MARKET LETTER

PACIFIC PORTFOLIO CONSULTING, LLC

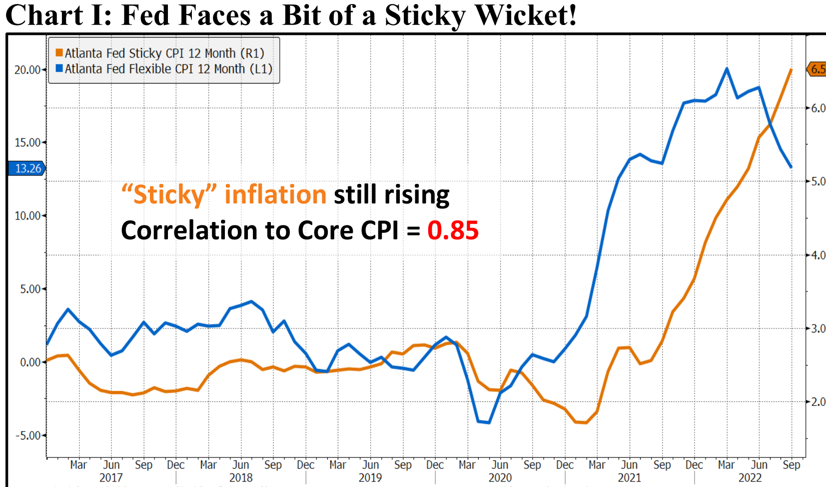
Third Quarter 2022

ARE YOU NOT ENTERTAINED?!?

Forgive me; no sooner had the words hit the page than it occurred to me that "entertained" is almost certainly not the word you would have chosen. Stunned perhaps? Or maybe nauseous would have been a better choice. A twenty-five percent bear market decline in stocks disrupted by sporadic and occasionally quite violent ***counter-trend*** rallies; a huge spike in the number of one to two percent swings up or down in the market from one day to the next and some of the largest intra-day reversals ever seen. Let's not forget global currency and interest rate markets seeing two standard deviation daily moves; killer drones over Kyiv – Iranian ones at that, mind you; and, of course, a rousing cover of "Anarchy in the U.K." led by – now former – British Prime Minister Truss on her way out the door of one of the shortest administrations ever, anywhere. Somebody, please, pass the bread because we've clearly got circuses aplenty!

So, is all of this chaos and confusion part of some nefarious, Joaquin Phoenix-esque scheme designed to distract us from what is really going on behind the scenes? Sadly, no; there is actually some substance to all of this. You see, investors remain at the crossroads – or, perhaps more appropriately, within the crosshairs – of a broad-based regime change, as a number of powerful forces continue to pressure the global economy while fundamentally reshaping financial markets. Now, hopefully, you will not be surprised when I tell you that this is not a time to panic – not to be insensitive, but we both know there is no such thing as a good time to panic; nor, however, is this necessarily a time to sit idly by and simply watch events unfold. Although the recent decline in asset prices has likely not quite come to an end yet – nor, most certainly, has the volatility that recently has gripped financial markets – it has already gone a long way towards resetting the bar for fairly reasonable returns over the coming 5-10 year cycle. Meanwhile, new areas of opportunity have begun to emerge – some of which, I would wager, were NOT the ones you were expecting – towards which our Investment Committee has been actively tilting portfolio positioning. In many cases, these developments may offer the potential to adjust the asset mix in your portfolio to continue the pursuit of the objectives laid out in your financial and investment plans (which, at the end of the day, will stand as the only benchmark of success or failure that really matters) with less risk and lower volatility, thus making this an opportune time to review your strategy with your advisor.

Chart I: Fed Faces a Bit of a Sticky Wicket!



Problems only get worse if you ignore them: having been snubbed upon arrival, inflation has decided to make a scene and spoil the party for everyone. It's possible we've now seen a peak in the fairly scorching rate of inflation – something of which both Wall Street and Main Street have become convinced on multiple occasions already, only to be proven wrong fairly quickly – but the overall inflation problem is likely to take much longer to resolve. "Flexible" inflation – made up of items that change price fairly quickly, like energy or food – has, indeed, begun to move lower; "stickier" items (a basket that contains many of the core goods and services that make up the bulk of the U.S. economy – think education, medical care, or transportation), whose prices adjust more slowly, continue to move higher. As a result, it's highly likely the Fed has further to go before this hiking cycle is complete. For context, historically, it has taken at least five years for inflation to move back to the Fed's targeted 2% rate once it has moved above the 5% level.

