MARKET LETTER

PACIFIC PORTFOLIO CONSULTING, LLC

First Quarter 2024

EXECUTIVE SUMMARY

- Nothing off the table, as conflict between data and policy refuels possibility of a "No Landing" scenario
- Higher than expected: inflation, above all, but also economic growth, job creation, and of course, the stock market
- Lower than expected (and falling): the number of rate cuts you can expect to see from the Fed this year
- Also lower is the risk of recession, at least near-term (though there's always one out there somewhere!)
- The Fed wants to start easing but the tension of higher growth and inflation is unlikely to resolve overnight, making any attempt to put a timetable around interest rate cuts a highly questionable exercise
- For the time being, the market continues to take "Good News" as good news, but inflation trend bears watching, as this could become the catalyst that shifts investors' mindset

LET'S GET PHYSICAL!

No, sadly, much as I know we all love her, we are talking, here, about Physics the science, not Olivia Newton-John's 1981 smash dance hit – although, in a "strange twist of fate", Newton-John just happened to be the granddaughter of Nobel-winning physicist Max Born, one of the founders of the theory of quantum mechanics alongside the likes of Heisenberg and Schrödinger (see what I did there? Now, no matter how the rest of this commentary goes, you've all learned something new!)

If I can, though, I'd like to avoid spending much more time on the whole issue of quantum theory – to be honest, it just makes my head hurt. Nonetheless, if I were brave enough to try to grapple with the concept for just a moment longer, I just might be able to make the case that it frames rather nicely a key area of uncertainty currently defining the financial landscape: that critical question of whether or not Schrödinger's proverbial cat – as I recall, he had (quite bizarrely!) named it "Inflation" – is, in fact, alive or dead. Here, however, we encounter a different kind of "Observation Problem" than the theory originally envisioned in that, in our case, there simply is no box for us to open in order to ascertain inflation's current state of being.

