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tailored wealth strategies

May 1, 2015 – ***To hike or not to hike…***

As always, we hope that this letter finds you well. Thus far, 2015 has been a volatile year for markets and is off to a disappointing start for the US economy. As of the date of this letter, the S&P 500* and the Dow Jones Industrial Average* are up 1.3% & 0.1% year-to-date, respectively. The yield on the 10-year US Treasury Note has vacillated widely, having started the year at 2.12%, dropping to as low as 1.65% in late January, as high as 2.24% in early March and closing the month of April at 2.03%.

Volatility has continued in the currency and commodity markets as well. The US Dollar Index had a tremendous up-surge in the second half of 2014, rising by more than 12%. This unexpected bout of Dollar strength has been pointed to as a major reason for first quarter economic weakness, as has the harsh winter weather in the Northeast and a temporary port shutdown on the West Coast. With roughly two thirds of the S&P 500 having reported first quarter earnings so far, earnings are up +2.57% but sales have declined -2.58%.

So far in 2015 we have seen the USD Index run from $90.27 at the start of the year, all the way up to its mid-March high of over $100 and has since been swinging in a 5-6% range, ending April at $94.78. Crude oil also saw a dramatic back half of 2014, losing more than 50% in price per barrel. West Texas Intermediate (WTI) crude oil, which was priced at $107 in late June 2014, dropped to below $44 per barrel in mid-March and has since rebounded to over $59.

Our expectation is that recent volatility in US equity, bond, currency and commodity markets will continue as market participants strive to read the tea leaves of the economic data points monitored by the Federal Reserve's Federal Open Market Committee (FOMC). The FOMC is the twelve member panel of Reserve Bank presidents and members of the regional Board of Governors, headed by Fed President Janet Yellen, tasked with setting interest rate policy for US financial institutions. The FOMC's monetary policy decisions have far-reaching effects on global financial markets and it is the uncertainty surrounding the timing and magnitude of their next move that has set markets on edge for the past 6-9 months.

Historically, the FOMC has attempted to maximize price stability and a robust labor market solely by adjusting the interest rate that banks must pay for overnight loans to each other and to the Fed. Banks need these short-term loans to maintain the reserve requirements set by the Fed based on total deposits vs. total loans outstanding. In the past, if the Fed wanted to stimulate economic activity via credit creation they would reduce this short term interest rate, the Fed Funds Rate, to make it more affordable and potentially profitable for banks to lend and for businesses and individuals to borrow. In the event of an overheating economy, in order to prevent unwanted excess inflation, the Fed has been able to constrict economic activity by raising the Fed Funds Rate to make borrowing more costly and thus less desirable. An appropriate analogy is to think of this interest rate policy as the Fed's gas and brake pedals useful in the 'driving' of the US economy.

