MOMMAERTS MAHANEY
FINANCIAL SERVICES, INC
ACHIEVE MORE.

989 W Washington St., Suite # 101
Marquette, MI 49855
(906) 226-8711
www.mommaerts-mahaney.com

January 31, 2023

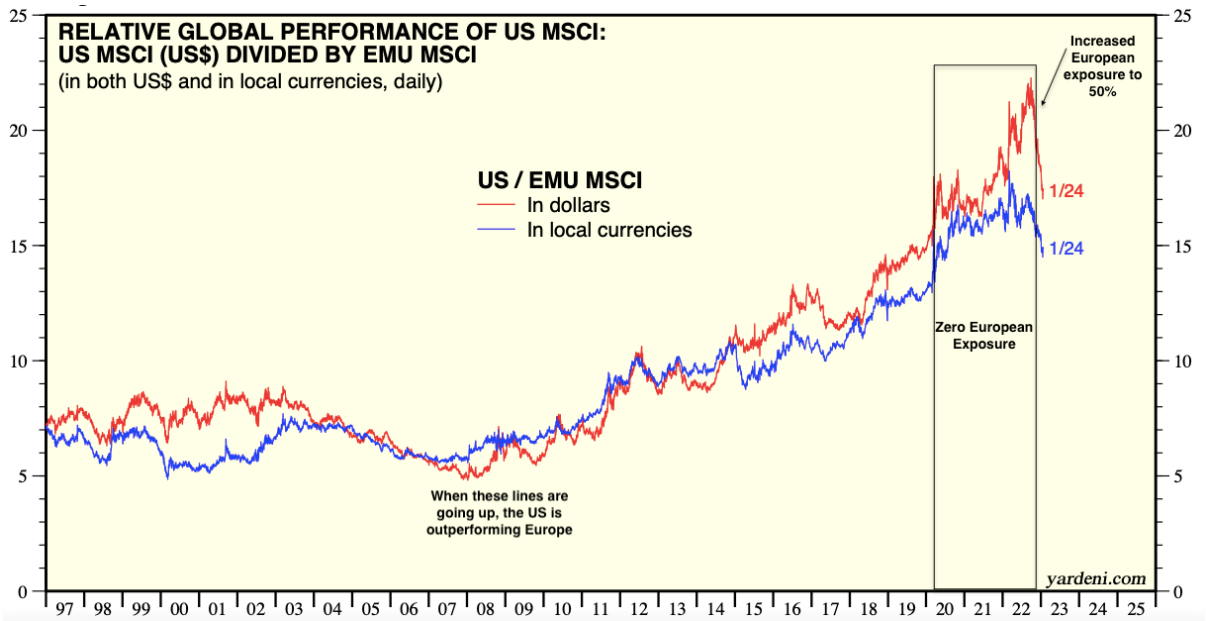
Returning to Neutral International Stock Exposure

Executive Summary - Well sort of. We have moved our International Stock weight back to neutral. Within International Stocks, we are now overweight Europe and remain uninvested in Asia. (The absolute value of the European overweight is equal to the absolute value of the Asian underweight.) Domestically, we are returning to a neutral allocation across both size (Large Cap, Mid Cap, Small Cap) and style (Growth vs. Value).