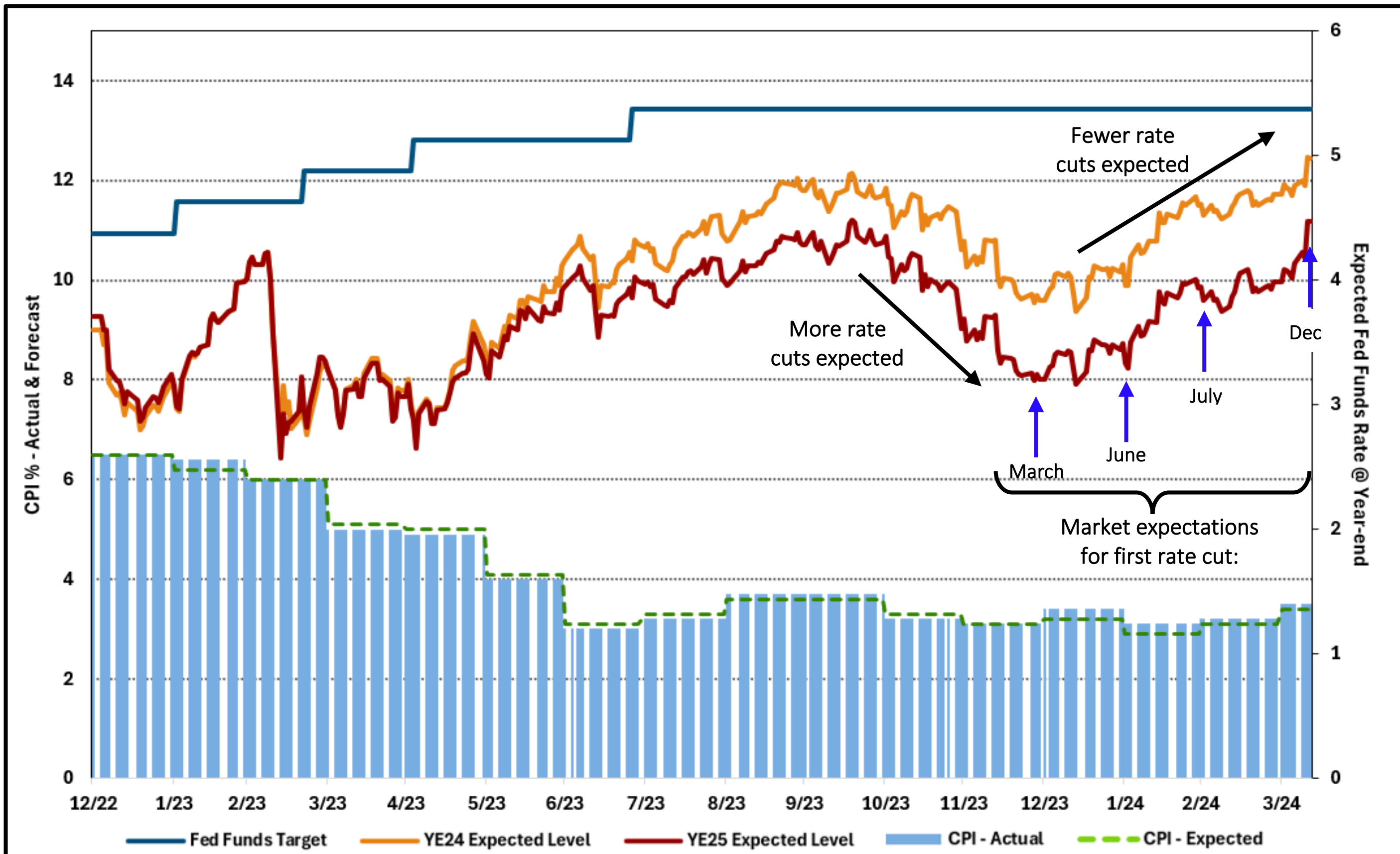
Now, one could argue that this is no different than any other time in any other cycle; decision making under conditions of uncertainty is just part of the daily grind for central bankers (note that I am NOT saying they are any good at it, just that they do a lot of it!) Still, I don't exactly feel like I am pushing the envelope when I suggest that monetary policy makers currently face an unusually challenging set of circumstances and that the scale of current growth and inflation uncertainties far exceeds that to which they have become accustomed in recent…decades! So too do the potential ramifications should they get things wrong. Monetary tightening cycles in general are reasonably rare occurrences as it is, but all the more so within the context of a high-inflation environment: there are really only a couple of those instances in modern history (the early 1970s and the late-'70s/early-'80s).

Any Fed playbook we might derive from those periods would likely contain some very unfamiliar formations. After thirty years, most of us are used to the Fed charging to the rescue as soon as they hear the whistle; prior to all that, however, the Fed had shown some willingness to be the "grownup in the room," at least when given the luxury to focus on its actual mandate (price stability with full employment) rather than propping up markets. In plain terms, such conditions could translate now to a policy of higher-for-longer until the Fed's convinced inflation is good and dead, even if it means recession (just so long as nothing breaks!) That scenario is probably not at the top of the list for most investors and it's no doubt not the Fed's first choice either. Powell and his teammates are hoping – and recently acting as if – they can pull from the '94-'95 playbook instead, whereby "decisive policy action" will have put the inflation genie back in its bottle, freeing them to make a handful of "insurance cuts," easing their policy interest rate slightly to hopefully extend the expansion phase of the economic cycle. Like any good scientist, though, they are relying on empirical evidence – aka they have declared themselves to be data-dependent! – which, for now, seems bent on challenging their hypothesis.

