MARKET LETTER

PACIFIC PORTFOLIO CONSULTING, LLC

Fourth Quarter 2022

THE KING IS DEAD, LONG LIVE THE KING!

Hear ye, hear ye: Twenty Twenty-Three hereby demands a blood oath of undying loyalty! After all, that's how it's supposed to work, isn't it? The people must throw their full, unquestioning support behind the new monarch before the body of the prior ruler is even cold. So, too, are we, as investors, expected to banish all of last year's heartburn and frustration entirely from our memories into the disturbingly full dustbin of market history and pin all of our hopes and dreams to the prospects of the year ahead...as if this were our first time being led down this particular garden path!

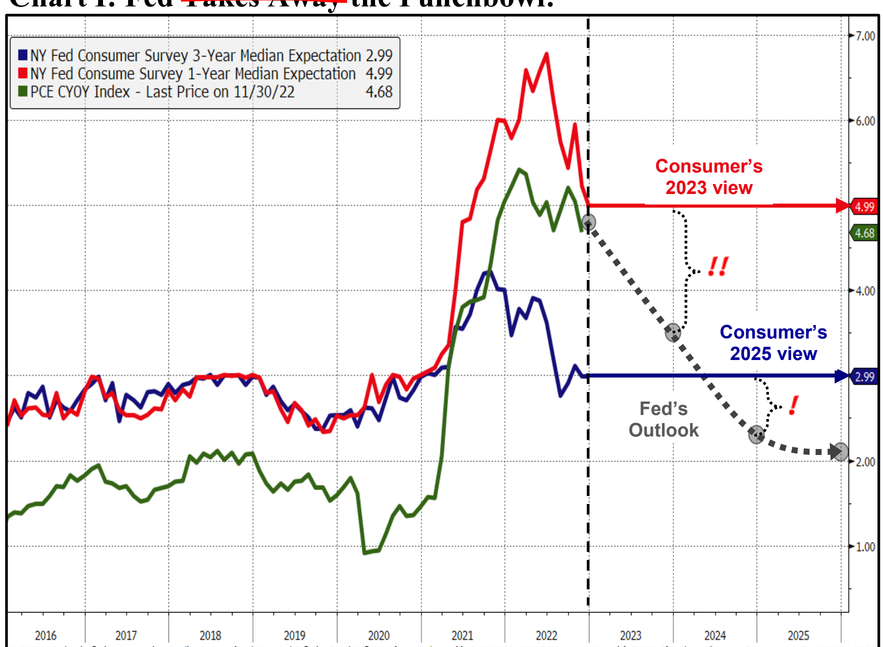
What an utterly charming concept. You know, one of the many talking heads that can't help but take to the airwaves at times like this went off on a similar tack the other day about how "every new year deserves to be greeted with optimism and positivity" (and, judging by the way markets have ripped through the month of January, apparently a lot of you saw that same interview!) To this, I say to you, as an investor: good luck with that!

Now, as I see out of the corner of my eye a few of my colleagues already gathering up their torches and pitchforks to a louder chant of "Dr. Doom!" than I have heard out of them in quite some time, allow me to add a quick "HOWEVER!" and perhaps a "but don't get me wrong!" to see if I can't elaborate my way out of the corner into which my natural cynicism appears to be painting me. Pivoting quickly, therefore, I will readily acknowledge one of last year's most worrisome themes – inflation, voted Public Enemy No. 1 by stocks everywhere in 2022 – has, indeed, begun to ease in recent months, a trend that our Investment Committee sees continuing over the course of the year ahead.

As we'll see shortly, this is genuinely good news; as you might imagine, however, markets have thought best to just run with it and take things to about as rosy a conclusion as anyone could imagine. I promise you: I am not out to spoil anyone's fun (even though I sometimes feel like that's kind of my job) but I do feel the need to remind investors that we live in the real world where "neat and simple" loses out to "messy and complicated" more often than not. As such, it might at least be worth considering the possibility that as the gray clouds of inflation part, they may ultimately reveal…well, simply more clouds! You see, the very medicine the Fed is using with such apparent success to beat back inflation's fire comes with a pretty scary warning label, given that past clinical trials have shown its potential toxicity to economic growth. So, while Fed policy makers are busy slapping each other on the back, the level of economic activity is already slowing, both in the U.S. and globally, and, with that, the risk of a recession is on the rise.

