MARKET LETTER

PACIFIC PORTFOLIO CONSULTING, LLC

Fourth Quarter 2023

EXECUTIVE SUMMARY

- Twenty twenty-three saw economic resilience hold sway, but will it be enough to carry the day? We're not convinced yet: although the risk of recession has eased meaningfully, a brief, mild economic contraction remains our base case for the second-half of 2024.
- Inflation has come down – A LOT! We're expecting more gradual and grudging progress going forward.
- Hikes are over, but when do rate cuts begin? Probably not as soon as many think. Monetary conditions remain restrictive in the meantime, as the Fed tries to balance the risk of renewed inflation against the risk of tipping us into recession.
- Despite all of this economic uncertainty, 2024's financial markets prospects look "respectable", with bonds paying their way in this new, higher-rate environment and stocks delivering healthy gains (even if slightly below their long-term average).
- If interest rates do decline as we expect, Growth stocks should retain a tailwind over Value, particularly as more cyclical Value names feel the effects of slowing economic growth. Nonetheless, we are otherwise expecting the market to look quite a bit different along several dimensions in 2024 relative to the handful of "magnificent" stocks that called the shots last year.
- New highs: take them for what they are – a good thing, obviously, but don't get too carried away in the excitement of it all. Stick to the plan and you'll do just fine!

A HORSE WALKS INTO A BAR…

Why the long face? Another year in the can, all wrapped up nice and festive with a pretty little bow, Santa Claus rally and all! Any investor with the nerve to complain that they did not get everything on their Christmas list should at least have been able to find solace in the market's recent move to all-time highs, so let's just keep the tidings of comfort and joy rolling all the way through 2024, right?!

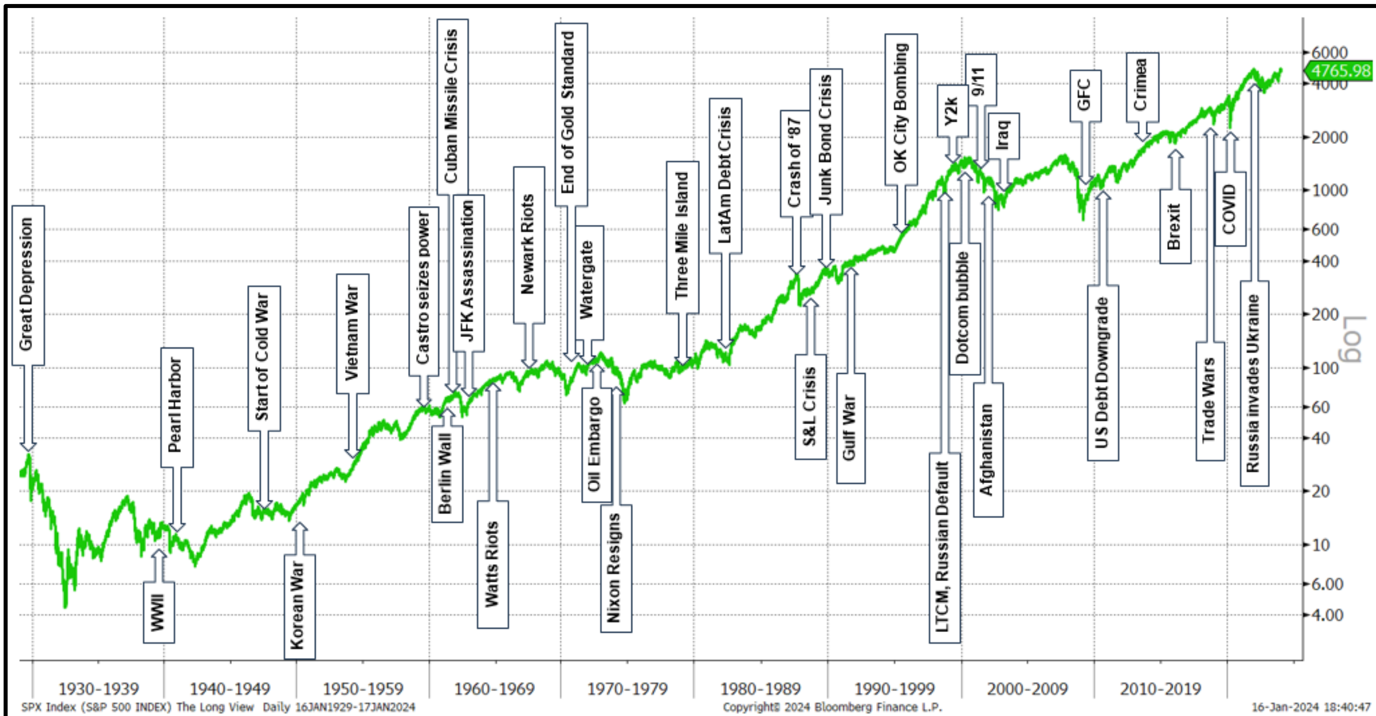
What's that you say? You're worried about the seemingly endless economic uncertainty? Trust me, I feel you! Things on that front are anything but clearcut right now. Why, just this morning, I couldn't help but laugh at the near-simultaneous emails I received from a couple of prominent Wall Street firms, one of them warning me that a key gauge of economic activity has "just posted its lowest reading since the pandemic," while the other trumpeted that "strong data suggests a reversal of growth concerns!"

