MARKET LETTER

PACIFIC PORTFOLIO CONSULTING, LLC

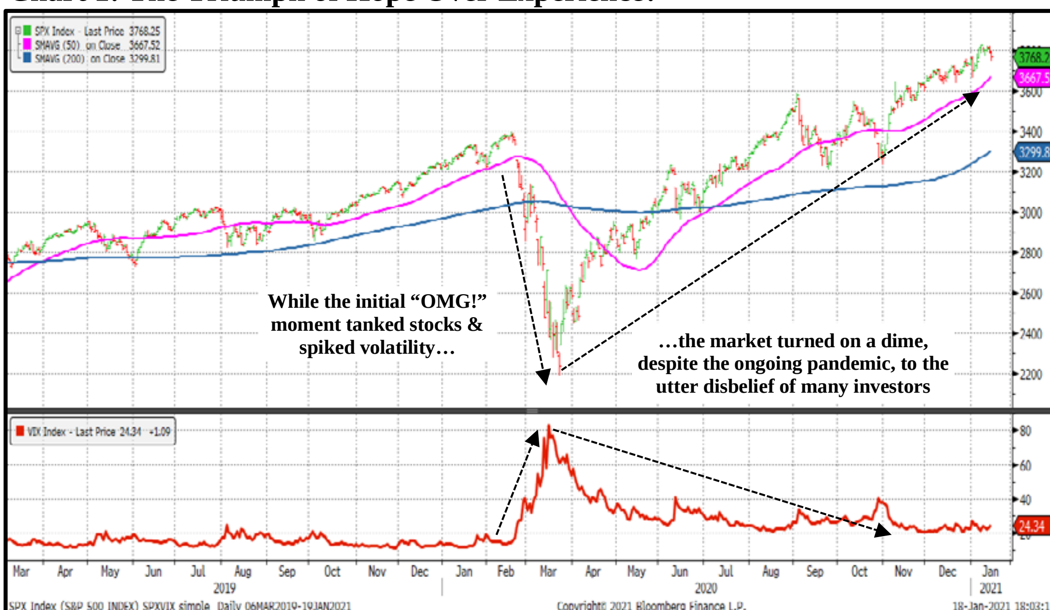
Fourth Quarter 2020

KEEP CALM AND RALLY ON!

You'd be right to suspect that – as usual – a very different working title originally was queued up to open this quarter's piece. Truth is, my first impulse was to go with a rousing chorus of Life of Brian's "Always Look on the Bright Side of Life," as I could imagine no more fitting salute to 2020's swirl around the toil…I mean "dustbin"…of history (at least not one fit for polite company) than a proper Pythonesque satirical skewering! And yet, I could hear this little voice inside my head – the one I usually don't listen to – telling me that it's too soon; people aren't ready to laugh about this yet. Which is a shame, really, because one aspect of writing the commentary that I genuinely look forward to each quarter is the opportunity to throw in a healthy dose of good-natured but (if I am successful) bluntly irreverent irony, innuendo, and general cheekiness. The harsh reality is, however, that people are still getting sick, people are still dying, and over 10 million people remain unemployed (in an ironic twist, roughly the same number of people the U.S. had managed to get vaccinated as I finished writing this sentence!). There is nothing funny about any of this.

There is another side to this coin, however – even though both sides are "Heads," mind you – telling me that there may be more to this than simply trying to be sensitive enough not to kick people while they're down. Could it, quite literally, still be too soon to let down our guards, breathe a sigh of relief, and enjoy a good laugh? Here we are a few weeks into the new year and, as a wise man once said (quite recently, in fact), "people are still getting sick, people are still dying, and over 10 million people remain unemployed." When you add to that an alarmingly slow pace of vaccination and violent riots inside our halls of government, it looks as though 2021 means to give 2020 a run for its money!

Chart 1: The Triumph of Hope Over Experience?



