

THE WEATHER REPORT

FROM A FUND FOR ALL SEASONS[®]

A WORD FROM THE PRESIDENT

I am pleased to introduce you to our very first issue of *The Weather Report*. On a semi-annual basis, our goal is to provide investors with insight into current events, market outlooks and topics we find interesting that may help you achieve success in reaching your financial goals.

Additionally, I'd like to introduce you to Derek D. Hyatt, our Senior Investment Analyst. Mr. Hyatt is the author of Derek's Desk, a section of *The Weather Report* where he will share his extensive knowledge on all things bonds. I hope you enjoy reading *The Weather Report* as much as we enjoy sharing it with you. We welcome any feedback you may have. Happy reading!

— Michael J. Cuggino

GET ACTIVE

“If everybody indexed, the only word you could use is chaos, catastrophe. The markets would fail.”

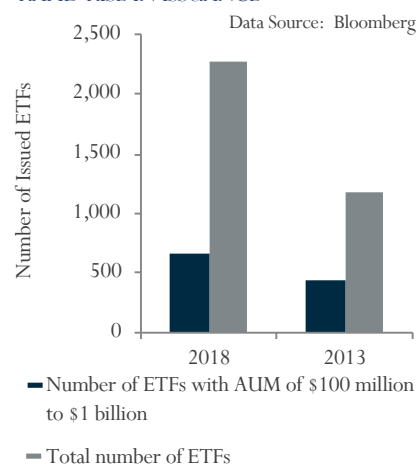
John “Jack” Bogle, Founder of Vanguard, 2017 Berkshire Hathaway Shareholder Meeting

It takes a lot for a legendary innovator to publically acknowledge the limitations of his or her own

creation. But, the comments of the late Mr. Bogle are foretelling. The first half of 2017 saw roughly \$240 billion come into exchange-traded funds (ETFs) and would help make 2017 one of the most successful years ever for ETFs. However, over the first half of 2018, that number was \$148 billion, and according to Bloomberg, 1-year flows into U.S.-based ETFs are sitting at roughly \$260 billion. These are massive numbers for sure, but recent data suggests the momentum may be slowing. Similarly, custodial firms providing services to registered investment advisers (RIAs) have seen ETF flows flat-line, and in some cases decline year-over-year (October 2016 - September 2017 v. October 2017 - September 2018). The assumption being ETFs are nearing absorption capacity among RIAs. While there has been a proliferation of ETFs since 2013, what shouldn't be overlooked is the dominance by a small group of firms. In general, of the top ten firms by assets and category, two firms control between 70% and 80% of the assets. Bringing it back to Mr. Bogle's quote, we think there exists a significant risk when a single ETF owns 5%, 6% or sometimes 8% of the shares outstanding of several tech

companies. If absorption capacity has indeed been reached, flows should continue to moderate. This takes out one form of price support that has existed for the past seven years. If you take momentum away, then the investment case becomes a story of fundamentals. If fundamentals break down, or investor psychology shifts to risk-aversion, the resulting reversal of flows could prompt an even bigger correction than we experienced in the 4th quarter of 2018. Now is the time to explore ways to lower correlation, decrease beta and look to the oversold and unloved assets that have been left behind during this nearly decade long passive/indexing craze.

RAPID RISE IN ISSUANCE



INSIDE THIS ISSUE

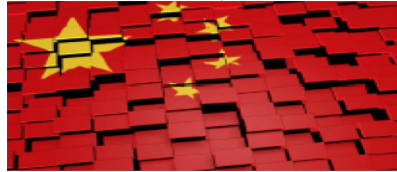
- A WORD FROM THE PRESIDENT
- GET ACTIVE
- CHINA: CRISIS OR CORRECTION
- RUDDERLESS EUROPE
- INTERESTING READS
- SIGNS OF INFLATION?
- DEREK'S DESK – THE APPEAL OF BBB BONDS

CHINA: CORRECTION OR CRISIS

Is China just crisis bound or correction bound? Some say pent up demand will prevent a nasty crisis in China so long as no “financial crisis” develops, but some really smart people with a deep understanding of China disagree. In the November 30th issue of *Grant’s Interest Rate Observer*, Anne Stevenson-Yang, co-founder and research director at J Capital Research, made an interesting point that bears watching – “Steel production is supposedly up almost 8% year-to-date. In reality, it is down 1% year-to-date. When have you ever had 6.5% growth with a negative 1%

steel production?”

