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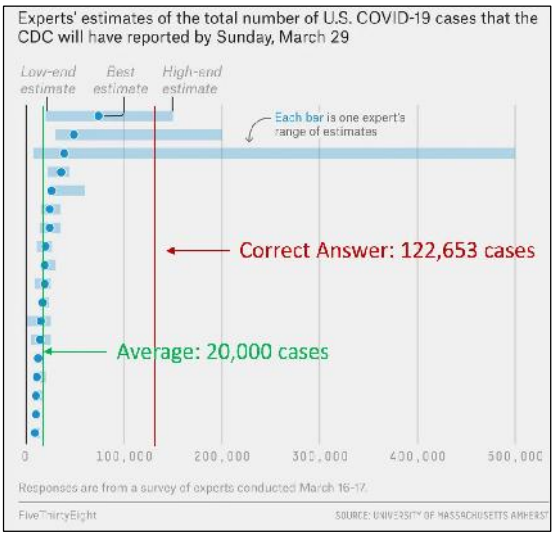
tailored wealth strategies

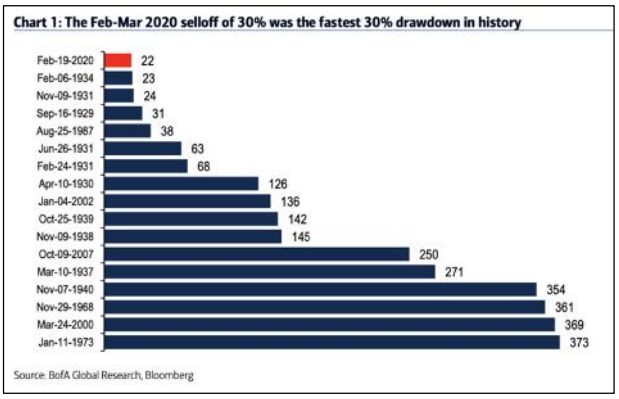
April 1, 2020 – Not Yet

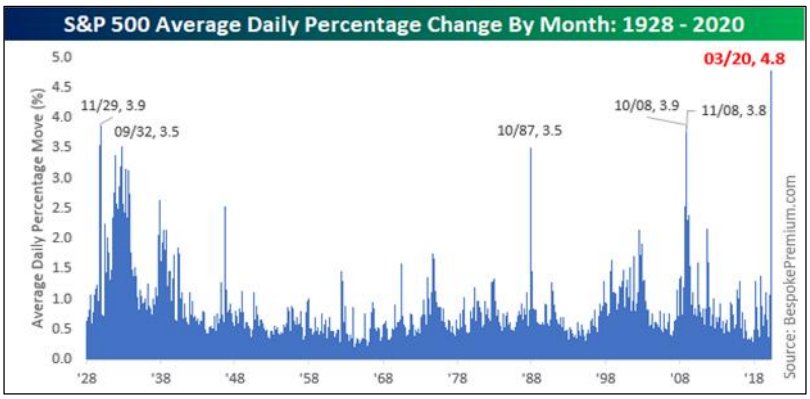
We hope that this letter finds you well. We've used that opening line for years, and we have always meant it sincerely, but that expression of well-wishes has taken on a different meaning since our last letter in January. In the midst of the COVID-19 (CV19) pandemic, our thoughts are with you and your family that you are able to stay healthy, both physically and mentally, while this humanitarian, economic and financial crisis plays out.