Let's be honest: if every investor had to go back and do a post-mortem on their picks for last year, I think it's safe to say that not many would have made it to the final four. There's no shame in that (as long as a short-term view was not allowed to disrupt a long-term investment plan): 2020 truly was a "bracket buster" of a year! Few investors appreciated the magnitude of the COVID freight train as it was first barreling towards global economies and financial markets – bringing an end to the longest economic expansion and bull market in history – and few realized just how much Wall Street's collective wisdom and lore would point many people squarely in the wrong direction – towards caution, fear, and mistrust – during the blistering, V-shaped market recovery that followed. While the Teflon-coated advance in stocks has led cynics to speculate that we were witnessing the triumph of hope – for a vaccine, for more stimulus, or just for higher prices – over experience, perhaps a more useful perspective is to see this as the triumph of a specific type of experience, one that has taught prudent investors the importance of discipline, of staying smart rather than trying to get clever, helping these investors ride out the whipsaws and stay in the game.

You'd be sorely mistaken, however, to extrapolate on this fairly dire backdrop to assume the market must be in shambles by now, that 2020 could not have been anything short of an utter catastrophe for stocks – as COVID-related shutdowns triggered the first recession and bear market since the Great Financial Crisis – and that stocks must be down "YUGE!" right out of the gate this year, too. Indeed, much as you could be forgiven for thinking that markets were doing literally anything right now other than simply shrugging off bad news to trace out a series of new all-time highs, you would nonetheless be deeply in the wrong.

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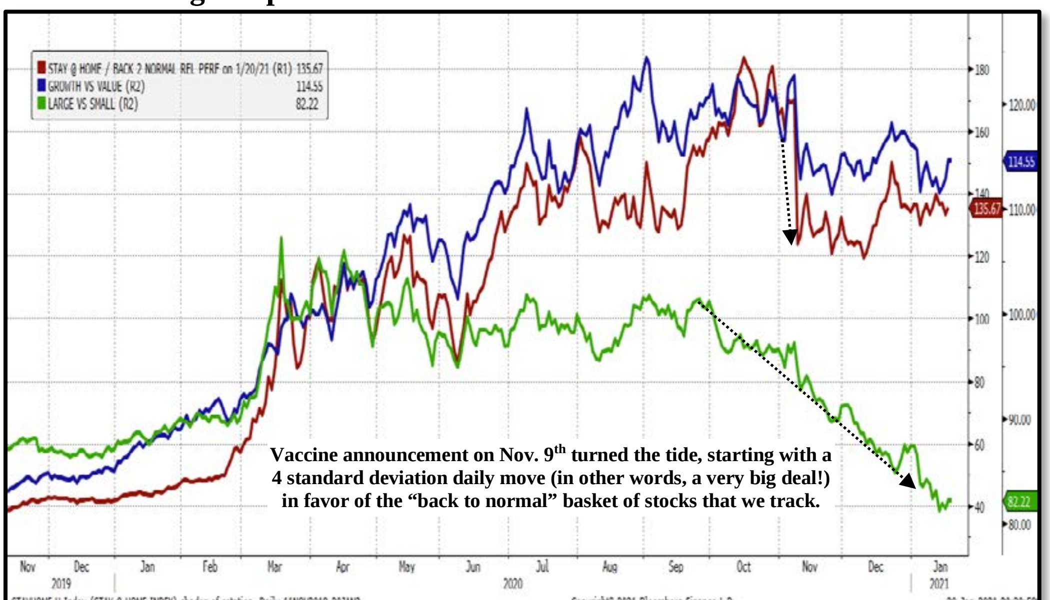
"How can this be?!" you might be asking yourself. Is it possible that investors are, in fact, looking on the bright side of life? Well, we certainly know that they don't *always* do so, but it does appear as though positive sentiment currently is having some impact (more on this later) on the market's ability to "keep calm and rally on". Nonetheless, we believe the far more powerful driver at work here is likely the market's "look-ahead steering," which currently seems to be focused on many of the positive forces we see bearing on the U.S. and global economies, corporate profits, and financial markets.

