MARKET LETTER

PACIFIC PORTFOLIO CONSULTING, LLC

Second Quarter 2019

THE PLOT THICKENS

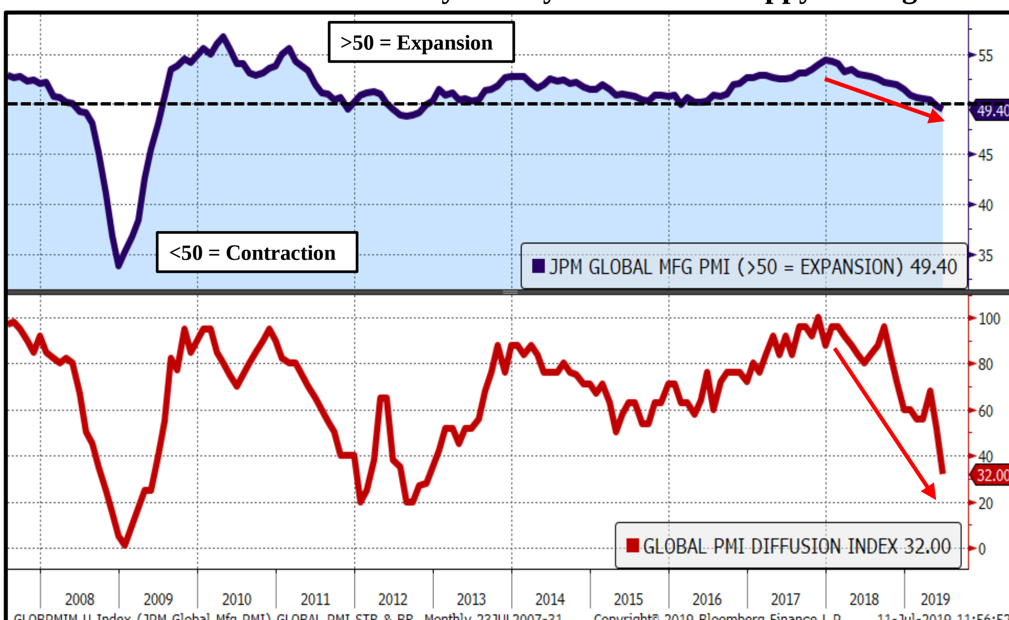
While even this summer's most action-packed blockbuster will ultimately deposit a physically- and emotionally-drained audience back into its seat as the lights come up, the same cannot be said of the drama that continues to unfold in the global economy and financial markets. Ten-plus years in and this nail-biter is acting as though it may still have a couple of reels left to go; just when investors are sure they know exactly how it's all going to end, they are utterly blindsided by a plot twist that seems to take things in a completely different direction.

We've had quite a few such twists and turns in the past several months, in spite of which our basic storyline is not much the worse for wear at this point. Both the U.S. and global economies remain in expansion and, we believe, likely will be for some time yet. Global equity markets, meanwhile, have maintained a relatively steady course to new all-time highs, punctuated only by fairly modest – if still uncomfortable – corrections. Nonetheless, there is a growing list of sub-plots all jockeying for their fifteen minutes of fame that are sure to keep investors on the edge of their seat; this certainly leaves markets prone to sporadic bouts of higher volatility (likely making this an opportune time to rebalance portfolios to target) though we do not believe such conditions will be sufficient to "flip the script" on what is still a reasonably favorable economic and financial market backdrop.

MIXED REVIEWS

The critics have been judging the global economy pretty harshly lately; frankly, its performance has given them no shortage of reasons to do so. The pace of global activity has slowed quite significantly over the past 18 months, a trend particularly apparent within the manufacturing sector, where the global PMI index (see Chart 1) has now declined an unprecedented 14 months in a row (as we noted last quarter, the prior record had been 11 months back in 2008, although we continue to note that – back then – the level of the index had literally cratered to the low-30s, whereas now it sits at 49.4, having dipped just barely below the "50" threshold beginning in May).

Chart 1: Can the Global Economy's Story Still Have a Happy Ending?



