HarborView Capital Management LLC

Global Investment Advisors

Investor Letter – 1st Quarter 2016 **January 5, 2016**

Highlights:

- First down year for U.S. markets since 2008
- The FED raises interest rates for the 1st time in nine years
- Is the high yield market signaling the end of the bull market?

We are very happy 2015 is over, and we are certainly not alone. The S&P index went from positive to negative and back again 28 times in 2015, rebounding from a material 12%+ loss mid-year before ending the year down close to 1%. A trendless market with enormous volatility. Global stock markets ended down, some significantly. Across the bond market prices were lower for 2015, from U.S. Treasuries down the credit spectrum to high yield (agencies & municipal bonds being the exception). Commodities? Oil ended down over 30%, gold down over 10%.

The old saying "there is always a bull market somewhere" did not hold true for 2015. (Please review the last page of our Investor Letter for various global investment product returns for 2015.)

What happened, and where do we go from here?

2015 was a year of a strong US$ due to diverging global monetary policies (the trade weighted $ was up 7% in 2015) and continued weakness in energy/commodities, with knock on effects for industrials and transports. Warm weather into year-end pressured retailers (Macys, for instance, was down 44% for 2015). The media sector was pressured by the continued movement toward "cord-cutting". Technology disrupting traditional business models became a big theme in 2015, a theme that will continue. But buying 2015's best performing stocks, disruptors Amazon & Netflix, at sky-high valuations at the end of 2014 did not seem prudent at that time, and we would argue it still does not, with valuations of 980 times earnings (Amazon) and 305 times earnings (Netflix).

Seasoned investors such as Warren Buffett, Carl Icahn, Dan Loeb, Bill Ackman and David Einhorn were down well into the double digits for 2015.

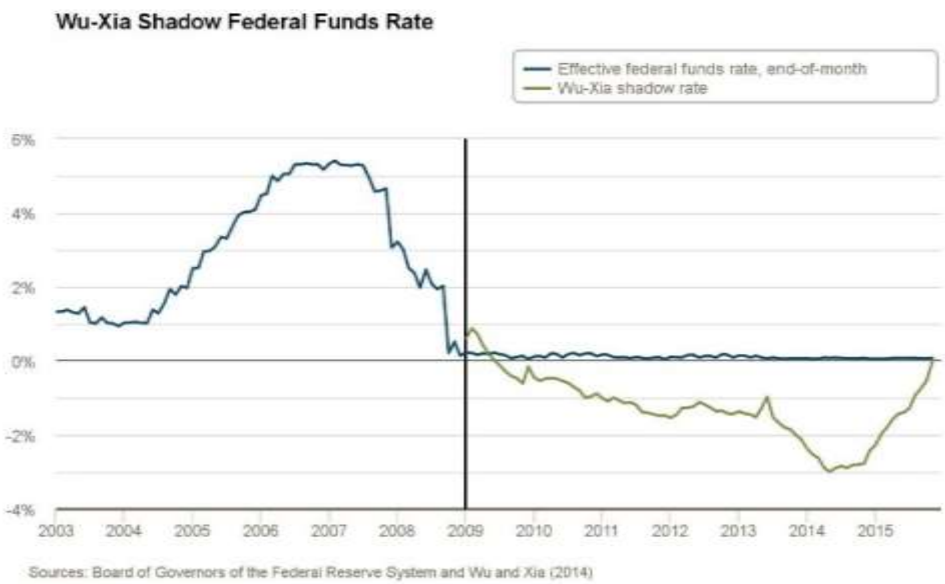
Partially responsible for poor performance was the narrow market breadth. The S&P500 is a market capitalized weighted index, and as such it is a momentum index that will always overweight the positive performance of the largest and best performing stocks. The top 10 stocks accounted for the majority of the gains in the S&P500, while the other 490 stocks were down an average of 15% from their highs. The "equal weighted" S&P500 index was down close to 5% for 2015. Some observers see this narrow breadth as bearish for the markets, while others look for market breadth to widen in 2016 as the majority of stocks have already "corrected".

