MARKET LETTER

PACIFIC PORTFOLIO CONSULTING, LLC

First Quarter 2022

DON'T LOOK UP

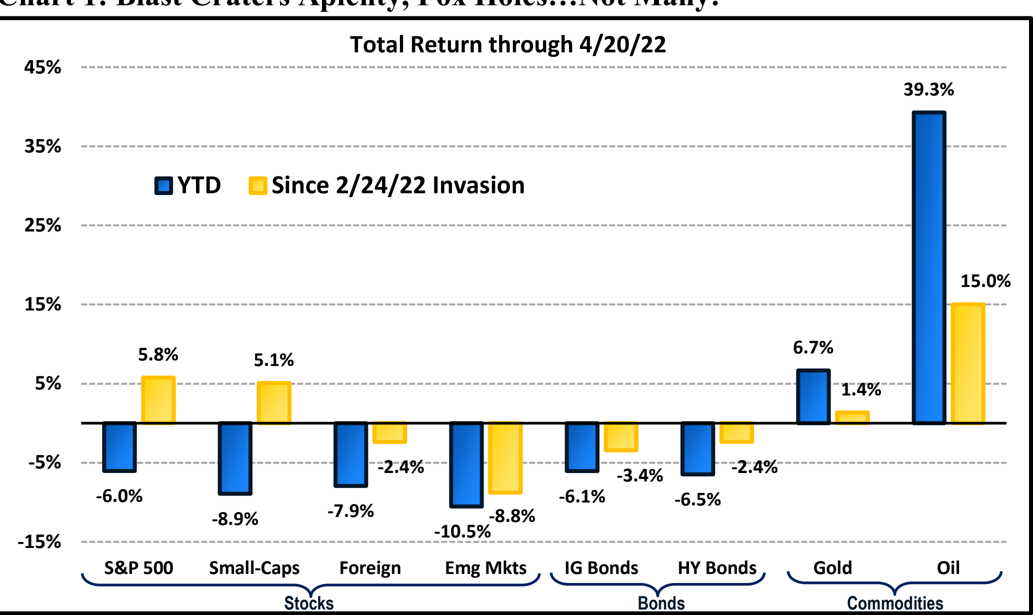
Believe me, I get it; it's ugly out there right now and nothing sounds quite so appealing as the thought of being able to turn a blind eye to it all and pretend that none of this is happening. Frankly, I suspect that's exactly what many of our duly elected officials and otherwise world "leaders" would like us to do – certainly, Vladimir Putin would love nothing more! (By the way, that's likely all I will have to say about Putin here, as one of the few hard and fast guidelines I am given in writing these missives is "No swearing!")

Of course, it's possible we're all just chasing our own tails at this point since, truth be told, there really isn't much to look "up" at right now; stocks are down, bonds are down, consumer and business confidence are down. Ooh, wait, I know: inflation and interest rates – those are both up! For that matter, so are the Fed's hackles and so, correspondingly, is the risk of a recession. No, we definitely do seem to have more than enough reason to worry right now and – just as was the case in the movie – not "looking up" isn't going to make any of it go away. Quite the opposite, in fact: we should all be looking up, looking down, and looking out these days, as recent regime shift has left us well outside the bounds of the rather idyllic, risk-loving environment that characterized much of the past several years.

Now, as we noted in our piece last month on the Russian invasion, this is not the first and it certainly won't be the last time the human race Forrest Gumps its way into another fine mess of the economic, financial, or geopolitical variety. Granted, our rapidly shifting landscape helps render things all the more complicated, but it's good to recall that these sorts of challenging conditions – and much worse, in fact – are all explicitly considered within the framework of our long-term asset class assumptions and asset allocation process. As a result, we stand by our most basic rule of engagement for times like these, which is that investors should avoid making hasty decisions that materially alter their risk positioning in the absence of any change in their actual circumstances.

