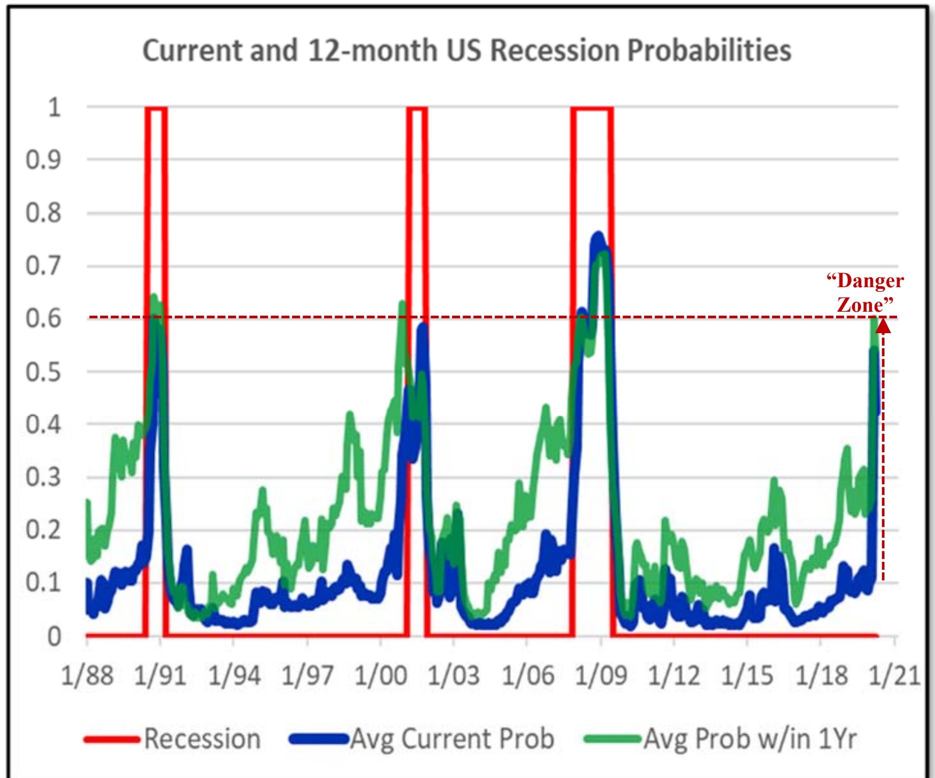
MARKET LETTER

PACIFIC PORTFOLIO CONSULTING, LLC

First Quarter 2020

Chart 1: Global Economy Closed for Business



As quarantine-related lockdowns in the U.S. and other primary economies have imposed a "hard stop" on the global economy, the risk of recession – both domestically and globally – has sky-rocketed. Financial markets – which had been projecting a twelve-month U.S. recession risk of just 1% as recently as January – have been screaming recession warnings, as investors shed risk with both hands, sending stocks sharply lower and credit spreads dramatically higher. Although the lower frequency of economic data has caused the alarm to be raised more slowly on that front, the message emerging is relatively clear, with the prospect of recession now staring us squarely in the face. Although an absence of the excesses typically present at the onset of recession could speak to this one being milder than most, the almost complete lack of economic activity going on during the shut-down says otherwise, pointing to a potentially very sharp contraction in growth. One bright spot is the potential for a short-lived recession, with growth expected to return once the shut-down is lifted, though this remains clearly dependent on our ability to curtail the rate of new infections.

WORLD INTERRUPTED

The COVID-19 pandemic and, more pointedly, the drastic measures that have been enacted in an effort to contain – and, ultimately, eliminate – the global threat it poses has turned the global financial and economic landscape on its ear.

Massive amounts of pain have been inflicted on risk assets (and a few traditionally safe ones, too) in a remarkably short period of time, sending the stock market from all-time highs to bear market territory in a matter of weeks. Readings on the state of the U.S. and global economies, meanwhile, are only just now starting to tell their story and – though still in draft form – it's reading a bit like a Greek tragedy at this point, rife with job losses, potential bankruptcies, and a vast erosion of confidence among both consumers and businesses. Basically, all the things you would expect if you were headed into a recession – which, in fact, is exactly what we believe is now unfolding around us.