In fact, rather than getting locked in a cage match with 2020 over which one is more deserving of the title of "Craziest Year Ever!", our Investment Committee actually believes that as 2021 unfolds, it will exhibit a growing divergence from last year, as vaccination gradually brings the concept of "normalcy" closer to a reality once again, broader sections of the economy are able to continue (or, at least, begin) to heal, and a steady flow of massive monetary and, increasingly, fiscal stimulus around the world sets a relatively solid footing under risk assets. Bearing in mind that, in finance as in life, things don't always go exactly as planned (certainly 2020 had more than its fair share of surprises), we go into this knowing that 2021 may not necessarily "play nice" and stick to the plan. Thus, we have no doubt there will be surprises, there will be volatility, there will be corrections; our Committee believes, however, that there will also be reasonably fertile fields of opportunity for those investors with the discipline to stick to their game plan.

WHEN A CHRISTMAS CAROL MEETS LEWIS CARROLL

"So, this is Christmas;" well, you sure could have fooled me! I don't know about you, but "Do They Know It's Christmas?" really took on a whole new meaning for me this past holiday season under the eerie pall of the ongoing pandemic. Families were separated, age-old traditions upended; even holiday spending suffered a fair-sized ding, despite the ever-greater migration to online shopping! Somehow, the market managed to keep its head up, although it wasn't entirely immune (no pun intended) to this discomfort: year-end – typically a fairly joyous time for stocks (Santa Claus rallies and all) – came and went with more of a fizzle than a bang. Still, there were few obvious signs of any outright battle for investors' souls, of the tug of war going on between the fear of worsening COVID infections, hospitalizations, and deaths – and, thus, also the threat of a renewed shutdown – on one side versus the hope of a vaccine "just around the corner" on the other.

Chart 2: "Large-Cap Growth?? That's SO 2020!"



We've been getting this a lot lately; you probably have, too. In a sense, there is some truth to it: last year *was*, indeed, the year for large-cap, it was the year for growth investing. It was the year for U.S. stocks over the rest of the world. We tilted our strategies towards all of these in 2020 and enjoyed a nice tailwind for most of the year as a result. And, yes, as the chart above clearly shows, there has been rotation on several fronts, from "COVID-friendly" work-from-home stocks towards "vaccine-friendly" travel and leisure stocks, from growth towards value, from large-cap towards small, to name the more prominent ones. Based on our outlook, which is for broader vaccination, strong economic growth, and a big rebound in corporate earnings, we think this rotation in leadership "has legs," as they like to say on Wall Street, and we have begun to adjust portfolios accordingly; if anything, however, our Committee believes that we are likely to see a much more balanced year than was the case in 2020, in which areas like small-cap and value do "better," but last year's leaders continue to do very well nonetheless.

Thus, although the scenery often felt Dickensian, it played more like Alice in Wonderland in financial markets. Each day, the toll of the pandemic crept higher…and so did the market. Every week, this or that piece of economic data seemed to hint at stalling …but not so the market. It seemed that bad news was good news ("Weak economic data? That means more stimulus! Buy!"), good news was good news ("Good economic data? That means the economy is on the mend! Buy!"), and no news was good news