THE FED SMILES AT US ALL. ALL AN INVESTOR CAN DO IS SMILE BACK.

Having bent over backwards to get the global economy good and hooked on cheap, easy money over the past thirty years the U.S. Federal Reserve seems to have made a rather sudden conversion to Christianity, for it is having one heck of a "come to Jesus" moment! This revered institution somehow found greater value in spending much of 2021 waffling on about digital currencies while downplaying the threat of the inflationary pressures that were beginning to build in the system; this year, however, it has found religion with a vengeance and, in the process, has reached the difficult decision to throw investors to the lions. Inflation is now, bar

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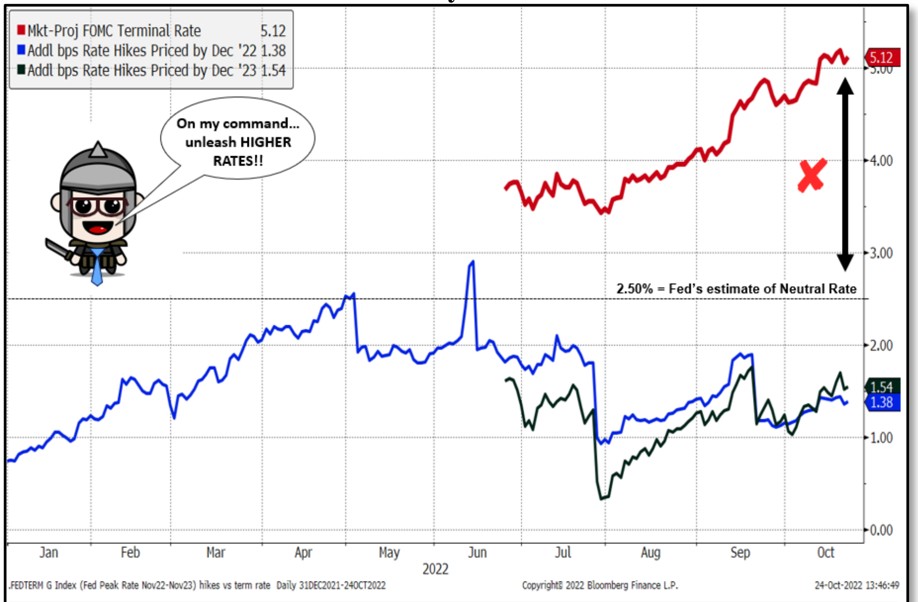
none, the top priority of a dual-mandated yet now singularly-minded Fed – perhaps this is as it should be or, more accurately, how it *should have been* much earlier in the game than was the case – and markets be damned!

Chart II: We Have Met the Enemy and He Is…Jerome Powell!!!



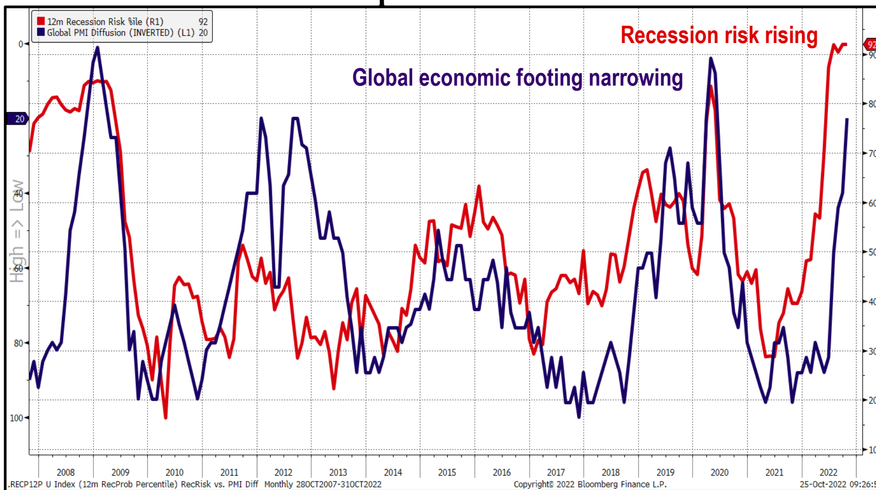
The Federal Reserve has thrown the playbook of the last thirty years out the window in 2022. Having abandoned its long-standing role as best friend and benefactor to the markets, sweeping in to ease policy and, thereby, catch investors whenever they stumbled, we now face a newly heavy-handed Fed armed with an elephant gun loaded with extremely large, "front-loaded" interest rate hikes (don't get me started on how they can be called "front-loaded" when they didn't start until a year into the inflation problem…). The Fed has raised rates by a full 3% since it began in March, with broad expectations for an additional +125 to +150 basis points' worth of hikes before the year is out. Even that won't spell the end, however, as further hikes are seen playing out over the first half of 2023, as the Fed takes the U.S. economy deep into restrictive policy territory: the Fed's own estimate of the neutral rate of interest – the level beyond which it begins to weigh on growth – is just +2.05%, a level that has already been breached but that remains well below the 5%+ level to which the market currently believes the Fed is headed.

