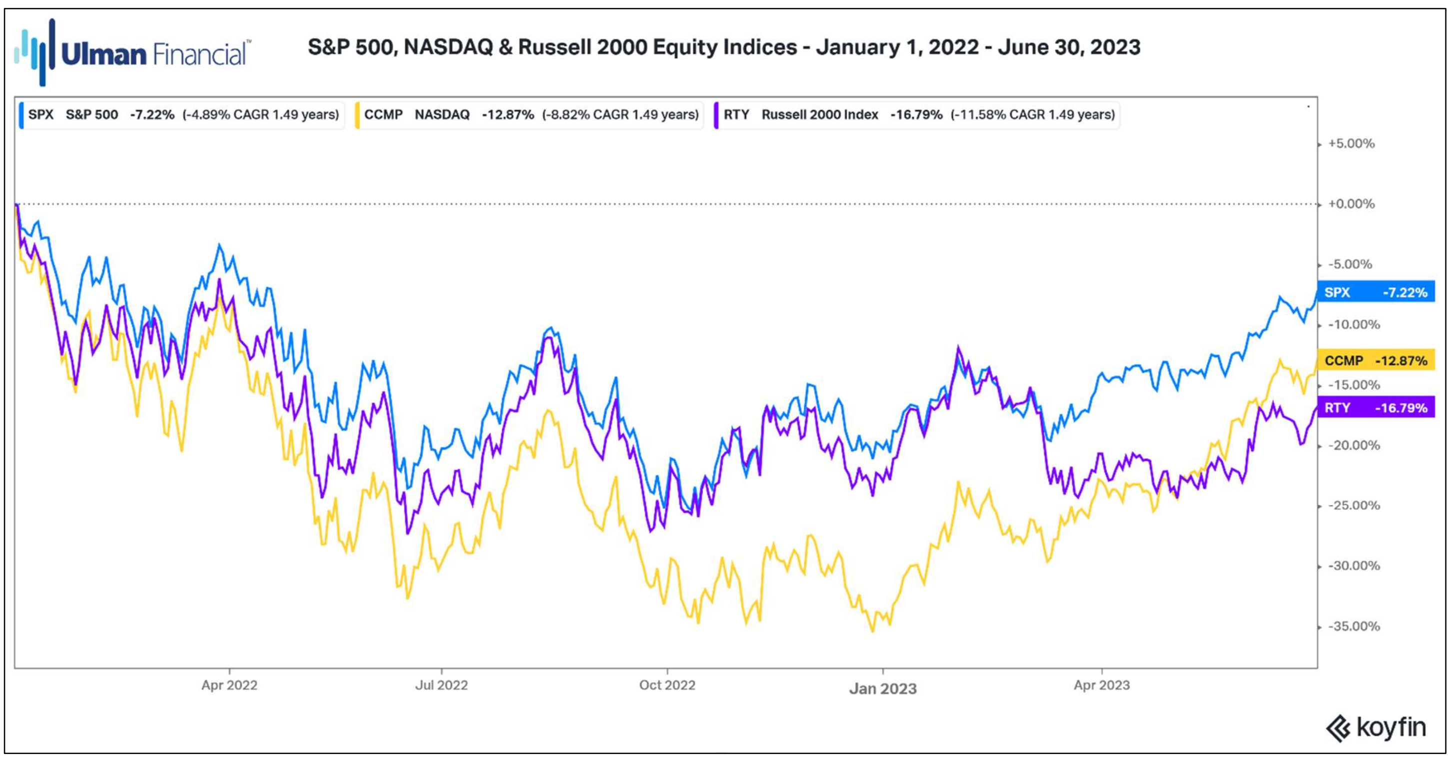
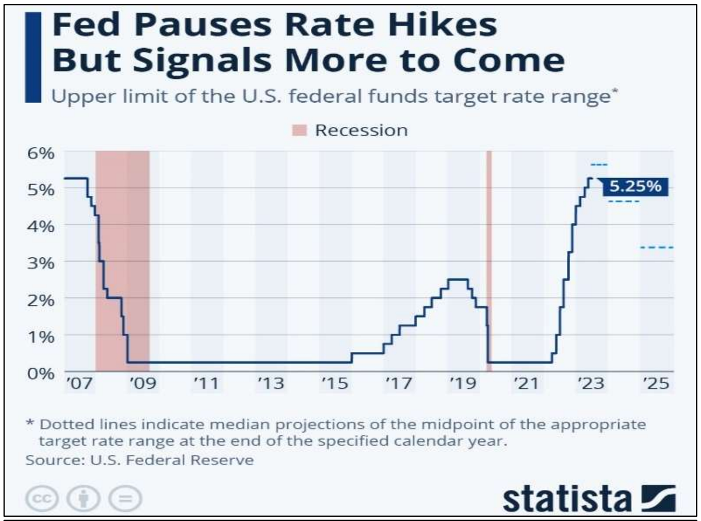
July 3, 2023 – Resilient Economy, Resilient Market