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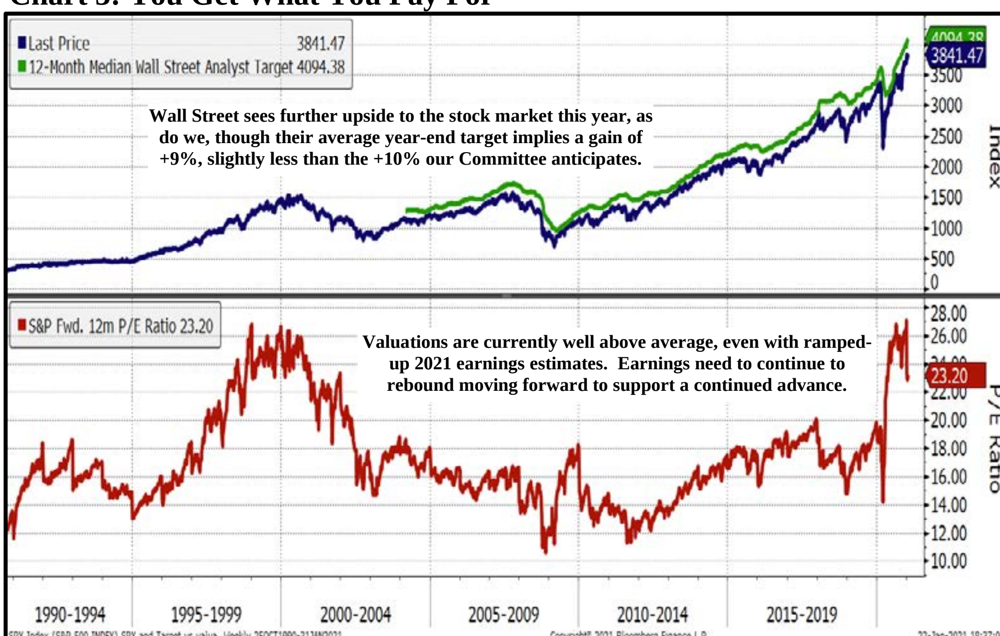
("uuuh…buy? Buy! Just BUY!!"). It seemed as though nothing could faze this market.

Of course, Christmas did come a bit early this year, brought to us "courtesy of the good people at Pfizer," whose November 9th vaccine announcement appeared to mark a fairly significant turning point for the market on several fronts. As a result, the final month of the year could not help but seem somewhat muted by comparison; nonetheless, the market still saw solid performance, the S&P 500's +3.8% monthly return placing it just inside the top quartile of all Decembers since the 1930s. Now, you tack onto that November's +11% return and – even with October's "The sky is falling – no, really, I mean it this time!" pullback – suddenly you're talking about real money. In fact, the S&P's fourth quarter showing of just north of +12% put it in the top 10% of all calendar quarters in the past 100 years. But wait…there's more! You then also have to take into account the +20% gain we saw in Q2 as the market scorched higher from the bear market lows and the +9% – ONLY +9%, mind you! – we gained in Q3 and you end up with a more-than-respectable +18.40% total return for the whole of 2020 (well above-average, even if it does pale by comparison to 2019's +31.5%)! So, about those 2020 brackets…

That's the S&P, though, and who wants to talk about that anymore anyway? I can hear you asking, "Why do you keep devoting space to talking about large-cap U.S. stocks when there are so many more interesting segments of the market to talk about?" Small-cap stocks, value stocks, foreign stocks – that's what's hip these days, right? Well, yes and no. Certainly, it is true that *last* year was a year for large-cap domestic stocks and our bias towards this segment of the market served our strategies very well: in the aftermath of the abrupt – if brief – bear market and amid the ongoing uncertainty surrounding any eventual resolution to the COVID pandemic (and how much havoc it would have wreaked on the global economy by that time), investors had relatively few choices. What was a safety and income investor to do? Interest rates were back at zero (again!), making for decent (i.e., mid-single digit) backward looking returns for bonds but setting the stage for utterly anemic fixed income performance on a go-forward basis. Welcome back to T.I.N.A. conditions (which, as a reminder, stands for "There Is No Alternative"): stocks were the only game in town to offer any sort of return. Even traditional equity investors, however, did not want to stick their necks out terribly far; given massive uncertainty and little prospect for meaningful economic growth for some time – you know, the kind of robust growth that could have kick-started a rally in cyclical names – they played it "safe" and stuck to the companies that were making their own growth in the most liquid and stable market they could find – the U.S. stock market.