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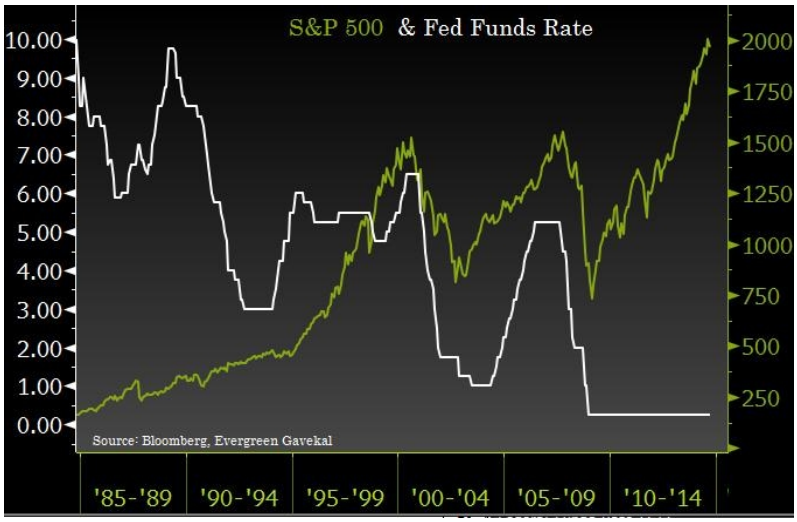
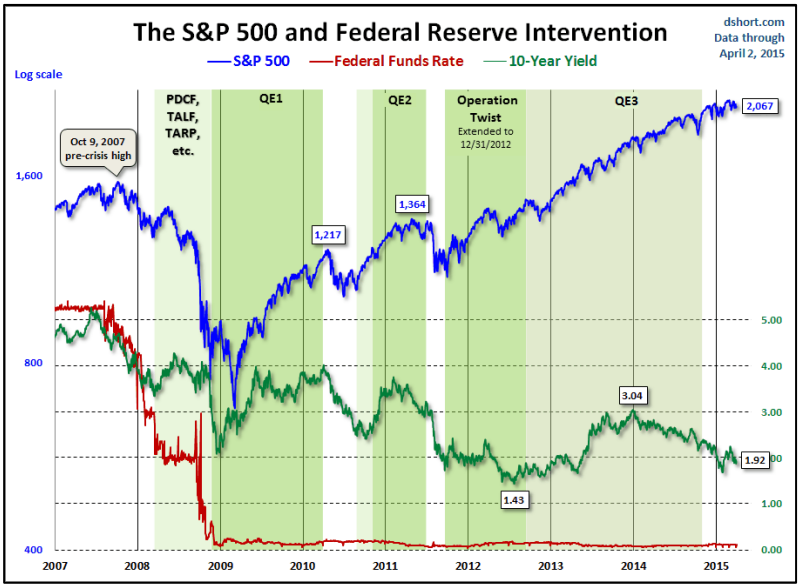
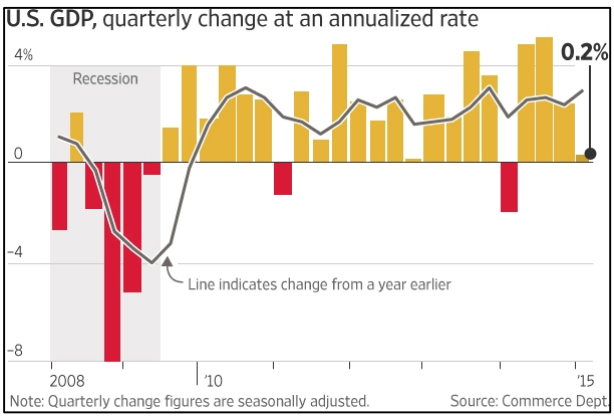




As we have discussed at length in past letters, the efficacy of these pedals reached a limit in late 2008 when the Fed Funds Rate was lowered to what has been referred to as the 'zero lower bound'. As you can see in this chart from Bloomberg which overlays the S&P 500 (green) and the Fed Funds Rate (white) for the past thirty years, historically as the US economy hit a soft patch and markets sold off the Fed was able to lower the Fed Funds Rate to ease the contraction and then raised rates as the economy and markets found their footing and began to recover from recession. If you envision the Fed Funds Rate as a virtual heart rate monitor for the US economy, you can see the ebb and flow of the business cycle with rising short term interest rates in response to economic expansion and falling rates in response to periods of contraction. Continuing that analogy, the US economy has been flat lined since 2008 and it has only been the defibrillator paddles of three successive rounds of quantitative easing (QE) that has shocked any life back into the economy, with much of the voltage having gone straight into juicing up equity prices.

The most recent and largest round of quantitative easing, QE3, ended in October 2014 and members of the FOMC have been debating since then the most appropriate time to begin to normalize monetary policy by raising the Fed Funds Rate. Their decision will be 'data dependent' of course, which means that they will be regularly monitoring the state and strength of the economy to determine if the time is right to finally begin to hike rates. The last time the Fed raised interest rates was back in 2006, and the beginning of that most recent rate hike cycle was in 2004. The uncertainty surrounding how businesses, households and, in turn, financial markets will react to the beginning of the first rate hike cycle in more than a decade is what has kept the FOMC cautious and markets on edge.