Note that this is by no means an invitation to just sit back, relax, and wait for impact. Rather, it is yet another reminder that while your spouse, your neighbor, and your dog may all be your friend, your emotions are not.

Chart 1: Blast Craters Aplenty, Fox Holes…Not Many!



It's certainly been a while since we faced a scenario such as this – I'm not just referring to an environment characterized by violent geopolitical conflict, mind you, but also one that, for one reason or another, proves deeply toxic to both stocks and bonds at the same time. There have only been 19 quarters (including the current one) over the past 50 years in which the S&P 500 stock index and the Bloomberg Intermediate Government/Credit bond index have been down in tandem, so slightly less than 10% of the time. I don't think it will surprise you much to learn that a majority of those observations took place within a monetary tightening cycle (i.e., a rising interest rate environment) and/or close to the start of a recession. Now, this is not to say that this is necessarily a harbinger of doom – let's face it, there really is nothing with that level of predictive power (and can you imagine the chaos that would ensue if there were?!) but it is certainly a flag red enough to warrant keeping a close eye on. Much will hinge on the actions of the Federal Reserve going forward which, if they are successful in executing a "soft landing" and take the wind out of inflation's sails without tipping the economy into recession, could return us to more benign and stock-/bond-friendly conditions (albeit, likely dissipating some of the momentum currently driving returns in the commodities sector). If, on the other hand, the Fed's response is overly aggressive, we could find ourselves facing even more challenging conditions on a number of fronts.

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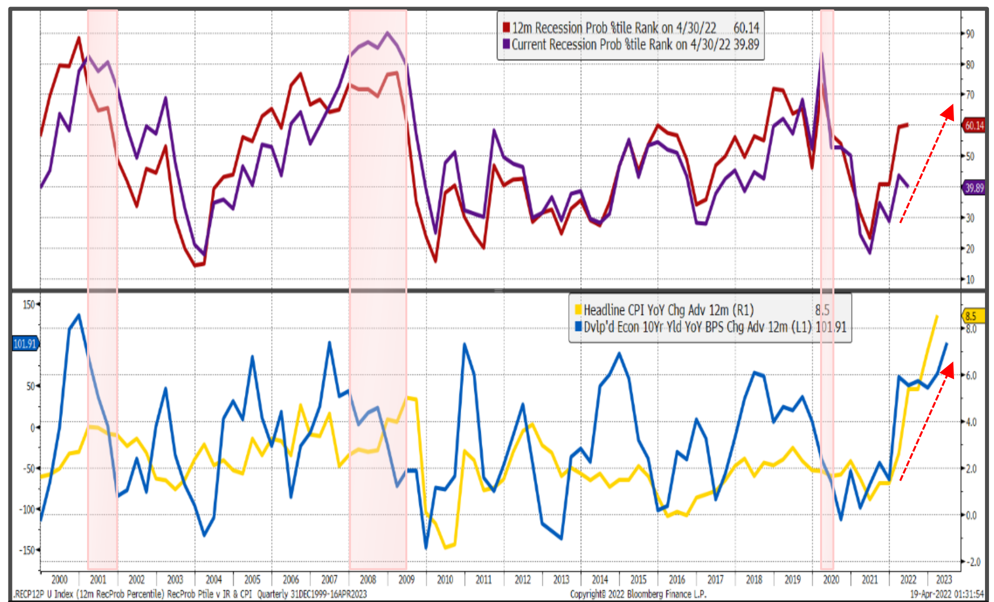
Admittedly, we currently face highly uncertain and often unnerving conditions, in spite of which investors must remember that the actions they take – and, quite critically, those they consciously choose NOT TO TAKE – in response could end up having very material effects on the potential success of their long-term financial and investment plans. As a result, you should go into this expecting us to continue trumpeting the merits of long-term strategic tools like discipline and diversification, albeit employed in concert with managed tactical tilts intended either to take advantage of a nascent opportunity or sidestep an emerging risk. In response to some fairly significant shifts we have perceived in economic and financial market conditions as well as in the prospective risk/reward propositions offered by various asset classes and market segments, our Investment Committee recently has made several such tactical moves (not surprisingly, these have been mostly on the "risk avoidance" side of the ledger), which are laid out in some greater detail herein, and is currently evaluating potential additional shifts. Consistent with our core philosophy, however, such moves are designed to remain consistent with the core risk characteristics that define each of our client's strategies. We continue to believe these strategies encapsulate the key qualities necessary to promote a high likelihood of reaching your goals and objectives over the long-run, despite the potentially hairy conditions we may encounter in the short-run.