Chart 3: You Get What You Pay For



Nothing comes cheap, certainly not the current stock market. Although we are not at extreme levels of valuation, the massive rally in the market alongside the sharp decline in corporate earnings stemming from the pandemic-induced recession certainly has left the market on the pricier side, at least temporarily. As economic growth improves and corporate earnings continue to rebound, Price/Earnings multiples should continue to move back towards more "normal" levels. In this respect, 2021 is set up to be a very different year from both 2020 and even 2019, when it was multiple expansion that drove stock market gains, whereas it should be strong improvements in the earnings themselves that serve as the primary driver of the additional upside that we see for stocks this year.

It seems that the times they are a-changin', however. Growth is on the rebound (our Investment Committee is looking for around +4.5% U.S. GDP growth this year), life is expected to return to somewhat more normal conditions at some point this year (benefitting many of the more depressed names in areas like travel, leisure, energy, etc.), and global monetary and fiscal policy continue to run at full throttle. An up-tick in growth combined with cheap credit and lots of liquidity chasing assets sets the stage, we believe, for a reasonably positive year for return-seeking assets (i.e., mostly stocks of all flavors), although our Committee's +10% consensus outlook for the S&P may seem underwhelming compared to the past couple of years; we are not expecting a bear market this year, however, so that should at least give investors a relatively smoother ride than was the case in 2020.

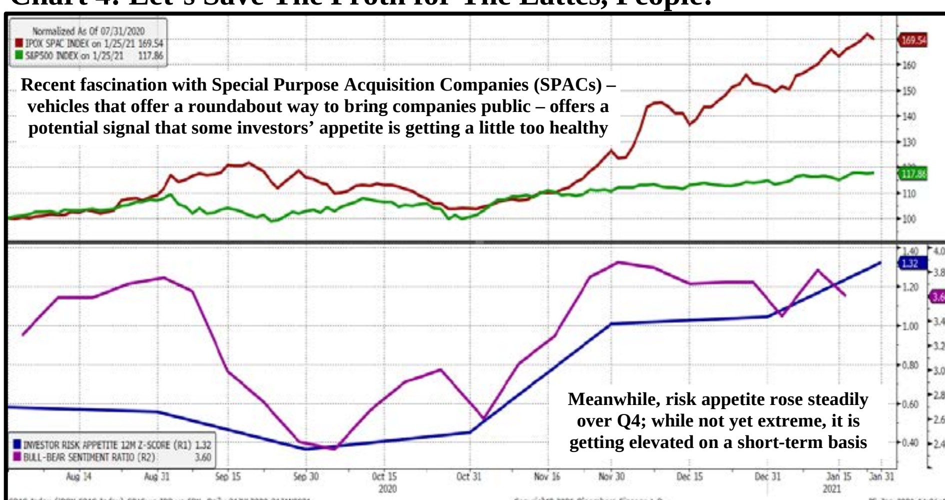
We do believe, however, that many of the primary beneficiaries of the above-noted shift in conditions may well dwell outside of the S&P 500 index. In fact, our Investment Committee's consensus for the year projects that small-cap stocks will likely exhibit a lead over large-caps – they have already started to perk up – and, while we expect growth stocks to do just fine, we do expect value stocks to do incrementally better. On the one hand, as risk and uncertainty subside – even ever so gradually, with the election out of the way, the vaccination process starting to pick up steam, etc. – there is less need for the market's focus to be as narrow as it was last year, when investors simply added over and over again to the same small basket of growth stocks at steadily higher prices. Meanwhile, as growth improves, there is liable to be considerably less willingness among investors to pay up for many of these growth stocks, which closed out 2020 at a hefty premium to their long-term average price-to-earnings ratio (meaning investors have been willing to pay a lot more for every dollar in earnings these companies generate) – let's face it: there simply won't be a need to do so, as better growth will mean broader growth, including many of the more neglected – and, thus, currently cheaper – and, these days, mostly value, stocks.