On April 29th, the advance estimate of first quarter (Q1) GDP was released and was expected by economists to reflect a decrease in activity due in large part to another harsh winter and the export-dampening effects of a stronger Dollar. The Wall Street consensus expectation was for a subpar quarter of 1.0% GDP growth, but the actual advance estimate came in well below those expectations at just 0.2%. This advance estimate was the first of three estimates for Q1 growth that will

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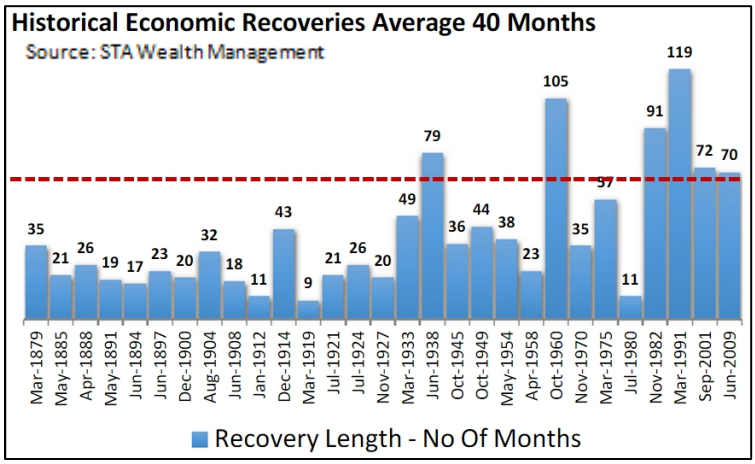
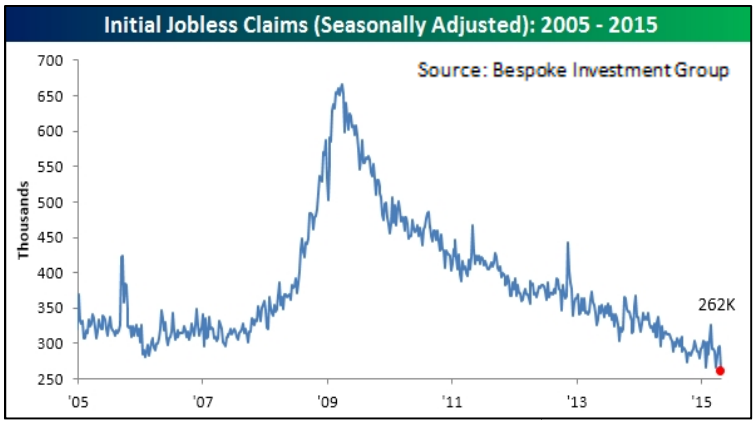
be released in the coming months, as each successive estimate will be revised higher or lower to reflect the more detailed Q1 data that becomes available. It is worthwhile to note that last year the advance estimate for Q1 2014 GDP growth came in at +0.1% but the final revision indicated that the economy had in fact contracted by -2.1%.



The most recent FOMC statement was released on the same day as the GDP number and it appears as though the members are choosing to view the first quarter weakness as having been transitory and expect the economy to rebound over the rest of the year, as it did in 2014. It is entirely possible that the Fed will begin raising rates later this year regardless of whether or not we see a strong bounce back in the second quarter like we saw last year. With the current recovery already having lasted longer than all but a handful of recoveries in the last 140 years, it is very likely that the Fed is looking at the tools available to them to combat the next recession and finding nothing but the bottom of the toolbox. With the Fed Funds Rate having been pegged at zero for six years and counting and each successive round of QE having shown a diminishing economic bang for the buck, the FOMC is well beyond the point of running low on ammunition.



What makes matters much more difficult for the FOMC and market participants trying to anticipate the Fed's next move is that the majority of macroeconomic data has been disappointing so far in Q2, but the labor market has reached a level that has historically been characterized as full employment. We have discussed in the past how the dramatic decrease in the civilian labor force participation rate since the Great Recession makes the current official (U-3) unemployment rate of 5.5% look better than it really is, but the broader measure of unemployment (U-6) is also at its lowest level since 2008 and trending lower. Moreover, the most recent reports of both initial and continuing jobless claims were the lowest in 15 years. In fact, this week's initial jobless claims report was the second lowest in 43 years. Another metric that the Fed is tracking closely with regards to its dual mandate of full employment and price stability is wage growth. While year-over-year wage growth is not yet back to pre-crisis levels, the trend over the last several