Since peaking back in late-2017, global economic growth has steadily slowed. Reflecting in part the impact of ongoing trade tensions, the Global Manufacturing PMI index – a monthly survey of global business conditions – has declined a record 14 months in a row; the index dipped below 50 in May, indicating a further slowing in the pace of the global economic expansion. Meanwhile, Pacific Portfolio's PMI Diffusion index – which looks at what percent of the global economy is currently seeing an expansion of Manufacturing activity – has declined sharply in recent quarters from 100% in November 2017 to just one-third of countries currently. It's important to note that much, if not all, of this information is likely already reflected in financial markets; provided US trade policy does not go off the rails, we believe the slowdown will likely trough and the global economy stabilize in the coming quarters.

While both the strength and breadth of the (still) ongoing global economic expansion had been looking as though they were ready to stabilize (or perhaps even start to turn) last quarter, escalating global trade tensions increasingly

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have weighed on both activity and confidence, resulting in an additional leg down in both measures.

The issue extends well beyond just trade policy, however; all of the props and scenery with which the global stage has been set – whether it be the tidal shift in monetary policy, the coming presidential election (yes, already!), or rising tensions in the Middle East – are helping to drive global uncertainty to its highest level in years (which is really saying something!). Needless to say the U.S. has not been immune to all of this: while it has held up considerably better than most and the pace of U.S. economic growth remains positive, there has been a very clear slowdown in activity here as well. Part of this, as we have been noting for some time now, simply reflects the dwindling effects of the late-2017 fiscal stimulus, the impact of which will continue to fade over the remainder of the year. Once again, however, tariffs on the import of Chinese goods (and those threatened – if not actually enacted – against our other large trading partners) are increasingly being cited as a material headwind. In fact, the drastic swings in the perceived risk of a trade war in recent months as well as the significant damage an outright war could inflict represent the largest "swing factor" that could tip what otherwise appears to be a fairly routine mid-cycle slowdown into an outright recession.

This eventuality does not appear to have been lost on Jay Powell and his crew over at the Federal Reserve. As we had noted in some of our commentary over the course of Q2, the odds of the Fed making a benign rate cut aimed strictly at fueling greater inflation were slim, to say the least, despite meaningful market expectations to the contrary. Now, however, once you introduce a further escalation in the level of uncertainty and the possibility of an expansion at risk, suddenly you are talking about a whole different ball of wax. In fact, this appears to have been sufficient to knock the Fed off its extremely short-lived "patient" perch in favor of an explicit policy of vigilance and responsiveness to act in a manner appropriate to keep the expansion alive – in other words, "rate cuts!"

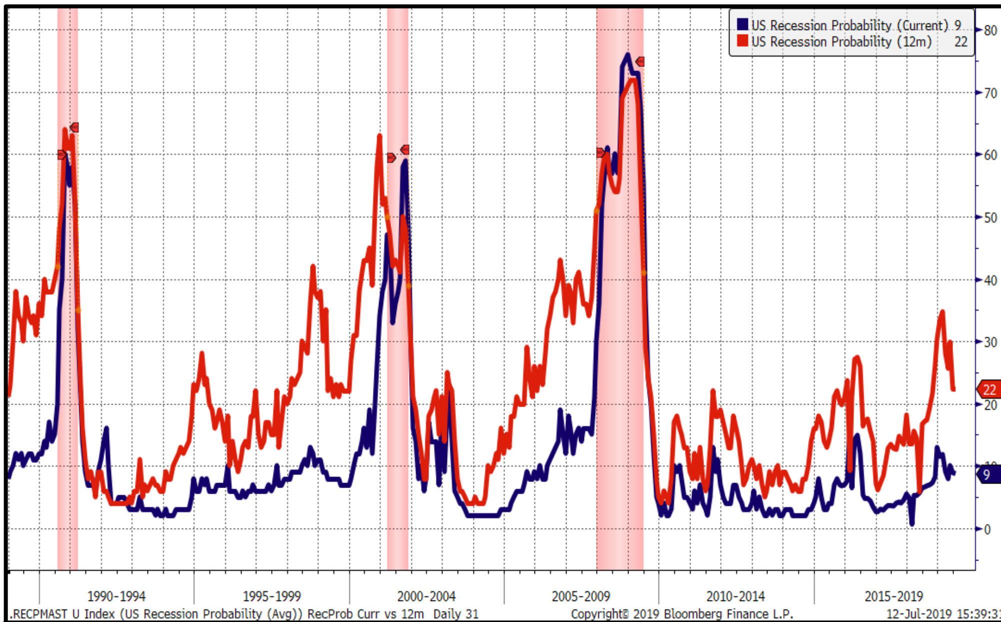
Chart 2: Markets Bet the Fed Is About to Yell "CUT!!"