Now, did I also hear you saying that the upcoming election's been weighing on you, too? I'm sorry, I'll need you to be a bit more specific: you see, there are elections taking place all around the world this year in countries that collectively account for nearly half of both the world's population and economic activity (setting aside Taiwan, which held its elections earlier this month, with China's "least-favorite" candidate winning on a platform of preserving the island nation's independence…gosh, what could go wrong there??)

Then, of course, there's the possibility that you're just deflecting; that it's actually something else entirely that sits at the heart of your uneasiness – say, the potentially elevated valuation of the stock market, for example. Well, the "good news" there is that, historically, such conditions have – in and of themselves – not been sufficient to generate an adverse outcome; of course, should something else provide the spark, high P/E ratios can certainly add fuel to any resulting fire.

So, I get it; it can be really hard not to worry. Believe me: as a natural born cynic, I find this to be the case even on a good day and, as we have just seen, there's no shortage of worries out there that could easily make this anything but. Still, as I often have to remind myself, the reality is that things generally tend to work out for the best (or, if not for the best, then at least for the "reasonably okay"). So, you fret, you stress, you second-guess, you catastrophize, and yet, ultimately, the storm passes; life goes on. Certainly, market history would throw its considerable support behind this idea (see Chart I), at least so long as we are taking a long-term view – and, just to be clear, that *IS* what we are talking about here, is it not? (Hint: If you're investing in financial markets, well known for their fondness for finicky flights of fancy, it certainly should be with a long-term approach.)

Chart I: Too Many Reasons To Count…But The Irony Is: Do Any Of Them Actually Count?



Now, this is one you probably have seen around before, but that's okay because it's a powerful visual that contains an absolutely crucial message. In reality, the above graph depicts only a fraction of the key economic, national, and geopolitical events of the past 90-odd years – we could not have fit them all without giving up any semblance of legibility! It manages to hammer home the key points nonetheless, specifically 1) there will always be a laundry list of reasons you could point to if you wanted to justify NOT being in the market and 2) even though financial markets exhibit volatility in the short-run as a result of such factors, they have shown the ability to ride them out over the long-term – even to the point that certain market "shocks" that felt catastrophic at the time may ultimately be reduced to mere blips on a more reasonable timeline. It's the old Benjamin Graham adage: the market is a voting machine in the short run – dominated by fear, greed, and opinion – but a weighing machine in the long run, over which it reflects the real value of profits driven by such things as growth in productivity and innovation. We show you this not with any realistic expectation that you will be able to turn a blind eye to the headlines but instead that you may see them for what they are and within an appropriate context, one in which they are never put in a position to derail your long-term plan.

