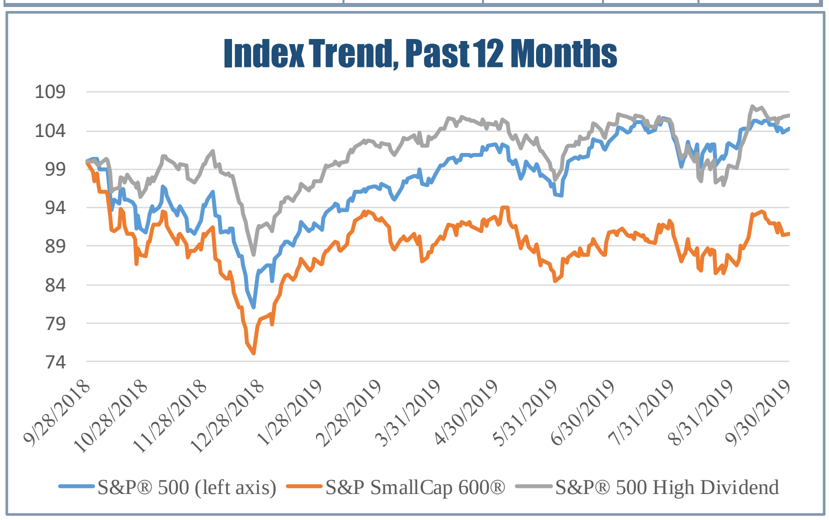
PALOUSE CAPITAL MANAGEMENT, INC.
Quarterly Commentary for 3Q19
October 2019

QUARTERLY RECAP

	Last Quarter	Previous Quarter	YTD	Past Twelve Months
S&P 500®	1.7%	4.3%	20.6%	4.3%
S&P 500® Equal Weighted	0.8%	3.7%	20.1%	3.4%
S&P SmallCap 600®	-0.2%	1.9%	13.5%	-9.3%
S&P 500® High Dividend	1.1%	1.6%	15.3%	6.0%
Consumer Discretionary	0.5%	5.3%	22.5%	2.4%
Consumer Staples	6.1%	3.7%	23.3%	16.9%
Energy	-6.3%	-2.8%	6.0%	-19.2%
Financials	2.0%	8.0%	19.6%	3.9%
Health Care	-2.2%	1.4%	5.6%	-3.6%
Industrials	1.0%	3.6%	22.6%	1.4%
Technology	3.3%	6.1%	31.4%	8.6%
Materials	-0.1%	6.3%	17.1%	2.7%
Telecom	2.2%	4.5%	21.7%	5.7%
Utilities	9.3%	3.5%	25.4%	27.1%
Real Estate	7.7%	2.5%	29.7%	24.7%
Crude (WTI)	-7.5%	-2.8%	19.1%	-26.2%
10 Year Treasury Rate	-17.0%	-16.6%	-38.0%	-45.6%
30 Year Treasury Rate	-16.6%	-10.1%	-30.0%	-34.2%
Dollar Index	3.4%	-1.2%	3.3%	4.5%
Vix	7.7%	10.0%	-36.1%	34.0%



Market Recap

The S&P 500® index ("SPX") was up 1.7%[1] in the quarter ended September 30, 2019 ("3Q19"), a weaker result than the previous two quarters. There were eight large cap sectors up and three large cap sectors down during the quarter, indicating a fairly broadly-based move. Both utilities and real estate stocks were strong in 3Q19, at least partially due to declining interest rates. The interest rate environment was an important economic and equity market factor in 3Q19 (see below). The worst sector during 3Q19 was energy, which was off a similar amount as crude oil prices.

The big market returned 20.6% in the year to date time frame through the end of September, mostly due to the strong post-correction move in the first quarter of the year. The best sector this year so far was technology, which was up 31.4% between the beginning of the year and the end of September; 59 of the 68 SPX technology sector stocks were up during that time frame. Shares of technology titans Microsoft Corp. and Apple Inc., both of which now have market capitalizations in excess of $1 trillion, were up more than 35% in the year to date time frame. Utilities, real estate and consumer stocks were also all strong this year so far. The worst sector this year so far was healthcare, which is only up 5.6% through September. Some material detractors to healthcare sector performance were UnitedHealth Group Incorporated, Pfizer Inc. and AbbVie Inc.

