MARKET LETTER

PACIFIC PORTFOLIO CONSULTING, LLC

Fourth Quarter 2021

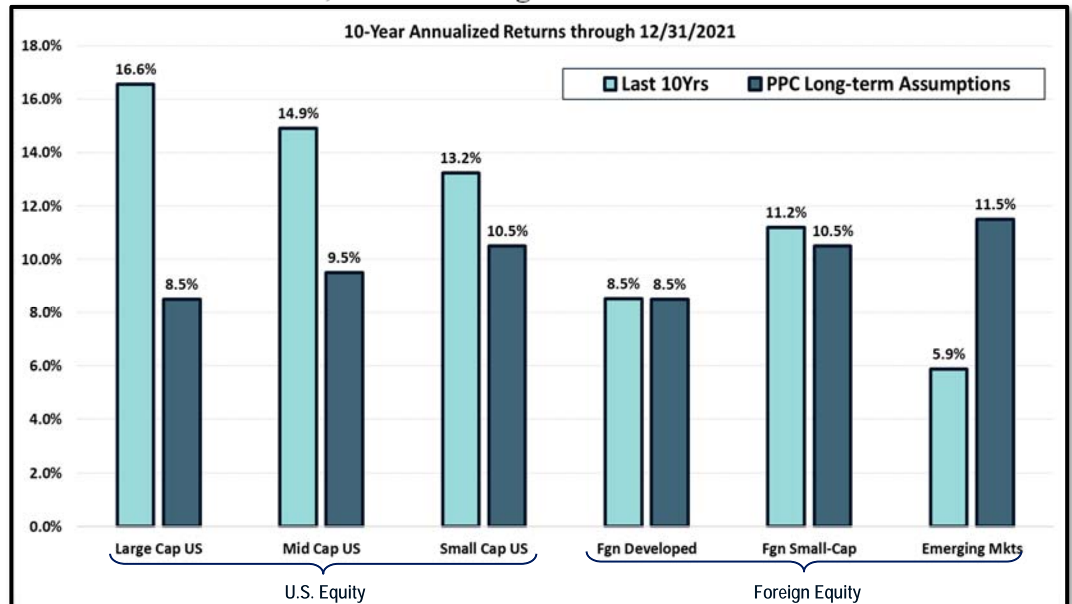
BACK WHERE WE STARTED, HERE WE GO 'ROUND AGAIN

Another year under our belts, another one already storming out of the gate. Before 2022 completely gets away from us, though, conventional wisdom dictates that, as investors, it is our duty to stop and scrutinize the books we only just barely closed this past December 31st. The purpose? Why to assess the very validity of our investment strategies, of course, based solely on the degree of success (or lack thereof) they exhibited over the preceding twelve-month period.

Common sense, on the other hand, would start by asking why the heck anyone would ever want to use a one-year window for this sort of exercise, as that is WAY too short a period over which to evaluate the true merits of any investment strategy. It would then attempt to draw our attention to the fact that there really is no magic to this January-December period – it's a twelve-month return window like any other, with the exception that it happens to coincide with the end of the calendar year.

Still, we humans do love to find order and meaning in almost everything we see, a tendency that – in the financial arena – often leads investors to attach undue importance to certain specific dates, price levels, etc. Further, we also tend to be easily overwhelmed by the "big picture," causing us take our cues instead from only a small slice of the data (such as a single calendar year).

Chart 1: Take a Picture, It'll Last Longer!



A quip frequently overheard during client meetings in recent months, "You might want to take a picture of these returns!" highlights a couple of key ideas. First, it serves to underscore just how good things have been not just over the past year but the past several years and even the past decade as a whole, over which time many of the primary return-seeking assets have delivered a level of performance that dwarfs their long-term historical averages. The other side of this same coin, however, is that returns are unlikely to be this good over the next ten-year window. On the one hand, this second statement is somewhat of a corollary to our first statement: the exceptional strength evident in the stock market over the past ten years stands out as an outlier and, given the very nature of outliers, a similar outcome over the subsequent period is statistically unlikely. On the other hand, more pragmatically, a number of the tailwinds to speed markets to current heights have already begun to fade. Moving forward, meanwhile, some of these will morph into headwinds – at least in the short-run: economic growth slowing as we move back towards trend, earnings growth slowing as the effect of the COVID recession fades, valuations moving lower as interest rates rise from their abnormally-low levels. Before you panic, however, understand that this is not to imply that financial assets will not do well over the coming decade, merely that they are unlikely to do THIS well, something investors need to take to heart in setting realistic expectations and evaluating their progress.

