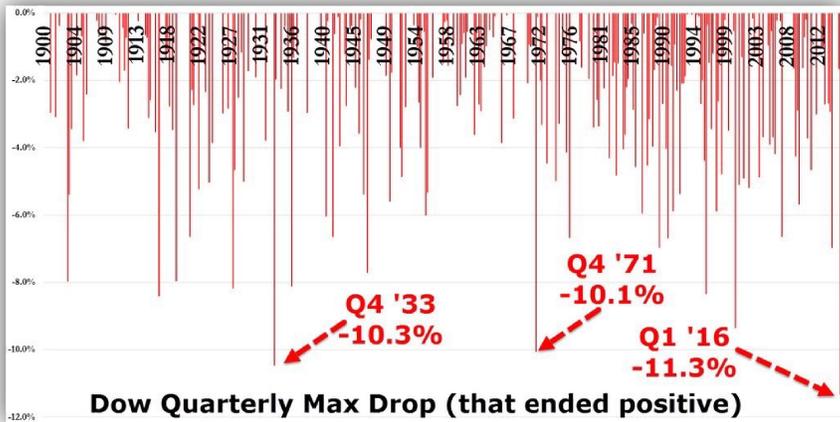


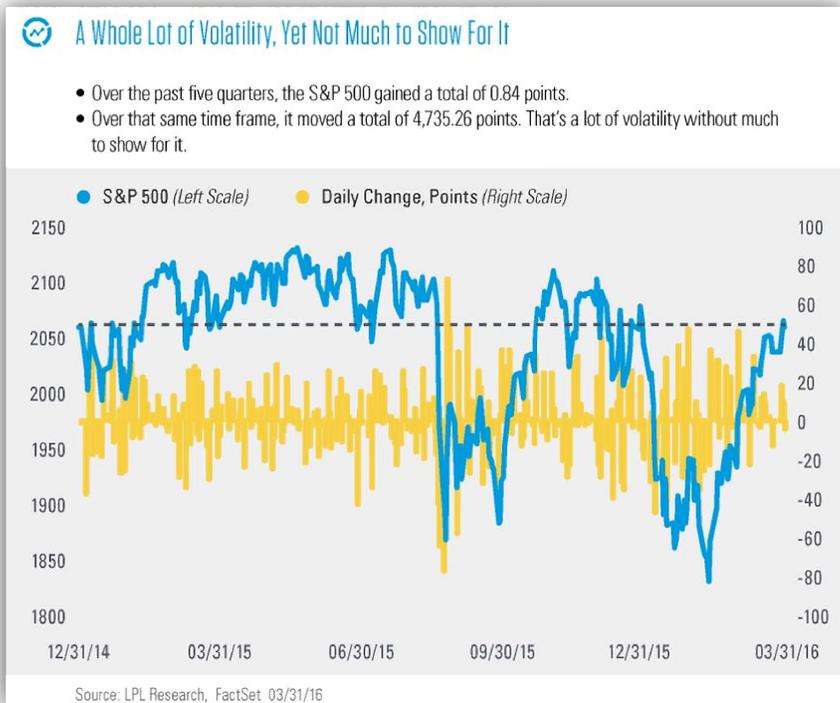
April 8, 2016 – *Standard Correction or Bull Trap?*

We hope that this letter finds you well. The volatility that markets experienced in the second half of 2015 has persisted into 2016. Following the Fed’s decision to hike rates in late December, the first quarter opened with a precipitous drop in what was reported as the worst start to a calendar year for the Dow Jones Industrial Average* and S&P 500* in history. These two major domestic stock indices each fell by more than -11% from January 1st through February 11th, before reversing course and logging five straight weeks of gains to finish the

quarter in positive territory. According to ZeroHedge, this was the largest quarterly whipsaw in the history of the Dow.