How far should we carry this line of reasoning, though? Do we simply "decide" to stop worrying, belly up to the bar for a big glass of Kool-Aid, and join the masses giving thanks and praise to the mighty Jerome Powell? Has he not succeeded where (virtually) all others before him failed, orchestrating the Great Disinflation without so much as a hiccup in the job market, only the very slightest indigestion to the financial system, and little to no heartburn for the markets? In the words of the once sort-of-famous comedian Judy Tenuta, "Yeah, that could happen!!"

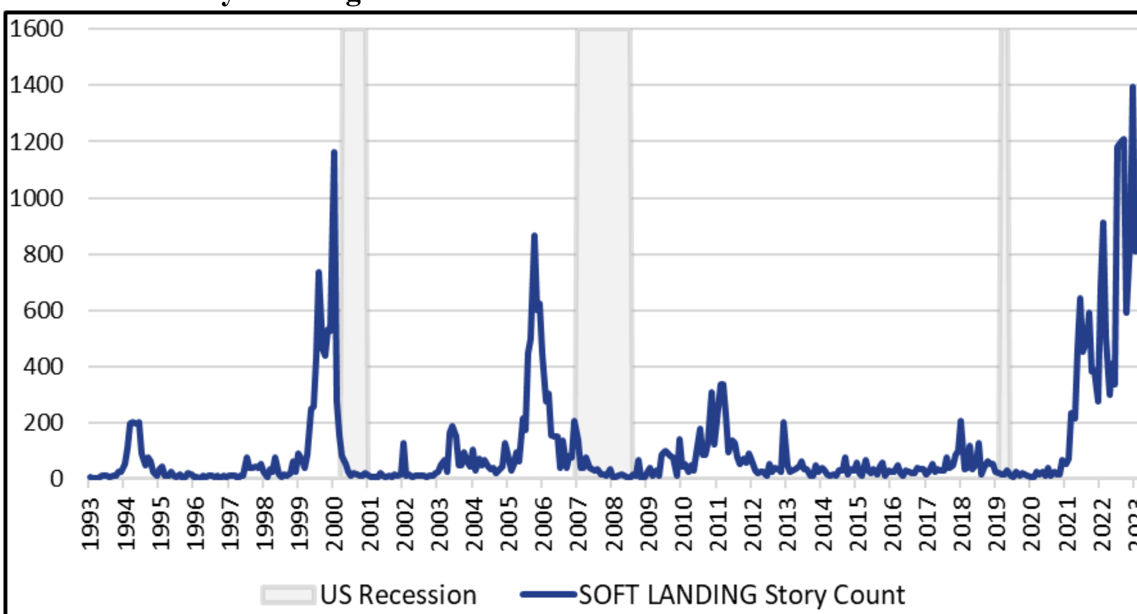
Okay, let me send my inner cynic to do a few minutes of deep breathing exercises, giving the realist in me a moment to seize the floor to admit that I know how hard it can be not to focus on the six inches in front of your face. If anything, that's all the more true in financial markets, where investors (and Wall Street analysts!) have a long-held fixation on short-run outcomes, not to mention the near constant barrage of financial "news" (and, yes, I am using the term loosely!) purporting to explain PRECISELY what is driving each and every tick of the market. Does it matter if what the talking heads say today contradicts what they said yesterday? Of course not (let's face it: investor attention spans ain't what they used to be)! As a result, however, I realize all too well that any attempt on my part to dismiss the worries and concerns of investors is destined to fall flat. Nonetheless, before you allow your worries to make a snap judgment for you and start throwing tomatoes at 2024, you should know that our Investment Committee actually believes the year will – consistent with the above philosophy – satisfy all of the requirements to achieve or exceed the proverbial "reasonably okay" outcome noted above. In other words, despite what we see as an inevitable slowing of the U.S and global economy, we see patient and diversified investors as poised to notch respectable gains – less dramatic, certainly, than was the case last year, but likely across a broader and more balanced set of assets.

