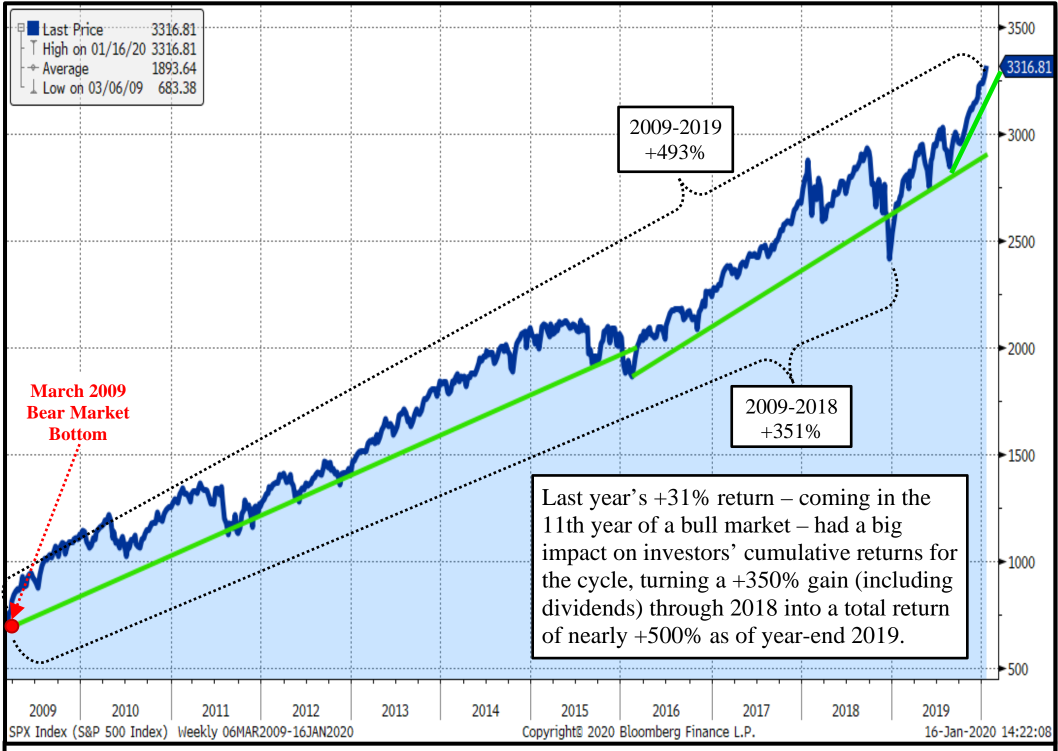
MARKET LETTER

PACIFIC PORTFOLIO CONSULTING, LLC

Fourth Quarter 2019

MARKETS ROAR INTO THE TWENTIES!!

Chart 1: Stocks Come In Like a Lion, Go Out Like an Even Bigger Lion



It may not have felt that way in real time, but – on the heels of the "lost decade" (the inauspicious sounding "Aughts") – the stock market just wrapped an extremely strong ten-year run, during which it returned an impressive (and well above-average) +13.5% per year. While not without hiccup, any volatility likely feels more vivid in our memories than it appears in the chart above, which clearly shows the benefits of relying on a long-term, disciplined strategy to ride out the inevitable short-term shakeouts. What is also clear, however, is just how quickly we have scaled to successive new heights in recent months, a pace that will not be sustained and which sets the stage for an eventual correction, one that – so long as our prediction of no near-term recession continues to hold – will likely turn out to be buying opportunities.

Laying out the blueprint for this quarter's commentary in late-December, the first thing I did was promise myself not to use one of those cheesy "20/20 Vision" puns that currently clutter the landscape of financial papers, magazines, and TV shows; sure, some things have gotten a bit clearer than they were but there's no shortage of issues out there still causing me to squint.

Not far behind this was a desire to steer clear of the now equally ubiquitous "Roaring Twenties" references. The market's setup has been too perfect, however, not to indulge ourselves just a little, given the sheer joy and enthusiasm with which investors closed out last year and have plunged into the current one.

