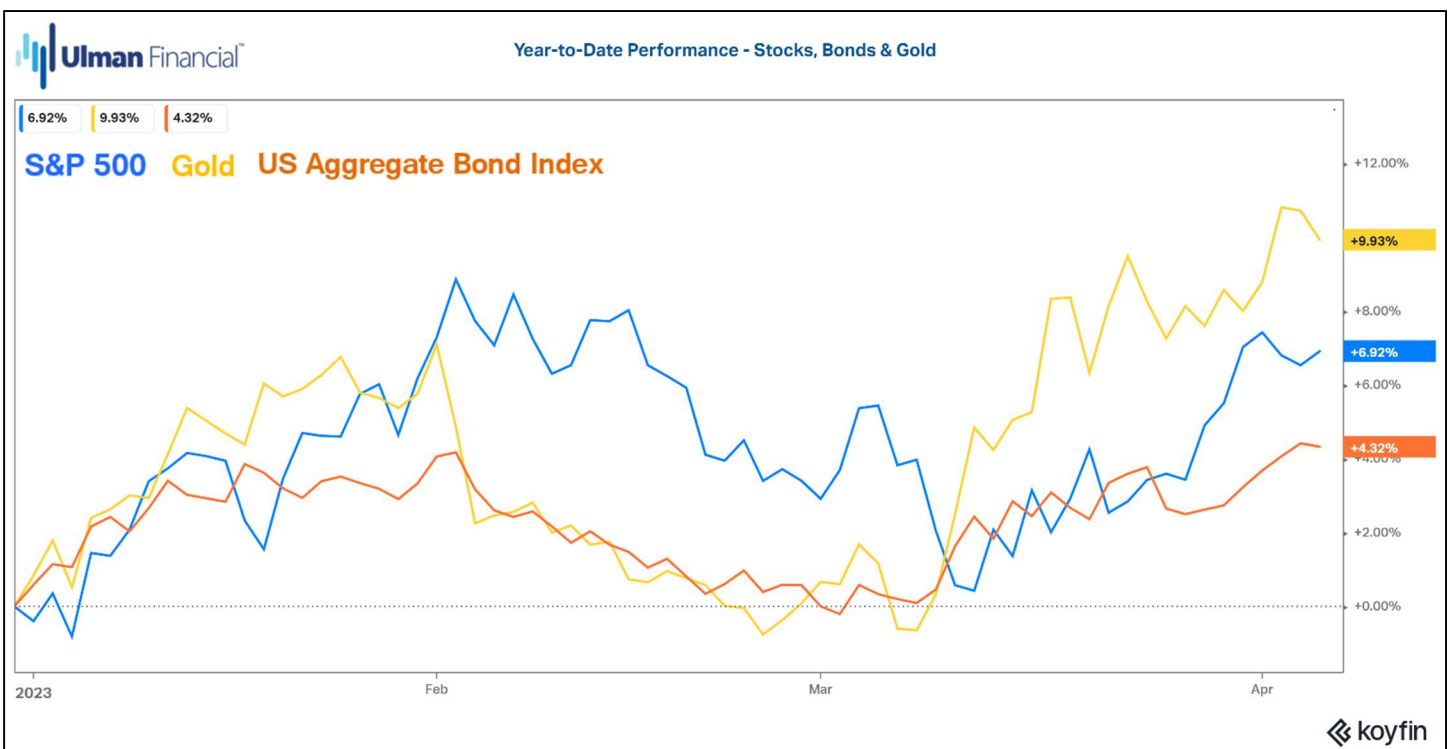


April 7, 2023 – Paid to Wait

Never a dull moment in financial markets. The first quarter of the year featured the collapse of the largest US bank since the 2008 financial crisis, followed quickly by two smaller US regional bank failures, a new Federal program to secure the balance sheets of small and medium sized banks and the shutdown and acquisition of one of the thirty largest “global systemically important” banks, this one in Europe. Despite the apparent crisis of confidence exhibited by fleeing depositors amid the latest signs of cracks in the global financial system, the Federal Reserve remained resilient in its war on inflation by hiking the Fed Funds rate to 5%. The Fed continues to insist that rates will remain higher for longer in the face of a confident consumer, robust labor market and a seemingly resilient economy.