Adding to Stevenson-Yang’s concerns is Derek Scissors, resident scholar at the American Enterprise Institute. Scissors says look no further



than China’s very low money supply despite a 13.5% increase in lending. As Scissors says: “so banks are pushing money out to firms and they aren’t using it – that is a sign of deflationary pressure and slow growth.” Last

month, several news outlets reported that Chinese-led acquisitions of American companies were down roughly 95% from their 2016 peak. And, many of the Chinese acquirers that closed major deals two years ago are now sellers – divesting the hotels, office buildings and airline companies that they purchased just a couple of years ago. None of this is the result of today’s tariffs, however, Xi Jinping could be using the tariff theatrics as a convenient cover to mask other deep-seeded issues. Whatever the case, expect continued headline risk out of China.

RUDDERLESS EUROPE

France Negotiates – Emmanuel Macron caves to protestors’ demands, but protestors still post in the streets of Paris. Macron’s approval rating plummets with barely 20% of respondents in a recent poll saying they “were happy with his presidency.”

From Brexit to Bre-main – Theresa May has seen her approval rating hit a level not seen since becoming Prime Minister in 2016. Her 47% approval rating hardly has her on stable ground. Nearly half (53%) of all voters disapprove of how she’s handled Brexit overall. What’s more, new polls are showing that if Britons voted today, nearly 50% would vote to remain in the European Union (EU). How quickly things can change!

The Queen of EU Austerity – Angela Merkel is throwing in the towel! Germany’s Chancellor has arguably been the CFO of Europe for nearly a decade, but she is out come 2021. We doubt whoever replaces Merkel can continue to carry the austerity mantle quite like she has.

Not to be forgotten – “Do Whatever It Takes” Mario Draghi retires this year.

Germany, France and the United Kingdom are essentially the tiller, rudder and mast of the EU. The remaining 25 members of the EU are passengers in life vests. The tiller, rudder and mast may be about to fail and we believe a storm is approaching on the horizon. The combination of leadership transition at the European Central Bank and inside Germany, coupled with poor polls for Macron and May, make us think EU leadership will forsake fiscal responsibility and go for what makes the voters happy. This, as discussed in our last webcast, will likely perpetuate bloated balance sheets, suspect debt and currency disruptions, leading more EU investors to seek out assets to hedge against Euro volatility – maybe gold, Swiss Franc, Swiss Bonds and Treasuries. We believe rough seas are ahead for the Euro Zone!

INTERESTING READS

Online Articles

“Get Ready for Europe’s Next Crisis” – BARRON’S

“Brexit’s Only Sure Bet is Higher Pound Volatility” – Bloomberg

“Gold Is Cheap. Inflation Is Coming. You Do the Math” – BARRON’S



Looking for a good book?

Our Institutional Sales team really enjoyed *Bad Blood: Secrets and Lies in a Silicon Valley Startup*, by Wall Street Journal reporter John Carreyrou.

SIGNS OF INFLATION?

The Fed likes personal consumption expenditures (PCE), but that doesn't mean the consumer price index (CPI) is any less important. CPI takes into account imported goods, as well as food and energy. So yes, it is more volatile, but watching the spread between PCE and CPI is important. CPI has been above 2% since September 2017. PCE broke 2% July 2018, a first since December 2011. However, going forward we don't have quantitative easing distorting things. CPI does tend to drag PCE along behind it (chart 1). Keep an eye on the U.S. Dollar. While the U.S. Dollar Index (DXY) isn't at all-time highs, it is in the 95 to 100 range which has proven to be a ceiling – as the saying goes – a weaker currency is by definition inflationary (chart 2). Wage growth has moved in fits and starts, but a quick look at the Atlanta Fed's Wage Growth Tracker shows a sharp tick higher from its December 2017 low, and over 5 years wage growth is on pace to hit 4% growth, nearly doubling from

INFLATION-SENSITIVE ASSETS: 1 YEAR RETURN (%)

Energy	Return	Precious Metals	Return	Base Metals	Return
WTI Crude	-17.70	Spot Gold	-2.10	LME Aluminum	-13.80
Brent Crude	-11.30	Spot Silver	-7.70	LME Copper	-16.00
NYM HH Nat. Gas	-9.20	Spot Platinum	-15.10	LME Lead	-22.55
NYM Gasoline	-22.00	Spot Palladium	22.40	LME Nickel	-11.30
ICE Coal	-15.00			LME Zinc	-25.20
As of January 10, 2019				LME Iron Ore	2.60

its 2014 levels (chart 3). Higher wages mean producers have the green-light to pass on higher input costs to the consumer. Speaking of producers, while the Institute for Supply Management (ISM) and the producer price index (PPI) turned lower at the end of 2018, both are well above their 5-year lows (2015 - PPI, 2016 - ISM (chart 4)). In the December 2018 "ISM Report on Business," some respondents reported seeing higher commodity and other input costs. The traditional basket of inflation-sensitive assets has been unloved and oversold for a long time, but for an investor looking to place a hedge against inflation there appears to be some good value (above table).

