MARKET LETTER

PACIFIC PORTFOLIO CONSULTING, LLC

Third Quarter 2023

EXECUTIVE SUMMARY

- A surprisingly resilient U.S. economy is holding fast; the risk of recession has moved lower though not yet been eliminated, as the effects of higher rates will continue to work their way through the system
- Inflation has continued to edge lower over the course of the year, though the path from here may be stickier; it will likely still take quite a bit longer to get back to the 2% target than the Fed would like to acknowledge
- The Fed's monetary tightening campaign looks close to being done; the market is currently split on the potential for one more quarter-point hike in December
- Expectations for rate cuts in 2024 have shrunk, however, as economic resilience and stubborn inflation help reenforce the new "higher for longer" mentality
- The market's shift in outlook caused longer-term interest rates to move sharply higher during Q3, causing some indigestion for both stock and bond markets
- For most of 2023, the so-called "Magnificent 7" have dominated the field, frustrating diversified investors in the short-run but creating increasingly attractive opportunities in the more "unloved" segments of the market for those with the patience and discipline to tap into them
- Bond markets have faced challenging conditions once again this year, though this has left bonds looking fairly attractive, with high quality fixed income yields their highest since 2007

WILL THE ECONOMY BACK IT UP OR PACK IT IN? WHERE TO BEGIN!?

You're no doubt hearing a lot about how remarkably "resilient" the U.S. economy has been looking lately. Despite the Fed's move to hike interest rates sharply higher over the past 18 months, economic growth in the U.S. has managed to remain in positive territory in recent quarters, steadily exceeding economists' expectations in the process.

The monetary tightening campaign pursued by the Fed has been extremely aggressive, exhibiting by far the steepest hiking path markets have experienced since the early 1980s, conditions that materially raised the risk of an economic recession…or at least they did on paper…

The reality – so far – has been very different, as the economy has shown a remarkable ability to take a licking and keep on ticking, not just coming up for air but, in fact, coming back for more! After having initially shown some fairly material signs of softening, economic data has actually begun to improve. Certainly, the quite robust advance reading for GDP for the 3rd quarter – in the face of what, logically, should have been growing headwinds – will have knocked a few economists' socks off. Make no mistake: consumer sentiment remains relatively poor – having rebounded only modestly off its mid-2022 trough; nonetheless, consumers have continued to spend at a very healthy clip ("healthy" for economic growth, mind you, though not necessarily for their household balance sheets). Small business sentiment, meanwhile, is perhaps one notch above "abysmal," yet businesses have continued to hire, contributing to the continued tightness of the labor market and corresponding growth in wages. The result has been a very significant retrenchment in – though by no means the elimination of – the risk of an economic recession over the coming year, thus reopening a window of opportunity to the idea that the Fed might be able to make good on its promise of a "soft landing," whereby it aims to tighten monetary conditions enough to squash inflation while somehow managing to keep the economy chugging along (well, at least "putting" along) in modestly positive territory.

