THE HARBOR VIEW

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

QI 2023

EXECUTIVE SUMMARY

Up until recently, the Fed's actions have been slow to trickle down into the economy. Labor markets have remained strong while consumer spending has remained relatively resilient. Since monetary policy tightening operates with a lag, earnings estimates have largely ignored the possibility of any negative outcome that might arise. The recent turmoil in the regional banking sector indicates that cracks are beginning to show and further unintended consequences of a potential liquidity squeeze have yet to fully transpire. While bond volatility has soared, equity markets have continued to interpret bad news positively and have seen these developments as a reason for the Fed to pause rate hikes sooner than expected. Regardless of whether the Fed pauses or not, credit availability will continue to decrease for a large portion of the economy. As banks are likely to lend even less, businesses may begin to struggle, and profits could ultimately get hit. We don't know how much longer the market can ignore just how difficult the Fed's job has become. Finding a balance between taming stubbornly high inflation and avoiding further financial instability and a potential recession is no easy feat. We believe investors should be prepared for the market to finally price this in before a new bull market can begin.

Current Thoughts

- We believe equity markets are ignoring that the Fed may not be able to successfully lower inflation without causing further pain in the economy.
- We see a greater possibility of stagflation if the Fed is forced to pause prematurely. This would mean that inflation remains higher for longer while growth continues to slow.
- We believe that tighter credit availability will further slow both economic and corporate profit growth going forward.
- The degree to which small and medium sized businesses experience a liquidity squeeze will determine how resilient the labor picture could remain.
- Equity markets may begin to finally price in a downturn in earnings before estimates actually get cut further.
- We believe a defensive positioning on the equity side with a focus on balance sheet strength, earnings stability, and low debt is warranted.
- We prefer large cap companies over small caps, which are more reliant on loans from regional banks.
- We see opportunities in private credit as banks are likely to lend less going forward.
- We continue to consider alternative investments as options to mitigate risk and portfolio diversifiers for eligible investors, where appropriate.
- We believe the market may need a final pullback before a new bull market begins.

Markets

After a painful 2022, we witnessed a very strong start to the year as December's Consumer Price Index (CPI) headline inflation number was in line with expectations while nonfarm payrolls showed wages decelerating. The Institute for Supply Management (ISM) prices paid data also showed a slowdown. A warmer winter helped energy prices fall meaningfully, bringing overall inflation down from its peak. After core inflation saw three consecutive month-over-month declines, the Federal Reserve (Fed) gave investors confidence by announcing it would slow its pace of short-term rate hikes starting with a 25-basis-point hike at the February meeting. This sent yields lower across the curve, supporting bond prices and reflating equity multiples and valuations, especially in beaten down growth stocks. While corporate earnings were far from strong, they came in better than expected while China's reopening gave investors even more reasons to cheer and reignited hopes for a soft landing. Markets continued to look on the bright side of mixed data readings. Strength in services accompanied by weak manufacturing orders was viewed as contributing to just enough growth to keep the economy from avoiding a recession while still being weak enough to prompt a Fed pause. However, this slowdown in inflation proved to be short lived. New January data showed significantly better-than-expected retail sales that were accompanied by a strong labor market. Both the Consumer Price Index (CPI) and the Producer Price Index (PPI) reports pointed to positive economic surprises which signaled that not only has progress on lowering inflation slowed but growth has reaccelerated. While bond markets were quick to reprice in anticipation of higher rates once again, stocks continued to ignore that the Fed may be forced to stay higher for longer. Financial conditions began to tighten once again as the positive surprises reignited a rebound in both oil prices and the US dollar. Just as equities celebrated inflation on the way down, they seemed to ignore it on the way up, dismissing Fed guidance and the implication that the longer economic resilience continued, the more tightening the Fed would do. The February jobs report threw even more fuel on the fire, showing more strength despite the Fed's rate hikes. The fed funds futures terminal rate now soared to 5.5% from 4.8%, causing the market rally to finally reverse. Equities briefly acknowledged that strength in both services and labor markets may cause the Fed to risk overshooting as opposed to abandoning the fight against inflation too soon.