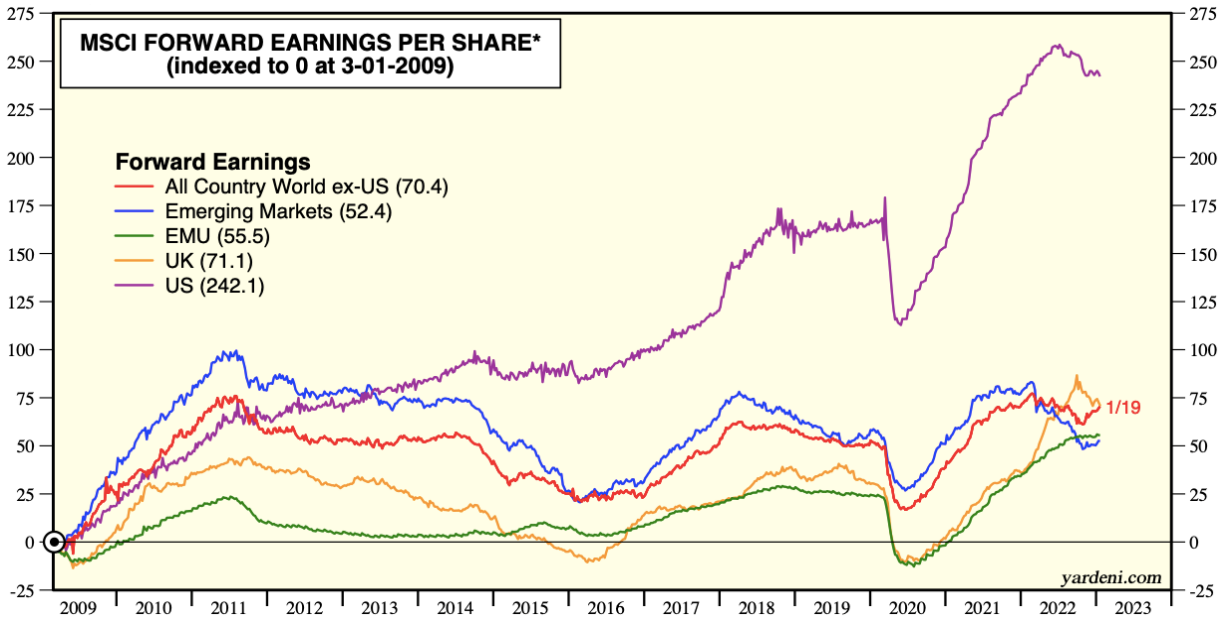
International Stocks - We eliminated all International Stock exposure back in early 2020. Our reasoning was twofold; we expected the U.S. economy to outperform other world economies and also expected the U.S. Dollar to appreciate against foreign currencies. Both theses proved correct. The U.S. economy outperformed due to its lower reliance on global trade and the U.S. Dollar once again proved to be a safe-haven currency during uncertain times. At the start of 2022, our expectation was that we would reinvest in European Stocks at some point during the first half of the year. Valuation in European stocks had become attractive and global trade was recovering as Covid shutdowns were eased. Then Russia invaded Ukraine. Aside from the obvious human tragedy, it greatly impacted European economics. The direst predictions regarding the now one-year-old war in Europe have not come to fruition. Most notably, that European reliance on Russian energy would crush European economies and that Russia would quickly conquer Ukraine and then go on to invade other European countries. We are certainly not ruling out the possibility of something dire still happening, however, it now appears the war has blended into daily European life and its business as usual in Europe.

International Stock Performance - The overly annotated chart below shows the magnitude of U.S. Stock outperformance since we repatriated all assets in early 2020. The lines on the chart represent the price of U.S. Stocks divided by the price of European Stocks. We've included performances in both