In this respect, it's possible to see the Jan-Dec window as playing the role of lap marker, if you will; an investor unable to fathom a 20-plus-year race can eaily wrap his or her head around a seemingly logical point along the course at which to measure how things are going. Taken in this "supporting actor" role rather than as the "main course" (to mix metaphors), I suppose we can allow ourselves to indulge these all-too-human urges without risking too much damage; and, if we are to do so this year, it's clear that what we really need is a victory lap marker, as return-seeking assets have delivered a very strong showing.

Going forward, meanwhile, our Investment Committee remains reasonably constructive on return-seeking assets (by the way, when you see the term "return-seeking assets," always feel free to substitute the word "stocks;" although there are

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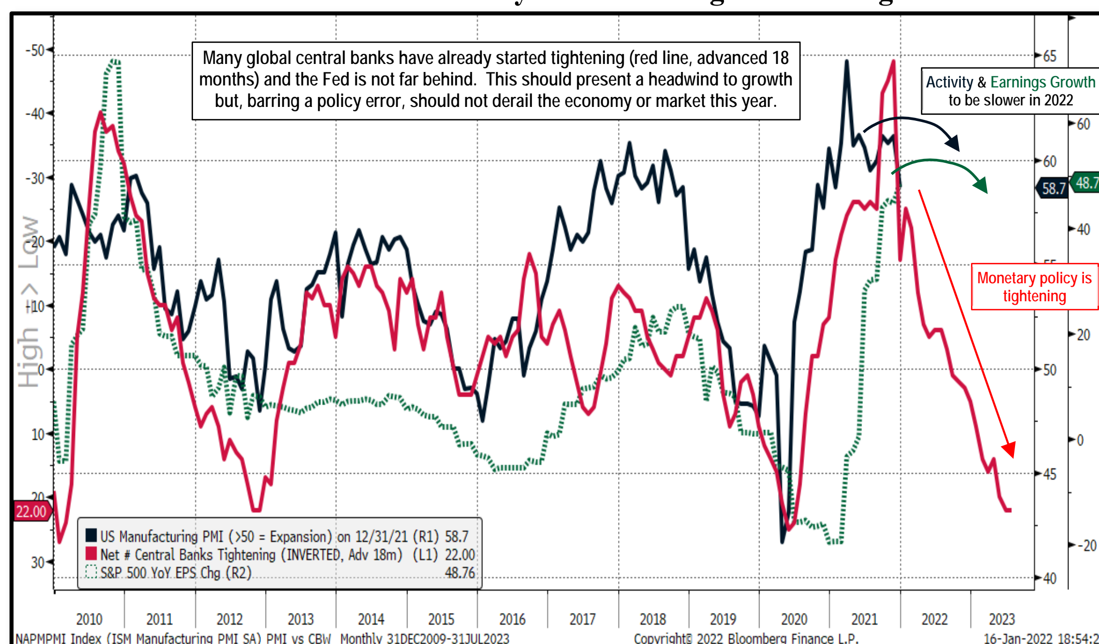
a handful of other things that land in this category, stocks make up the lion's share of it), as the fundamental economic and financial market backdrop we foresee continues to look relatively good. This is not to say that the road ahead will not be characterized by some headwinds, volatility, and even – gasp! – corrections, nor is it to imply in the slightest that performance over the year(s) to come is likely to be nearly as good as that which we leave behind us. Nonetheless, disciplined and – quite critically, as markets continue to broaden and rotate leadership – well-diversified investors should remain in good position to realize portfolio returns consistent with the achievement of their goals and objectives over the long-term.