NEWTON'S 1ST LAW OF MOTION: A BODY AT REST TENDS TO STAY AT REST

If you're like me, nothing brings a concept home quite like a real world example. The Federal Reserve, ladies and gentlemen, is currently the posterchild for a body at rest. The Fed is experiencing the full force of inertia in all its glory, paralyzed by measures of U.S. economic activity that appear to reject any assertion that monetary policy currently is the least bit "restrictive" and inflation that has not only plateaued but even recently ticked up very slightly. Now, the Fed has plenty of potential energy, mind you; not only could it change its policy, it actively WANTS to change its policy – Powell has literally come out and told the market that he wants to get the rate cute process underway some time this year. The question, then, is how and when the Fed will manage to turn its potential energy into actual kinetic energy. If you followed the path of inflation from its mid-2022 peak, if you followed the vector of Fed rhetoric through its dovish pivot at the December 2023 FOMC meeting, you (and we and all of Wall Street) likely have been thinking "right…about…NOW!!" The devil is in the details, however, and the full language of the law says that a body at rest will stay at rest "until acted upon by an outside force." In this case, the force in question would have to be either faltering economic growth or benign inflation readings (or some combination of both). That being the case, I guess we will all be taking physics again in summer school, because the **recent data on both of those fronts is entirely unsupportive of Fed easing, leading the market's expectations for fewer and fewer rate cuts to be pushed further and further down the road.**