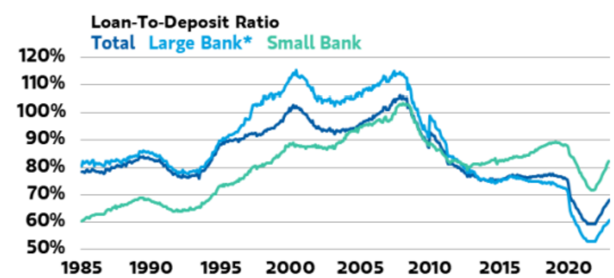
We have argued that consumer spending could remain strong as consumers shift their consumption from goods to services. Services demand, which makes up two-thirds of total US consumption, is now enjoying the same strength as manufactured goods during lockdown. Pent-up demand for things like travel, leisure, and dining out is likely to keep services inflation high, thus distorting both the inflation and employment readings. We have noted how the pandemic caused structural changes to the labor market including a decline in labor force participation. The migration away from traditional urban centers in addition to the shift to remote work has further exacerbated this issue. Most of our current labor shortages remain in the areas with the most pent-up demand. Total employment in services remains well below the pre-pandemic level, leaving these businesses chronically understaffed. Therefore, strength in services is keeping labor markets tight and contributing to upward wage pressures. Most of the recent wage gains have come from this lower income cohort. Further complicating the data is the large amount of excess savings concentrated in the top wealth quintiles. This distorts how much liquidity and spending power are really in the system. As many inflation variables operate on a lag, the Fed is essentially using backward looking data to determine whether or not policy changes are working. On those measures, it might seem that they were not doing enough despite the yield curve showing otherwise. Its inversion created a challenging environment for banks to make profits on new loans. The recent stress in the banking system started to show some of the unintended consequences of the Fed raising rates too quickly. Since the onset of the pandemic, US banks took in a large number of deposits. While most of them used these deposits to make quality loans and issue mortgages, one bank disproportionately collateralized their deposits with treasury bonds and other fixed-income securities that declined in value once the Federal Reserve raised rates. Once investors realized that banks were paying them below market rates on their deposits, they began to withdraw funds in order to invest in higher yielding securities. The run-on deposits combined with unrealized losses on bank balance sheets created a crisis of confidence across smaller regional banks and intensified fears that something else might break. This bank's account balances consisted mostly of operating cash which was in a continuous drawdown as cash burn accelerated once capital markets closed and rates soared.

Other regional banks were better positioned as their depositors were more diversified by industry and better balanced between individual and corporate clients. The FDIC helped alleviate fears by guaranteeing all depositor funds, including those that were previously uninsured. This preserved companies' ability to support their employees' payrolls and stay afloat. The Fed was equally supportive by issuing a new loan program for banks to pledge US treasuries, agency mortgages and other qualifying assets at par value in exchange for loans with maturities of up to one year. This liquidity line essentially eliminated the need for banks to sell high-quality securities at a loss to meet deposit withdrawal shortfalls. While this should help prevent any further bank runs, we think investors are still missing the bigger picture - slowing growth is now inevitable.

Despite the failures of three banks and discounted sale of another bank in a single week, markets remained bullish, focusing solely on plunging interest rates. The 10-year Treasury yield collapsed by more than 65 basis points while the two-year Treasury yield fell over 100 basis points. While bond markets acknowledged that the odds of an economic recession have now increased, equities continued to interpret these negative developments with renewed optimism for a Fed pivot. Meanwhile, the Fed continued to hike rates anyway for the ninth consecutive time and mentioned no changes to the balance sheet program. For her part, Treasury Secretary, Janet Yellen, also squashed hopes for a broad increase in deposit insurance. Despite all of this, markets were reassured by Fed Chair Powell's comments that the recent tightening of financial conditions has altered the Fed's outlook for growth and inflation and signaled that while further tightening may still be needed given the high levels of inflation, there may be less work to do in the future.

