HarborView Capital Management LLC

Global Investment Advisors

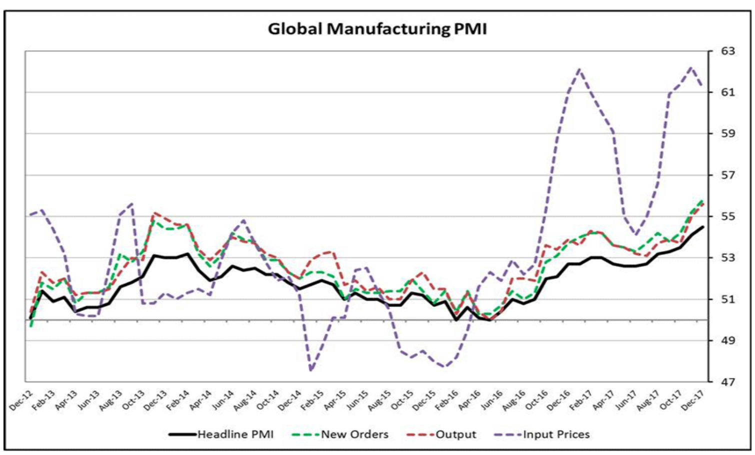
Investor Letter Q1 2018 January 21, 2018

- Risk on, globally!
- Earnings growth key to the continuation of rally
- Time for commodities?
- Housing bubbles and higher interest rates
- Bottom line…

Regardless of what one thinks about the process, the lack of bipartisanship, and the many bits of terrible policy within the sausage that is tax reform, the fact is tax reform has been passed by Congress, and signed into law by President Trump. As the Trump agenda is ambitious, how does this "win" impact other major policy initiatives? At least until the mid-term elections this fall, we think there is plenty of momentum in Congress to pass more bills, including an infrastructure package – this latest government shutdown notwithstanding.

The impact of tax reform on corporate earnings will be significant. Prior to tax reform consensus analysts' operating earnings estimates for the S&P 500 in 2017, 2018 and 2019 were $131.47, $146.24 and $160.81, respectively. This implied 10%+ earnings growth for the next two years. As tax reform is implemented, annual earnings growth could climb to the 15%-20% range.

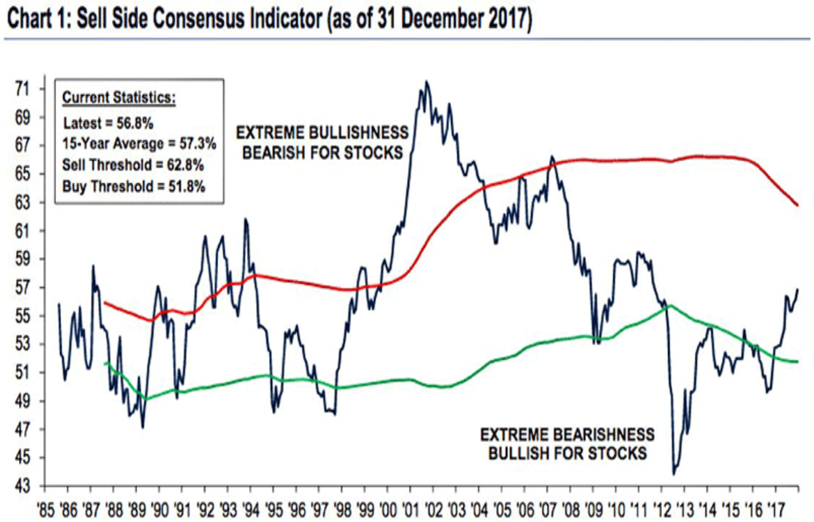
Combined with synchronized global growth, historic amounts of global liquidity and low inflation globally, risk markets look well supported by the fundamentals for 2018.



As far as synchronized global economic growth goes this chart says it all!

As 4th quarter earnings continue to be reported over the next couple weeks, earnings calls will provide investors a good idea of managements outlook for improved bottom lines. Already many companies have announced increases in bonuses and wages, specifically crediting the tax cuts for these initiatives. One risk we see for 2018-19 is over optimism among management teams that leads to excess inventory buildup. **A far cry from the pessimistic days of the financial crisis!**