The result has been an extremely aggressive monetary tightening campaign unlike anything we have seen in decades. The Fed's game plan appears to be to hike at each meeting by as much as it thinks it can get away with. The result has been a massive tightening of financial conditions – higher interest rates, wider credit spreads, a massive run of strength in the US Dollar, and, of course, sharply lower stock prices – that has weighed increasingly on economic activity and rippled progressively through global asset markets.

Now, we've been on record with all of you for some time with our expectations for an economic recession, which remain anchored somewhere towards the halfway mark of the coming year. It's becoming an increasingly consensus view on the Street lately, something I hate to see happen but which likely is a prerequisite in order for us to witness a wholesale capitulation of investors' hopes and dreams. Now, our friends – and I use the term loosely – over at the Federal Reserve would continue to have you believe that they can pull this trick off and – meaning no disrespect to the brain trust backing Powell & Co. – I would strongly discourage you from putting your money where their mouth is. It's not that it's impossible for them to pull off a so-called "soft landing" – i.e., in this case, somehow manage to tame inflation and magically reintroduce slack into the labor market WITHOUT hurtling the economy off of a recessionary cliff in the process – it's just extremely unlikely. Granted, the sample size is small, given how infrequent recessions are. There have been only a dozen recessions in the post-WWII period; <u>every single one</u> of them, however, was preceded by monetary tightening (aka higher interest rates) on the part of the Fed. And yes, I am throwing the 2020 COVID recession into the mix, even though higher rates were not the main culprit there – in fact, the Fed had stopped tightening a year before the recession hit, having successfully deciphered a rather blunt message from the market that the economy was headed for trouble. So, fine, let's not count that one against them; that's really not the point. The relevant point here is that there is only one single, solitary instance in which the Fed has managed to implement a meaningful tightening of monetary conditions without triggering a recession. In that case, back in 1994, the Fed wasn't even trying to squash inflation, they were just trying to prevent it. At the time, the US was enjoying extremely robust real (i.e., after inflation) economic growth of more than +5% and inflation, based on the Consumer Price Index (CPI), was a mere 2.5%-3.0% per year, entirely tolerable – in fact, downright appealing relative to our recent >8% readings. The Fed was, indeed, successful in its effort to *avert* inflation and, given how strong the economy was when they started, unemployment actually went DOWN throughout the tightening process. Over the course of just under a year, the FOMC hiked its short-term discount rate by 3% – coincidentally, the same percentage by which they have tightened thus far in the current cycle; of course, this time around it has come over a period of roughly 6 months. Even so, the Fed's campaign is clearly far from won at this stage and, thus, expectations remain for a further 75 basis point hike at the November meeting, followed by continued hikes – albeit, at a less drastic pace – in

December and into the first half of next year. The market's current estimate of the Fed's terminal rate for this hiking cycle is now north of 5% (after the September hike, we are at 3.25%), in other words deep into restrictive territory relative to the Fed's own estimate of the neutral rate (that "holy grail" of interest rates that is neither so loose as to fuel inflation nor so tight a to crimp growth) of just 2.50%. Economic growth, meanwhile, is a far cry from the healthy clip seen in the mid-90s: after modestly negative prints in Qs 1 and 2 of this year, the first estimate for 3rd quarter real GDP growth came in at +2.6%. "That's amazing!" said literally no one, ever; granted, this managed to just offset the modestly negative prints we got over the first half of the year but, when you consider that we averaged +5.7% over the course of 2021, it's pretty hard to get too excited about it.