CHART 1 – PCE V. CPI (%)

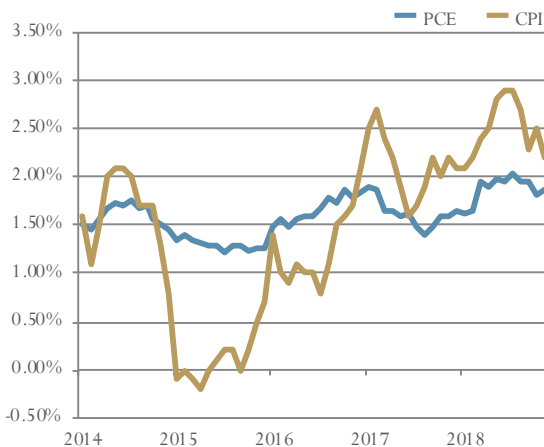


CHART 2 – DXY PRICE

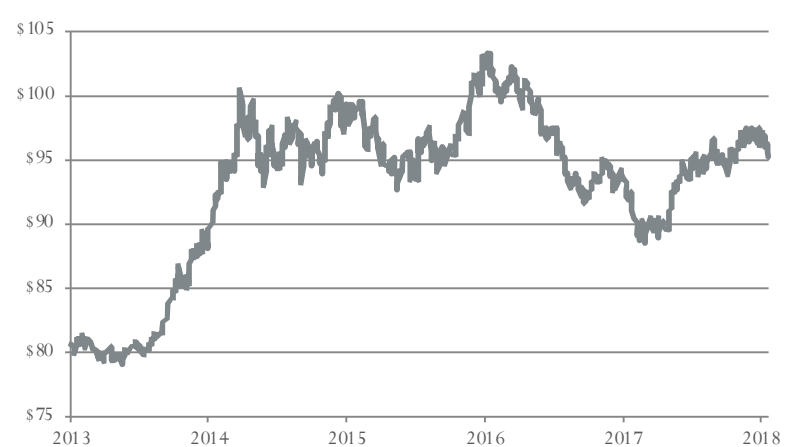
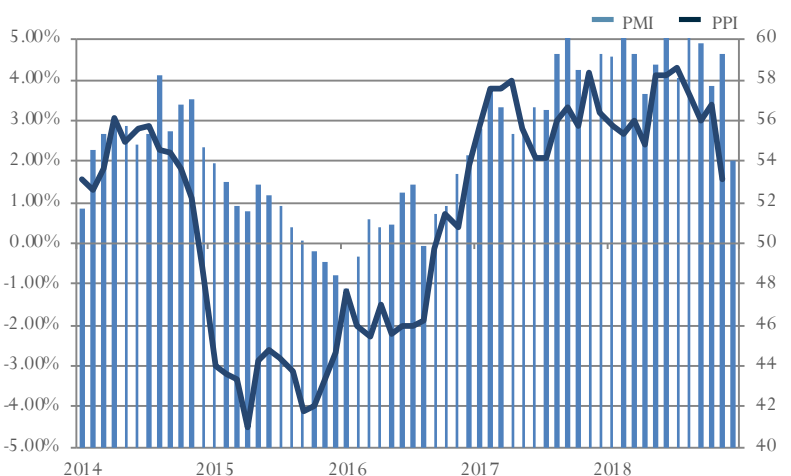


CHART 3 – WAGE GROWTH – ATLANTA FED



CHART 4 – PPI V. PMI (PURCHASING MANAGERS INDEX)



DEREK'S DESK – THE APPEAL OF BBB BONDS

If you listened to the Wall Street analysts and the financial media pundits throughout 2018 you would have thought investment grade debt, in particular BBB-rated debt, was radioactive. In hindsight, perhaps more scrutiny should have been directed towards the valuations of the equity market and the high yield bond market – neither of which were spared in the Q4 2018 meltdown. That's not to say there isn't room for caution in the BBB subsector. Issuance of BBB debt is at decade highs relative to it's A, AA & AAA siblings. Yes, a lot of BBB issues have been used to facilitate mergers, acquisitions and other initiatives to help companies expand the moat around their businesses. Many of these issuers are media, telecom and technology companies, the exact same companies that dragged everyone else under in Q4 2018. Making matters more complicated in 2018 was the repatriation trend where we saw U.S. companies sell foreign held cash (in the form of corporates)

and bring that cash back to the U.S. There simply weren't enough end-buyers. As a result, by July 2018 investment grade debt was down circa 5%. Then, the equity markets wobbled in Q4, hedge funds started to accelerate closure and spreads gapped wider.