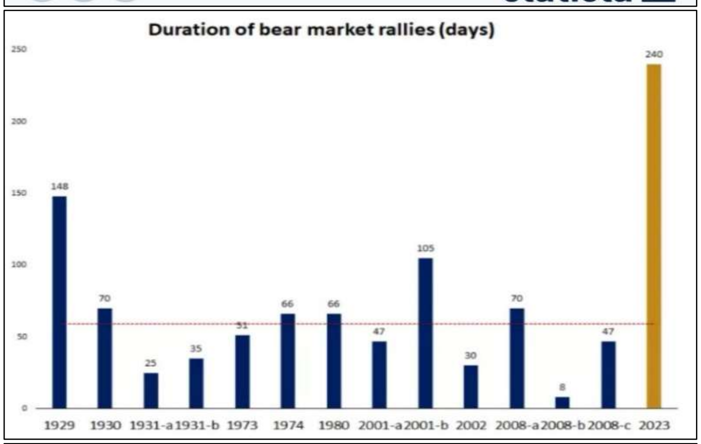
Six months into this year and fifteen months into the Federal Reserve's aggressive policy tightening to battle post-pandemic inflation, the US economy has remained incredibly resilient. The final estimate for first quarter GDP growth recently surprised to the upside, revised higher from 1.3% to 2.0%, and the unemployment rate remains pinned near multi-decade lows. Consumer confidence regarding both the current situation and expectations for the future have ticked higher of late and inflation continues to abate (see charts, page 7).

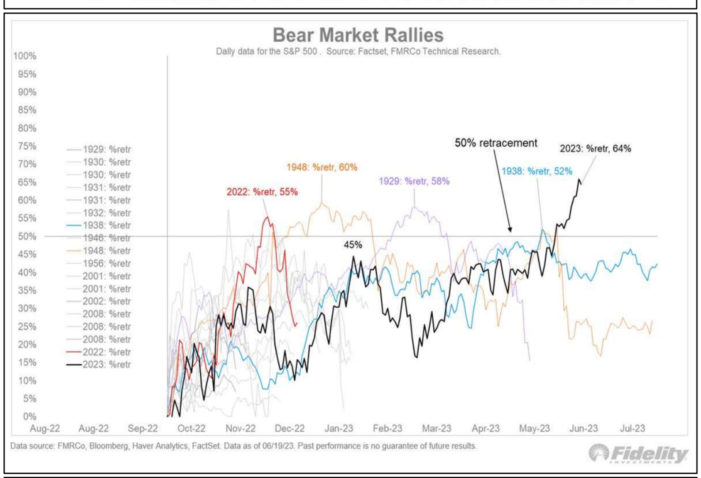
The much-discussed recession that earlier in the year we and much of Wall Street expected to be right around the corner due to the Fed's rate hiking regime has yet to materialize and its imminence and potential depth is being called into question. From the New York Times:

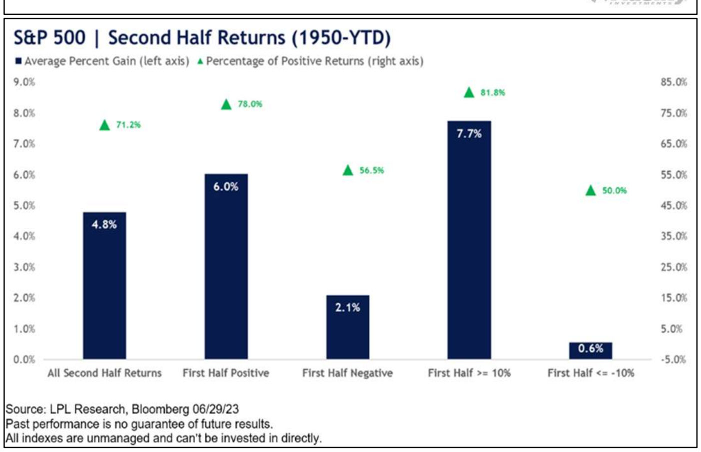
> *Stubbornly high inflation, a debt ceiling brawl, a brief banking crisis and the prospect of even higher rates: The past six months brought much to unsettle even the most optimistic investor. Yet at the halfway point of 2023, the tone among investors is noticeably more upbeat than it has been over the past 12 months…*
>
> *Investors have welcomed data showing that the economy remains on more solid footing than was expected at the start of the year. Corporate profits have surpassed expectations. Inflation is easing, albeit more slowly than forecast, and policymakers have signaled that they expect interest rates will soon reach their peak…*
>
> *The S&P 500 stock index ended the first half of 2023 more than 15% higher, after some analysts at the start of the year expected the market to lurch lower. The rally has been so strong that early in June, the S&P 500 stood 20% above its October low – the technical threshold for the start of a bull market.*
>
> \- *New York Times, June 30, 2023*











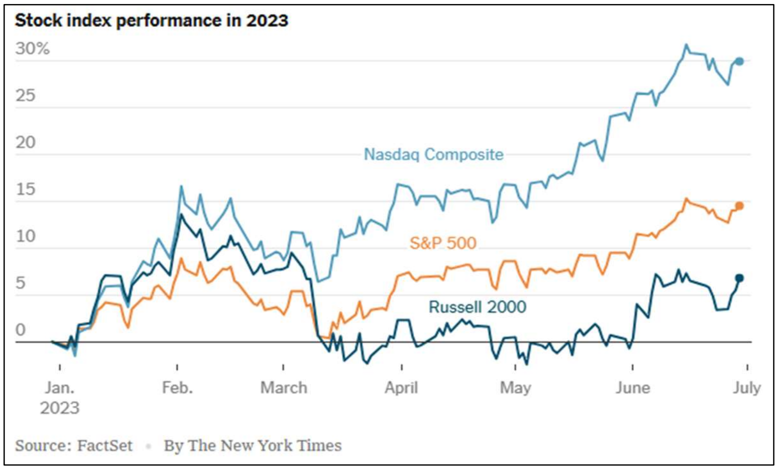
The US economy has weathered the rapid increase of interest rates well thus far, but it is by no means out of the woods. Fed Chairman Jerome Powell recently warned that the five percentage points of hiking the Federal Open Market Committee has already done has not yet worked its way through the economy and that, while not his base case, "there's a significant possibility that there will be a downturn." At their latest meeting in mid-June, the FOMC decided not to raise interest rates but indicated that they anticipated raising rates two more times before the end of the year.

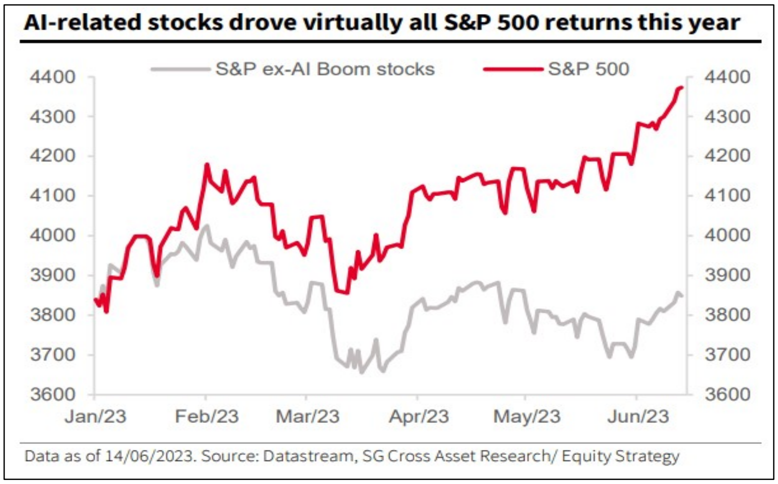
We remain cautious about the economic outlook for the next several quarters, and we expect at some point over the back half of the year the equity markets will need to consolidate to some extent. This is why we maintain a recommended overweight to high quality US Treasuries and money market funds that are offering the best yields in over a decade and a half. However, we are also open to the possibility that, even though the economy could be in for a contraction in the near future, the equity market may very well have put in a durable bottom in the fourth quarter of last year.

