to cap inflation while making rising costs more manageable for businesses going forward. Energy prices are also expected to be less of a drag next year. The U.S. Energy and Information Administration recently projected that retail gasoline prices will continue to fall after reaching their highest levels since 2014. We can also see that an equally weighted basket composed of the Baltic Dry Index, coal and natural gas prices has already started to roll over.



Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of Dec. 9, 2021

Despite the rising costs, supply chain pressures and labor shortages, durable goods spending remained strong. While some of that spending is likely to slow, we do see more opportunities in the services sectors where spending remains well below pre pandemic levels. We believe that the combination of goods prices eventually dropping while wages increase puts the consumer in a strong position to spend on services.

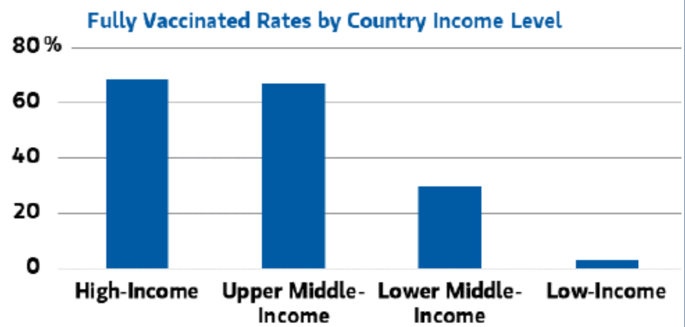


Source: BCA Research Inc., Morgan Stanley Wealth Management Global Investment Office as of Nov. 19, 2021

We remain optimistic that COVID will become less of a headwind going forward, which should also bode well for the services sector. There is growing consensus that as the virus continues to mutate, it will continue to become less severe although it may spread more easily. So far, data has indicated that fully vaccinated people are protected against severe illness while those with boosters have increased protection against infection. While it is increasingly unlikely that Omicron causes a sustained pullback in the U.S., it has been met with stringent zero-Covid tolerance policies in some places overseas.

International Markets

The global recovery has been extremely uneven as the pandemic has hit different regions at different times. There have been many instances where different sectors and regions have had both moments of recovery and relapse. In addition, the pace of vaccinations and new outbreaks has been extremely inconsistent. Eventually, vaccination rates, oral anti-viral pills and natural immunity acquired through infection will dampen the impact of the pandemic and make the recovery globally more synchronous. Once this occurs, we believe that both international and emerging markets can catch up to their U.S. counterparts. However, in the near term, we expect the U.S. to maintain its lead for several reasons. As we've mentioned, despite the frustrations many have had, restrictions in the U.S. have at least been less stringent than what we have seen overseas. In fact, we would argue that another reason why the U.S. service sector has not recovered is because of foreign tourism being a drag. Many countries continued to impose travel restrictions while others such as Austria returned to a full national lockdown in November. Norway and others also imposed restrictions on bars, gyms and restaurants. In fact, labor shortages have been even more pronounced in countries such as Australia and Canada that have been stricter in their handling of COVID cases. The uneven recovery has caused international equity valuations to remain depressed. Lower income countries have not been able to keep up with high-income countries with regards to vaccinations for a variety of reasons.



Source: Our World in Data, Morgan Stanley Wealth Management Global Investment Office as of Dec. 7, 2021

Given this dynamic, there are still headwinds to growth in emerging markets with low vaccination rates. Industries in Europe that have been dependent upon exports or sell predominantly to China and other emerging markets have also suffered disproportionately due to recurring COVID lockdowns and government protocols. In order for international markets to recover or follow the bounce back we have seen in the U.S., we have to get past the lockdowns being reinstated throughout many parts of Europe, especially in the most economically sensitive sectors. Ultimately, the high savings rate will propel international consumers to spend their way into a recovery as demand remains robust. However, much of this depends upon the path of the virus and the measures being used to combat it.