WHERE DO WE GO FROM HERE? WHICH IS THE WAY THAT'S CLEAR?

As we set out down the long and winding road that will no doubt be 2022, would you be terribly surprised to learn that our Investment Committee is expecting to find lower returns at the end of it than was the case last year? You really shouldn't be; we've just come off a strong run and, if market history tells us anything, it's that markets tend to mean-revert over time, so that a period of unusual strength is often followed by one of below-average performance. Of course, (I can hear the rabble-rousers now!) there's NO POINT in trying to market-time such events; to attempt to do so has the potential to inflict near-fatal harm to one's portfolio – for example, leading an investor to go to cash (or even short the market) in 1997 or 1998 or – more recently – in 2020 or 2021. None of those decisions would have ended well.

Chart 2: We Are Gathered Here Today to Get Through This Thing Called Life

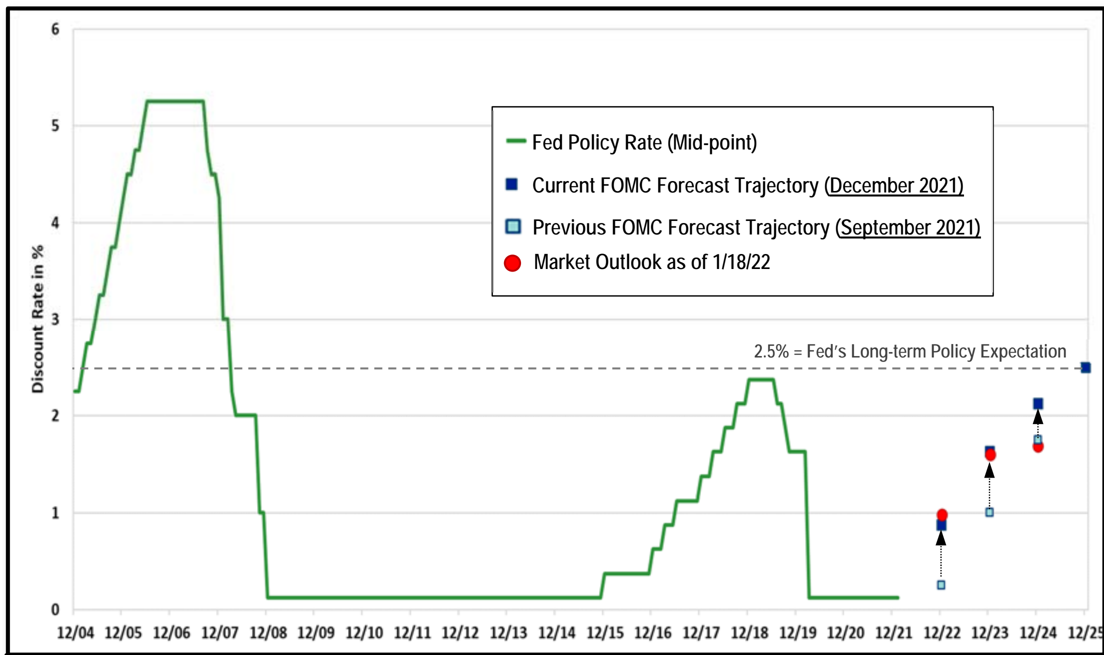


"That's life, or so they say; growth is set to slow down, but don't dismay!" Let's face it: there is, indeed, a good reason why I am a finance geek and not a Broadway lyricist, but we've got more important things to focus on right now. Specifically, the fact that we are facing a deceleration in economic growth – with all that this portends – and, not to appear glib about it, but that really is life, economically speaking. We experienced a massive pop coming off the 2020 COVID-induced recession – perfectly normal in that respect – but, moving forward, we are past the easy comparisons and more and more tailwinds are beginning to fade, causing us to migrate gradually towards a more "normal" pace of growth. Now, given the maturity of the U.S. economy, our trend growth rate is likely much closer to +2%, so anyone proposing that the nearly +5% year-over-year growth rate the economy has posted over the last four quarters (through September, pending release of the 4Q'21 data) is sustainable certainly has their work cut out for them. Don't get us wrong, though: we do not expect the economy to get their overnight; in fact, our Investment Committee's outlook for 2022 is actually pretty good, with a consensus view for this year of +4% real U.S. GDP growth. Nonetheless, as monetary policy progressively normalizes and fiscal policy support subsides, economic growth – and, thus, likely also the growth of corporate earnings – will begin to edge its way lower towards a level that – while still positive – will prove more sustainable over the long-term.