The final quarter of 2019 saw heightened global tensions began to ease on several fronts, producing strong performance across risk assets of all variety. This also made for an impressive – if sporadically volatile – year for the markets overall, one that dwarfed even the most bullish expectations (including our own). Although there's certainly no law against the stock market having two great years back-to-back (it actually happens more often than most people think), for reasons we discuss herein, our Investment Committee's outlook for 2020 anticipates more modest returns from the markets over the coming year.

Nonetheless, as we often note, short-term expectations should not be allowed to wag the dog. Thus, stepping back one level, first to look at the decade just ended – one that began in the still-early days of the ongoing equity bull market – we note that investors in nearly all asset classes truly have been able to have their cake and eat it too, enjoying historically high levels of return alongside unusually low levels of volatility. Looking ahead, frankly, we're hard-pressed to identify the sorts of catalysts that might materialize to produce such a similar outcome over the coming ten years. Thus, the Twenties may, ultimately, not turn out to be quite as roaring for the markets as the Tens were; nonetheless, we continue to see meaningful opportunity in global markets going forward, although we would not necessarily look for it to manifest itself in the same asset classes, segments, styles, and sectors that have seen such remarkable gains in recent years, once again serving to reinforce our belief in the importance of staying diversified and sticking to a long-term plan.

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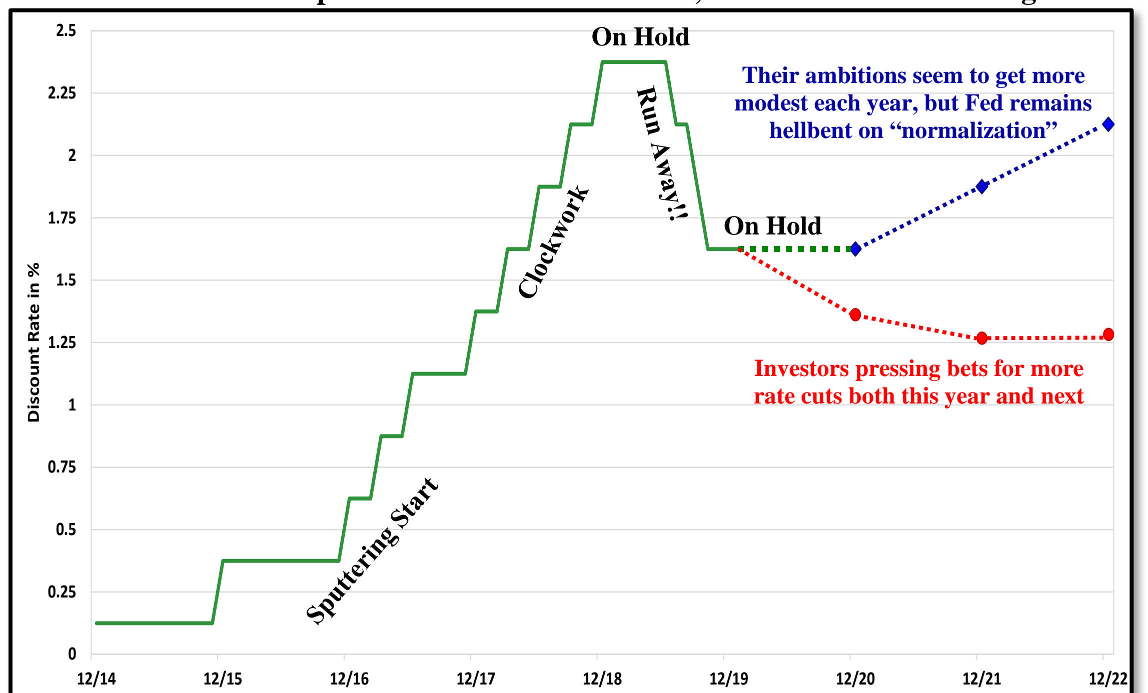
Welcome to the Good Place – Watch Out for Spoilers!

