MARKET LETTER

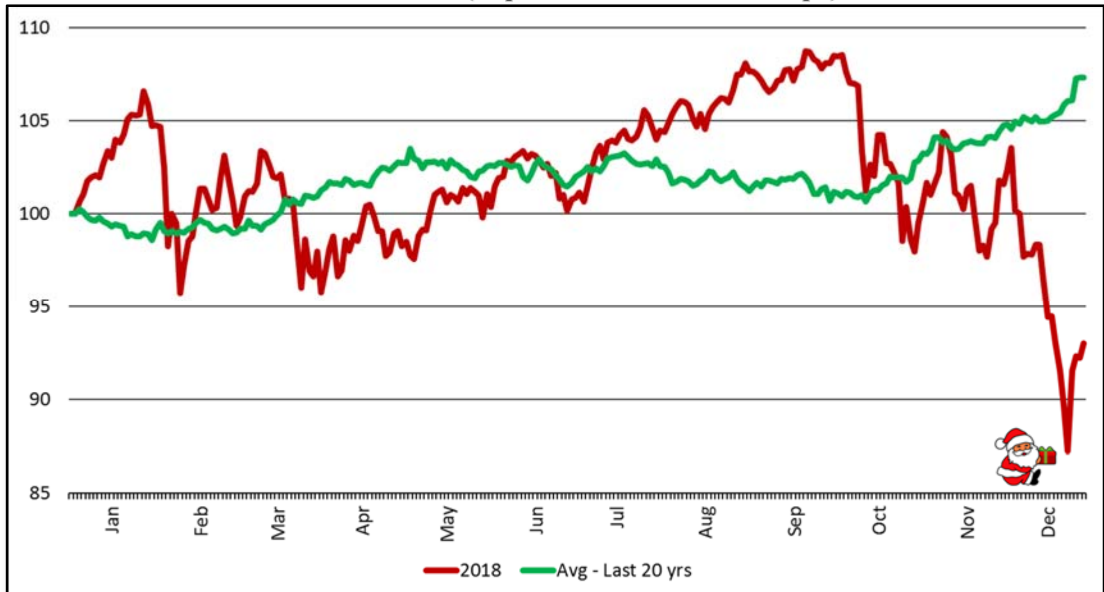
PACIFIC PORTFOLIO CONSULTING, LLC

Fourth Quarter 2018

SILVER LININGS PLAYBOOK

It was not so very long ago that we had become accustomed to beginning our end-of-year commentary with a rousing declaration of "Good riddance!" to the year gone by; we doubt anyone will object too strongly if we revive this tradition – for only a limited engagement, we hope – in honor of 2018, a frustrating year of extreme highs and lows, much of which investors spent on their tippy-toes in a neck-deep sea of uncertainty and volatility as far as the eye could see.

Investors' Xmas Gift Came Late (Tip: Save the Gift Receipt)



Instead of the usual "Santa Claus" rally that typically boosts stocks into year-end, investors got a lump of coal in 2018, as the S&P500 moved sharply lower in light holiday trading to within spitting distance of the symbolic -20% "bear market" level. Stocks rallied strongly into the final week of the year (and into January), though we suggest investors "save the gift receipt" on this rally for now, as market action thus far remains consistent with a snap back from deeply oversold conditions, and not yet an outright "all-clear" signal. Nonetheless, it should be noted that the deep, recent correction in stock prices has brought valuations on U.S. stocks down to attractive levels relative to their long-term historical average, setting the stage for more meaningful return expectations for stocks in the year to come.

As uncomfortable as last year may have been, however, we believe it has actually put us in an interesting position for the year ahead: as easy as it can be to lose sight of the positives when dark storm clouds have been looming large, it's important to be able to spot the silver linings as they begin to emerge. For example, although economic conditions are moderating, the global economic expansion remains in relatively good shape. Policy issues, though not going anywhere, appear to be coming up shy of the worst-case scenarios investors had begun to price in. Finally, risk assets have been put through the wringer over the past several months, in spite of which market fundamentals remain sound: equity valuations are now noticeably more attractive than they were just three months ago (let alone a year ago) and earnings growth expectations for the year ahead – though perhaps meager relative to 2018's stimulus-juiced levels – are still solidly positive. As a result, even though the economic and financial market backdrop remains characterized by late-cycle dynamics, our Investment Committee believes the stage has been set for reasonably favorable prospects for globally-diversified investors over the course of year ahead.