Small caps trailed large caps materially during both 3Q19 and the year to date time frame; the S&P SmallCap 600® index was down 0.2% during 3Q19 and it was only up about 13.5% year

[1] We use total return indexes to measure index and sector returns.

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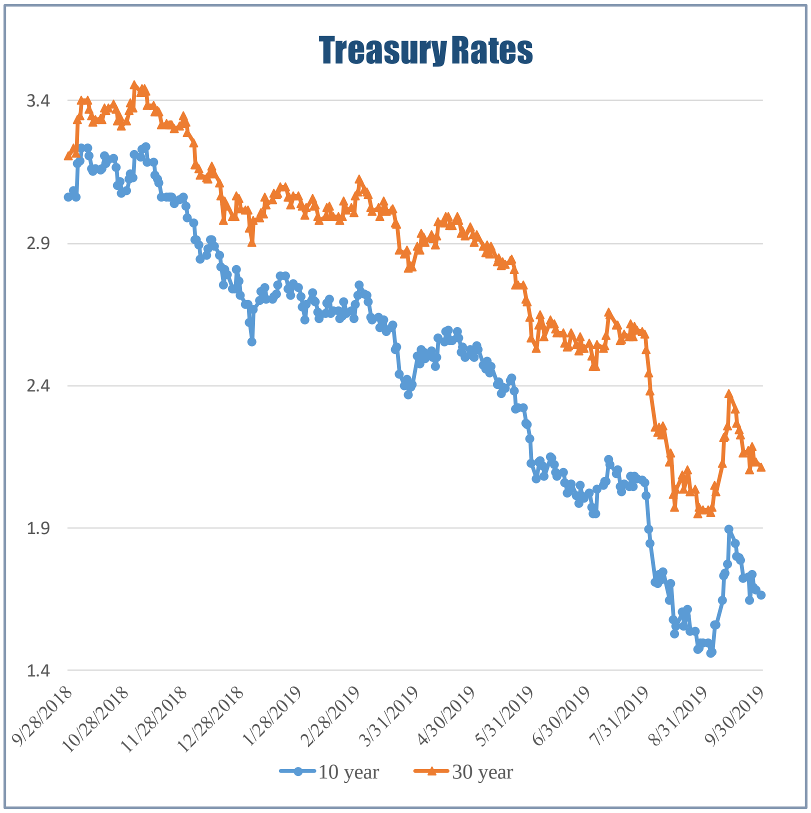
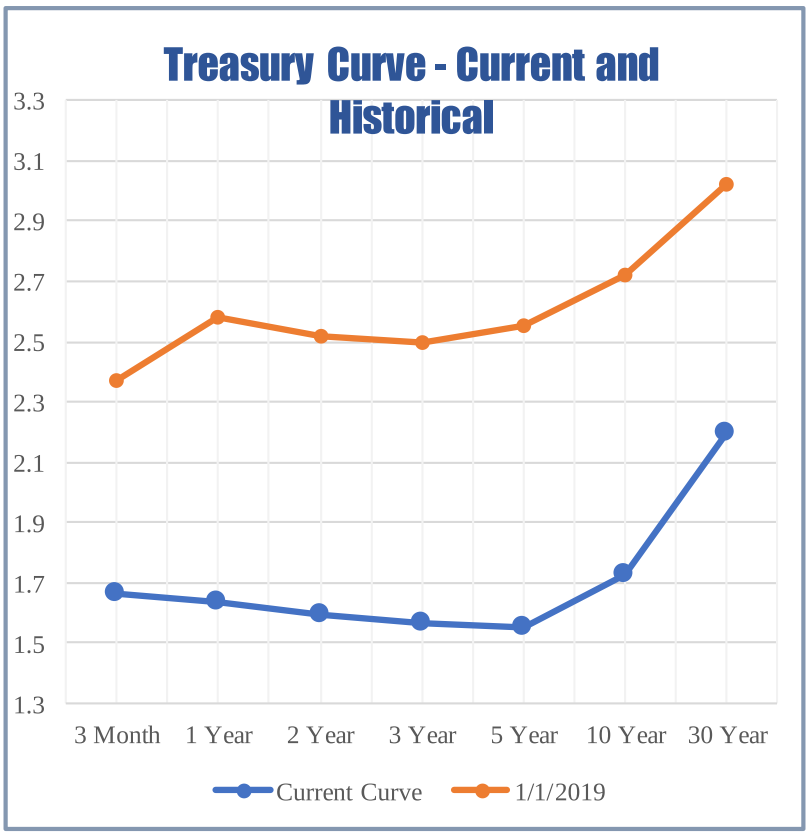
Source: Bloomberg. Past performance is not indicative of future results.





to date through September. Small caps generally corrected more severely than large caps during the last correction and they generally did not rebound as much as large caps since then.