While I ribbed my fellow analysts in my intro, I did hear an anecdote that I really enjoyed not too long ago. It went something like this: "we like investment grade bonds, not the investment grade market." In other words, not all BBB debt is created equal. But, with challenges come opportunities and 2018 has presented us with some recent opportunities:

- *BBB spreads are cyclically wide at the moment.*
- *2018's net supply of investment grade debt was down -24% year-over-year, and since peaking in 2015 investment grade supply is down -26%.*
- *BBB yields are easily 50 to 150 basis points greater than U.S. Treasuries anywhere along the yield curve.*

For 2019, we see the battle playing out between BBB and Treasuries. If the longer-term risks are the Fed will continue to raise rates, this will cause pain for those holding intermediate- to long-term Treasuries. Under the same scenario, we would expect shorter duration investment grade corporates to do much better. If the Fed should decide to take a more dovish stance and cave to market demands, one can imagine then that investment grade issuances with solid balance sheets and shorter duration will be the preferred choice for the income investor. With a tough 2018 behind us, we look forward to seeing what we can find in the BBB space going forward. Finding the good stuff is pretty straightforward – in 2019 you will have to peel back the onion, do the grunt work and find those solid offerings. Indexing won't do it. To paraphrase a recent quote in a BARRON'S article – gone are the days an investor can cozy up to a 30-year Treasury for ironclad protection against a downturn in stocks.

The Fund's investment objectives, risks, charges, and expenses must be considered carefully before investing. The Prospectus contains this and other important information about the investment companies. A hard copy may be obtained by calling (800) 531-5142. Read the carefully before investing. Opinions expressed and views mentioned are those of Michael J. Cuggino and Derek D. Hyatt as of the date provided. They are subject to change at any time, are not guaranteed, and should not be considered investment advice. Any forward-looking statements speak only as of the date they are made and the Fund assumes no duty to and does not undertake to update forward-looking statements. Forward-looking statements are subject to numerous assumptions, risks and uncertainties, which change over time. Actual results could differ materially from those anticipated in forward-looking statements. Personal Consumption Expenditures (PCE) measures price changes in consumer goods and services. Consumer Price Index (CPI) is a measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food and medical care. The U.S. Dollar Index (DXY) is a measure of the value of the U.S. dollar relative to the value of a basket of currencies of the majority of the U.S.'s most significant trading partners. Atlanta Fed's Wage Growth Tracker is a measure of the nominal wage growth of individuals. Producer Price Index (PPI) is a family of indexes that measures the average change in selling prices received by domestic producers of goods and services over time. Purchasing Managers Index (PMI) is an indicator of economic health for manufacturing and service sectors. Basis point (BPS) refers to a common unit of measure for interest rates and other percentages in finance. One basis point is equal to 1/100th of 1%, or 0.01%, or 0.0001, and is used to denote the percentage change in a financial instrument. Beta is a measure of systematic risk or the sensitivity of a manager to movements in the benchmark. **Investments in debt securities typically decrease in value when interest rates rise. This risk is usually greater for longer-term debt securities. Investments in foreign securities involve greater volatility and political, economic and currency risks, and differences in accounting methods. Mutual fund investing involves risk; loss of principal is possible. Not FDIC Insured. No Bank Guarantee. May Lose Value.** Pacific Heights Asset Management, LLC ("Pacific Heights") is the investment adviser to Permanent Portfolio Family of Funds ("Fund"). The Fund is distributed by Quasar Distributors, LLC ("Quasar"), a member of FINRA. Quasar is not affiliated with Pacific Heights. Permanent Portfolio®, The Permanent Portfolio Family of Funds®, A Fund for All Seasons® and The Permanent Portfolio Family of Funds logo are registered trademarks of Pacific Heights Asset Management, LLC. Copyright © 2019 Permanent Portfolio Family of Funds. All rights reserved.