How many boxes of tissues we end up needing to see our way through to the next chapter of this tearjerker will ultimately hinge on the timeline over which we are able to defeat – or, at the very least, get the upper hand on – this virus, a variable that does not lend itself terribly well to modeling. As a result, markets could potentially remain challenging for some time, as both medical and economic data emerges that appears to point either towards a quicker or more prolonged resolution, and volatility – which has been swinging wildly one way or the other (or both!) by the day – is something we should all learn to live with for the foreseeable future. Although there are certain tactics that can be brought to bear on the portfolio management process at times like this, panicked, indiscriminate selling – which has been painfully evident in the market on several occasions in recent weeks – is not one we view as likely to drive favorable outcomes. There are other steps, however, many of which we are incorporating into our clients' portfolios as we speak, that may enable us to take advantage of or at least dampen the pain of current market dislocations. Beyond which, the core principles of discipline, patience, and risk management that underlie our strategies must, necessarily, remain intact, as we navigate what is sure to remain a highly uncertain landscape.

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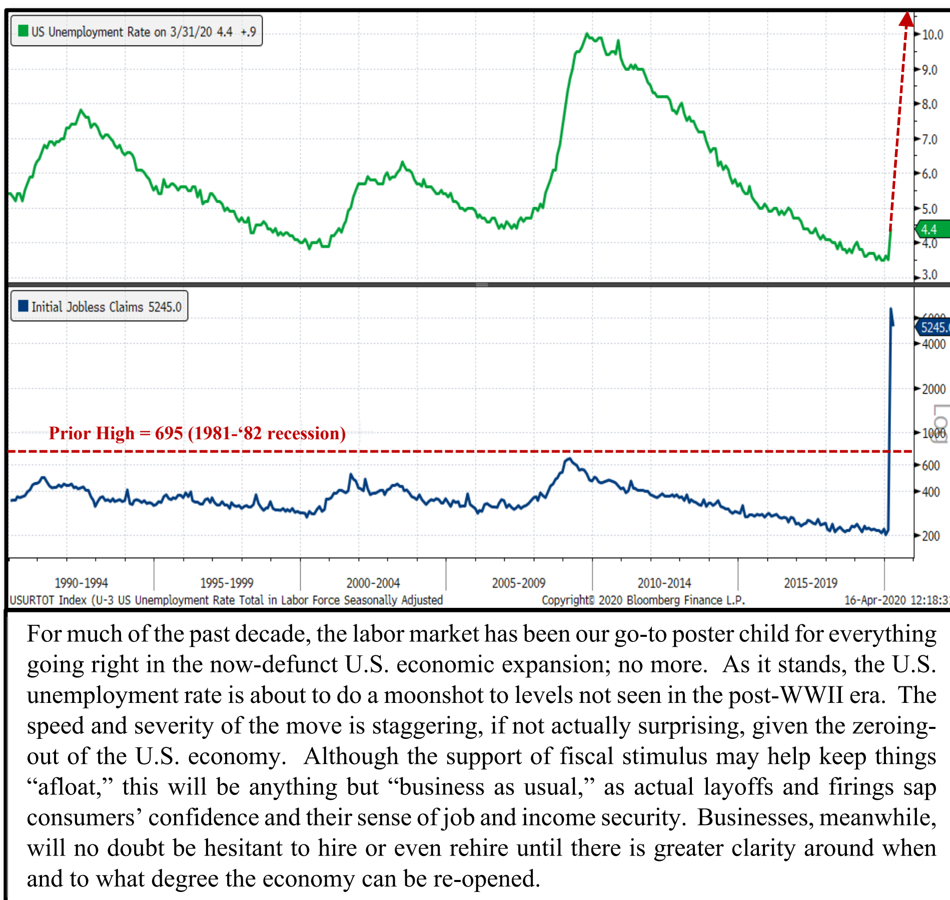
Buh-Buh-Buh-Baby, You Just Ain't Seen Nothin' Yet!