A Funny Thing Happened On The Way To Q2

Some of you might be doing a double-take at this point, wondering what the heck happened in three short months to produce such a marked escalation in tone since our year-end 2021 piece. Well, as eventful quarters go, 1Q 2022 was right up there! I guess you could say that some of the things we were watching have actually gone somewhat "as planned": the economy has, indeed, begun to cool, inflation has persisted, and the trailing twelve-month return on stocks…well, fair to say that, at +5% currently relative to +48% a year ago, it has indeed come down…a lot! Truth is, though, all of these things have been playing out quite a bit faster than anticipated, owing largely to certain other things that have gone considerably less to plan.

Chart 2: We Have Met The Enemy And He Is Us



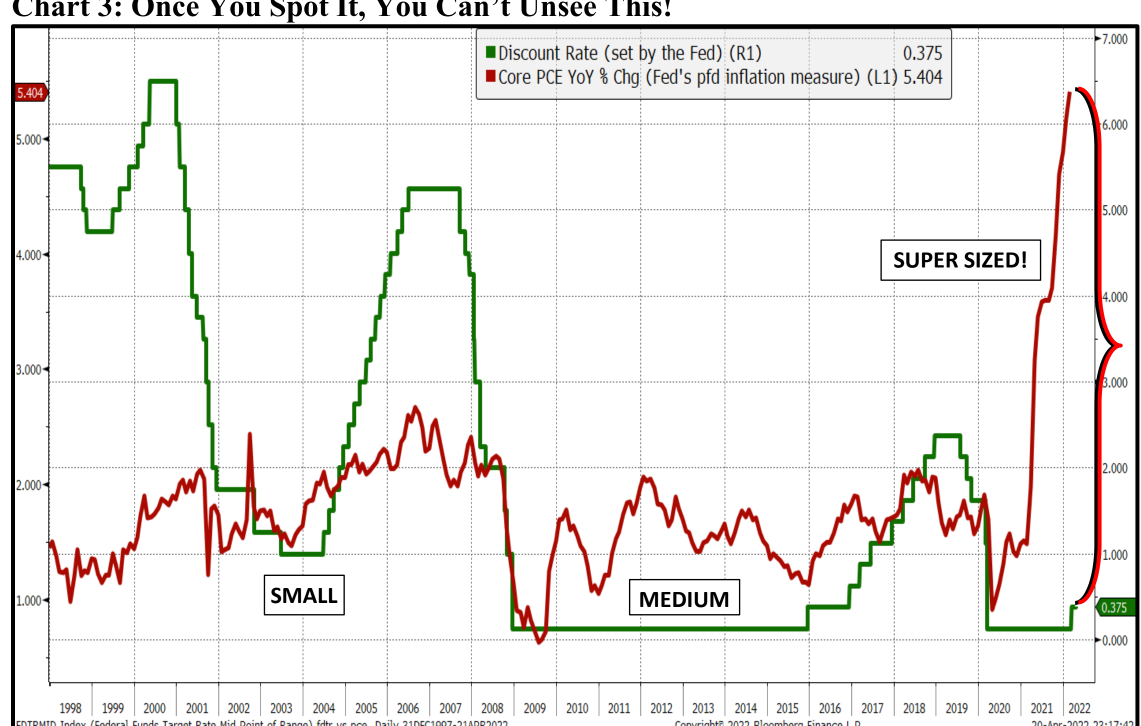
While the very nature of an economic cycle is to follow its inexorable path from peak to trough and back again, the timing of the process can vary wildly. Some cycles are on the shorter side; for example, the 1980-81 expansion clocked in at a mere 16 months. Others run for years, as was the case with the one following the 2008 financial crisis, which lasted over a decade. A key factor influencing the life expectancy of an expansion is the attitude and actions of the central banks – primarily the U.S. Federal Reserve – which can either keep policy loose to infuse extra life into the expansion or tighten policy in an attempt to gut inflationary pressures. Such well-intentioned central bankers often end up spoiling the party for everyone by raising interest rates too far, too fast in the name of price stability. This is a potential concern in our current context, in which pricing pressures have shown an alarming increase over the past year and, to our mind, appear unlikely to abate any time soon. This has produced an important shift in the Fed's prime objective, bringing a more acute focus on taming higher inflation before it becomes engrained into consumer and investor expectations. As inflation and, in turn, interest rates have risen, the likelihood of a recession has increased as well; while not yet at alarming levels, the risk of recession looks poised to continue rising based on recent moves in inflation and interest rates, which provide a reasonably good leading view into how such risks are likely to evolve over the year ahead.