The monetary tides have turned quickly over the past couple of quarters, as a cycle of steadily tightening global monetary policy crested into year-end 2018 only to come crashing down in recent months. Not only does the Federal Reserve appear poised to fulfill at least some of the market's rate cut expectations – quite lofty ones, we might add – but the remaining global monetary authorities look poised to follow their lead, notably at the European Central Bank, where well-known dove Christine LaGarde is set to take the helm, adding weight to rising expectations for both additional rate cuts (deeper into negative territory, mind you!) as well as a renewed round of Quantitative Easing.

As they have always been prone to doing – all the more so, it seems, since the Great Financial Crisis – investors have seized upon this latest view with both hands and run with it, now betting the Federal Reserve will orchestrate a wholesale reversal in policy and proceed to cut short-term U.S. interest rates multiple times in the months and quarters to come (see Chart 2, above). So far, the Fed has not really pushed back against the market's lofty expectations, despite having been given several chances to do so; nonetheless, given the still reasonable state of the economy, it's unclear whether the Fed will, by the time it is all said and done, actually go so far as to completely fulfill the expectations investors have priced into the market. For the time being, our Investment Committee is following the script as written – at least through its opening scenes – looking for the Fed to cut rates once this year based on current conditions, with the progress (or lack thereof) on global trade issues featuring as the critical determinant of whether or not there are additional interest rate cuts to follow later in the year.

The Fed has had to perform other such "insurance cuts, " as they are known, in the past – notably, in 1995 and 1998 – in an attempt to alleviate the risks that a period of weakness or heightened uncertainty appeared to pose to an existing expansion; in theory, the Fed would be expected to try to "take back" such easing measures once the risks to the economy

Chart 3: The Next Recession Is Not Yet Ready for Its Close-up



There's no getting around the fact that the risk of recession has risen, particularly looking over a forward twelve-month window. Nonetheless, such risks have receded recently, a result of such factors as stronger job creation, continued stock market gains, and easy credit conditions; more to the point, however, is the fact that, while the probabilities of a recession implied by the macro and financial market data have risen overall in the past 18 months, they remain fairly low relative to their historical levels. We continue to monitor the evolution of such risks, as our Investment Committee continues to believe we are fairly late in the economic cycle, though, for now, we continue to see the timing of any recession as likely at least 18 to 24 months out.