Think about it for just a moment: what was it - a mere 7 or 8 weeks ago? The sun was shining, skies were blue (maybe not here in Seattle, but somewhere), the global economy was open 24/7, and stocks were busy setting a string of new all-time highs. Jobs were plentiful, inflation wasn't, businesses and consumers were feeling pretty good about life, policymakers had managed – at least temporarily – to put the pin back into the trade war hand grenade, and the Fed had managed to orchestrate a literal hairpin turn in policy with remarkable grace. Even so, given where we perceived ourselves to be in both the longest economic expansion and longest equity bull market of all time, our expectations for the year on either front were relatively modest but – quite critically! – positive. So much for all of that.

Instead, here we are now sitting on the brink of a recession – and, frankly, "brink" is at best a loosely chosen term, as it would seem to imply that we are teetering and at risk of falling into recession, whereas, in fact, we believe the scales have already tipped. How could they not have?? The private sector economy has literally shut down. Global trade is faltering, scheduled airline flights are down 90%, restaurant dining is down 100%, and vehicle traffic in cities like New York, London, Paris, and Rome is down 50% to 70%; the same is true of pedestrian traffic in the shopping districts of many of those same cities. Meanwhile, moving from gut check to data check, Chart 1, on the prior page, helps to confirm our concerns. It depicts the current readings of our recession probability model, showing that the risk of recession at some point within the next 12 months (the green line) has quickly risen to around a 60% probability, a critical level that, historically, has presented a "point of no return" in the shifting of the economic cycle. At the same time, current recession risks (in blue) have escalated very sharply in short order, which – when taken in conjunction with the above rise in the 12-month probability – has typically been seen to occur just as a recession was going "live".

Chart 2: Short-run Economic Trajectory Likely to Be Jaw-Dropping



For much of the past decade, the labor market has been our go-to poster child for everything going right in the now-defunct U.S. economic expansion; no more. As it stands, the U.S. unemployment rate is about to do a moonshot to levels not seen in the post-WWII era. The speed and severity of the move is staggering, if not actually surprising, given the zeroing-out of the U.S. economy. Although the support of fiscal stimulus may help keep things "afloat," this will be anything but "business as usual," as actual layoffs and firings sap consumers' confidence and their sense of job and income security. Businesses, meanwhile, will no doubt be hesitant to hire or even rehire until there is greater clarity around when and to what degree the economy can be re-opened.

Mind you, the picture's actually worse than Chart 1 even lets on: you see, our overall recession probability model is currently benefitting from the relative stability of activity, prices, and sentiment within the housing market (how long can that last?), without which the risks would appear even higher. Labor market statistics provide the most vivid example of this, currently projecting a 100.00% likelihood that we are already in a recession. Initial jobless claims have skyrocketed, with a combined 22 million people filing new claims for unemployment in the past four weeks, the biggest increases on record by a massive factor, completely erasing the job gains achieved over the past ten years. As is clearly implied in Chart 2 (left), the U.S. is poised to jump from deep within "full employment" territory – where our biggest concern was that a too-tight labor market might stoke inflation – to a rate of unemployment likely to rival, if not dwarf, anything on record: with an estimated 155 million in the U.S. labor force, if things stay where they are, we're talking about a 14 percentage point increase in the unemployment rate overnight!

We believe we are likely to see a lot more of these "I didn't think it could do that!"-type of data prints moving forward and, as a result, "unprecedented" is a word we are all likely to get tired of hearing in the weeks and months to come

Chart 3: Of Elephant Guns, Bazookas, and Nuclear Options

Source: Cornerstone Macro	Central Bank Liquidity Injections		Govt Fiscal Stimulus		Combined Total	
	$T	% GDP	$T	% GDP	$T	% GDP
U.S.	$4.80	22.4%	$2.71	12.7%	$7.51	35.0%
Eurozone	$1.10	8.3%	$1.43	10.7%	$2.53	19.0%
Japan	$0.20	3.9%	$0.99	19.2%	$1.19	23.1%
U.K.	$0.25	9.0%	$0.07	2.4%	$0.31	11.4%
China	$1.27	9.0%	$0.54	3.8%	$1.81	12.8%
Others	$0.65	-	$1.85	-	$2.50	-
TOTAL	$8.27	9.5%	$7.59	8.8%	$15.86	18.3%

