

# MARKET LETTER

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## PACIFIC PORTFOLIO CONSULTING, LLC

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Second Quarter 2024

### EXECUTIVE SUMMARY

- Policy outlook continues to fluctuate, with the revival of rate cuts expectations, as data now points to tapering economic activity and inflation
- Look for the Fed able to get the ball rolling this year but unlikely to see too much policy easing in 2024
- Investors like what they see, as “bad news is good news” mentality has taken hold...
- ... but *where* they see the opportunities appears to be changing, as signs point to a material rotation in market leadership
- These shifts should underpin a further advance in equity markets, where, even though many high-flyers look expensive, most stocks still trade at relatively reasonable levels

### LIFE IN PURGATORY: NOT AS BAD AS YOU'D THINK?

Certainly not the most comforting analogy, but apt, nonetheless, as we sit here, essentially trapped between two realms. On the one hand, stocks have been on a tear for nearly two years; now, seemingly-lofty valuations and historic highs in market concentration are causing some investors to anticipate a reversal of fortunes. With strong corporate earnings and no sign of an impending recession, however, the path of least resistance from here remains higher, nonetheless.

Similarly, we have seen nothing short of an economic miracle over the past year, as the pace of US growth survived a near-death experience to come back – not merely resurrected but resurgent – just as recession had seemed all but a certainty. Now, however, the strength of economic growth is starting to fade – as is, thankfully, also the inflationary hellfire that has been torturing both investors' wallets and their portfolios; could this be the sign from above that monetary authorities have been waiting for letting them know the time has come to pivot towards easier monetary policy, setting the stage for the proverbial “soft landing” and, thereby, becoming the savior of the economy and markets?

Certainly, the clouds on this front appear to be in the process of parting; whether or not a heavenly light actually comes shining through, however, remains to be seen. In the meantime, we, as investors, cannot simply rely upon our faith; we need, instead, to actively navigate this ever-changing landscape between confidence and uncertainty, between greed and fear, between the potential for euphoria or despair. To help us adhere to the (financially) pious path as we do so, I offer here a simple investor dogma, a set of commandments, if you will – hey, I figure if Louisiana can mandate it in public school classrooms, I should be able to get away with it here too! Of course, with all the inflation we've had recently, I'm afraid the tablets have shrunk quite a bit – just like the size of a Hershey's chocolate bar – so I've had to cut it down to just four commandments. The price will still be the same, of course!

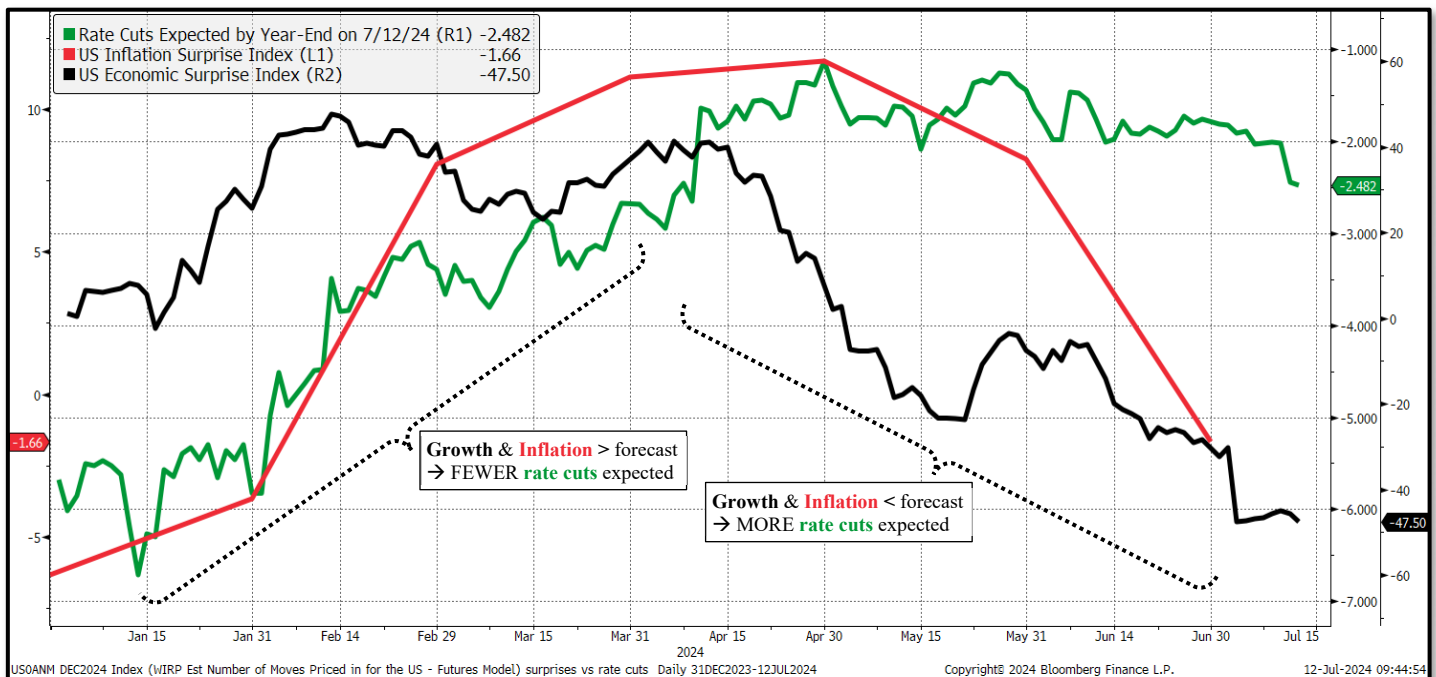
### THOU SHALT NOT BECOME WEDDED TO THY NARRATIVE