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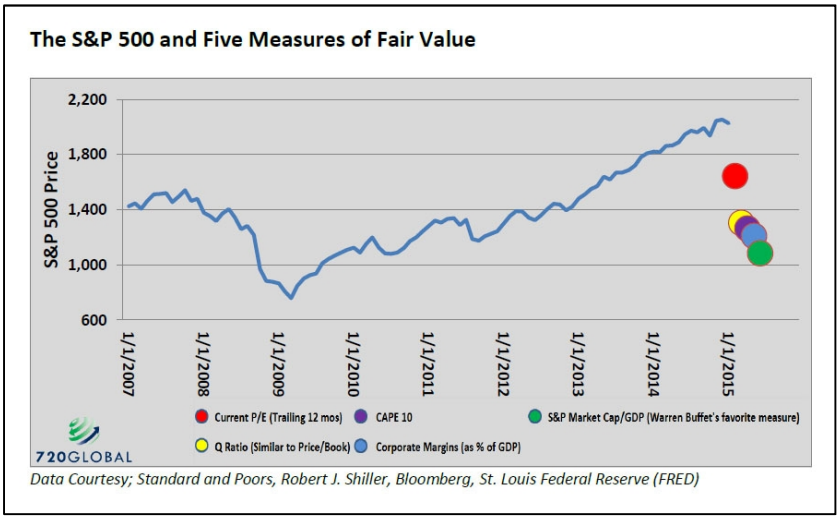
quarters is decidedly to the upside. This is indicative of a tightening labor force, which is one guidepost the Fed is using to determine when would be the most appropriate time to raise rates.

So what we are very likely to see over the next several months is a continuation of the day-to-day volatility that we've seen since the end of QE3 last fall. With each economic data point that is released, market participants will move their flagstick of when they expect that first rate hike and prices on every global financial market will adjust accordingly. Our feeling is that, barring a total collapse in the labor market, the Fed's bias will be to raise rates by 25 basis points (0.25%) in the fall and monitor the fallout before making any additional increases.

This brings us to the question of what we expect the potential fallout of a rate hike to be. From an economic standpoint, simply consider the ramifications of every variable rate debt instrument in the country (and much of the $9 trillion of US Dollar denominated foreign debt) becoming more expensive overnight. This includes home equity lines of credit, credit cards, most student loans and obviously variable rate mortgages, of which there are still a surprisingly large number due to the fact that millions of homeowners with negative equity have been unable to refinance to fixed rate mortgages. If the US was only able to generate 0.2% GDP growth in the first quarter, despite six years of zero-interest rate policy, it follows that GDP growth could quickly turn negative as soon as the cost of servicing outstanding debt rises. Higher debt payments will eat even further into households' disposable income and corporations will have to refinance expiring debt at higher rates. This is not even considering the cost to our state and local governments which heavily rely on debt markets to fund major projects and to our Federal government, which currently spends approximately 10% of tax revenues on debt service despite all-time low borrowing rates.

Past tightening cycles, during which the FOMC has raised rates, have typically occurred during periods of robust growth. Our expectation is that by raising rates in the interest of preserving interest rate policy as a tool to fight the next battle the Fed will actually be precipitating the next recession. Any rate hikes the Fed is able to pull off this year will likely be quickly reversed next year, but the financial markets are likely to have paid a dear price in the meantime.



We have discussed in each of our recent client letters (available on our website, www.UlmanFinancial.com) that numerous widely used valuation metrics find the S&P 500 to be extremely overvalued at current levels. The chart to the left shows the level at which each of five such metrics indicate, based on historical averages, what fair value on the S&P 500 should be right now. These metrics are used to determine fair value by comparing current equity prices to a variety of economic data points: corporate earnings over the past 12 months; real average corporate earnings over the past 10 years; total corporate assets' replacement value, similar to book value; corporate profit margins as a percent of GDP; and overall economic production as measured by GDP. Historically, when an overvalued market has peaked and reversed course

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the market does not stop its downtrend once it reaches fair value. In every bear market of the past 140 years the equity market has overshot to the downside, exasperating losses for those who remained invested through the overvalued peak and creating generational buying opportunities for those who had sold equities prior to the peak and preserved capital to deploy once the market approached its undervalued low.