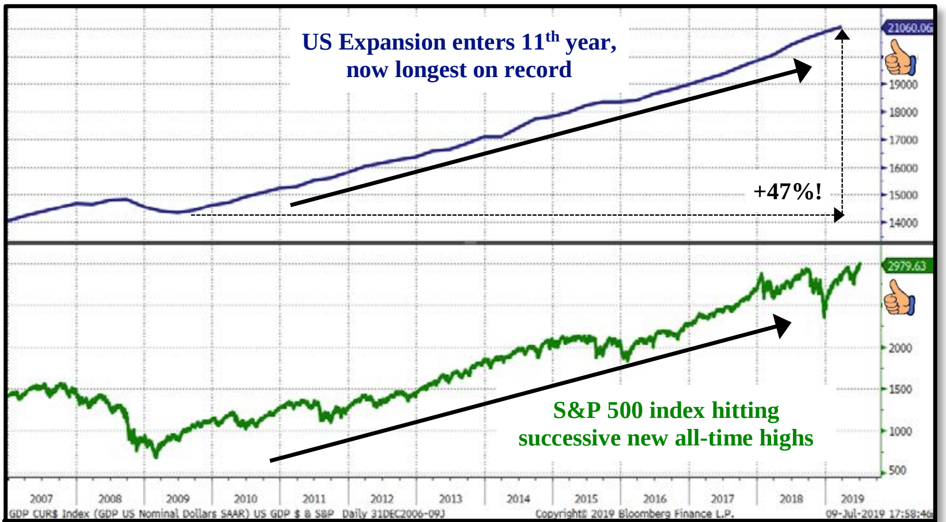
subside, though it is unclear in this case – given only modest growth and the conspicuous recent lack of inflation (not to mention the upcoming presidential election, which makes it harder for the Fed to maneuver without appearing "political") – when or even if we might see the sort of conditions that would cause them to hike (or even allow them to do so) prior to the U.S. economy entering its next recession. Our Investment Committee continues to believe any such recession is probably at least 18-24 months out, i.e., unlikely to manifest itself until some time in 2021. While the slope of the yield curve remains – despite some very slight recent steepening – remarkably flat (traditionally, a reliable precursor to an eventual inversion of the yield curve and, from there, economic recession) much has been made about the potential distortions that may have been introduced by years and years of government bond buying, which may reduce the validity of this signal by artificially depressing the longer-end of the curve. Other economic measures, meanwhile, continue to point to relatively little short-run risk of recession (see Chart 3, above). Confidence – both at the consumer and businesses level – has eased off its peak, but remains elevated, nonetheless, and well above levels typically evident heading into a downturn. Even more so the labor market, which – benefitting from a further up-tick in the participation rate (i.e., people coming off the sidelines to take or look for a job) – saw the rate of unemployment tick up marginally for all the right reasons. At 3.7% unemployment – just off its fifty-year low and well below anyone's estimate of "full employment" – the U.S. labor market's strength continues to fuel greater optimism among consumers even if, for now, only gradually rising wages. Coupled with healthy housing and stock markets, the consumer – which, as we often note, accounts for nearly 70% of U.S. economic activity – appears to remain in good shape. Businesses, for their part, are direct beneficiaries of the above-noted modest pace of wage growth, which takes some pressure off of their bottom line; easing financial conditions, meanwhile, by way of falling interest rates, tight corporate credit spreads, and a U.S. Dollar that is finally starting to cede some ground, create a tailwind poised to drive improved corporate prospects in the quarters ahead. Thus, we remain firmly in our seats, despite our continued belief that we remain later (if not outright late) in the cycle, as we watch the U.S. expansion cross the threshold into its eleventh year to make it the longest – if not largest – expansion on record, for we continue to believe this economic show will go on.

Roll Credits? Not Yet

Even though the U.S. economy has been making headlines, it has had to share the spotlight with the stock market, which continues to vie for top billing (see Chart 4, next page). It certainly has not been an entirely smooth ride, but stocks were able to retain much of the momentum they began to exhibit in Q1 after bouncing off the deeply-oversold conditions in which they entered the year. Following a sharply "risk-off" month of May, the S&P 500 rebounded to post its best June in over 60 years; it closed out Q2 with a gain of +4.30%, thereby notching its strongest first half since 1997 with a return of over +18.5%.

This index – the most closely-watched bellwether of U.S. equity market performance – is made up primarily of the largest, best-known, and most liquid U.S. companies, casting it in the role of "sweet spot" on the global equity market stage for

Chart 4: Summer Blockbuster Double Feature Gets Two Thumbs Up!



Both the US economy and stock market have been breaking box office records this summer. Effective July 1, the ongoing economic expansion entered its 11th year to officially become the longest in US history. Although its pace has been quite a bit more subdued than past expansions, US economic output is up some 47% over the past decade to over $21 Trillion. Meanwhile, the US stock market hit a new all-time high in June, quickly followed by a series of further new highs in July, with the index breaking above the 3,000 level for the first time.

some years now. While that was generally true in the 2nd quarter as well, it looks as though it might at least be getting more of a run for its money these days from the rest of the equity market; mid-cap stocks, for example, came in just behind large-cap stocks this period and, although it's still no contest over the one-year window, actually hold a lead of nearly 3% over the year-to-date timeframe as a result of their exceptional Q1 showing. Small-caps are still waiting in the wings for now, having added roughly +2% in Q2 to bring their 2019 performance to +17%, in spite of which their return remains slightly negative for the trailing year, reflecting the broad-based stampede away from risk in late 2018.

