PALOUSE CAPITAL MANAGEMENT, INC.
Quarterly and Annual Commentary for 2019
January 2020

Changes - 1,000 Equities*

	4Q19	3Q19	2019
1,000 Largest Equities	10.1%	0.9%	29.5%
Largest 100 Equities	11.7%	1.8%	30.6%
Largest 500 Equities	10.2%	1.2%	29.9%
Smallest 500 Equities	8.3%	-1.8%	26.1%
Consumer Discretionary	6.8%	-0.4%	28.1%
Consumer Staples	2.6%	4.9%	22.9%
Energy	4.8%	-7.5%	6.6%
Financials	9.2%	1.3%	28.5%
Health Care	16.7%	-3.1%	28.5%
Industrials	8.1%	-0.1%	20.0%
Information Technology	15.7%	3.3%	47.6%
Materials	3.1%	-1.6%	20.9%
Communications Services	12.5%	1.4%	38.3%
Utilities	-0.6%	8.0%	23.9%
Real Estate	-0.6%	7.7%	31.1%

*All calculations based on internal analysis of 1,000 domestic companies. Changes are based on the change in float adjusted market cap for companies that were in the model at the beginning and end of each period. The model does not use published index data and does not include the effect of dividends.

Other Data

12/31/2019	Last Data Point	4Q19 Change	3Q19 Change	2019 Change
Crude Oil (WTI)	$61.06	12.9%	-7.5%	34.5%
Gold Spot	$1,517.27	-3.0%	4.5%	18.3%
Fed Funds Upper Bound	1.75%	-25 bp	-50 bp	-75 bp
Fed Funds Lower Bound	1.50%	-25 bp	-50 bp	-75 bp
Two Year Treasury Rate	1.57%	-5 bp	-13 bp	-92 bp
Ten Year Treasury Rate	1.92%	25 bp	-34 bp	-77 bp
Thirty Year Treasury Rate	2.39%	28 bp	-42 bp	-62 bp
Two to Ten Spread	0.35%	31 bp	-21 bp	15 bp
Dollar Index	$96.39	-3.0%	3.4%	0.2%
Vix	13.78	-15.1%	7.7%	-45.8%

Market Recap

As usual, I went back and looked at what I wrote in my last annual commentary as I sat down to write this year's commentary. At that time, equities were still really hurting from the wicked correction that we had in late 2018. All through 2018 investors were increasingly worried about the Fed's rate increases, rising bond yields, a flattening yield curve and the prospect of a trade war, among other things. That uncertainty led to the correction and also some attractive valuations in January of 2019. The big market's forward P/E multiple was about 15x back then, which is a very attractive number in light of recent trends. Our market model (see below) was forecasting a one year market return of 26.5%, which is a really good number. While I was optimistic at the time, I was still cautious because of the very high volatility that we had just experienced.

What happened after that was remarkable; the big market rose over 30% to close out 2019, which was the best market year since 2013. By our calculation, all eleven equity sectors were positive. The best sector was technology, which was up about 50% on the year. Shares of Apple Inc. and Microsoft Inc. were up 89% and 58%, respectively, in 2019 – and both of those companies passed the $1 trillion market cap level in 2019. The worst sector in 2019 was energy, but it was still up almost 7%.

What drove such strong equity performance in 2019? My first comment as I try to answer that question is that it was not earnings growth. Trailing EPS for the