KNOCK, KNOCK

Who's there? The economy. Notice that I did not say the market, I said the economy. These are not the same thing. Of course, they're related; more so at some times than others but, in the long-run, their fates are pretty fundamentally intertwined. Thus, they tend to follow a similar overall trajectory, albeit one with no shortage of detours by either of them along the way. Over shorter periods, however, their relationship may appear loose at best and a number of other factors will often make their presence known. Such is likely to be the case this year, we believe, as our outlook for global stocks and bonds is fairly encouraging, even as our expectations for the U.S. (and, broadly, global) economy are fairly lackluster, though not necessarily somber.

For the time being, our base case remains for a fairly brief and shallow recession to take place later this year. We certainly cannot deny the fact that the probability of such an outcome has diminished quite a bit relative to where it was last year, when virtually every indicator used to forecast such events – some with remarkably reliable records, I might add – were all flashing severe warnings in unison. Nonetheless, as the leading indicators of recession have abated, more coincident indicators of economic activity are showing signs of slowing.

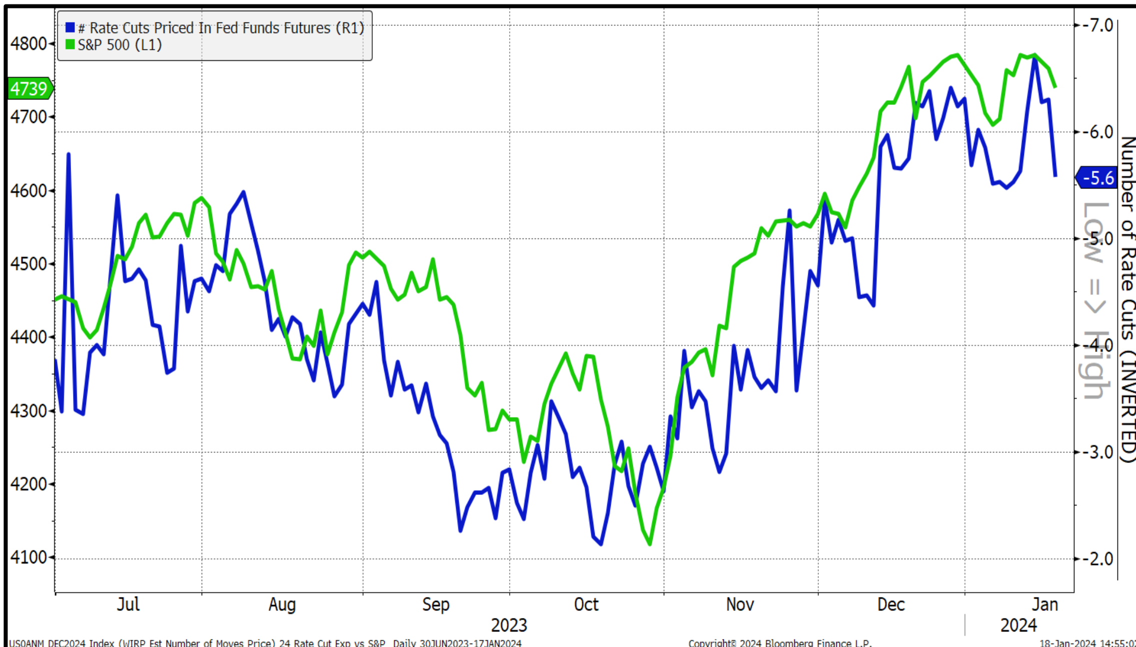
Chart II: Every Landing's A Soft One Until It Gets Punched In The Mouth