Chart III: The Economic Expansion Has No Clothes



The risk of a recession in the not-so-distant future continues to rise, as we see the forces of already deteriorating economic data and a steadfast Federal Reserve likely producing a U.S. – and, thus, also global – recession some time over the first half of 2023. Our proprietary recession probability model (red line, above) – which covers the past 35 years of economic history back to 1987 – is currently giving its highest readings on record; at the same time, our diffusion index of global manufacturing activity has recently fallen off a cliff (note that the blue line, above, is inverted), showing only 20% of global economies currently remain in expansion. The one silver lining is that, given the lack of any obvious excesses or strain within the financial system, we believe we are facing a fairly shallow recession, though with inflation continuing to tie the Fed's hands to some degree, it may be somewhat more drawn out than we would like.

Feeble as it may be, however, this positive showing should, if nothing else, help to finally put to rest all of the talk of the U.S. *already* being in recession. As we have attempted to address in recent missives, even though the U.S. economy had met the back-of-the-envelope "rule of thumb" of two consecutive quarters of negative GDP growth (-1.6% in 1Q22 and -0.6% in 2Q22) – the record for which is not as good as you think – we have been making the case (and believe the Business Cycle Dating Committee over at the National Bureau of Economic Research, whose job it is to actually rule upon when a recession starts/stop, would support us) that the modest declines over the first of half of this year do not meet the spirit of the definition of a recession, which we would argue is meant to describe a material and sustained decline in activity across a broad swathe of the economy. Now, the celebrating may end up being relatively short-lived, if we do, indeed, end up in a recession next year, as we predict; nonetheless, given the lack of any extreme excesses among consumers or businesses or obvious time bombs within the financial system that could trigger a crisis, we're currently expecting more of an old-school, "plain vanilla" recession, more on par with the longer-term average in terms of duration – so, likely a little bit less than a year – and on the milder side in terms of its hit to GDP and, importantly, corporate earnings.

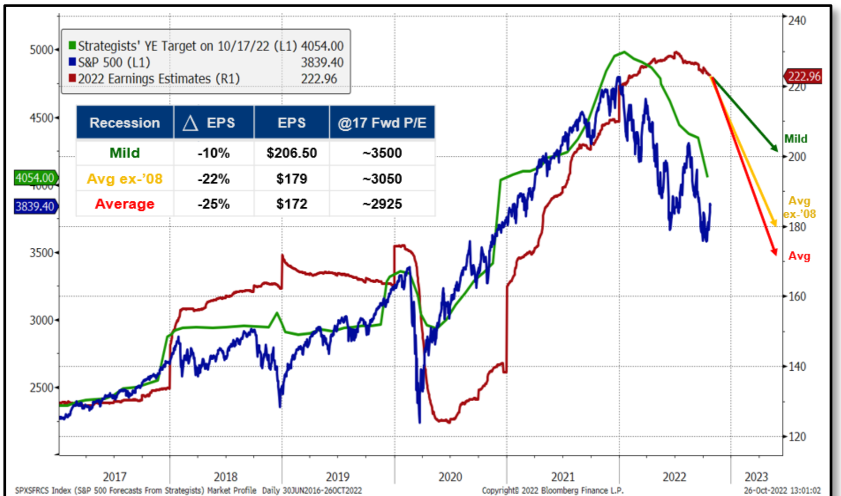
We Will Meet New Highs Again…But Not Yet

As I write, the market has been bouncing off of some fairly oversold conditions and a pretty decent short-term rally has taken hold to lift the market a little over +10% from its lows, at which point it appears to be encountering at least some modest overhead resistance. Thus far, things are not too dissimilar from what we saw unfold between mid-June and mid-August, and that's really not too surprising, as we'll discuss herein. Of course, the summer rally initially was able to make even further progress off the lows, with stocks surging an impressive +19%; now, ancient Wall Street folklore states that had this Q3 rally in stocks NOT stopped just shy of that "magical" +20% mark, I would have had the very considerable headache of trying to convince you that we are still in a bear market, so in that respect I am – quite perversely – grateful.

