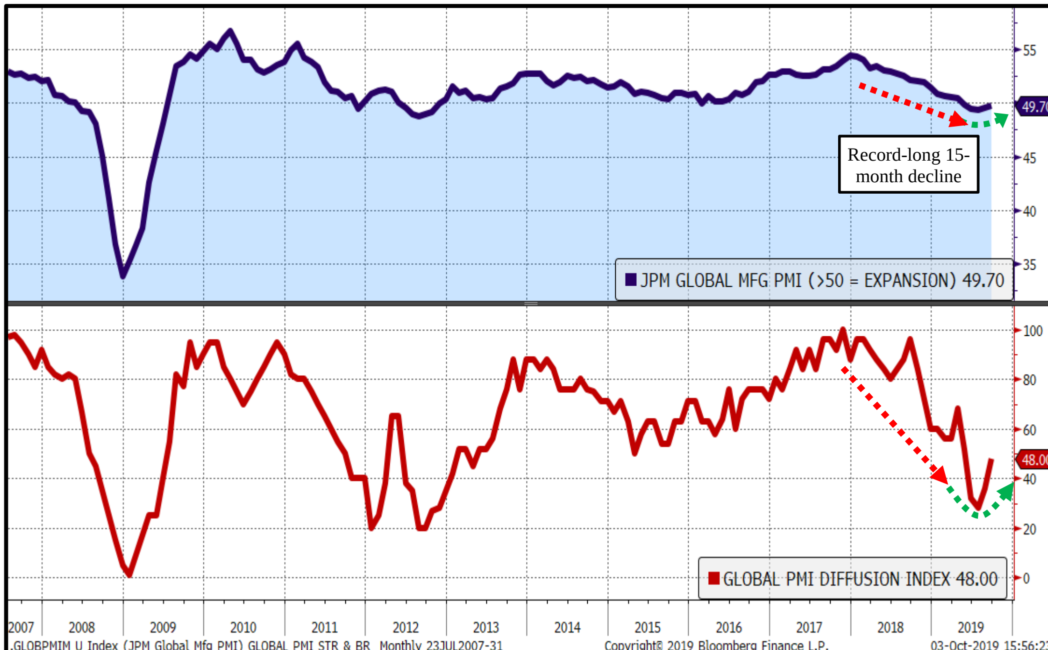
MARKET LETTER

PACIFIC PORTFOLIO CONSULTING, LLC

Third Quarter 2019

I HAVE TO ADMIT IT'S GETTING BETTER (IT CAN'T GET NO WORSE!)

Chart 1: A Broken Record: Can the Global Economy Finally Change Its Tune?



There's no arguing the global economy has been proceeding at a painfully slow pace, one that has only been made worse by growing tensions on the U.S.-China trade front. After a record 15 months of uninterrupted decline, however, the Global Manufacturing PMI index finally began to tick up in August, at the same time that the breadth of the expansion – which had all but collapsed over the past year – also began to recoup some ground, pointing to stabilization and potentially even some improvement on the horizon for the global economic landscape.

Actually, as far as the global economic data is concerned, it can, it is, and it probably will continue to get worse for a while longer, as timely U.S. readings reveal softening activity within what is already an unnervingly slow global economic scenario. The same may not necessarily apply to investors' outlook, however, which – under the weight of heightened trade and policy uncertainty – has come to look about as downbeat as one could imagine without something going majorly off the rails.

We would challenge the urge to bunker down in a "bond shelter" and await the all-clear, however, as we would characterize what we see going on here as a spike in recession fears but not in the recession probabilities themselves. In fact, beyond merely a lack of conditions typically associated with cycle turning points, we actually see indications that the lengthy slowdown in the global economy is likely approaching a near-term trough, following which we are likely to begin seeing some modest improvement (see Chart 1, above).

It's important to note, however, as we often find ourselves reminding investors these days, that holding on to reasonable expectations will remain critical: while the progress we expect should continue to forestall a move into recession for some time yet, global growth likely still will remain lackluster. Nonetheless, even mediocre growth is considerably more than markets currently appear to have priced into their expectations, laying the path for a positive surprise. Add to this what we see as an almost certain continuation of easy global monetary policy and the potential for trade and/or geopolitical tensions to recede and the stage would appear to be set for a fairly constructive environment for investors with well-diversified portfolios (and a stomach for volatility) over the course of Q4 and into 2020.