Chief among these has been the collapse of the geopolitical landscape with Russia's February invasion of Ukraine. Setting politics and common human decency aside for a moment, we will limit our treatment here to the current and prospective economic and financial implications of this conflict, for they are many. For one thing, the war is weighing on global trade – obviously, Ukraine is pretty busy with other things right now, while Russia has managed to earn itself the status of pariah in the eyes of pretty much everyone (yes, China and India, we see you hiding there in the back!) As a result, global economic activity, which was already poised to slow, now is likely to slow more than previously anticipated. More potent still has been the war's impact on inflation, as it has effectively now given us supply disruptions on top of supply disruptions. Russia is the second-

largest crude oil exporter and a major supplier of energy to European nations, not to mention the world's largest wheat exporter. As a result, the outbreak of war and resulting, well-deserved sanctions against Russia have lit a bonfire under some of the key terms in the inflation equation, setting the stage for already high prices to move even higher. This has triggered an abrupt recasting of the Fed into a meaningfully different role than the one it was reading for previously. You see, it is no longer about "normalization" for the Federal Reserve – the Fed no longer has the luxury to allow it to be so. Had inflation actually proven as transitory as it originally believed, the Fed could have taken its sweet time to get back to more "normal" monetary conditions for the sake of not overturning the market's applecart, something they proved their willingness to do during the last tightening cycle that began back in 2015, when inflation was hovering around one percent. Now, they face very significant pressure to take swift and decisive action to tighten monetary conditions – through both interest rate hikes and balance sheet reduction – if they are to continue to pose a credible threat to inflation in the eyes of the market. Of course, this, too, will tend to provide an additional headwind to global economic activity beyond what was already in the cards.

So, where does all of this leave us? Well, a strange thing happens when you type the words "Fed tightening into an economic slowdown" into an internet search engine: not that many results come up (well, at least not compared to the just under 4 billion hits that came up for the terms "Will Smith Chris Rock" when I checked a moment ago, just over a week after the "slap heard around the world"). There are a couple of seemingly good reasons for this apparent shortage of results to our search. On the one hand, such a scenario has hardly ever played out: there are only a handful of historical instances in which the Federal Reserve has found itself raising interest rates against the backdrop of an already slowing economy. The other reason – which, coincidentally also happens to be a key driver behind the first reason – is that this expression doesn't seem to make any logical sense. I can hear economists everywhere scratching their heads to ask, "Why would anyone even search for 'tightening into a slowing economy'?!? The only search result they need is 'JUST DON'T DO IT!'" Rate hikes almost always take place within the context of a BOOMING economy, one in which the demand for resources – be it raw materials, workers, money, etc. – is in excess of what the economy can provide, at least in the short-run, leading to a natural "rationing" process by way of higher prices and, hence, the inflation that establishes the needs for rate hikes in the first place. Thus, such hikes – which are, almost without

Chart 3: Once You Spot It, You Can't Unsee This!