Many emerging markets have already removed policy accommodation and have started to hike rates to combat high inflation despite weaker vaccination rates and lockdowns. Brazil faces widespread inflation as economic growth weakens. President Jair Bolsonaro has proposed a new cash-transfer program to low-income Brazilians by breaching the country's spending-cap rule to enhance his favorability ahead of next year's election. Turkey continues to suffer as the government cut rates at a time when inflation reached 20%. Mexico's longer-term growth prospects also remain challenged due to policy missteps and fiscal austerity. As it comprises over a third of the MSCI Emerging Markets Index, China remains a large determining factor in the broad recovery of emerging market equities. Investors need to gain more visibility on the impact of recent reforms. Once investors gain confidence about the end of surprises, Chinese equities may be able to find their footing. This will ultimately be a key determinant of whether China and emerging markets can outperform in 2022. China has made it clear that it is willing to tolerate somewhat weaker growth to achieve its goal of "common prosperity" and doubling its middle-income population. We have already seen the government impose fines on many technology companies and has asked Didi Global to delist from the U.S. Chinese technology stocks have seen even greater losses due to tax loss selling and fund redemptions. Many of the largest companies listed in the U.S. have already undertaken dual listings in Hong Kong. While we expect many more to follow, we do believe many investors will ultimately convert share classes. As we expect stricter regulation in China to persist as the country continues to prioritize social and economic objectives, we do believe that the worst is behind us. Given slowing growth and troubles in the property sector, policy easing has already started to accelerate. We believe China will continue to increase its vaccination rate as its zero-tolerance Covid approach has been a detriment to growth, particularly in the services sector. The property sector has also been a cause of concern as indebted developers have caused a major slowdown in the construction sector, which has comprised one fifth of GDP. Strong domestic consumption is likely to offset this and be a key growth driver going forward. The good news is that the slowdown in China has now become the consensus view. While calling a bottom is never a wise thing to predict, especially as regulatory overhangs are likely to keep sentiment depressed, we disagree with those who are calling China "un-investable." We believe that increased stimulus and visibility on the direction of reforms could serve as catalysts at some point in 2022.

Fixed Income & Rates

Despite the Federal Reserve committing to a faster tapering schedule than previously anticipated and forecasting a faster pace of rate hikes, investors continued to flock to safer havens like bonds as COVID related news initially sparked fear. While we believe rates will continue to rise gradually, we acknowledge that there will be a cap as to how high rates can go as yields globally are likely to remain depressed. Longer term yields are likely to move slightly higher as we get closer to the first-rate hike. We have already been proactive in shortening duration across bond portfolios and continue to favor such positioning. We continue to like credit as strong growth and healthy corporate balance sheets are likely to keep default rates at record lows. While spreads remain tight, we continue to favor taking on credit risk as opposed to duration risk at this point in the cycle. We believe the Fed will be more gradual than the market is currently expecting. A faster taper will at least give the Fed the option to hike rates if inflation does stay elevated. We believe that liquidity will still be ample and supportive for asset prices as the Fed recognizes that the pandemic is still not over. It has no intention of hiking too quickly at a time when certain parts of the economy have not yet fully recovered. Nevertheless, tightening conditions are likely to pressure riskier and speculative asset classes.

Alternatives

We believe that the need for alternatives has grown considerably as uncertainties in equity markets and low yields globally continue to plague investors. Real estate remains our preferred inflation hedge as rent growth continues to stay elevated. This is another inflation contributor that is unlikely to fade. We also continue to like direct lending as private equity growth and increased M&A activity supports the need for capital and financing. We believe there are certain overarching themes including life sciences, the energy transition and the increased importance of software innovation that continues to support the need for venture capital. The investment universe has become increasingly complex and finding low correlation to public markets has become increasingly essential. There have been many sectors and stocks in the public markets that have become subject to systematic trading strategies and macro calls. The same sectors in private markets have offered less downside and volatility.

Closing Thoughts

Tightening financial conditions are likely to impact speculative assets such as unprofitable momentum names in 2022. We continue to believe that the pandemic will not upend the market's recovery but it will certainly bear watching as it will ultimately determine how much and how quickly the services sector can recover. It will also determine how quickly international and emerging markets can recover. Midterm elections in 2022 will be increasingly important as the potential for a divided Congress will impact the future of fiscal stilumus. If Democrats are successful in passing more social spending bills, we may risk seeing inflation surprise to the upside. Earnings stability will be a key driver of stock performance as price makers will continue to outperform price takers across all sectors and styles. Strong growth will need to offset lower multiples going forward. We believe there is currently sufficient liquidity in the system to handle some monetary tightening. Falling unemployment and easing of supply chains should help tame inflation; however it it likely to remain higher than what most investors are used to. We remain optimstic overall but continue to remain selective as higher returns will likely be more diffult to come by. We would like to thank you all for your continued trust in us and wish you and your families a wonderful Holiday and a Happy New Year!

Hot Topic

If you have not made your retirement contributions for 2021, it may not be too late.

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