Policy interest rates back to the zero-bound; the Fed buying Treasuries, mortgage-backed securities, AND corporate bonds – including some non-investment grade!! Add to that the largest fiscal stimulus package in history with components aimed at consumer spending, unemployment benefits, liquidity needs of businesses, corporate tax credits, and money for state and local medical services and supplies. And that's just the U.S.! Globally, nearly 20% of world GDP is being pumped into the system in some form of stimulus! Believe it or not, this will help but it's still not enough. While this will certainly soften the blow, it can't be expected to completely offset foregone private consumption.

(particularly given the context in which it will most likely be used). This will be true not only for the U.S., but also for the global economy as a whole; as a result, there would appear to be little room to debate the severity of the recession we are facing, which is expected to see global growth contract even more than it did during 2008-2009 – even though that was the so-called "Great Recession" – though, as noted earlier, this recession could potentially be far briefer in duration. At this stage, the hope is that the recession will turn out to have been "front-loaded"; in other words, the first half of 2020 is shot – globally – but, in the event state officials are able to come up with a safe and reasonable plan to reopen at least portions of their economies in late-Spring or early-Summer, then positive growth could begin to dig us out over the latter-half of the year. While that doesn't necessarily sound like a walk in the park, there are – thankfully – a couple of factors in play that may help turn the tides. After some initial missteps, global monetary policy authorities have pulled out all of the stops at once in an effort to backstop virtually every crack, crevice, and corner of the financial system, led by the U.S. Federal reserve, which has cut short-term interest rates back to zero and relaunched an essentially unlimited quantitative easing (i.e., bond buying) program, expanding its purchases to new – and, critically, riskier – segments of the bond market where it previously would not even have thought to tread (all those people who used to snark about QE∞ must be feeling pretty smug right about now!) Similarly, after some initial missteps – specifically, an appalling display of both hesitation and partisan bickering reminiscent of the days immediately following the Lehman failure in 2008 – Congress has passed a massive stimulus package, the $2+ Trillion CARES Act, which includes direct cash-in-pockets for individuals, as well as support for state and local governments, and forgivable loans and tax credits for businesses. Realistically, all of this (particularly when extrapolated onto a global scale, as depicted in Chart 3, above) will help ease the sting of the recession but can in no way be expected to take the place of the private sector – U.S. consumer activity alone accounts for over $14 Trillion of U.S. GDP! Business investment adds another $3 Trillion and change. As a result, depending on how the timeline to re-opening of the U.S. (and global) economy evolves, an additional round of stimulus might end up being necessary; nonetheless, for the time being at least, investors have viewed the above actions as meaningful and "enough for now", allowing the market to regain some stability, start sifting through the rubble, and building a base camp in which to await some greater clarity.