As a result, even though we would love to pop whatever happy pill they have been passing around at the Fed, we just can't quite shake the feeling that investors face

Chart I: Fed ~~Takes Away~~ SPIKES the Punchbowl!



The Federal Reserve should be a life coach for crying out loud – Jerome Powell is making Tony Robbins look clinically depressed! Here we are in of one of the most aggressive hiking cycles ever as we battle a major flare-up in inflation and the Fed would have us believe that everything is A-OK and that – for some unknown reason – the path back to sanity will be about as short and sweet as it gets. Never mind that history shows that a breakout in inflation such as we have just experienced typically takes 5 years or longer to get back to the Fed's 2% policy target. Never mind the fact that markets don't agree– not even a little! Relax, kick back, have some Kool-aid.

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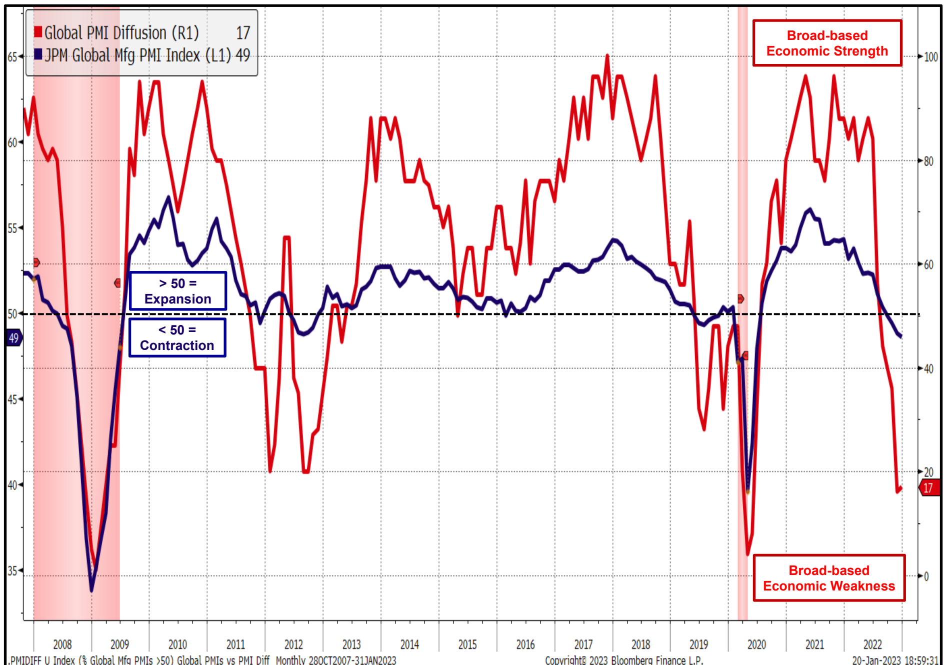
yet another year of uncertainty in 2023, a good portion of which may be spent worrying, peeking around corners, and jumping out of the way of an occasional dropping shoe or falling domino, as we move further through the economic (and market) cycle that began to unfold last year. Needless to say, none of this is likely to feel terribly good as it's happening; nonetheless, given what we currently expect will be a fairly mild and brief recession as well as the battering to which markets were already subjected last year, our Investment Committee believes investors may be feeling quite a bit better about things when they are looking back from the safety of their rearview mirror this time next year at what we expect should be reasonably respectable returns for a diversified portfolio of global stocks and bonds (and, yes, alternatives!).

SLUMDOG INVESTOR

Suddenly, everyone thinks they're Jamal Malik and that they have all the answers! Once again trying very hard to keep myself in check, I will say – respectfully – that I don't care who you are or what your experience has been, but many of the questions facing investors these days remain so up in the air as to be completely unknowable at this point.

Inflation is waning; how far will that go, and how fast? Will the Fed blink or toe the line and force markets to come around and adopt a less hospitable scenario than currently priced in? Would this, in turn, lead us into an economic recession and, if so, when would the Fed be willing and able to cut interest rates from what are already restrictive levels? Or could the Fed actually pull off a "soft landing" and successfully introduce slack back into the labor market to relieve wage pressures, yet somehow not take things so far that job creation slumps?