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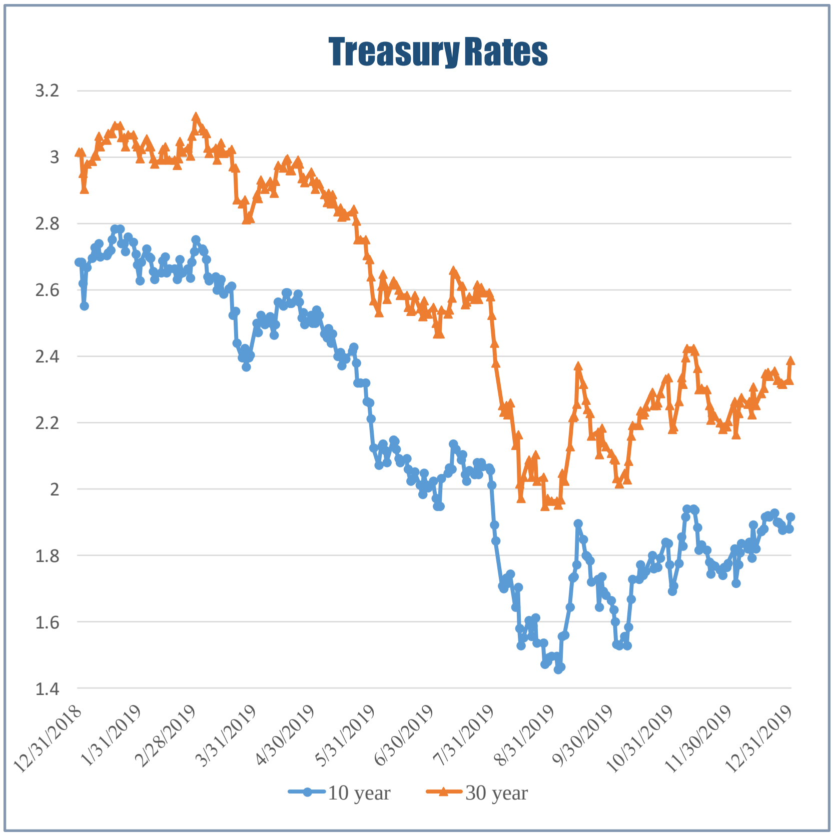
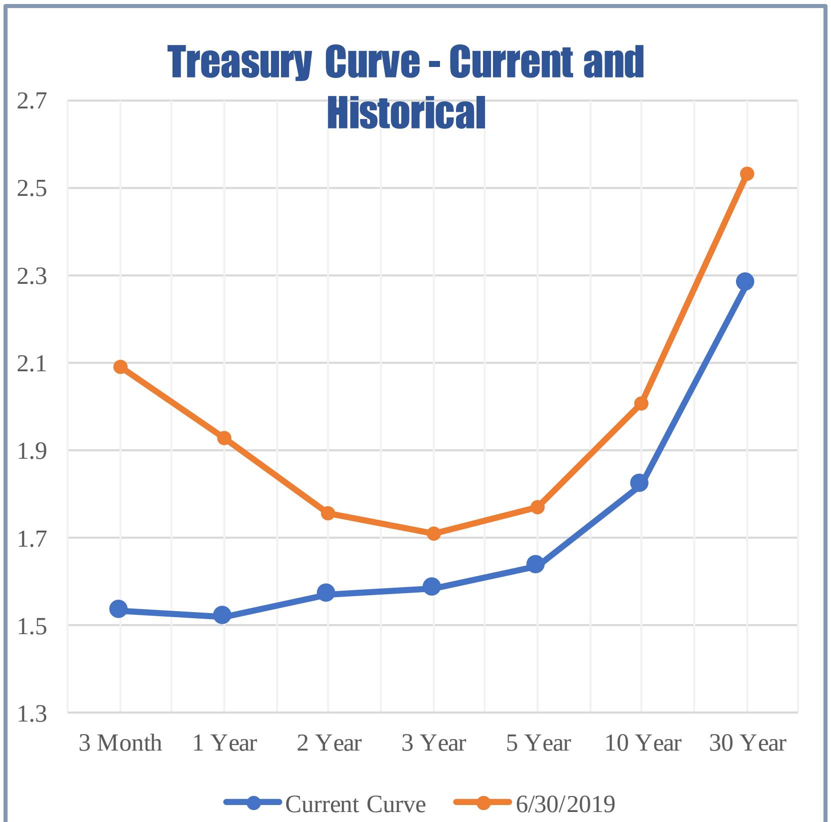
Source: Bloomberg. Past performance is not indicative of future results.