IF 6 WAS 9

Or, more to the point, if 9 were 6 – as in 201*9* and 201*6*. In some key respects, had you slept through the last three years, you could well be forgiven for waking up to think that you had only been out for a quick power nap – particularly if you were looking at the bond market! Over that time, the yield on the 10-year US Treasury bond rose from its post-Brexit vote (and all-time) low of just under 1.4% to a high of roughly 3.25% by late-2018; of course, just as all of Wall Street finally became convinced the only sane bet on interest rates was a one-way trade higher, rates inevitably began the unflinching decline that has defined most of their 2019 to date. Gathering a considerable head of steam over the course

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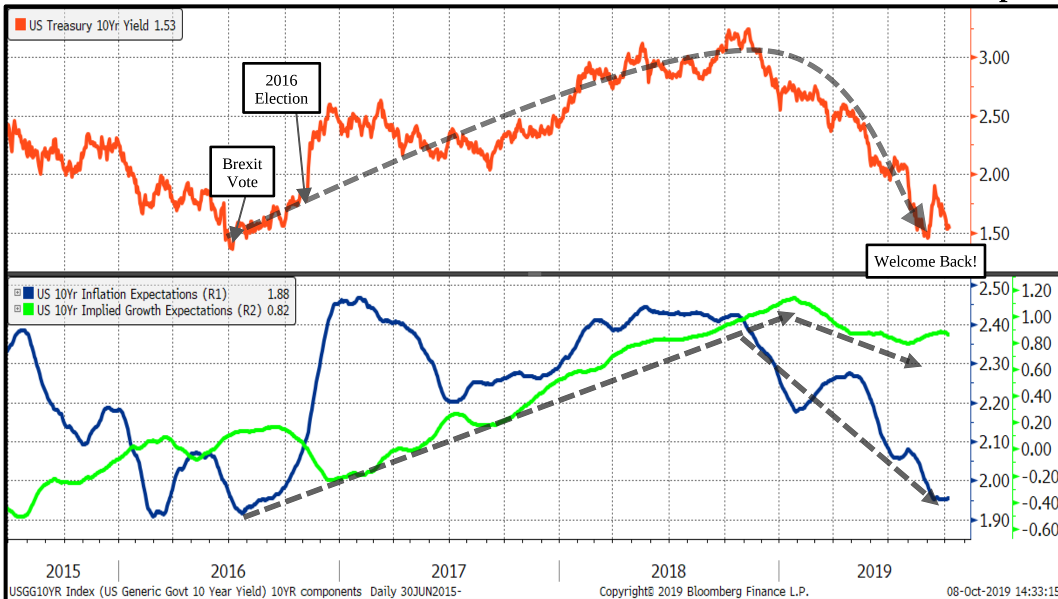
of this past quarter, the plunge in long-term interest rates has left them having very nearly round-tripped back to their lows (see Chart 2, below), driving solid returns for bonds and helping to perpetuate investors' relatively skittish mindset and the correspondingly narrow stock market that has accompanied it for some time now.

Chart 2: Bond Market Had a Ticket to Ride – Who Knew It Was Round Trip



In typical market fashion, once everyone became convinced in late-2018 that the only way for interest rates to go was up, the curveball most likely to disrupt the plans of the greatest number of investors – the so-called "pain trade" – became a sharp move lower in rates. As steady rate hikes by the Federal Reserve and the spirited game of chicken playing out on the U.S.-China trade front caused markets to pull materially forward their expectations for economic recession, investors' expectations for inflation and economic growth have eroded sharply over 2019 to date, causing the yield on the 10-year US Treasury to roll over and sink rapidly back towards its all-time lows.