It is, however, an important point to acknowledge: the bear remains on the prowl until proven otherwise and, as such, these advances that we are seeing are "counter-trend" or, as more commonly known, bear market rallies. Such rallies are extremely common and, what's more, can be quite impressive, given that they tend to come at a time when sentiment is absolutely at its lowest and, therefore, risk positioning tends to be at its lightest. At times, they may even exhibit some modest staying power, though they ultimately conclude with the stock market's downtrend still intact. Such was the case with the prior rally that we saw peter out in mid-August, when an increasingly hawkish read of the Fed's intentions in the face of stronger than forecast economic data led stocks to resume their decline and close the quarter at their lows for this bear cycle. This sort of on-the-fly reassessment of Fed policy is becoming somewhat of a "usual suspect" behind recent market downdrafts, having caught investors flatfooted on more than one occasion, as they persist in playing a risky game of trying to call the point of peak central bank hawkishness. Certainly, it's hard to blame them for trying, given the short-term payoff for getting that call right could be substantial; not surprisingly, however, in practice, such investors have embraced a level of absolute conviction that this time, this MUST be it, that they inevitably have flown too close to the sun, where their wings – and their portfolios – have gotten burned, helping to explain some of the literally "convulsive" action the market has displayed at times.

Where does all of this leave us, then? Will we ever see new highs again? Well, as we have discussed in recent quarters, bear markets do not last forever, although they do usually last longer than the current cycle. Having peaked on the very first trading day of the year, the S&P 500 has spent – through the end of Q3 – 270 days in this bear market cycle, quite a bit less than the 408-day average for all bear markets in the past 60 years. Now, there is, obviously, no requirement that the bear market last this long: over the period examined, the range has been between 33 days (the recent COVID bear market) and 929 days (the extremely painful bear market that followed the dot-com bust). Similarly, there is quite a bit of variation in the depth to which such bear cycles generally sink (beyond, obviously, the minimum -20% it takes to qualify as a bear market!) but, on average, they have declined roughly -35%, implying the potential for some – at this point, relatively modest – incremental downside from the recent market low.

Chart IV: Rome Has Fallen…Now Earnings Must Too



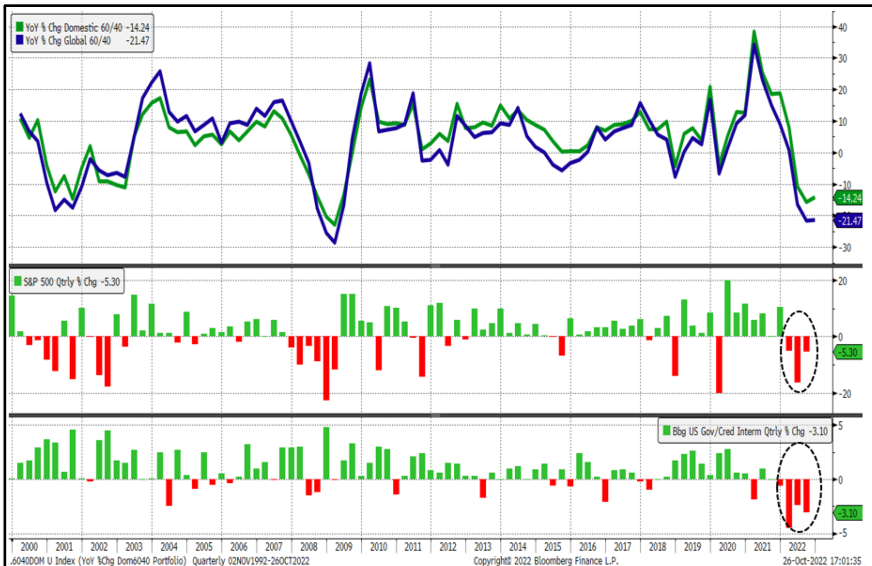
Against a backdrop of a recession expected to unfold some time in 2023, forward earnings estimates remain stubbornly high, having eased only -3% since their peak in June. This is a far cry from the average decline in earnings of -22% seen over all recessions since WWII; even in our scenario of mild recession, we expect to see earnings decline by around 10% or so, which would – at current multiples – still imply slightly more downside to the market. If, on the other hand, the Fed miscalculates meaningfully and allows monetary tightening to trigger a worse-than-expected recession, we could be looking at something more along the lines of a -20% hit to earnings, which could quickly bring what so far has been a rather mild bear market much closer in line with the historical average.