TOO MUCH, TOO SOON

The above statement could apply equally well to a number of different aspects of the recent economic and financial market landscape. Certainly, it does seem to capture the market's message to the Federal Reserve regarding its recent and – more to the point – projected pace of monetary tightening (more on this later). It also, however, sums up rather nicely our view of financial markets' reaction to the flow of economic data this past quarter – which has hinted at a slowdown – and the further evolution of the economy that investors seem to be discounting as almost inevitable over the next 12-24 months, which could perhaps best be described as mix of shock and awe along with more than a hint of impending doom thrown in for good measure.

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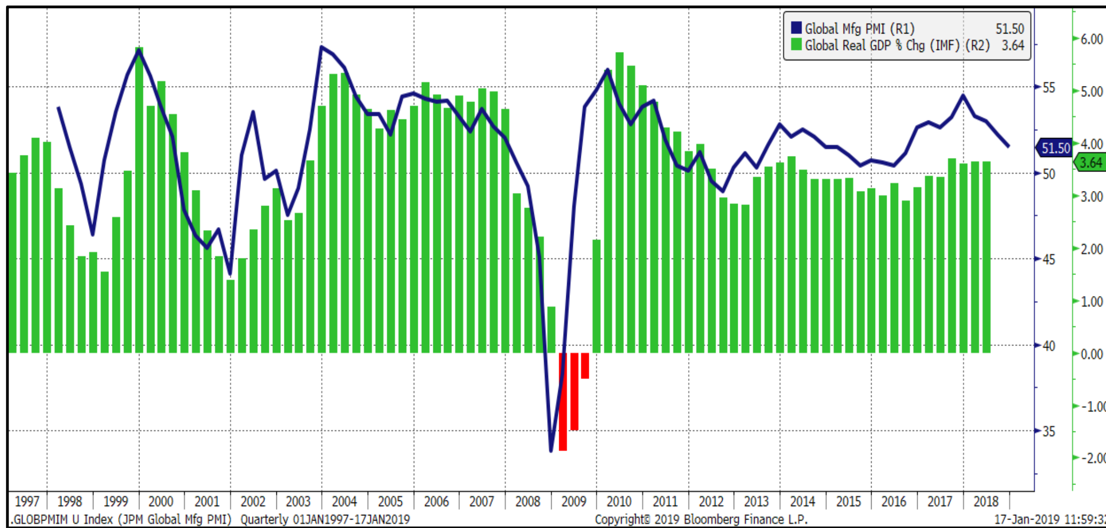
Pragmatically speaking, there really should be relatively little question left in the mind of the market at this stage that the trajectory of the US economy (and, by implication, the global economy as well) is towards slower growth over the next couple of years as the impact of recent fiscal stimulus fades (particularly as the political gridlock introduced by the outcome of the recent mid-term elections makes another fiscal "shot in the arm" considerably less likely). Such developments, however, do not have embedded within them any intrinsic requirement that the U.S. or global economies slip into recession, at least not in the short run. In fact, although we have long challenged the concept that the business cycle had been or ever could be repealed – making a recession literally inevitable at some point – we continue to believe the current expansion will endure and go on to become the longest U.S. economic expansion on record, a milestone it will achieve provided it makes it to summer of this year.

Thus, while we are, admittedly, late in the cycle and the probabilities of recession implicit in the economic data recently have risen, we view as more likely for now a "re-synchronization" of the paths of the primary global economies, with U.S. economic activity gradually tapering back towards the more subdued pace of growth that prevailed back in 2016 and 2017. Our Investment Committee currently sees U.S. GDP growth easing to +2.75% in 2019 – only a modest decline from the slightly more than 3% that will likely be recorded for 2018 as a whole once the final numbers are in (provided they actually manage to reopen the Federal government at some point!) – with some further slowing to unfold in 2020.