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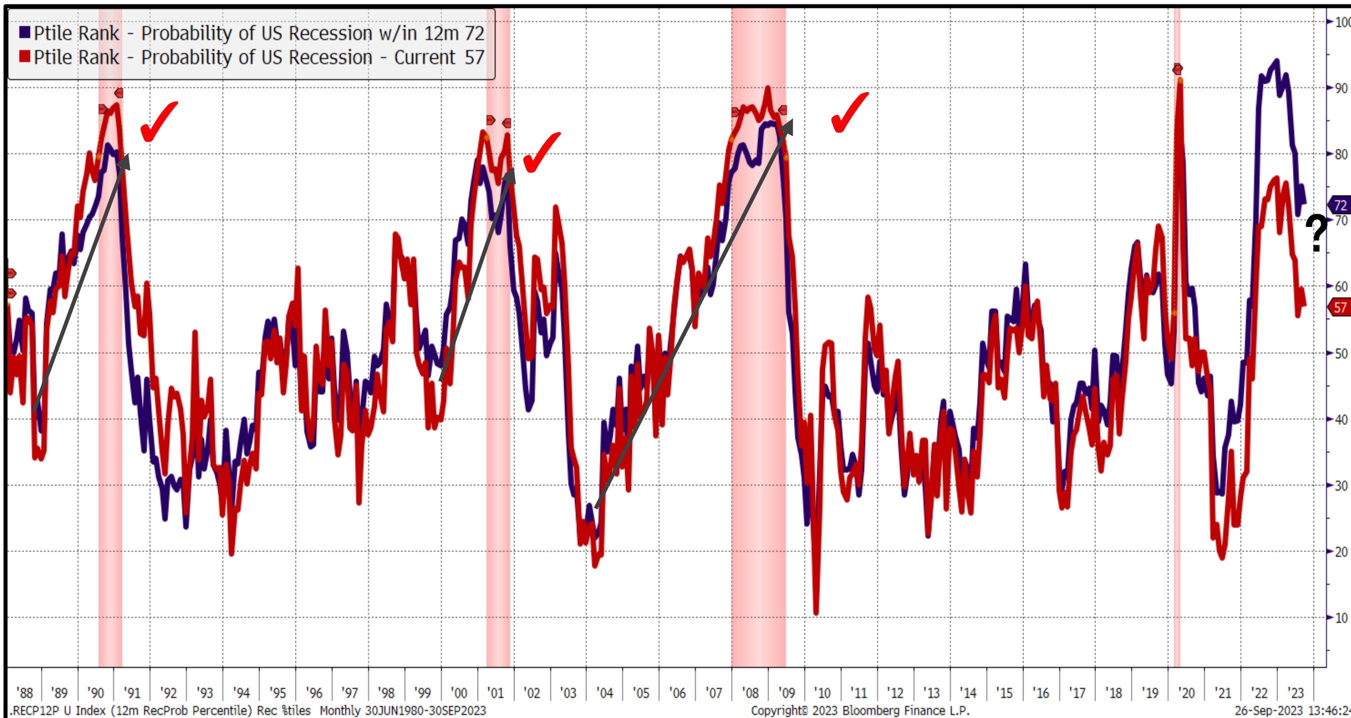
Chart I: One Of These Things Is Not Like The Others



Early on in the current Fed rate hike cycle, the risk of an economic recession began to rise fairly quickly, moving steadily higher over the course of 2022 to reach alarming heights as we entered into 2023. In fact, the average probability across all of the indicators we monitor placed the overall likelihood of a recession "within 12 months" (the blue line in the chart above) in the top decile of its 35-year history as recently as March of this year. Unlike prior cycles, however, the probability that the U.S. economy was currently in recession – the red line in the above chart – ultimately failed to follow through, peaking in the mid-70s instead of the >80 readings typical of the onset of recession. Looking at the overall message from the above chart, it seems that we have some breathing room, that the recession that previously appeared to be all but a certainty for 2023 has, at a minimum, been pushed out to 2024 (if at all!). Realistically, however, "recession watch" will need to continue for the foreseeable future, given the eyepopping increase we have seen in the cost of money, which – as one would expect and as we will see in Chart IV, below – has historically tied very closely with the pace of economic activity.