Chart II: Witness As We Creep To A Low Speed



Under sharply tighter global monetary conditions, economic activity has fallen off abruptly, with little save the emerging market economies remaining in expansion at this point. Nonetheless, the U.S. and global economies have managed to steer clear of recession – so far, at least. Based on the sharp recent deterioration, however, as well as expectations that even when they are done hiking (soon, but not yet!) global policy makers will keep short-term interest rates high for some time, it is not overly difficult to make a fairly solid case for continued slowing in the pace of economic growth. As the heat on investors from inflation continues to cool, this prospect of slower growth and, very likely, of recession is looming ever larger as the "next big thing" in what we see as another year of worry for the market.

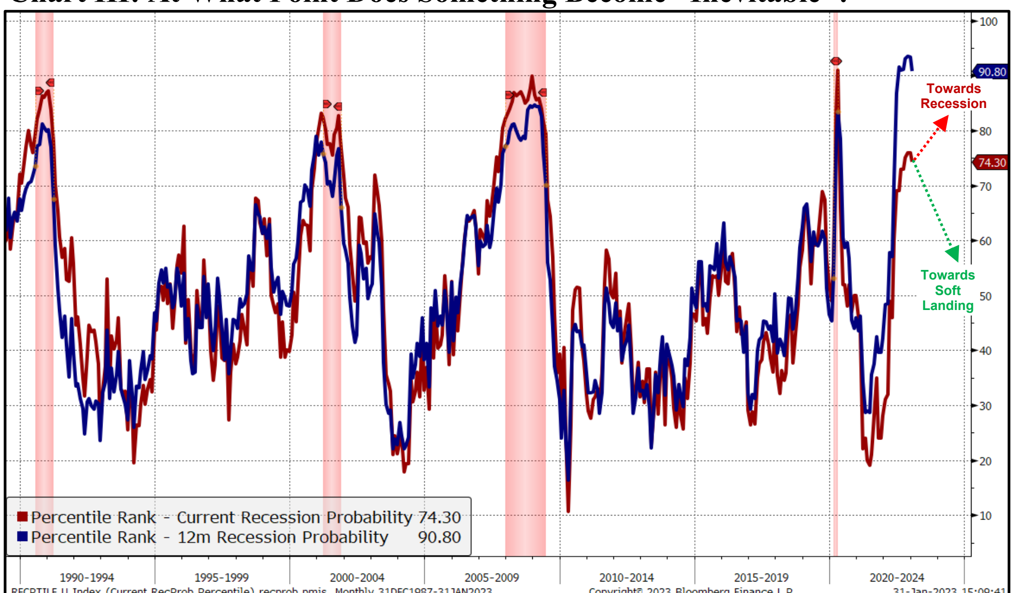
Those are all really good questions. In fact, take them all together and you'd have more than a pretty good game show going for you; answer them correctly, meanwhile, and you'd have basically resolved the very heart of the issues facing investors over the year ahead. Even Jamal, however, would likely throw his hands up at this point, take what he had won so far, and head for the exit! Before you feel tempted to do the same, however, bear in mind that you still have some lifelines available. No, you can't call a friend, but you can ask the audience (or, in this case, the market) and – if my gameshow trivia holds – it's worth noting that this was actually one of the more reliable lifelines back in the day. In theory, financial market pricing follows a somewhat similar process as the show's polling of its audience members, recording the opinions of the many and distilling them down into a single point of collective wisdom. It would likely be encouraging, then, to note that stocks rallied hard off of their cycle lows in mid-October to stage a robust rally through mid-December, gaining +17% as continued signs of easing – though still high – inflation once again fueled hopes of a less aggressive policy path for the Fed. That sounds like a fairly strong vote of confidence in the Fed's ability to successfully orchestrate an orderly slowdown and take the legs out from under inflation without compromising the growth outlook. Of course, looking at the bigger picture (though only slightly bigger), stocks were still well in the red over the trailing one-year timeframe, giving a fairly solid – though by no means table-pounding – recession warning. So, what of the bond market then? Those bond investors worry about literally everything – surely, they must be freaking out by now, simultaneously projecting both raging inflation AND recession! Remarkably, things are fairly orderly on the fixed income front as well these days. Yes, the yield curve is quite thoroughly inverted, as aggressive Fed policy pushes short-term rates higher all while bond investors foresee the need for rates to fall in the future – i.e., future monetary easing to respond to an economic contraction. However, credit spreads – the yield premium that bond market investors demand in order to invest their money in bonds with varying degrees of default risk – remain well shy of levels reached in prior recessions, a surprisingly benign reading on the risk of an economic contraction within the next year.