Now, valuations on the broad market as a whole have actually come down a little recently, even with the healthy market appreciation with which we started the year (we are +3% three weeks in), as they benefitted from the annual "bump" in Wall Street analysts' earnings estimates. Even so, however, the market is by no means currently cheap: the Price-to-Earnings (P/E) ratio on the S&P 500 for the trailing twelve months is around 30 times earnings, or some 75% higher than its long-term average of around 17 times. Things improve if we look at the forward P/E ratio – i.e., the ratio based on the earnings that analysts expect companies to generate this coming year: here we are looking at a P/E of 23 versus, once again, a long-term average of about 17 times, or a premium of about 35%. From this, we can see two things: 1) things are expected to get better: 2021 estimates show Wall Street expectations for better earnings that would make the market less expensive and 2) perhaps more importantly, things need to continue to get better over the course of this year and into next year as well, as even the forward 12-month P/E is elevated versus history.

CATCH THE WAVE

This will, we believe, indeed, prove to be the case, as global economies and financial markets ride a series of waves, the combined positive momentum of which should be more than enough to continue driving meaningful gains in corporate profits for some time, all while continuing to foster conditions hospitable towards a broad array of return-seeking assets. From the increased COVID relief stimulus and infrastructure spending spurred by the "Blue Wave" – now that the Georgia elections have given the Democrats control of Congress – to a Federal Reserve we view as squarely determined to keep policy rates at the zero bound for the next couple of years, the policy front seems clearly tilted not only towards growth but also towards keeping a floor under risk assets by taking some of the more extreme tail risks off the table. Meanwhile, global economic growth should continue to ride a wave of its own, coming back from very depressed levels and spurred onward and upward not only by the above stimulus but also by the – hopefully – decreasing

Chart 4: Let's Save The Froth for The Lattes, People!



The current landscape is one of receding uncertainties, fading headwinds, and improving fundamentals, all in all an environment in which we believe stocks of all kinds will do relatively well. Having said that, this is still a process that will take time to unfold and, as always, risks remain. Meanwhile, we know that investors tend to be emotional and focused on the short-term, often getting ahead of themselves as a result, chasing the market higher or crowding (often without fully appreciating) into some of the market's more speculative bets. There are some hints at this sort of behavior as we speak, though nothing too extreme – yet. For the time being, this is merely another reminder that market corrections – as we often stress, a natural part of this process – are inevitable. While these may present a speed bump, we do not expect them to prove to be an outright stop sign to the market's advance over the year.

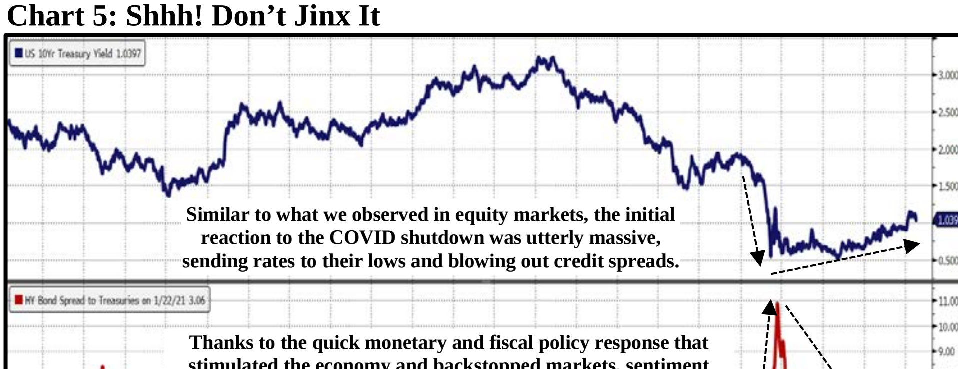
threat of the coronavirus, as vaccination begins to make greater activity possible across swaths of the economy that have remained all but dormant for the past year.