Don't worry – no plot spoilers here (we hate that as much as you do!). Rather, the spoilers we should be concerned with here are those that could potentially up-end the apple cart on the seemingly-idyllic conditions in which the U.S. economy currently appears to have nestled itself. This, at least, according to recent comments by Fed Chairman Jay Powell, though – for the time being – our Investment Committee is inclined to agree with him. U.S. GDP growth looks set to remain positive, if slow (we are looking for just north of 2% growth this year – lackluster, but more than enough to keep us out of recession) with a potential upturn in manufacturing in the offing. Global economic activity, meanwhile, continues to inflect from what we perceive as its recent trough following an extended slide and, we believe, will also see relative improvement vis-à-vis the U.S. Most importantly, in spite of such positive developments, inflation appears poised to remain well-contained.

Chart 2: Fed's Rate Expectations Remain Dauntless, but Market's Are Divergent



A whiplash-inducing policy reversal last year took the Federal Reserve from steady, quarter-point interest rate hikes to three rates cuts over the second half of 2019 as part of a massive "mid-cycle adjustment." The Fed hoped to provide some insurance against the possibility of the U.S. economy tipping into recession, the perceived risk of which had risen considerably in the face of escalating U.S.-China trade tensions. At this point, a couple of things seem likely: 1) the maneuver appears to have been "successful," in that investor concerns have receded, allowing markets to recover, and the probability of entering recession in the next 12 months has decreased; and 2) the Fed feels a lot better about the current economic scenario and, thus, is done cutting rates for the time being. By the same token, however, we see them in no hurry to resume rate hikes any time soon, a privileged position afforded them by the continued low risk of meaningful inflation.

Such conditions provide what our Committee sees as a relatively clear indication that – barring any serious shocks – the "mid-cycle adjustment" to short-term interest rates is complete and the Fed will likely be on hold throughout 2020. With the economy in a so-called "good place" and financial markets happy, there is no real incentive for an already-reluctant Fed to cut rates any further at this time. Meanwhile, in the absence of any credible inflation threat, there is little to light a rate hike fire under a Fed wary both of roiling markets and of appearing political by acting ahead of the Presidential election in November.

While a Federal Reserve pledging to sit on its hands helps provide some welcome clarity on the monetary policy front, the level of policy and – increasingly – geopolitical uncertainty in the system remains considerable. Tensions around trade – an issue investors back-burnered fairly quickly at the mere announcement of an initial, limited resolution – look less likely to flare in the near-term, given neither side really seems to have much to gain by pressing their position right now. Nonetheless, this has proven time and again to be a volatile policy issue for the current administration, leaving open the threat of another late-night tweetstorm that pulls the rug out from under us. Meanwhile, those issues that will be demanding the attention of the Trump administration for the time being – most notably, the ongoing impeachment proceeding and the upcoming Presidential election – bring their own risks to the table. While the impeachment hearings tend to make for good headlines, it's not clear that all that much will have changed when the dust finally settles. The election, however, looks for now to have greater likelihood of moving the needle and is increasingly being flagged as a top concern among investors. Setting all politics aside, Trump's reelection would be expected to be broadly market-positive, given his administration's bias towards deregulation and business-friendly policy as well as the comfort provided