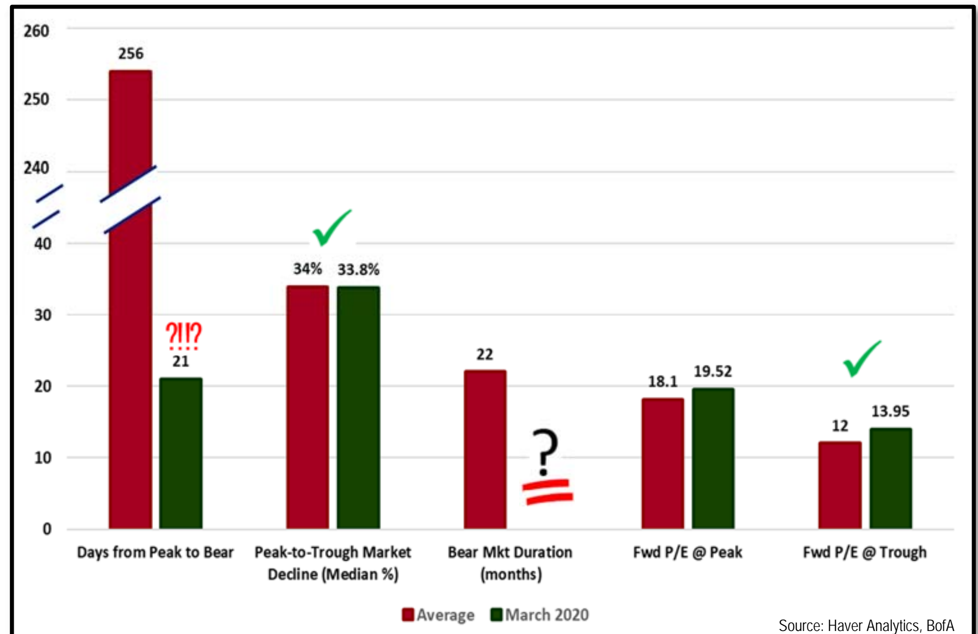
CATS AND DOGS LIVING TOGETHER

The words. They're sitting on your lips right now – I'm willing to bet it! They're "Mass hysteria!"…am I right??? Of course I am! Coincidentally enough, these also just happen to be the best two words I could imagine to capture the frenzied state of financial markets over the latter-half of Q1. As it first began to dawn on investors that the global economic steam engine going clean off the rails was actually a possibility, risk appetite simply evaporated and correlations between various assets – with the exception of the rare "safe havens" – began to converge towards one. Baby, bath water, kitchen sink – you name it: if investors could get their hands on it, they were dumping it. The result

was a landscape literally cluttered with "shock & awe" moments: the worst month since 2008, the worst Q1 EVER, the best week since 1974, as well as the biggest single-day gains since 1933 AND the biggest single-day losses ever!

Sure, we were looking for a correction, but COME ON!! The speed and severity of the market decline were nothing short of staggering. The S&P 500 index of blue chip, large-cap U.S. stocks went from setting a new all-time high in mid-February to neck-deep in a bear market within the span of just three weeks, the fastest descent into bear territory in history. By the time the lows (for now) were in a couple of weeks later, the market was down -33.8%, putting the decline on par with the median of -34% for all bear markets going all the way back to (and, importantly, including) the Crash of 1929.

Chart 4: The Bear by the Numbers - the Good, the Bad, and the Scary



The young bear cub currently wreaking havoc in the market has already satisfied some of the metrics typical of a complete bear market cycle, most notably the size of the total peak-to-trough decline (though there is considerable variance around that "mean" value), but also the overall compression in price-to-earnings multiples (well, almost!). Given what we see as a very sharp shift in sentiment and near-term washout in investor positioning in risk assets, this leaves us inclined to believe the late-March lows may end up being "*the* lows" for this cycle, though we do believe these lows will be tested along the way. While testing (not necessarily "touching") the lows is not an outright requirement, it is *exceedingly* rare for the market to touch bottom and never look back (4Q 2018 being the rare exception).

Meanwhile, the absurdly short time span over which it unfolded helped add rocket fuel to the shock value of the decline – or, even, "crash" might be a more appropriate term – so as to leave most investors shellshocked in its wake. Faced with an outcome over which extremely little was known other than it was "bad," investors engaged their flight-to-quality autopilots, selling everything they could, everything they had; while they may have started with what they viewed as the most risky – smaller-cap stocks, high yield bonds, etc. – the stock market quickly experienced a pandemic of its own, as "contagion" spread from the sale of riskier assets to safer assets, all for the sake of buying only the most liquid U.S. Treasury bonds – sending yields to once-unimaginable lows – and some gold, and – of course – cash: money market funds saw assets spike by $900 Billion within the span of 6 weeks, the largest and fastest increase ever.