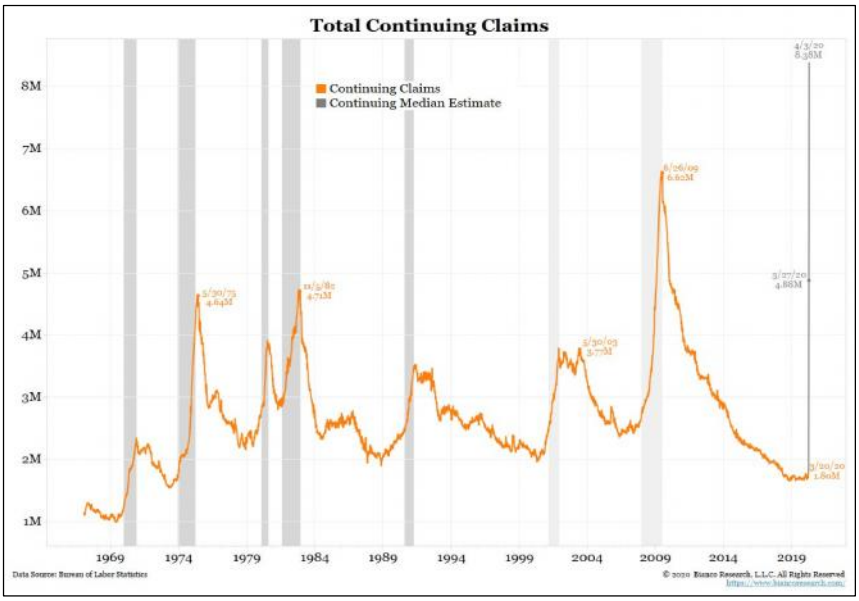


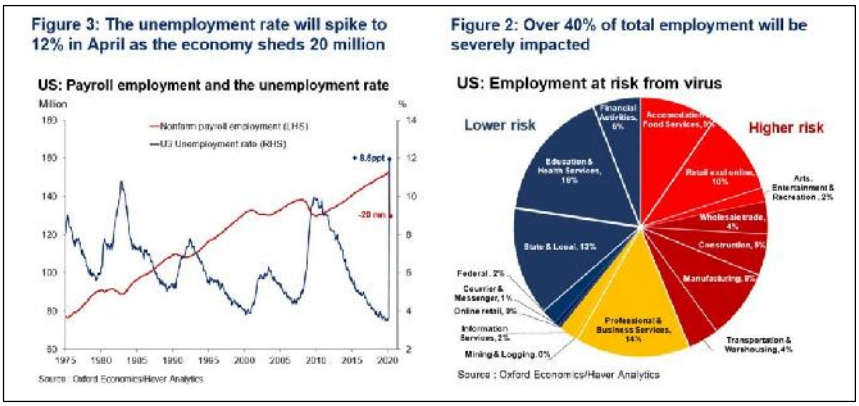
In this letter we will not be discussing US or global CV19 case numbers. We will not opine on R-naught, case fatality rates or timelines. We are not epidemiologists and, frankly, even the most qualified scientists in the world can only posit best- and worst-case possible scenarios and, as can be seen on the left, their estimates on CV19 spread in the US have been overly optimistic. The severity and duration of this pandemic will be affected greatly by human behavior on an individual and societal level, possible viral mutation, potential seasonality and, perhaps scariest to consider, whether or not the world will see a second wave of infections in the fall as happened during the Influenza Pandemic of 1918. Public health policy isn't our wheelhouse, but the current and potential future economic and financial impacts of this crisis are our wheelhouse. That is where we will focus the attention of this letter.

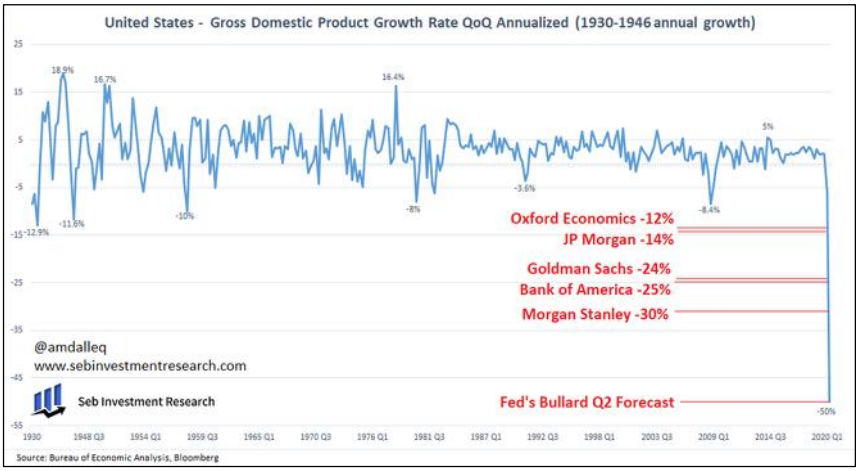
What we know is that much of the global economy has come to a standstill and is unlikely to return to anything resembling its pre-crisis level of normalcy any time soon. It took only 22 days for the US stock market to go from all-time highs to a loss of -30%, the fastest selloff of that magnitude in history. March was the most volatile month in stock market history, with an average daily move on the S&P 500* of more than 4.5%. What we have seen in the stock market in the last six weeks is reminiscent of the volatility seen during Great Depression.