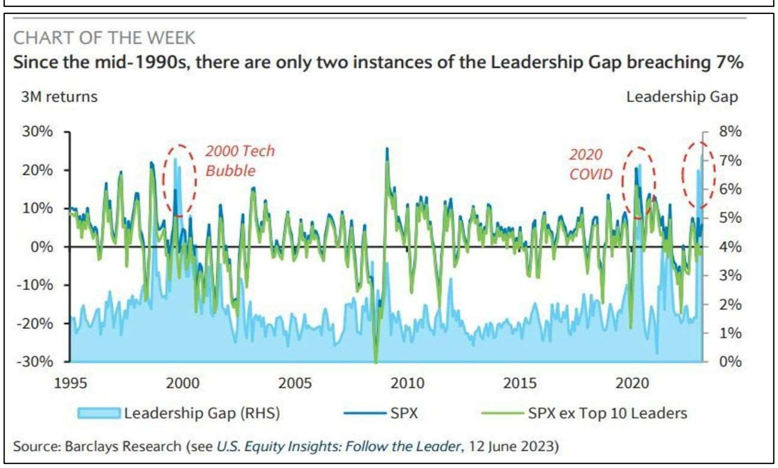
We've suggested in recent letters that as long as the Fed remains in tightening mode, the rally off the October 2022 low should be viewed skeptically as a bear market rally until proven otherwise. As is shown in the two middle charts on the left, this rally has now outpaced any bear market rally since 1929 in both duration and in magnitude relative to the prior selloff.

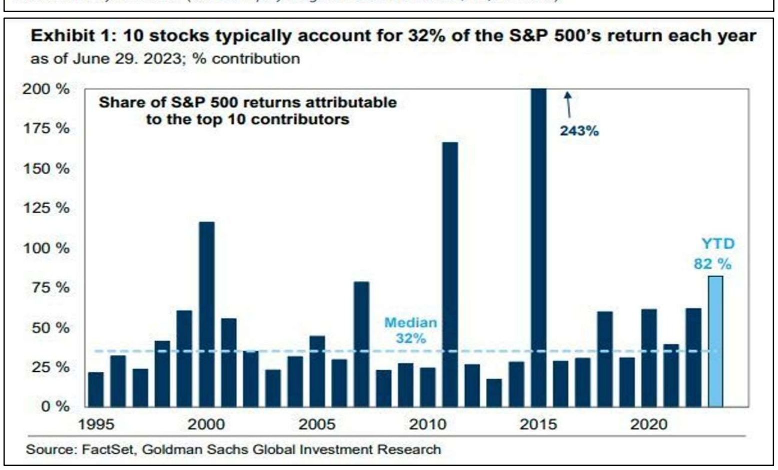
What's more, historical odds favor a positive market performance over the next two quarters. The bottom chart on the left, created by LPL Research, indicates that since 1950 the highest probability of a positive second half return for the S&P 500, and the highest average magnitude of second half returns, occurs in years when the first half of the year returned greater than 10%, as we have just experienced.

We could see a new low for the cycle if a substantial recession were to appear in coming quarters, but history suggests we should view any near-term pullbacks as buying opportunities in a young, new bull market.