For now, though, let's simply try to overlook 2021's extremely strong performance – a step that is not necessarily as crazy as it sounds: as we said earlier, a single year in isolation is too short a period on which to base our decisions. Furthermore, there is a whole array of factors that can cause a wide dispersion of outcomes in year-to-year performance comparisons so what happens this year is anything but certain. Some of the other statistics are becoming harder to ignore, though: double-digit positive returns in 8 of the past 10 years, for example, including over the last 3 years, during which time the market is up over 100%.

Now, if there was a time for the market to have this sort of eye-popping advance, this was certainly it. As you would have expected, stocks rocketed off the 2020 bear market lows and continued to move higher at a vigorous clip in

Chart 3: It'd Be Easier to Keep Dancing If the Fed Would Stop Changing Its Tune



Just like the cast of a new "Real Housewives" franchise, the members of the Federal Reserve apparently looove attention and just can't seem to create enough drama! Having worked diligently to establish itself as the most transparent, disciplined, and patient Fed in history, Powell and his team have now decided to start doling out the whiplash! Gone are the promises of "No rate hikes before 2024!"; granted, some FOMC members had already begun to hint at their belief that rate hikes would likely be needed before that time but it was not until November and December that the party line literally crumbled, as the Fed announced a faster wrap to its bond buying program and the likelihood of three quarter-point rate hikes in 2022 alone, conceding that the higher inflation we have seen is unlikely to be as transitory as originally believed. Markets have grappled with the revised narrative, swinging between their hatred of higher rates, which are less risk- and valuation-friendly, and their relief that the Fed is moving to squash heightened pricing pressures. Meanwhile, we are seeing a divergence in outlooks between markets and the Fed reminiscent of the face-offs that took place at the start of the last tightening cycle back in 2015, as markets are now actually forecasting the Fed will tighten even more aggressively than it has indicated so far, pricing in 4 quarter-point hikes by year-end 2022. Perhaps more interesting, though, is the market's longer-term view, which sees the Fed being forced to move quite a bit more slowly in the outer years and potentially stop short of its anticipated 2.5% terminal rate objective.

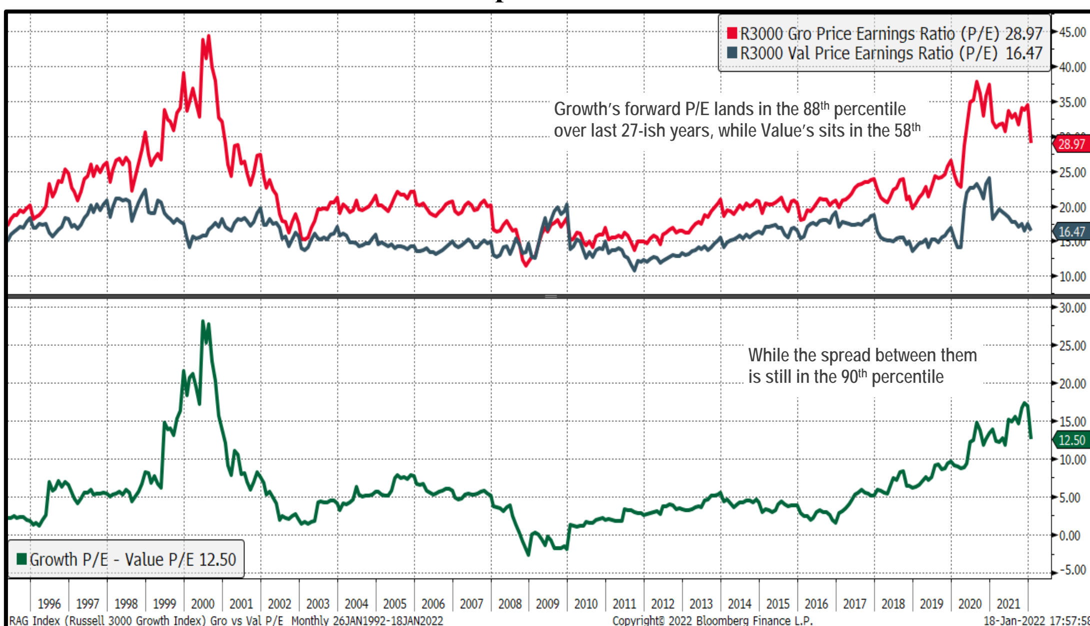
conjunction with the sharp rebound in corporate profits typical of the recovery stage of the economic cycle. At the same time, the concept of risk was largely retired from most investors' lexicon, as Fed policy effectively served to backstop, well… everything. Now, growth is poised to moderate – as it should, as we move deeper into the expansion phase; policy makers, meanwhile, are quickly trying to swap out the spiked punch for some kool-aid – they're not ready to take away the punchbowl entirely at this point but they do want us all to start sobering up! All of this inevitably points to a more subdued fundamental backdrop going forward, one in which performance of the broad market as a whole is, unsurprisingly, also likely to be more muted than what we have seen in recent years.