Assuming we do not head into recession in 2016, which right now looks unlikely, and energy and the $ stabilize, then we should see positive earnings growth (current estimates are for +8% earnings growth)

and a 5-8% return for the S&P500 in 2016. These maybe big assumptions however, and if the best case scenario is not realized then stocks & commodities could easily trade down again this coming year.

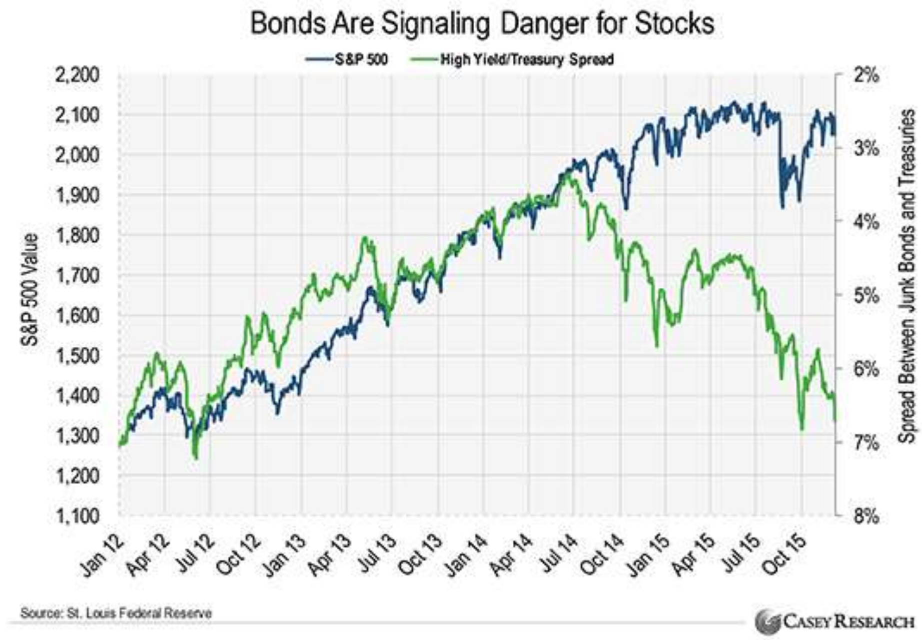
The bond, stock, commodity and foreign exchange markets have to contend as well with the Federal Reserve tightening monetary conditions. As most of you know the FED raised their target Fed Funds rate by 25bps in December, for the 1st time in 9 years, and the FED has projected another 100bps of tightening in 2016. The market has priced in just ~50bps of tightening at this point so the FED's projections are more aggressive than the market (another way to view this is the market does not believe the FED will be able to raise interest rates at the pace it expects).

Why might the FED be wrong and the market correct? Continued strength in the US$ is a de facto tightening of monetary policy. If the FED does indeed move along its projected path of raising rates the market will have to adjust to still higher rates, thereby driving the US$ up further. One must consider also that the end of QE in 2014, as shown in the chart below (from the Atlanta FED), has effectively tightened monetary policy the equivalent of 250bps already.



What is the high yeild market telling us? Many market observers are questioning the ability of the stock market to move higher with the high yeild (ie junk bond) market under pressure the past year, given the historical correlation between the two. The decline in energy, which is in a "recession", is responsible for the majority of the selloff in the junk bond market (25% of the defaults in 2015 were energy related).

However one must remember the companies that make up the junk bond market are at the lowest end of the quality spectrum and are highly leveraged. The key difference between the junk bond market and the S&P is quality, with the companies that make up the S&P500 being the highest quality companies in the world.