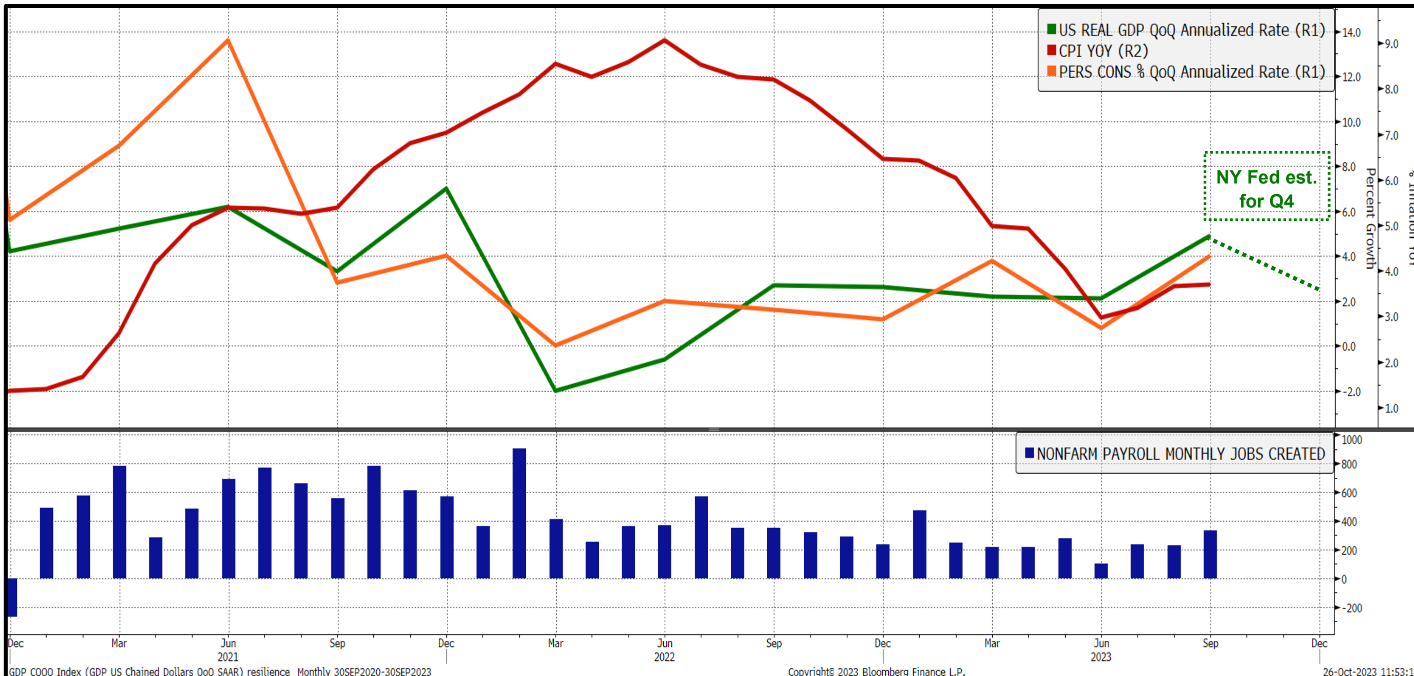
The Bad Side Of Good

So, economic activity has been surprising to the upside; that's good, right? And inflation, well, that has come down significantly – in fact, until very recently it, too, was outpacing most economists' expectations in terms of how quickly its fires were cooling (ignoring – for now – just how high inflation remains in spite of all that). That's also good, right? Yes, it is, in the sense that we were discussing above – i.e., placing even a skeleton of scaffolding under the credibility of a "soft landing" scenario. The whole truth, however, is that such "resilience" will ultimately cut both ways: "good news" will be seen as good until it suddenly becomes seen as "bad news" (a dynamic that markets have highlighted vividly of late, as intermediate- and longer-term interest rates have spiked higher).

For example, we would argue that, on the one hand, so long as both the consumer and the labor market remain vibrant and healthy, the Fed would appear to have all the leeway it needs to keep going. If its policy prescription to date – an utterly massive 500 basis points of increase in the discount rate in little over a year – has not caused the economy to slow materially, then do they really need to be all that concerned about continuing a ways further down this same path for the sake of ensuring that the inflation genie has been definitively stuffed back into the lamp?

What's more, should the demand side of the economic equation remain robust and job market stay as tight as it has been, inflation could easily prove more stubborn going forward than it has been over the past year, casting even greater doubt on the Fed's projection that core U.S. inflation will be back at their magical 2% target by year-end 2026. At its extreme, this could conceivably bring the Fed around to the idea of additional rate increases (beyond the one additional quarter-point rate hike they have left dangling out there to keep markets on their toes), although a more likely scenario is simply a further escalation in the definition of the "higher for longer" mentality that has been sinking its grip into the mind of the market in recent months.

Chart II: "Resilient" Is Not A Synonym For "Done"