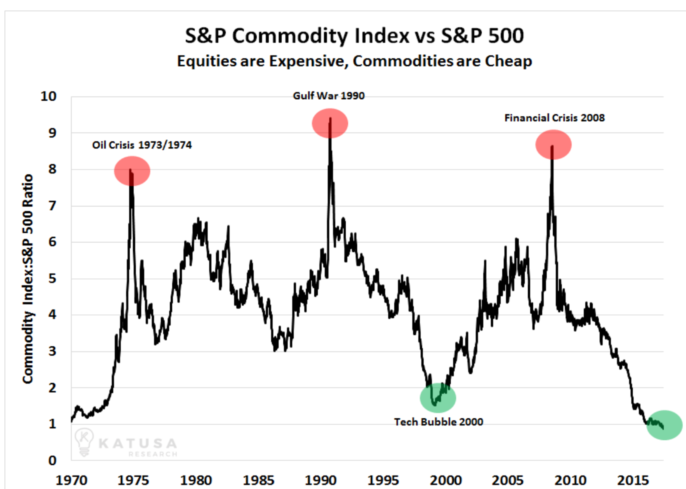
Its not just in the U.S. either. We have not been alone in pointing out the unsustainability of China's economic strategy of buying GDP thru increasing credit. Investors have either shied away or gone short "Asia" and stayed overweight U.S. risk as a result. But with the current global "risk-on" environment betting against Asia for the time being looks to be a losing proposition. Timing, as we have always taken pains to point out, is the key to exploiting opportunities – just ask Crispin Odey!



Institutional investors remain somewhat bearish on risk!

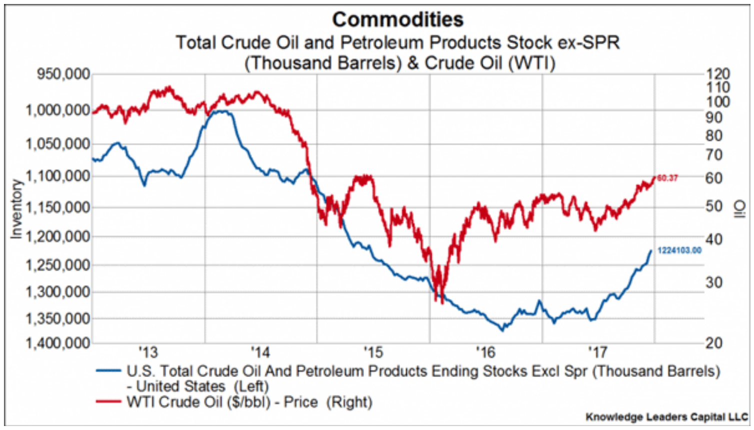
Investors have also underweighted Europe the last few years. However, with the Macron victory in France's general election last May, a resumption of growth on the continent and better relative values vs the U.S., investors began moving back into European equities in 2017. Spain and Greece recently have even received upgrades by the bond rating agencies. The next potential problem comes in March with the Italian election, where, believe it or not, former PM Berlusconi could actually become PM again (!), and of course the continued drama with BREXIT negotiations. For now however growth is surprising on the upside, corporate and consumer lending is healthy, inflation is low, the ECB continues to ease, the euro is rallying and risk is on.

Commodity's, in S&P500 terms, have only been this cheap a couple times in the last 50 years (in bond terms, commodity prices are at all-time lows!). Each low was followed by a sharp rally. As the fundamentals for the stock market are still quite positive this leads us to think commodities are poised for a significant rally. While precious metals should participate in any commodity rally, especially given their inclusion in commodity ETF's that investors increasing favor as investment exposures, any rally will not be driven by concerns about the soundness of the fiat money system but fundamental supply/demand imbalances, synchronized global growth and China.



Commodities, in S&P500 terms, are historically cheap.

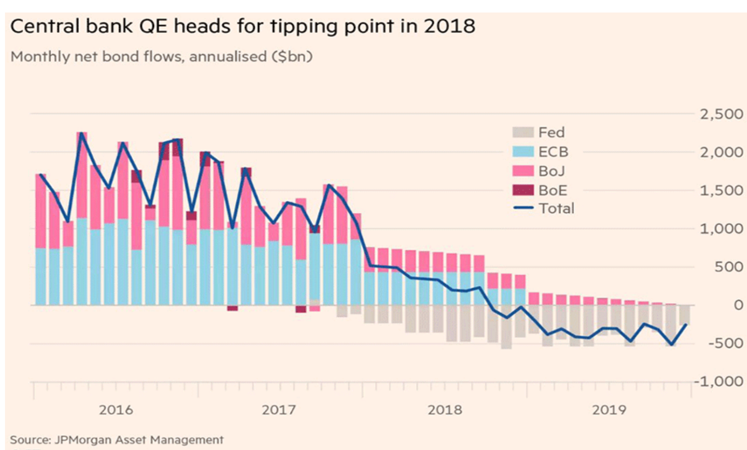
While commodities are notoriously volatile, for a change the fundamentals are beginning to provide support (there have been many "bear market rallies" the last few years, none supported by the fundamentals). **The bull in the proverbial China shop, as regards commodities, is China.** And China is forcing the "shutting in" of a significant amount of capacity domestically due to environmental concerns. While the environment may not have seemed a major policy issue 20 years ago, the world has changed, and Chinese leadership is keenly aware of the environmental impact of inefficient and under regulated commodity suppliers. The steps the Chinese have recently taken are beginning to "bite". Supply constraints combined with increasing demand, as the global economy strengthens, suggest solid fundamental support for the commodity complex.