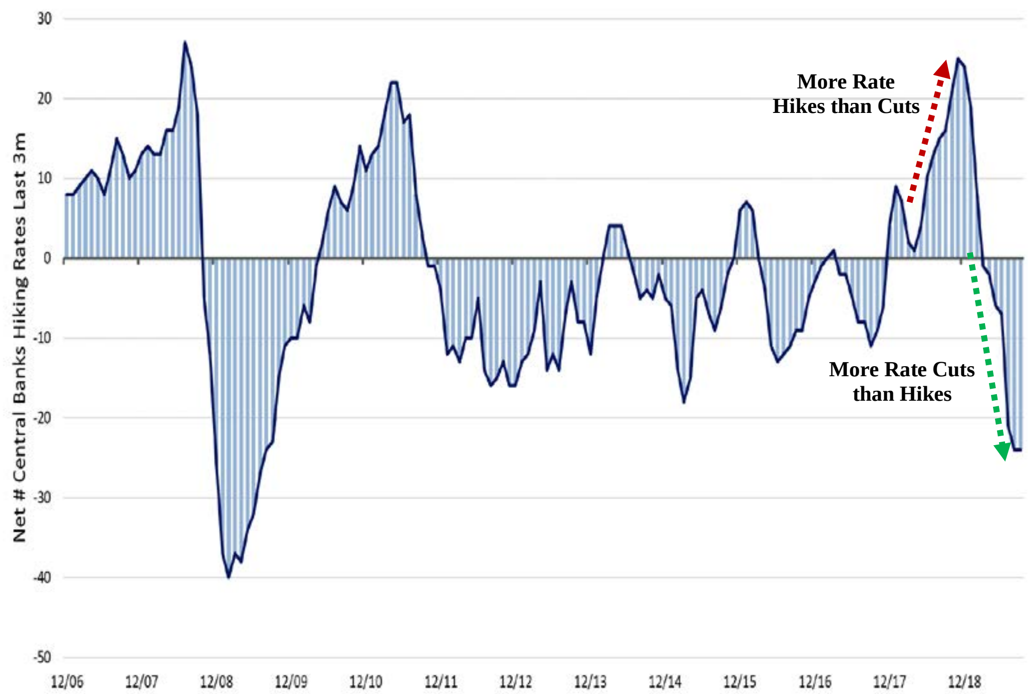
The inescapable question this leaves us trying to wrap our heads around is this: have the fundamentals really changed so much and so quickly as to justify what appears to be a complete reversal in outlook? From mid-2016 through late-2018, interest rates rose on the back of a narrative of improving global growth, reflation, and a gradual normalization of monetary policy – was all of that just wishful thinking? Are we really right back where we started, seemingly trapped in a world of permanently depressed interest rates, inflation, and economic growth, with no choice but to sit and wait for the other shoe to drop?

We continue to think otherwise. Certainly, the current weakness makes it difficult not to go back and question the underlying narrative – and many market participants appear to be doing just that - in spite of which, in hindsight, it really does not seem to be that much of a stretch, as global economic growth and inflation expectations did, in fact, improve significantly over that time. U.S. economic output growth increased from sub-2% in mid-2016 to over 3.5% a year by late-2017, at the same time that the breadth of the global expansion was reaching its peak, with essentially all developed and emerging economies participating. The U.S. benefited further from the subsequent fiscal boost provided by the tax cuts in late-2017, Europe from the ECB's decision to keep monetary conditions relatively easy, Japan's permanently stimulative polices finally managed to rack up multiple quarters in a row of increasing growth AND inflation, and even China pushed back against its own internal initiative to transition from investment to consumption for the sake of boosting growth; it was a synchronized global expansion party and everyone was invited!

The party has petered out over the last couple of years, however, as more and more economies have decided to call it a night as their punchbowls have run dry: from 100% participation in late-2017, the percentage of economies with PMIs in expansion sank to just under one-quarter by mid-2019, at the same time that we saw the overall level of global manufacturing activity dip modestly into contraction territory after declining for a record 15 months in a row. While there are any number of forces that have been at work, an overzealous Federal Reserve – with its hard-won reputation for taking away the punchbowl – deserves its fair share of credit: despite efforts to clearly communicate what appeared to be wholly-reasonable policy intentions – given the painstakingly gradual pace at which the Fed planned to wean the economy off of a decade of extraordinary monetary life support – the market had begun to voice loud and clear its view that the Fed was moving too far, too fast. While it first appeared to be digging in its heels, the Fed ended up turning tail in the face of the increasingly adverse and destabilizing effects of aggressive and often erratic trade policy.