With the panic selling out of the way, investors have since begun to work their way through the various "stages of grief" in recent weeks and – having no doubt seen their fair share of "Denial", "Anger", "Depression", and maybe even a little "Bargaining" – now appear to have reached some acceptance of where they are at and are now free to begin working out some idea – necessarily, a very malleable one – of where they may be headed. This has enabled stocks to stage an impressive rally off the lows, rising over 28% from late March through mid-April, *technically* putting U.S. stocks back in a bull market (no, seriously!). Of course, in our book, this highlights the hype, hoopla, and hot air that lies behind some of Wall Street's folklore: in the real world, defining a new bull market simply as a rise of 20% or more can be hazardous to your wealth and, instead, we would reserve the term for a time when stocks are rising and conditions appear conducive to further sustained gains over time. In this case, the fact that stocks have exhibited such strength is impressive, but this comes within the context of some of the most oversold conditions we have seen and, rather than a new bull, our expectation that the March lows will be tested (although we do not expect them to be broken) leaves us thinking that for now we are dealing with a bear market rally within an ongoing period of consolidation from which we believe markets will – eventually – emerge to the upside.

In such a setting, investors have – not surprisingly – reverted back to "what worked" before all of this – in other words, large-cap, U.S. stocks -preferably of the growthier variety; on the other hand, this also reflects an apparent view – one that we actually share – that the U.S. may fare better than the rest of the world coming out the other end of this. Certainly, the U.S. went into this crisis in a superior position both economically and monetarily and – even if it is no great shakes itself – will, as a result, likely also be on a sounder footing once the dust has settled. This bias benefited the performance (relative, not absolute, obviously!) of both the large-cap S&P 500 index, which was only down (only!) -19.60% for the full quarter, and the tech-heavy NASDAQ (remarkably, the NASDAQ 100 index of the largest growth companies was down just -10.29% and is one of the only equity indices to retain a positive one-year showing!)

So, what about the rest of the market? Well, the easy answer is "Worse!" whereas a more refined answer would be "A heck of a lot worse!" Value stocks, for example, were battered, particularly within the small-cap space, reflecting a particular aspect of the above-noted market outlook, specifically that when growth resumes it is likely to be unsteady and uneven – and even unimpressive, after the initial bounce-back – giving preference to buying the stocks of companies that can generate their own growth rather than betting on cyclicality (i.e., those companies that could benefit the most from an improvement in economic growth). Thus, the trend continues, as growth – which has soundly outperformed value in recent years – appears poised to maintain that edge going forward. While the cycle will no doubt turn and begin to revert to more normal levels some day, the fact that value stocks are relatively cheaper than growth is a "necessary but insufficient" factor to induce such a tidal shift at this time and we can see little to indicate any further catalyst that might trigger this any time soon.

Foreign stocks, meanwhile, have seen a similar dynamic lately. As it has for some time now, the space as a whole lagged behind U.S. equities during the quarter – the broad, large-cap, developed MSCI EAFE index dropping just shy of -23% this period – but riskier smaller-capitalization foreign equities, as well as stocks within the less-developed emerging and frontier markets, underperformed abroad as well. Once again, despite the continued viability of an argument in favor of an allocation to foreign equity for the sake of diversification over the long-haul, we are hard-pressed to identify a scenario in which such exposure is likely to outperform an equivalent exposure to domestic equity in the short-run.

Based upon this outlook, which centers on a belief that the U.S. economy will be better-positioned vis-à-vis the rest of the world once economic life resumes (as the recent damage only adds to the existing problems of places like Europe, Japan, and China), that growth is likely to be somewhat scarce once it does reemerge, and that quality and stability – of growth, of balance sheet, of management, etc. – are likely to be prized characteristics in such an environment, we have begun the process of tilting our portfolio strategies appropriately. This is not a question of wholesale changes but of tilts and biases in order to have strategies lean towards those segments of the market we view as most likely to prosper over the next 3-5 years in the environment we envision. In addition, as we have been rebalancing portfolios – taking advantage of the incredible appreciation seen in core fixed income to reallocate to beaten-down equities to bring them back towards target, we have also been seizing the opportunity to harvest tax losses for our clients; while we may also be presented with the "opportunity" to do so again closer to year-end, as we normally would, depending on the market's path from here, locking these in now ahead of an anticipated recovery in the market ensures they will be available for our clients to use to shield equivalent gains from taxes for some time to come.