As the current environment continues to evolve, complacency could easily become a mortal sin for someone attempting to assess the state of the economy or market. In the words of the immortal economist John Maynard Keynes, “When the facts change, I change my mind” and so must investors be willing to do as the data continues to unfold or risk being smited for their hubris.

The U.S. has been experiencing an ongoing series of economic twists and turns this year that should be more than enough to keep any reasonable investor from getting too cozy with any one narrative. The early days of 2024 saw surprisingly resilient and even robust economic growth that easily surpassed what had, by that time, become very meager expectations; at the same time, inflation data – previously “sticky” – had begun to come in higher than forecast as well. Neither of these seemed the least bit consistent with a Fed pivot towards easier policy and markets quickly began to infer a “no landing” economic scenario as a result, causing expectations for interest rate cuts to evaporate. Initially, stocks rallied, as the strong growth supported optimism around corporate earnings; interest rates, meanwhile, moved higher as well, but not by enough to cause any meaningful alarm – that is, until things abruptly took a more sinister turn with the release of the March CPI data in mid-April, which showed a hotter-than-expected – and, even, reaccelerating – rate of inflation. This jolted markets and caused US interest rates to jump, the 10-year Treasury briefly touching 4.7%, as stocks sold off in what ultimately proved to be an entirely benign

~5% pullback that lasted a matter of a few weeks. Of course, as is so often the case, after having notched this steady streak of upside beats, the trend in the data began to reverse course beginning in the latter-half of April, with both growth and inflation – and, more recently, even the labor market! – beginning to disappoint relative to what were now newly-heightened expectations. With this, the narrative has quickly morphed from “no landing” back to “soft landing”, the economic “bad news” laying the foundation for the Fed to have sufficient cover to begin cutting policy rates and, thus, for market rates of interest to come back down towards the more moderate levels seen earlier in the year, and for stocks to rally through quarter-end (and beyond).

**Chart I: No Rest For The Wicked**



In part because so many investors were still on recession alert, US economic data began to steadily exceed economists’ paltry expectations early this year, leading the **US Economic Surprise Index** – the black line in the chart above, which compares the actual data to economist forecasts – to begin moving higher. Meanwhile, inflation, once finally roused from the plateau it had settled into for several months, did not resume its prior disinflationary path but, instead, also started to run hotter than economists were expecting, driving the red line, above, which depicts the **US Inflation Surprise Index**, higher as well. The “dependent variable” in all of this – and, from the market’s perspective, a very critical one – is depicted by the green line above, which shows the changes over time in the **number of quarter-point interest rate cuts the market expects the Fed to implement by year-end 2024** (because it reflects the number of *negative* changes to rates relative to current levels, the rising line indicates fewer rate cuts expected). The trajectory of this line over the past 6 months clearly highlights the dramatic changes in narrative that have played out in the market, as expectations shriveled from the wildly-optimistic 7 rate cuts seen at the beginning of the year – reflecting the exuberance that followed Powell’s extremely dovish comments after the December Fed meeting – to only a single rate cut expected by the end of April. The outlook has gotten a modest boost over the past 4-6 weeks as the data has cooled, the market now anticipating 2-3 quarter-point cuts this year. Of course, things get increasingly complicated the closer we get to the November election and, while conceding that two cuts are possible, our Investment Committee is currently only looking for the Fed to implement a single quarter-point cut this year, with most of the policy easing playing out over the course of 2025.