Would it all have proved "transitory" had everything else really had been "equal"? The point really is largely moot, as it's pretty clear that the conditions that drive pricing pressures have shifted decisively in favor of inflation moving higher for longer than anyone's base case foresaw. As a result, the Fed can no longer afford to be delicate in its approach. Job number one for Powell & Co. has become talking, looking, and acting tough on inflation in order to accumulate enough "street cred" to retain the faith of global financial market participants not only that it is taking the situation seriously but also that it still has the backbone to do what is required in order to fulfill the price stability portion of its mandate. For this, it has its work well cut out for it: as the chart above depicts, the gap between the Fed's Discount Rate (green) and its preferred Core PCE measure of inflation (red) has never been wider. In fact, it's actually flipped on its head: outside of the highly abnormal period of emergency life support following 2008's Great Recession, the Discount Rate has rarely stayed below the rate of inflation for very long and has never trailed it to this extent. This points to a Fed that, based on what it says it wants to accomplish, will be focused a lot more on how it is affecting inflation trends than on pulling its punches for fear of riling the stock market. However, even based on the meaningfully more aggressive rate hike projections coming not just from financial markets but out of the Fed itself, there will still remain considerable ground to cover.

exception, kryptonite for the bond market – are typically indicative of an environment that heavily favors the stock market: strong economic growth, good earnings, and financially healthy and confident consumers (which make up in excess of two-thirds of the economy) capable of driving continued demand for goods and services. What's not to love, from an equity investor's point of view? Transition now from that backdrop to one in which growth is – quite naturally – already slowing of its own accord; the bounce back from the COVID recession and lockdown is well behind us, the spigot for both monetary and fiscal stimulus has largely been cut off, and now both trade and supply channels are being disrupted. Sure, the job market looks good – really good, in fact. Too good, apparently, at least according to the Fed, who – after bending policy over backwards to boost employment now view U.S. job market conditions as too tight and overheating. Truly the wonders of government in action! In such a scenario, a material tightening of monetary conditions – and based on Fed jawboning (i.e., an attempt by the Fed to get the effects of a tightening without actually having to pull the trigger) that appears to be what we are facing, with threats of a 50 bps hike in May and/or June – promises to pose challenges across the board within the primary traditional asset classes of stocks and bonds.

No Country…Err, I mean No Market For Old Men

It should not come as a surprise, therefore, to learn that investors in most areas of the global financial markets felt like they, too, were under attack for much of the 1st quarter and that they might need to prepare themselves to bunker down for a "long winter". As we saw in Chart 1, above, few have been spared by the challenging landscape. From its all-time high on the first trading day of the new year, the S&P 500 index of large, blue chip, U.S. stocks began to feel the increasing weight of investors' rapidly evolving expectations with regard to both inflation and monetary tightening, a burden that was progressively compounded by growing tensions in Eastern Europe – so much so that investors appear to have largely "sold the rumor" leading up to the actual invasion itself, since which time many equity market segments have either experienced a partial rebound or at least managed to tread water. Even with that, however, the S&P ended Q1 with a loss of -4.60% for the three-month period, in spite of which its trailing one-year return remained a fairly impressive +15.65% (on the coattails of its very strong +28% return in 2021). In, as noted earlier, a relatively uncommon turn of events, the Bloomberg US Intermediate Government/Credit index of high-quality, U.S. bonds was down nearly as much with a loss of -4.51% for Q1, dealing a one-two punch to traditional balanced portfolios which, thankfully, some of the lesser correlated exposures contained in a well-diversified portfolio were able to soften, though by no means come anywhere close to offsetting.