Chart I: Market Expectations Moving A Lot Faster Than The Fed

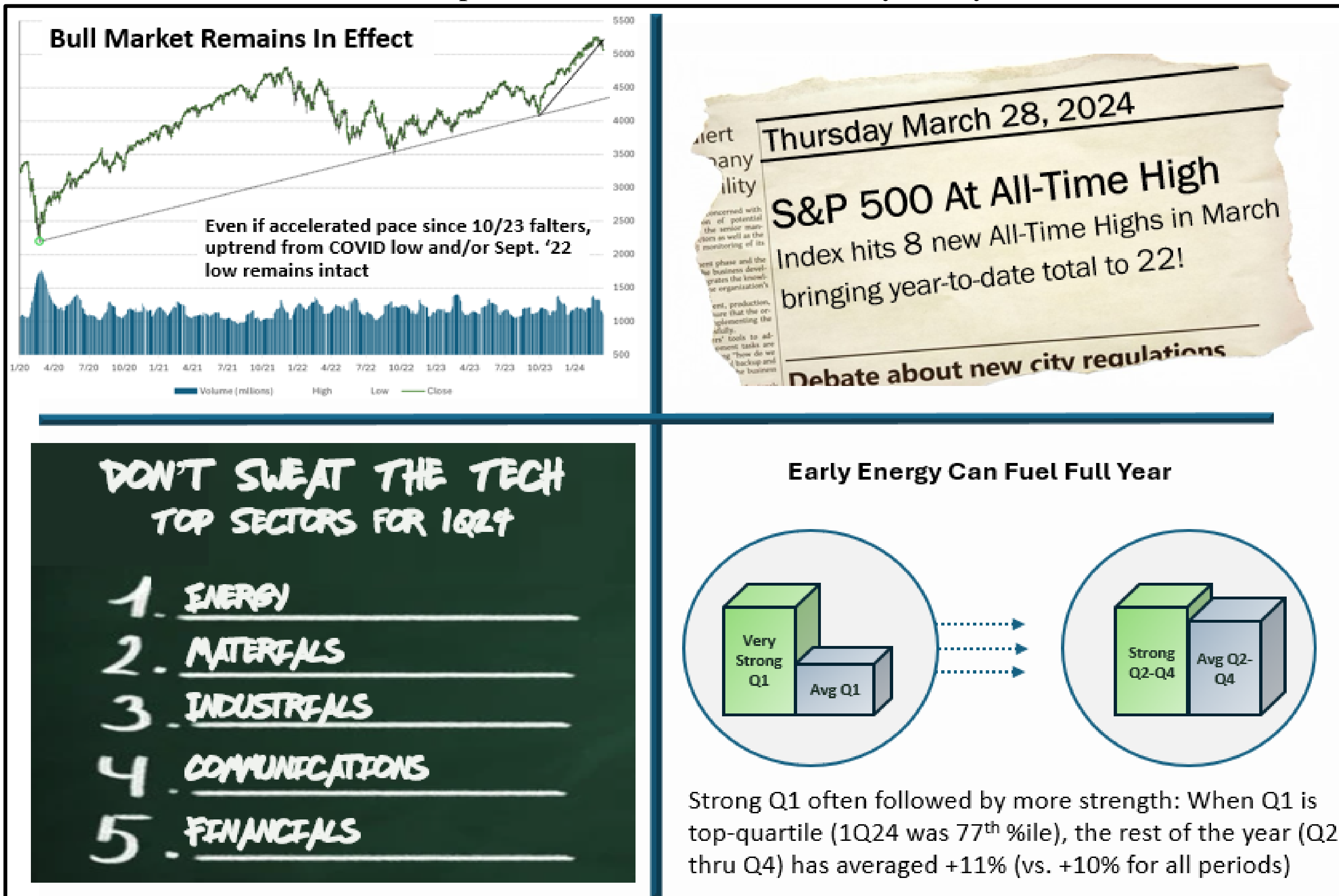


I lack even a conversational familiarity with the theory of relativity but, it seems to me that it says something along the lines of "if two entities – say, the market and the Fed – are moving at vastly different speeds, then each will experience time passing at a different rate." Something tells me, nonetheless, that the past several months will have felt like an eternity to them both! Let's be real: markets were ready to go before Jerome Powell had even finished talking at his press conference last December! Just a few months ago, markets anticipated a whopping 7 quarter-point interest rate cuts in 2024 starting as early as March; now, it's down to 2 or 3 cuts starting with the September or December FOMC meeting. The Fed, meanwhile, has been a bit more disingenuous about the whole thing, hiding behind its "data dependency" – it needs to see convincing evidence that inflation has, indeed, been tamed – while openly signaling its eagerness to get the easing process underway as soon as it can (reasonably justify it!) With the first three inflation readings of the year having come in hotter than expected, however, with growth looking solid, energy prices moving up, …the list goes on…, the Fed is unlikely to get the cover it needs to cut rates any time soon but also seems unlikely to stick its neck out too far by cutting rates ahead of such data, given how poorly doing so has worked out for the Fed (and, more importantly, the economy) in the past.

NEWTON'S 2ND LAW OF MOTION: A BODY IN MOTION TENDS TO STAY IN MOTION

Once again, we are fortunate enough to have a ready example at hand; I refer here, of course, to the stock market, the motion of which has continued to defy not only some investors' seemingly well-reasoned skepticism but at times even the very laws of gravity! Thus far, the first few months of 2024 have served up conditions fairly reminiscent of 2023, which – in its own right – ended up widely surpassing most investors' expectations. Now, our own view is NOT that we are in store for a full-year showing as exceptional as we saw in 2023 – which, looking back over the past (nearly) hundred year was roughly a top-quartile performance – but we are not inclined to argue with a market that seems to retain an impressive set of winds at its back that could continue to send it climbing up a wall of worry. This is particularly the case as we see valuations – though still far from not cheap – come down to a less rarified atmosphere, corporate earnings surprising to the upside, and a welcome and long-overdue expansion of market leadership beyond that same handful of darlings that have been biasing market performance so severely for some time now. I think it's fair to assume, nonetheless, that a pickup in "entropy" – aka market volatility – becomes more likely as evidence continues to mount of a move away from the goldilocks scenario that had become widely priced into stock and bond markets.