All of these forces, meanwhile, are helping to fuel yet another wave, one of investor optimism. Now, at some point, this factor tips to become a negative, at least in the short run: as those of you who have been with us for some time now probably know, we strive to be extremely mindful of when investors' appetite for risk has moved to an extreme. If recent trends were to persist, the market would eventually get extended and become vulnerable. For the time being, however, improving sentiment has continued to drive the market higher as fear-of-missing-out (FOMO) has been driving many of those investors who got stuck on the sidelines back into the market. As Chart 4 on the prior page also shows, however, the past several months have seen a sharp rise in investor interest in some of the unproven and, often, speculative companies out there, many of which lack earnings, some of which lack so much as an ongoing business. Thus, although our outlook leads us to view the broad equity market as reasonably attractive at this time, we continue to urge caution in the face of the more speculative investment trends that seem to so engross the market these days, instead encouraging our clients to stick with a patient, diversified approach and to discuss with us any thoughts they may have of materially increasing their risk exposure at this time.

Pivoting to fixed income, we find a refreshing counterpoint to all of this commotion. Bonds across the board have done extremely well over the past year, albeit not all at the same time. No surprise, the highest quality and most liquid bonds did best early in the year, when the onset of the recession/height of the bear market drove a staggering flight to quality, pushing U.S. interest rates to their "all-time lows" (yes, again!) Over the back half of the year, meanwhile, the more credit-oriented segments of the market have performed nicely as credit risk has subsided, more than recouping their losses from earlier in the year. Going forward, our base case outlook sees relatively smooth sailing for fixed income in 2021. We expect duration risk to remain contained by the Fed, who we view as unlikely to tighten policy any time soon, given its growing willingness to tolerate an inflation overshoot to offset it having undershot their 2% target for much of the past decade. Meanwhile, although speculative debt defaults – at just north of 8% - remain at their highest level since the Great Financial Crisis, the rebounding economy (not to mention the many policy backstops) should keep the damage fairly contained in this space; this is already apparent in the improved credit market sentiment, which has caused credit spreads (the extra yield cushion investors earn for taking on the risk of default) to tighten back down to levels consistent with a very benign view of default risk.

Thus, our assessment on both of the primary fixed income fronts – high quality and credit – are fairly similar for 2021; on the one hand, we see little in the way of material risk, as neither interest rates nor credit spreads are likely to rise too much in any of the scenarios we consider likely, but at the same time there is little room for either of these factors to go much lower either, thus limiting the near-term upside return potential from here. Both segments of our clients' fixed income allocations continue to serve a purpose, helping to hedge against equity market risk, smooth portfolio volatility over time, and – at least in the case of credit – continuing to provide some modest income.

Chart 5: Shhh! Don't Jinx It



Fixed income investors had it pretty good – for a while, at least – in 2020, as declining rates and – over the back-half of the year – tightening credit spreads helped to squeeze just about every ounce of return out of the bond market. Although our forward expectations for bond returns may be meager (short-term, at least), there appears to be little in the way of any obvious threats on the horizon. This helps to further solidify our view of the diversification and risk-reduction benefits offered by the space, even in the absence of any meaningful return expectations. We look for interest rates to rise only very modestly this year from current levels, despite some concerns in the market that all of the liquidity in the system will fuel an inflation spike. Inflation should firm, we believe, but we are not expecting anything of a caliber that would spook the Fed. Meanwhile, the recovery in economic growth should continue to work to benefit the credit space, helping it to sustain somewhat higher income payouts without undue risk to principal.