Chart 4: Enquiring Minds Want To Know: Markets Love The Rumor!

Event	Date	Initial Reaction	Fwd 1Mo	Fwd 3Mo	Fwd 6Mo	Fwd 12Mo
Pearl Harbor	12/7/1941	-10.19%	-0.99%	-10.23%	-7.23%	7.25%
Start of Korean War	6/25/1950	-12.94%	-7.84%	3.87%	9.45%	22.03%
Cuban Missile Crisis	10/16/1962	-6.29%	5.40%	14.41%	23.27%	32.09%
Iran Hostage Crisis	11/4/1979	-2.58%	3.72%	13.09%	5.90%	31.22%
USSR Invades Afghanistan	12/24/1979	-2.27%	6.09%	-6.57%	9.96%	33.06%
Iraq Invasion of Kuwait	8/2/1990	-12.64%	-7.68%	-10.44%	-0.60%	14.02%
Gulf War	1/16/1991	7.92%	17.16%	23.57%	22.65%	36.53%
1st WTC Bombing	2/26/1993	1.60%	1.20%	3.02%	5.45%	8.05%
Russian War in Chechnya	10/11/1994	-1.06%	-0.49%	-0.18%	10.36%	27.78%
9/11	9/11/2001	-11.60%	0.59%	4.42%	7.69%	-15.50%
Iraq War	3/20/2003	-3.14%	2.16%	14.18%	19.34%	28.94%
Crimea Annexation	2/20/2014	-1.31%	1.91%	2.30%	9.07%	17.07%
Tonkin Gulf/Vietnam War	8/5/1964	-0.94%	0.82%	4.45%	8.01%	7.76%
Average		**-4.26%**	**1.70%**	**4.30%**	**9.49%**	**19.25%**
Russia Invades Ukraine	**2/24/2022**	**-13.05% ***	**-4.83% * +7.13%****	**-**	**-**	**-**

** As measured from the market's peak on Jan 3, 2022, as risks built steadily through January and February leading up to Russia's invasion of Ukraine.*
*** As measured from 2/24/2022, the date of the actual invasion*

Within the equity market, several of the dynamics evident were very much consistent with what one might expect from this kind of backdrop. For example, large-cap U.S. stocks – which tend to be less reliant on the tightening credit markets – outperformed both mid- and small-cap stocks, which declined -5.7% and -7.5%, respectively, during the quarter. Similarly, value stocks soundly outperformed growth stocks; despite value stocks' generally greater sensitivity to economic growth, stocks in the sectors that make up the value camp (perhaps most notably the materials and energy sectors) tend to exhibit a considerably greater ability to pass on or even benefit from the effects of inflation. An additional headwind for the growth sector – and one that may

show some legs, given the inflation outlook – is the effect of rising interest rates on valuations – which have been and remain much higher on growth stocks – as well as on the discounted value of growth companies' earnings, which in some cases are far out in the future and, thus, highly sensitive to changes in interest rates (so-called "high duration" equities). On the foreign equity front, meanwhile, developed foreign stocks performed only very slightly worse than U.S. stocks, given how much more affected many countries are by the conflict than is the U.S., particularly on the energy front, where we have, for most intents and purposes, achieved energy independence and were not importing from (or doing much of anything with) Russia going into all of this. Emerging markets were a more interesting story, albeit one with no "happily ever after" – at least not yet. Last year's big laggards, emerging market stocks had come into this year looking as though they might be ready to turn the tables on the rest of the equity market, as they appeared to feel the benefit not only of mean reversion as well as the strength in commodities (of which many such countries are exporters) and largely brush off shifts in monetary policy outlook that – at the time – still appeared manageable. Their momentum proved short-lived and ill-fated, however, in the face of the invasion; obviously, Russia made up roughly 3% of the MSCI Emerging Market index, the most widely recognized benchmark for the space – that is, before Russian stocks dropped some 70%-80% before the country was ultimately kicked entirely out of the index as being "uninvestable". Of course, the resulting surge in an energy and agricultural commodities was not exactly a blessing to many of these countries, nor was that of the U.S. Dollar, the currency in which many such countries are forced to service their debts. At this stage, EM would normally appear to present an opportunity based on valuation, its 11.6 times forward P/E ratio a full 2 times below the 13.6 times of its foreign developed counterpart and a massive discount the S&P 500's 19.3 times. Nonetheless, even within a world of trouble, EM sits in what appears to be a fairly precarious position, given the extreme levels of uncertainty that prevail around so many factors pivotal to the fate of the space as well as the current prospects for prolonged military conflict. Of course, there is no reward without risk and – in theory – such reward should be commensurate with the level of risk being taken so it is likely that – somewhere down the road, just don't ask me when – emerging markets will once again rise to the top. But not yet…