The uncertainty around the Fed’s monetary policy path two or three quarters in the future in the face of the competing narratives of inflation and recession has resulted in considerable month-to-month swings in both stock and bond markets. Investors started the year in an exuberant mood, expecting that the continuing decline in reported inflation would mean that the Fed would soon end their hiking cycle and would be back to an accommodative stance by lowering short term interest rates late in the year. The S&P 500* was up by more than 8% in January, before stronger than expected employment and inflation numbers dashed the hopes of an imminently easier monetary policy, driving the market back to almost break-even by the second week of March. Enter the aforementioned banking crisis on March 12, and with it renewed hopes that the Fed would soon ease.

With clear evidence that the Fed’s hiking cycle has gone too far, too fast, market participants are back to betting that the Fed will be their best buddy again come the fourth quarter. We would remind those overanxious

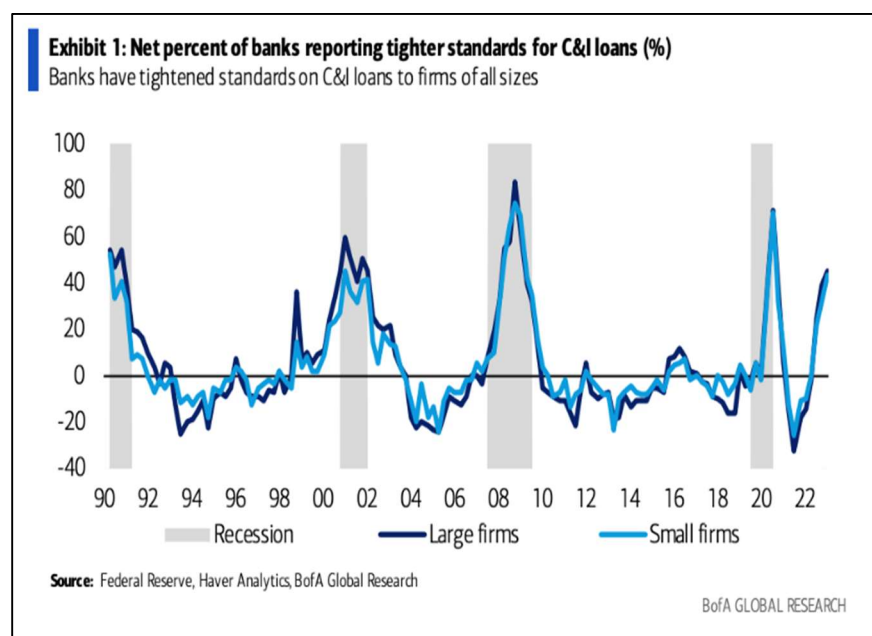


speculators that now that the Fed has sufficiently injured the banking system, simply halting further rate hikes is unlikely to kick start the small and regional bank lending that is the lifeblood of the economy. From Josh Brown at Ritholz Wealth Management:

Construction and Industrial (C&I) loans are a \$2.8 trillion business (approximately) for banks all over the country. If they roll over, we have a soft landing. If they roll over hard, we have a hard landing. It's not complicated, the only thing that's up in the air is the timing and severity.

C&I loans take the form of either lump sum or revolving credit. They are usually a year or two years in length and are made to businesses so that they can expand, hire, invest in new equipment or facilities, improve owner-occupied real estate or just have working capital on hand. This is what small and mid-sized banks really do outside of mortgages and checking accounts. It's their real business. It's their whole purpose for existing. Small companies cannot tap Wall Street for capital. They cannot issue bonds or sell stock. They need banks to grow and improve and fund new projects.

The economy needs this activity as well. Over the two decades between 2000 and 2019, the SBA estimates that 64.9% of all new jobs were created by businesses with fewer than 500 employees. That's two thirds of the total employment growth in the United States for twenty years, mostly funded by C&I loans and credit arrangements between banks and business owners.



When banks start diverting capital away from this line of business or saying no to making new loans, stresses begin to appear economy-wide. Small business owner confidence takes a hit. Employment hits the wall. This is how recessions materialize from being a thing the stock market is worked up over to being an actual, tangible reality on Main Street.