As one would expect, the shuttering of the US economy in an effort to "flatten the curve" of the CV19 pandemic has resulted in some of the worst economic projections in history, including during the Great Depression. Initial Jobless Claims last week, at 3.2 million, was four times higher than the previous weekly record. Tomorrow's jobless claims report is expected to be worse still, and total continuing unemployment insurance claims will have already surpassed the June 2009 peak during the Global Financial Crisis.

Oxford Economics recently predicted that the unemployment rate will spike from a historic low of 3.5% last month to 12% in the April report. The Federal Reserve Bank of St. Louis recently released an estimate suggesting the unemployment rate in the second quarter could reach 32.1%. That is not a typo – 32.1% unemployment.

If the social distancing restrictions were lifted tomorrow and bars, restaurants and theaters all reopened, it would likely still be weeks or months before consumers, especially those most vulnerable to CV19, felt comfortable enough to return. With 40% of jobs having been negatively impacted during the shutdown, discretionary spending is likely to be limited for a vast percentage of the population. Without confidence that their customers will return, business owners are going to be hesitant to rehire, or perhaps even to reopen.

It will be four months until we see the advance estimate of second quarter GDP from the Bureau of Economic Analysis, but Wall Street expectations are already painting a very grim picture. To this point the worst annualized quarter of economic contraction on record took place during the Great Depression. Many analysts are preparing for a number considerably worse, as you can see from the bottom chart above. During the Global Financial Crisis, the first quarter of 2009 saw a contraction of -8.4%. It is hard to fathom a single quarter in which GDP could shrink by double digits, let alone multiple quarters, but that is what is currently expected.

We have spent the last several years urging our clients to maintain a material underweight to overvalued US equities and an overweight to safe-haven assets that have always performed well in times of heightened volatility. Before we talk about our current outlook and whether that broad allocation recommendation has shifted at all, let's have a look at the relative performance of US large cap stocks vs Gold and long-dated US Treasuries over the past quarter, year, 3-years and 5-years. (All past UF newsletters are archived on our website, www.UlmanFinancial.com. We welcome you to direct friends and relatives to our past letters for more detail on our views.)

With gold having hit a six-year high this week, and Treasury rates unlikely to rise materially given a weak global economy, low inflation and increasing geopolitical tensions, our preference is as it has been, a material underweight to US equities and an overweight to safe-haven assets that will benefit from continued economic weakness, market turbulence and the monetary and fiscal responses to such turbulence.

- *Ulman Financial Client Letter, January 6, 2020*

As we have since before the yield curve began to flatten in earnest one year ago, we recommend a strong underweight to equities and an overweight to safe-haven assets like US Treasuries and precious metals. We also continue to recommend an increased cash position that can be deployed back into equity markets as they near more favorable valuations. The time to resume a more traditional allocation to equities will come, but according to all available historical data that time is not now.