And Now Back to Our Regularly Scheduled Slowdown…

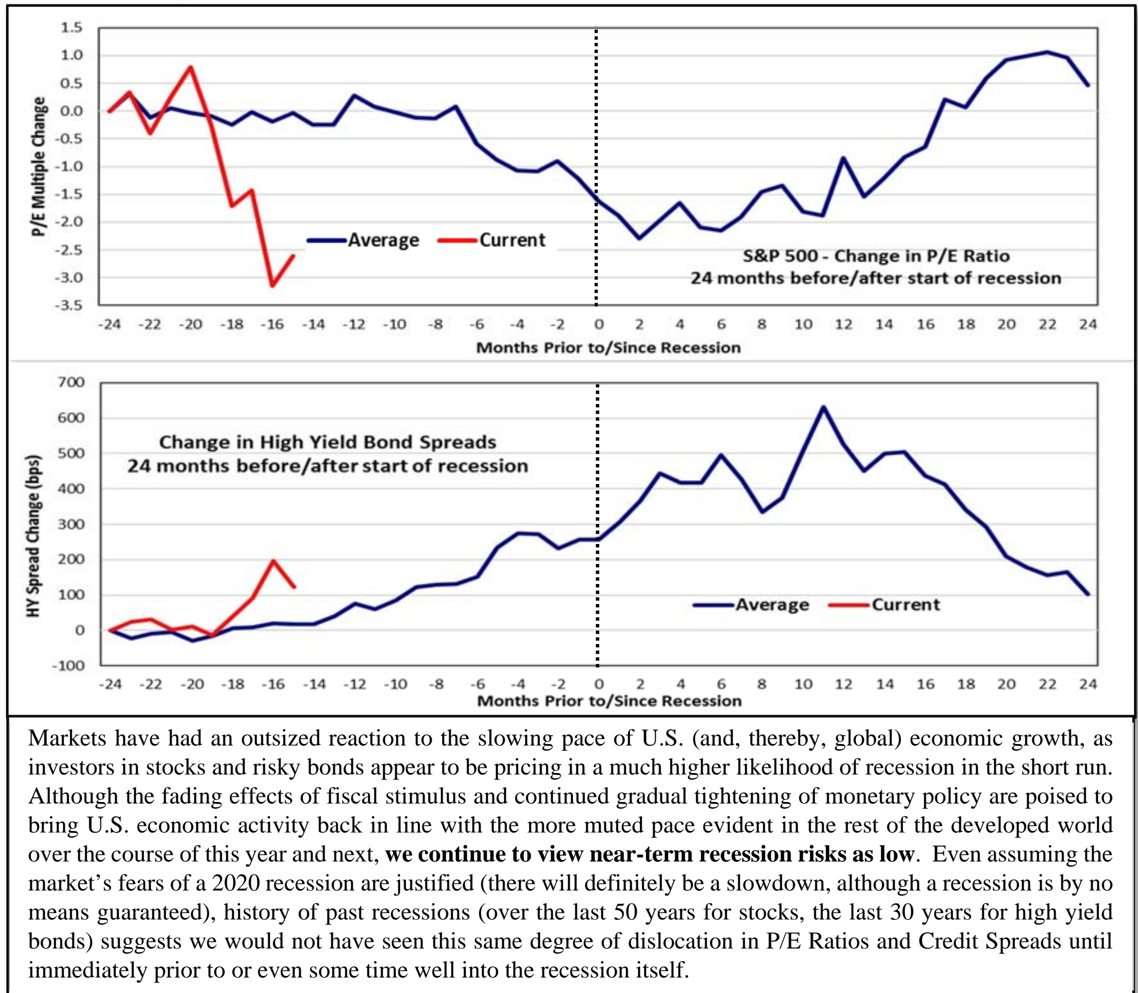


While the U.S. economy has seen greater positive momentum over the past 12-18 months, most other regions of the globe – while still in expansion – have been slowing over that time. As the effects of fiscal stimulus progressively fade over the next couple of years, the U.S. economy should "rejoin the fold," its pace of economic activity gradually easing to a level more in-line with that of the rest of the developed world. Overall, we expect this to translate to more subdued – but still positive – growth for the U.S. and global economies in 2019, with our Investment Committee looking for U.S. GDP growth to cool slightly to +2.75% this year. Meanwhile, the global economy should slow in tandem with the U.S. – its single largest constituent – although, based on historical relationships, it's worth noting that the most-recent global PMI reading of 51.5 still remains consistent with a rate of global GDP growth north of +3%.

This is not to say that there haven't been some red flags. Notably, the US Manufacturing PMI index (a leading indicator of the level of economic activity) posted a sharp decline in December; while it remains firmly in expansion territory at 54.1 (any reading above 50 is indicative of expansion in the economy, whereas below 50 denotes contraction), it fell from a relatively high reading of 59.3 in November, its biggest month-over-month drop since the 2008 crisis and its 11th biggest one-month fall in fifty years. Encountering such an unexpected "air pocket" in what recently had been a fairly smooth economic flight should, quite appropriately, cause us to pause for a moment to see if there is perhaps something more serious going on: based on historical data since WWII, a single-month drop of this magnitude has been consistent with a roughly 40% chance of being in a recession within a year (though it should be noted that based on the current level of the PMI – as opposed to its monthly change – the historical probability of recession within twelve months is only around 20%). It need not, however, be seen as an omen of doom and gloom for the stock market: even looking at the top 5% of largest monthly declines in the US Manufacturing PMI index over the past 50 years, the average annual return on the S&P 500 over the following 12 months was slightly more than +9% – i.e., not drastically different than the long-term average return for large-cap stocks over all periods.

One could certainly be forgiven for having inferred a much gloomier prognosis from investors' reaction, which was broadly reminiscent of the China-induced global recession scare that unfolded in late-2015/early-2016. Although there still seems to exist a broad consensus out there behind the idea that 2020 is the year of the U.S. economy's "date with