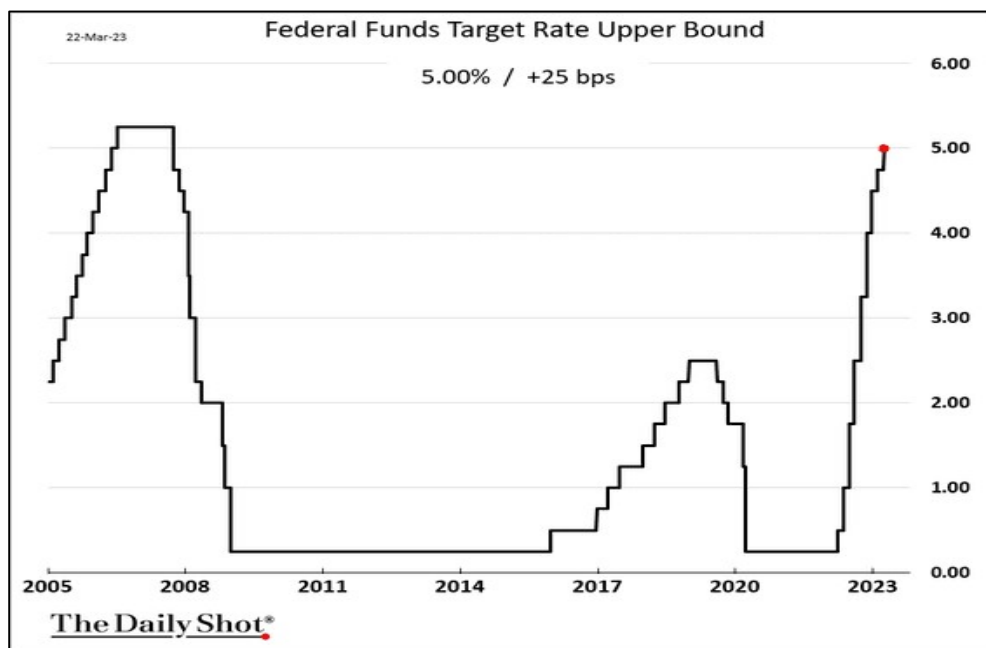
So here's a look at the net percent of banks cutting back on C&I loans by tightening their lending standards, via Bank of America this morning (left chart).

You can see that historically lending standards at large banks rise and fall with those at small banks, so if we see the contraction in loans continuing at the small banks, the impact will be meaningful for everyone. We know that the large banks are current beneficiaries of the regional bank panic in terms of the shifting of deposits, but that doesn't mean they're going to play offense on loan growth. Everyone's on defense right now. This is the very definition of a financial shock.

- Josh Brown, Ritholz Wealth Management, March 27, 2023

We wrote the following in our October client letter in reference to the increasing probability of something systemic breaking as a result of the Fed's aggressive rate hiking regime...

The good news is that we don't have to stand in the ring and take the beatings. By reducing overall equity and bond market exposure and increasing our cash [money market] position, we can sit ringside and wait it out. Based on the speed with which markets seem to be unraveling, particularly sovereign bond and currency markets, and the increasing stress those ructions are causing on the plumbing of the global monetary system, it is possible that we won't have to wait too long.



At some point in the not-too-distant future, either higher interest rates will translate to the economic slowdown the Fed is shooting for and they will be able to take their foot off of the brake, **or the stress of such extreme monetary tightening will cause an issue at a systemically important financial institution**, as happened in the UK last week, and the Fed will have to step in to prevent a cascading event." (bold emphasis added)