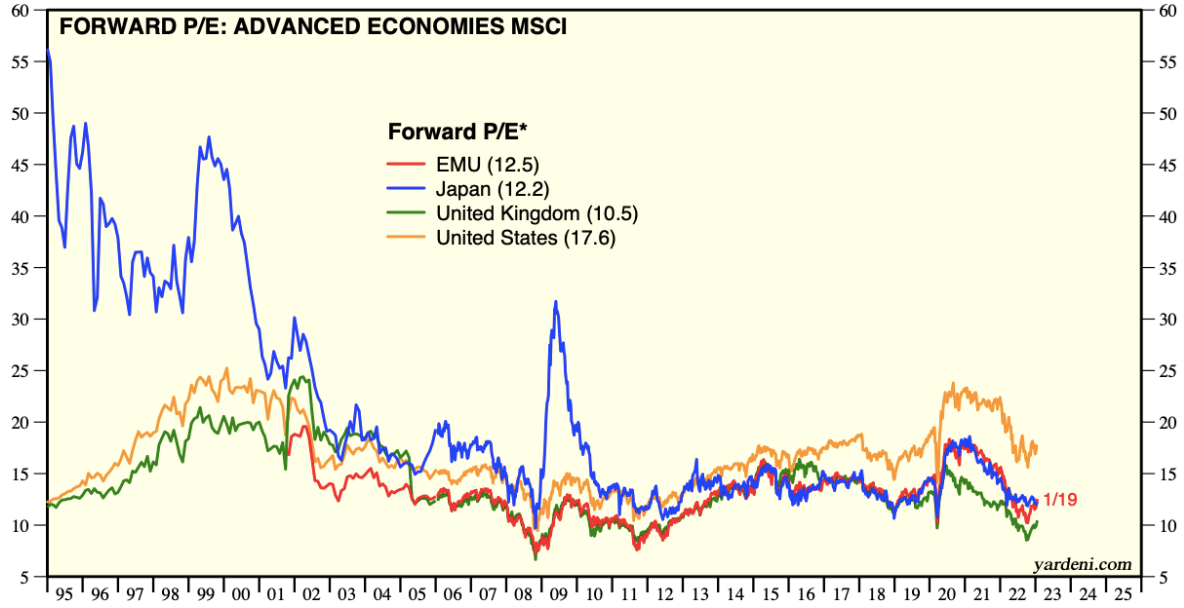
local currencies and U.S. Dollars. (U.S. investors receive the U.S Dollar price). When the lines are rising, it means U.S. Stock prices are going up more than European Stock prices. When falling, Europe is outperforming the U.S. The U.S. outperformed Europe by 15% from early 2020 until October 2022. Since then, Europe has gained back 8% of its underperformance. U.S. outperformance was due to superior U.S. Stock Market returns and a stronger U.S. Dollar. Recent European outperformance has been attributable to superior European Stock Market returns and a stronger Euro.



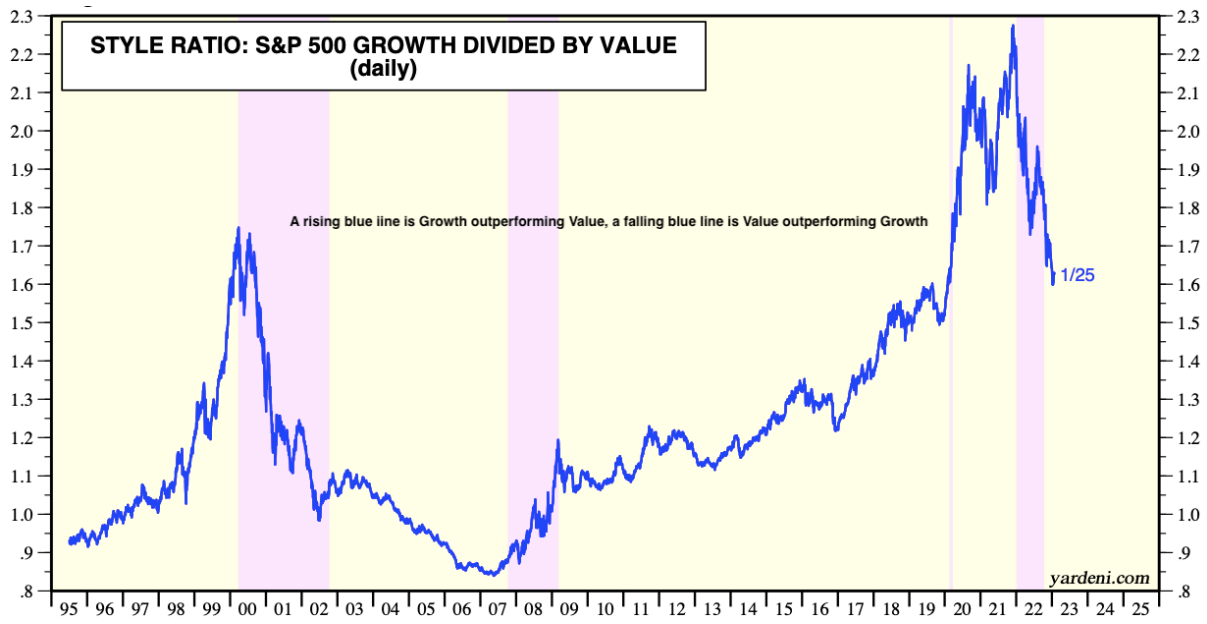
European Valuation - US. Stocks generally trade at a slight premium (higher valuation multiple) to European stocks. We believe this valuation difference is justified. U.S. corporate earnings have consistently grown at a faster growth rate than European earnings. We've often presented our argument that portfolios should systematically overweight U.S. Stocks for this reason, in contrast to the conventional view that a global portfolio should be weighted relative to global market capitalization. The executive summary of our thesis is that the U.S. economy is a purer form of capitalism than International economies. The result is U.S. corporations are more profit-oriented than International corporations. The chart below supports this thesis (we suppose we wouldn't include it if it didn't). Notice how much faster U.S. earnings (purple line) are growing compared to corporate earnings for the rest of the world's developed economies (red line). The European Monetary Union (EMU, aka Europe ex UK) is the green line. Although superior U.S. earnings growth was more dramatic during the pandemic, it's also been consistently superior over the longer-term time period.