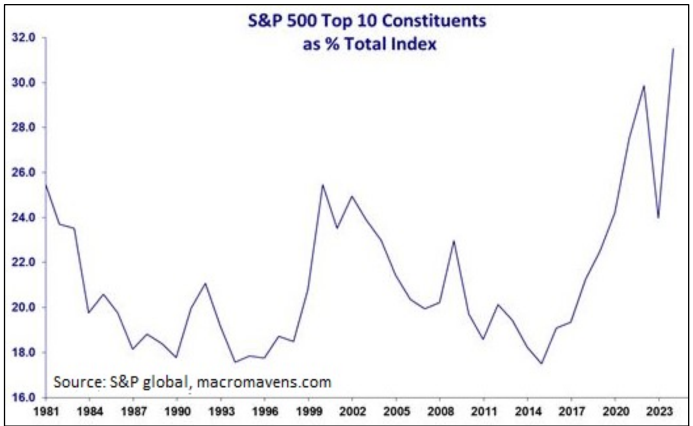


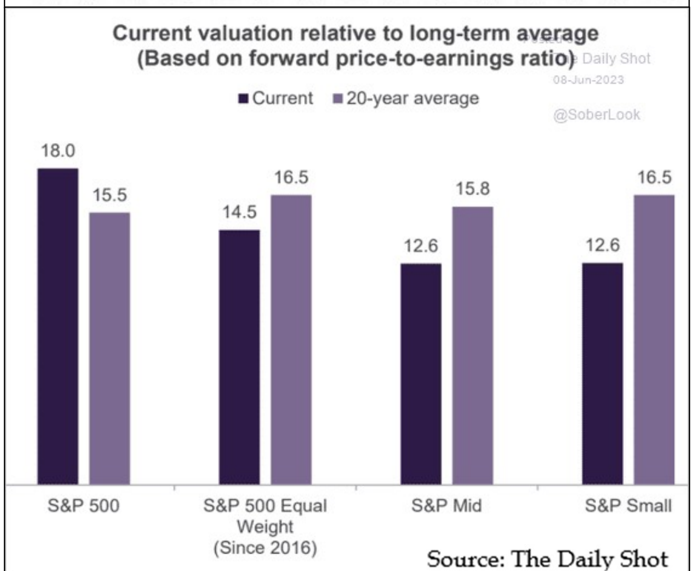
In the short term, recent gains are likely to beget more gains as investors that have been stockpiling cash rush from the sidelines to participate in the rally. Absent an exogenous shock like a geopolitical event or another banking or credit concern, both of which are possibilities, we would expect stock market momentum to continue in the second half. That does not mean, however, that the first half's stock market winners will again take the crown in the second half.

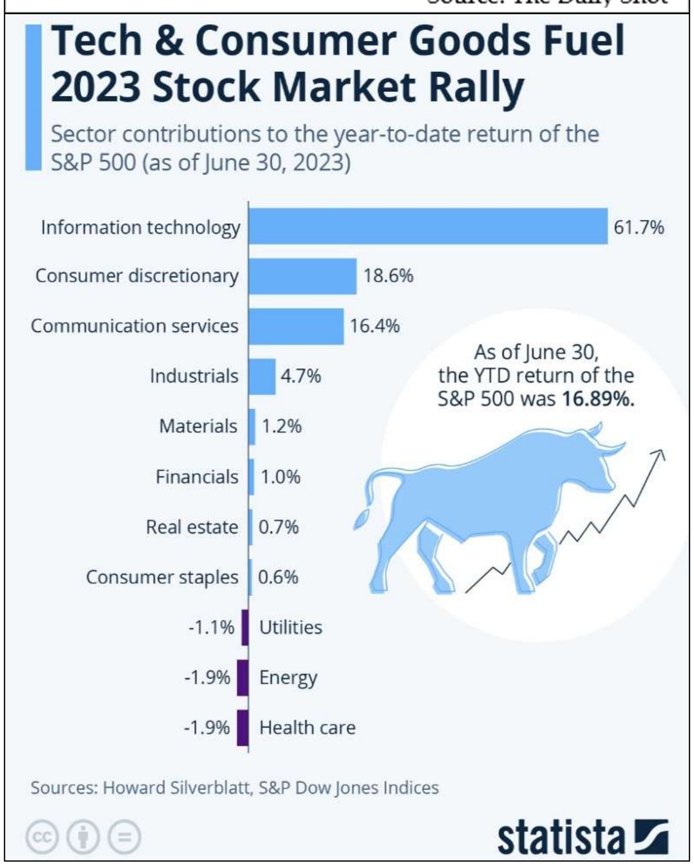
As you can see in the top chart on the left, the equity index that has garnered the most investor enthusiasm this year has been the tech-heavy Nasdaq, which got absolutely clobbered last year. Despite gaining 30% in the first half of this year, the Nasdaq remains almost -13% below its peak set eighteen months ago.

Virtually all the year-to-date gains in the broader S&P 500 have been concentrated in companies that investors believe are best positioned to benefit from the next major technological innovation, artificial intelligence. As you can see in the second chart on the left, as of June 14th, the S&P 500 would be virtually flat if it weren't for the handful of stocks that investors anticipate will most benefit from the rise of the machines.