Petroleum inventories are at multi-year lows.

Oil prices are likely to remain elevated at least until the Saudi Aramco IPO later this year (this will be the largest IPO in history). OPEC and Russia have just agreed to keep quotas in place until past year end 2018, with the strong likelihood of them being extended beyond that. $75 oil? Could be.

The $ remains a bit of a wild card. A weaker $ generally is supportive of commodities, which are priced in $'s. The $ index was down 9% in 2017, and short $ positions, especially against currencies such as the Euro, are at record highs – even as the FED continues to tighten monetary policy. Short $ positioning = $ buying power. As well tax reform (even as it adds $150 billion a year to the deficit) and the repatriation of foreign profits (at favorable tax rates) provide additional $ buying power. But as foreign central banks begin talking about their exit strategy's from accomodative monetary policy the $ is more likely to weaken, thereby supporting the commodity sector.

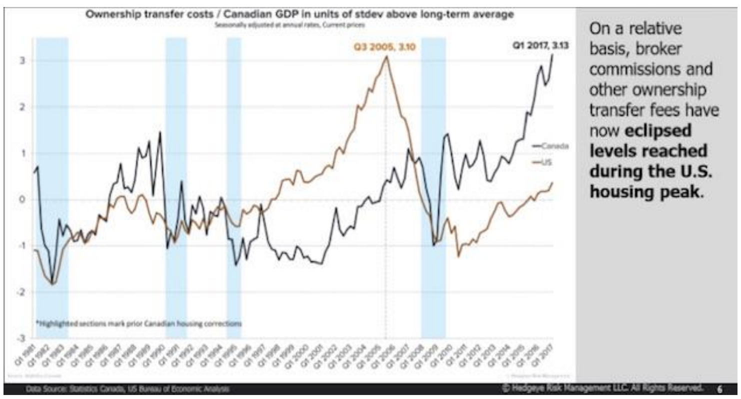


Though bottoming, for the foreseeable future central bank liquidity remains abundant.

While global central bank QE (quantitative easing) is slowly turning into QT (quantitative tightening), the reality is it's only the pace of easing that is being reduced (in the last week even the Bank of Japan has reduced is buying of long dated bonds thru its open market operations**). As PIMCO Global Strategic Advisor and friend of HarborView Capital, Richard Clarida, describes it, the current central bank tightening is akin to going on a diet by eating only one ice cream a day, instead of two.** We agree with that analogy, as it will be years before central bank balance sheets, and interest rates are "normalized" (whatever that means these days!).

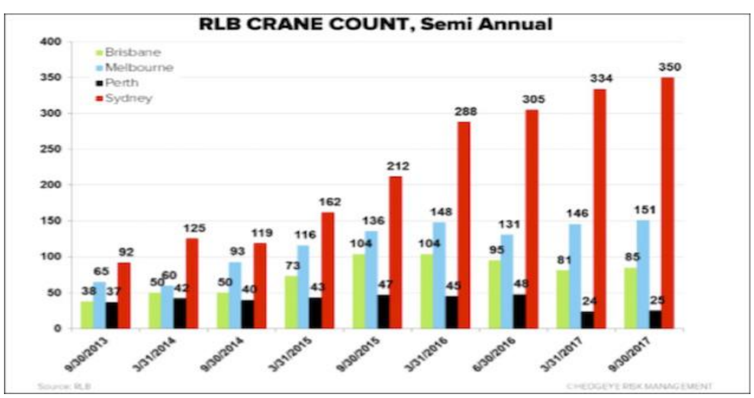
The Fed continues to lead other central banks in tightening policy with 3 interest rate hikes priced in for 2018 along with an announced $450bn reduction of its balance sheet. Interest rates may have finally bottomed, especially as other central banks move toward tightening policy.