So, with valuations having come down fairly substantially over the past several quarters, now sitting right around the 20-year average (having quickly pulled back from roughly two standard deviations above this average), and investor sentiment languishing in the basement fairly consistently these days, what shoes might there be left to drop that could lead to a further evolution and, ultimately, a resolution to this ongoing bear? Based on our economic outlook, the most likely catalyst would appear to be corporate earnings. Although analyst estimates for the coming 12 months have come down very slightly, the adjustment thus far strikes us as woefully insufficient to reflect the impact of the recession we expect next year. Even a mild recession would likely take earnings down enough to leave the market down somewhere closer to -30% from its all-time high based on the current Price-to-Earnings multiple; a more "average" recession, meanwhile, would likely take the market down to around the average decline of -35% noted above. Under either of these scenarios, however, we have likely already been through the worst of it; although it might still be a little bit early to buy (although the market is offering periodic opportunities to step in new money), it is almost certainly too late to sell.

Now let's pause for a moment and put stocks aside to talk about the *gasp* bond market instead, something I did not think I would ever hear myself say. We can't help but notice, however, that the dramatic recent shift in interest rates has left bonds looking considerably less expensive relative to stocks than they did at the start of the year. Even more remarkable, there is actually some yield – and safe yield, at that – to be had out there. For nearly 15 years, investors have suffered under a regime of financial repression orchestrated by the world's central banks that made a mockery of the term "fixed income" – oh, it was fixed alright…at zero percent! Now, however, that the bond market has already gone a long way towards incorporating investors' expectations for the full effect of the ongoing Fed tightening cycle across the intermediate and long end of the yield curve, the yield on a diversified core bond exposure has gone to nearly 5% from a mere 1.5% at the end of 2021. Given the roughly 85% correlation between the current yield on a high quality bond investment and its return over the subsequent 5 to 10 years, investors can now once again begin to look to their fixed income allocations to deliver returns – nominal ones, anyway – more on par with long-term historical expectations. Heck, you can actually invest in a one-year Treasury bill – and we have been! – to lock in as close to a "money-good" guarantee of principal as you will find, earning an attractive +4.5% yield in a challenging environment, while still being positioned nimbly enough to redeploy proceeds in fairly short order should yields continue to rise over time.

Of course, none of the above buffet of bond benefits is by any means a "free lunch" – far from it, in fact: to get here, investors have had to survive a vicious attack by a "Balanced Bear," an extremely rare beast known for its declines in both stocks and bonds at the same time. In fact, with the close of the most recent quarter, we've actually just experienced a third straight such quarter in which both of the primary traditional financial asset markets have been down in tandem. Now, normally after this sort of this happens, well…who knows?? You see, it has never happened before! Yes, we've had periods like 2008 when we saw two successive quarters of simultaneous declines in stocks and bonds but we're in uncharted waters on this front from here on out. Will financial markets go for a 4th straight quarter? Certainly, recent conditions have highlighted that anything is possible and that outlook and sentiment can change on a dime. Nonetheless, we believe we would likely have to see another wholesale reset in expectations to the downside, stemming either from Fed posturing hinting that we "ain't seen nothin' yet!" or perhaps a very sharp decline in economic activity that causes markets to reassess the potential depth of the coming economic contraction.

Chart V: Balanced Strategies Badly Mauled, But Not Dead



With the convergence of high inflation, rising rates, and slowing economic activity, we have experienced an unprecedented three straight quarters of declines in both stocks and bonds at the same time. The result has been some of the worst returns on record for balanced investors. In the process, however, the potential for forward returns has been reset, setting the stage for what we believe will be performance roughly in line with the long-term averages over the next 5-10 year cycle, quite a bit higher than could have been expected coming into the year.

As a result, rather than being dead and buried, we believe the mix of stocks and bonds into a balanced portfolio strategy looks poised for a resurrection. Certainly, there's no escaping the fact that recent returns experienced by a mix of such assets – whether confined to the U.S. or applied globally – have been among the worst on record. On a forward looking basis, however, if ever there were a time to abandon a balanced approach, this certainly would NOT be it; while that may seem counterintuitive – or at the very least run contrary to most investors' emotional reactions – the truth is that – as we discussed above – future return prospects for both stocks and bonds over the next market cycle have been boosted considerably from what were fairly skinny levels. What's more, we believe it is likely that much of the diversification benefit missing from the mixing of equity and fixed income assets lately will shortly reestablish itself going forward. As such, we cannot help but continue to pound the table on the importance of sticking with a well-diversified approach.

