THE HARBOR VIEW

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

QI 2022

EXECUTIVE SUMMARY

2022 has been off to a volatile start as we move towards the later stage of what has been a much hotter but shorter economic cycle. Given the strong pace of inflation, Chair Powell has made it clear that the Fed must normalize interest rates as quickly as possible and perhaps even go further into restrictive policy. Unlike previous tightening cycles, this one comes at a time when geopolitical concerns are on the rise and economic growth is slowing. Russia's invasion of Ukraine has created both a devastating humanitarian crisis as well an additional inflationary catalyst. While we hope for a peaceful and quick resolution, we acknowledge that it may not be so easy. The aftermath has further exacerbated rising energy and commodity prices while hindering already strained supply chains. This could negatively impact corporate earnings just as consumer demand and sentiment moderate after a period of post lockdown overspending. We have therefore become increasingly cautious for the coming quarter but are far from anticipating a recession. While risks to the downside remain as the Fed tightens financial conditions, we believe the U.S. economy is in a very strong position to weather the storms that may lay ahead.

Don't Fight the Fed

- We expect corporate earnings growth to slow from elevated levels as companies grapple with accelerating costs, declining consumer and business confidence and lower demand.
- Market conditions will remain volatile as the war between Russia and Ukraine continues.
- We believe the Fed's hand might be forced to raise rates faster and possibly taper sooner than expected given that they are "behind the curve" in fighting inflation.
- The probability of a 50-basis point rate hike at both the May and June meetings has increased given that near term inflation is likely to remain elevated.
- Despite near term support, we would not chase energy and commodity related investments as we think prices will self-correct over time.
- We prefer a more defensively oriented positioning across stocks and sectors as we enter a late cycle. We believe companies with greater earnings visibility and strong pricing power are more likely to see a soft landing while the most speculative parts of the market continue to remain vulnerable.
- We continue to favor the U.S. which is more insulated from the disruptions abroad and has recovered more quickly from the COVID-19 pandemic.
- Within ex-U.S. equities, we prefer exposure to Asia, which is seeing policy support and an improving regulatory environment.
- We see recession risks as low as corporate and consumer balance sheets remain strong.
- We continue to like private real estate, structured products, and alternative investments as a hedge and source of diversification.

Markets

A $6 trillion fiscal response to the pandemic has allowed U.S. GDP and corporate earnings to speed past prior cycle highs. We have seen the fastest earnings recovery in 40 years, taking only 16 months to reach the prior cycle's peak. Easy monetary and fiscal policy led to an overstimulated economy where supply struggled to keep up with elevated demand. Given the unpredictable path of the virus and its impact on employment, the Fed was initially comfortable with allowing inflation to "run hot." However, it had underestimated just how hot that could be. Pandemic related restrictions and quarantine mandates made it difficult for service-related industries to see the recovery that many hoped for. This allowed the consumer to continue spending on goods which further pressured companies to keep up as they grappled with labor shortages and supply constraints. Meanwhile, inflationary pressures continued to build. After getting renominated as Chairman of the Federal Reserve, Jerome Powell finally admitted that he underestimated the strength and persistence of inflation. The Fed announced that it had no choice but to start hiking interest rates and tapering its asset purchases to maintain price stability. This increasingly hawkish policy pivot caused long duration assets to underperform and sparked extreme drawdowns for growth stocks. Russia's invasion of Ukraine has since created an even greater supply shock for energy and commodities. We acknowledge that the concerns this causes for markets is incomparable to the loss of human life and the horrific humanitarian crisis that has resulted. We deeply sympathize with all those who are impacted.
Russia and Ukraine combined comprise only about 2% of global GDP. However, a prolonged war could further slow economic activity around the world by further hampering global supply chains and consumer sentiment. Russia is the world's third largest oil producer after the U.S. and Saudi Arabia, accounting for approximately 10% of global output, and the second largest gas producer after the U.S., responsible for 17% of global output. Russia is also a major exporter of industrial metals that are used in automobiles, aerospace, and semiconductors. Both countries are major exporters of food inputs such as wheat and corn, to name a few. The West has also imposed financial and trade related sanctions causing metals and agricultural commodity prices to further spike. The price of Brent crude oil temporarily surpassed $130 per barrel while U.S. gasoline prices hit all-time highs. The European Central Bank (ECB) has even announced a faster than expected end to its asset purchases that will also be followed by rate hikes. The Fed has also pivoted to an increasingly hawkish tone and noted that it must act to normalize interest rates as quickly as possible and perhaps even go further sooner than most investors anticipated. Chair Powell mentioned that rate hikes could be as high as 50 basis points if necessary, doubling the more traditional 25 basis point increases. While markets initially supported the Fed's resolve to fight inflation, concerns quickly grew once they also cut GDP forecasts and acknowledged that inflation and macro events would contribute to a slowdown in growth.

