Pacific Horizon Investment Management, LLC
Investment Commentary

October 8, 2019

U.S. equities—measured by the S&P 500—ended up 20.56% through the third quarter 2019. Most of the year-to-date gains occurred early in the first half of 2019—a rebound from the Q4 2018 sell-off.

From our perspective, the U.S. economy seems to be proceeding through a flashing yellow light. U.S. job growth has been solid, today's unemployment rate is at a fifty-year low and consumer spending continues to be positive. The cautionary note, manufacturing numbers signal recession both here and abroad.

The usual litany of uncertainties continue to keep the markets on tenterhooks: global economic growth has slowed in response to simmering trade tensions, a "hard" Brexit looms in the UK and none of the usual geopolitical tensions have moderated. To reinforce the markets, the Fed cut interest rates as expected.

Monetary conditions reflect global weakness. Interest rates in many major economies are now negative as central banks struggle to stimulate borrowing, investment and growth. Here in the U.S., the U.S. Treasury yield curve has teetered on and off into inverted territory since March. (An "inverted" yield curve occurs when long-term rates are lower than short-term rates; many economists consider an inversion to be a harbinger for recession.) However, other commonly watched indicators, such as corporate credit yields vs. Treasury yields, are currently showing a very low probability of recession.

So, we think that the outcome of three factors will determine how 2019 ends:

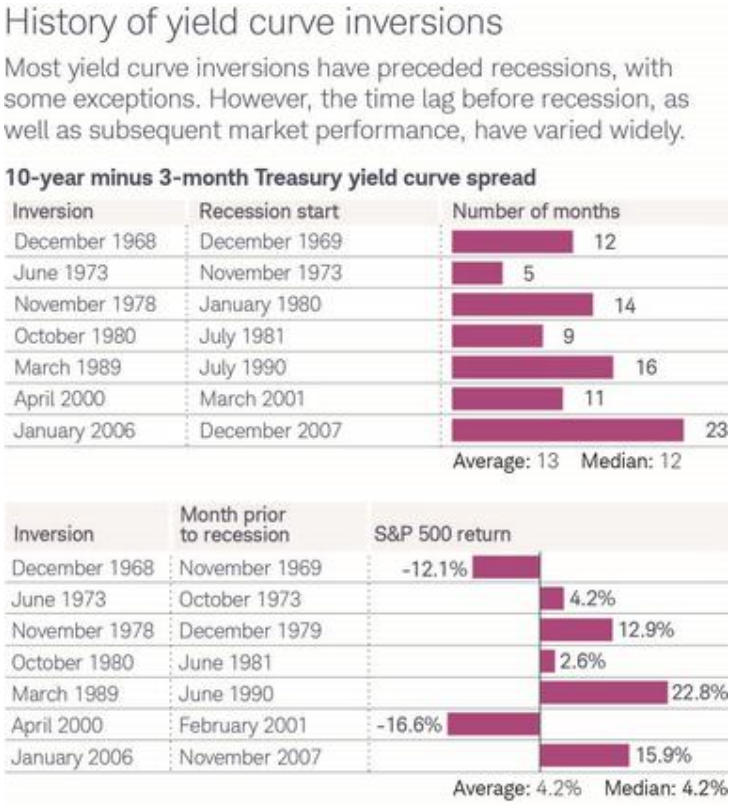
1.Trade. The uncertainty surrounding the U.S.-China trading relationship is the primary weight on market sentiment and the biggest challenge to economic confidence. Although the U.S. has trade deals signed or pending with four of its top seven trading partners that combine for 60% of U.S. trade (Japan, South Korea, Canada and Mexico), the dispute with China continues to be in the forefront. Going into 2019, China was the U.S.'s biggest trading partner but by the end of the first-half it had slipped to third place.

2.Tension in the Middle East. While Iran's attack on Saudi Arabian oil facilities in mid-September has elevated oil prices, our primary concern surrounds a retaliatory Saudi response that could trigger a severe regional conflict.

3.Corporate earnings. S&P 500 earnings grew more than 20% in 2018 and subsequent quarterly data in 2019 continues to be slightly positive. The next two quarters will be key indicators of the effect that recent tariffs have had on consumer-goods spending both here and abroad.

With all this in mind we believe it's important to maintain a diverse portfolio, so we've been actively rebalancing most accounts. Historically, stocks have posted their weakest performance during the six months leading up to recessions. We have a bias toward large-capitalization stocks; generally, as small caps have weaker profit profiles, are less agile against tariffs, and have highly leveraged balance sheets. Hence, they tend to underperform later in the business cycle. The value of global diversification means more international exposure. Today, the stock markets of the largest countries are tending to move more independently than any

time over the past twenty years. Finally, now is the time to enhance the credit quality for the fixed-income portfolio allocation. Hard economic times make things harder on less-creditworthy borrowers with significant debt obligations.



Source: Charles Schwab, Bloomberg, National Bureau of Economic Research (NBER). For illustrative purposes only.