A similar, if more modest, process is gradually taking place within fixed income as well, where we have begun to lighten – but certainly not eliminate – our strategies' bias towards shorter-duration fixed income, given a general lack of concern over interest rates moving substantially higher in the foreseeable future. Credit exposure, meanwhile, which has been a source of tremendous value-added to portfolios over the past dozen years or so, is also seeing its allocation trimmed; we believe an exposure to credit-sensitive fixed income remains important, as both a diversifier and potential performance driver, but must acknowledge the risk of a recession-induced increase in the rate of corporate defaults that argues against treading too heavily in this space.

In spite of such "course adjustments" along the way, we continue to stress the importance of both patience and discipline, both of which are essential to overcoming the natural emotional reaction that can cause investors to abandon ship – usually at just the wrong time. Listen, we know there will always be a contingent of die-hards that believe that attempting to time the market is the best way to manage money – not surprisingly, their ranks seem to swell after a big market decline: it's only natural to want to believe that there was something that could have prevented all of that pain inflicted on one's portfolio! Make no mistake: if you can do it, come talk to us: we have a job waiting for you! Nonetheless, we remain convinced by everything we have witnessed within and throughout pretty much every type of market cycle

imaginable that such efforts are broadly counter-productive to the long-term well-being of a portfolio: when it comes to investing, the ability to be completely right fifty percent of the time or half-right one hundred percent of the time – given the catastrophic impact it can have on a portfolio, as highlighted in Chart 5 (right) – may, ultimately, be more of an exercise driven by pride than profit.

Chart 5: Market Timing Is No Way to Go Through Life, Son!

Decade	Price Return	Excl. 10 BEST days per decade
1930s	-42%	-79%
1940s	35%	-14%
1950s	257%	67%
1960s	54%	14%
1970s	17%	-20%
1980s	227%	108%
1990s	316%	186%
2000s	-24%	-62%
2010s	190%	95%
Since 1930	**14,962%**	**91%**

Source: S&P, BofA

It's tempting to think we can outsmart the market. Who hasn't looked at a chart of the broad market after a big run and thought, "Of course! It was obvious!"? Well, not only is it much harder to make such calls in real time (as opposed to after-the-fact) but – and this is the REALLY tricky part – you have to be consistent: no timing trade is complete after just one decision, even if it's the right one – you also need to get the timing of the closing trade right too. As the table above makes clear, getting it even partially wrong can take a big bite out of your performance, while repeated mistakes can be ruinous!

A cool head will, no doubt, prove difficult for many to maintain in the months and even quarters to come, as we navigate a landscape literally shifting under our feet from day to day. While the market is, indeed, forward-looking and good at discounting events before they actually occur, the possible scenarios that it is discounting change routinely, as do the various probabilities that the market associates with each one – a complicated way of saying the market has the potential to swing from ebullient complacency to apocalyptical gloom as efforts to reduce the rate of new infections or treat those already infected meet with more or less success than expected, as corporate earnings – which are a guessing game at this point – crumble or merely erode, and as incoming economic data provides clues as to the true state of the U.S. economy. Certainly, public health must remain the first priority, regardless of the cost; having said that, the longer the private sector remains furloughed, the greater the risks that more lasting damage will be done to the economy. Thus, there exists a very clear incentive to get things back to "normal" as soon as it can be done safely. The ball is now in the court of the various state officials, who must now attempt to figure out what "safely" actually means: not only when but also how much to reopen their respective economies, as well as what to do if there is a resurgence in the rate of infections; for better or worse, we are about to get the first "real world" example of this process, as Texas prepares to begin lifting certain COVID-related restrictions over the latter-half of April. Let's all hope for the best, for everyone's sake.