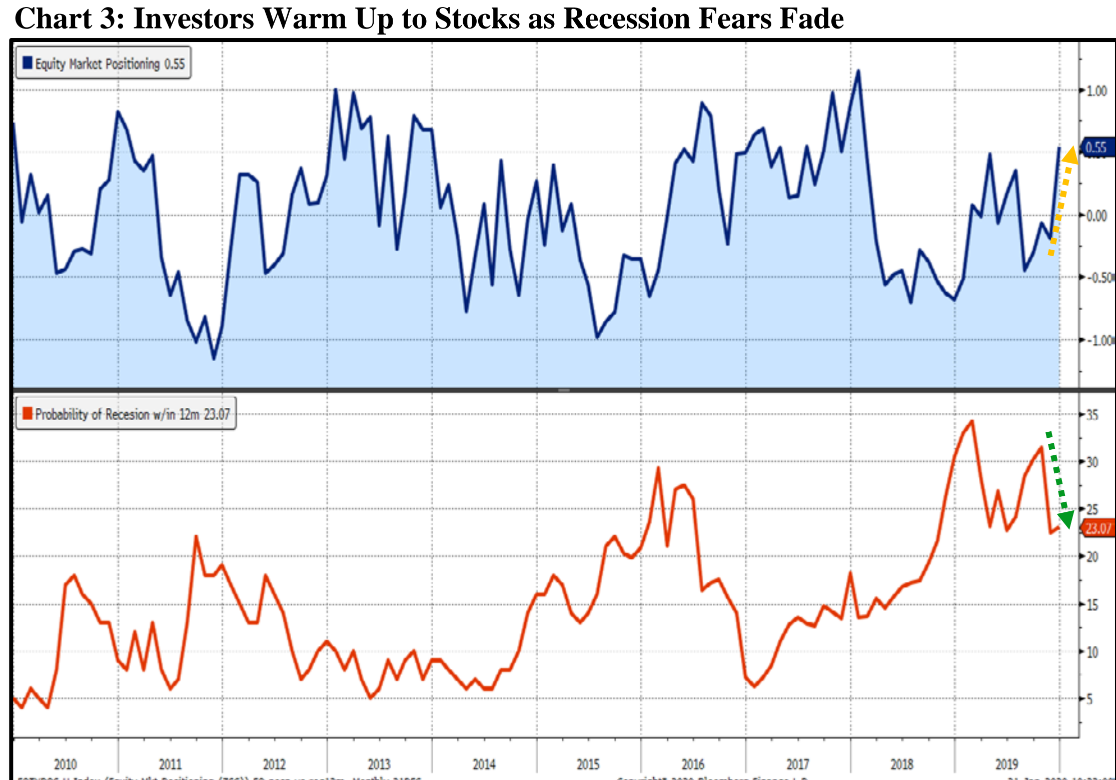
by the continuity of a known entity. At the other end of the spectrum, meanwhile, the possibility of one of the more progressive candidates on the left taking up residency in the Oval Office is giving pause to some market participants, who see in that the risk of higher regulation stifling economic activity and higher taxes – including a possible roll-back of the 2017 corporate tax cuts – taking a big chunk out of profits. While the primaries will progressively address the uncertainty around who the players will be, the outcome itself remains relatively binary, given the market's perceived level of risk will either fall or rise drastically depending on which candidate is ultimately chosen to head the Democratic ticket.

The potential for drama also exists outside the United States: as noted above, geopolitics is increasingly threatening to take over the limelight. While tensions with Iran were quick to subside – temporarily – following the escalation of hostilities in late December and, in particular, early January, nothing is actually resolved nor is it likely to be any time soon. As Iran backs away from the hard-won 2015 deal to limit its nuclear weapon ambitions, meanwhile, the prospect of an escalated, global standoff appears to be on the rise. Beyond the possible loss of life such a conflict could entail, some entirely plausible economic and financial side-effects include lower interest rates and a higher US Dollar, as investors seek safe havens, as well as a slower global economy, as oil prices spike and rising uncertainty dents consumer and business spending. Thus, even as we continue to see gradual progress on some fronts, policy-driven uncertainty – and, with it, the likelihood of sporadic spikes in market volatility – is likely to remain elevated for the time being.

"It's Gettin' Hot in Herre"

Seriously, is it hot in here, or is it me? Modesty, naturally, precludes opining on the latter issue, though with respect to the former – i.e., a recent rise in the temperature of the stock market – we believe there is little to debate, as we evaluate recent trends in investor sentiment surveys as well as our own measure of investor positioning, which incorporates such factors as net exposures in the futures and options markets, hedge fund positioning, and stock and bond fund flows, all of which point to a recent – and not entirely unenthusiastic – recovery in investors' attitude towards the stock market.