It is becoming increasingly clear that the lagging effects of cumulative Fed rate hikes and balance sheet reduction are finally starting to bite. This is unlikely to reverse even if the Fed were to pause. An equity market that has remained in a tight range between 3,900 and 4,100 for months, as measured by the S&P 500, doesn't seem to be acknowledging this even as consensus earnings forecasts have declined since last summer. Banks' cost of deposits has been rising for months and the events at troubled institutions are likely to put further upward pressure on those costs. When banks pay more to secure deposits, their net interest income falls, and their profits weaken. Recent downgrades from ratings agencies are also likely to tighten lending standards. A slowdown in bank lending tightens financial conditions by inhibiting credit growth and money supply. This is likely to disproportionately impact small and medium sized businesses, which are more dependent on loans from regional banks. Since the Great Financial Crisis, regional banks have played a larger role in lending as larger banks were held back by increased regulation.

Loan Exposure Has Declined Since 2008 ...



*25 largest domestically chartered banks ranked by domestic assets. All others are small banks.
Source: BCA Research as of March 16, 2023

Regional banks with less than $250 billion in assets account for roughly 50% of all commercial and industrial (C&I) loans, 70% of commercial real estate (CRE) loans and 38% of the residential mortgage market. [1] Among the C&I and CRE loans, the vast majority go to smaller businesses. As Ellen Zentner and the Morgan Stanley & Co. US economics team point out, the link between C&I loans and unemployment is strong since small businesses account for roughly two-thirds of all jobs. Therefore, C&I loan growth is directly linked to economic growth as it impacts employment and

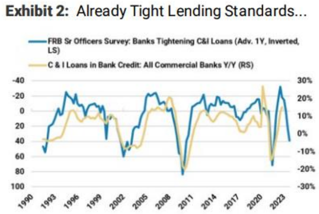
[1] The GIC Weekly – March 27, 2023 (Morgan Stanley Publication)

ultimately consumption. Their analysis suggests that a 10-point increase in lending standards translates into 35 basis points of unemployment. [1] As lending standards have already tightened by 70 points so far, that indicates that unemployment could increase by 2.5 percentage points. Unemployment claims have remained muted thus far as hiring by small service companies has offset layoffs at larger ones. Historically, initial claims have been directly correlated with loan availability to small businesses, which account for nearly two-thirds of all jobs.

Source: Bloomberg as of Feb. 28, 2023

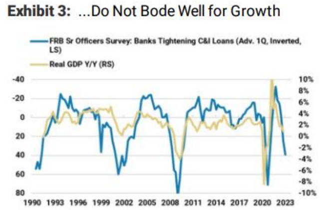
Tighter lending standards since the regional bank turmoil is likely to result in less lending to small businesses which can have a profound impact on overall employment. A rise in unemployment will likely lower demand and corporate profits. We have argued that this is not currently priced in and will likely operate on a lag.

Exhibit 2: Already Tight Lending Standards...



Source: Bloomberg, Morgan Stanley Research

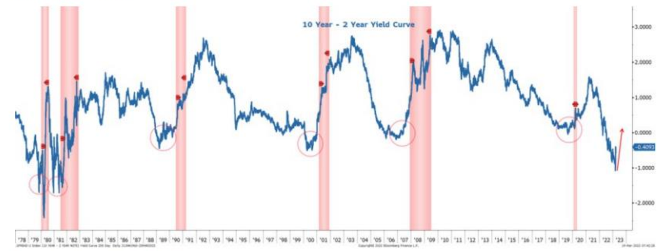
Exhibit 3: ...Do Not Bode Well for Growth



Source: Bloomberg, Morgan Stanley Research

Bond markets have exhibited extreme volatility around these developments as the yield curve has re-steepened. While its inversion typically signals a recession within 12 months, its re-steepening implies even greater risks for growth. Equity investors risk being caught wrong footed as the market can reprice quickly before companies even begin to lower guidance.