If you've done the impossible before breakfast (assuming you ate back in 1994), surely you should be able to do it again after lunch, right? To mix metaphors, once you have seen a black swan, you know for certain that not all swans are white. So, even when you consider that a recession has followed or accompanied every one of the eleven monetary tightening cycles of the past 70 years except for ONE, that the Fed orchestrated a soft landing back in 1994 stands as a testament to the fact that it is, in fact, doable. Even conceding that fact, however, my skepticism hackles are firing on all cylinders just on the basis of the odds alone! According to the chart above, though, the idea that the Fed is going to land the U.S. economic plane on a runway made of eggshells without cracking a single one is currently quite a popular one. It also shows, however, that the current "Soft Landing" optimism is not an anomaly – in fact, history shows that it's par for the course for markets to assume each time that *THIS* time will different. Have they been right in the past? Of course not! Meanwhile, given the economy has started showing signs of slowing, monetary policy has been in restrictive territory for over a year now, and any move by the Fed to ease such conditions may still be several months out, are the odds really that much different this time?

Meanwhile, you've got a Federal Reserve that has every incentive – so long as economic resilience holds out – to sit on its hands, at least for a while, before declaring victory. Inflation has made remarkable progress since peaking in mid- to late-2022, considerably outpacing, quite frankly, our (and most others') expectations. Nonetheless, you have to assume that, when assessing the biggest spike in pricing pressures since the pre-Volker era, the one lesson the Fed might have learned is not to take its foot off the brake too early for fear of a repeat of a late-70s style inflation resurgence. With wage growth having settled in above +4%, rent increases remaining elevated, and the Middle East conflict's spread to a key component of global shipping routes, how likely are they really to throw caution to the wind?

Chart III: Stock Market's Bet On Rate Cuts Is No Joke



Stop me if you've heard this one. A Wall Street strategist goes on a popular financial talk show and presents an extremely optimistic outlook predicated upon "we get a soft landing PLUS we get rate cuts from the Fed." That's it! That's the whole joke; come on, with a setup like that, who needs a punchline?? Throwing those two events together so casually as if they just naturally go hand-in-hand seems, itself, somewhat comical. Sure, even in a "soft landing" scenario, the Fed would be inclined to cut interest rates eventually, since monetary policy currently is outright restrictive – i.e., actively impeding economic activity. If, however, the economy remains resilient, the consumer robust, and the labor market tight, they would be in no hurry to do so, nor would they be looking to cut terribly far, since they would not be looking to actually stimulate the economy, merely to ease policy to neutral. The chart above shows the movements of the stock market alongside market expectations for the number of interest rate cuts in 2024. As optimism for rate cuts dwindled throughout 3Q23 and into October, stock investors were pretty glum; as the Treasury maneuvered longer-term interest rates lower in October, however, and Fed-speak turned more dovish, rate cut expectations spike higher and stocks have gone along for the ride. In typical fashion, the Fed said "three," the market heard "five" and proceeded to price in seven cuts!