THERE WILL BE BLOOD

How much and exactly whose remains to be determined. Stock investors, bond investors…a little bit of both if you ask us. Our Investment Committee's outlook has moderated considerably in recent months and, while we continue to hold some of the same views – specifically, stocks over bonds, U.S. over foreign, and value over growth – our expectations are more muted across the board than was previously the case. Uncertainty is high; so is volatility, with markets seeing big swings up and down from day to day and even intra-day. So is the risk of additional downside within what, for now, remains a correction.

Our hearts may remain focused on Ukraine, but our minds are preoccupied with inflation and – closely related, but of even more concern – the resulting path of the Federal Reserve in implementing the tightening cycle that has only just begun. For now, we continue to believe the U.S. economy will manage to avoid recession in 2022 but the scale of the inflation problem and the magnitude of the – so far, threatened – response from the Fed continue to lift the level of our concerns for 2023. We cannot help but note the Fed's past record of consistently overdoing it on the rate hikes and tipping the economy into recession while attempting to pull off one of those nefariously tricky "soft landings". If this turns out to be the case this go around, it would obviously go a long way towards drastically

Chart 5: Yet Another Scary Chart! (Where We Tell You Not To Panic…Yet!)

Bear Market			Macro environment			
Market peak	Bear return*	Duration (months)*	Recession	Commodity Spike	Aggressive Fed	Extreme Valuation
Sep 1929	-86%	32	◆			◆
Mar 1937	-60%	61	◆		◆	
May 1946	-30%	36	◆			◆
Aug 1956	-22%	14	◆		◆	◆
Dec 1961	-28%	6				◆
Feb 1966	-22%	7			◆	◆
Nov 1968	-36%	17	◆	◆	◆	
Jan 1973	-48%	20	◆	◆		
Nov 1980	-27%	20	◆	◆	◆	
Aug 1987	-34%	3				◆
Mar 2000	-49%	30	◆			◆
Oct 2007	-57%	17	◆	◆	◆	
Feb 2020	-34%	1	◆			
CURRENT CYCLE			×	?	?	×

changing some of the scores on the board for a number of asset classes, rewarding – of all things – high quality, long-duration bond investors (can you even imagine?!) to the detriment of, well, pretty much everyone else (who would almost certainly be facing a bear market). Of course, that is assuming that, in so doing, the Fed has actually been successful in squashing inflation; if not we would be looking at something more like stagflation, i.e., painfully slow (or even negative) growth accompanied by painfully high inflation (think early-1970s for those of you who were around for that little walk in the park) – in other words, a losing proposition for traditional asset classes across the board.