Much the same can be said of foreign equities; while the relative performance of the larger-cap portion of developed non-US markets has perked up recently, the same cannot yet be said of emerging markets, which notched only fractionally-positive returns in Q2 and whose year-to-date and trailing one-year showings remain relatively lackluster. Interestingly, while frontier markets (which we like for their relatively lower correlation to the rest of the global equity market and where we perceive a broad and often untapped opportunity set) would, until recently, have been similarly "typecast", these have sprung to life lately, actually edging out a fractional lead over the S&P 500 for Q2. Needless to say, however, that all of these foreign equity market segments retain considerable ground to make up, given the very pronounced investor preference for U.S. stocks for most of the past decade (with only a handful of relatively short-lived exceptions).

This provides a fairly natural transition to a discussion of the market's other massive disconnect, specifically the remarkable (and painful for a diversified investor) divergence between the performance of growth stocks and value stocks that has dominated the post-financial crisis era. Although still far shy of its "dot-com" era peak, the difference in performance between the two styles of investing has become increasingly stretched over the past several years, currently standing two standard deviations above its average for the past 30 years – in other words, at a level most market observers would characterize as more than ripe for a reversion to the mean. That's a call that many have been making for several years now, but one that repeatedly has been frustrated by investors' disturbing lack of faith in the global economic expansion, which has continued to drive a steady bet on the stocks of companies already growing (i.e., growth stocks) and away from those companies positioned to benefit from an improvement in economic growth (i.e., value stocks).

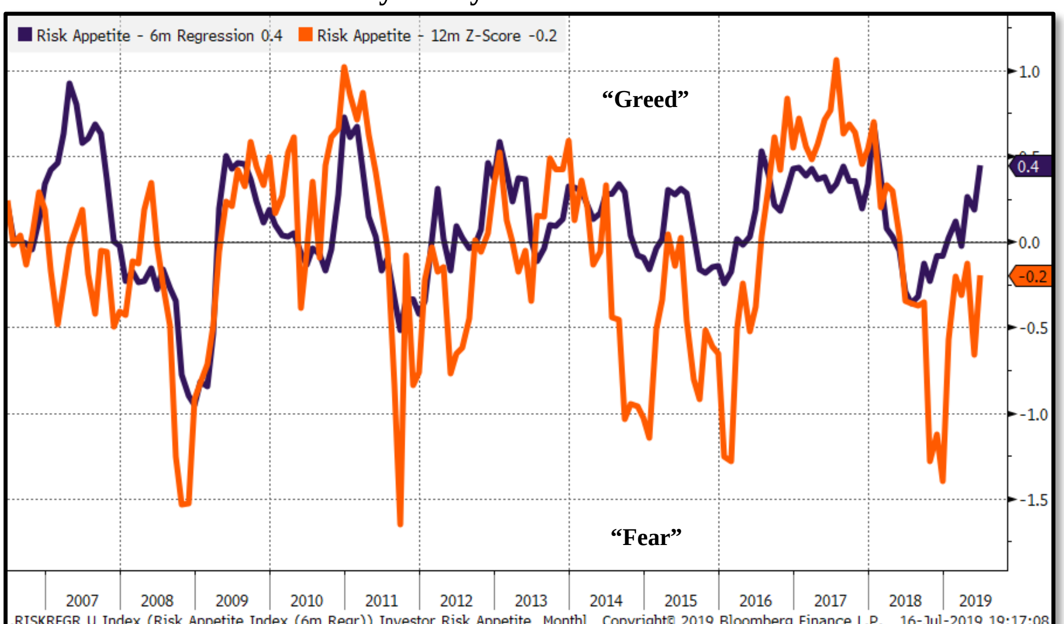
Quite frankly, all of these divergences – be it small versus large, foreign versus domestic, or value versus growth – could conceivably persist for some time yet: while we would not hesitate to describe the dynamic in all three cases as "overdone," market history provides ample proof that such phenomena can take things considerably further than anyone would have predicted ex-ante. Nonetheless, particularly as equity investors' defensive positioning seems to have been taken to an extreme (via the heavy favoring of growthier and lower-volatility stocks, as well as the more interest rate-sensitive, so-called "bond proxy" sectors like REITs and Utilities), a rotation back towards the more unloved segments of the market would not be terribly surprising, particularly should we begin to see greater inflection in the path of either the economic or market cycle toward either a recession or bear market, respectively, developments that have historically tended to be conducive to those sorts of pronounced reversals in leadership.