Slowing growth was already on the table coming into the year as consumers and businesses overspent during the pandemic. However, the overall macro environment has since gotten worse. With inflation running at 40-year highs, consumer and business confidence has started to drift downwards. The University of Michigan Consumer Survey showed that personal finances were expected to worsen in the year ahead by the largest proportion since the surveys started in the mid-1940s. The Index has recently hit at an 11-year low as real wages for all income groups have turned negative after adjusting for inflation. Companies have also seen the benefits of positive operating leverage starting to fade. Those that have guided for a decline in sales or an increase in higher costs have been severely punished by the market. Strong growth that is slowing is no longer being rewarded as the market becomes unwilling to pay higher multiples for it. Companies had to over-order to meet the excessive levels of demand that the pandemic pulled forward. That is no longer sustainable, and we are seeing a slowdown in the favorable earnings revision cycle we've experienced for the last 18 months.

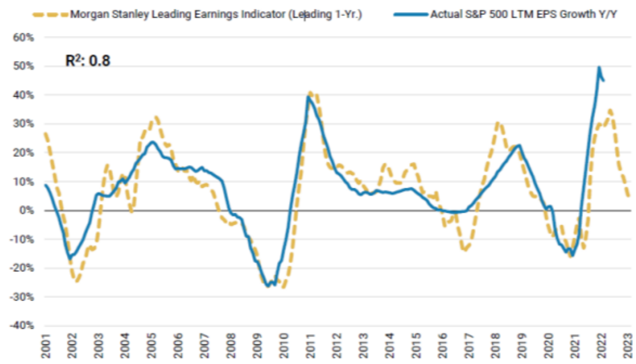
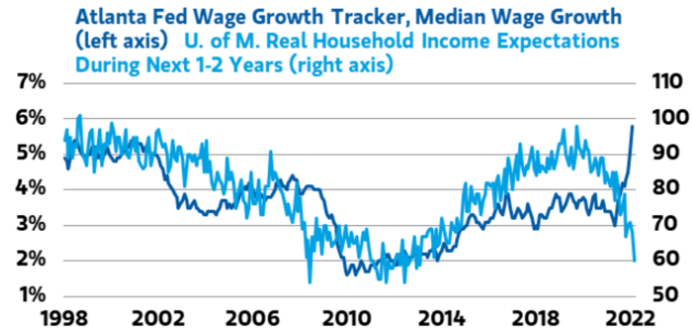


Exhibit 3: Our leading EPS growth indicator is speeding toward zero

Source: Factset, Bloomberg, Morgan Stanley Research



Source: Bloomberg as of March 17, 2022

This explains why so many companies that were perceived to have benefitted disproportionately during the pandemic are no longer in favor. This includes companies in areas such as software, gaming, and home improvement, just to name a few. While the services that many of these companies provide have become ubiquitous to their customers, it is only normal for sales growth to slow from very elevated levels. The underperformance in many of these companies has been extreme as they are considered long duration assets (meaning that they receive a larger portion of their cash flows in the future and are therefore more sensitive to rising interest rates). Multiple contraction, even for high quality names with strong pricing power, may not be over yet as the market continues to shift towards the perceived safety of defensives.