Meanwhile, being mindful of the nature of the comparisons we choose to make (or run the risk of yelling "Fire!" in a crowded theater), we do need to note that the last time that the S&P saw three years in a row of +15% returns or better was in 1999 (although in that instance we were actually dealing with 5 straight years of 20%+ returns). Now, this does not imply that we are on the brink of a bear market as we were back then – although corrections do form part of our base assumptions, a bear market does not: valuations are nowhere near the extreme levels that prevailed at the time, growth – while set to slow – remains good, and policy – while normalizing – remains easy. However, similar to what we did see back then, we believe the index itself – which has become increasingly concentrated in the high-flying stocks and the growthiest economic sectors in recent years – may face some headwinds relative to those areas of the market that have been largely neglected for some time, which should begin to see greater favor. In fact, I really should say "continue to see greater favor," as a rotation away from Big Tech and into smaller-cap and more value-oriented names already began to manifest itself as last year was drawing to a close, a phenomenon that has gained some momentum thus far in January as well.

Based on how we see the year ahead evolving, we would not be surprised to see this pattern persist over the course of 2022. Not only does the value style segment of the market currently offer a deep discount to some of the fairly lofty multiples evident on the growth side of the ledger but many of the sectors that make up the value space – things like energy and materials, for example – tend to have a higher degree of pricing power, helping them better navigate an inflationary environment. Meanwhile, with the Fed having re-oriented its mandate back over to price stability, longer-

term interest rates have – quite naturally – begun to react, the yield on the 10-year US Treasury moving from 1.44% in mid-December to 1.88% as of mid-January; our Committee thinks rates have some more room to run as the year progresses, putting greater pressure on stock market valuation multiples, in particular those of growthier companies with earnings far out in the future and, thus, more steeply discounted as interest rates rise (aka "long duration equities," a term I never thought we would have to worry about!)

Chart 4: Are Growth's 15 Minutes Up?



We see the stage as set for a more durable flip in the market's script, whereby some of its high-flying stars will be directed into the background while some of the "anti-heroes," those areas of that market that apparently "can't get no respect" step into the limelight. This, of course, following several years of investors skewing heavily towards growth and away from value, creating a stark divergence not only in performance but also in valuation. It should be noted, nonetheless, that, even at their peak in 2020, valuations on growth stocks were still well shy of their dot-com levels; still, at roughly 29 times forward 12-month earnings, they remain somewhat lofty vis-à-vis their value counterparts, which clock in at a relatively more palatable 16.5 times. Now, it has often been noted – quite accurately, mind you – that valuation alone typically is not sufficient to dictate a rotation, that there usually has to be some fundamental shift underway to serve as a catalyst. We would argue that the recent (and ongoing) move into a good growth, higher inflation, rising interest rate environment fulfills this role in spades. For one thing, continued solid economic growth and the absence of another COVID-related shutdown (which no one seems to have the stomach for at this point) reduces the price investors are willing to pay for what was previously relatively scarce growth; meanwhile, not only do value-oriented sectors often exhibit better pricing power in an inflationary environment but the rising interest rates necessary to combat such inflation are also likely to weigh more heavily on growth companies.