The third chart on the left depicts the historic rolling 3-month performance of the S&P 500 (dark blue line), the 3-month performance of the S&P 500 without the Top 10 performance leaders (green line) and the gap between the two (shaded light blue area), which Barclays Research calls the Leadership Gap. This is a way of depicting the narrowness of the market's performance in each three-month period, which is a valuable insight because the more companies that are participating in a market rally, the stronger and more durable that rally has historically proven to be. This is only the third time since the mid-1990's that the leadership gap has been as wide as it is now.







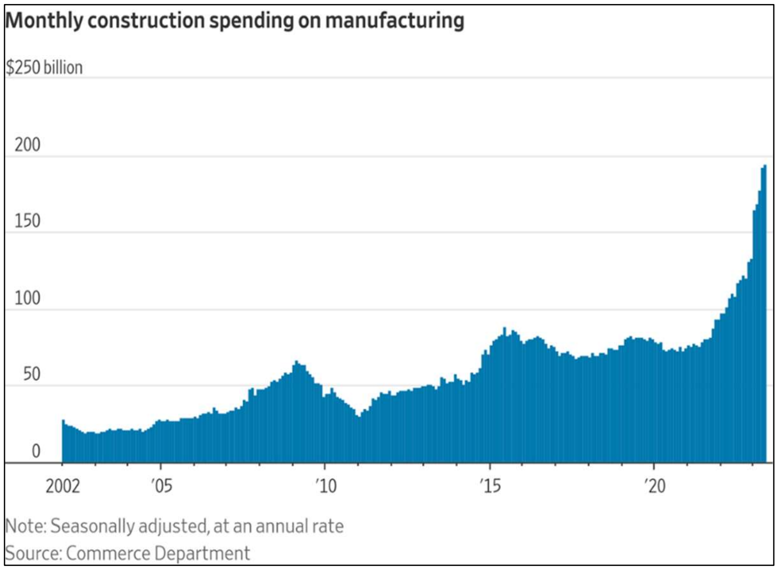
The bottom chart on the prior page similarly looks at market breadth over the past three decades, but in a slightly different way. Here we see what proportion of the S&P 500 calendar year performance was accounted for by the top ten companies. So far this year, more than 80% of the S&P 500's first half performance was thanks to just ten companies.

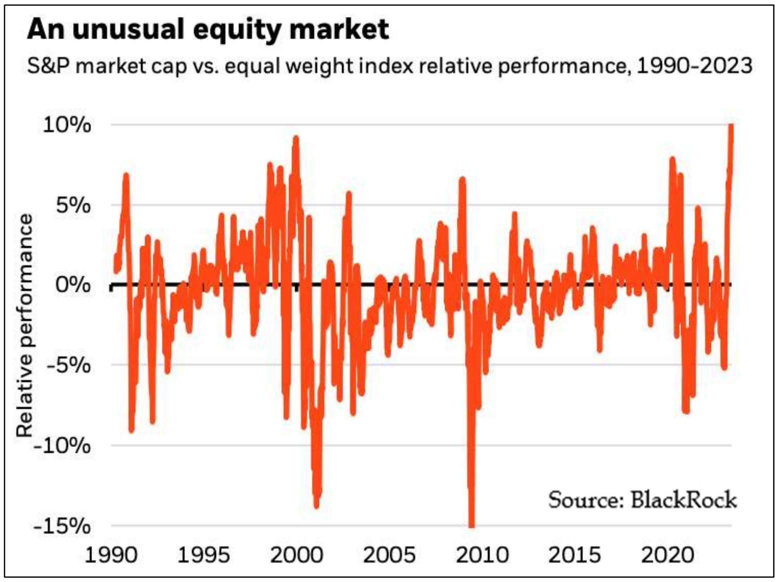
One more way to visualize the narrowness of the current market is by looking at how much of the total market cap of the S&P 500 is accounted for by those top ten names. Not since 1999 has the S&P 500 been anywhere near this highly concentrated, and as we know, the subsequent years proved to be very painful for that period's concentrated heavyweights.