Investors Cry "Recession 2020!" But Then Act Like It's "Recession Next Week!"



Markets have had an outsized reaction to the slowing pace of U.S. (and, thereby, global) economic growth, as investors in stocks and risky bonds appear to be pricing in a much higher likelihood of recession in the short run. Although the fading effects of fiscal stimulus and continued gradual tightening of monetary policy are poised to bring U.S. economic activity back in line with the more muted pace evident in the rest of the developed world over the course of this year and next, **we continue to view near-term recession risks as low**. Even assuming the market's fears of a 2020 recession are justified (there will definitely be a slowdown, although a recession is by no means guaranteed), history of past recessions (over the last 50 years for stocks, the last 30 years for high yield bonds) suggests we would not have seen this same degree of dislocation in P/E Ratios and Credit Spreads until immediately prior to or even some time well into the recession itself.

destiny" (i.e., recession), judging by their aggressive de-risking of portfolios in December, investors seemed to believe they were already staring into the whites of the recession's eyes: the S&P 500 index, which had set a new all-time high just prior to the end of the 3rd quarter, saw a volatile Q4, culminating in the worst December in fifty years that left the bellwether benchmark for U.S. stocks within an inch of bear market territory by Christmas.

From such oversold conditions, stocks rallied sharply into the final week of the year – an advance that continues as we write – with the S&P posting a one-day gain of 5%, its biggest since bouncing off the post-Crisis market bottom in March of 2009. This was, nonetheless, insufficient to salvage the 4th quarter for stocks, which the S&P ended still down over -13%, or the year as a whole, over which the index recorded a loss of -4.4%. This disappointing recent market action appears to have made an impression, at least on investors if not on strategists: Wall Street has not exactly been tripping over itself to recommend investors pile into stocks at this point, but the consensus 2019 outlook for strategists tracked by Bloomberg still targets what looks like a fairly lofty level of 2,900 on the S&P 500. This dwarfs the consensus in many surveys of investors that show expectations clustered more in the high single-digit area, a level more consistent with our own view that looks for large-cap, U.S. stocks to return a little over 9%, or just slightly shy of their long-term average.