The Good News

We are far from forecasting a recession given that labor markets remain strong with current job openings handily outpacing the availability of workers. While rising prices are painful, both businesses and consumers are in much better shape than they have been historically. Excess savings rates remain high while household and corporate balance sheets are healthy. Credit conditions also remain benign as default risks are well contained. While inflation has dampened consumer confidence and sentiment, MS & Co.'s chief US economist, Ellen Zentner, expects real wages to turn positive for all income groups by midyear. Currently wage growth exceeds income expectations by a large margin, signaling that consumer sentiment may have actually gotten too bearish.

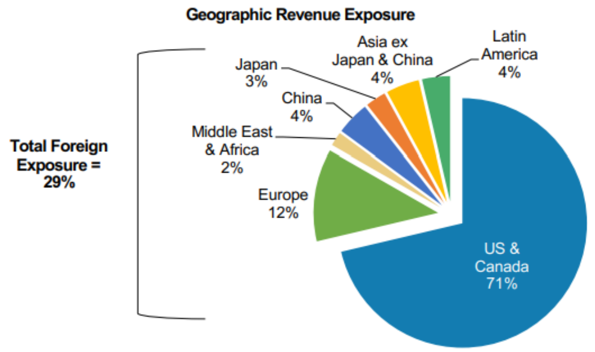
While she estimates that current oil and natural gas prices could reduce 2022 household spending by $200 billion, this can be more than offset by the estimated excess savings of $1.5 to $2.0 trillion that currently sits in individual bank deposits and money market funds. Furthermore, gasoline currently makes up a much smaller share of the consumer's wallet than it did during the energy price shocks in the 1980s. It is also roughly half of what it was during the oil price highs between 2006-2008. We also note that rising commodity prices tend to self-correct due to the demand destruction that they cause. We are already seeing this as oil prices have backed off after hitting a high of $130. In addition, consumers are also much more likely to transition to shift their spending from goods to services as COVID related restrictions ease. Given the high pent-up demand for services that has been pushed back far too many times, we expect most consumers will absorb higher oil and gas prices in order to enjoy delayed leisure activities such as traveling and dining out. We do not believe that new variants will cause restrictions to be reinstated in the U.S. given that most of the population is now better protected and more therapeutics have become available.

International Markets

We have become less optimistic on international markets and continue to prefer the U.S. for investing new capital. Although Europe is taking steps to find alternatives to Russian energy, it will take time for new supplies of liquified natural gas, green energy sources and nuclear power to fill in the large gap. Russia currently provides Europe with nearly 40% of its natural gas and 25% of its oil. Overall, U.S. company exposure to Europe is moderate at 12%, with bulk of revenues generated at home. U.S.

companies only have about 1% of revenues coming from Russia. However, a decline in European consumer sentiment is likely to negatively impact multinational U.S. companies to some extent.

Exhibit 18: US Revenue Exposure by Region



Source: Morgan Stanley Research

While the U.S. economy is unlikely to see a recession unless nuclear threats escalate, Euro clearly has much larger recession risks. Nevertheless, the ECB has stated that it will likely proceed with tapering and hiking rates as early as October. The geopolitical uncertainty has strengthened the argument for energy independence and exposed the need to address the continent's defense shortfall. While defense spending is set to finally increase, consumption growth is likely to slow as Eurozone inflation hits all-time highs. We are, however, pleased to see greater EU unity and believe this will eventually bode well for more synchronized fiscal spending in the future.

Emerging Markets performance has continued to be inconsistent. Overall, EM has been slower to recover from the COVID-19 pandemic as it never received the type of stimulus that we witnessed in developed markets. We believe the general Index has been somewhat de-risked with the removal of Russian investments given the implications of sanctions on Russia's economy. There have also been some countries that have benefitted by picking up some of the commodity slack. This includes Latin America which is home to many oil and commodity exporters. This has created large discrepancies in performance.