Exhibit 4: Growth Risks Become Increasingly Apparent When the Yield Curve Re-Steepens from the Trough—Like Now



Source: Bloomberg, Morgan Stanley Research

More importantly, we would not necessarily view a Fed pause as a positive. The latest inflation data shows core CPI running at 5.5% year over year, way above the Fed's target,[1] If policymakers pause too soon, we will run the risk that inflation remains higher for longer. High inflation that is coupled with falling growth can result in a recession with above-average inflation in which consumers' real incomes suffer the most. This triple threat of slow growth, persistent inflation and rising unemployment is what we define as stagflation. Consensus 2023-2024 earnings estimates and current equity valuation multiples are not factoring in these risks.

Exhibit 2: ...Forward EPS Estimates Remain Too High

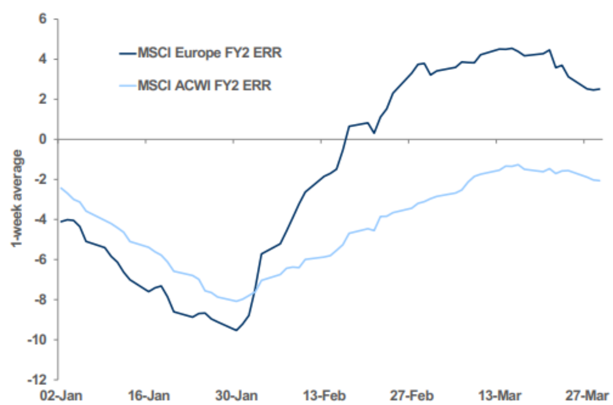
Source: FactSet, Haver, Bloomberg, Morgan Stanley Research

We are in the early innings of witnessing the unintended consequences of aggressive policy intervention. Regardless, of whether or not we are on the cusp of seeing a more accommodative backdrop, we believe the damage has already been done and investors must finally accept that recession and stagflation risks have increased. While high quality larger cap names are likely to fare better, we argue that the index as a whole will have a harder time proving to investors that is immune to a growth downturn.

International & Emerging Markets

US equity markets have not been isolated in their optimism. MS & Co. European Equity Strategist, Graham Secker, notes that March 2023 is the first month in 20 years when global equity markets posted a positive return despite a near 10% drop in Financials. In fact, the Euro Stoxx 50 index is back to within 1% of its prior high, and Europe's broader outperformance over the US is holding up better than expected considering its lack of mega cap tech exposure in an environment of technology stock outperformance. Typically, international equities are cheaper than US equities and are therefore viewed in the context of a value over growth trade. However, their outperformance comes as value meaningfully underperforms growth this year. While China makes up a much smaller portion of US revenues, it is the third largest market for European exports. China's reopening has therefore been a major positive for Europe, especially for their higher margin luxury goods segment. A weaker dollar has also helped as the DXY index fell over 3% this month.

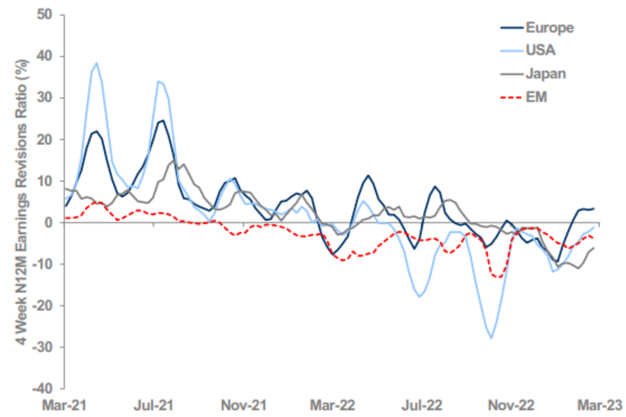
Exhibit 4: Earnings revisions remain resilient for now, especially in Europe where they are still positive



Source: MSCI, IBES, Morgan Stanley Research

However, we have often noted that markets do not operate in a vacuum and tightening financial conditions are likely to impact international stocks as well. While global markets as a whole are likely to see some sort of pull back, we do note that earnings revisions in Europe are outperforming relative to the US and are actually still positive.

