Third Quarter 2020

Quarterly

A quarterly update from The Pacific Financial Group | TPFG.com

Outlook

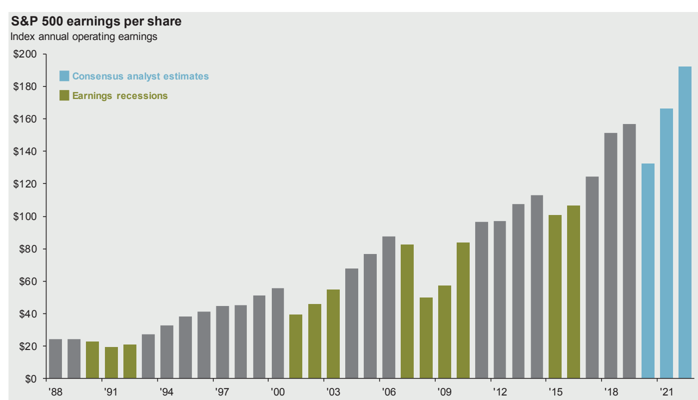
Markets have staged a remarkable recovery during the pandemic as the world waits for a vaccine. The S&P 500 has continued to perform exceptionally well, with a gain of 8.93% in the third quarter and up 5.57% year-to-date. Almost all sectors were positive for the quarter, with Consumer Discretionary leading the way, up 15.29%. Materials, Industrials, Communication Services, and Technology all returned 10% or more. Energy trailed as demand remains limited with ample excess production capacity. Financials also continue to struggle as low interest rates compress their earnings. Internationally, the MSCI Emerging Markets Index outperformed the MSCI EAFE Index, rising 9.56% vs 4.80%.

Growth continued its outperformance over Value and is up 20.61% year-to-date, compared to Value which is down 11.47%. A rotation to Value would typically require an acceleration in economic growth, elevated inflation, and higher interest rates. While economic growth may recover once a vaccine is widely distributed, we continue to expect low inflation and low interest rates, which is why we remain favorable on growth stocks.

Most fixed income sectors were positive, led by the ICE BofA High Yield index up 4.71%. Municipals and Intermediate Corporate bonds also performed well, up 1.23% and 1.33%, respectively. The Federal Reserve remains committed to expansionary monetary policy, and numerous credit facilities have helped to compress spreads. Recently, the Fed announced a new policy of average inflation targeting. This would avoid preemptive tightening that could derail a recovery. These factors are likely to keep yields low for some time. Note that Core Personal Consumption Expenditures (Core PCE), the Fed's preferred measure of inflation, has spent most of the past 12 years below its 2% target. We do not expect the new policy, nor inflation, to be an area of concern for some time.

The current consensus is for third-quarter GDP to rise at around a 30% annualized rate. The Organization for Economic Co-operation and Development (OECD) has improved its GDP forecast, estimating that the U.S. economy will shrink by only -3.8% in 2020, a significant improvement from the -7.3% contraction forecasted in June. America's fiscal stimulus has been the world's largest, both in absolute terms and as a proportion of GDP. Household disposable income has risen since the pandemic began, but Americans did not spend all the stimulus at once. The current savings rate (18%) is roughly double the 70-year average (9%), and there could be leftover spending support remaining.

Per FactSet, the estimated earnings decline for 3Q-2020 is -21.0%, which would be the second largest decline since 2009. Overall, expectations are for a -18.0% decline for the calendar year 2020, then a reversal to earnings growth of +12.6% in 1Q-2021. There is potential for new all-time highs in earnings in 2021 or 2022.



Source: Market Insights: Guide to the Markets. J.P. Morgan Asset Management. 4Q 2020

The U.S. has done well to lower confirmed cases from a July peak, though we do see a small recent resurgence. It is difficult to know if we will see another sharp decline in the months ahead. Schools and colleges are re-opening and winter weather will drive people indoors. If another surge in cases is met with targeted, localized restrictions rather than a national lockdown, resumption of economic activity should remain on pace. There has been tremendous progress on a vaccine in a short period, with widespread distribution potentially in 2021. Currently, there are at least 5 phase 3 trials underway, including Moderna, Pfizer/BioNtech, and AstraZeneca.