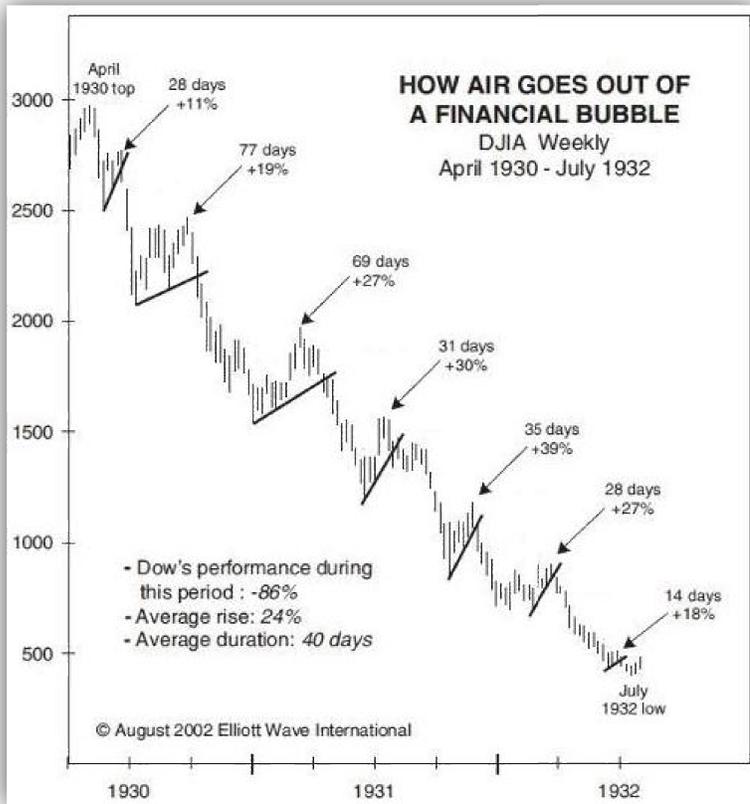
Incredibly, despite the tremendous volatility of the past three quarters, the S&P 500 finished the first quarter of 2016 just 0.89 points higher than it finished the fourth quarter of 2014. The chart on the bottom left, created by LPL Research, illustrates this five quarter period of churn which ultimately resulted in virtually no change.



What we would like to point out, however, is the development over the past 10 months of a discernible downtrend in stocks. As defined by Investopedia.com, a formal downtrend occurs when each successive peak and trough is lower than the ones found earlier in the trend.

The all-time high for the S&P 500 of 2,134 was reached on May 20, 2015. Following the greater than -11% correction that took place in just four trading days in late August, the market bottomed at 1,867, then over the next several months recovered to a November 3rd peak of 2,116. This October rally allowed the S&P 500 to regain the level from which the market

tumbled in mid-August but did not allow it to reach the previous May 20th high. After failing to put in a new high, the market retreated by close to -5% over the next two weeks.



This sharp rejection suggested to market technicians that a downtrend was possibly forming and prompted many to warn that a potential lower low was possible in coming months. Those warnings proved to be prescient, as the market meandered lower for the next two months and then welcomed the New Year by falling off a cliff. The subsequent low of 1,810 achieved on February 11th was -3% below the prior trough of August 2005. Unless stocks can surpass the November 3rd and May 20th peaks in the near future they will be viewed by traders to be stuck in a well defined downtrend and vulnerable to further downside pressure.

The three charts on the left depict how stocks performed during the bear markets of 1929-1932 (Dow Jones Industrial Average, top left), 2000-2002 (S&P 500, middle left) and 2007-2009 (S&P 500, bottom left). As you can see, it is very typical during a major bear market for stocks to experience multi-week periods of very strong gains which are unable to surpass prior peaks. These bear market rallies are often referred to as 'bull traps' because they fool eager investors into thinking that the worst is behind them and that it is safe to once again plow money back into stocks.

For a clue as to whether the recent August and January meltdowns were simply standard corrections in an ongoing bull market or, inversely, that the subsequent recovery rallies were common bull traps in a bear market that began last May, we suggest looking at the earnings trajectories of the companies that make up these major stock market indices. Based on a company's recent and expected earnings relative to the price of their stock, one can form an opinion as to whether that company's stock is undervalued, fairly valued or overvalued. This metric, called the price/earnings (P/E) ratio, can also be used to value a stock index such as the S&P 500.

Because there are two variables in a company or index's P/E ratio, even when stock prices are in a downtrend the P/E ratio can increase (making it more overvalued or expensive) if earnings deteriorate at a faster rate than share prices are falling. From Bloomberg:

Corporate profits fell -7.8% in the [fourth] quarter, the biggest decline since 1Q11 (-9.2%). Profits have declined in four of the last five quarters, and are now down -11.5% in year-on-year terms. This is the worst drop since the Great Recession. Plunging profits are a troubling development, because they can foreshadow a loss of "animal spirits" in the private sector, which can ultimately result in recession.