Exhibit 29: Global Earnings Revisions Ratio



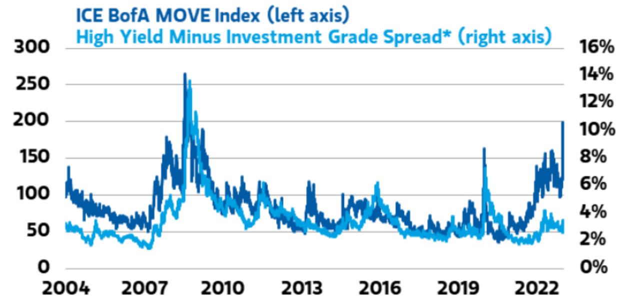
Source: MSCI, IBES, Morgan Stanley Research

A warmer winter has helped Europe avert the energy crisis and recession that many were calling for given its historic dependance on Russian oil and the ongoing war. It has had its own positive economic surprises, which has allowed the European Central Bank (ECB) to continue on its own rate hiking path. It raised its key target rate by 50 basis points but announced that it would stop providing forward guidance. Adding to that uncertainty, international markets faced their own negative publicity around banking issues. Nevertheless, we believe valuations in Europe have also gotten ahead of themselves and would wait for a pullback given tightening financial conditions.

Absent of macroeconomic events that may increase risks, we continue to see growth accelerating this year in Asia ex-Japan. While policymakers in the US and Europe continue to tighten, China remains a self-help story with low valuations. Its economy is likely to benefit from its economic reopening while the government continues to enact stimulus that targets domestic consumption. We also see opportunities in India given its underperformance this year, despite an improving growth outlook. An improvement in its digital infrastructure has led to an increase in lending (unlike in the US and Europe). Furthermore, favorable demographics continue to spur domestic demand. Tensions between the US and China have also worked in India's favor. While moving entire supply chains is out of the question for many companies, there has been a pickup in new factories being built in India driven by cheaper labor costs. USD relative strength and commodity prices are both important inputs into EM economic conditions and returns. While we are not currency experts, we believe dollar strength may be in its last innings. EM central banks are closer to the end of their tightening cycle relative to the developed world. This diversion in policy makes us more optimistic on EM. We do note, however, that macro risks have increased. Geopolitical risks have been an issue facing China for a long time now. Investing in China often requires investors to take on higher levels of risk. The U.S. shooting down a Chinese surveillance balloon and threats of banning certain Chinese apps highlights the increasing distrust and tension between the two nations. China's perceived allyship with Russia and Xi's reaffirmation of his intention to unify Taiwan has not been well received by the West. While military action is not in our base case, risks may increase over time.

Fixed Income & Rates

While current equity valuations are not compensating investors sufficiently for risk, we continue to see better opportunities in fixed income and cash alternatives. Given all the risks we have mentioned so far, receiving a yield of over 4% on cash or investing in a cash equivalent investment does not sound so bad. While yields in bonds have meaningfully repriced lower across the curve, we still see opportunities for total return relative to equities in anticipation of falling growth and a flight to defense. For now, cash is king. Investors are no longer being compensated for taking on extra credit risk. As measured by the ICE BofA MOVE Index, the last time interest rates were this volatile was during the Great Financial Crisis. [1] As the current regional bank turmoil has been about liquidity and deposit management as opposed to credit and asset quality, credit spreads have remained well behaved. This can be seen in the tight differential between high yield and investment grade bonds. While this is a good indicator of economic stability, we would argue that both investment grade and high yield credit spreads remain historically tight.