One must also consider that while the junk bond market recently experienced a liquidy event, with certain very poor quality junk bond mutual funds imploding, those funds are small in size and not themselves representive of the junk bond market. **Default rates are still below the historical ~4% level, even after coming off of a borrowing binge driven by low rates and easy credit.** While there will more defaults, with oil hedges coming off during the 1st six months of 2016, the weak performance of energy/commodities/resource-related debt is disproportionately making the junk bond space look worse than it is.

The same story applies to corporate earnings - if you strip out the energy sector U.S. companies are actually doing reasonably well. For the record S&P500 earnings will be down close to 1% for 2015 but ex-energy will be up close to 6%. The energy sector, as a percentage of the S&P500, has declined from 10.74% to 7.1% so a weak energy sector will have a declining impact on the overall S&P500. And as bad as it is for energy, oil production is expected to fall off aggressively this year (please refer to the charts at the end of this letter), and the markets should see oil bottoming sometime toward mid-year. **There will be multi-generational opportunities in the energy sector as a result.**

Bottom line: While it's fair to say that deteriorating credit markets have been a harbinger for a peaking economy, which would indicate that a recession could be coming, we think it is too early, and an overeaction, to exit risk at this point. The lowest quality part of the credit markets, the junk bond market, appears to be resetting itself more than anything, perhaps in anticipation of higher interest rates down the road.

While we are cautiously watching developments in the credit markets the long term bull market in stocks is still intact. **Long term bull markets tend to stay in place until 1) Recession looms 2) Valuations get extended (such as in 2000).**

Recession? Looking at traditional signals for signs of recession tell us 2016 will not be the year recession starts. A recession is defined by the NBER as two quarters in a row of negative GDP growth.

Even after a historically long economic recovery, real GDP growth continues at 2% or so. Not strong, but positive, with this mediocre growth actually helping extend the expansion cycle by not stimulating bubbles (though one may be forming in the commercial real estate markets domestically and in certain credit markets globally).

While the U.S. Manufacturing ISM has recently printed below 50 for the 2nd month in a row, suggesting recession in the domestic manufacturing sector, the poor result is largely driven by familiar themes – weak energy and exports, driven by the strong US$. Historically the manufacturing sector has acted as a leading indicator for the broad economy but one must consider that the makeup of our economy is much different now than in the past, with the service sector contributing the majority of GDP (and increasing).

Consumer Spending Reasonably strong labor markets (we say reasonably strong because while the unemployment rate is 5.1% the participation rate is at multi decade lows) and the energy dividend are finally being reflected in consumer spending which grew at a 3%+ pace in 2015, and shows no signs of slowing. Initial claims, historically an excellent leading indicator for recession, is at multi decade lows.

According to MasterCard's Spending Plus report 2015 holiday shopping revenue was up 7.9% vs 2014. That easily outpaces 2014's 5.5% improvement (this material improvement despite early reports of weak holiday sales). eCommerce sales were up 20% year over year.

Auto sales for 2015 at an all-time high. While we think auto sales may be peaking given 85% of auto purchases are financed, with the average maturity 72 months, for now these numbers are hardly recessionary. We own no auto or auto related exposure in client accounts.

At the same time consumer spending is rising consumers are also paying down debt. The chart below shows household debt service as a % of GDP recently hit multi decade lows.

Finally the U.S. Treasury curve has not yet inverted. Since WWII the U.S. economy has experienced nine recessions, and an inverted yield curve preceded each one of them. With the 2yr – 10yr spread at ~+120bps an inversion of the curve looks a fair ways off.

Valuations? The stock markets current trailing PE of 17.5 looks extended vs the long term historical average PE of 15 but markets look forward. For 2016 expectations are for S&P500 earnings of $126 which gives us a PE of 16.3. PE's in the latter stages of a bull market typically move higher than average as investor confidence improves, and a PE of 17-18 is not atypical at this point in the cycle.