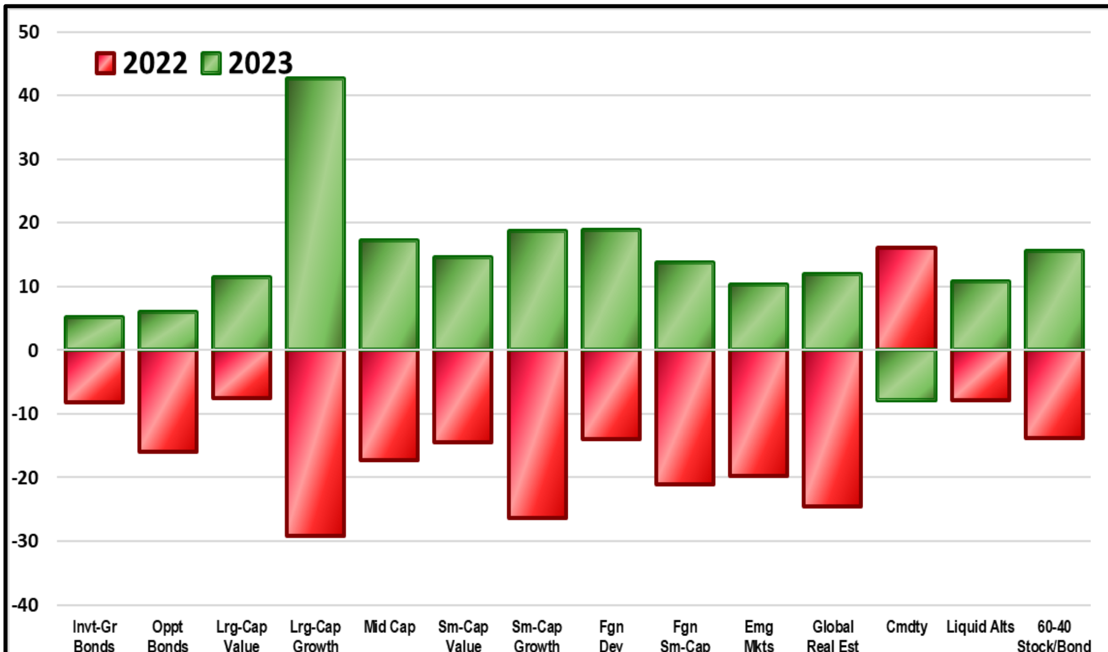
How, then, to interpret what has been dubbed a dramatic pivot – even if in language only – by Jerome Powell at the December press conference? Surely, it seemed quite appropriate – based on where we and the markets believed the Fed was at in their thinking – that he telegraph the shift in the Fed's bias towards a more balanced and neutral policy stance. Markets, however, saw in the statement verbiage and Powell's answers a reason to craft a much dovish narrative. The statement introduced the word "any" – as in "any additional policy firming" – but markets heard "rate hikes are done." Chairman Powell said they were not ready to take additional rate hikes "off the table" and, apparently, markets heard "we're getting ready to cut rates!" The Fed's quarterly Summary of Economic Projections (which you likely here bandied about as the "SEP") said the consensus outlook was for three quarter-point interest rate cuts in 2024, markets heard "BUY!!"

Of course, somehow the market managed to overlook the fact that the Fed's SEP also projected US economic growth to slow to around +1.4% this year. Funny how it works when you want to have your cake and eat it too. Anyway, since then, of course, much of Fed jawboning has been directed at paring back market expectations for rate cuts – both the number of cuts and their timing – perhaps explaining some of the volatility and pressure on stock prices over the first couple of weeks of January.

Why Did The Fed Cross The Road?

Probably to get away from belligerent investors demanding interest rate cuts! Even before Powell had said a word, markets were already pricing in four quarter-point rate cuts this year; by the time he was done talking, that was up to six (on its way to seven by mid-January) and the market-based probability of a March rate cut was headed to a whopping 90%. Since that time, of course, some investors' astronomical expectations have settled into a slightly lower orbit, the market's consensus view now standing at five rate cuts in 2024, with only a 45% probability of the easing starting in March. Recent Fed pushback likely has not been the sole factor to introduce this (very slight) moderation in the market's bullishness; it has also been the growing popularity of the "Soft Landing" view – one to which we cannot ascribe at this point – in which the economy stays resilient, good growth underpins corporate earnings, inflation – despite good growth and a tight labor market – for some reason continues to ease, and the Fed (given the preceding rosy backdrop, don't ask me why!) still decides to cut its policy rate of interest from 5 ½% to 4¼%...