What We Do In Our Portfolios Echoes In Eternity

Well, if not for eternity, then at least for a really long time! I know it's tempting to tweak and tinker; the urge to do something – anything! – in this sort of environment can be difficult to contain. Such moves are rarely productive, however, and – to be blunt – are unlikely to move you any closer to your long-term goals. So, while Wall Street's best and brightest sharpen their No. 2 pencils and prepare to prognosticate on where the market will finish out 2022 or – the REALLY bold ones – even what it might do next year, consider that there might actually be something to be gained from taking a longer-term view.

This belief sits at the very heart of our approach to the management of our clients' wealth: that the thoughtful construction of diversified portfolio strategies that can be tailored to the risk tolerance and individual circumstances of each client applied with a patient, long-term perspective represents the optimum means through which to pursue their long-term goals and objectives.

This is not necessarily meant to imply a passive approach, however, merely a disciplined one. As you know, our Investment Committee is active at the margin, tactically tilting portfolio positioning within a strategy towards those areas that appear to hold more favorable prospects. So, for example, given expectations for a challenging economic backdrop, our strategies have recently begun to lean into higher quality and dividend paying stocks within the large-cap segment of the equity sleeve, as these should be better able to withstand not only an economic downturn but also the higher level of market volatility we expect to persist. Meanwhile, within fixed income, as briefly mentioned above, we have moved a portion of the bond exposure towards the ultra-short end of the duration spectrum via an investment in one-year U.S. Treasury Bills, which are providing a level of yield not seen since before the financial crisis and which leave us with the liquidity to respond to any further bond market developments that may emerge.

For your part, meanwhile, we believe the current setting provides a good opportunity to check in with your advisor and review your portfolio strategy; now that financial repression is clearly over and the bond market actually once again offers some potential for return, it may be possible to continue to pursue your same portfolio objectives with less volatility using a more conservative strategy. And, of course, our CEO Larry Hood and I remain available to address any questions or concerns you may have.

-Jim Ayres, CIO

3RD QUARTER 2022 CAPITAL MARKET PERFORMANCE

Index (as of 9/30/2022)[1]	**1 Qtr**	**YTD**	**1 Year**	**3 Year**	**5 Year**	**10 Years**
FTSE 3-month T-Bills	0.59%	0.87%	0.88%	0.60%	1.16%	0.68%
Bloomberg Barclays Gov't/Credit Int.	-5.04%	-10.02%	-10.03%	-1.91%	0.30%	0.94%
ICE BofAML US High Yield	-3.64%	-12.12%	-11.35%	0.19%	1.90%	4.06%
Bloomberg Barclays Multiverse	-9.27%	-20.24%	-20.57%	-6.03%	-2.30%	-0.81%
S&P 500	-5.86%	-17.70%	-14.61%	10.22%	10.44%	12.79%
Russell 1000 Value	-2.41%	-9.32%	-7.00%	7.31%	7.21%	10.30%
Russell 1000 Growth	-8.90%	-26.61%	-24.60%	11.75%	12.59%	14.69%
Russell Mid Cap	-4.31%	-17.55%	-17.17%	7.84%	7.95%	11.36%
Russell 2000	-1.68%	-16.86%	-18.54%	7.05%	5.56%	9.93%
Russell 2000 Value	-2.08%	-11.19%	-10.73%	8.08%	5.31%	9.37%
Russell 2000 Growth	-1.29%	-22.57%	-26.02%	5.11%	5.17%	10.15%
MSCI EAFE	-8.95%	-22.81%	-22.62%	-0.82%	0.39%	4.61%
MSCI EAFE Small Cap	-11.77%	-28.93%	-29.95%	-1.88%	-0.92%	6.01%
MSCI Emerging Markets	-14.01%	-29.15%	-30.73%	-4.07%	-2.73%	1.16%
MSCI Frontier Markets	-11.53%	-28.69%	-30.93%	-2.71%	-2.07%	3.59%
Wilshire US REIT	-14.04%	-26.75%	-20.52%	-1.17%	3.91%	6.67%
DJ Global Select RESI	-14.90%	-26.90%	-22.88%	-5.01%	0.85%	4.04%
Bloomberg Commodity Index	-6.20%	15.83%	11.15%	13.44%	6.92%	-1.56%
IQ Hedge Multi-Strategy	-3.70%	-10.67%	-11.45%	-0.93%	0.35%	1.88%
60-40 Balanced EQ/FI – US Only	-5.40%	-14.37%	-12.43%	5.67%	6.67%	8.16%
60-40 Balanced EQ/FI – Global	-6.44%	-16.40%	-15.60%	2.78%	3.89%	5.68%

[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.