Chart II: Market Vector Retains Upward Direction, Even If Velocity Likely To Slow



Look, putting a scientific spin on the old "trees don't grow to the sky" adage, let's establish as a given the fact that there's no such thing as a "perpetual motion" machine. Yes, it is true that the stock market spends most of its time (around 70%) advancing, but pullbacks and corrections happen fairly regularly and are unpleasant but necessary components of a healthy bull market. Now, not to get in trouble for using the "B-word" but it bears (!) saying explicitly: bear markets happen as well (depending on the time period you look at, every 5 to 7 years or so). While this last proposition may be troubling within the context of the investing history of anyone likely to be reading this, bear in mind that long-term market performance and, more importantly, the assumptions that have been driving your long-term investment and financial plans incorporate these adverse periods alongside the good ones. Meanwhile, for the time being, our "null hypothesis" that the stock market remains in "bull" mode stands, as the preponderance of the evidence currently points to the potential for continued strength going forward resting on a broader mix of stocks and sectors, as market leadership appears to be in the throes of a more meaningful and, perhaps, finally sustainable rotation. Make no mistake: tech is doing just fine but as we have watched the "Magnificent 7" whittle down to the "Fabulous 5" (so long Tesla! see ya' later, Apple!) the "up & comers" showing greater strength in recent months have been more likely to come from areas like energy, steel, and industrials.