- *Ulman Financial Client Letter, April 5, 2019*

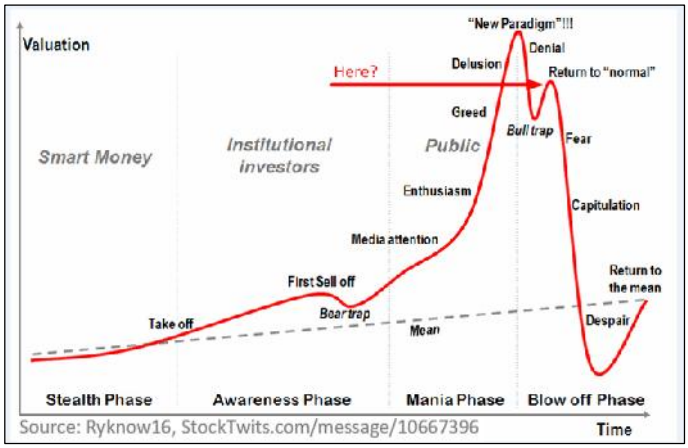
It is difficult to sit on the sidelines and watch an ebullient stock market do what every late-stage bull market does, but what is right is not always what is easy. It is our expectation that those who have exercised value-driven discipline and a greater appreciation for hard data will be the ones to benefit from the completion of the current extraordinary market cycle. An extreme underweight to US equities during this period of extreme overvaluation is the most prudent course of action.

- *Ulman Financial Client Letter, April 5, 2017*

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.

- *Ulman Financial Client Letter, May 1, 2015*

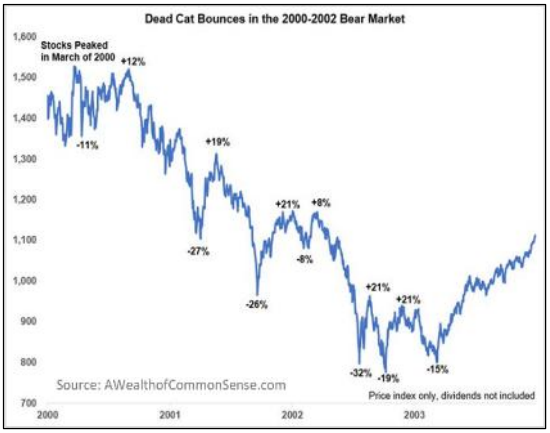
We, of course, had no idea when making those allocation recommendations that a pandemic was coming, but we didn't need to know. CV19 is not the cause of the market crash, only the catalyst. The virus has revealed and exploited the pre-existing comorbidities in the US stock market that we have been writing about for years: extreme overvaluation, false/inadequate fundamental underpinnings, and a Federal Reserve with limited effective fire power with which to fight the next recession.



Now that the decade long bull market and economic expansion that followed the last financial crisis has ended, and the stock market has bounced dramatically from the recent low in mid-March, many are wondering if now is the time to be buying stocks. Our response has been: "Not yet."

#	Bounce start	Bounce end	Trading days	Size of bounce
1	17-Sep-08	19-Sep-08	2	9%
2	10-Oct-08	13-Oct-08	1	12%
3	15-Oct-08	20-Oct-08	3	9%
4	27-Oct-08	4-Nov-08	6	18%
5	20-Nov-08	28-Nov-08	5	19%
6	1-Dec-08	8-Dec-08	5	11%