- Ulman Financial, October 1, 2023

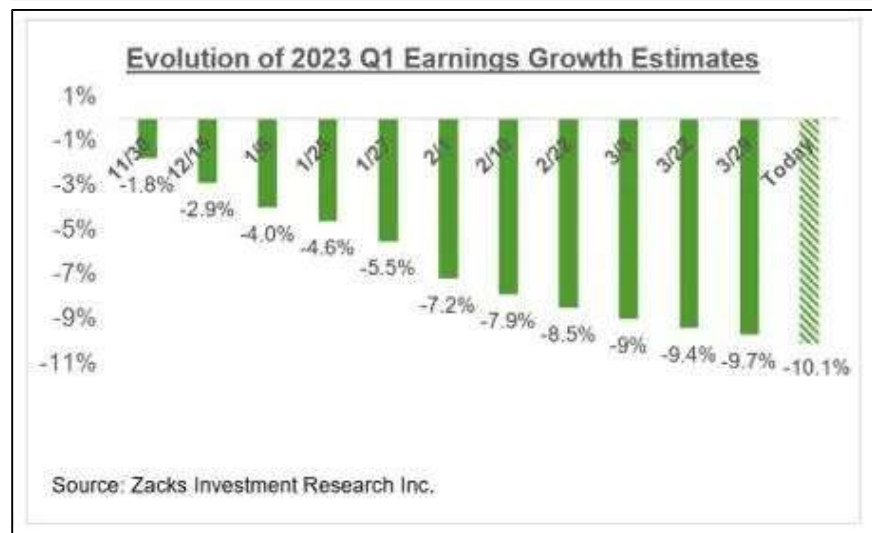
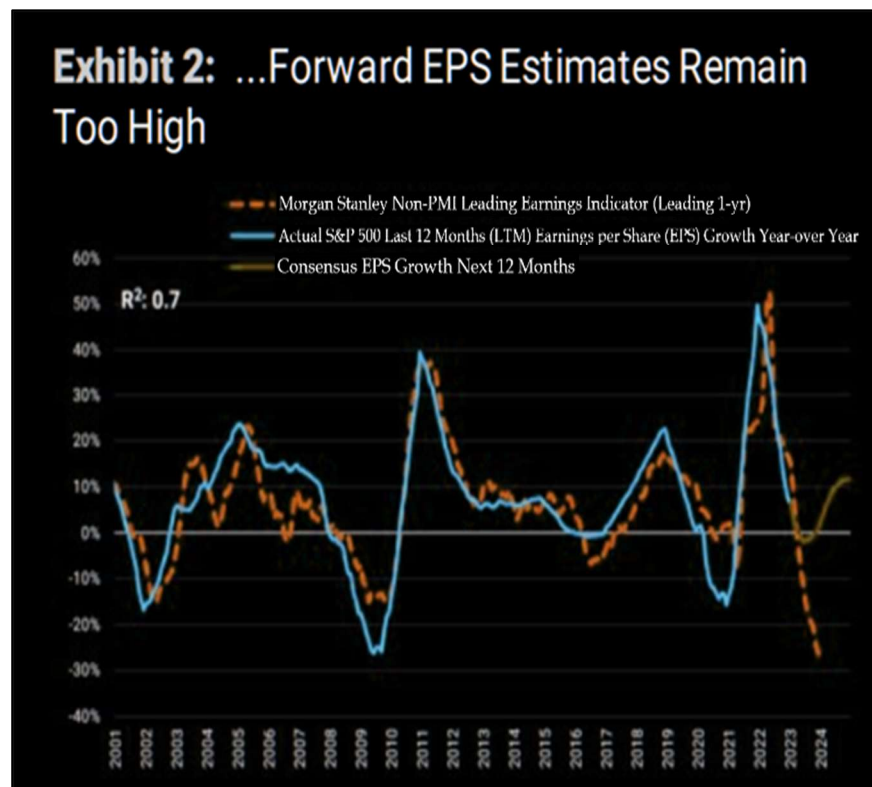
Ironically, the Fed may have inadvertently achieved both outcomes - an economic slowdown precipitated by a clog in the financial plumbing. As Josh Brown wrote above, if banks are less willing to lend, and businesses lose access to the necessary funding to grow their businesses, the result will be stagnation or contraction. This will translate directly to businesses' bottom lines, and aggregate earnings will take a hit. From our most recent client letter written and delivered in early January...

Historically, corporate earnings per share (EPS) have fallen by an average of almost 30% during economic recessions... **yet Wall Street analysts are still forecasting year-over-year earnings growth in 2023**. Our expectation is that forecasts for corporate earnings will be revised much lower over coming quarters, proving the current level of the S&P 500 to be dramatically overvalued, despite last year's losses. The bulk of past S&P 500 bear market losses typically occur after the recession has begun... suggesting the likelihood for considerably more downside to come." (bold emphasis added)

- Ulman Financial, January 4, 2023

Since we wrote that paragraph, analysts' calendar year 2023 earnings expectations have fallen by 3.8%, according to FactSet. With earnings estimates declining since the start of the year and the S&P 500 having appreciated by close to 7%, the S&P 500 has gotten more expensive while the outlook for the economy has gotten worse. It is unlikely that a tightening in lending standards late in the quarter will be reflected in companies' reported

numbers when Q1 earnings season kicks off at the end of this week, but investors will be focused on executives' guidance for the quarters to come. Our view that earnings expectations are still too optimistic and that their rerating lower will ultimately drive the broader stock market to new lows has been influenced by the work of Institutional Investor's 2022 Strategist of the year, Mike Wilson of Morgan Stanley:



Morgan Stanley's Michael Wilson said the stress in the banking system marks what's likely to be the beginning of a painful and "vicious" end to the bear market in US stocks.