Based on all of the above, we see a high likelihood that one of the two following scenarios will play out in order to return the market to a more normalized level of performance and allocation concentration. If the ten companies that drove the market higher in the first half continue to surge higher and their stock prices become further and further stretched relative to fundamentals, there is likely to be a painful reckoning at some point just as there was following the last tech boom in the late 1990s. In this scenario, the broad market as a whole could eventually sell off, but with the greatest pain being felt in the tech sector.

Adversely, if we are in the early stages of a new bull market and the broad market is to continue higher in coming quarters, the normalization of the leadership gap will be because the first half leaders take a breather and consolidate sideways or slightly lower while the recent laggards outperform and catch up. In either case, we recommend focusing equity exposure on the portions of the market that have underperformed year-to-date.

In the middle chart on the left, you can see that while the forward price-to-earnings ratio of the S&P 500 is currently well above its 20-year average, those of Small and Mid-Cap stocks are more than 20% below their 20-year averages. We like an allocation to small caps, as they have more to gain in a scenario where the laggards play catch-up, and less to lose in the event of a selloff.





The bottom chart on the previous page shows the first half performance of each of the eleven sectors of the S&P 500 and pretty much speaks for itself. Tech may very well have more gas in the tank, but this level of performance concentration cannot perpetuate. We remain committed to our long-term view, outlined in prior letters, that industrials, materials and energy will be beneficiaries of the push to fortify domestic manufacturing, reduce dependence on China and modernize US infrastructure.

The chart on the bottom left illustrates the relative performance of the S&P 500, which is a market cap-weighted index, and the equal weighted version of the S&P 500, in which all 500 constituents have a weighting of 0.2% of the index. As you can see, the market cap weighted index has recently outperformed by the greatest margin in the past 40 years. Perhaps the more interesting observation about this chart is that each period of very high outperformance by the market cap weighted index has been immediately followed by a period of even greater underperformance, meaning that the equal weight index quickly catches up either by outperforming to the upside or by losing significantly less in the subsequent quarters.

As seen in the valuation chart on the prior page, when all constituents are weighted equally the forward p/e of the S&P 500 drops from a premium to a discount. We prefer an allocation to the Equal Weight S&P 500 in order to benefit from a potential continuation of the new bull market or to minimize potential downsize should a near term correction or a new bear market materialize.

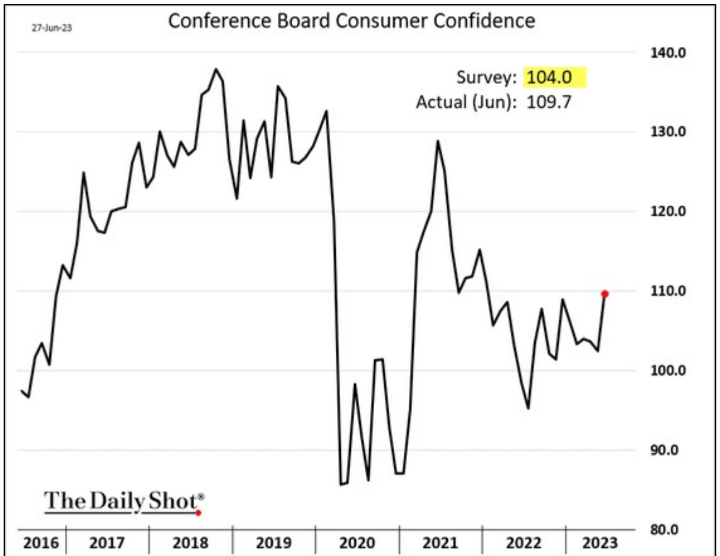
Thank you for taking the time to read our comments. We welcome you to share this letter with family and friends, and we invite you to contact us via phone or email with any questions or concerns.