Recent conditions – which, of course, remain subject to potential further changes as we move forward – appear to provide the Fed with the necessary confidence that inflation is on a path to return to their 2% long-term target over a time period reasonably consistent with their forecasts (which – as expressed in the June release of their Standard Economic Projections, which you will often hear simply referred to as the “SEP” – would be by the end of 2026). Growth, meanwhile, appears to be slowing towards the long-term trend rate for the U.S., which – as a mature economy – is generally considered to be somewhere in the +1.5%-+2.0% range; while this does not necessarily dictate use of an “insurance cut” by the Fed – i.e., a lowering of rates to ensure the economy does not fall into recession – the tapering growth rate does provide additional collateral supporting a shift to easier monetary policy, which we think we will, indeed, see either late in Q3 or once the election is out of the way in Q4.

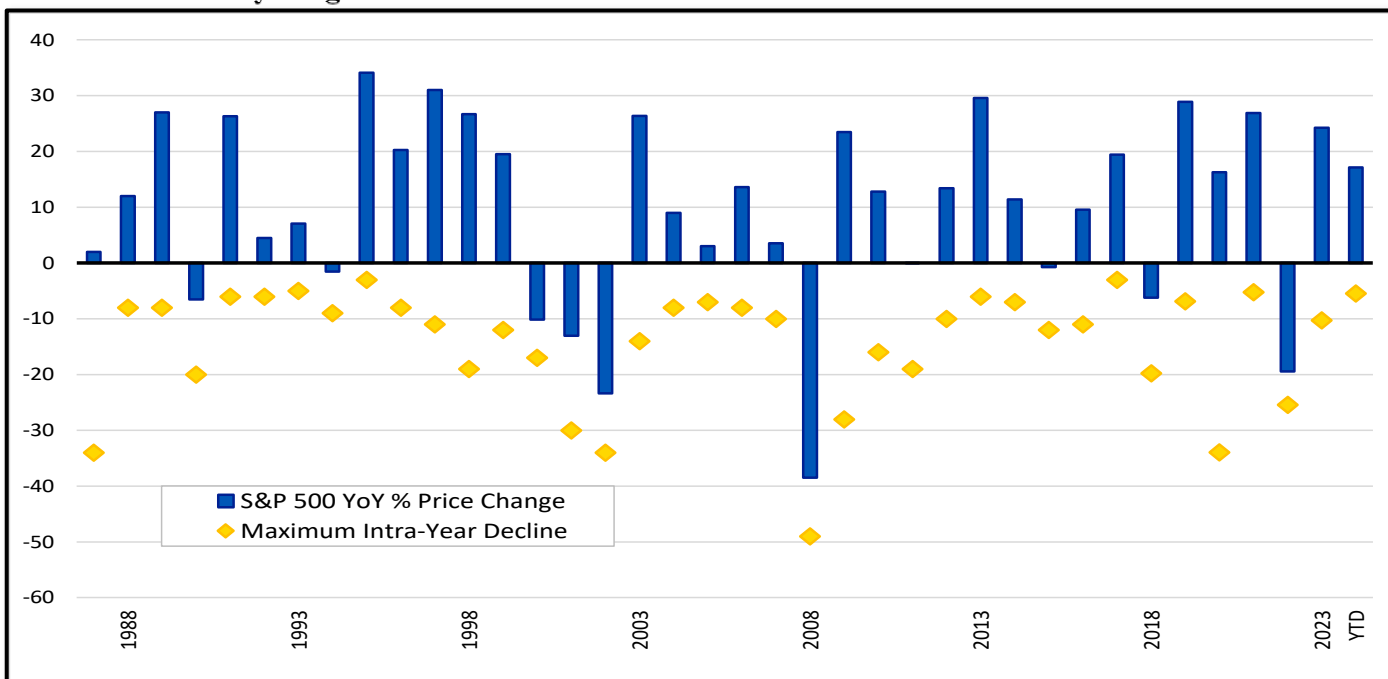
## THOU SHALL KEEP DANCING SO LONG AS THE MUSIC IS PLAYING

A paraphrasing of the “famous last words” uttered by Chuck Prince, former CEO of Citigroup, back in 2007, shortly before he was shown the door. He might not exactly have meant for his words to be taken in the way history has chosen to interpret them, but his quote is often used to highlight the devil-may-care attitude that was widely taken towards the idea of risk in the