Overall, therefore, it would seem that the current message from the financial markets is a relatively reassuring one overall: inflation has peaked, Fed hawkishness has peaked, sentiment – which had gotten too bearish for too long – is improving (all points with which we agree!) and while there is some risk of recession, it's not worth worrying about (sadly, this is where our views part ways!)

Never Tell Me The Odds

Naturally, we are big Han Solo fans – and I say "naturally" because let's face it: who isn't?! Unlike everyone's favorite ne'er-do-well, however, we very much do like to know the odds – in fact, we insist on it whenever possible. Concepts like "inevitable" just don't work in investing so – inevitably (HA!) – we need to adopt a probabilistic view of outcomes. Based on what we see unfolding across a range of economic and market datapoints, based on the various scenarios we have seen such variables play out in the past, what are we likely to face this time around?

Chart III: At What Point Does Something Become "Inevitable"?

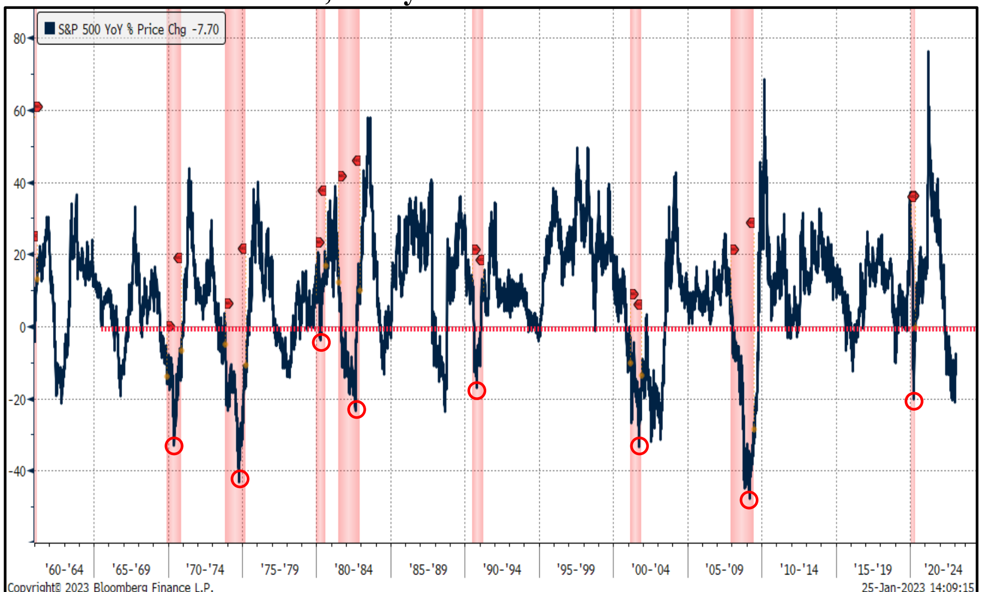


The probability of seeing a recession some time in 2023 has risen quite rapidly over the past year as tighter Fed policy has weighed on many key measures of economic health. An increasing number of indicators – such as a sharply inverted yield curve or sagging business confidence, for example – are flying bright yellow or even deep red flags…all while the labor market has yet to flinch, an ironic twist, as it is likely the labor market that the Fed most wants to influence at this point. In order to defeat inflation, the Fed will need to introduce enough slack – aka unemployed people – into the labor market to take some air out of wage pressures. Now, there has been some good news on this front recently, no doubt adding to the Fed's conviction they can successfully execute the much-hyped "soft landing" – i.e., knee-capping inflation and softening the labor market all WITHOUT tipping us into a recession. Now, I have no doubt the Fed can stick the landing – I just can't tell you where (there's that darned "no cursing" rule again!). In the meantime, a mild recession materializing around mid-year remains our base case scenario.