Chart IV: Like Looking In A Mirror, Only…Not…



Our final chart in this installment looks the near-mirror reversal that 2023's strength brought relative to the bloodbath of 2022, thereby bringing us another valuable lesson and reminder of the importance of discipline and planning and the dangers of emotional reactions that cause us to overreact and extrapolate events and market conditions too far into the future. Let's face it: there is an entire branch of economics built around how investors' mental and emotional biases influence their behavior in financial markets. Recency bias: "Where are we headed? Well, where are we right now? In a bear market? Oh, ok, then!" Anchoring bias: "We're in a bear market. Stocks look oversold? Yes, but we're in a bear market. They look like they might have put in a bottom? OK, but we're in a bear market." Overconfidence bias: "I can time this thing. I'm better off sitting on the sidelines right now because I will be able to tell when it's time to get back in!" If you remember that the market is a discounting mechanism, you will expect it to turn long before (you or the headlines) see any tangible reason for it to do so. Meanwhile, if you stick with your long-term plan, you can better insulate yourself from these innate biases – that affect all investors, by the way; this is not your fault! – and we are here to help you with that as well; you will also find that when markets do move, you are already positioned in a mix of assets that will allow you to participate at a level consistent with our objectives and risk exposure.

Frankly, it's not hard to see why we are at new all-time highs against such a rosy backdrop. Even in the somewhat more muted (and, dare I say, realistic?) context of a minor economic contraction this year, we remain fairly constructive on stocks. Corporate profits should – after a basically flat 2023 –show some gains in 2024, riding on the shoulders of a seemingly tireless consumer. In addition, the slower growth we expect is much more consistent with a scenario of Fed rate cuts, which should help support equity market valuations, not to mention providing a potential boost to the bond market.

All in all, this looks to be a pretty decent landscape to navigate as a diversified investor, once again dispelling recent toutings of the death of "60-40" portfolios. Of course, as you should well know by now, we have never been straight, by-the-book, stock-bond diversifiers, instead believing strongly in the ability to lower portfolio risk without sacrificing return through the use of less-correlated, liquid alternative strategies; these have really been earning their keep the last couple of years, providing stability (and positive return!) during the recent market decline and were then up double-digits in 2023. We believe this is likely to remain an attractive area for long-term investment, as markets may remain volatile and newly-normalized short-term interest rates have removed a long-standing headwind to many of the strategies underlying this asset class.

And to be frank, it would be helpful if the market could broaden out a bit; not only would this benefit diversified investors, but it would actually help to take quite a bit of risk out of the index, which became very concentrated in last year's high-flyers. Notable areas due for a rebound include value stocks, given the historic divergence that has accumulated between the value and growth styles in recent years (although we are not necessarily holding our breath on that one for this year). We do believe, however, that small-cap stocks could be a key component to a broadly-successful 2024 outcome. These also fell into neglect during the multi-year dominance of mega-cap US growth stocks and recently appear to be getting back into the game. They have been keeping pace with the S&P 500 since the October rebound and have notched a couple of days of very decisive relative strength during that time that hints at a potentially more meaningful and durable rotation towards this less glamorous, perhaps, but also less efficient and more US-sensitive segment of the market.

Even in its current form, however, conditions appear reasonably favorable for stocks to deliver reasonably favorable outcomes. After two years, we have finally achieved new highs across the equity market benchmarks, an encouraging development based on history: there have been 14 other such instances since 1926 in which the market took a year or longer before notching a new high, of which 13 had positive returns over the following twelve months to the tune of an average +14% (even if you exclude the rebound from the Great Depression, the average was still an impressive +12%!) Meanwhile, even though it feels as though the market has been on a tear, the S&P is only up +2% year-to-date; while there are a number of strategists out there who are no doubt ratcheting their full-year projections higher as we speak, we see the potential for additional upside from here, as we look for the broad market – as represented by the S&P 500 – to return around +8% for 2024 as a whole. What's more, the trailing three-year return on the S&P 500 through 12/31/2023 was +10% to which I say "not bad!"…there's really not much more to it than that. That puts the most-recent three-year window only in the top third of observations over the past 45 years; that's very respectable! Still, it is a far cry from the late-90s – a period to which current conditions are often compared – when stocks experienced back-to-back-to-back three-year showings in the +25% to +30% range. It is, in fact, pretty much right in line with the long-term expectations of Pacific Portfolio's Investment Committee.