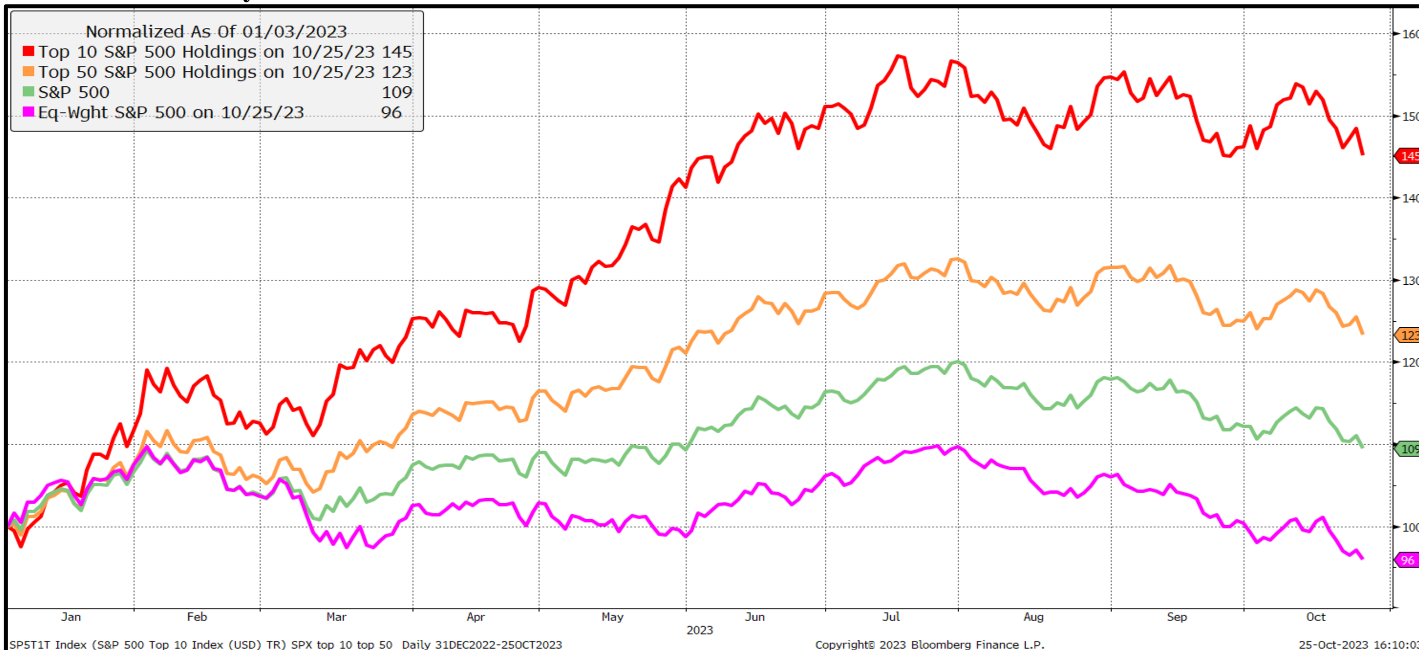
The U.S. economy has defied expectations – and gravity – in recent quarters, clinging to positive territory despite a seemingly insurmountable amount of monetary tightening by the Federal Reserve. Growth had generally settled into the +2%-ish area – at least prior to the eye-popping +4.9% advance estimate for Q3 – and the Fed's own models currently project it will come in somewhere in that area in Q4 as well. That would put the U.S. on track for growth of roughly +2.8% for 2023, better than even the rosiest Wall Street economist's current outlook. Much of the economy's ability to remain on its feet despite the onslaught of aggressive monetary tightening has been credited to the consumer's continued willingness to spend, even now that all of the stimulus money is long gone, as well as a reasonably healthy pace of job creation that has steadily topped expectations for most of the past two years. Somewhat perversely, this backdrop is not the most conducive to a Federal Reserve pivoting to those rate cuts that markets have been eagerly anticipating; in fact, so long as this state of affairs persists, the Fed not only continues to have carte blanche to continue tightening (or at least keep things tight) but may actually need to do so if the recent pause in progress on the inflation front turns into an outright stall. This dilemma is not lost on the market, which appears increasingly wary of further such signs of "resilience."

The Down Side Of Up

Does the cream of the crop really rise to the top? Well, apparently it does as long as it's part of the so-called "Magnificent Seven" club of stocks (formerly known as the "Great 8" but – let's be honest – did Google really deserve to be counted twice??). As of late October, the standard, market-cap weighted S&P 500 index is +9% so far this year, while the equal-weighted version of that very same index is actually DOWN -4%. An even starker contrast is evident when you consider the top holdings within the index: taken to its extreme, the top 10 holdings within the S&P 500 index are up a staggering +45% year-to-date.

So, these stocks are at the top; can't really argue with that. But are these really the "cream of the crop"? Well, I suppose it depends on what type of crop an investor is trying to farm. Certainly, these companies appear to be enticing some investors with the perceived offer of some sort of defensive benefit – which seems strange,

Chart III: Whaddya Got? MAGNIFICENCE!!