In the meantime, we find ourselves in the extremely challenging position of attempting to forecast the return on stocks for the remainder of the year with a market sitting on a >20% year-to-date gain that continues to set successive all-time highs (but we're not complaining!). There is a clear consensus among members of our Investment Committee that this bull has not yet played out its final scene, though – with year-to-date gains sufficient to make for a well above-average full year's return – there is, not surprisingly, also a definite sense that distinctly more modest expectations are essential going forward. There are, frankly, few fundamental catalysts we can conceive of at this stage that could be expected to provide stocks with a meaningful near-term boost; in fact, where the fundamentals have been changing, they have generally been tending to worsen. Earnings growth expectations have not been rising – in fact, slower global growth and rising trade fears have driven analysts to revise their earnings expectations sharply lower thus far in 2019 – leaving multiple expansion – i.e., investors feeling more confident and becoming willing to pay more for the same $1 of earnings than they were previously – as the sole driver of the market's impressive gains year-to-date.

This highlights just how critical the script is in the current environment: at this point, all of the positive developments have been taking place within the market narrative (which changes considerably more frequently and more rapidly than the fundamentals themselves) – i.e., the stories that investors are using to justify their investment decisions. Right now, embedded within this narrative is a monetary policy outlook about as easy as it can get barring a major deterioration in the U.S. economy; meanwhile, the pendulum of trade policy fears has currently swung back toward relief in the aftermath of the G-20 meeting, though not so far as outright complacency.

Obviously, this opens the door for higher market volatility and a potential correction should events on these key policy fronts fail to materialize as the market consensus has planned (or even if the expectations around these issues embedded in the narrative begin to shift). Nonetheless, given the ramp up in bearishness that we saw in May, both sentiment and positioning would still seem to argue that the current "pain trade" in the equity market – i.e., the scenario that would be most disruptive to the outlook and positioning of the largest number of investors – is higher stock prices. The outlook of professional investors turned its most negative since the financial crisis as market conditions deteriorated in mid-Q2, leading to a spike in cash held on the sidelines, only some of which has since been put back to work as stocks have recovered. Similarly, individual investors began to bunker down and dial up the pace at which they have been transitioning money out of stock funds and into both fixed income and, especially, money market funds. The outlook of both groups has, quite naturally, become steadily more optimistic as the market has resumed higher, though by no means would we characterize investors' overall appetite for risk as extreme at this stage (see Chart 5).

Chart 5: Are Investors Really Ready to Go Back in the Water?



Risk appetite peaked in late-2017, effectively getting a little bit ahead of itself as complacency began to set in. Since then, there has been a deep retrenchment in investors' appetite for risk that appears to have troughed out late last year; thus far in 2019, risk-taking behavior has resumed, albeit on a somewhat more limited basis for the time being, as our in-house gauges of risk appetite have rebounded, but remain well shy of extreme bullishness. This is true both at the broad asset class level, as fund flows continue to reveal an exodus of investor money from stocks to bonds, as well as within equities, where even investors who want to own stocks are erring on the skittish side for the time being, positioning in the more defensive areas of the market and broadly avoiding cyclicality.

Meanwhile, on the other side of town, this policy-driven narrative has also been giving the bond market its own fair share of "jump scare" moments lately, with hefty rate cut expectations dogpiling on top of slow growth and low inflation to send longer-term interest rates sharply lower. As a result, although the more credit-sensitive segments of the bond market did well – high yield tacked on an additional +2.5% last quarter, bringing its one-year gain to nearly 8% – duration (i.e., an investment's degree of interest rate sensitivity) was a much bigger driver of performance in Q2 than it has been for some time. U.S. Government and corporate bond sectors with greater exposure to duration returned somewhere between 3%

and 4% this past quarter, leaving them with trailing twelve-month returns rivalling those of their non-investment grade counterparts that carry significantly greater risk of default. Our Investment Committee continues to expect credit conditions to remain relatively good – benefiting the more credit-sensitive bond market segments – for the time being, given the relatively low risk of meaningful defaults so long as the economy continues to skirt recession. As for the interest rate side of the equation, meanwhile, our expectations are for only a modest recovery in rates over the remainder of 2019, given our modest outlook on both the growth and inflation fronts and expectations for easy policy out of the Fed. If we were, however, to attempt to apply the same concept of "pain trade" to the bond market as we did above, it would almost certainly come by way of an unexpectedly sharp rise in interest rates – triggered either by the Fed's failure to fulfill bond investors' fantasy scenario (not impossible) or some nightmarish runaway inflation scenario (which seems a lot less likely) – given the seemingly wholesale consensus that rates are never going up again (the median Wall Street analyst estimate for the 10-year Us Treasury yield by year-end 2020 is currently just 2.25%, with only 2 of 55 analysts predicting a level of 3% or higher).