- Bloomberg Intelligence, March 28 2016

It is important to note that in the above quote, the profits referred to as having been down four of the last five quarters are the non-GAAP (commonly referred to as adjusted or pro forma) earnings reported by the companies. From Business Insider:

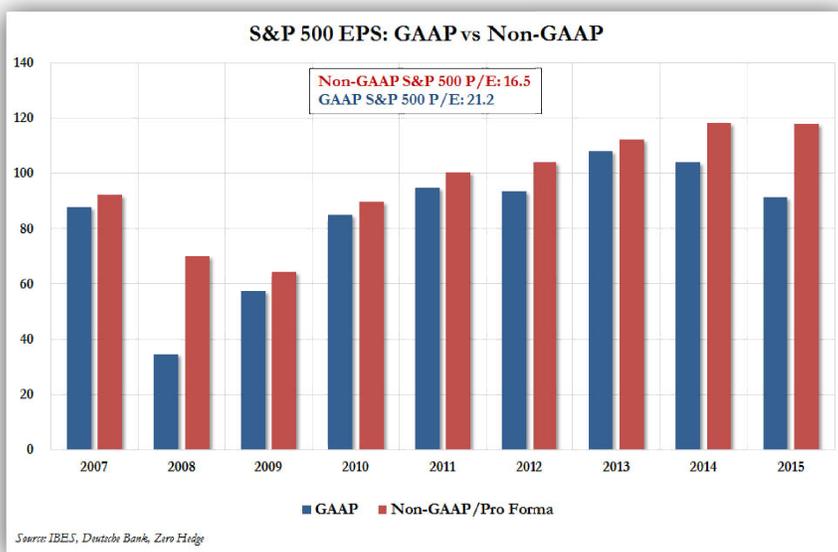
US companies tried to hide a lot of bad news from investors in 2015. When companies report earnings they give investors a series of numbers. The most basic measure of earnings per share is profit divided by diluted shares. This figure is most often referred to as GAAP – or Generally Accepted Accounting Principles – earnings.

*But a growing trend has been reporting an "adjusted," or non-GAAP figure, which includes the company's best estimate of things that came up during a quarter or year that, **in the company's judgment**, were charges outside the normal course of business. As a result, non-GAAP earnings tend to be higher.*

Earlier this week Yahoo Finance's Sam Ro wrote about the possibility of an "illusion" of corporate earnings propping up stocks. That is: do corporate earnings look better because of the growing trend in reporting non-GAAP earnings that hide charges which may not actually be all that special?

In a note on Friday, FactSet's John Butters looked at this "illusion" by examining the growing spread between these figures. And whether you think non-GAAP or GAAP earnings represent the "true" profitability of US corporates, it is very clear things looked a whole lot better on a non-GAAP basis last year.

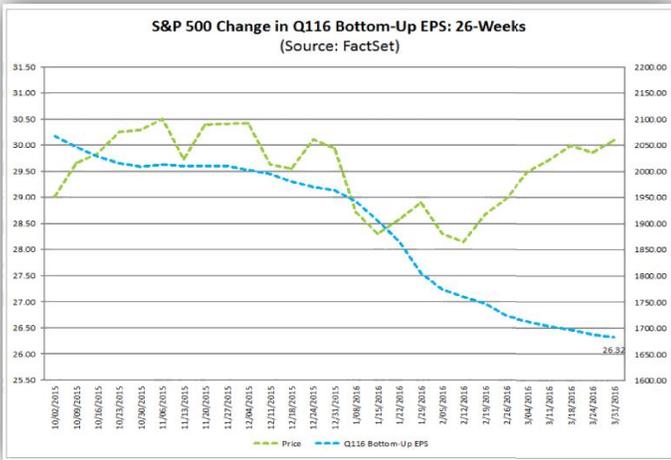
- Business Insider, March 11 2016



The chart on the left shows the increasing disparity between GAAP and non-GAAP reported earnings over the past several years, through the fourth quarter of 2015. While it appears that corporate profitability has held up based on non-GAAP earnings, stripping out the accounting gimmickry indicates a vastly different picture. This growing disparity between GAAP and non-GAAP earnings also results in vastly different P/E valuations for the S&P 500, as indicated in the chart.