The S&P 500® Value ("SVX") index beat the S&P 500® Growth ("SGX") index in 3Q19 in a reversal of trend going back to the first quarter of 2013. Since the first quarter of 2013 the SGX outperformed the SVX (measured quarterly) over 70% of the time. In contrast, between 2005 and 2012 the SVX outperformed the SGX over half of the time.

Treasury rates and treasury rate spreads dropped materially in 3Q19, continuing a trend that started about a year earlier. The ten year treasury started the quarter at 2% before dropping to a low of about 1.5% in September. The two to ten spread fell below zero in August; the last time that happened was back in 2006, right before the "Great Recession" and the wicked bear market that accompanied it, which is why interest rates and interest rate spreads attracted a lot of attention in 3Q19. The two to ten spread was not the only spread that dropped in 2019 so far and the treasury yield curve became more inverted as the year wore on. The inverted yield curve is concerning for equity investors because it has been associated with recessions at least a few times in recent history.

The ISM Manufacturing Index ("ISM") has dropped steadily this year so far after reaching a high of 60.8 back in the summer of 2018. The ISM dropped below 50 in August, indicating contraction for the first time since August of 2016. The September ISM was 47.8, the lowest figure since June of 2016. In addition, the last time the ISM put up two consecutive months below 50 was in the beginning of 2016. While this might seem like a relatively obscure topic for equity investors to analyze, the last time the ISM was in contraction for an extended period the big market went through an "earnings recession" and that is probably why the September ISM report attracted a lot of attention and caused some market jitters.

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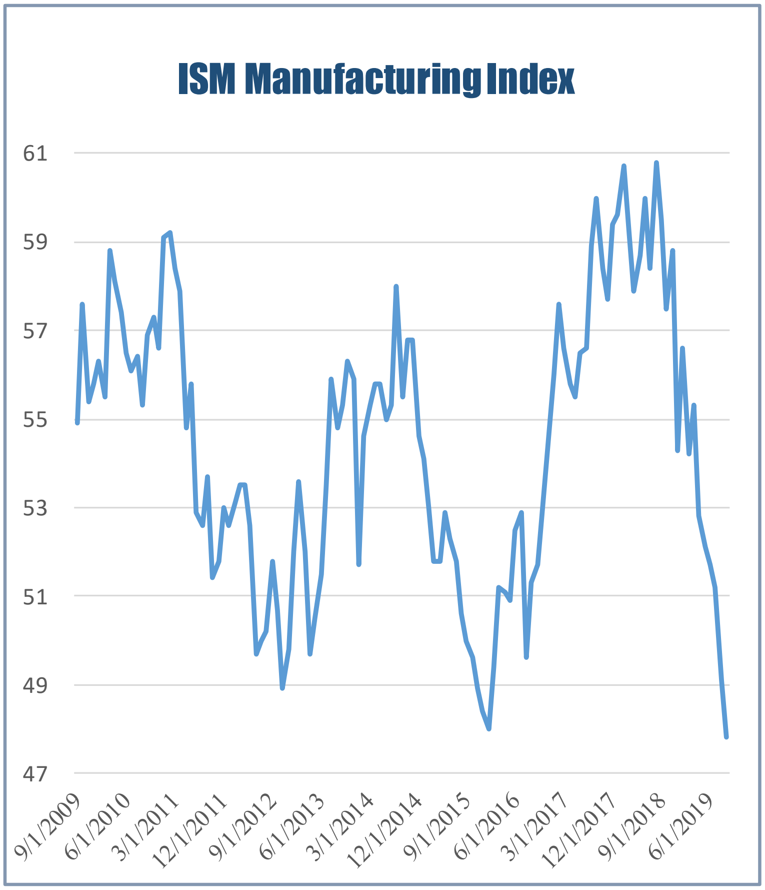
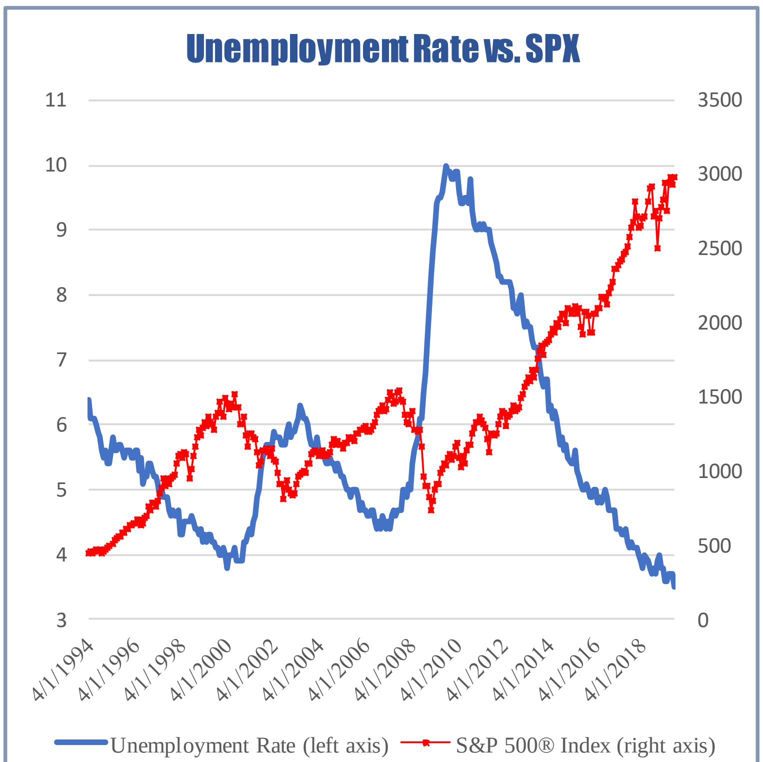