Thus, our overall outlook on prospects for diversified investors remains relatively constructive, but cautiously so; while we do not currently view equity market conditions as extreme, our mindfulness of risk leads us to believe the time is opportune for a rebalancing of broad asset class allocations within client portfolios, given the very considerable gains that have already accrued to equity investors thus far in 2019. Although the stabilization and modest improvement we expect to see materialize within the global economy in coming quarters should provide a more solid foundation under investor sentiment, in light of an environment that remains broadly dominated by policy risk as far as the eye can see, the potential for equity market volatility spikes remains significant, though we would – for the time being – continue to construe these within the context of corrections within an ongoing bull market. Finally, we would note that while much of the preceding deals with the immediate prospects over the second-half of 2019, the real heart of the matter has little to do with the next 6 months or year (or even 3 or 5 years, for that matter), but rather the strategic and disciplined process through which we, in partnership with our clients, work to manage and grow wealth for the long-term. We continue to encourage you to consult with your Advisor when contemplating any significant changes in strategy and, as always, invite you to reach out to Jim Ayres, our company's Chief Investment Officer, or your Advisor with any questions or concerns you may have with regard to your portfolio or the market.

2ND QUARTER 2019 CAPITAL MARKET PERFORMANCE

Index (as of 6/30/2019)[1]	**1 Qtr**	**YTD**	**1 Year**	**3 Year**	**5 Year**	**10 Years**
FTSE 3-month T-Bills	0.61%	1.21%	2.30%	1.36%	0.84%	0.46%
Bloomberg Barclays Gov't/Credit Int.	2.59%	4.97%	6.93%	1.99%	2.39%	3.24%
ICE BofAML US High Yield	2.57%	10.16%	7.61%	7.54%	4.70%	9.16%
Bloomberg Barclays Multiverse	3.31%	5.78%	6.01%	1.95%	1.35%	3.13%
S&P 500	4.30%	18.54%	10.42%	14.19%	10.71%	14.70%
Russell 1000 Value	3.84%	16.24%	8.46%	10.19%	7.46%	13.19%
Russell 1000 Growth	4.64%	21.49%	11.56%	18.07%	13.39%	16.28%
Russell Mid Cap	4.13%	21.35%	7.83%	12.16%	8.63%	15.16%
Russell 2000	2.10%	16.98%	-3.31%	12.30%	7.06%	13.45%
Russell 2000 Value	1.38%	13.47%	-6.24%	9.81%	5.39%	12.40%
Russell 2000 Growth	2.75%	20.36%	-0.49%	14.69%	8.63%	14.41%
MSCI EAFE	3.97%	14.49%	1.60%	9.65%	2.74%	7.40%
MSCI EAFE Small Cap	1.92%	12.88%	-5.97%	9.48%	4.78%	10.04%
MSCI Emerging Markets	0.74%	10.78%	1.61%	11.06%	2.87%	6.17%
MSCI Frontier Markets	4.90%	12.14%	5.23%	8.70%	-0.40%	5.18%
Wilshire US REIT	1.63%	17.92%	10.53%	4.11%	7.84%	15.66%
DJ Global Select RESI	0.63%	14.64%	7.75%	4.03%	5.51%	12.48%
Bloomberg Commodity Index	-1.19%	5.06%	-6.75%	-2.18%	-9.15%	-3.74%
Credit Suisse Liquid Alts	1.42%	5.80%	2.83%	3.13%	2.20%	3.73%
60-40 Balanced EQ/FI – US Only	3.75%	13.14%	9.47%	9.36%	7.51%	10.21%
60-40 Balanced EQ/FI – Global	3.43%	11.99%	6.94%	8.19%	5.16%	7.92%

[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.