years leading up to the Great Financial Crisis back in 2008-2009. Such a stance is, of course, quite contrary to our nature; for our purposes, though, we can easily turn Prince's battle cry on its head to give it meaning as a reminder to manage risk – rather than celebrate the flouting of it – within the scope of a thoughtful long-term plan.

When used in this manner, such a mantra can help investors to stay the course; keep from being tempted to fight the Fed, to fight the tape, to fight their own best long-term interests by trying to finesse – in true penny-wise/pound-foolish fashion – a leg up on the market by attempting to predict its next move. Say it with me: it's still a bull market until it is confirmed to be a bear market. It's still an economic expansion until it's officially declared a recession. There will be pullbacks and corrections in every bull market, just as there will often be slow patches within an economic expansion. Trying to predict the turning points for either of these phenomena ahead of time is notoriously difficult and can easily result in real, meaningful, long-lasting setbacks to an investor's efforts to achieve his or her long-term objectives.

**Chart II: To Everything There Is A Season**



We can learn a few important things from the above chart. For example, we can see clearly that the market spends quite a bit more of its time going up than down. Importantly, this becomes *all the more true* the wider your time horizon. For example, if you look at the S&P 500 on a daily basis, the upside still has an edge, albeit a skinny one, with the market going up 54% of the time; if, however, you take even a slightly longer view to, say, the one-year window, as we have done above, you can see that the probabilities have shifted meaningfully in investors' favor, as the S&P 500 was up a little over 73% of the time (this is true not only for the period since 1987, shown here, but would still be the case even if we went back a hundred years). What about from an intra-year perspective? Well, for one thing, we can see that market declines – far from being unusual – are, in fact, entirely routine: every single year had some degree of drawdown during the year. In fact, with the exceptions of 1995 and 2017, every year had a pullback of -5% or more, with the median intra-year decline coming in at -10.1% (the “average” – which would be skewed by the unusually large declines seen in years like 2008 or 2020 – would be -14.3%). Now, with that in mind, what was the annualized return over the full 37-year period observed here? Slightly more than +11%, provided you were in the market for the full period. While, as the chart makes clear, there was quite a lot of variability from year to year, such short-term volatility – while uncomfortable – becomes largely irrelevant when observed on the scale of the timelines around which your financial and investment plans are built.

Now, this is not to minimize how unnerving it can be to remain invested when things are going exceptionally well. The S&P 500 is already up over +18% year-to-date through mid-July (granted, the S&P 500 is NOT “the market” or, at least, it's not your portfolio; more on that later); that would make for a well above-average full year return! Inevitably, this will give rise to those saying it cannot continue; in fact, as we speak, in an ironic twist, the current CEO of the company that wound up gobbling up Chuck Prince's group has come out with the bold announcement that “a 10% correction is highly likely”... Forgive me, but that's hardly news: when it comes to corrections, it's never a question of “if”, merely “when.” There will always be one waiting for us somewhere down the road (heck, we had one just this past October – by a show of hands, we all survived, yes?) and, frankly, in the long-run, bull markets are better off for it! So, a correction is always a possibility; is one *more* likely with the market up the way it is? All other things being equal, logic would certainly say so; at the same time, logic, experience, and perspective would also tell you that any such correction is immaterial to your investment strategy and