This escalation of tensions in the ongoing trade war has proven to be the biggest drag on global activity, confidence, and sentiment over the past 18-24 months, as increasing threats, a broadening theater, and little obvious common ground have caused some to begin speculating that such conditions may be here to stay as part of yet another iteration of the "new normal." While we do not expect a quick resolution, our own view is not quite so extreme; we believe we will get a resolution, but not yet. In the meantime, we have for some time now been highlighting trade policy as the single biggest "swing factor" that could tip an otherwise fairly routine slowdown into a full-blown recession. We are by no means alone in this regard: Merrill Lynch's most-recent monthly survey of institutional investors and investment managers shows they continue to see the trade war as the largest tail risk out there (the 18th time in the past 20 months it has ranked at #1) and view a resolution to the ongoing U.S.-China dispute as the single most bullish thing that could happen for the stock market in the coming six months. Frankly, we're hard-pressed to see this as a realistic timeframe. Yes, there will be posturing and spin by the administration and certainly no shortage of speculation on the part of investors; we have little doubt that we will continue to hear about all sorts of "mini" deals along the way. Nonetheless, there likely remains insufficient incentive on either side at this time to drive the kind of tough decision making required for a broad, meaningful agreement (particularly as the current administration's position is potentially undermined by the current impeachment proceedings). In the meantime, the uncertainty fostered by the ongoing dispute will continue to weigh on investors' outlook for economic growth and inflation, as it has for some time now, leaving the market's forward expectations for both at deeply pessimistic levels (see Chart 2, prior page).

Chart 3: Global Monetary Policy Makers "Take it Easy"



Regardless of whether this chart's title leaves you humming Foghat or the Eagles, you are in very good company either way, as a literal choir of global central bankers busts out its best karaoke to sing along. Yes, it seems, the formulators of global monetary policy have decided to take it very, very easy, indeed, for the time being, as they execute a literal hand-brake turn in monetary policy to generate the deepest and most abrupt easing impulse since the Great Recession. Once the U.S. Federal Reserve started calling the tune – first with it dovish rhetoric, then by putting its money where its mouth is with two quarter-point interest rate cuts during Q3 – nearly 30 other central banks have begun to institute interest rate cuts (mostly emerging economies, as – let's face it – most developed economy central banks are already at or near the zero bound, although several of these economies continue to engage in Quantitative Easing.)

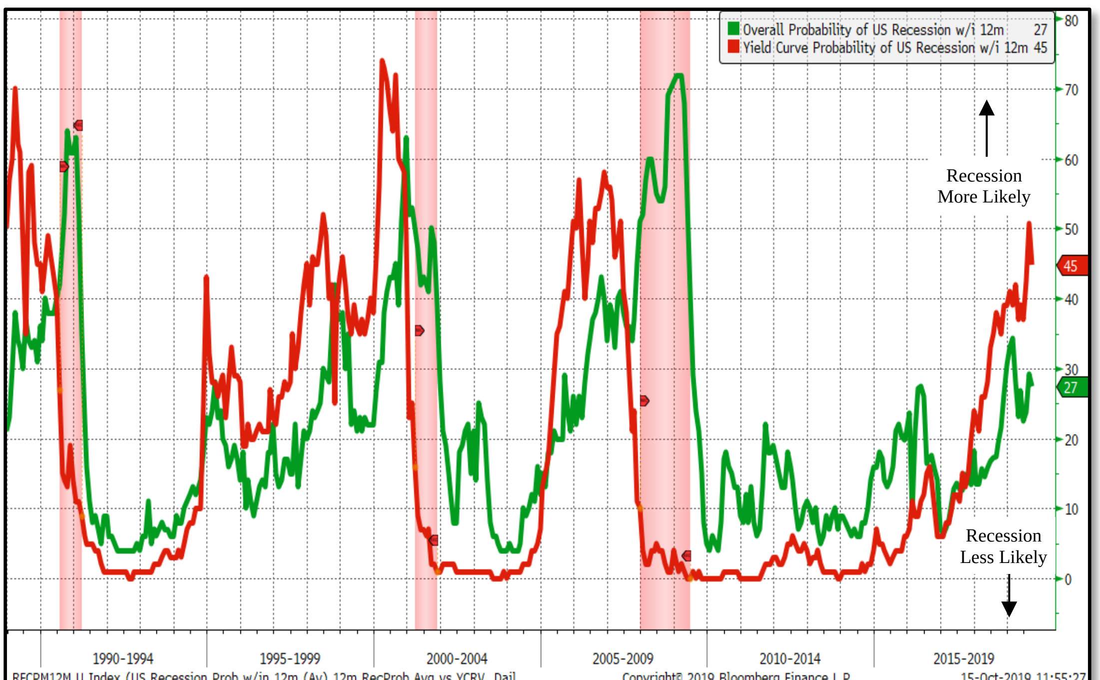
The shift in the Fed's position in response to such worrisome developments, has been nothing short of remarkable, in spite of which, it has thus far still fallen short of investor expectations: while already slow global growth paired with the incremental risk of the trade war produced two quarter-point rate cuts by the Fed during Q3, there remains abundant speculation among investors of more to come. Following its September meeting, the FOMC left the door open to additional cuts but the committee has recently appeared sharply divided on the issue, leaving the October and December meetings up in the air for now. Meanwhile, the Fed has couched its recent policy moves in terms of "mid-cycle adjustment" and "insurance cuts" – in other words, it still retains its longer-term objective of normalizing (in other words, raising) interest rates and should be expected to try to walk back these cuts at some point in the not-too-distant future – assuming, of course, that the market will allow it to do so! Given the ongoing risks to growth and in the continued absence of any meaningful inflation pressure, however, we don't think this is a scenario we need to worry about near-term, particularly as we move into next year and the presidential election makes it more difficult for the Fed to tinker with rates without appearing to be politically-motivated. For the time being, therefore, we face a monetary policy environment clearly biased towards accommodation – and not just in the U.S., as central bankers around the globe have (whether they wanted to or not) begun to file through the easy money doorway opened by the Fed (see Chart 3, above).