Exhibit 6: Forward PE multiples for the S&P500 are higher than past hiking cycles

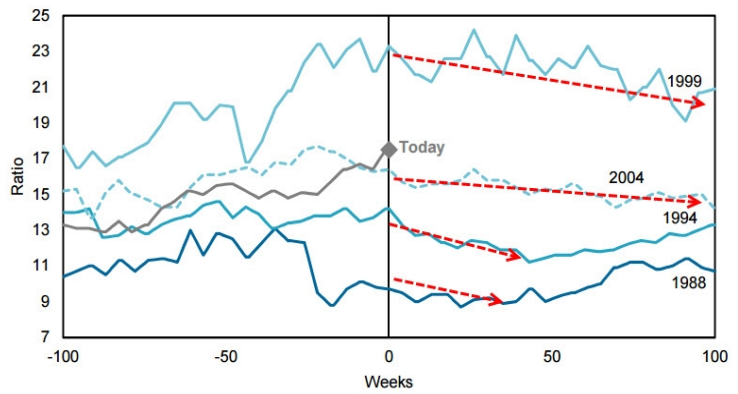
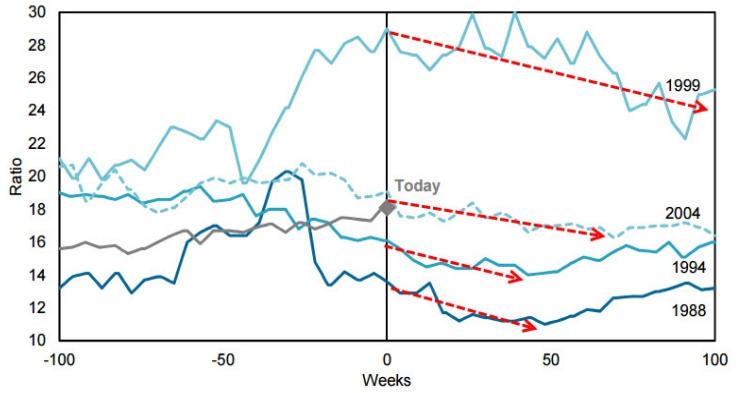
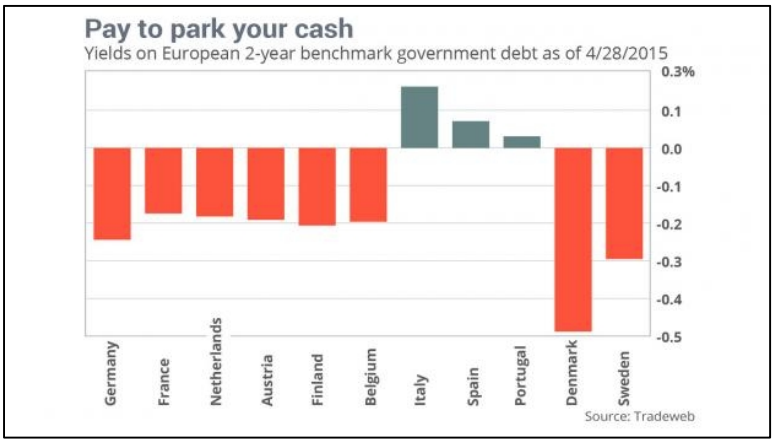


Exhibit 7: Trailing PE multiples for the S&P500 are similarly high vs. past hiking cycles



Source: Goldman Sachs Global Investment Research.



Will the onset of the next Fed rate hiking cycle be the catalyst that finally sends equity markets toward the more attractive (read: lower) prices we have been long anticipating? Based on the experience of the last four rate hiking cycles, it appears very likely. With the exception of the hiking cycle that burst the massively overvalued tech bubble of 1999-2000, forward and trailing price/earnings ratios are now as high as or higher than at the start of any recent hiking cycles and in each of those cases markets got considerably cheaper in the following year. With the economy as fragile as it appears to be now, a Fed Funds Rate hike could trigger a recession and the major equity market correction we have been writing would be the most probable endgame of monetary policy normalization.