The risk of tighter monetary policy causing major problems increases significantly into 2019 and beyond. While the financial crisis was caused in large part by the U.S. real estate bubble, coupled with 17 interest rate increases by the FED over the course of 2 years, real estate markets outside the U.S. are now becoming a problem. Chinese investors have been bidding up real estate in their domestic markets and Hong Kong for many years. As they have moved to diversify out of the Chinese RMB they have been bidding up real estate in Australia and Canada. The economies of Australia and Canada themselves have been big beneficiaries of the Chinese driven boom for commodities. **The majority of Australian investors have never seen a bear market in real estate.** Here in the U.S. home prices have regained all time highs once again (though as a % of GDP real estate does not look as bubbly as 2006).



Post-recession, housing activity and prices in Canada has climbed far faster than it in the US.

The chart below shows the crane count for Australia's four largest cities. The number of cranes operating in a city and the kinds of properties they are being used to build turns out to be a pretty good measure of housing activity. As of three months ago, **Sydney alone had 350 cranes being used to build high-rise residential properties**. That's more cranes than were deployed in *all* of North America's twelve largest cities. Most Australians have only known "boom" times, and the tax code encourages buying real estate that **LOSES** money (it's called negative gearing). Hmmm…



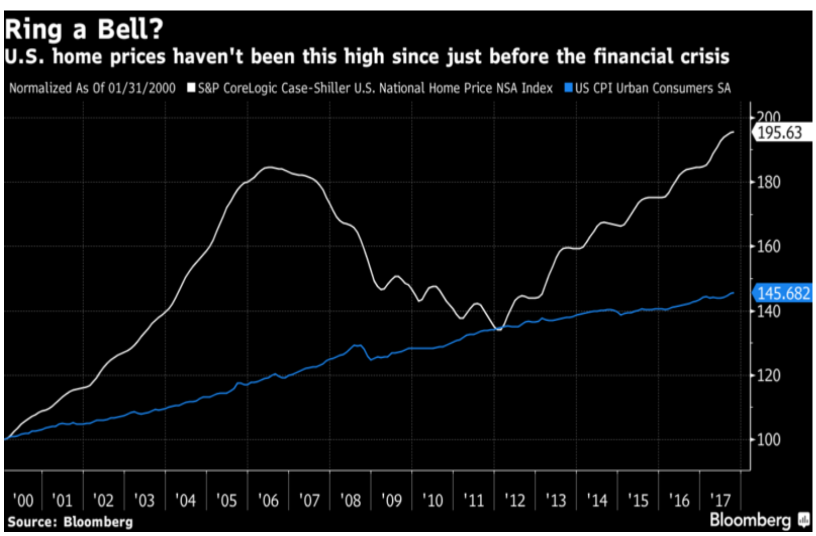
On a per capita basis, Australia has 14.6 times as many residential construction cranes working as North America does.

How is China's real estate market doing? On January 16, 2018, the *Wall Street Journal* ran a story, "[China's Hot Housing Market Begins to Cool]()."

> **"BEIJING—China's housing market has defied gravity and government restraints for two years, floating on a tide of bank loans and speculation. Until now.**
>
> **Demand has dried up in these areas as a result of government measures including higher mortgage rates, higher down-payment requirements and limits on buying a second or third home. Would-be sellers are increasingly putting plans on hold in hope that prices will rebound."**

In Beijing, Shanghai and other megacities, sales have stalled and prices have dropped, in some cases dramatically so.

Does "what happens in Canada/Australia and China" stay there? Or will a falling out in the real estate markets create fallout globally? We may find out soon, and we continue to "monitor the situation closely" as Janet Yellen would say.



U.S home prices have regained the 2006 peaks.

Other potential risks include:

1) the U.S. pulling out of NAFTA (the 6th round of NAFTA talks is this week, and Trump's trade authority expires July 1st)
2) A Trump led trade war with China

3) Russia, Turkey vying with the U.S. for control in Syria
4) Continued North Korean provocations
5) Continued Indian & Pakistan border wars (both nuclear powers!) over Jammu and Kashmir
6) Higher than expected inflation that forces central banks to move more aggressively to tighten monetary policy
7) U.S. mid-term elections this November

What could possibly go wrong?

Bottom line: For now we remain positive on global risk markets and remain fully invested. Recession does not look likely this year, and if earnings estimates, post tax reform, are close to correct, then the markets should see 8% - 10% upside, and any pullbacks should prove to be short and shallow.

We expect however that as we head into 2019 market conditions are likely to change. It is thought that monetary policy works with an 18-month lag. Famed investor Stanley Druckenmiller counsels investors not to watch earnings for clues about market direction, watch the central banks…2019 will be the year for investors to begin looking out for recession.

HarborView Capital and its clients had a reasonably good 2017. If you have any questions or comments regarding the markets, or your accounts, please contact us.

We wish everyone a Happy and Prosperous 2018!

Best Regards,

Paul Brian Gibson, Partner
HarborView Capital Management LLC