Thus, instead of using a lifeline to try to arrive at a single, "Final Answer!", we can use history as our guide to determine the likelihood of the various scenarios. Now, assuming you've been in and around the markets for any reasonable length of time, the odds are very good that your sense of history would lead you to pick very different answers than above. For example, over the past 75 years, how many recessions were preceded by a monetary tightening cycle? The correct answer is "All of them" (yes, as usual, I am throwing the COVID recession in there, too, even though it was not the proximate cause!). Now, how many times has the Fed successfully managed to tighten policy and rein in inflation without triggering a recession? If you said, "Only once!" (1994), then you're moving on to the next round. Lastly – and for one million rupees! – how long has it historically taken inflation to get anywhere near back to the Fed's 2% target after experiencing a breakout such as we saw last year? Five years or more – very much in contrast to the Fed's expectations depicted in Chart I, above (where Jerome Powell appears, instead, to be playing Name That Tune: "I can tame that inflation in 3 years!").

So, what should our takeaway be from this line of reasoning, and how does it differ from the markets' message? Well, inflation still comes down, it just takes longer to do so than the Fed expects. As a result, interest rates stay higher for longer than the Fed currently expects, which is already longer than what the market expects. The longer rates stay high, the greater the drag on economic activity and the higher the likelihood of a recession. Now, given the seemingly good health of the financial system, the consumer, and the corporate balance sheet, we don't see anything that would lead us to project anything terribly deep or protracted; the issue, however, is that at this point earnings expectations do not appear to reflect a realistic probability of even a mild economic contraction.

Chart IV: Good Or Bad, It Pays To Know The Odds



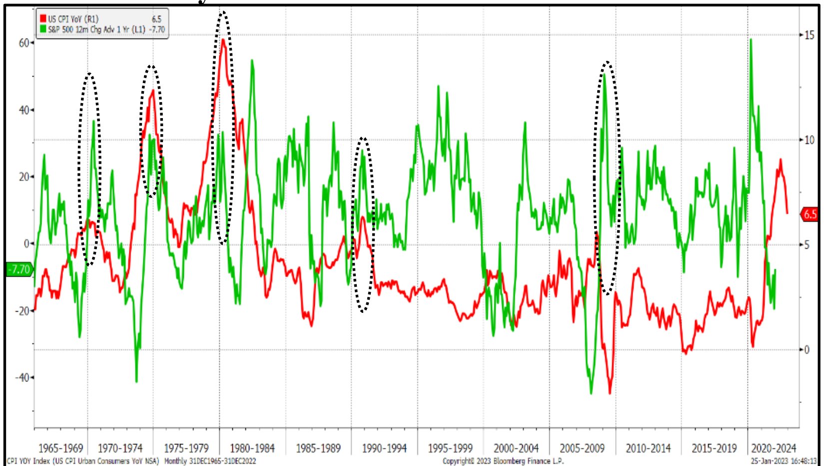
High inflation and the aggressive tightening policy adopted by the US Federal Reserve – and central banks globally – in response to it was the primary driver of lower stock prices last year. Similarly, an easing in inflationary pressures and the ensuing hopes for an end to the Fed's campaign of sharply higher interest rates has accounted for much of the wind at the back of the stock market in recent months. Moving forward, however, investors will need to remain mindful of the prospect of recession, which could begin to take on a much more prominent role in shaping the stock market's fate in the quarters ahead. Not surprisingly, given the tight linkage that usually prevails between economic growth and corporate profits, a recession will often spell trouble for stocks, with the market typically troughing well after the recession has begun, as opposed to doing so in anticipation of it. As noted elsewhere herein, there is little to be accomplished adopting a black and white perspective of inevitability on such matters, as no market cycle is ever the same as any other. Nonetheless, it makes sense to know what the key risks are under any scenario and be prepared to respond accordingly. Note that this does not mean panicking but may simply mean rebalancing to long-term target, tilting towards "defense" via a quality or income bias, or simply being ready to deploy fresh cash quickly when the opportunity presents itself.

This last point sticks out rather prominently as a potential threat to the stock market. The 2022 bear market was entirely a result of declining valuation multiples in the face of the higher interest rates deployed to stifle inflation. As a result, if we adopt a relatively sanguine outlook on inflation and, thereby, interest rates for 2023, it's not unreasonable to envision an environment in which multiples stay relatively stable. An economic recession, however, would typically be accompanied by an earnings recession; if we do go down that road and earnings decline, prices could find themselves under some pressure if the market's Price-to-Earnings ratio (aka valuation multiple) is to stay the same.