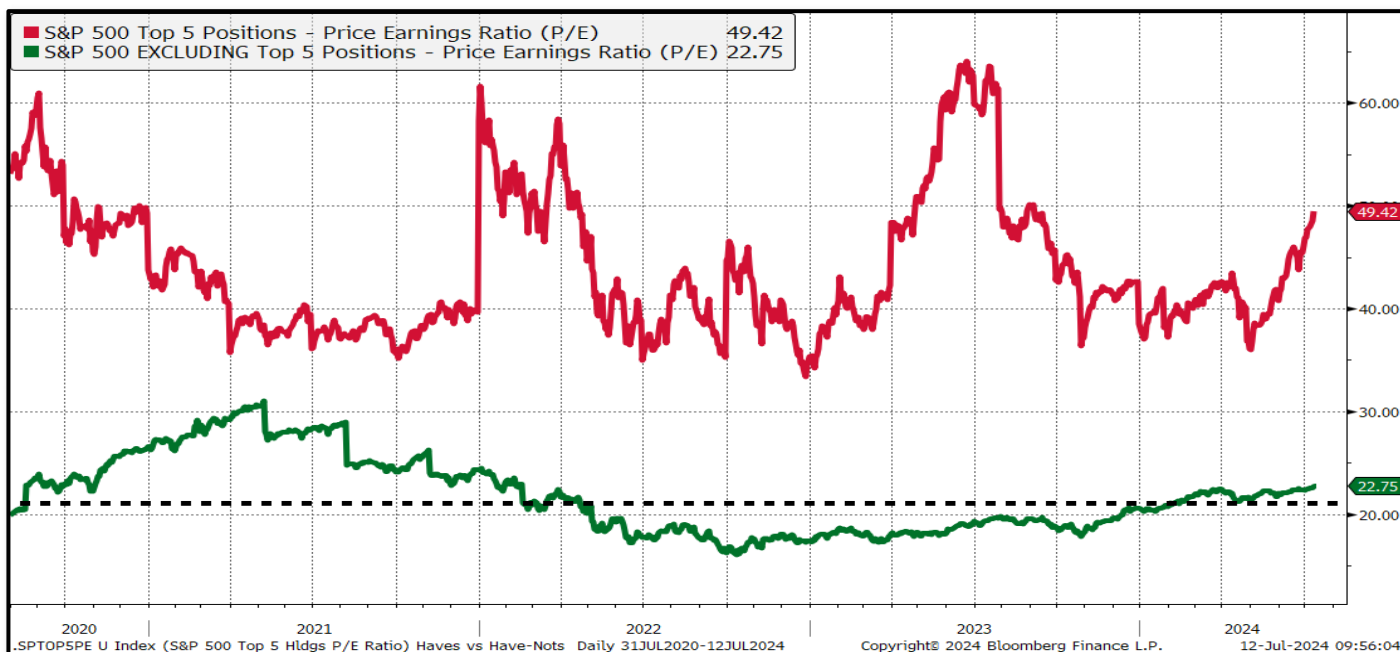
goals, none of which are predicated on such an extremely short time horizon. It's also largely irrelevant to the market's advance, which certainly can continue from here (it is, however, unlikely to do so at the pace it has exhibited since the end of the October 2023 correction, at which time it accelerated meaningfully). There's no question that we have had an outstanding 1<sup>st</sup> half of the year but we should, nonetheless, bear in mind that strong first halves often go hand-in-hand with above-average second-halves.

It's critical that we not allow emotions like fear or greed to call the shots for us. Those who move to the sidelines in an attempt to time the market almost invariably lose out. Notably, the same is also true of those who give up on diversification across the various different styles, market caps, and geographical segments of the equity markets, particularly when market leadership gets as narrow as it has been lately (but that is a topic for our next commandment).

## THOU SHALL NOT COVET THY NEIGHBOR'S PORTFOLIO – AKA DON'T BE NVIDIA(A)OUS!

Yea, for I have seen the number of the beast and it is...49?! Oh, no, wait!! Sorry: that's just the average price-earnings ratio on the top 5 stocks in the (cap-weighted!) S&P 500. Scary, yes, but not exactly the end of days type stuff. Nonetheless, I wouldn't call it prophecy to say the market darlings, those high-flying large-cap US tech stocks – in particular those with some connection to AI – are looking kind of pricey – the inevitable result of some truly astronomical performance. And, of course, in one of the more impactful “quirks” of capitalization-weighted indices, the more a stock goes up, the bigger a weight it gets in the index, and so on, and so forth. The result has been a sort of self-reinforcing momentum that has created a drastic increase in the concentration of the indices – most notably, the S&P 500, Russell 1000 Growth, and NASDAQ 100 – into a handful of names and, specifically, in the Tech sector – particularly when you add back names like Amazon and Alphabet that are not “technically” classified as being “tech stocks” (who do they think they're kidding?!).