A strengthening earnings environment would certainly improve valuation metrics such as the P/E ratio and thus make stocks at current levels seem more appropriately priced, but that doesn't appear to be in the cards.

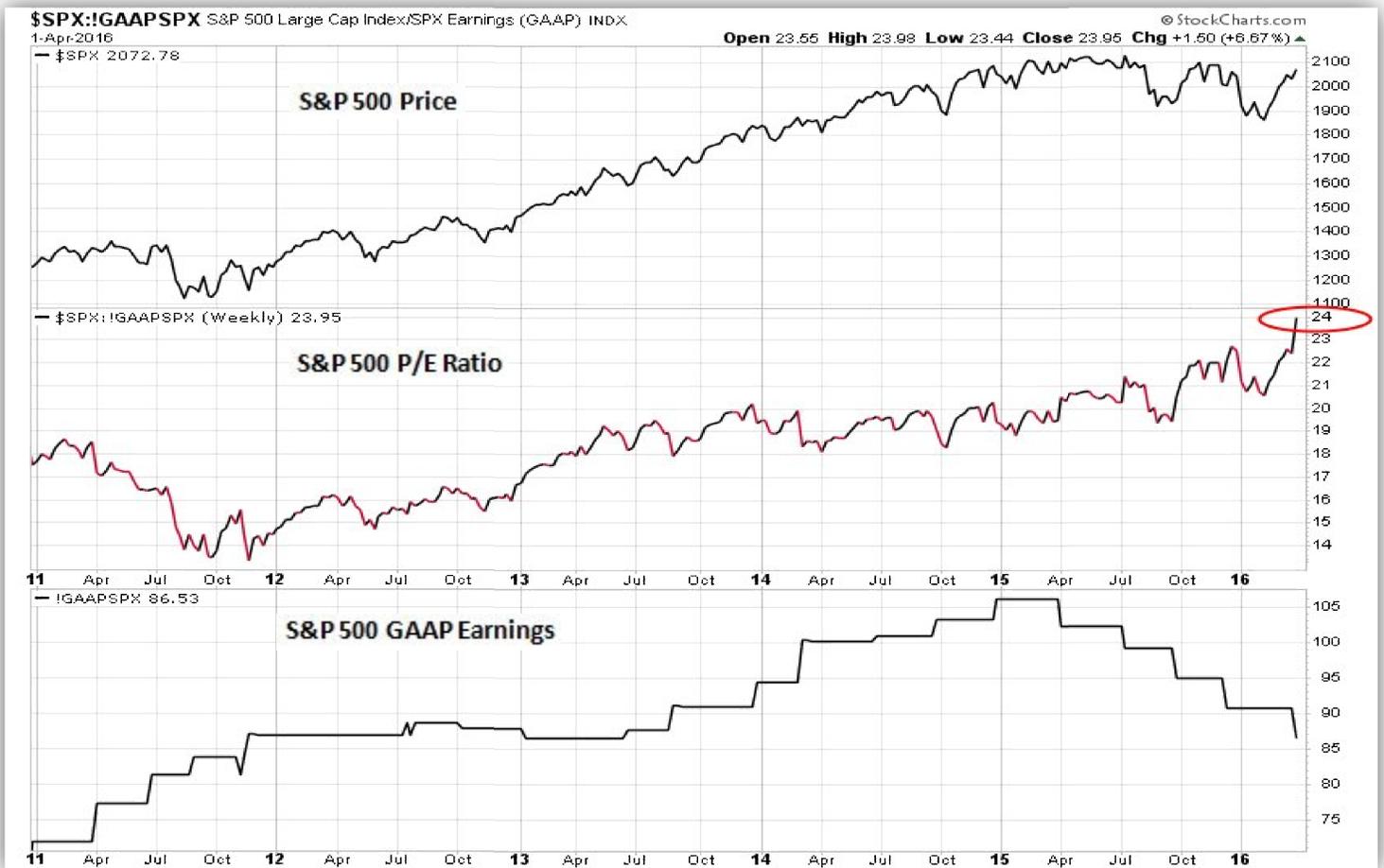
Expectations for S&P 500 earnings (both GAAP and non-GAAP) have deteriorated over the course of this year. From FactSet:

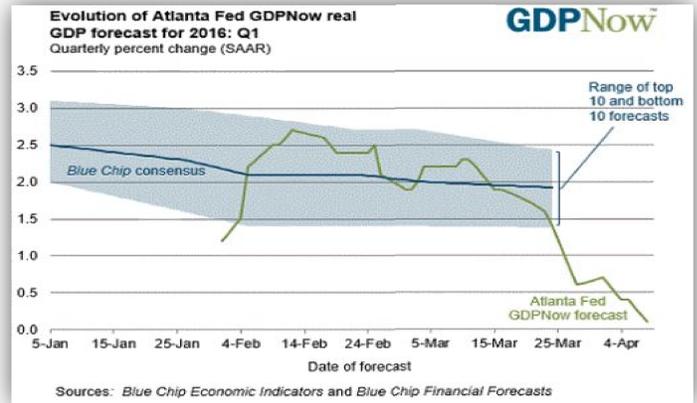
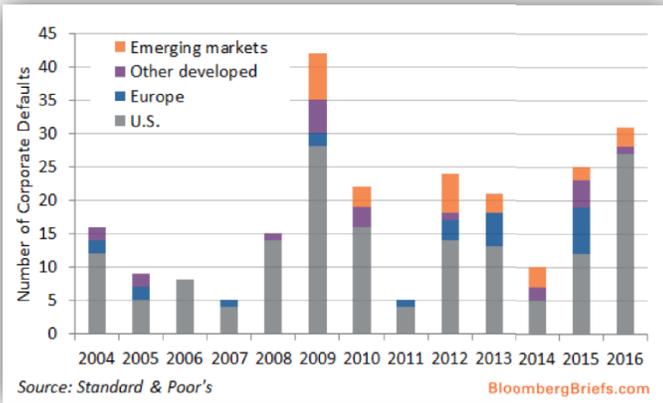


During the first quarter, analysts lowered earnings estimates for companies in the S&P 500 for the quarter. The Q1 bottom-up EPS [earnings per share] estimate (which is an aggregation of the estimates for all companies in the index) dropped by 9.6%... In fact, this was the largest percentage decline in the bottom-up EPS estimate during a quarter since Q1 2009.

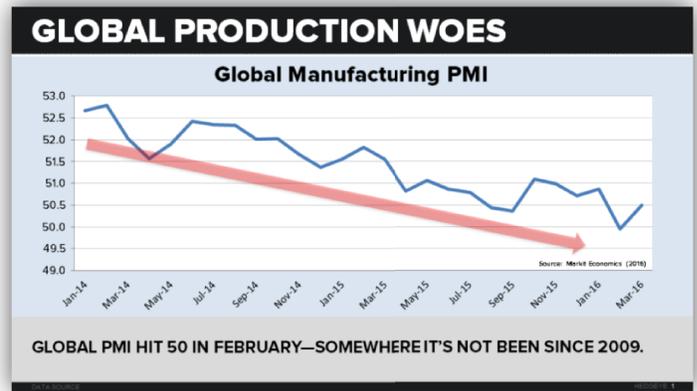
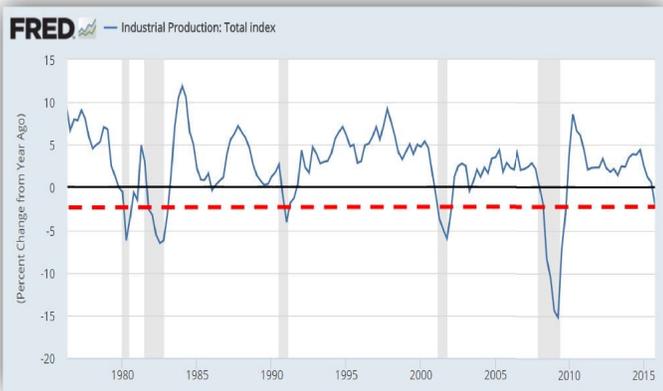
- FactSet Earnings Insight, April 1 2016

The below chart shows the S&P 500 index in the top panel, S&P 500 GAAP earnings in the bottom panel and the P/E ratio of the index (ie. top panel divided by bottom panel) in the middle panel. As you can see, because of the dramatic deterioration in earnings over the past several quarters and the expectation for another large drop in Q1, stocks are now more overvalued (expensive) than at any point in this seven year old bull market.