Of course, our primary focus remains the long-term management of our clients' wealth; nonetheless, faced with fairly harsh current conditions on some fronts and relatively stark potential outcomes under certain not-so-far-fetched scenarios, our Investment Committee has recently adopted some tactical postures to position our clients' investment strategies to better navigate what could potentially be challenging capital markets for some time to come. Given the considerable risk rising interest rates pose to traditional, investment grade fixed income, we have been reducing exposure to the core bond space, first by biasing further towards the short duration end of the spectrum (which is less exposed to the impact of rising rates) and reallocating towards the less interest rate sensitive Opportunistic Bond space. Meanwhile, we have also reallocated a portion of the overall bond sleeve towards the hedge equity exposure within portfolios' Alternatives sleeves. The recent performance of Alternatives in general has been exactly what would have been hoped for at a time when both stocks and bonds have taken it on the chin; we think that may remain the case for a while and, thus, feel more than comfortable with a moderate increase in the size of this slice of the pie. Meanwhile, the hedge equity piece of the Alts sleeve pursues a strategy that tends to correlate more with stocks than bonds but with a fraction of the volatility and, importantly, without any interest rate risk.

On the equity front, meanwhile, we have further biased portfolios towards value, with a large-cap value tilt now joining the existing tilts we have recently had in place for both small-cap and foreign equity. We continue to evaluate additional moves that might help further mitigate some of the more material risks out there. In the interim, I would also note that we have recently developed a series of strategies constructed with the explicit objective of adding greater protection against sustained high inflation. We invite you to discuss these with your advisor if it is of interest. Of course, you are always welcome to reach out to your advisor, our CEO Larry Hood, or myself with any questions or concerns. While we always love to talk to you, we know that you are more likely to need to hear from us at times like this so please do not hesitate.

Slava Ukraini!

-Jim Ayres, CIO

1ST QUARTER 2022 CAPITAL MARKET PERFORMANCE

Index (as of 3/31/2022)[1]	1 Qtr	1 Year	3 Year	5 Year	10 Years
FTSE 3-month T-Bills	0.03%	0.06%	0.76%	1.09%	0.60%
Bloomberg Barclays Gov't/Credit Int.	-4.51%	-4.10%	1.50%	1.81%	1.85%
ICE BofAML US High Yield	-4.53%	-0.28%	4.38%	4.55%	5.68%
Bloomberg Barclays Multiverse	-6.05%	-6.22%	0.77%	1.78%	1.21%
S&P 500	-4.60%	15.65%	18.92%	15.99%	14.64%
Russell 1000 Value	-0.74%	11.67%	13.02%	10.29%	11.70%
Russell 1000 Growth	-9.04%	14.98%	23.60%	20.88%	17.04%
Russell Mid Cap	-5.68%	6.92%	14.89%	12.62%	12.85%
Russell 2000	-7.53%	-5.79%	11.74%	9.74%	11.04%
Russell 2000 Value	-2.40%	3.32%	12.73%	8.57%	10.54%
Russell 2000 Growth	-12.63%	-14.33%	9.88%	10.33%	11.21%
MSCI EAFE	-5.79%	1.65%	8.29%	7.23%	6.77%
MSCI EAFE Small Cap	-8.43%	-3.28%	8.92%	7.82%	8.69%
MSCI Emerging Markets	-6.92%	-11.08%	5.31%	6.35%	3.73%
MSCI Frontier Markets	-7.82%	9.76%	7.60%	6.25%	6.25%
Wilshire US REIT	-3.87%	29.14%	11.94%	10.04%	9.90%
DJ Global Select RESI	-3.46%	18.89%	6.96%	7.16%	7.74%
Bloomberg Commodity Index	25.55%	49.25%	16.12%	9.00%	-0.70%
IQ Hedge Multi-Strategy	-2.34%	-1.90%	2.92%	2.99%	3.01%
60-40 Balanced EQ/FI – US Only	-4.50%	7.55%	12.06%	10.44%	9.59%
60-40 Balanced EQ/FI – Global	-4.92%	2.99%	9.39%	8.23%	7.23%

[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 IQ Hedge Multi-Strategy index is a trademark of New York Life Investment Management LLC.