Sincerely,

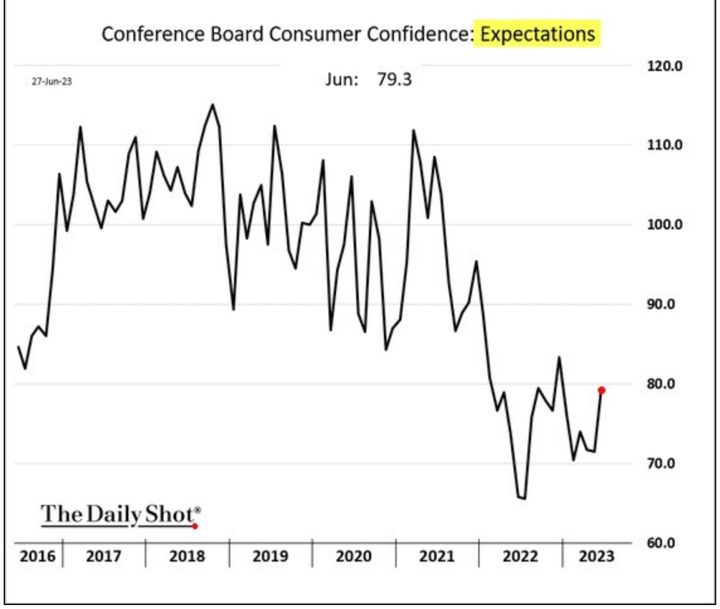
Clay Ulman, CFP®
CBU@UlmanFinancial.com
443-226-7716

Jim Ulman, ChFC, CLU, MBA
JWU@UlmanFinancial.com
443-866-6387

LPL Compliance Tracking # 1-05374672

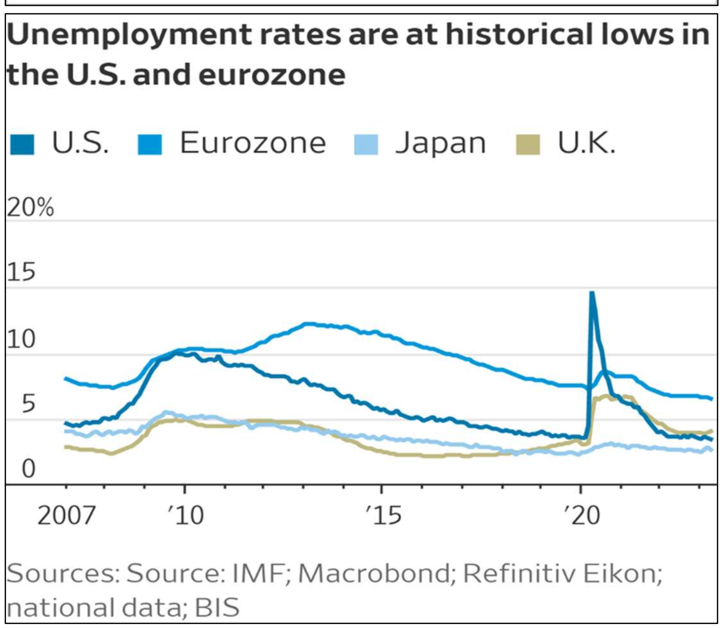

27-Jun-23
Conference Board Consumer Confidence
Survey: 104.0
Actual (Jun): 109.7
140.0
130.0
120.0
110.0
100.0
90.0
80.0
2016
2017
2018
2019
2020
2021
2022
2023
The Daily Shot®


Conference Board Consumer Confidence: Present Situation
27-Jun-23
Jun: 155.3
180.0
160.0
140.0
120.0
100.0
80.0
60.0
2016
2017
2018
2019
2020
2021
2022
2023
The Daily Shot®


Conference Board Consumer Confidence: Expectations
27-Jun-23
Jun: 79.3
120.0
110.0
100.0
90.0
80.0
70.0
60.0
2016
2017
2018
2019
2020
2021
2022
2023
The Daily Shot®


27-Jun-23
Richmond Fed Manufacturing: Prices Paid
Jun: 4.2
16.0
14.0
12.0
10.0
8.0
6.0
4.0
2.0
0.0
2016
2017
2018
2019
2020
2021
2022
2023
The Daily Shot®


27-Jun-23
Richmond Fed Manufacturing: Prices Received
Jun: 3.8
12.0
10.0
8.0
6.0
4.0
2.0
0.0
2016
2017
2018
2019
2020
2021
2022
2023
The Daily Shot®


Unemployment rates are at historical lows in the U.S. and eurozone
U.S.
Eurozone
Japan
U.K.
20%
15
10
5
0
2007
'10
'15
'20
Sources: Source: IMF; Macrobond; Refinitiv Eikon; national data; BIS

**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 Russell 2000 Index is a small-cap US stock market index that makes up the smallest 2,000 stocks in the Russell 3,000 Index. 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.

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful. All investing involves risk, including loss of principal. No strategy assures success or protects against loss.

All indices are unmanaged and cannot be invested into directly.