Market history paints a relatively consistent case for this sort of dynamic, as evidenced in Chart IV (right). Of course, history can cut both ways when it wants to and the counterpoint to the above risk posed by recession is the potential opportunity created by the peaking in the rate of inflation. Make no mistake: as we have said elsewhere herein, we believe (and markets believe – only the Fed does not believe!) that inflation will remain higher for longer and take several years before approaching the Fed's target (unless of course the Fed trips itself up and triggers a really nasty recession!) The market, however, has historically been focused more on getting past the peak in the rate of inflation. As made clear in Chart V on the following page, stock market returns in the year following a peak in inflation have historically been extremely good. The considerable tailwind that has accompanied such events in the past would, if repeated, go a long way towards lessening the potential impact of a recession, should one materialize later this year.

As these tailwinds and headwinds battle for dominance and we gradually feel our way through a pea soup of policy, economic, and geopolitical (we have not even touched on the war in Ukraine or China's increasingly inpatient aspirations towards Taiwan) uncertainty over the course of the year, a diversified portfolio will remain an investor's best friend. You have a plan in place, one that got you through last year – bruised, I know, but not broken; sticking with it will continue to serve you well as the cycle plays out. Don't abandon your value stocks just because growth has been crushing it over the past month – that's not your investment time horizon! Don't give up on your foreign stocks just because they lagged for most of last year – the extreme strength of the US Dollar was responsible for that and, now that it has reversed course, foreign stocks stand to reap the benefits; this is when you might actually want to consider MORE foreign (as our Investment Committee is in the process of doing) not less. And, while you're at it, stick with those "safety" buckets in

Chart V: Every Thorn Has Its Rose



The chart above depicts the rate of CPI inflation alongside the rolling one-year return on the stock market…but not over the last 12 months, but over the COMING ones! This ability to peer into a sort of "crystal ball" – at least historically, if that's not too oxymoronic – helps make quite clear the favorable reaction the stock market has had to getting the peak rate of inflation behind it. As can be seen, inflation often remain very high for a long time after this peak, but once the worst has been behind it, the market has tended to extrapolate lower inflation and interest rates forward to breathe some very considerable new life into stock prices. IF this proves to be the case this time around as well, then this would certainly help bolster the case for considerably better returns on stocks in 2023, in addition to helping to prop up what might otherwise look like a fairly weak case that the October lows were "THE" low for this bear market cycle.

your portfolio, if they make up part of your strategy; I get it – you're still in shock – but last year's bond market was the perfect storm meets the 100-year flood. After moving sharply higher in 2022, yields are now your friend: not only are they unlikely to move too much higher from here – they should even come down if we go into recession – leaving you exposed to very little in the way of interest rate risk, but you are now in a good position to earn a decent return on your fixed income holdings.

Make no mistake: it definitely is my intention to focus your attention on the year ahead – that is where the difference will be made. Last year is history and while a certain amount of wound licking is certainly understandable, 2022 has little left to offer us in terms of insight, with a few scarce exceptions.

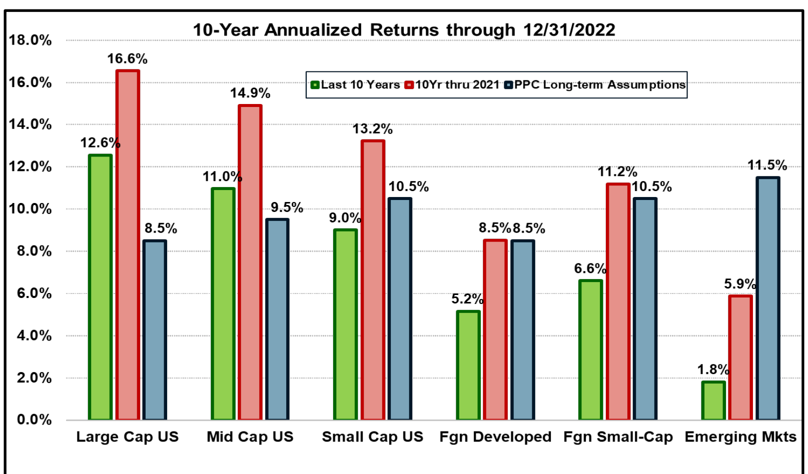
First of all, it was – as you already know all too well – a dismal year in just about every aspect of financial markets, that in and of itself being an anomaly. However, the sharp declines experienced have effectively given back to the future some of the returns that had been pulled forward by absurdly accommodative monetary and fiscal policy during and since the pandemic. As a result, as we were already alluding to last quarter, we believe diversified investors in stocks and bonds now face significantly higher prospective return expectations than was the case a year ago – and this is true pretty much across the board (although you will note in Chart VI, below, that it appears to be particularly the case in foreign equity).