Chart 3: Investors Warm Up to Stocks as Recession Fears Fade



Investors have exhibited a fairly itchy trigger finger over the past couple of years, hitting the "Sell" button first and asking questions later, reflecting a deep mistrust of this, the most thoroughly disrespected bull market of all time. The most common catalyst has been a rise in the perceived level of recession risk, consistent with the fact that, historically, the worst bear markets have tended to occur in recessionary periods. No surprise, therefore, that as U.S. economic data continued to soften in 3Q19 and recession fears increased (although recession probabilities also increased, they remained relatively low nevertheless), investors were quick to pull in their horns and shed stock market exposure. As such fears subsided into year-end, they were quick to plow back in, with measures of investor sentiment and exposure to the stock market moving up strongly as stocks moved to successive new highs throughout the quarter. Sentiment does not yet appear ebullient nor does positioning appear stretched, but there's no question that a lot of "dry powder" has been put to work over the last 3-4 months, raising the risk of a correction in the near-term and implying we will likely need additional positive developments – either on the growth, earnings, or policy front – to draw into stocks the additional capital needed to sustain the advance.

It really shouldn't come as a surprise that robust market gains and a streak of successive all-time highs, such as those we have seen in recent months, tend to work absolute wonders for investor sentiment. Thus, from the much more subdued levels observed when recession fears spiked

yet again in 3Q19, measures of investor sentiment rose meaningfully throughout the final quarter of the year. Professional investment advisors – who came into 2019 pretty squarely in the bearish camp – now count more than three times as many bulls as bears. Don't get me wrong: this is well shy of the eyepopping 5-to-1 ratio the measure hit in late-2017 but it is, nonetheless, still a full standard deviation above its long-term average level.

Individual investors, meanwhile, are also feeling reasonably bullish these days, although they have cooled their jets somewhat relative to year-end; in this arena, the ratio of bulls to bears is only 1.5-to-1, down from 2-to-1 in December and only modestly above average for the past decade. Portfolio positioning to stocks moved up substantially in the final months of 2019, however, and has continued into the current year: while investors' portfolios had gotten fairly "light" on stocks as recession fears sparked a sharp market decline in Q3 (see Chart 3, prior page), they have jumped right back into risk assets with both feet. This is not necessarily elevated – certainly, we are nowhere near the heights reached in late-2017 – but it does require us to take out of our forward expectations the natural "buoyancy" stocks receive as investors reposition into risk assets following a flight to safety. Valuations don't look stretched to us either, though – even with the better earnings growth we expect to see this year relative to last – stocks are by no means cheap, limiting the degree of further multiple expansion we can reasonably expect to see this year (although we should see some as/if uncertainty continues to recede).

So, what might any of this mean, anyway? Well, it could mean a couple of different things, depending on your time frame. From a short-term perspective – say, a couple of weeks to a couple of months (a window that, it should be emphasized, should generally be characterized as "noise" by the disciplined investor) – the market might be vulnerable to a correction. This, however, really isn't anything either surprising (since 1980, the market has seen an intra-year decline of 5% or more in 90% of calendar year periods, with an average intra-year drawdown of -12.7%; even if we limit ourselves to only look at bull markets, the average annual drawdown would still be -10% year!) or alarming. As unpleasant as they are, corrections clearly are very common and, ultimately, healthy and really should not be allowed to come anywhere close to derailing a well-founded long-term investment plan. If anything, so long as recession remains at bay (which we believe it does for now), such corrections are more likely than not to turn out to be reasonably good entry points (although you will only be able to know that for sure in hindsight).

Taking a somewhat longer-term perspective, it's possible that impressive recent gains have borrowed against future returns; certainly, there has been no shortage of people insisting that returns going forward will necessary be below average as a result of just how good things have been (in the interest of full disclosure, however, it's worth noting that such predictions have been extremely common over the past ten years as well, made at levels that would have left quite a bit of money on the table if heeded). Nonetheless, as noted at various points herein, most asset markets currently look fully valued to us, while others – i.e., bonds – actually look fairly rich; meanwhile, our expectations for economic and profit growth remain moderate, as do our hopes for much more multiple expansion. This leaves our Investment Committee predicting considerably more modest performance in 2020 than was the case last year, as we look for stocks to return +8% (relative to 2019's +31.5%). This is not to say that a repeat of last year's performance is impossible – as noted earlier, back-to-back good years happen more often than people think (or are willing to believe). In fact, since 1926 there have been 34 years (excluding last year) in which the S&P500 delivered returns in excess of 20%; two-thirds of the time, the market's return was positive the following year and in a full one-third of the cases it saw a second consecutive year of 20%+ performance (nay-sayers need only consider the five-year streak in the mid-to-late 1990s!). Nonetheless, in the 11th year of a bull market, the S&P having already notched nearly 500% cumulative gains under its belt, and little in the way of obvious catalyst, an encore of this caliber strikes us as unlikely, at least within the large-cap U.S. stock segment that has been the market's darling for several years now. In fact, a rotation towards some of those areas of the market that have been largely neglected for so long may offer the best hope for investors looking to sustain the performance of their portfolios for the time being.