Now, I'd love to sit here and say that we expect international equity markets to come into their own relative tailwind this year as well. Let's face it, having lagged the performance of their U.S. counterparts by 17% just last year and a sizable 12% per year over the last 3, foreign markets are overdue to catch a break. For the time being, however, our Investment Committee is sticking with its preference for domestic equity in 2022, although we would not expect the differential to be nearly as pronounced this year. Vaccination rates in the 75%-80% range and booster rates in the 45%-50% range, traction well ahead of that seen in the U.S., should help in Europe, as should their position earlier in the economic cycle. Meanwhile, within emerging economies, whose markets took it on the proverbial chin last year, we would expect to see some recovery, although the impact of a decelerating China will continue to loom as a fairly significant wildcard.

Turning our attention to the fixed income front, although this year may give us the opportunity to appreciate some of the diversification and stability benefits inherent in owning fixed income, our Committee's outlook for performance is fairly lackluster, looking for the bond market to come in just slightly better than flat for the year. Our current growth and inflation views lead us to expect that intermediate- to long-term yields will continues to rise moderately – we are looking for just shy of 2.25% on the 10-year by year-end, a move that should prove somewhat challenging to bond prices (though slightly higher income yields could help to dampen the blow). This is not a level at which we would expect bonds to look outright attractive, however, particularly as inflation – which we see remaining north of 3% this year – keeps real yields negative. As such, we would not be looking for bonds to pose much competition for the capital that is more likely to continue to make a home for itself in the equity market for the time being.

Last, but certainly not least, we would continue to emphasize the attractiveness and benefits of an allocation to liquid alternative strategies, which we have long included in a number of our strategies; this space as a whole more than held its own this past year, the Credit Suisse Liquid Alternative index – which we use as a broad, passive proxy for what is a

very heterogenous asset class – delivering nearly +9% in 2021. Particularly in the context of more subdued prospects for traditional asset classes – including somewhat hostile conditions for fixed income – such less-correlated allocations can allow investors to step out – at least partially – of certain risk exposures (such as interest rate risk) while gaining exposure to a much different set of performance drivers than those evident in the rest of the portfolio.

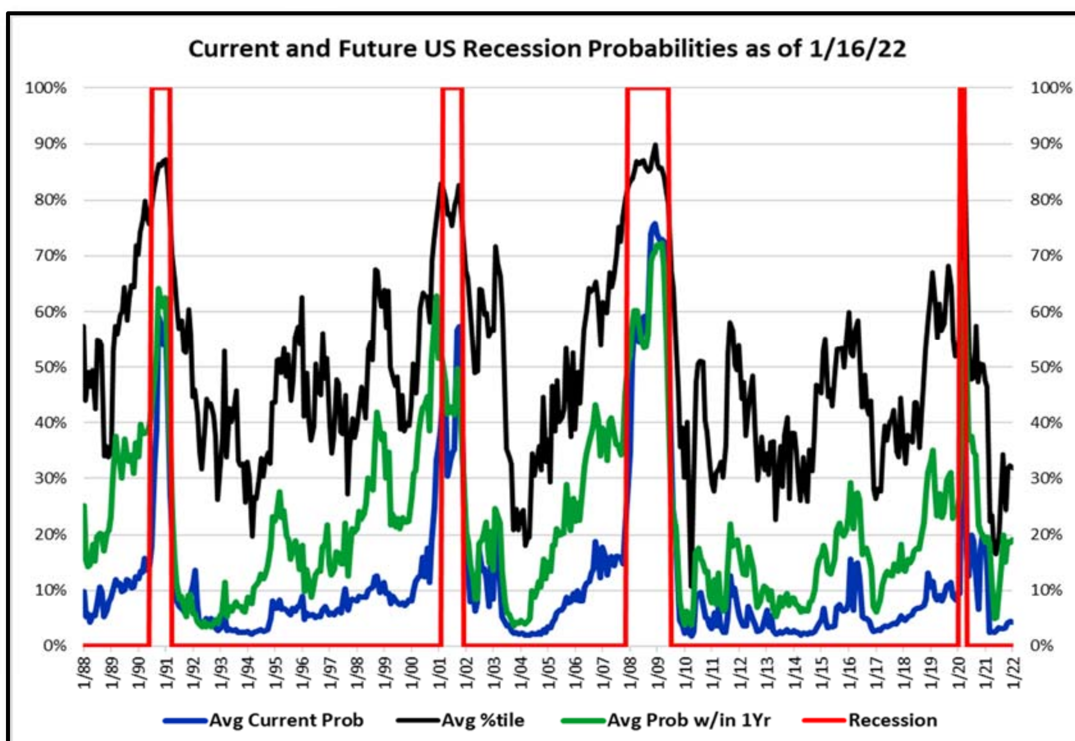
I Wish There Was a Way to Know You're in the Good Old Days