Of course, this all begs the question – What happens to markets if the Fed doesn't raise rates this year? This of course is a distinct possibility, and according to many analysts a distinct probability. When compared to short term rates in Europe, as seen on the bottom left, where in most countries investors are literally paying to own sovereign debt because of negative interest rates, the current 0.58% yield on 2-year US Treasuries already seems stratospheric. As is apparent in the chart on page 2 entitled 'The S&P500 & Federal Reserve Intervention', for the past six years it has only been during periods of large scale asset purchases by the Fed (QE1, QE2, Operation Twist & QE3) that US equity markets have moved decidedly higher. We have no reason to assume that this relationship would not hold unless the US economy suddenly was to achieve the traction it has been lacking since 2008. In the situation that the Fed stands down and leaves rates unchanged, but does not embark on QE4, we would expect continued volatility resulting in a sideways to moderately lower market through the end of the year.

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To hike or not to hike, that is the Fed's question. They have been left, as was Shakespeare's contemplative Prince Hamlet, to judge between the lesser of two evils. For the past six years they have *taken arms against a sea of troubles*^ while the financial world has grown complacent and increasingly accustomed to the safety net of ultra low borrowing rates and the excess liquidity provided by round after round of QE. As famed economist Hyman Minsky posited in his 'Financial Instability Hypothesis', it is precisely excess investor complacency and a prolonged perception of financial market stability that has always ushered in the next period of extreme market instability. The members of the FOMC and their staffs have surely studied the work of Professor Minsky and are keenly aware of the unintended consequences that lurk beneath the seemingly benign crutch of perpetual cheap money. *Aye, there's the rub.*^

The alternative course of action, to begin the painful process of weaning markets off of their six year addiction, would be viewed by many economists and value investors with an awareness of market history as the nobler path. We find ourselves in that camp and are thus positioned to weather *the heart-ache and the thousand natural shocks*^ that markets will likely have to suffer as a result. While we and the rest of the world continue to wait for some resolution regarding the timing of the Fed's next move, we continue to feel that a portfolio that is underweight US equities and corporate bonds and overweight cash and long maturity US Treasuries is most appropriate.

Long dated US Treasuries are currently yielding far above their counterparts in developed economies, so they are more attractive to sovereign wealth funds and long term institutional investors such as pension funds and insurance companies, who need to match their long term obligations with debt instruments of similar duration. The 30-year US Treasury is currently yielding 2.75%, compared to just 0.87% on 30-year German Bunds and 1.36% on 30-year Japan Government Bonds. US Treasuries have also historically served as the 'port in the storm' during periods of financial stress, so this safe haven asset stands to benefit from increased demand despite the disturbance that a rate hike would cause for debt of shorter duration.

An elevated cash position of course serves both defensive and opportunistic purposes. With interest rates on short term debt and global inflation rates at or near all-time lows, the risk-free opportunity cost of holding cash is negligible. Cash also will not be subject to equity and bond market volatility that will most certainly accompany the normalization of Fed policy. Most importantly, however, cash serves as that preserved capital that is required for a long-term, value-oriented investor to take advantage of extreme market undervaluation that always accompanies a bear market bottom. It is our, and your, patience now that will enable measured, opportunistic risk-taking at more appropriate valuations.

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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^To be, or not to be, that is the question—
Whether 'tis Nobler in the mind to suffer
The Slings and Arrows of outrageous Fortune,
Or to take Arms against a Sea of troubles,
And by opposing, end them? To die, to sleep—
No more; and by a sleep, to say we end
The Heart-ache, and the thousand Natural shocks
That Flesh is heir to? 'Tis a consummation
Devoutly to be wished. To die, to sleep,
To sleep, perchance to Dream; Aye, there's the rub…

- William Shakespeare's *Hamlet, Act III*

**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 US Dollar Index is an index of the value of the United States dollar relative to a basket of foreign currencies, often referred to as a basket of US trade partners' currencies. It is a weighted geometric mean on the dollar's value relative to other select currencies.*

Indices such as the S&P 500 Index, the Dow Jones Industrial Index and the US Dollar 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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