SPX was flat all year. As a result of rising stock prices and stagnant earnings the big market's forward P/E multiple rose from about 15x to about 19x in 2019. In other words, almost the entire market gain last year was from increased optimism and valuation parameters, not from earnings growth.

The next question naturally relates to what fueled such an increase in investor optimism. One factor was the Fed. The Federal Open Market Committee ("FOMC") started increasing the fed funds rates back in 2015 and it seemed like equity investors got more skittish every time the FOMC met in 2018. The last fed raise was in December of 2018, which was followed by no changes and then three fed rate drops in 2019. I do not think it was a coincidence that the equity market surged as this was going on. Equity investors often cite that trading multiples follow an inverse relationship with interest rates. As interest rates dropped all through 2019, multiples increased. I note, as I have done in the past, that while the theory behind this inverse relationship is valid, it is very difficult to prove mathematically.

A situation related to FOMC action was the change in the yield curve in 2018 and 2019. A flattening yield curve was the focus of many CNBC segments in 2018 because such a phenomenon has been related to peaking equity markets in the past. As the FOMC increased short term interest rates, short term bond rates followed suit. Long term rates did not rise as much as short term rates and the yield curve became very flat, and later inverted, as a result. The yield curve in mid-2019 was an ominous looking one, although as the FOMC dropped rates through 2019 the curve normalized significantly. In the last few

PCM All Cap Market Model

1/12/2020 12:01	Price to Earnings Ratio*	Price to Book Value**	Upside to Target	# Stocks
1,000 Largest Equities	19.9x	3.4x	5.8%	1,000
100 Largest Equities	21.0x	4.2x	4.9%	100
500 Largest Equities	20.0x	3.5x	5.4%	500
500 Smallest Equities	18.7x	2.4x	9.1%	500
Consumer Discretionary	23.4x	7.0x	8.5%	117
Consumer Staples	18.5x	4.4x	4.4%	49
Energy	15.0x	1.4x	14.5%	38
Financials	12.4x	1.4x	5.3%	148
Health Care	20.9x	4.7x	7.7%	117
Industrials	18.2x	4.7x	5.2%	138
Information Technology	27.1x	8.2x	2.5%	180
Materials	15.7x	2.1x	9.8%	46
Communications Services	21.0x	2.9x	6.2%	45
Utilities	21.2x	2.2x	3.6%	45
Real Estate	46.1x	3.0x	6.1%	77

All calculations based on internal analysis of 1,000 companies. The model does not use published index data.

* Calculated by comparing market capitalization to estimated earnings.

** Calculated by comparing market capitalization to last reported shareholder's equity.

months of 2019 it seemed like no one was talking about the yield curve anymore, which was another factor in the equity market's impressive gains.

Another issue that started to dog equity markets in 2018 was the US/China trade war. Headlines on the trade war caused some stock market volatility in 2018 and 2019. During the second half of 2019 it started to seem like a trade deal was becoming more likely, which seemed to result in increased equity market optimism.

Market Model and Outlook

Our simple market model - which is based only on average sell side target prices - now suggests that there is a 5.8% one year upside potential to the all cap market, a very low number in the historical context and a dramatic departure from last year's 26.5% number.

While the term "earnings recession" was thrown around a lot in 2019, and for good reason, investors largely ignored the flat earnings trend. In my view, this will not continue indefinitely. I think that the current earnings season is going to be important in determining the direction of the market. At some point, earnings projections are going to have to increase through a quarter to get valuations to a more reasonable level. If that does not happen then I think the market will be susceptible to a correction.

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.

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

Important Disclosures:

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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.

The PCM market model examines the universe of the 1,000 actively traded equities trading in the United States. The "Price to Earnings Ratio" is calculated by comparing the total capitalization for each market cap range and each sector to the total estimated net income (from sell side estimates) for the respective market capitalization range or sector. The "Price to Book Value Ratio" is calculated by comparing the total capitalization for each market cap range and each sector to the total last reported shareholder's equity for the respective market capitalization range or sector. "Upside to Target" is calculated using float adjusted market capitalization weightings and the one year upside potential to the average sell side target price for each security.

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.