While we continue to prefer Asia, we do realize it has struggled due to reinstated lockdowns. China has shown no tolerance to rising COVID infection rates. Such lockdowns, however, have become much shorter and more local in nature. While we believe zero COVID policies are unrealistic, we expect these to continue to ease going forward as China has become increasingly focused on hitting growth targets. Chinese officials have also suggested that the crackdown on technology companies may be coming to an end. Chinese leadership has since addressed financial stability concerns as economic activity has surprised to the upside. We also see China's alliance with Russia weakening as it has stated a willingness to provide humanitarian assistance to Ukraine. While China will continue to import Russian oil, this at least removes the political stigma of siding with Putin as the market feared. China has also cut rates and implemented tax cuts for small and medium enterprises to spur more wealth and job creation. While delisting fears once again caused knee jerk reactions, we are encouraged that regulators are keeping discussions ongoing. Overall, we continue to see opportunities but realize that investing requires an additional level of risk tolerance due to the unpredictable nature of the Chinese government.

Fixed Income & Rates

Core consumer prices (ex food and energy) increased 6.40% year-over-year in February while the fed funds rate was 0%. This represents the largest policy gap since 1974 and shows that there may be a need for the Fed to play catch up. After implementing its first 25-basis-point rate hike of the cycle, it gave a hawkish outlook for six additional hikes this year. Factors such as rising rents and wages do not appear to be transitory and have become major contributors to the recent upside surprises in inflation. Morgan Stanley & Co.'s U.S. economists expect that in addition to rate hikes, the Fed will need to do about $500 billion in balance sheet reduction through year-end; in tightening terms, that's the equivalent of another 25-basis-point hike. The chances of a policy error are now very real as it remains to be seen how much liquidity withdrawal the market can tolerate before multiples find a bottom. The Fed is now facing an unprecedented challenge in satisfying its dual mandate of controlling inflation and achieving maximum employment. It they tighten too much, they risk jeopardizing employment. If they tighten too little, they hurt consumers by keeping prices elevated. Therefore, the Fed has expressed that it reserves the right to change its mind on its monetary path. We believe the Fed will ultimately take a wait and see approach, especially if inflationary pressures abate in the second half of the year.

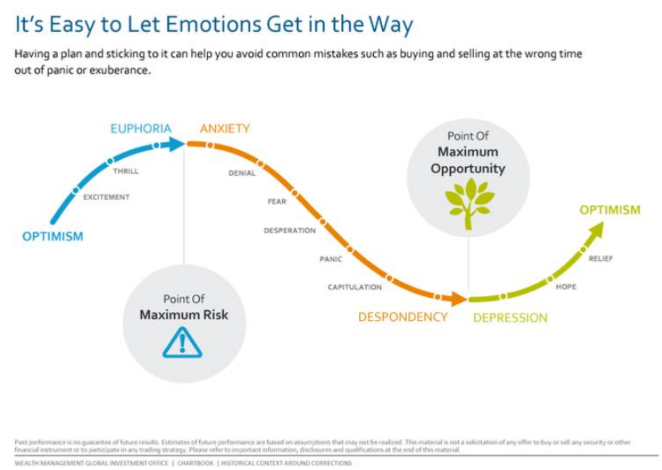
The bond market was quick to acknowledge the Fed's lowering of its GDP forecast to 2.8% from a robust 4.0%. It immediately priced in the slower growth outlook and caused the 2-year and 10-year yield curve to flatten. While it has since inverted, we note that this does not always mean a recession is looming, nor do we expect one. It also does not accurately predict when one begins post inversion. When the Fed used interest rate hikes to calm inflation in the 1980's, the yield curve inverted seven times but was followed by only four recessions. We also believe the curve has flattened for several technical reasons as pension funds and insurance companies flocked to treasuries as the Fed hiked rates.