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Strategy Commentary

Overview

The third quarter began with improving economic data along with an increase in virus cases and hospitalizations. While improving economic data was encouraging, the increase in cases was a concern. Thankfully, we then saw cases and hospitalization decline throughout August. There was no impact from the virus surge on economic data nor market technical indicators. By the end of August, we saw improving or positive readings across the virus data, economic conditions, and market technical indicators. This led us to deploy the remaining cash in our strategies. We will discuss below how the cash was deployed, along with other changes, in each strategy.

Balanced Strategy

Both stocks and bonds finished the quarter higher, with stocks outpacing bonds by a wide margin. Large-cap stocks led the way, with the S&P 500 posting a gain of 8.93%. Growth continues to outpace value, led by Technology and Consumer Discretionary. The Bloomberg Barclays U.S. Aggregate Bond Index was up marginally, 0.62%, led by investment-grade corporate bonds.

The Balanced Strategy had several changes during the quarter. We added exposure to home construction stocks through a diversified ETF. Strong fundamentals are supporting the housing market, such as low mortgage rates, limited inventory, and favorable demographics. We believe these are strong trends that should continue even as the economy recovers from COVID. We deployed the remaining cash to defensive and quality equity holdings. This includes a new hedged equity position, designed to provide upside participation with downside protection. Finally, we took profits in an innovation ETF that had a strong run.

Overall, there was solid performance from all three components of the strategy. Moderate allocation managers benefited from investment grade credit exposure and strong stock selection. The equity allocation benefited from sector exposure, such as technology and home builders, a growth bias, and the hedged equity holding. Non-agency mortgage-backed securities and investment-grade credit boosted the fixed income allocation.

Equity Strategy

U.S. equity markets continue to recover from the drawdown in March. The S&P 500 posted an all-time high in August, then pulled back modestly in September to finish the quarter up 8.93%. Mid and small caps followed a similar pattern as large caps but finished with more modest returns, 4.77% for the S&P MidCap 400, and 3.17% for the S&P SmallCap 600. Consumer Discretionary and Industrials sectors were two of the top performers across all market caps. The Energy sector struggled due to weak demand and ample production.

We made several changes to the Equity Strategy over the past three months. The first change added exposure to home construction stocks, which include diversified exposure to home builders, building products, and home improvement retailers. After the virus data stabilized and the economic recovery remained on track, we deployed the remaining cash. We took this opportunity to add a hedged equity position, reduce mid and small caps, and increase exposure to quality stocks. Lastly, after a strong run, we took profits in an innovation ETF.

The two primary contributors to performance were the allocation to large-cap stocks and the sector allocations. Within large caps, quality, growth, and hedged equity holdings were the top contributors. Sector contributions were led by technology and home constructions, while health care detracted modestly. Exposure to mid and small caps was the primary detractor from performance.

Global Strategy

Global equity markets were led by emerging markets, which posted a return of 9.56%, edging out U.S. large caps. Asian emerging markets were the top-performing countries, led by India, China, and South Korea. A more comprehensive response to COVID has helped propel the recovery in the region. International developed markets were positive, but trailed, posting a gain of 4.80%. Global sector leadership was found in Consumer Discretionary and Technology, with Energy trailing.

We maintained a preference for domestic equities during the quarter but made several changes. We diversified our emerging markets exposure to shift away from state-owned enterprises, which have been lagging. In the domestic allocation, we made use of the hedged equity holding when we deployed cash. We also reduced mid and small cap exposure, while adding home construction exposure.

Finally, we took profits in an innovation ETF. International developed exposure remains relatively unchanged with a tilt toward growth, along with exposure to Switzerland.

There was solid performance across holdings, with a global growth manager as the top contributor to performance. Domestically, growth, quality, and sector holdings contributed while mid and small-cap detracted. Emerging markets exposure post a positive contribution, along with international growth and Switzerland holdings

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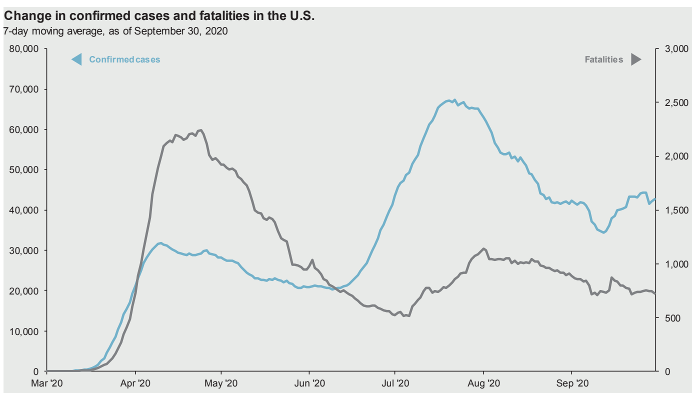