As unimpressive as large-cap stock performance might have been in 2018, it was actually the bright spot among U.S. equities, as the narrow breadth and defensive tone the market displayed – particularly over the second-half of the year – left small- and mid-cap stocks at a disadvantage, as made explicitly clear by the considerably wider losses posted by these market cap segments for both the quarter and full year. Although we do expect to see improved market breadth via broader participation among styles and sectors this year – as we have already begun to see – we think it likely that recent market action and continued late-cycle jitters may cause investors to continue to tilt defensively in 2019, thereby favoring the relative performance of large-cap stocks once again this year.

Our Investment Committee's outlook remains considerably more positive once we move outside of the U.S.: foreign equity markets have been trading at a discount to their U.S. counterparts for some time but after the wide divergence exhibited last year (although foreign stocks generally did better in Q4, their weakness earlier in the year left them down quite a bit more for 2018 as a whole) they now find themselves trading at their cheapest levels in several years and a

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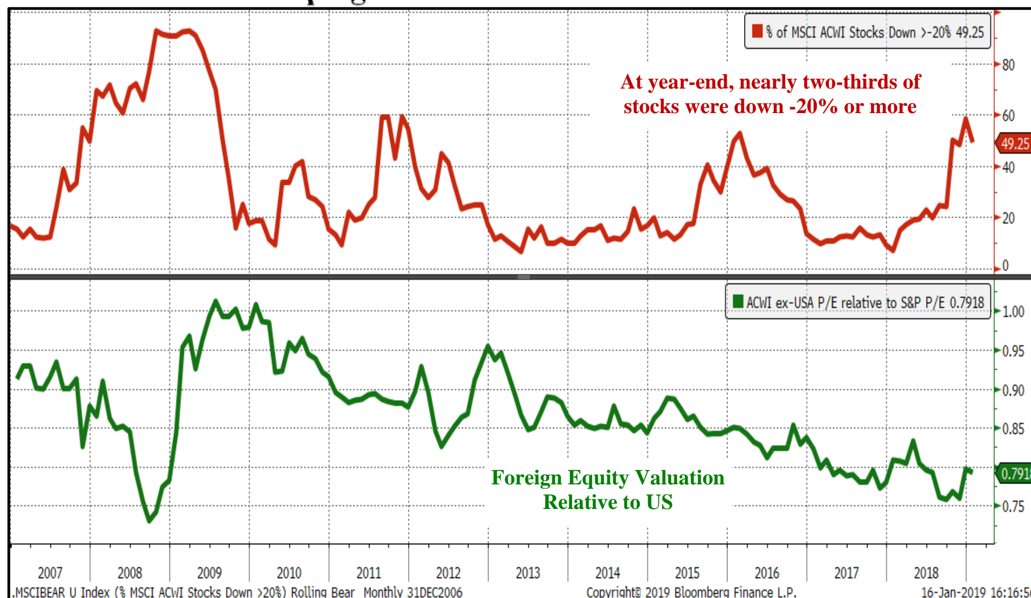
While You Were Sleeping…



The dramatic decline in the S&P 500 during the month of December made the headlines that finally gave investors their wake-up call but the index was really just playing catchup with the rest of the world. For much of 2018, strength in U.S. stocks masked damage being done elsewhere: **by the start of Q4, roughly half of all stocks globally were already down at least -20%.** Believing that opportunity can rarely be found following the crowd, we note that valuations on non-US equity markets – which had already been trading at a growing discount to the U.S. in recent years – now sit at their lowest levels in years and at fairly steep discount to the U.S.; particularly in light of our expectations for a weaker US Dollar this year (the strength of which in recent years has been a major headwind to U.S.-based investors in foreign equity) conditions appear conducive to a period of foreign equity outperformance.

fairly deep discount to the U.S. In reviewing the global equity market landscape, we note that even as U.S. stocks were doing relatively well earlier last year, much of the rest of the world's stock markets were already seeing bear market-like declines, leaving the foreign equity complex – non-US developed large- and small-cap, emerging, and frontier markets – looking better positioned to deliver outperformance in the year to come.