Despite U.S. Socks having a slighter higher price-to-earnings multiple pre-pandemic, we viewed U.S. and European Stocks as fairly valued on a relative basis. During the pandemic, for all of the reasons we mentioned earlier, U.S. Stock values increased far more than European Stock values. This led to an even wider disparity between U.S. and European multiples. We viewed this even wider disparity of multiples as justified due to the negative economic impact the pandemic and war were inflicting on Europe. The pandemic and war are no longer dominating economic results in Europe. We can no longer justify this historically wide valuation difference between U.S. Stocks and European Stocks. We are becoming increasingly concerned that materially lower price-to-earnings multiples in Europe are no longer justified and this may lead to European Stocks significantly outperforming U.S. Stocks. Lastly, we are choosing not to reenter Asian Stock Markets at this time. We continue to see systemic issues within Asian economies, demographics being of primary importance. We will expand on that in a future commentary. In the meantime, we are allocating our Strategic Asian Stock exposure to European Stocks. This returns our aggregate International Stock allocation to neutral for the first time in almost 3 years.

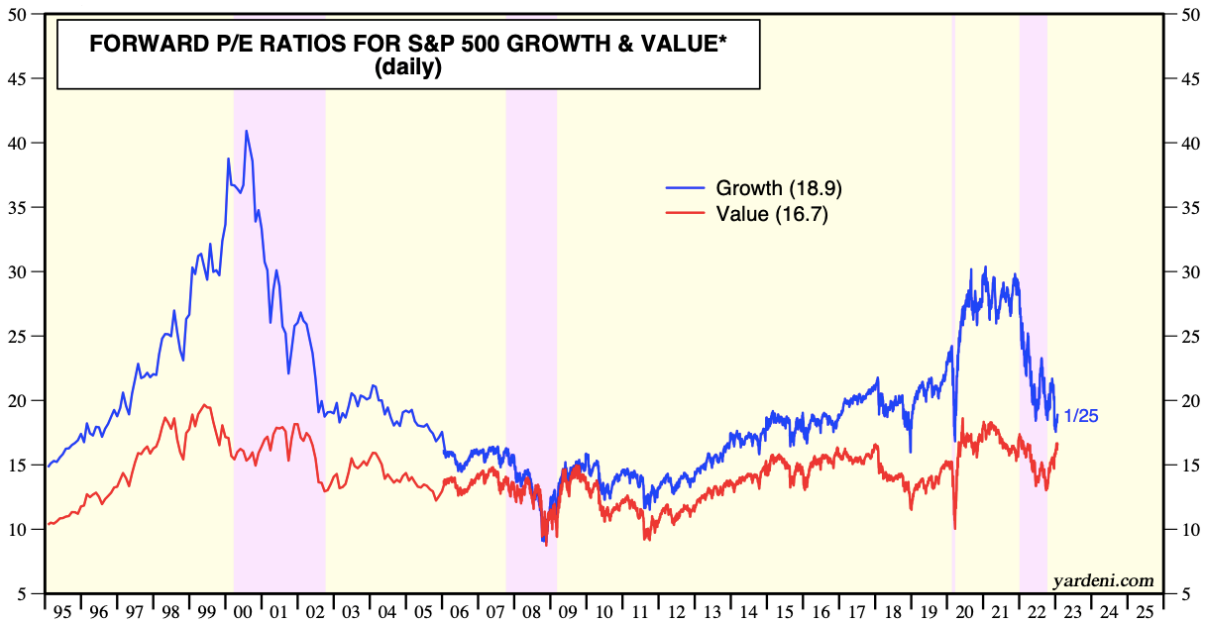


Size and Style - Our recent tilt toward Value Stocks has been beneficial. After nearly two decades of Growth Stock outperformance, Value Stocks dramatically outperformed Growth stocks in 2022. This was not surprising given the bear market of 2022 and the resulting price-to-earnings multiple compression. Higher multiple stocks (Growth) compress more when earnings multiples contract.