Lastly the relationship between stocks and US Treasury rates is historically important. Right now the S&P500 has an earnings yield of 6.2% ($126 earnings/2044 closing price) vs the US 10yr at 2.25%. Stocks are currently 2+ standard deviations cheap to US Treasuries.

While we fully expect more pain in the energy patch in 2016 as the market continues to adjust there are a number of shorter term risks globally we are on paying attention to as well (the known unknowns!):

1) **Potential for a significant devaluation of the RMB by China** - on August 11, 2015 China devalued its currency, the RMB, in a surprise move which seems to have precipitated the flash crash in the U.S. market on August 24th. This past weekend's Manufacturing PMI's have continued to weaken, even as the Services PMI's have strengthened.

   China's Producer Price Index has been negative for 45 months in a row. China's exports are clearly struggling to compete against Europe and Japan, who have devalued their currencies. The PBOC has already allowed the RMB to devalue 8% in 2015, with the majority of that coming after the RMB's inclusion in the IMF SDR basket this past fall.

2) **Mario Draghi's European Central Bank -** the ECB announced in December it would extend its QE policy until March 2017. It also reduced its deposit rate to -0.30% (that's right, a negative interest rate). However the European economy appears to be bottoming, while the ECB is running out of financial assets to buy. If the ECB signaled a tapering of expansionary monetary policy the euro would strengthen. The resulting weakness in the US$ would provide the FED with more runway to normalize its monetary policy.

Higher interest rates and tighter monetary policy than currently expected by the markets would cause a further readjustment in asset prices.

3) **Algorithmic trading, the machines and flash crashes -** this remains our biggest fear. On August 24th of 2015 the DOW crashed 1000points before recovering over the next few days. Many stocks and ETF's fell 30-50% or more in a 10minute span. These selloffs were not based in any way upon fundamentals, but were due to the "broken plumbing" of the markets infrastructure. **Because these moves are not based on any fundamentals there is no telling how far they will go or how long they will last.**

   We are 99% certain we will get another episode of massive computer driven selling sometime in 2016, and perhaps more than one. If possible we will try to take advantage of these flash crashes for the benefit of our clients.

There are a number of other potential threats to the global economy, such as hostilities in the Middle East and the South China Sea, a collapse of the Asian real estate bubble, major terrorist attacks & cyber warfare, but overall the global economy continues to grow, if somewhat slowly.

For now we do not believe we have reached the end of the bull market cycle. Recession is not imminent, valuations are not stretched, the FED has no intention of inducing a recession, there is not much in the way of excessive leverage outside certain sectors of the economy, sentiment is quite poor and investors are underinvested. Quite simply this remains the most unloved bull market in history. But given the wide range of potential outcomes this year, the volatility we experienced the 2nd half of 2015 is likely to continue.