### Chart III: The Number Of The Beast?



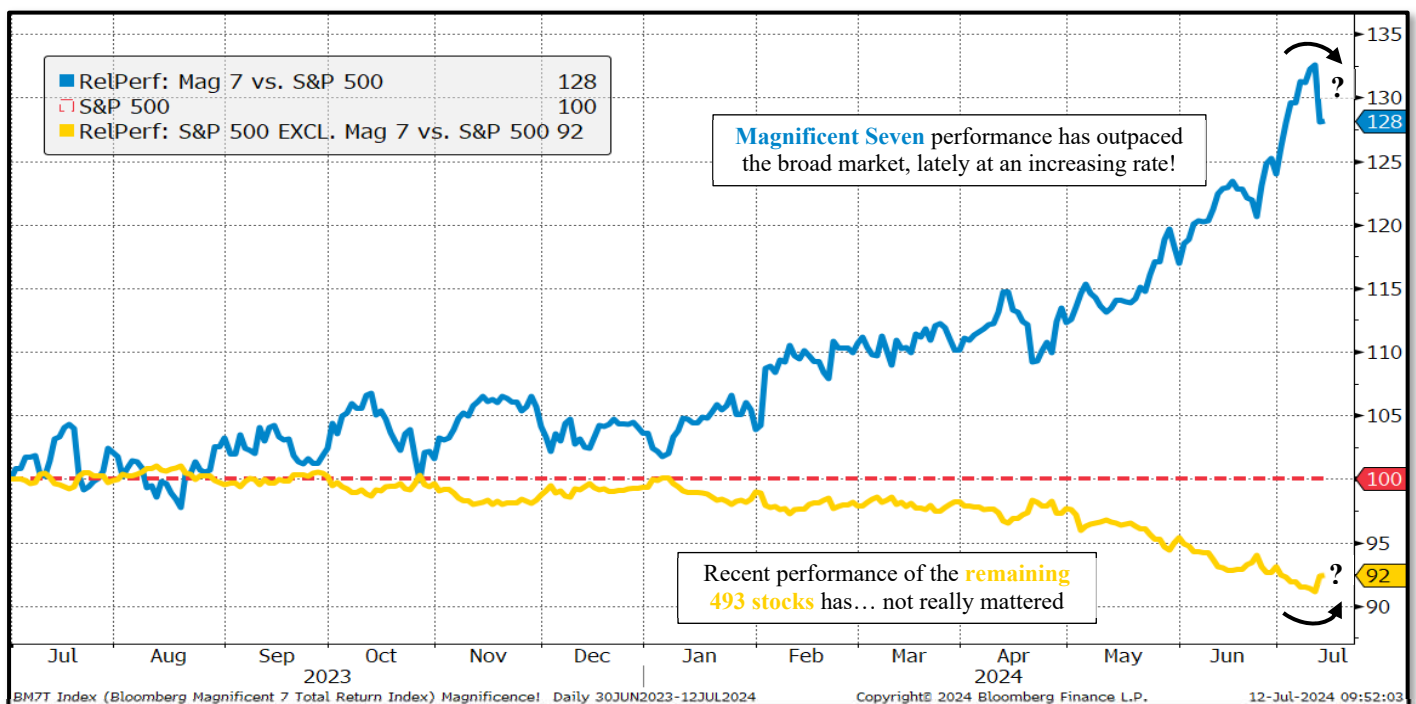
There is no question that the so-called “magnificent” stocks have had a spectacular run; while we would not encourage anyone to take the risk of not having some – **reasonable** – exposure to them (we have seen vividly what can happen to those who don't), this is no time to chase them, as the expectation **must** be that the market will, at some point, resume its long-term function as a weighing machine. At that time, the hefty p/e multiples (**red line**, above) at which these largest companies trade – and the extremely long runway to a payoff these imply – will come under increased scrutiny. The same is true of all of the market babies that investors have thrown out with the bathwater over the past few years, the neglect to which these have been subjected having created a number of opportunities waiting to be rediscovered. Certainly, when we look at the broader market excluding the highest flyers (**green line**, above), stocks look reasonably valued overall relative to the average of the past 10 years (**black line**, above), hinting at the market's ability to continue to see additional gains, particularly if investors rotate increasingly to these currently out-of-favor names and sectors.