Growth had consistently outperformed Value for most of the last two decades. Much of this outperformance was attributable to stronger earnings growth, but it was also attributable to more

multiple expansion in Growth vs. Value Stocks. Covid and lockdowns greatly benefitted technology (Growth Stocks) while harming traditional brick and mortar Value stocks. During the pandemic Growth Stocks were trading at 30X earnings while Value was trading at 17X. Right now Growth is only 2.2X more than Value. That's the tightest differential since the 2008 credit crisis. **Importantly, a large portion of the YTD tightening of this differential is not attributable to Value outperformance.**



Standard & Poor's (S&P) reconstituted their Growth and Value indexes at year-end. Giant tech companies such as Amazon and Microsoft are no longer considered pure Growth Stocks. They are classified as a blend of Growth and Value. Energy companies such as Exxon-Mobil and Chevron are no longer Value Stocks. They are now considered Growth Stocks. Price momentum and earnings momentum are two of the major criteria the S&P uses for differentiating between Growth vs. Value. Last year was wacky, to say the least. Due to the dramatic increase in energy prices, energy company profits skyrocketed. Energy Stocks which have always been considered Value Stocks, suddenly had the highest earnings and price momentum across all industries. So now they are classified as Growth Stocks. Companies such as Facebook (Meta) got crushed. Earnings fell dramatically and they were reclassified as Value Stocks for 2023. Cats are barking and dogs are meowing! We are likely guilty of TMI at this point in the commentary. We do our best not to burden you with our rants, but it's cheaper than paying for therapy. Needless to say, we are not comfortable making a Growth vs. Value decision until we have some time to sort through this data. Prior to this reconstitution, investors were basically

betting for or against the big tech stocks when over or underweighting Growth Stocks and Large Cap Stocks. That is no longer the case. We are returning to neutral for the time being.

In summary, we continue to expect a return to what we refer to as the *normal abnormal*. We now have the least amount of tracking error relative to our longer-term neutral portfolios since pre-pandemic days. Our expectation is that global central banks are nearing the end of their tightening cycles and that more normal times lie ahead. In this scenario, we view both Stock and Bond valuations near their longer-term equilibrium. There will likely be a few more minor changes to portfolios over the next few months before we re-enter a less active portfolio reallocation period.

Please reach out to us if you would like to discuss any of the specific changes we have made to your portfolio.

The MMFS Team

Jon C Mommaerts, CFP®: Jon is a Principal of Mommaerts Mahaney Financial Services, Inc. He has over 30 years of experience working with professionals and those about to retire. He is a member of the Financial Planning Association, as well as a founding member of the Preferred Financial Advisors.

J. Matthew Tuccini, CFP®: Matt has over 18 years of experience working in the financial services industry with vast experience in retirement planning, tax strategies, and financial planning.

Robert Kea, CFA: Bob has over 30 years of experience in portfolio management. He was a founding member and Co-Head on Putnam's Asset Allocation Group, which managed $12Bn in both retail and institutional assets.

Jason Rolling, Financial Advisor: Jason has been in the financial services industry for the past 16 years. His financial experience includes retail banking, consumer & commercial lending, bank management at the local, regional and SVP level, wealth management, and financial planning.

Haley Wainio, Financial Advisor: Haley has over 10 years of experience in the financial services industry. Her experience includes retail banking, treasury management, commercial lending & financial planning.

Mommaerts Mahaney Financial Services, Inc. provides advisory services through ERTS Wealth Advisors, LLC, a registered investment advisor.
989 W. Washington Street, Suite 101 Marquette, MI 49855
(906) 226-8711