Take it from Chic: these are (still) the good times. Yes, I realize we have spent a not immaterial amount of real estate in this quarter's missive talking about risk factors and potential headwinds. However, we should recall that – while the roster of "usual suspects" may turn over from year to year – the market is no stranger to challenges and uncertainties: risk is part and parcel of investing and investors in every market environment have always had to content with their fair share (I know: it feels like we have sometimes had to shoulder way MORE than our fair share!)

Further, the U.S. and global economic expansions remain on extremely sound footing and the specter of the next recession appears solidly at arm's length at this point. Corporate earnings, meanwhile, should post another strong showing this year (albeit considerably shy of the roughly +50% they popped in 2021); this should help to counteract the effects of some likely multiple compression as interest rates continue to rise to deliver moderately positive performance for stocks in 2022.

We expect such interest rate increases to be manageable for now, as inflation pressures gradually moderate and the Fed – at least the Fed that we have all come to know and tolerate – proves willing to curb its newfound enthusiasm for rate hikes should the economic evidence begin to show material signs of stress. Broadly, this continues to point to an environment in which investors are likely to continue favoring stocks over bonds. I would not worry too much about the bond market, though: you don't actually own it. A number of our

Chart 5: Don't Panic



Not to spook you, but we thought the time was about right to reintroduce our recession probability monitor – with which, frankly, there just hasn't been much point taking up valuable print space over the past year-and-a-half or so. Nonetheless, this economic expansion certainly seems to be moving through its stages at a faster pace than past cycles, so it may make for more interesting watching going forward. Make no mistake about it, though: the members of our Investment Committee are firmly in agreement in predicting no recession in 2022 – all other things being equal. The key variable here, though, which could easily prevent things from being "equal" is the U.S. Federal Reserve and the potential for a policy error. Certainly, we expect economic growth to remain above trend in 2022 at a level more than sufficient to withstand the gradual withdrawal of the remarkably accommodative monetary policy that has salved markets since the onset of the pandemic. Meanwhile, while we foresee inflation remaining "high" relative to levels to which we have all become accustomed over the past 10-20 years, we do expect pricing pressures to retrace a portion of their recent moonshot thanks to a more modest pace of economic growth and a gradual easing of supply chain bottlenecks. Nonetheless, with the U.S. economy now having surpassed a level most would consider consistent with full employment and the Fed having "accomplished" its objective of allowing inflation to reach its 2% target "on average", there has been an unprecedented pivot in Fed rhetoric and the policy normalization playbook – on which the ink was barely dry – apparently has had an unfortunate encounter with a flamethrower. We know that virtually every expansion eventually ends with a Fed policy error; the only real question is when. With the Fed having made a near-180 in recent months – a fact not lost on the markets – this risk will continue to bear watching over the course of the year to come.