Let's try to keep it real for a minute; the seemingly-magnificent stocks so near and dear to every investor's heart these days are really just the second coming of the FANGs (or FAANGs or FAAMGs or whatever "flavor of the week" they were on when you first became aware of them) of the last 10 years. Of course, one could just as rightfully call them the third coming of the "Four Horseman" stocks from the late-90s or the fourth coming of the Nifty Fifty stocks of the 1970s – in essence, simply the latest incarnation of what Wall Street has blessed as "one decision stocks" – i.e., "buy and hold forever" stocks. Wait, what's that? You weren't actually planning on holding your shares of these high-flying heroes forever-ever? Well, you may need to rethink that, considering a basket of these seven stocks currently trades at a forward P/E multiple of 32 times next twelve month earnings (versus an already-not-so-cheap 19 times for the broad market)! Now, I am not telling you not to own any – or even all – of these names; they did not get to be the biggest companies in the world by chance and choosing to avoid them is to take on a risk, just as is choosing to own them. However, we do have some benefit of hindsight to tell us how similar bouts of enthusiasm have played out historically. In such instances, investors' embrace of the old adage that if something is worth doing, it's worth overdoing leads the market darlings to get ahead of themselves and, effectively, borrow against futures returns, often leading them to underperform the broader market once leadership rotates.

frankly, given that as the stocks with the biggest gains, one might initially assume they had the furthest to fall. However, these are, quite objectively, the stocks of some of the largest and, it would seem, highest quality companies in the world. As such, some investors may currently be treating them as a new kind of "safe haven" in that they are endowed with healthy growth prospects considerably stronger than and at least somewhat independent of the state of the broader economy.

Of course, other investors view these as they key to getting on board with the AI (Artificial Intelligence) revolution, which they believe surely must be set to turn the world on its head within the next few…weeks! Now, I am not going to attempt to downplay the likely significant impact – over time – of the potential quantum leaps we may see in AI capabilities in the years to come but, as with any new technology, there will be winners and losers; there will be disruptors. And, make no mistake, there will be regulation. As a result, the landscape could end up looking very different than it does now – similar to the transformation that defined "Web 2.0" following the dot-com bust – and, thus, it likely makes sense to play such a theme both broadly and in moderation within a well-diversified portfolio.

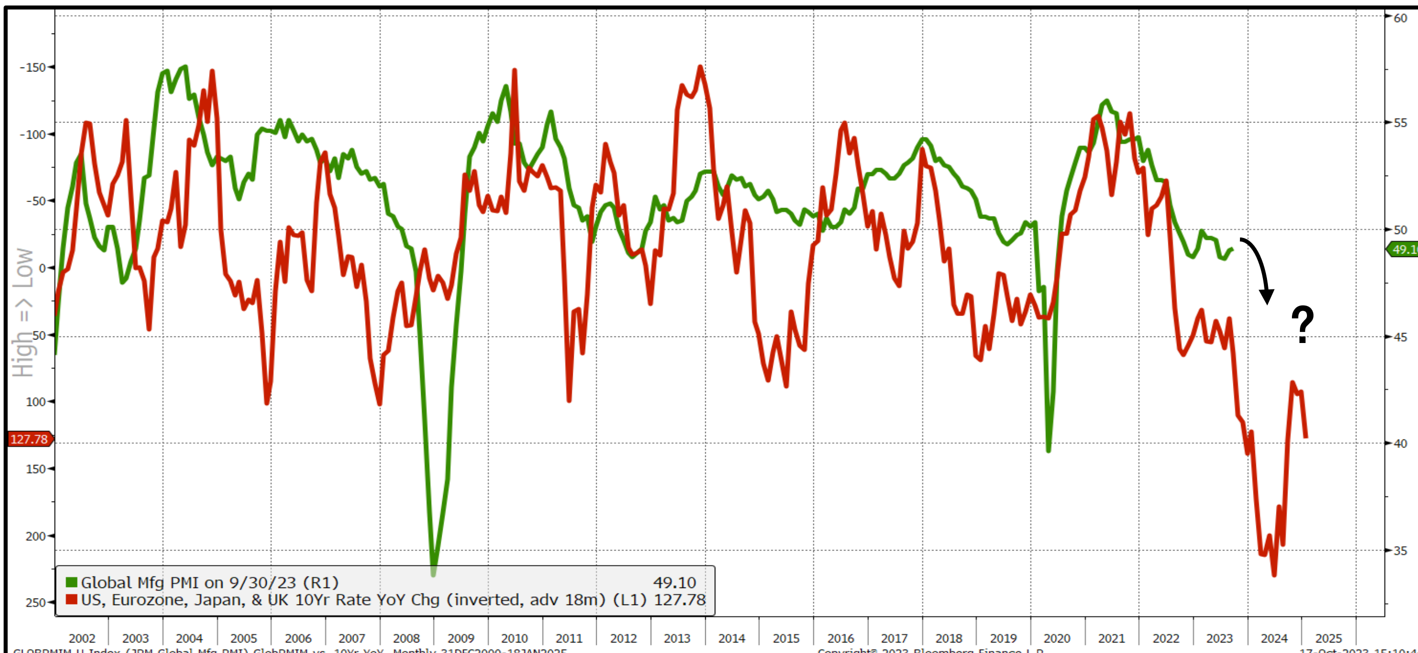
Lastly, there appears to be a contingent of investors suffering from a bad case of FOMO of the MOMO (aka fear of missing out on the momentum!), watching the seemingly endless gains such stocks have been racking up – anywhere from +32% to +198% year-to-date – and the self-reinforcing effect of their ever-growing representation in the market cap-weighted benchmark index, leading them to dogpile into the mix – and, thus, further reinforcing the process.