We are acutely aware of how trying and outright disconcerting the current environment must be. We have been attempting to communicate with you more frequently, both one-on-one and through market and economic updates, and want you to know that continuing to make ourselves available to you is a top priority of ours in this difficult time. Thankfully, we had been working with many of you long before the recent market decline, to review strategy and risk tolerance, as well as going over potential outcomes under different scenarios, increasing the likelihood that most of you are positioned in strategies appropriate to your objectives and risk tolerance and that you have the understanding of how you are positioned and why to be comfortable and sufficiently confident in your strategy to hold the course. Now more than ever, please feel free to consult with your Advisor if you have concerns or are contemplating any material changes to your strategy and, as always, we invite you to reach out to Jim Ayres, our company's Chief Investment Officer, or your Advisor with any questions you may have with regard to our economic or market outlook.

1ST QUARTER 2020 CAPITAL MARKET PERFORMANCE

Index (as of 3/31/2020)[1]	1 Qtr	1 Year	3 Year	5 Year	10 Years
FTSE 3-month T-Bills	0.39%	2.04%	1.74%	1.12%	0.60%
Bloomberg Barclays Gov't/Credit Int.	2.40%	6.88%	3.79%	2.76%	3.14%
ICE BofAML US High Yield	-13.06%	-7.40%	0.57%	2.68%	5.49%
Bloomberg Barclays Multiverse	-1.11%	3.47%	3.37%	2.67%	2.58%
S&P 500	-19.60%	-6.98%	5.10%	6.73%	10.53%
Russell 1000 Value	-26.73%	-17.17%	-2.18%	1.90%	7.67%
Russell 1000 Growth	-14.10%	0.91%	11.32%	10.36%	12.97%
Russell Mid Cap	-27.07%	-18.31%	-0.81%	1.85%	8.77%
Russell 2000	-30.61%	-23.99%	-4.64%	-0.25%	6.90%
Russell 2000 Value	-35.66%	-29.64%	-9.51%	-2.42%	4.79%
Russell 2000 Growth	-25.76%	-18.58%	0.10%	1.70%	8.89%
MSCI EAFE	-22.72%	-13.92%	-1.33%	-0.13%	3.20%
MSCI EAFE Small Cap	-27.45%	-17.81%	-2.50%	1.34%	5.18%
MSCI Emerging Markets	-23.57%	-17.36%	-1.25%	0.01%	1.04%
MSCI Frontier Markets	-26.57%	-18.72%	-4.04%	-2.53%	1.40%
Wilshire US REIT	-25.63%	-19.38%	-2.49%	-0.19%	7.67%
DJ Global Select RESI	-29.33%	-24.14%	-4.31%	-2.04%	5.54%
Bloomberg Commodity Index	-23.29%	-22.31%	-8.61%	-7.76%	-6.74%
Credit Suisse Liquid Alts	-5.80%	-2.43%	0.28%	0.62%	2.58%
60-40 Balanced EQ/FI – US Only	-11.15%	-1.17%	4.89%	5.38%	7.76%
60-40 Balanced EQ/FI – Global	-12.22%	-3.58%	3.04%	3.40%	5.38%

[1] The Bloomberg Barclays U.S. Government Credit Intermediate and Multiverse indices are registered service marks of Bloomberg Finance LP. Barclays is a service mark of Barclays Bank Plc, used under license; the ICE BofAML US High Yield index is a registered service mark of Intercontinental Exchange; BofAML is a service mark of BofA Merrill Lynch, used under license; the S&P 500 Index is a registered trademark of the McGraw-Hill Companies, Inc.; the Russell 1000, Russell 1000 Value, Russell 1000 Growth, Russell Mid Cap, Russell 2000, Russell 2000 Value, and Russell 2000 Growth indices are registered trademarks of the Frank Russell Company; the MSCI EAFE and MSCI Emerging Markets indices are registered trademarks of MSCI or its subsidiaries; the Wilshire REIT index is a registered trademark of Wilshire Associates Incorporated; the DJ global Select RESI index is a registered trademark of Dow Jones Trademark Holdings LLC; the Bloomberg Commodity Index is a service mark of Bloomberg Finance L.P.; the Credit Suisse Liquid Alternative index is a trademark of Credit Suisse Group AG.

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