Alarmingly, corporate defaults in the US are being reported at their highest rate since 2009 and deteriorating economic data has driven the Atlanta Fed’s estimate for first quarter GDP growth down from +2.25% to just +0.1% over the past four weeks. Industrial production in the US is being reported at recessionary levels and the global Purchasing Managers Index (PMI), which measures the health of an economy’s manufacturing sector, recently hit its lowest level since 2009.



The recent spate of weakening data has urged analysts around the world to reduce their forecasts for global GDP growth. Christine Lagarde, Managing Director of the International Monetary Fund (IMF), has urged monetary and fiscal authorities to remain extremely accommodative and, where possible, to loosen policy further. From Bloomberg:

The world outlook is clouded by “weak growth, no new jobs, no high inflation, still high debt -- all those things that should be low and that are high,” Lagarde said in an interview in Frankfurt on Tuesday with Bloomberg Television’s Francine Lacqua. The downside risks have increased and “we don’t see much by way of upside,” she said... The International Monetary Fund’s view of the world economy has dimmed over the last six months, exacerbated by China’s slowdown, lower commodity prices and the risk of financial tightening in many countries..

- Bloomberg, April 5, 2016

Unfortunately, central banks are running out of viable and effective options. In late January, the Bank of Japan (BOJ) shocked markets by adopting a Negative Interest Rate Policy in an effort to stimulate consumption and investment (and unofficially to strengthen exports by weakening the Yen). In early March, the European Central Bank (ECB) attempted to do the same by driving interest rates further into negative territory (now at

-0.40%) and expanding the size and scope of their quantitative easing program to now include the direct purchase of corporate debt. So far neither of these two central bank policy moves has borne fruit. In fact, both Japanese and European stocks are lower and both the Yen and the Euro are stronger today than they were prior to these recent actions. From the Financial Times:

The yen touched new highs on Thursday, defying Tokyo's effort to weaken the Japanese currency in the latest sign that policymakers in leading economies are running out of tools to kick-start sagging growth and battle the threat of deflation... the yen's momentum comes despite the Herculean efforts undertaken by central banks to spur growth in Asia and Europe. Like the BOJ, the European Central Bank has intervened in the capital markets at unprecedented levels to little effect.

- Financial Times, April 7, 2016

According to David Kotok of Cumberland Advisors, 23 countries, 5 currencies and 24% of global output are now under some version of Negative Interest Rate Policy. What was just months ago considered to be a last-ditch weapon of monetary policy shock and awe seems to have run out of both shock and awe. In the face of a slowing global economy, central banks are looking increasingly defenseless.

Our expectation is that the next several quarters will look much like the last three. Steep corrections to new lows followed by strong rallies that fail to take out the previous high. Bearing in mind that past performance is no guarantee of future results, our recommendation is to underweight risk assets, such as overpriced equities, and overweight those asset classes that have historically benefited in times of financial turbulence - cash and US treasuries.

Despite the strong recovery of risk assets in the last six weeks of the quarter, the traditional safe haven long-dated US Treasuries outperformed the S&P 500, Dow Jones Industrial Average and the Nasdaq in the first quarter. At 2.50%, the yield on a 30yr US Treasury is currently 175 and 208 basis points higher than that on a 30yr German Bund or 30yr Japanese Government Bond, respectably. This makes the US debt more attractive from a real yield standpoint and offers much more potential for capital appreciation as that relatively higher yield may have further to fall in the event of a deflationary shock.

An increased cash allocation has the potential to reduce overall portfolio volatility and could provide purchasing power if equity valuations drop to levels that have historically presented the most favorable long-term risk/return opportunities. With interest rates as low as they are, the short-term opportunity cost of holding cash is lower now than it has been historically.

Please feel free to share this newsletter and do not hesitate to call or email with any questions or comments or to schedule a face-to-face portfolio review.

Sincerely,

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**The Standard & Poor's 500 Index (S&P500) is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of the 500 stocks representing all major industries. The Dow Jones Industrial Average (Dow) is a price-weighted index of 30 significant stocks traded on the New York Stock Exchange and the Nasdaq. The Bloomberg Commodity Index is a broadly diversified commodity price index for the global commodities market distributed by Bloomberg Indexes.*

Indices such as the S&P 500 Index, the Dow Jones Industrial Index and the Bloomberg Commodity Index, and any others listed above, are unmanaged and investors are not able to invest directly into any index. Past performance is no guarantee of future results.

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