While it may be tempting to throw the book at this last group as the most egregious violators of prudent investment practices, none of the above students of the market deserve a gold star. Meanwhile, all of their collective actions continue to introduce not only distortions (see Chart III, above) but also risk into the market, as their index weightings and valuations get further and further out of whack. While remaining cognizant of the hard-proven investing axiom that states that the market can stay irrational longer than investors betting against it can stay solvent, we remain big believers in reversion to the mean over time – one that will bring to light the opportunities currently being cultivated in the neglected segments of the market but also one that, given how influential the top stocks have become, is unlikely to be either pretty or painless.

Has The Script Been Rearranged?

Things rarely look clear cut in the financial markets and, when they do, looks often end up being deceiving. What is clear right now is that there are any number of potential issues lurking on the horizon and below the surface, issues that, based on economic and market history, are unlikely to go quietly. What is decidedly unclear is the durability of the highly atypical recent economic activity in the face of what would traditionally have presented some highly challenging conditions. Is it actually different this time? Well, unless you're new

Chart IV: We Still Might Know What It's Like To Live In A House Of Pain



You would never guess it from looking at the actual data, but if historical economic relationships continue to hold true, there is likely still a bill to be paid for the massive tightening in monetary conditions over the past 18 months. Looking at the rate of change in developed economy interest rates – depicted above in red and inverted (i.e., red line lower = interest rates moving up faster) – it would appear to portend a pronounced slowdown in global manufacturing activity. Long-term, the relationship between the two data series exhibits a pretty good fit, one that – if it holds – could see the global PMI measure of economic activity sink quite a bit lower than its current unimpressive but reasonably benign 49 and change. As a result, we continue to view the risk of recession over the course of 2024 to be meaningful – no change to our standing outlook in terms of depth or duration, both of which we still expect to be fairly modest, but a delay in the expected timing. In addition, the overall probability of a recessionary outcome has come down, as what had appeared all but a certainty earlier this year now looms as a credible threat coexisting alongside the non-negligible chance of the Fed pulling a soft landing out of its hat.

here you probably have a pretty good feel for where we land on that question. Nonetheless, even while remaining mindful of the lessons provided by past experience, we mustn't allow them to lead us to try to fit every situation we encounter into an existing box. Certainly, if it looks like a duck and quacks like a duck…well, we're going to proceed as if it is a duck. At this point, however, it's not necessarily clear what type of waterfowl we are dealing with; thus, we remain quite mindful of the risks implied by current monetary conditions, but we also remain open to interpreting the leading and coincident economic data as it presents itself to us to better inform our outlook of where the economy and markets may be headed next.