AND NOW FOR SOMETHING COMPLETELY DIFFERENT…

Unlike the Spanish Inquisition (which, for some reason, no one ever seems to expect), many investors – ourselves included – have been expecting to see such a rotation for some time now. Not just a tilt, but a big, beautiful, "Great Rotation" from growth stocks to value stocks, from large- to small-cap, and – especially – from U.S. to foreign stocks (not to even mention from bonds to stocks, but that's another story, as investors' inexplicable and precarious love affair with bonds continues!). To put it mildly, such a rotation seems entirely overdue; for a number of reasons, though, we have had only fits, starts, and spurts of rotation, just enough of a hint at mean reversion to get investors' hopes up, yet – in the end – nothing sustainable and, certainly, nothing on a scale worthy of superlatives. Despite these many false starts, however, a number of our current views would seem to align rather nicely with the potential for some rotation into these disaffected market

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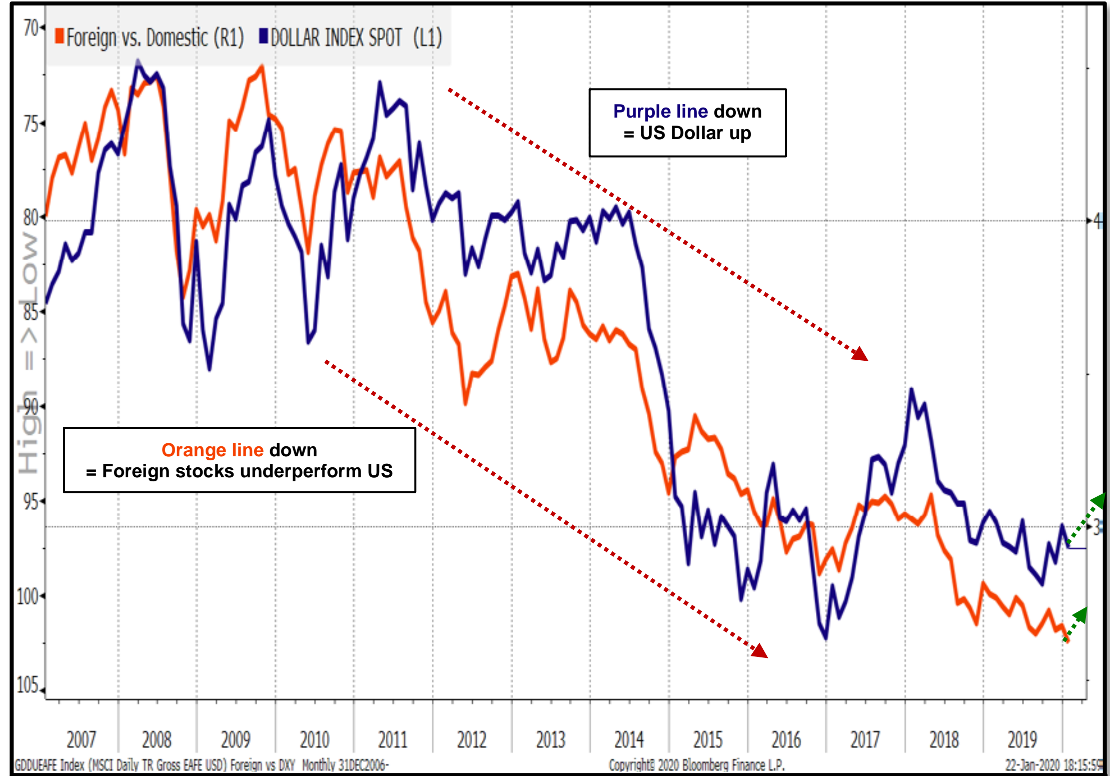
segments in the near-term. Specifically, the reacceleration of the global economy (particularly its improvement relative to the U.S.) and the accompanying steepening of the yield curve and potential for U.S. Dollar weakness are all factors that have, historically, been associated with the outperformance of more cyclical, small-cap, value, and foreign stocks over the large-cap, US, growth stocks that have been so heavily favored by investors for some time now. Taken in combination with the considerably more attractive valuations that can be found in these areas, our Investment Committee continues to view non-US equity markets – and, particularly, the lesser-developed markets – as holding the richest opportunity set for the coming year (and for the next several years, in fact). We continue to position our portfolios to take advantage of these perceived opportunities, employing – consistent with our overall philosophy and process – a patient, diversified portfolio approach allocated broadly across global capital markets. Given our long-term, risk-conscious mindset, our strategies are designed to include not only the current "hot dots" but also more out-of-favor asset classes and styles, such as those noted above, and to rebalance back towards long-term targets, both as a means of controlling risk but also of imposing the discipline we view as critical to the growth and preservation of wealth over the long run. All the more so this year, as uncertainty and the potential for periodic volatility spikes remain elevated. 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 our economic or market outlook.