In addition, we attempted to do one of the few things that can actually add value in such an ugly year: harvesting tax losses. We were actually given multiple opportunities to do so in 2022 and, mark my words, we took advantage of all of them, leaving many clients with sizable loss carryforwards to shield gains, all while having remained fully invested to strategy.

Our Investment Committee does not currently anticipate many such opportunities coming our way this year, something I'm sure you will not be too torn up over. We continue to review your portfolio strategies and adapt – gradually and subtly – to evolving conditions as appropriate, as we did over the latter half of last year to take advantage of the highest fixed income yields available in over a decade. We see current conditions as continuing to offer a good opportunity to check in – frankly, it's not like there's a bad time to do so! Your advisor, our CEO Larry Hood, and I all remain available to address any questions or concerns you may have.

-Jim Ayres, CIO

Chart VI: The Bear Market That Refreshes?



I would have loved to have simply called this graph "Back to the Future" – reference to the fact that recent losses have given back some of the returns that had been "borrowed" from the future – but I do NOT want to be seen as implying that returns are going to be so good as to take the long-term averages back to the extreme levels seen under complete monetary accommodation. What the above chart does show us, however, is that last year's bear market has taken a lot of the pressure off many of the key asset classes, the ten-year averages for which are all sharply lower than they were a year ago and a number of which are now well below the long-term expectations of our Investment Committee. This has once again set the stage for decent long-term performance for diversified investors willing to take on appropriate levels of risk.

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4TH QUARTER 2022 CAPITAL MARKET PERFORMANCE

Index (as of 12/31/2022)[1]	1 Qtr	1 Year	3 Year	5 Year	10 Years
FTSE 3-month T-Bills	0.87%	1.50%	0.71%	1.25%	0.74%
Bloomberg Barclays Gov't/Credit Int.	1.54%	-8.23%	-1.26%	0.73%	1.12%
ICE BofAML US High Yield	4.07%	-11.11%	-0.20%	2.14%	3.94%
Bloomberg Barclays Multiverse	4.70%	-16.01%	-4.38%	-1.57%	-0.28%
S&P 500	7.56%	-18.11%	7.66%	9.42%	12.56%
Russell 1000 Value	12.42%	-7.54%	5.96%	6.67%	10.29%
Russell 1000 Growth	2.20%	-29.14%	7.79%	10.96%	14.10%
Russell Mid Cap	9.18%	-17.32%	5.88%	7.10%	10.96%
Russell 2000	6.23%	-20.44%	3.10%	4.13%	9.01%
Russell 2000 Value	8.42%	-14.48%	4.70%	4.13%	8.48%
Russell 2000 Growth	4.13%	-26.36%	0.65%	3.51%	9.20%
MSCI EAFE	17.40%	-14.01%	1.34%	2.03%	5.16%
MSCI EAFE Small Cap	15.85%	-21.02%	-0.54%	0.35%	6.60%
MSCI Emerging Markets	9.79%	-19.74%	-2.34%	-1.03%	1.81%
MSCI Frontier Markets	-0.75%	-26.05%	-3.36%	-2.19%	3.58%
Wilshire US REIT	4.05%	-26.81%	-0.49%	3.35%	6.31%
DJ Global Select RESI	6.94%	-24.59%	-3.79%	0.57%	3.95%
Bloomberg Commodity Index	2.22%	16.09%	12.65%	6.44%	-1.28%
IQ Hedge Multi-Strategy	4.47%	-7.89%	-0.67%	0.76%	2.18%

[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 IQ Hedge Multi-Strategy index is a trademark of New York Life Investment Management LLC.