The domestic employment situation remained strong in 3Q19, as was generally expected by economists. The unemployment rate is now 3.5%, equal to the lowest rate put up in the past 50 years. The year over year change in average hourly earnings for September was 2.9%, slightly less than expected. The change in average earnings has been steadily trending up since 2012. The labor force participation rate for September was 63.2%, matching estimates. Through the end of July there were still more job openings than unemployed people in the United States, something that happened for the first time starting in March of 2018 (using data going back to 2000).

Market Model and Outlook

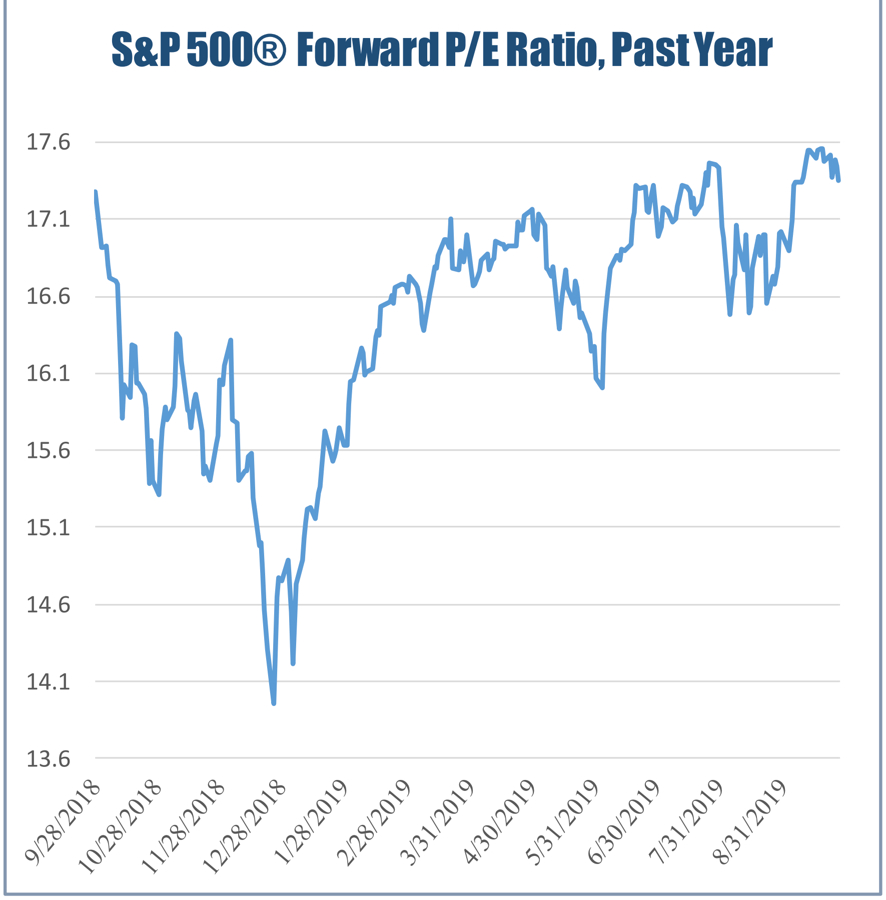
Our simple market model, which is based only on average sell side target prices, now suggests an 11.6% one year upside to the SPX. Expected returns on staples, utilities and real estate still look limited, although those sectors contain stocks with decent dividend yields. There will also be a surge of target price setting as we make our way through 3Q19 earnings season and upsides might (hopefully) improve as a result. The big market's forward P/E multiple is now 17x, in line with the recent range.