Keep Your Eyes On The Road, Your Hands Upon The Wheel

The recent path of interest rates is not the only similarity we see between the current period and 2016 – or 2012, for that matter. Both of those periods also presented mid-cycle slowdowns in economic growth, heightened recession fears, spikes in volatility, and meaningful stock market corrections. In those cases, a disciplined approach that enabled an investor to stay in the market and stick with a diversified strategy proved to be the right decision; we believe it will be so this time around as well. The global economy should begin to stabilize and see gradual improvement in response to the profound shift taking place in the monetary policy tides, producing better-than-expected – if still unspectacular – growth, to the benefit of a diversified portfolio of return-seeking assets, which, in our opinion, are currently being too steeply discounted by the market.

Safe haven assets, meanwhile, still provide stability and ballast to a diversified portfolio, appear rich, as this same monetary policy shift has driven interest rates to levels we view as extreme for anything outside of a recession scenario, thereby continuing to push the price of bonds and other interest rate-sensitive sectors steadily higher. Core intermediate-term bond positions returned slightly more than 1% in Q3, a fairly modest showing considering, but enough to leave them with a gain of over 8% for the trailing twelve months. Meanwhile, the impact of duration has indeed been the more powerful driver in this space recently, allowing high-quality fixed income market segments to best the performance of the more credit-sensitive multi-sector (what we typically refer to as "opportunistic") and high yield fixed income segments. Meanwhile, for both the quarter and the year, it is real estate – which, as we often note, is incredibly interest rate sensitive – that tops the charts, a showing that will likely prove difficult to replicate, barring the recession likely required to send rates lower still, something our Investment Committee continues to view as likely at least 18 months out.

Chart 4: Next Recession Inevitable but Not Imminent



The timing of the next recession – it is a "when," not an "if" – figures prominently into the calculus of what comes next for investors. Sooner and stocks will take a hit while bonds continue to surge; if it's later, on the other hand, then the market's current outlook is too bearish and stocks are underpriced. Based on the economic and financial market conditions typically observed heading into recession – from manufacturing activity to labor market conditions, from housing to consumer confidence – the risk of a recession over the coming year still appears low to us (green line, above); in fact, other than the yield curve – which implies a higher recession probability, shown above in red – none of the components of our recession probability monitor are currently pointing to any meaningful near-term risk.