The practical conclusion to such an outlook is, unsurprisingly, a reinforcement of the importance of discipline and diversification, two principals at the heart of the approach we take in managing our clients' portfolios. Certainly, no investor is completely immune to FOMO; everyone looks at the index sometimes and thinks "Why isn't my portfolio up THAT much?!?", but typically without consideration for risk tolerance or time horizon; without consideration of how they are actually invested, which – quite correctly, for the sake of risk management – is very differently than the index. These differences are important – key, in fact – in the risk-managed pursuit of financial and investment objectives over the long-term. They are also, we believe, going to be critical to the generation of outperformance once market leadership begins to rotate and broaden. Foreign equities – despite the burden of a strong US Dollar – have already begun to shine; it's only a matter of time before areas like value and small-cap do the same. Meanwhile, the alternatives sleeve of your portfolio – which most of our clients' strategies include – have done their very best to redeem themselves over the past couple of years, adding not only stability but also return in an environment that has challenged both traditional stock and bond markets. And, lastly, speaking of bonds, you're finally in a position to earn a respectable return on your fixed income; you've held it for its diversification and risk reduction properties – helping to alleviate the full impact of the zigs and zags of the equity market – but now, with high-grade fixed income yielding in the neighborhood of 5%, there's actually some return to be made.

We're not expecting the clouds to part overnight; we'll continue to monitor the many aspects of risk we have discussed herein but, in the meantime, are feeling relatively good about how we are positioned for the most likely scenarios going forward and will continue to adapt as and if our outlook shifts. In the meantime, you are, of course, always welcome to reach out to your advisor, our CEO, Larry Hood, or myself with any questions you may have.

-Jim Ayres, CIO

3RD QUARTER 2023 CAPITAL MARKET PERFORMANCE

Index (as of 9/30/2023)[1]	1 Qtr	YTD	1 Year	3 Year	5 Year	10 Years
FTSE 3-month T-Bills	1.38%	3.80%	4.71%	1.78%	1.74%	1.12%
Bloomberg Barclays Gov't/Credit Int.	-0.83%	0.65%	2.20%	-2.93%	1.02%	1.27%
ICE BofAML US High Yield	0.53%	5.90%	10.21%	1.81%	2.81%	4.15%
Bloomberg Barclays Multiverse	-3.46%	-1.92%	2.69%	-6.62%	-1.48%	-0.28%
S&P 500	-3.27%	13.07%	21.62%	10.15%	9.92%	11.91%
Russell 1000 Value	-3.16%	1.79%	14.44%	11.05%	6.23%	8.45%
Russell 1000 Growth	-3.13%	24.98%	27.72%	7.97%	12.42%	14.48%
Russell Mid Cap	-4.68%	3.91%	13.45%	8.09%	6.38%	8.98%
Russell 2000	-5.13%	2.54%	8.93%	7.16%	2.40%	6.65%
Russell 2000 Value	-2.96%	-0.53%	7.84%	13.32%	2.59%	6.19%
Russell 2000 Growth	-7.32%	5.24%	9.59%	1.09%	1.55%	6.72%
MSCI EAFE	-4.05%	7.59%	26.31%	6.28%	3.74%	4.32%
MSCI EAFE Small Cap	-3.42%	2.27%	18.48%	1.54%	1.18%	4.70%
MSCI Emerging Markets	-2.79%	2.16%	12.17%	-1.34%	0.94%	2.45%
MSCI Frontier Markets	2.14%	7.82%	7.01%	2.12%	1.96%	2.61%
Wilshire US REIT	-6.41%	-0.17%	3.94%	5.74%	2.87%	6.01%
DJ Global Select RESI	-5.96%	-3.55%	3.15%	2.93%	-0.23%	3.14%
Bloomberg Commodity Index	4.71%	-3.44%	-1.30%	16.23%	6.13%	-0.75%
IQ Hedge Multi-Strategy	0.83%	6.27%	11.02%	1.06%	1.79%	2.49%
Domestic Balanced	-2.27%	8.06%	13.73%	5.04%	6.68%	7.81%
Global Balanced	-2.29%	6.57%	13.57%	3.41%	4.92%	5.57%

[1] The Bloomberg U.S. Government Credit Intermediate and Multiverse indices are registered service marks of Bloomberg Finance LP. The ICE BofA US High Yield index is a registered service mark of Intercontinental Exchange; 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. The Domestic Balanced benchmark represents a blend of 60% S&P 500 and 40% Bloomberg US Intermediate Government/Credit, rebalanced monthly, while the Global Balanced benchmark represents a blend of 60% MSCI ACWI and 40% Bloomberg US Intermediate Government/Credit, also rebalanced monthly.

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