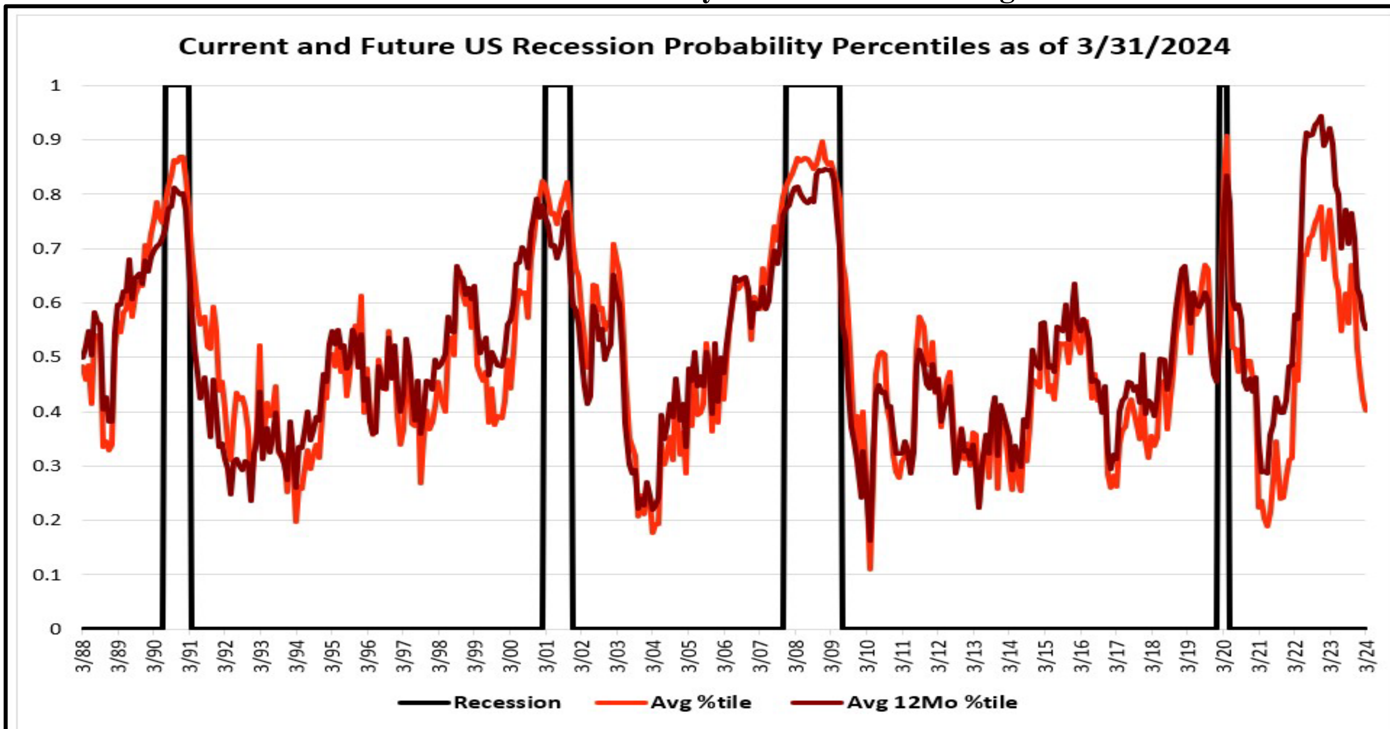
EXTRA CREDIT

Yes, there will be a test and – fair warning – the only "curve" I care about is the yield curve! I am, nonetheless, willing to offer up this opportunity for some extra credit to those who would wish to boost their grade. This works out perfectly, in fact, since we actually have a second case of a body in motion that warrants examination. We've looked at policy at rest and the market in motion; now for the economy itself, giving clear signs that it, too, is in motion. However, taking my chances by wading back into the field of quantum mechanics one last time, the specific nature of that motion is anything but certain right now.

Signs of strong economic growth? Check: the month-over-month change in the US Leading Economic index ticked into positive territory – a whopping +0.1%! – for the first time in two years, at the same time that the US Manufacturing PMI moved back into expansion territory. Signs of weakening economic growth? Yup, got those too! Consumer confidence is showing signs of fading, as is their stash of excess disposable income; oh, and let's not forget about small businesses, whose outlook the James Webb Space Telescope recently mistook for a black hole. Hints at higher inflation, meanwhile? Feel free to take a look at recent trends in Energy and, broadly, Services in general, home to most of the "sticky" inflation components. Weaker inflation? Well, year-over-year wage growth is lower (though not "low") – another straw on the back of consumers – in spite of which the labor market remains remarkably tight, with unemployment at just 3.8%.

The one thing that does seem clear in all of this is that all of the hand-wringing over the "final mile" of bringing inflation back down to target looks, for the time being, as though it may have been warranted. I would posit that most of the anecdotal evidence – and, in this realm, that's about as good as it ever gets – suggests the days of inflation surprising to the downside – i.e., coming down faster than expected – are over, as a slower, more give-and-take process likely takes hold. Economic growth – we believe – is still likely to ebb, though, clearly, we must soften our stance on recession: while not necessarily completely out of the woods, it is looking considerably less likely in the near future across virtually all of the measures we monitor. We do not, however, appear to be looking at the sort of decline in growth that would either a) solve the inflation problem or b) spook the Fed into cutting in spite of still-high inflation. As a result, we likely find ourselves in, if not an outright "no landing" scenario then, at the very least a "holding pattern" for now.

Chart III: Lower Recession Risk A Problem? Only If You Were Waiting For Rate Cuts!



Seeming to defy not only the odds but the laws of nature themselves, the US economy's risk of recession has staged a remarkable recovery, easing from quite literally perilous heights to a much more reasonable and benign level. Under current conditions – specifically, a Fed forced to delay interest rate cuts – this state of affairs could easily persist, since the economy has been shrugging off what had been assumed to be "restrictive" monetary conditions. If it's to work, however, growth almost has to come in, even if it stays positive, to have a reasonable chance of definitively taming inflation. We are NOT, at present, in the camp of some pundits who, having recently abandoned all hope, are looking for the Fed to HIKE rates, rather than cut them; we, like the Fed, however, will need to remain data-dependent as we attempt to observe the true state of the economy.

The Final…Word, Not Exam

Physics is a "hard science," while economics is "merely" a social science. And investing? Well, it's often said that is more art than science (though we would argue that there IS a scientific way to go about it – i.e., a long-term, disciplined, and risk-managed approach!) Even in the hard sciences, however, things don't always turn out the way you expect. That is certainly also true when it comes to forecasting the path of the economy and it is ROUTINELY the case when trying to forecast markets.