strategies make use of extremely liquid, high-quality municipal bonds which, while they may exhibit some interim volatility as rates move around, were purchased with the intention of being held to maturity. Meanwhile, all of our strategies' fixed income allocations – whether taxable or tax-free – have been designed to incorporate varying degrees of short-duration and credit exposure with the goal of mitigating the concentration of interest rate risk that currently characterizes the high-duration, low-yield, government-heavy bond market indices. While you're at it, stop worrying about the S&P 500, too, because you don't actually own that either. Okay, so you very likely do have a small slice of your portfolio allocated to it but that is within the context of a very broadly diversified mix of equity exposures to the various styles, market caps, and geographic regions. Dispersion between market segments is likely to be more significant this year, giving this broader exposure (not to mention active management!) an edge vis-à-vis an index that may feel the weight of the handful of stocks and sectors to which it has become skewed in recent years.

Now, while all of this (hopefully!) makes for an interesting conversation about the prospects for 2022, we are, obviously, not investing for one year and, in the end, the discipline to stick with a sound, risk-appropriate investment strategy over the long-term will no doubt prove much more influential than which asset class does the best or even what the overall market returns this year. And, of course, I would be sorely remiss if I did not take this opportunity to quite literally pound the table on the concept of diversification. Not only is it a core component of the risk-controlled pursuit of one's financial objectives over the long-term, but conditions appear ripe for investors to once again see greater short-term benefit to its use as well, as we set a course for the rest of the year that is likely to continue to be marked by potentially sizable rotations and sporadic bouts of volatility.

With that, let me step off of my soapbox and extend to you all wishes for a happy and prosperous (and safe!) 2022 on behalf of everyone here at Pacific Portfolio. As always, we appreciate your continued faith through these unusual times and look forward to being able to see you all in person again some time soon! As usual, please feel free to reach out to your advisor or me with any of your questions or concerns.

-Jim Ayres, CIO

4TH QUARTER 2021 CAPITAL MARKET PERFORMANCE

Index (as of 12/31/2021)[1]	1 Qtr	1 Year	3 Year	5 Year	10 Years
FTSE 3-month T-Bills	0.01%	0.05%	0.96%	1.11%	0.60%
Bloomberg Barclays Gov't/Credit Int.	-0.57%	-1.44%	3.86%	2.91%	2.38%
ICE BofAML US High Yield	0.71%	5.29%	8.56%	6.09%	6.69%
Bloomberg Barclays Multiverse	-0.70%	-4.51%	3.70%	3.45%	1.96%
S&P 500	11.03%	28.71%	26.07%	18.47%	16.55%
Russell 1000 Value	7.77%	25.16%	17.64%	11.16%	12.97%
Russell 1000 Growth	11.64%	27.60%	34.08%	25.32%	19.79%
Russell Mid Cap	6.44%	22.58%	23.29%	15.10%	14.91%
Russell 2000	2.14%	14.82%	20.02%	12.02%	13.23%
Russell 2000 Value	4.36%	28.27%	17.99%	9.07%	12.03%
Russell 2000 Growth	0.01%	2.83%	21.17%	14.53%	14.14%
MSCI EAFE	2.74%	11.78%	14.08%	10.07%	8.53%
MSCI EAFE Small Cap	0.12%	10.48%	16.05%	11.45%	11.19%
MSCI Emerging Markets	-1.24%	-2.22%	11.33%	10.26%	5.87%
MSCI Frontier Markets	0.74%	20.09%	13.04%	9.88%	7.70%
Wilshire US REIT	17.14%	46.18%	19.19%	10.92%	11.47%
DJ Global Select RESI	11.75%	31.24%	13.03%	8.17%	9.46%
Bloomberg Commodity Index	-1.56%	27.11%	9.86%	3.66%	-2.85%
Credit Suisse Liquid Alts	2.03%	8.76%	9.84%	5.75%	4.69%
60-40 Balanced EQ/FI – US Only	6.33%	15.91%	17.12%	12.33%	10.91%
60-40 Balanced EQ/FI – Global	3.84%	10.53%	14.23%	10.30%	8.54%

[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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