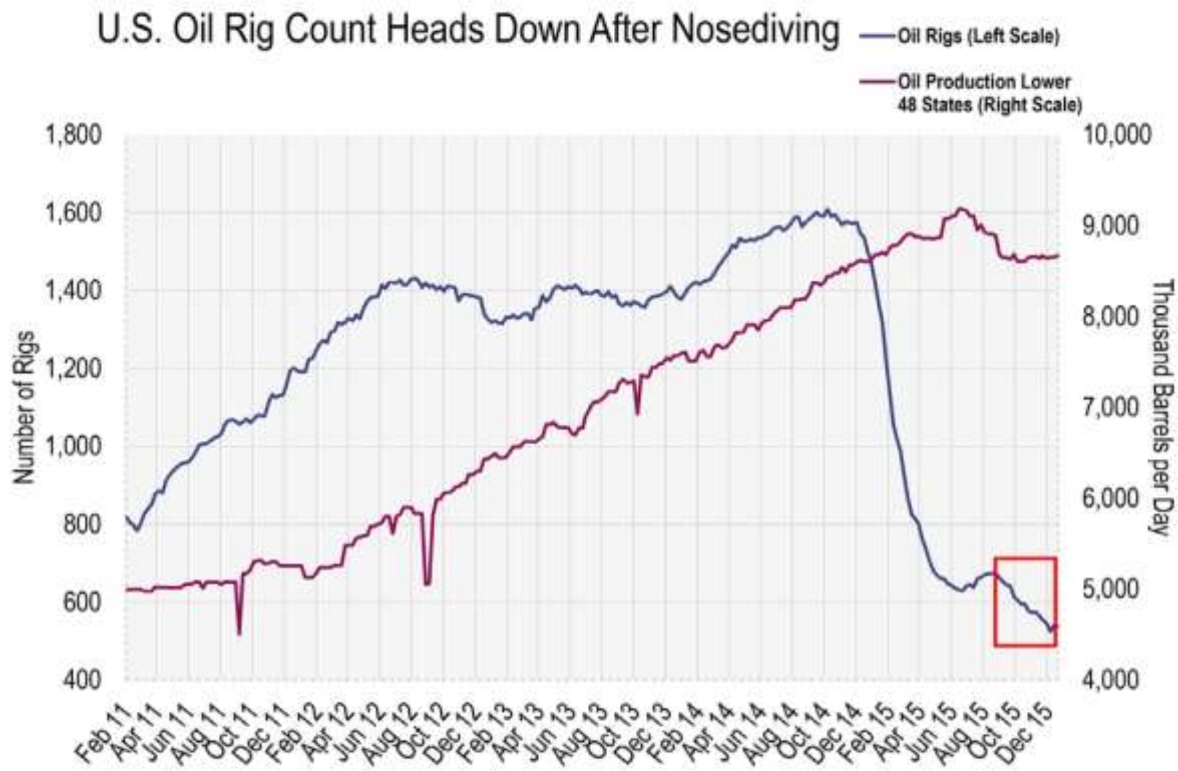
If the best case scenario for stock market returns in 2016 is for 5-8%, then it makes sense to increase allocations to other asset classes where the probability is much higher of a 3-5% return in a much lower volatility manner.

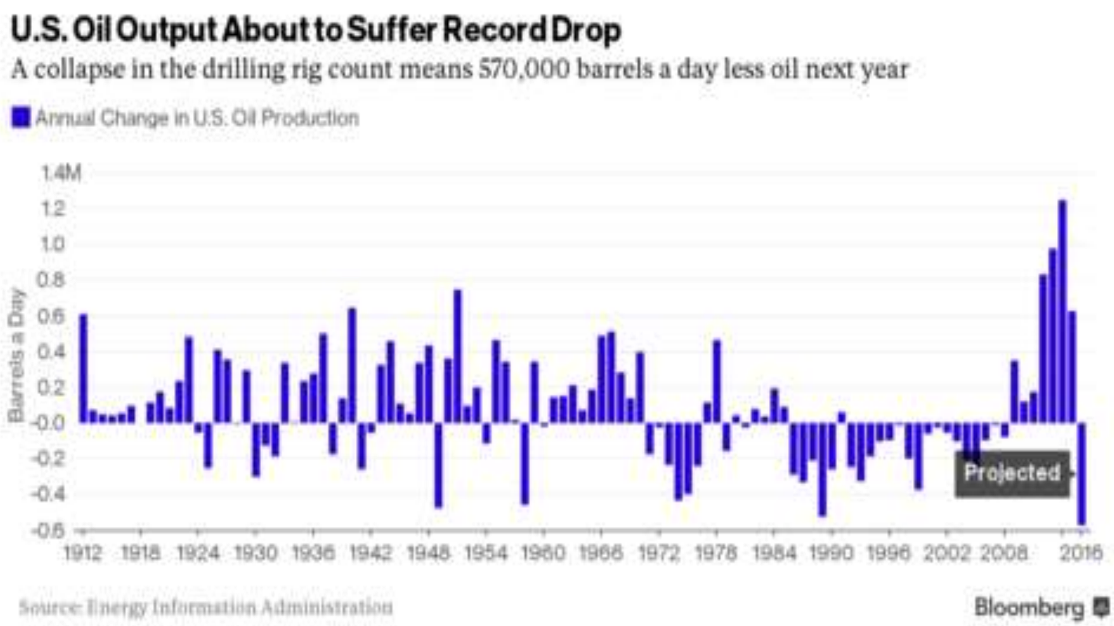
We think certain parts of the bond market will continue to perform well, and we will be increasing client's bond exposure at the expense of equity allocations. Alternative investments are another asset class we will be investing in this year. There are a number of excellent managers who have exhibited low volatility with reasonably good returns, and with a low correlation with stocks & bonds.