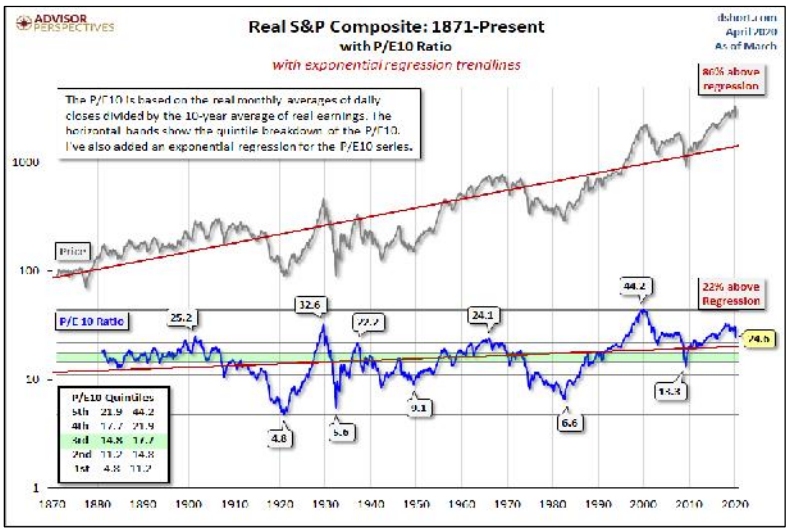
We have included charts like those on this page in many prior letters in one format or another. What they show is that in each of the largest bear markets in history stocks have had multiple 10-20% rallies like we have seen over the past few weeks. Investors have been conditioned over the past 25 years, and particularly since 2009, that the Fed has their back and that every stock market dip is an opportunity to buy. Short term relief rallies often suck over-eager investors back into the market before ultimately reversing course and plumbing to new lows.

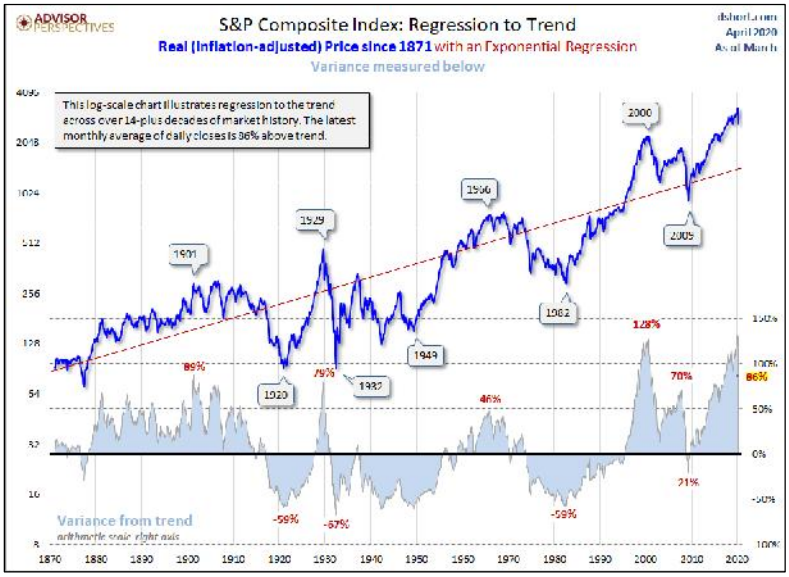


S&P 500 valuation vs. history

Source: RealInvestmentAdvice.com

Valuation metric	Aggregate index Current	Aggregate index Historical %ile	Median stock Current	Median stock Historical %ile
US market cap / GDP	186 %	95 %	NA	NA
EV / sales	2.6 x	99	2.9 x	97
EV / EBITDA	13.1 x	95	13.1 x	100
Forward P/E	18.5 x	89	18.4 x	96
Price / book	3.7 x	90	3.5 x	99
Cyclically adjusted P/E (CAPE)	28.5 x	90	NA	NA
Cash flow yield (CFO)	7.2 %	85	7.3 %	87
Free cash flow yield	4.0 %	55	4.1 %	61
Yield gap vs. 10-year UST	389 bp	22	NA	NA
Median metric		**90 %**		**96 %**





So how will we know when it is time to start moving out of safe-havens and into equities? Well, we have already begun to reduce our exposure to US Treasuries. They have performed extremely well for us over the past several years, as you saw in the multi-period performance charts above. However, with short term interest rates back at zero, where we expect they will stay for a long, long time, and the yield on 10yr Treasuries at just 63 basis points (0.63%), the capital appreciation benefit of holding US Treasuries has been dramatically reduced. It is time to take some of those chips off the table.