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In Markets, As In Comedy, Timing Is Everything

No, we're not talking about market timing; we could, mind you, but if we did we would simply be reminding you of such crucial principles as "time in the market" versus "timing the market", the importance of sticking with a long-term, diversified strategy, and the potentially grievous bodily harm an investor can inflict on his or her portfolio simply as a result of missing even a few of the market's best days (notice how we still managed to slip all of that in there?). Instead, we are referring to the need for investors to be patient as things play out: even though markets like to make quick decisions, the events themselves inevitably require time to unfold. The vaccination process is finally gaining some traction – which is very good news – but we still face many long months ahead of us before in which at least some aspect of our economic lives (not to mention personal, social, etc,) is constrained to some extent. Things will get better, but over time. Meanwhile, on a short-term basis the market may appear expensive; however, it could be (and, we believe, is) poised for significant gains in earnings that would make its valuation much more palatable, thus offering opportunity over the intermediate- and long-term. Once again, however, this will take time. It becomes critical, therefore, to avoid simply watching the market day-by-day in an attempt to decide if one should be "in" or "out." If you are in the market, stick with it – it pays off over time! If you happen to be out of the market, meanwhile, don't panic your way back in but, instead, talk to us: we can help devise a plan to get you invested in a diversified, risk-appropriate portfolio once again in a manner that makes sense. Meanwhile, strive to incorporate the afore-mentioned "look-ahead steering" mindset; this will help keep you more in synch with discounting mechanism of the market, which we know often begins to reflect both positive and negative factors long before they are even visible to the naked eye. Coupled with a long-term strategy consistent with your return objectives and risk tolerance implemented in a diversified and disciplined manner, to which modest tilts may be implemented periodically towards those areas of greatest opportunity, we believe you will find yourselves well-equipped to navigate not only the reasonably favorable year-to-come – corrections and all! – but also for the long-term horizon over which you – and we – seek to achieve your financial goals.

We look forward to being in greater touch with all of you over the coming year, as we explore and implement new methods of communicating our views and outlook on the economy and markets. In the meantime, we invite you – as always – to reach out to your advisor or me to discuss any questions or concerns you may have.

-Jim Ayres, CIO

4th Quarter 2020 Capital Market Performance

Index (as of 12/31/2020)[1]	1 Qtr	1 Year	3 Year	5 Year	10 Years
FTSE 3-month T-Bills	0.02%	0.58%	1.56%	1.16%	0.60%
Bloomberg Barclays Gov't/Credit Int.	0.48%	6.43%	4.67%	3.64%	3.11%
ICE BofAML US High Yield	6.45%	6.20%	5.90%	8.41%	6.61%
Bloomberg Barclays Multiverse	3.52%	9.02%	4.83%	4.99%	2.98%
S&P 500	12.15%	18.40%	14.18%	15.22%	13.88%
Russell 1000 Value	16.25%	2.80%	6.07%	9.74%	10.50%
Russell 1000 Growth	11.39%	38.49%	22.99%	21.00%	17.21%
Russell Mid Cap	19.91%	17.10%	11.61%	13.40%	12.41%
Russell 2000	31.37%	19.96%	10.25%	13.26%	11.20%
Russell 2000 Value	33.36%	4.63%	3.72%	9.65%	8.66%
Russell 2000 Growth	29.61%	34.63%	16.20%	16.36%	13.48%
MSCI EAFE	16.09%	8.28%	4.79%	7.97%	6.00%
MSCI EAFE Small Cap	17.32%	12.75%	5.25%	9.80%	8.23%
MSCI Emerging Markets	19.77%	18.69%	6.56%	13.22%	4.00%
MSCI Frontier Markets	11.23%	1.65%	0.27%	6.59%	3.62%
Wilshire US REIT	10.62%	-7.90%	3.30%	4.25%	8.27%
DJ Global Select RESI	14.24%	-10.03%	1.30%	3.39%	6.27%
Bloomberg Commodity Index	10.19%	-3.12%	-2.53%	1.03%	-6.50%
Credit Suisse Liquid Alts	10.80%	12.76%	5.13%	5.01%	3.81%
60-40 Balanced EQ/FI – US Only	7.48%	14.28%	10.75%	10.76%	9.70%
60-40 Balanced EQ/FI – Global	9.03%	13.38%	8.65%	9.39%	7.28%

[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.