"With the back-stopping of bank deposits by the Fed/FDIC, many equity investors are asking if this is another form of QE and therefore 'risk on'," the strategist — who correctly predicted the selloff in stocks last year and rebound in October — wrote in a note. "We argue it's not, and instead represents the beginning of the end of the bear market as falling credit availability squeezes growth out of the economy..."

"The last part of the bear can be vicious and highly correlated," he said. "Prices fall sharply via an equity risk premium spike that is very hard to prevent or defend in one's portfolio.... This is exactly how bear markets end — an unforeseen catalyst that is obvious in hindsight forces market participants to acknowledge what has been right in front of them the entire time," Wilson wrote.

The ongoing turmoil in the banking system should lead investors to focus on the deteriorating growth outlook

amid restrictive credit conditions, according to Wilson. "The events of the past week mean that credit availability is decreasing for a wide swath of the economy, which may be the catalyst that finally convinces market participants that earnings estimates are too high," he wrote, adding that the risk of a credit crunch has increased materially.

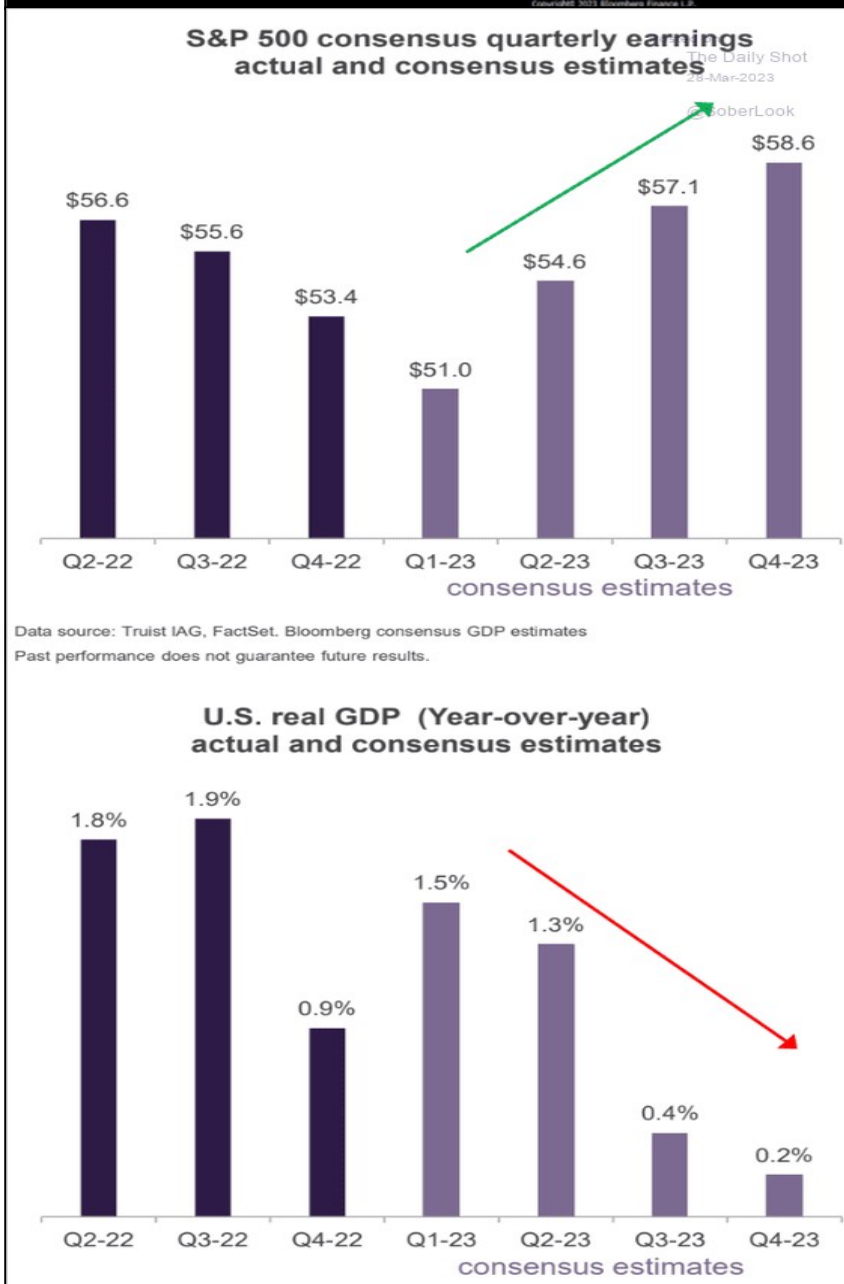
The strategist expects analysts to slash expectations as the reporting season approaches, while corporates prepare to lower guidance in a notable way, he said.