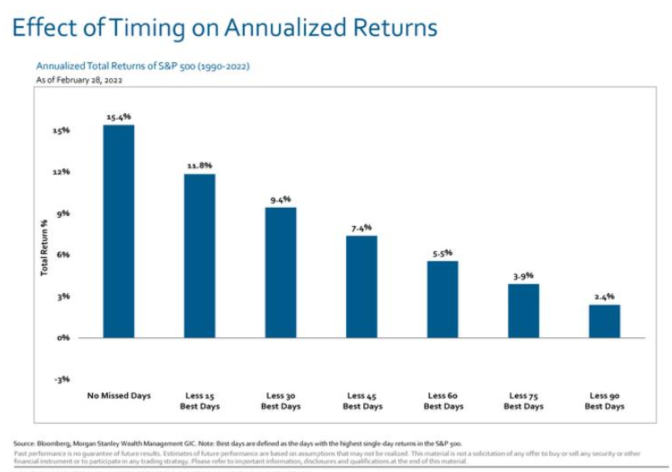
Alternatives

We believe that the need for alternatives has grown considerably as uncertainties in equity markets continue to plague investors. Real estate remains our preferred inflation hedge as rent growth continues to stay elevated. We would not chase commodity-oriented funds at this time. We also continue to like direct lending as private equity growth and increased M&A activity supports the need for capital and financing. Private equity continues to benefit from patient capital that is less impacted by knee jerk market reactions and violent short-term swings. We believe structured notes provide opportunities to access markets with contingent downside protection and an opportunity to earn additional income. As uncertainty is on the rise, we remind eligible investors that such tools are available to help mitigate risk and diversify portfolios.

Closing Thoughts

There has certainly been a lot going on for the markets to digest. Inflation is posting its highest readings in years, a tragic war continues to unfold, there are growing fears about Russia's potential use of chemical and nuclear weapons, the Fed is set to tighten financial conditions and now news reports are mentioning the spread of a new variant. While the U.S. economy is strong enough to withstand such concerns, equity multiples are still too high given these risks. We expect there is room to see additional downside in the coming months. While growth stocks have already been punished, rising yields will continue to weigh on their valuations. Value-oriented and defensive stocks, on the other hand, are likely to be supported as inflationary pressures persist in the near term. While we understand that extreme bouts of volatility can be tough to stomach, we remind investors that U.S. equities had posted a strong rally for most of the previous 18 months with relatively little volatility. The equity market typically has a significant pullback in each calendar year. However, the market has generated positive returns in 35 of 42 calendar years going back from 1980–2021. Trying to time when to get in and get out has proven to disappoint over the long run.





Corrections do not equate to recessions. It is extremely unlikely to have a recession less than two years after a previous one. While the next quarter is likely to still be volatile, we do expect some concerns surrounding inflation to abate in the second half of the year. Companies with strong balance sheets and pricing power will continue to navigate these challenges quite well. In addition, fading pandemic effects should support pent-up demand for services.

Hot Topic

Cash Management and Lending Solutions

We have access to Private Bankers who can help you find cash management and lending solutions that may help meet your goals, including mortgages. Contact us for more information.

Team Updates

It is our distinct pleasure to report that Harbor Group Managing Directors, John Vessa and Jeff Winik, and a number of their esteemed colleagues at Morgan Stanley have made the 2022 list of Barron's Top 1,200 Financial Advisors. This recognition is a reflection of our ongoing commitment to you, your family and your financial future.

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Source: Barrons.com (March, 2022). Top 1,200 Financial Advisors: State-by-State as identified by Barron's magazine, using quantitative and qualitative criteria and selected from a pool of over 6,000 nominations. Advisors in the Top 1,200 Financial Advisors list have a minimum of seven years of financial services experience. Qualitative factors include, but are not limited to, compliance record and philanthropic work. Investment performance is not a criterion. The rating may not be representative of any one client's experience and is not indicative of the Financial Advisor's future performance. Neither Morgan Stanley Smith Barney LLC nor its Financial Advisors or Private Wealth Advisors pays a fee to Barron's in exchange for the rating. Barron's is a registered trademark of Dow Jones & Company, L.P. All rights reserved.

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