Chart 4: Investors in Foreign Stocks Would Settle for a "Mediocre Rotation"



The strength of the US Dollar has been but one – albeit, a considerable one – of the headwinds working against foreign equity investments in recent years. As the strength of the global economy improves relative to that of the U.S. over the coming year, the Dollar weakness we expect appears to set the stage for some outperformance by foreign stocks in 2020. Meanwhile, the gradual improvement in the U.S. economy and modest steepening of the yield curve should also help support the relative performance of out-of-favor segments like small-cap, and value stocks in addition to foreign equities.

4TH QUARTER 2019 CAPITAL MARKET PERFORMANCE

Index (as of 12/31/2019)[1]	1 Qtr	1 Year	3 Year	5 Year	10 Years
FTSE 3-month T-Bills	0.46%	2.25%	1.65%	1.05%	0.56%
Bloomberg Barclays Gov't/Credit Int.	0.37%	6.80%	3.24%	2.57%	3.05%
ICE BofAML US High Yield	2.59%	14.40%	6.32%	6.12%	7.49%
Bloomberg Barclays Multiverse	0.64%	7.13%	4.40%	2.51%	2.68%
S&P 500	9.07%	31.49%	15.27%	11.70%	13.56%
Russell 1000 Value	7.41%	26.54%	9.68%	8.29%	11.80%
Russell 1000 Growth	10.62%	36.39%	20.49%	14.63%	15.22%
Russell Mid Cap	7.06%	30.54%	12.06%	9.33%	13.19%
Russell 2000	9.94%	25.52%	8.59%	8.23%	11.83%
Russell 2000 Value	8.49%	22.39%	4.77%	6.99%	10.56%
Russell 2000 Growth	11.39%	28.48%	12.49%	9.34%	13.01%
MSCI EAFE	8.21%	22.66%	10.11%	6.18%	6.00%
MSCI EAFE Small Cap	11.56%	25.47%	11.35%	9.25%	9.12%
MSCI Emerging Markets	11.93%	18.90%	11.99%	6.01%	4.04%
MSCI Frontier Markets	6.64%	18.34%	9.48%	3.07%	5.72%
Wilshire US REIT	-1.14%	25.76%	7.63%	6.87%	11.94%
DJ Global Select RESI	1.47%	22.29%	7.84%	5.93%	9.82%
Bloomberg Commodity Index	4.42%	7.69%	-0.94%	-3.92%	-4.73%
Credit Suisse Liquid Alts	2.11%	8.05%	2.54%	2.36%	3.38%
60-40 Balanced EQ/FI – US Only	5.54%	21.30%	10.52%	8.17%	9.47%
60-40 Balanced EQ/FI – Global	5.53%	18.94%	9.21%	6.58%	7.04%

[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.