Investors possess, it seems, a strong natural urge to focus on those stocks seeing the biggest gains, even singling out the performance of this or that individual stock and thinking, “Gee, if only I had all of my money in XYZ!!” Sadly, there does not appear to be an equivalent counterbalancing instinct to cause them to consider the massive risk that necessarily accompanies such an approach. As a result, investors can often experience some of their most counterproductive impulses at the worst possible time, insisting on comparing the greenness of their own grass to that of their neighbor and

often giving in to their fear of missing out by jumping onto an already overcrowded bandwagon. Times like this, people start wondering if they should be pursuing a more aggressive strategy or questioning why they even have any value stocks...or small-cap stocks...or foreign stocks...

If, like me, you were around the last time we saw this sort of investor mentality take hold on the scale it has recently, then I likely do not need to convince you that it will, indeed, come to an abrupt and definitive end at some point. Don't misunderstand me: I am not trying to put the fear of god into anyone by hinting at anything as ominous as the bust we saw following the dot-com bubble. I am merely emphasizing a market tenet that we should all take as gospel: simply that every, single cycle has an end. At some point, fate's favor must necessarily shift away from the market's current darlings and onto the rest of the flock. Already, the divergences have been stretched to levels that appear neither reasonable nor sustainable, be it in US versus non-US stocks, growth versus value stocks, mega-caps versus – well – literally anything the least bit smaller than them, and in Tech versus anything “not Tech”! It is not surprising that the so-called “Magnificent Seven” stocks sit right in the sweet spot at the intersection of all of these market dominant factors, as a result of which they have been endowed with a divine tailwind – or at least massive investor enthusiasm – that has lifted them up to where only angels dare to fly. It is, however, precisely this inordinate success that now makes a rotation away from them more likely – a shift of which we may already be starting to see the genesis thus far in Q3.

#### Chart IV: The Last Shall Be First



Not only have the Magnificent Seven stocks delivered eyepopping performance but they have, on a relative basis, left the rest of the market in the dust. As we saw in Chart III, above, this has come at a price – an ever-higher price, in fact! That has not deterred investors, though, many of whom took the fact that these stocks were doing better than everything else as a reason to load up on them even further. As the chart above makes clear, the result was a stark divergence between these **high-flyers** – whose contribution to the broad market's gains effectively went exponential over the past several months – and the **rest of the market**, which seemed to languish by comparison. At some point, however, their lofty valuations reflect all of the growth these companies are going to deliver – in fact, towards the end of the cycle, these actually start to reflect overly optimistic expectations. Meanwhile, everyone who could own these stocks already does – potentially a serious problem for such high-momentum stocks! Thus, it begins: the trend begins to reverse and such divergences begin to resolve themselves through a process of mean reversion that should see the broader, non-magnificent part of the market begin to outperform (as we appear to have been seeing play out so far over the first couple of weeks of July).

#### THOU SHALL HAVE A PLAN...AND STICK TO IT!

Listen, I don't care if it's a roaring kitty, a serpent, or even a burning bush that tells you to do it: do not allow yourself to deviate from your plan in response to short-term market dynamics, lest ye inflict serious damage on your wealth! As I noted earlier, your portfolio is not the S&P 500, it is not the latest hot stock setting fire to internet chat rooms. Sure, having it all in Nvidia over the past year, instead of only a small percentage of your funds, would have made you A LOT of money...but the hindsight with which we perceive this supposed “missed opportunity” is, very conveniently, blind to the nosebleed levels of risk it would have entailed. I know we all can get caught up in the headlines – it makes for good entertainment! – but all of

this has precious little to do with your strategy, which does not have the same level of return potential as such narrowly-focused approaches because, more importantly, it does not have anywhere near the same level of risk.

At the end of the day, the most relevant performance comparison you can make is between your portfolio and the return assumption incorporated into your financial plan; if you are on track there, then you are making progress towards those financial objectives you have identified as most important to you. The approach used to manage your portfolio has been tailored to these specific goals, to your time horizon, your tax situation, and, importantly, to your tolerance for and ability to absorb risk. To the extent there has been no material change on those fronts, it's likely you are in the appropriate strategy and, therefore, the best thing for you is likely to stick to your current level of risk exposure; if anything, such times offer a great opportunity to rebalance – take some profit off the table and use it to reload those assets that have underperformed.