Last, but not least, we're in a presidential election year. Now, I'll be the first to admit that there is nothing magical about that, per se, though I will also point you to the record that shows that in the 24 election years since 1928, all but 3 (i.e., 83%) have been positive and that the average election year return on the S&P 500 (including the 3 down years) was a little over +11%. It being an election year also helps lay the groundwork for both sides of the political aisle to try not to upset any applecarts, while – perhaps more importantly – also discouraging the Fed from making any drastic moves in either direction to avoid the appearance of being partisan. As a result, the bar that needs to be cleared before seeing renewed rate hikes seems pretty high at this stage of the game; rate cuts, meanwhile, are possible (and, we believe, probable) should the Fed decide to move to a neutral policy stance, though these may become more difficult the closer we get to election time.

All kidding aside, folks, investing is no laughing matter; it is not, however, meant to be a punishment, either. The objective here is to have in place a plan structured to achieve YOUR specific, personal goals in a manner that makes it easy (or at least possible) for you to stick to the plan and still sleep at night. I encourage you, therefore, to take it in stride, to the extent you can; review your strategy and your situation with your advisor to ensure that you are positioned appropriately and then let your portfolio (and us) do the heavy lifting – as our motto says: we are here to increase the value of your time!

-Jim Ayres, CIO

4TH QUARTER 2023 CAPITAL MARKET PERFORMANCE

Index (as of 12/31/2023)[1]	1 Qtr	1 Year	3 Year	5 Year	10 Years
FTSE 3-month T-Bills	1.41%	5.26%	2.25%	1.91%	1.26%
Bloomberg Barclays Gov't/Credit Int.	4.56%	5.24%	-1.63%	1.59%	1.72%
ICE BofAML US High Yield	7.08%	13.40%	2.01%	5.22%	4.51%
Bloomberg Barclays Multiverse	8.13%	6.05%	-5.26%	-0.13%	0.53%
S&P 500	11.69%	26.29%	10.00%	15.69%	12.03%
Russell 1000 Value	9.50%	11.46%	8.86%	10.91%	8.40%
Russell 1000 Growth	14.16%	42.68%	8.86%	19.50%	14.86%
Russell Mid Cap	12.82%	17.23%	5.92%	12.68%	9.42%
Russell 2000	14.03%	16.93%	2.22%	9.97%	7.16%
Russell 2000 Value	15.26%	14.65%	7.94%	10.00%	6.76%
Russell 2000 Growth	12.75%	18.66%	-3.50%	9.22%	7.16%
MSCI EAFE	10.47%	18.85%	4.53%	8.69%	4.78%
MSCI EAFE Small Cap	11.20%	13.72%	-0.26%	7.02%	5.20%
MSCI Emerging Markets	7.93%	10.27%	-4.71%	4.08%	3.05%
MSCI Frontier Markets	4.03%	12.17%	-0.13%	3.68%	2.36%
Wilshire US REIT	16.30%	16.10%	7.52%	7.56%	7.72%
DJ Global Select RESI	16.03%	11.91%	3.46%	4.03%	4.76%
Bloomberg Commodity Index	-4.63%	-7.91%	10.76%	7.23%	-1.11%
IQ Hedge Multi-Strategy	4.26%	10.80%	0.72%	3.50%	2.63%
Domestic Balanced	8.84%	17.61%	5.48%	10.22%	8.07%
Global Balanced	8.53%	15.66%	3.25%	8.22%	5.98%

[1] The Bloomberg U.S. Government Credit Intermediate and Multiverse indices are registered service marks of Bloomberg Finance LP. The ICE BofA US High Yield index is a registered service mark of Intercontinental Exchange; 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. The Domestic Balanced benchmark represents a blend of 60% S&P 500 and 40% Bloomberg US Intermediate Government/Credit, rebalanced monthly, while the Global Balanced benchmark represents a blend of 60% MSCI ACWI and 40% Bloomberg US Intermediate Government/Credit, also rebalanced monthly.

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