So, for example, slower growth did not materialize over the (widely) anticipated timeframe, thus pushing out rate cuts and, thereby, producing disappointing near-term returns for fixed income. Stocks, on the other hand, have eaten these conditions up with a spoon, posting returns quite a bit stronger than expected; these, however, are now starting to show greater volatility as inflation hints that it may not go quietly. Should you find yourself getting too caught up in all of this, however, I would ask you, on the one hand, why you were so focused on such a short-term time horizon and tell you, on the other hand, that none of the above necessarily portends anything ominous for the rest of the year ahead (we actually remain constructive on the remainder of 2024) but – more importantly – will likely have little to no impact on the success of your long-term strategy, provided you stick with it.

Truth is, there's really no getting around any of this; uncertainty is unavoidable (though perhaps not levels such as those we seem to rapidly be becoming accustomed to) and, as we often note in these pages, there is no return without risk. Remember, however, that you're diversified. Yes, you do have exposure to the high-flyers of the day but, thankfully, you've also got exposure to what may turn out to be the high-flyers of tomorrow. Your portfolio is not the S&P 500 and – no matter how big the index's stake in Nvidia is – that's actually a good thing. Believe it or not, there is little to no diversification – or risk control of any kind, really – investing in a single index, asset class, style, geography…you get the picture. Stocks are your friend – that's easy to see right now, though you might struggle with it at some point – but bonds are too (something likely harder to acknowledge right now). So is diversification, broadly, and the lower-correlated assets we add through our mix of alternatives, to which many of our clients have exposure, and which continue to do quite well, as they have for the past couple of years. Most importantly, though, provided you have managed to arrive at a portfolio strategy that allows you to sleep soundly at night, stay the course. If, instead, you find yourself tossing and turning, give your advisor a call to try to find something more conservative in your size. That's it for today, class dismissed. No homework!

-Jim Ayres, CIO

1ST Quarter 2024 Capital Market Performance

Index (as of 3/31/2024)[1]	1 Qtr	1 Year	3 Year	5 Year	10 Years
FTSE 3-month T-Bills	1.37%	5.52%	2.70%	2.07%	1.39%
Bloomberg Barclays Gov't/Credit Int.	-0.15%	2.69%	-1.06%	1.09%	1.61%
ICE BofAML US High Yield	1.46%	10.98%	2.23%	4.03%	4.35%
Bloomberg Barclays Multiverse	-1.94%	0.94%	-4.47%	-0.99%	0.09%
S&P 500	10.56%	29.88%	11.49%	15.05%	12.96%
Russell 1000 Value	8.99%	20.27%	8.11%	10.32%	9.01%
Russell 1000 Growth	11.41%	39.00%	12.50%	18.52%	15.98%
Russell Mid Cap	8.60%	22.35%	6.07%	11.10%	9.95%
Russell 2000	5.18%	19.71%	-0.10%	8.10%	7.58%
Russell 2000 Value	2.90%	18.75%	2.22%	8.17%	6.87%
Russell 2000 Growth	7.58%	20.35%	-2.68%	7.38%	7.89%
MSCI EAFE	5.93%	15.90%	5.31%	7.85%	5.30%
MSCI EAFE Small Cap	2.51%	10.98%	-0.92%	5.38%	5.11%
MSCI Emerging Markets	2.44%	8.59%	-4.68%	2.61%	3.33%
MSCI Frontier Markets	5.32%	14.50%	1.32%	3.37%	2.15%
Wilshire US REIT	-0.01%	12.43%	4.53%	4.41%	6.68%
DJ Global Select RESI	-1.32%	8.81%	0.84%	1.09%	4.02%
Bloomberg Commodity Index	2.19%	-0.56%	9.11%	6.38%	-1.56%
IQ Hedge Multi-Strategy	2.61%	10.32%	1.70%	3.17%	2.78%
Domestic Balanced	6.20%	18.47%	6.59%	9.64%	8.56%
Global Balanced	4.89%	15.10%	4.21%	7.54%	6.36%

[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.