With regards to when we will start the gradual process of dollar cost averaging back into US equities, the simple answer is we will buy them when they are cheap. When the market was at an all-time high just a month and a half ago, it was among the most grossly overvalued markets in history, based on the most widely used valuation metrics. Even after shedding -20% in the first quarter, the S&P 500 is still more expensive today than it was at the beginning of every major bear market except 1929 and 1999. Considering the expected coming decimation of disposable income, corporate earnings and GDP, the market will need to continue to fall just to maintain its currently still excessive valuation. No secular bear market in the past 150 years has put in its ultimate low without posting a cyclically adjusted price-to-earnings ratio (CAPE or P/E 10) at least half of the current value. At the bottom of the crash that began in 1929, a period being more and more frequently referred to when framing the magnitude of our current crisis, the CAPE bottomed at 4.8, compared to 24.6 today.

Bear Market Recoveries

S&P 500 Index Length To Recover From A Bear Market

Month of Peak	Month of Low	Length of Bear (Months)	% Decline	Length of Recovery (Months)	Recession?
August-56	October-57	14	-22%	11	Yes
December-61	June-62	6	-28%	14	No
February-66	October-66	8	-22%	7	No
December-68	May-70	17	-36%	21	Yes
January-73	October-74	21	-48%	69	Yes
September-76	March-78	18	-19%	17	No
November-80	August-82	21	-27%	3	Yes
August-87	December-87	4	-34%	20	No
July-90	October-90	3	-20%	4	Yes
July-98	August-98	1	-19%	3	No
March-00	October-02	31	-49%	56	Yes
October-07	March-09	17	-56%	49	Yes
April-11	October-11	6	-19%	4	No
September-18	December-18	3	-20%	4	No
February-20	March-20	1*	-30%	?	?
Average For All Bear Markets		12	-30%	20	
Average Bear Market (In Recession)		18	-37%	30	
Average Bear Market (No Recession)		7	-24%	10	

Source: LPL Research, CFRA FactSet 3/17/20

* The current bear market is still active

A bear market is when a stock index or security closes 20% or more below a 52-week high. For this analysis, we take liberty with this and included 19%.

All indexes are unmanaged and cannot be invested into directly. Past performance is no guarantee of future results.

The modern design of the S&P 500 Index was first launched in 1957. Performance before then incorporates the performance of its predecessor index, the S&P 90.

We don't need to wait for the absolute bottom to start buying, but we certainly don't want to jump back in too soon before the real magnitude of the coming economic damage has been digested by markets.

According to a March 23rd research note from Vanguard, the second largest asset management company in the world, "more than 90% of Vanguard US self-directed individual investor clients have 'stayed the course' and not traded in response to the market decline." If the market has lost 20% of its value without the average retail investor having sold any stocks, imagine what is likely to happen once they open their March statement and decide, as they have in every past bear market, that they've had enough and reduce their equity exposure.

Much may have changed between the time I am typing this letter on the evening of April 1st and the time you read it, both in terms of the spread and impact of CV19 and in terms of financial markets. So far, the second quarter is off to a rocky start, with the S&P 500 having fallen another -4.41% today. Once upon a time (two months ago?) a day in which the Dow Jones Industrial Average* was down 1,000 points would have been a major event. Now it's just another Wednesday.

The next several months will be horrific for millions of Americans. The market volatility will most certainly continue, but more importantly many people will lose their livelihood, and many will lose their lives. Please take good care of yourself and your loved ones. This is a very stressful experience that none of us have been through before, so try to be especially patient and compassionate. At the same time that many people are dealing with virus-induced stress they will also be dealing with dramatic wealth destruction.

For those wise investors who were not over-exposed to one of the most overvalued markets in history, this bear market will present an incredible long-term investment opportunity. As this crisis progresses, we will be looking for the most compelling entry points for the positions on our shopping list. That shopping list is based on our expectation for what the post-CV19 world will look like, which we plan to discuss in our next letter.

Please do not hesitate to call or email with any questions or concerns. Stay safe and be well!

Sincerely,

Clay Ulman, CFP®

Jim Ulman, ChFC, CLU, MBA

**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. Indices such as the S&P 500 Index and the Dow Jones Industrial Index 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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