Turning to fixed income, we believe bond markets are likely to face somewhat more benign conditions this year than has recently been the case, as there are few clear catalysts that appear poised to drive interest rates materially higher near-term. Interest rates at the short end of the maturity spectrum should continue to rise gradually, as the Fed continues to tighten – albeit, we believe, at a more modest pace than previously indicated. Our Investment Committee is looking for 1-2 quarter-point hikes this year from a newly-chastened Fed that appears finally to be softening its tone in response to broad financial market weakness. It's worth noting that even this reduced pace of tightening is still quite a bit more than financial market's have priced in: in the immediate wake of December's disappointing PMI number, investors in the Fed Funds futures market had actually begun to price in the possibility of a rate cut in 2019, though they have since raised their outlook to predict no hikes in 2019 and a rate cut in 2020. Although markets have been at odds with the Fed's forecasted pace of rate hikes for some year now – quite correctly in 2015 and 2016, although much less so over the last couple of years – this seems overly dovish in our minds, barring a significant deterioration in economic conditions or material further tightening of financial conditions via equity market declines, a

Gut Check for the Fed or Reality Check for the Market?

The Powell Fed has been a lot more reluctant than its predecessors to step in to support financial markets by slowing its pace of rate hikes, determined to restock its monetary policy arsenal while under the cover of the recent fiscal stimulus. The message from the market has been clear, though: even if the economy can take it, the implied pace of policy tightening contained in Fed guidance is more than the market will bear. The Fed appears to be getting the message, having recently moderated its rhetoric to emphasize a patient approach. This newfound dovish tilt has gone a long way to reducing the market's angst over a potential policy error though it's important to note that investors may have overcorrected their rate hike expectations, which still look too low.

significant widening of credit spreads, and/or a meaningful further reduction in market liquidity. Nonetheless, we do believe there is little on the immediate horizon to force the Fed's hand into hiking more aggressively this year, given a context of gradually slower growth and inflation conditions that remain remarkably benign for the time being (the Fed's preferred Core PCE measure was up just 1.9% in the latest release, below the Fed's 2% target.) Not surprisingly, such an economic backdrop is supportive of what will likely be a reasonably uneventful year for rates at the intermediate- to long-end of the yield curve as well: our Committee looks for the yield on the 10-year US Treasury to rise back towards the 3% level over the course of the year, a relatively modest increase that is unlikely to give bond market investors outright grief, though it will eat through much of income portion of their returns, leaving them with expectations for only very meager performance this year. Such lackluster expectations for the fixed income complex overall leave in place our recent preference for cash and ultra-short bond positions, which continue to offer attractive risk-adjusted returns, given their relatively high quality, little to no interest rate risk, and yields that have become dramatically more competitive over the past 12-18 months.

A Bend in the Road, Not the End of the Road

Believe it or not, last year's loss for the S&P 500 was actually the first negative year for the broad U.S. stock market since the financial crisis; it certainly doesn't feel that way, the muscle memory of steep market declines in 2008 and early-2009 seeming to have hung over investors for most of the past decade. The ten years just behind us have been interesting times, certainly, often uneasy, occasionally angst-inducing; when it comes right down to it, though, they were actually pretty good for diversified investors (at least those who stuck to their game plan), providing balanced investors with returns in the high single-digits, slightly better than the long-term average and head-and-shoulders above what anyone was projecting for the decade ahead back when the dust of the financial crisis was still settling. Replicating such a showing over the coming ten years may be harder to do, given the lateness of the cycle and reduced return expectations for many asset classes, at least in the near-term; we are of a mind, nonetheless, that neither the longest bull market in history nor the soon-to-be (we believe) longest economic expansion in history are necessarily at the end of the road at this point. As such, we view the sharp market downdraft into year-end 2018 as having potentially created a value opportunity for investors willing to stomach the sporadically higher levels of volatility (which is really only moving back towards a more normal level) associated with an aging economic cycle and gradually tightening monetary policy.