As always if you have any questions regarding the markets or your accounts, please let us know. We wish everyone a happy, healthy and prosperous 2016!

Best Regards,

Paul Brian Gibson, Partner
HarborView Capital Management LLC


U.S. Oil Rig Count Heads Down After Nosediving
Oil Rigs (Left Scale)
Oil Production Lower 48 States (Right Scale)
Number of Rigs
Thousand Barrels per Day
1,800
1,600
1,400
1,200
1,000
800
600
400
10,000
9,000
8,000
7,000
6,000
5,000
4,000
Feb 11 Apr 11 Jun 11 Aug 11 Oct 11 Dec 11 Feb 12 Apr 12 Jun 12 Aug 12 Oct 12 Dec 12 Feb 13 Apr 13 Jun 13 Aug 13 Oct 13 Dec 13 Feb 14 Apr 14 Jun 14 Aug 14 Oct 14 Dec 14 Feb 15 Apr 15 Jun 15 Aug 15 Oct 15 Dec 15


U.S. Oil Output About to Suffer Record Drop
A collapse in the drilling rig count means 570,000 barrels a day less oil next year
Annual Change in U.S. Oil Production
Barrels a Day
1.4M
1.2
1.0
0.8
0.6
0.4
0.2
-0.0
-0.2
-0.4
-0.6
Projected
1912 1918 1924 1930 1936 1942 1948 1954 1960 1966 1972 1978 1984 1990 1996 2002 2008 2016
Source: Energy Information Administration
Bloomberg

Investment Product	12/31/14 Close	12/31/2015 Close	2015 YTD
S&P500 (index)	2058.90	2043.94	-0.73%
S&P500 (Equal Weighted - RSP)	80.05	76.64	-4.26%
DJIA (index)	17823.07	17425.03	-2.23%
NASDAQ (index)	4736.05	5007.41	5.73%
World Stock Market (MSCI index)	1710.08	1662.79	-2.77%
Emerging Markets (VWO)	40.02	33.78	-15.60%
Europe (MSCI index)	391.95	368.21	-6.06%
China (FXI)	41.62	36.31	-12.75%
China "A" Shares (ASHR)	37.21	36.41	-2.15%
Japan (EWJ)	11.24	12.27	9.19%
Latin America (ILF)	31.81	21.88	-31.22%
Brazil (EWZ)	36.57	21.52	-41.14%
Canada (EWC)	28.86	22.00	-23.76%
Australia (EWA)	22.17	20.00	-9.79%
20 Yr.+ U.S. Treasuries (TLT)	125.92	123.73	-1.74%
Barclays Aggregate Bond (AGG)	110.12	110.66	0.49%
Investment Grade Corporate (LQD)	119.41	117.97	-1.21%
High Yield Corporate Bond (HYG)	89.60	85.34	-4.76%
U.S. Dollar (UUP)	23.97	25.65	7.01%
Oil (WTI spot)	53.71	37.08	-30.96%
Gold (spot)	1183.20	1060.50	-10.37%
Gold Miners (GDX)	18.38	13.72	-25.35%
AAA Strategy (no fee)	551.14	526.05	-4.55%