Source: Market Insights: Guide to the Markets. J.P. Morgan Asset Management. 4Q 2020

We now see that the shape of the recovery is neither V-shaped nor U-shaped, etc. Instead, it will likely be defined by the progress and expectations of a vaccine. Thus far, the economic recovery has been uneven, grouping industries into three categories. First are those industries that do well during a pandemic, including technology, health care services, and consumer staples. Second are industries impacted to a lesser degree by social distancing policies, including home building, manufacturing, and auto sales. Housing sales have surged to their highest level since 2006, driven by low interest rates. Third, we have service industries including airlines, hotels, restaurants, and other in-person services. These will likely require wide distribution of a vaccine before recovering.

In total, economic and market performance will likely follow vaccine progress and distribution for the next year. Our base case is for a vaccine to be approved and widely distributed by the middle of 2021. This should allow social activity to normalize, earnings to rebound, and GDP to recover to pre-pandemic levels by 2022. Central banks will likely remain accommodative, and a new round of U.S. fiscal stimulus should provide some support.

Upside scenarios include the possibility of an earlier vaccine and/or more effective treatments. Fiscal stimulus could also be larger than expected. Consumer finances are in good shape, with household debt at a 40-year low, and household net worth at a 30-year high. A well distributed vaccine could unleash consumer demand, boosting economic growth. A downside scenario could result from delays in vaccine approval, sharp increases in virus cases, and/or delays in fiscal stimulus. We continue to monitor a wide range of data points measuring the path of the virus, economic growth, and technical indicators. We remain diligent in our pursuit of balancing risk and return.

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Morningstar Direct.

Has anything happened we should know about? If there are any changes in your financial situation, investment objectives or specific restrictions, please contact your Investment Advisor or The Pacific Financial Group, Inc. It is critical to the achievement of your investment goals and the success of our relationship to discuss any changes in your financial needs.

Our clients receive quarterly performance on their accounts. For performance on any of our strategies, please contact your Investment Advisor.

Multi-Mandate Approach

We believe that an effectively diversified portfolio should be built around three distinct mandates, with each mandate having a unique objective, expectation, and contribution to the portfolio. It is through the combination of mandates that we believe a client can experience greater diversification, improved risk management, and enhanced returns.

Strategic

The strategies offered in the market movement segment are designed to replicate the risk and return of overall stock and bond market movements. Emerging markets, with strong performance in Asia, was the top-performing equity market this quarter, posting a gain of 9.56%. Large-cap stocks in the U.S. posted similar returns, with the S&P 500 finishing up 8.93%. Sector leadership was found in Consumer Discretionary and Technology. Cyclical sectors, Industrials, and Materials, also posted strong results, pointing to a recovering global economy. Fixed income sectors were led by corporate credit, as spreads tightened, and yields were range-bound.

Tactical

Strategies in this mandate are designed to actively adjust asset class weightings to increase/decrease market exposure. At the beginning of the quarter, most indicators were favoring risk assets, such as equities and credit. In a risk-on environment, a manager's ability to overweight the most favorable sectors becomes a differentiator in performance. Those managers who tilted their portfolio towards Technology, Consumer Discretionary, and Industrials benefited. In fixed income, holders of high yield bonds benefited from spread tightening. Those managers with exposure to Treasuries and more defensive equities trailed.

Diversifiers

Strategies in this mandate are designed to provide a source of risk and return that is independent of overall stock and bond market movements. This is a broad mandate, representing a range of strategies with a wide dispersion of returns. Overall, it was a solid quarter for diversifiers with most categories posting positive results. Managers with commodity exposure led performance due to the rally in precious metals. Strategies that incorporate equities, such as option-based and long/short, benefited from the broad rally in stocks. The uneven nature of the recovery has also benefit long/short credit managers.

THE PACIFIC FINANCIAL GROUP
ENHANCED BY RISKPRO

11624 SE 5TH STREET | SUITE 100 | BELLEVUE, WA 98005 | TOLL FREE 800-735-7199 | SALES 866-583-8734 | WWW.TPFG.COM