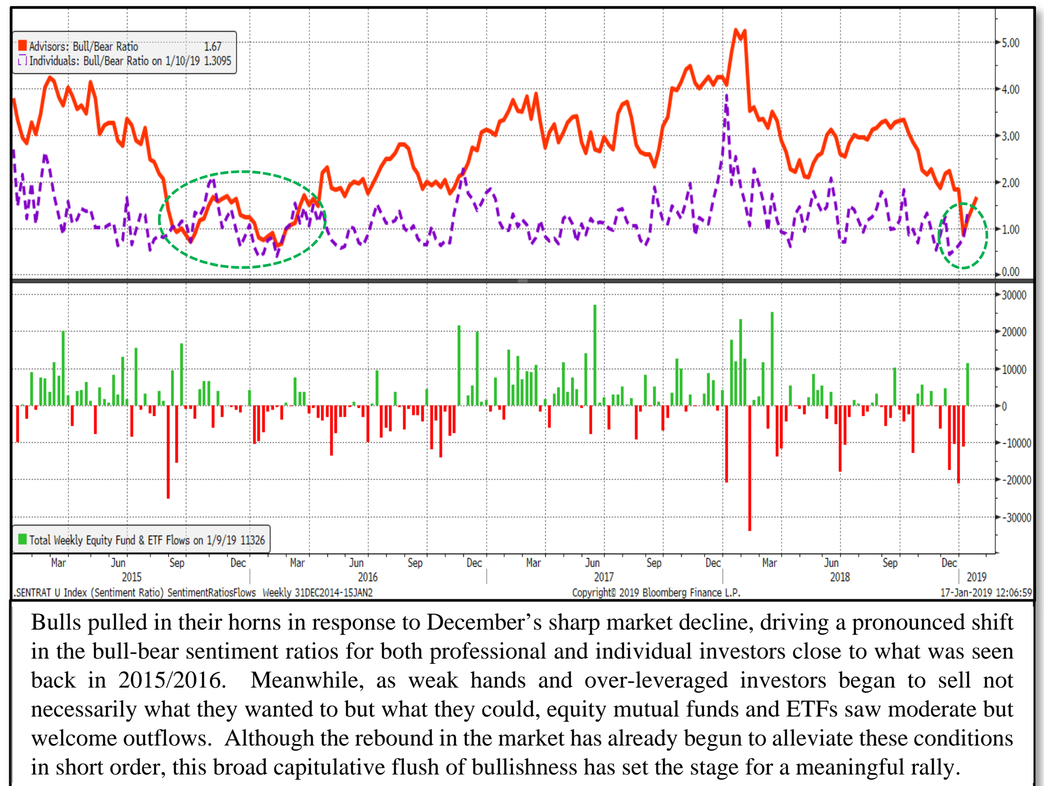
Having said that, this past quarter provided investors a clear reminder that the economy and the financial markets – while intricately linked – are not the same thing, as the spike in volatility and steep equity market downdraft seemed squarely at odds with the reasonably solid tone exhibited by the incoming economic data. In part, this reflects heightened concerns around several of the more prominent policy issues littering the landscape, although it is also indicative of the pronounced recent shift in investor focus from the economy's more immediate prospects towards what markets believe (or fear) is likely to unfold over the next 12-24 months. Certainly, many of the policy issues fueling investors' angst are very real; we believe, however, that conflicts like the US-China trade war and government shutdown in DC are likely to find at least interim resolutions before their impact becomes sufficient to derail the expansion (though perhaps not until it becomes too politically unpopular to continue dragging things out). The economy itself, however, remains in good shape: the pace of U.S. growth will indeed moderate over the coming couple of years as the fiscal boost progressively fades but a recession continues to look very unlikely this year and, we believe, is still far from a certainty in 2020. The pace of job creation remains strong (something that has helped to reassure markets lately) but unemployment, already below the "full employment" threshold, is likely to stabilize as more sidelined candidates rejoin the ranks of the workforce. This would seem to paint a relatively benign near-term picture of inflation as well, as it may allow wage growth to continue moving up only slowly, as would the recent decline in energy prices.