Ultimately, this will likely turn out to be one of those times. Looking at market performance for Q2 (below), you can see that almost nothing on the equity front was even in positive territory aside from Large-Cap Growth. This is the 4<sup>th</sup> time in the roughly six quarters since the trough of the last bear market that large growth stocks have dominated the field, and not by a small margin either: over that period, the large-cap growth index is up some +72%, while the next-closest S&P 500, which holds many of the same high-performing stocks, albeit in smaller size, has a cumulative return of +46%. Given this long stretch of extreme outperformance, such a narrow pool of stocks inevitably starts to lose its appeal from a fundamental perspective; at the same time, with an increased likelihood of Fed rate cuts – which benefit both small-cap and non-US equity exposures – and the possibility of a soft landing, prospects for a much broader set of companies are looking considerably better. Investors have been taking notice: thus far in July, participation has broadened considerably and just about everything seems to be up, including large-cap growth stocks. Meanwhile, although it has only been a little over 2 weeks and this would not be the first time we have seen the tides appear to be turning – so far the Magnificent Seven are actually lagging the broader market, while foreign stocks are outperforming and small-cap stocks are literally ripping higher (rest assured: given our diversified approach, you have a healthy allocation to both of these areas in your portfolio).

While we remain mindful of a landscape that continues to evolve, we expect to see more of this sort of behavior play out, as the stage appears set for a dividend to globally diversified approaches such as the one used in managing our clients' portfolios. Meanwhile, we continue to pursue the patient, disciplined, and risk-conscious approach that has served our clients well for so many years now and encourage you to embrace these same principles to guide your own investment thinking. Should you need a little bit of help with this – or simply wish to review your portfolio or strategy – we encourage you to reach out to your Advisor, our founder, Larry Hood, or myself.

-Jim Ayres, CIO

## 2<sup>ND</sup> QUARTER 2024 CAPITAL MARKET PERFORMANCE

<i>Index (as of 6/30/2024)<sup>1</sup></i>	<b>1 Qtr</b>	<b>YTD</b>	<b>1 Year</b>	<b>3 Year</b>	<b>5 Year</b>	<b>10 Years</b>
FTSE 3-month T-Bills	1.37%	2.76%	5.64%	3.17%	2.22%	1.53%
Bloomberg Gov't/Credit Intermed.	0.64%	0.49%	4.19%	-1.18%	0.71%	1.55%
ICE BofA US High Yield	1.02%	2.50%	10.34%	1.65%	3.71%	4.20%
Bloomberg Multiverse	-1.03%	-2.95%	1.30%	-5.26%	-1.84%	-0.26%
S&P 500	4.28%	15.29%	24.56%	10.01%	15.05%	12.86%
Russell 1000 Value	-2.17%	6.62%	13.06%	5.52%	9.01%	8.23%
Russell 1000 Growth	8.33%	20.70%	33.48%	11.28%	19.34%	16.33%
Russell Mid Cap	-3.35%	4.96%	12.88%	2.37%	9.46%	9.04%
Russell 2000	-3.28%	1.73%	10.06%	-2.58%	6.94%	7.00%
Russell 2000 Value	-3.64%	-0.85%	10.90%	-0.53%	7.07%	6.23%
Russell 2000 Growth	-2.92%	4.44%	9.14%	-4.86%	6.17%	7.39%
MSCI EAFE	-0.17%	5.75%	12.09%	3.43%	6.98%	4.84%
MSCI EAFE Small Cap	-1.63%	0.85%	8.30%	-2.90%	4.63%	4.70%
MSCI Emerging Markets	5.12%	7.68%	12.97%	-4.68%	3.49%	3.18%
MSCI Frontier Markets	0.86%	6.23%	12.87%	-2.79%	2.57%	1.07%
Wilshire US REIT	-0.25%	-0.26%	8.56%	0.32%	4.02%	5.91%
DJ Global Select RESI	-2.05%	-3.35%	5.45%	-3.03%	0.54%	3.00%
Bloomberg Commodity Index	2.89%	5.14%	5.00%	5.65%	7.25%	-1.29%
IQ Hedge Multi-Strategy	0.72%	3.35%	8.64%	1.30%	3.03%	2.55%
Domestic Balanced	2.84%	9.22%	16.17%	5.69%	9.45%	8.48%
Global Balanced	2.07%	7.06%	13.54%	3.27%	7.25%	6.20%

<sup>1</sup> 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 depicts a blend of 60% MSCI ACWI and 40% Bloomberg US Intermediate Government/Credit, also rebalanced monthly.

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WE ARE MOVING! Effective August 1<sup>st</sup> our new address will be: 450 Alaskan Way S, Suite 500 Seattle, WA 98104