- Bloomberg, March 20, 2023



We have discussed in prior letters the recessionary warning sign that is triggered when the yield on 10-year Treasuries is below that of 2-year Treasuries, a phenomenon known as an inverted yield curve. You can see in the chart on the top left that over the past year the yield curve has been more inverted (greater negative difference between the yields on 2 and 10-year Treasuries) than at any time since the last inflation shock of the early 1980's.

The yellow arrows in the chart indicate the point immediately preceding the last three major economic recessions (not including the short and sharp pandemic recession in 2020) at which investors began reallocating money from riskier assets to the relative safety of 2-year Treasuries, driving the 2-year yield lower and re-steepening the yield curve. The banking panic of the last several weeks may have marked the low in 2-year yields for this cycle and started the countdown to the next major economic contraction. Expectations for GDP growth are indicating this possibility of contraction, but earnings estimates have yet to get the message. From MarketWatch:



The bond market is already pricing in a high likelihood of a recession, which is why the 2-year Treasury yield is suggesting 100 basis points (1.00%) of Fed rate cuts will likely arrive before the end of the year...

And estimates for gross domestic product show growth is expected to slow later in the year. That doesn't quite square with the consensus estimates for corporate earnings. According to FactSet, earnings are expected to rebound to record levels by the fourth quarter.

- MarketWatch, March 27, 2023

CHART 8: Combined Imports and Exports

United States: ISM Services PMI (index)



Shading indicates recession

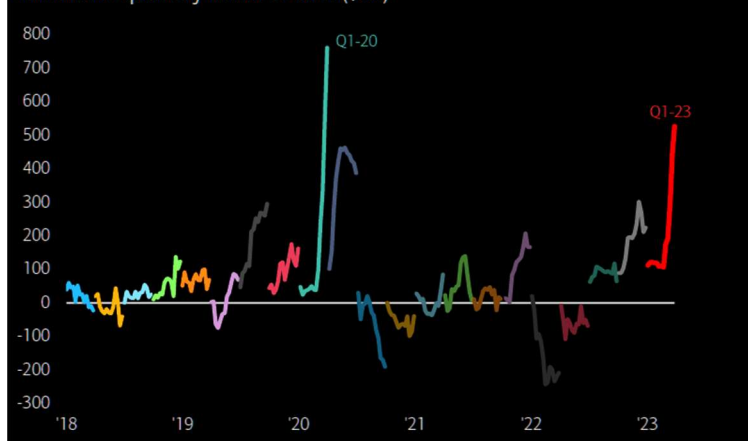
Source: Haver Analytics, Rosenberg Research

As economic data continues to point to recession, we think it is inevitable that earnings expectations will be lowered and the stock market will respond.

Business activity softened to 55.4 from 56.3 in February and 60.4 in January, while employment retreated to 51.3 from 54.0 (validating the weakness in the ADP employment report). Not just that, but two-way trade flows cratered, with new export orders (43.7 from 61.7) experiencing their largest drop on record and imports collapsing to 43.6 from 52.6. **In fact, the combined export and import index, a proxy for overall trade flows, is now at a level that we only have ever see during recessions.** (bold emphasis added)