While the domestic economy is still strong, the risks to the bull market have been increasing. The flattening yield curve has been a concern for several quarters. While new tariffs might have had a lot to do with it, the weakening ISM data is troubling. The excellent employment situation is something to be very happy about, but it seems unlikely that it can improve much from here. The current economic recovery and bull run have been great, but they are both getting a little long in the tooth.

Macroeconomic factors aside, I continue to see the flat earnings backdrop as the biggest issue with the equity market. The SPX's trailing EPS is currently $163.72, about 4.4% higher than a year ago and only

PCM Market Model

10/12/2019 10:59	Forward P/E	Price to Book Value	Upside to Target
S&P® 500 Index	**17.0**	**3.4**	**11.6%**
Consumer Discretionary	20.8	8.0	15.2%
Consumer Staples	19.8	6.0	6.2%
Energy	15.4	1.5	21.4%
Financials	12.1	1.4	10.1%
Health Care	14.7	4.1	16.1%
Industrials	15.8	4.8	9.9%
Information Technology	20.1	7.7	8.9%
Materials	17.2	2.3	10.3%
Communications Services	16.4	3.3	15.6%
Utilities	19.9	2.3	2.8%
Real Estate	44.5	3.9	2.8%

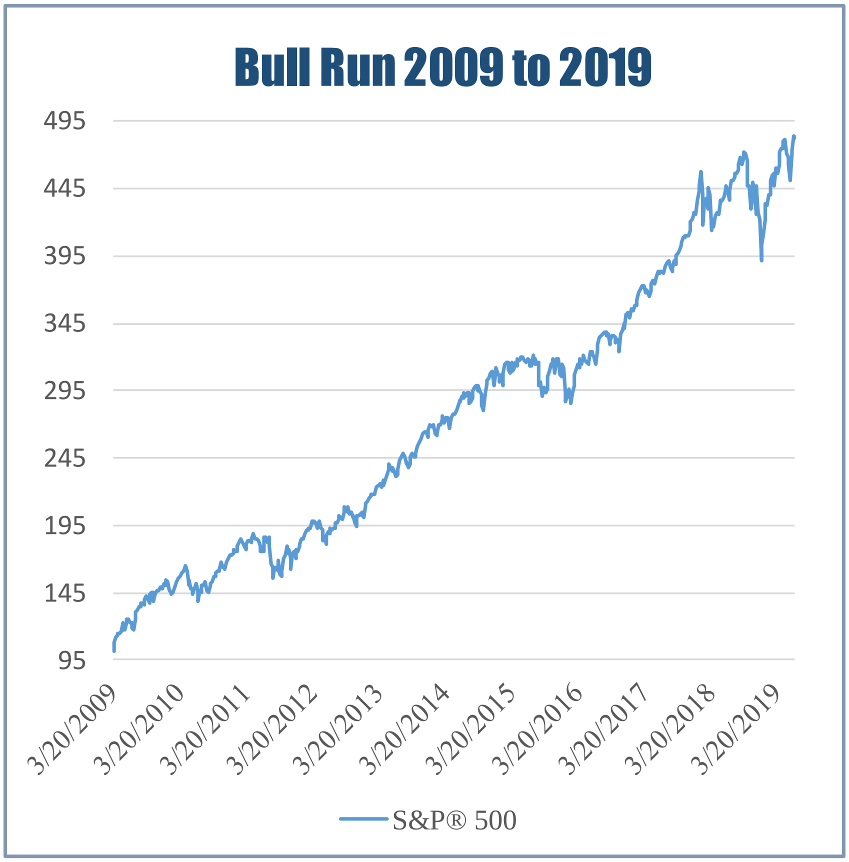


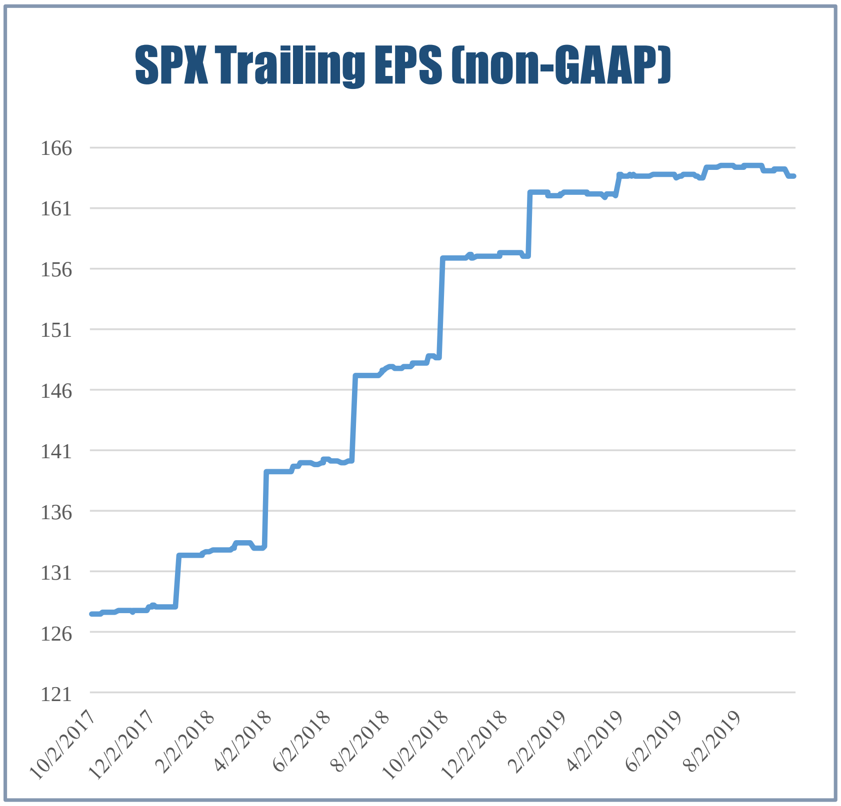
0.88% higher than the start of this year. I am currently calculating cap weighted average EPS growth for the SPX at a little over 6% by comparing EPS estimates to trailing EPS. For context, the SPX's EPS grew at a rate higher than 6% in 19 of the last 28 years – and four of those nine below 6% years coincided with bear markets. As long as EPS estimates hold through this earnings season (which could be a bold assumption) then that EPS growth could drive single digit annual equity market returns, other things being equal.

The equity market remains very sensitive to headlines about trade and the Fed, among other things. The market has so far not been particularly sensitive to impeachment news, probably because this kind of thing has been dragging on for years. With higher than average trading multiples and elevated headline risk, the probability of correction is greater than it might otherwise be. I also think that 3Q19 earnings reports will generally have to be decent in order to keep stocks at these levels.

Weekly Report, Conference Call and Podcast

Our clients are invited to receive our CIO's weekly podcast and weekly report. In addition, all clients are invited to participate in our weekly conference call. We provide these services to our clients free of charge and they are not available to non-clients. In the weekly report and the audio programs, Ken Roberts and Bryn Harman discuss market developments and trends that we





observe in our week to week research efforts. Please contact Bryn Harman at bharman@palousecap.com for more information.

Important Disclosures:

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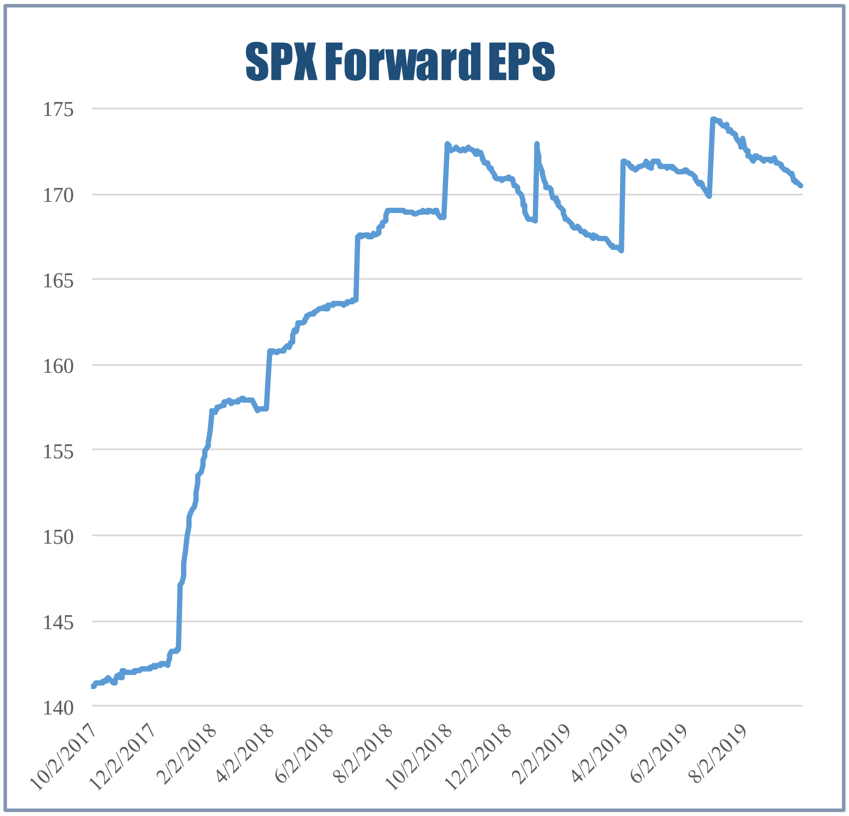

forecasted growth values. The source for all market data is Bloomberg, S&P Dow Jones Indices, and Russell Investments. Information regarding the services provided by PCM is available in Form ADV Part 2, which is available upon request or on PCM's website at www.palousecap.com.

If readers have any questions about anything mentioned in this report please feel free to contact us any time at 800-624-3833. Readers can also refer to our website, www.palousecap.com, for more information and can email PCM's Chief Investment Officer directly at bharman@palousecap.com with any questions. Readers should not assume that any investments in the securities mentioned in this program were or will be profitable or will continue to be held in the future. Pursuant to Rule 206(4)-1(a)(2)(A) we will provide a list of all trades made on behalf of clients in the past year upon request.

All data used to create this report was provided by Bloomberg.

"Market cap" means market capitalization.

"LCV" refers to PCM's Large Cap Value Strategy.

"TR" means our Large Cap Total Return Strategy.

"SMID" means Small to Mid Capitalization and also refers to our Small/Mid Cap Value Strategy in certain contexts.

"ACT" means our All Cap Tilt Strategy.

"SPX" and "the big market" refer to the universe of stocks in the Standard & Poors® 500 Index ("S&P® 500"). The Standard and Poor's 500 Index is a free-float capitalization-weighted index of 500 stocks. The index is designed to measure performance of the broad domestic equity market. The S&P 500 equal weighted index is the equal weighted version of the SPX. The S&P High Dividend Yield Index measures the performance of 80 high dividend yield equities within the SPX.

The Russell 3000® Index is a float-adjusted, market capitalization weighted index comprised of equities of the 3000 largest domestic companies. The Russell 2500® index is a subset of the Russell 3000 index comprised of the 2500 smallest cap equities in the Russell 3000 and represents the SMID segment of the domestic equity market. The Russell® 2000 Index is a subset of the Russell 3000 index comprised of the 2000 smallest cap equities in the Russell 3000 index and represents the small cap segment of the domestic equity market.

About Mr. Harman:
Bryn Harman, CFA is the Chief Investment Officer and Chief Executive Officer of PCM. Mr. Harman holds a Bachelor of Commerce degree (Finance and Economics) from the University of Saskatchewan (1992) and he earned the Chartered Financial Analyst designation in 1997. Bryn began his career with a financial planning firm in 1994. Since then, Bryn has worked in several investment and corporate finance roles in Western Canada and the Pacific Northwest. Bryn is the former Director of Research for an investment management firm that had over $2 billion in assets under management at the time. Mr. Harman has been a portfolio manager with PCM since 2011 and he has held the position of Chief Investment Officer since 2013. Mr. Harman is a 50% owner of Palouse Capital Management.