*Indexes used are Bloomberg US Aggregate Corporate Average Option-Adjusted Spread and Bloomberg US Corporate High Yield Average Option-Adjusted Spread
Source: Bloomberg as of March 22, 2023

Alternatives

Manager and fund selection has become increasingly important in selecting alternative investments. The dry powder that fund managers amassed while valuations were elevated should position them well to deploy capital at attractive prices. While private markets are not immune to valuation markdowns, we believe that certain pockets of private markets are well positioned to capitalize on dislocations that may arise given the economic backdrop. For instance, while there has been stress in the commercial real estate market given regional bank turmoil, experienced managers have been able to raise rents in properties across other subsectors and negotiate inflation protected rent escalators. Meanwhile, private credit is likely to become an even bigger source of capital as banks are forced to lend even less. As the cost of capital rises, many companies will continue to depend on them for funding assistance. We do expect fundraising to become more difficult for managers and see an increased need for co-investments. Managers with dry powder and experience across sectors are well positioned as others depend on them for extra capital in order to close deals. We favor managers which have experience in taking advantage of distress and market dislocations. We also like the ability of secondaries focused managers that can take advantage of forced selling at depressed prices. Portfolio companies who rely on their credit facilities may be calling more capital than anticipated from investors. As uncertainty is on the rise, we remind eligible investors that such tools are available to help mitigate risk and diversify portfolios.

2023 Honors

The Harbor Group is proud to have been named #3 on the **Forbes Best-In-State Wealth Management Teams** list for 2023! Jeff Winik and John Vessa were also recognized as **Barron's Top 1,200 Financial Advisors: State-by-State 2023**. Along with Jeff Winik and John Vessa, Jeff Di Napoli was named to the **Forbes Best-In-State Wealth Advisors** ranking for 2023! It's an honor to be recognized among this group of outstanding Financial Advisors. A special thank you to our clients who helped to make this possible!

Source: Forbes.com (Awarded Jan 2023) Data compiled by SHOOK Research LLC based on time period from 3/31/21-3/31/22.

Source: Barron's.com (Awarded Mar 2023) Data compiled by Barron's based on time period from Sept 2021 - Sept 2022

Source: Forbes.com (Awarded April 2023) Data compiled by SHOOK Research LLC based on time period from 6/30/21 - 6/30/22.

See Awards Disclosures for criteria and methodology at the end of the material:

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Past performance is no guarantee of future results. Actual results may vary. Diversification does not assure a profit or protect against loss in a declining market.

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Private equity funds typically invest in securities, instruments, and assets that are not, and are not expected to become, publicly traded and therefore may require a substantial length of time to realize a return or fully liquidate. They typically have high management, performance and placement fees which can lower the returns achieved by investors. They are often speculative and include a high degree of risk. Investors can lose all or a substantial amount of their investment.

They may be highly illiquid with significant lock-up periods and no secondary market, can engage in leverage and other speculative practices that may increase volatility and the risk of loss, and may be subject to large investment minimums.

An investment in Structured Investments is subject to significant risks and may not be appropriate for all investors. These risks can include, but are not limited, to: fluctuations in the price, level or yield of underlying asset(s), interest rates, currency values and credit quality; substantial loss of principal; limits on participation in appreciation of underlying asset(s); limited liquidity; credit risk of the issuer; and, conflicts of interest.

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Investing in commodities entails significant risks. Commodity prices may be affected by a variety of factors at any time, including but not limited to, (i) changes in supply and demand relationships, (ii) governmental programs and policies, (iii) national and international political and economic events, war and terrorist events, (iv) changes in interest and exchange rates, (v) trading activities in commodities and related contracts, (vi) pestilence, technological change and weather, and (vii) the price volatility of a commodity. In addition, the commodities markets are subject to temporary distortions or other disruptions due to various factors, including lack of liquidity, participation of speculators and government intervention.

International investing may not be appropriate for every investor and is subject to additional risks, including currency fluctuations, political factors, withholding, lack of liquidity, the absence of adequate financial information, and exchange control restrictions impacting foreign issuers. These risks may be magnified in emerging markets.

Bonds are subject to interest rate risk. When interest rates rise, bond prices fall; generally the longer a bond's maturity, the more sensitive it is to this risk. Bonds may also be subject to call risk, which is the risk that the issuer will redeem the debt at its option, fully or partially, before the scheduled maturity date. The market value of debt instruments may fluctuate, and proceeds from sales prior to maturity may be more or less than the amount originally invested or the maturity value due to changes in market conditions or changes in the credit quality of the issuer. Bonds are subject to the credit risk of the issuer. This is the risk that the issuer might be unable to make interest and/or principal payments on a timely basis. Bonds are also subject to reinvestment risk, which is the risk that principal and/or interest payments from a given investment may be reinvested at a lower interest rate.