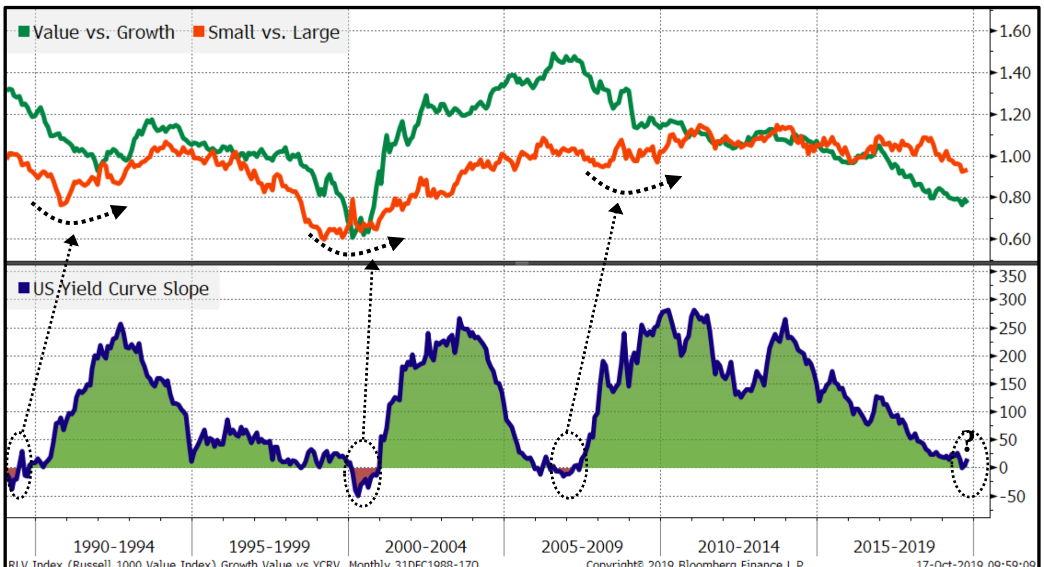
In fact, unlike the yield curve – by far the best-known harbinger of recession – which got a lot of attention for inverting briefly in late-August, our broad-based recession risk monitor (which incorporates the yield curve as one of its components) continues to point to a relatively low likelihood of recession within the coming year – in fact, at just 27% (see Chart 4, left), not only is the current projected probability not extreme, it's actually lower than where we entered the year.

This stands in fairly stark contrast to the dour mood expressed by investors, implying a potentially meaningful opportunity for return-seeking assets (i.e., stocks) if we're right. Investors remain fairly demoralized and positioning within equities is not only light, but also defensive; investor monies continue to flow out of stocks and into bonds, while investment managers have been letting cash accumulate. Now, we are not going to try to convince anyone that stocks are outright cheap right now, but valuations really do not look out of line to us either: even after the sizable year-to-date rally, the forward price-to-earnings ratio on the S&P 500 sits at 18, just a smidge above its long-term average of 17. Meanwhile, we don't need economic growth to be stellar, we just need it to be better than the abysmal outcome currently priced in by investors; based on the recent uptick in both the strength and breadth of the global expansion evident in August and September (Chart 1, above), we believe such a positive surprise is likely to unfold as we move into year-end and into the new year.

We view this as offering not only the prospect of rising earnings estimates but of multiple expansion as well, as investors reposition their way back into equities as the economic outlook improves. This helps to affirm our view that stocks will work their way higher over the remainder of the year and – while we may tread water until the market starts to see tangible improvement in the data – we continue to anticipate new all-time highs for stocks before the current bull cycle ends. Higher levels of volatility will likely stay with us going forward, however, given not only the lateness of the cycle but also what are likely to remain high levels of policy and geopolitical uncertainty.

This is a pattern to which investors should become accustomed, if they are not already after their 2019 experience thus far. This past quarter was no exception, with the S&P 500 seeing some fairly wide swings in response to changes in the perceived level of trade policy risk, which tweeted its way up, down, and all around. Having notched a modest gain for Q3 overall, the index of large-cap, blue chip stocks found itself up over 20% year-to-date. Turning to the full year requires us to incorporate the impact of last year's steep 4Q decline, however, causing the trailing one-year performance on the large-cap U.S. stock index to drop to a much more meager +4.25%. Even so, this segment clearly remains the darling of the market, as investors have maintained their narrow focus and skinny appetite for risk.

Chart 5: Change the Station – Neglected Market Segments Need More Airtime



Investors want to own stocks, but don't want to take risk (or, at least, want to feel like they are not taking risk) given weak economic growth and high levels of uncertainty. This has them concentrating on the stocks of large, U.S. growth companies, leaving segments like value, small-cap, and foreign to languish. At some point, the market will broaden out and leadership will rotate towards the opportunities accumulating in these neglected areas of the market. The timing of such shifts is notoriously difficult to figure, though – historically – periods in which the yield curve has moved into negative territory have often led to periods in which such segments outperform.