With regard to the market itself, we continue to see the fundamentals as sound; valuations recently have come down quite a bit and, while we do not think we are likely to see price-to-earnings ratios bid back up to the lofty levels seen this time last year, a move back towards long-term average levels seems likely as risk aversion recedes. Earnings, meanwhile, should continue to grow this year, albeit at a pace that – not surprisingly – will pale relative to the tax-cut induced "pop" seen in 2018. Finally, as many of you who have been following our recent commentary will know, we had been looking for a more pronounced deterioration in investor sentiment to allow for the establishment of a more definitive near-to-intermediate term low. With the collapse in bullish sentiment that unfolded very rapidly – if only briefly – at year-end,

it appears as though we may finally have satisfied such conditions in early January, setting the stage for the meaningful rally currently underway (although a bottoming process, with a possible retest of the lows, would not be surprising).

Overall, such conditions appear conducive to moderately positive performance for risk assets in 2019, even within the context of our expectations for continued uncertainty and volatility. We continue to encourage clients to retain the discipline and long-term perspective that has helped them navigate the past ten years as they negotiate the next ten as well. We 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.

The Silence of the Bulls



Bulls pulled in their horns in response to December's sharp market decline, driving a pronounced shift in the bull-bear sentiment ratios for both professional and individual investors close to what was seen back in 2015/2016. Meanwhile, as weak hands and over-leveraged investors began to sell not necessarily what they wanted to but what they could, equity mutual funds and ETFs saw moderate but welcome outflows. Although the rebound in the market has already begun to alleviate these conditions in short order, this broad capitulative flush of bullishness has set the stage for a meaningful rally.

4TH QUARTER 2018 CAPITAL MARKET PERFORMANCE

Index (as of 12/31/2018)[1]	1 Qtr	1 Year	3 Year	5 Year	10 Years
FTSE 3-month T-Bills	0.57%	1.86%	0.99%	0.60%	0.35%
Bloomberg Barclays Gov't/Credit Int.	1.65%	0.88%	1.70%	1.86%	2.90%
ICE BofAML US High Yield	-4.64%	-2.26%	7.22%	3.81%	10.89%
Bloomberg Barclays Multiverse	1.02%	-1.36%	2.99%	1.20%	2.77%
S&P 500	-13.52%	-4.38%	9.26%	8.49%	13.12%
Russell 1000 Value	-11.72%	-8.27%	6.95%	5.95%	11.18%
Russell 1000 Growth	-15.89%	-1.51%	11.15%	10.40%	15.29%
Russell Mid Cap	-15.37%	-9.06%	7.04%	6.26%	14.03%
Russell 2000	-20.20%	-11.01%	7.36%	4.41%	11.97%
Russell 2000 Value	-18.67%	-12.86%	7.37%	3.61%	10.40%
Russell 2000 Growth	-21.65%	-9.31%	7.24%	5.13%	13.52%
MSCI EAFE	-12.50%	-13.36%	3.38%	1.00%	6.81%
MSCI EAFE Small Cap	-16.02%	-17.58%	4.11%	3.42%	10.88%
MSCI Emerging Markets	-7.40%	-14.25%	9.65%	2.03%	8.39%
MSCI Frontier Markets	-4.32%	-16.20%	4.58%	1.05%	5.12%
Wilshire US REIT	-6.93%	-4.84%	2.06%	7.87%	12.19%
DJ Global Select RESI	-5.88%	-5.52%	2.40%	5.50%	10.98%
Bloomberg Commodity Index	-9.41%	-11.25%	0.30%	-8.80%	-3.78%
Credit Suisse Liquid Alts	-3.57%	-4.63%	1.58%	1.50%	3.87%
60-40 Balanced EQ/FI – US Only	-7.56%	-2.01%	6.35%	5.96%	9.17%
60-40 Balanced EQ/FI – Global	-7.04%	-4.89%	5.11%	3.78%	7.41%

[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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