Bonds rated below investment grade may have speculative characteristics and present significant risks beyond those of other securities, including greater credit risk and price volatility in the secondary market. Investors should be careful to consider these risks alongside their individual circumstances, objectives, and risk tolerance before investing in high-yield bonds. High yield bonds should comprise only a limited portion of a balanced portfolio.

Duration, the most commonly used measure of bond risk, quantifies the effect of changes in interest rates on the price of a bond or bond portfolio. The longer the duration, the more sensitive the bond or portfolio would be to changes in interest rates. Generally, if interest rates rise, bond prices fall and vice versa. Longer-term bonds carry a longer or higher duration than shorter-term bonds; as such, they would be affected by changing interest rates for a greater period of time if interest rates were to increase. Consequently, the price of a long-term bond would drop significantly as compared to the price of a short-term bond.

This material contains forward looking statements and there can be no guarantees they will come to pass. The information and statistical data contained herein have been obtained from sources believed to be reliable but in no way are guaranteed by Morgan Stanley as to accuracy or completeness. There is no guarantee that the investments mentioned will be in each client's portfolio.

Technical analysis is the study of past price and volume trends of a security in an attempt to predict the security's future price and volume trends. Its limitations include but are not limited to: the lack of fundamental analysis of a security's financial condition, lack of analysis of macroeconomic trend forecasts, the bias of the technician's view and the possibility that past participants were not entirely rational in their past purchases or sales of the security being analyzed. Investors using technical analysis should consider these limitations prior to making an investment decision.

Equity securities may fluctuate in response to news on companies, industries, market conditions and the general economic environment. Companies cannot assure or guarantee a certain rate of return or dividend yield; they can increase, decrease or totally eliminate their dividends without notice.

Because of their narrow focus, sector investments tend to be more volatile than investments that diversify across many sectors and companies.

Growth investing does not guarantee a profit or eliminate risk. The stocks of these companies can have relatively high valuations. Because of these high valuations, an investment in a growth stock can be riskier than an investment in a company with more modest growth expectations.

Value investing does not guarantee a profit or eliminate risk. Not all companies whose stocks are considered to be value stocks are able to turn their business around or successfully employ corrective strategies which would result in stock prices that do not rise as initially expected.

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For index, indicator and survey definitions referenced in this report please visit the following: https://www.morganstanley.com/wealth-investmentsolutions/wmir-definitions

Source: Forbes.com (Jan 2023) 2023 Forbes Best-In-State Wealth Management Teams ranking awarded in 2023. This ranking was determined based on an evaluation process conducted by SHOOK Research LLC (the research company) in partnership with Forbes (the publisher) during the period from 3/31/21 – 3/31/22. Neither Morgan Stanley Smith Barney LLC nor its Financial Advisors or Private Wealth Advisors paid a fee to SHOOK Research LLC for placement on its rankings. This ranking is based on in-person and telephone due diligence meetings to evaluate each advisor qualitatively, a major component of a ranking algorithm that includes client retention, industry experience, review of compliance records, firm nominations, and quantitative criteria, including assets under management and revenue generated for their firms. Investment performance is not a criterion. Rankings are based on the opinions of SHOOK Research LLC and this ranking may not be representative of any one client's experience; investors must carefully choose the right Financial Advisor or team for their own situation and perform their own due diligence. This ranking is not indicative of the

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Please visit our team website for information on each member of the team. Team members featured in photo (from left to right): Hugo Rea, Client Service Associate; Corey Fleisher, Financial Advisor; John Vessa, Financial Advisor; Jeffrey Di Napoli, Financial Advisor; Jeffrey Winik, Financial Advisor; Iraida Gonzalez, Group Director; Diana Patrascu, Director of Investments; Richard Frank, Financial Advisor