This pronounced bias has left many other sectors with much less impressive – and, in some cases, even negative – performance: small-cap stocks – both value and growth – declined in Q3, contradicting the sizable diversification and risk-adjusted return benefits that have accrued to investors in this space over the long-term. The same has also been true of foreign equity for some time now, despite the lower valuations and higher yields it offers relative to the U.S. market; non-U.S. stocks actually managed to break the habit this past quarter, at least temporarily, with large-cap, developed foreign markets topping – if only barely – the showing of the S&P this period. Further, in what seems a long-overdue reversal, frontier markets – the stock markets of the least-developed (and, generally, least correlated) foreign markets – made a very strong showing, rising nearly 5% during the quarter. Our Investment Committee's outlook continues to anticipate a sustained shift – as we have been for some time already – back towards the foreign, small-cap, and value-oriented segments of the market that have become sorely neglected in recent years and, thus, likely offer opportunity.

Such opportunity, however, is clearly for the patient investor, as timing such rotations in leadership is an exercise in frustration more than a path to profits (see Chart 5, above). By all reasonable measures, we would have thought we would already be seeing it unfold but, thus far, the market has served up nothing beyond the occasional head fake; nonetheless, it's clear that the wind will eventually go out of the sails of the narrow universe of large-cap, domestic, growth-oriented stocks in which many investors are currently concentrating their exposure and the broad, long-term benefits of a diversified approach will once again become evident. This framework speaks to the continued benefits of a disciplined approach to a strategic asset allocation that remains true to each investor's return objectives and risk tolerance as a means of achieving critical goals over time in our efforts to grow and preserve wealth over the long run. As always, we encourage you to consult with your Advisor if you have concerns or are contemplating significant changes to your strategy and 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 your portfolio or the market.

3RD QUARTER 2019 CAPITAL MARKET PERFORMANCE

Index (as of 9/30/2019)[1]	**1 Qtr**	**YTD**	**1 Year**	**3 Year**	**5 Year**	**10 Years**
FTSE 3-month T-Bills	0.56%	1.78%	2.36%	1.52%	0.96%	0.52%
Bloomberg Barclays Gov't/Credit Int.	1.37%	6.41%	8.17%	2.40%	2.68%	3.05%
ICE BofAML US High Yield	1.23%	11.51%	6.34%	6.06%	5.36%	7.82%
Bloomberg Barclays Multiverse	0.63%	6.45%	7.54%	1.81%	2.14%	2.55%
S&P 500	1.70%	20.55%	4.25%	13.39%	10.84%	13.24%
Russell 1000 Value	1.36%	17.81%	4.00%	9.43%	7.79%	11.46%
Russell 1000 Growth	1.49%	23.30%	3.71%	16.89%	13.39%	14.94%
Russell Mid Cap	0.48%	21.93%	3.19%	10.69%	9.10%	13.07%
Russell 2000	-2.40%	14.18%	-8.89%	8.23%	8.19%	11.19%
Russell 2000 Value	-0.57%	12.82%	-8.24%	6.54%	7.17%	10.06%
Russell 2000 Growth	-4.17%	15.34%	-9.63%	9.79%	9.08%	12.25%
MSCI EAFE	-1.00%	13.35%	-0.82%	7.01%	3.77%	5.39%
MSCI EAFE Small Cap	-0.37%	12.47%	-5.54%	6.34%	6.41%	7.82%
MSCI Emerging Markets	-4.11%	6.23%	-1.63%	6.37%	2.71%	3.73%
MSCI Frontier Markets	-1.04%	10.97%	6.18%	7.35%	-0.92%	3.99%
Wilshire US REIT	7.88%	27.21%	18.39%	7.21%	10.17%	13.06%
DJ Global Select RESI	5.12%	20.51%	13.42%	5.81%	7.46%	10.10%
Bloomberg Commodity Index	-1.84%	3.13%	-6.57%	-1.50%	-7.18%	-4.32%
Credit Suisse Liquid Alts	0.02%	5.82%	2.04%	2.30%	2.29%	3.27%
60-40 Balanced EQ/FI – US Only	1.59%	14.93%	6.25%	9.08%	7.70%	9.28%
60-40 Balanced EQ/FI – Global	0.63%	12.70%	4.77%	7.25%	5.58%	6.77%

[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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