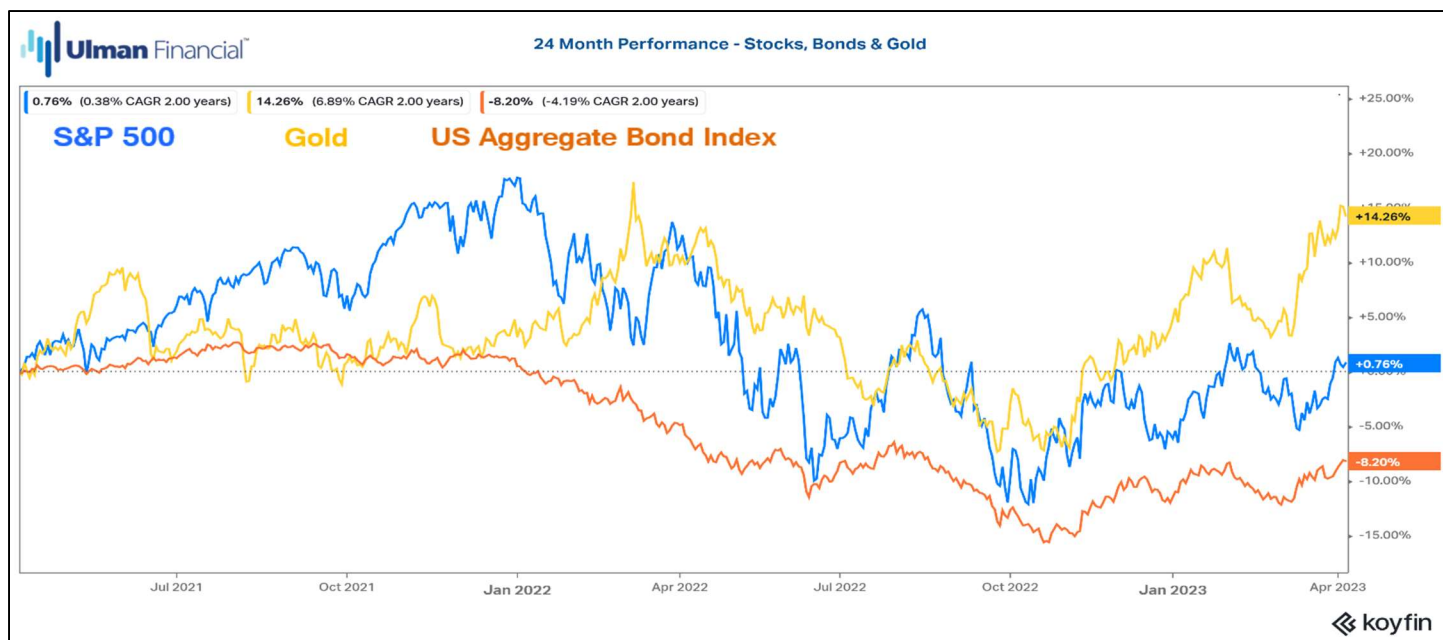
- Rosenberg Research, April 6, 2023

Cumulative quarterly inflow to cash (\$bn)



As has been the case for the past six months, we are satisfied with the increasingly attractive yield we are being paid in money market funds and 1-3 month treasuries, now close to 5%, as opposed to assuming undue risk on the increasingly expensive S&P 500. Many other investors have begun to move heavily to money market funds as well, as can be seen in the middle left char from TheMarketEar.com which shows the heaviest portfolio flows to cash since the pandemic crisis in the first quarter of 2020.


The below 24-month chart, which shows that the S&P 500 is at the same level it first visited in April 2021 and twelve times since, suggests that we have not missed out on much by being patient. We are nearing a point



when the Fed will be finished raising rates, perhaps as soon as their next FOMC meeting on May 2-3, and soon thereafter their focus will shift from battling inflation to battling the next recession their aggressive rate hiking has brought about. As economic weakness begets earnings forecast weakness markets should roll over and we will be one step closer to an investible market bottom. Until then, we're getting paid to wait.

Thank you for taking the time to read our comments. We welcome you to share this letter with family and friends, and we invite you to contact us via phone or email with any questions or concerns.

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 Nasdaq 100 Index is a basket of the 100 largest, most actively traded US companies listed on the Nasdaq stock exchange. The MSCI All Country World Index is a stock index designed to track broad global equity-market performance. Maintained by Morgan Stanley Capital International (MSCI), the index comprises the stocks of nearly 3,000 companies from 23 developed countries and 25 emerging markets. Indices such as the S&P 500 Index, the Dow Jones Industrial Average, the Nasdaq 100 Index and the MSCI All Country World Index are unmanaged, and investors are not able to invest directly into any index. Past performance is no guarantee of future results.*

The Bloomberg US Aggregate Bond Index is a market capitalization-weighted index, meaning the securities in the index are weighted according to the market size of each bond type. Most US traded investment grade products are represented. Municipal bonds, and Treasury Inflation-Protected Securities are excluded, due to tax treatment issues.

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All indices are unmanaged and cannot be invested into directly.