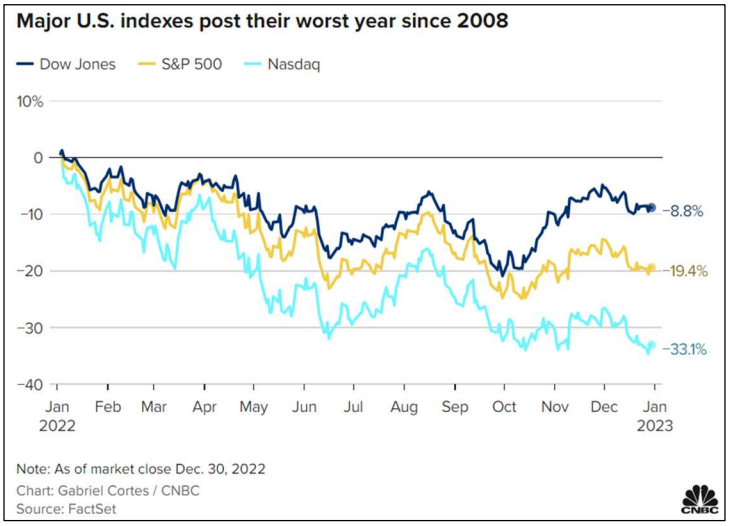
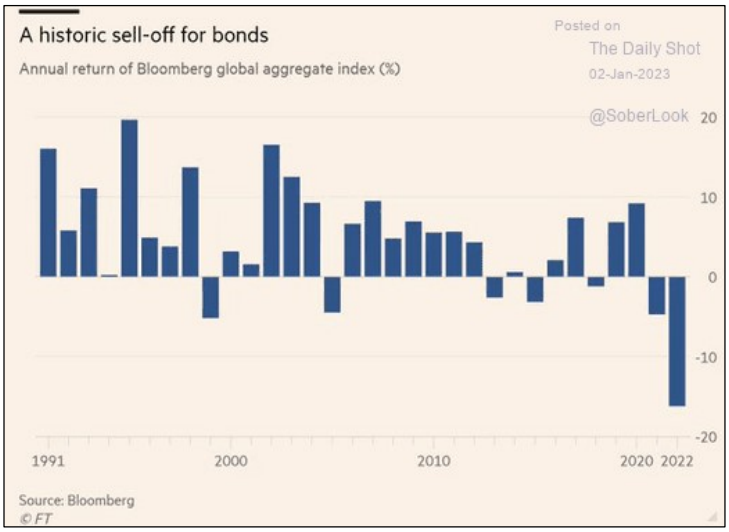
Ulman Financial™
tailored wealth strategies

January 4, 2023 – Corporate Earnings to Write the Next Chapter





The Worst Years Ever For a 60/40 Portfolio

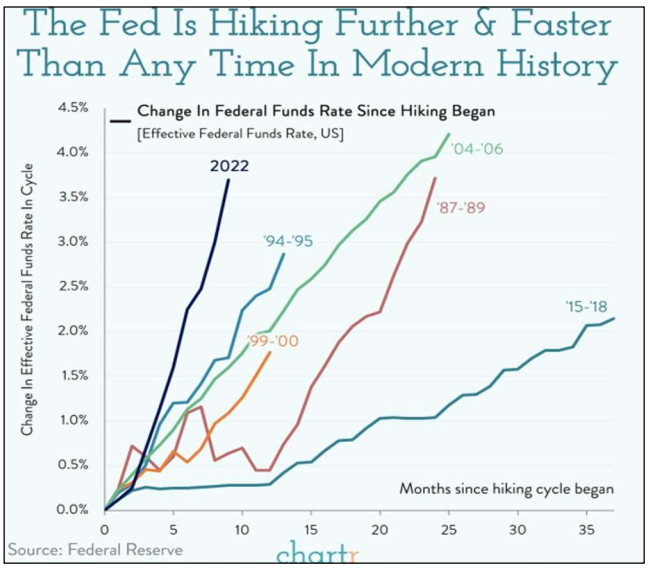
Year	60/40 Portfolio	Reason
1931	-27.3%	Great Depression
1937	-20.7%	1937 Crash
2022	-16.9%	The Great Inflation
1974	-14.7%	1973-74 Bear Market
2008	-13.9%	Great Financial Crisis
1930	-13.3%	Great Depression
1941	-8.5%	WWII
2002	-7.1%	Dot-Com Crash
1973	-7.1%	1973-74 Bear Market
1969	-6.9%	Nifty Fifty Crash
2001	-4.9%	Dot-Com Crash
1966	-4.8%	1966 Bear Market

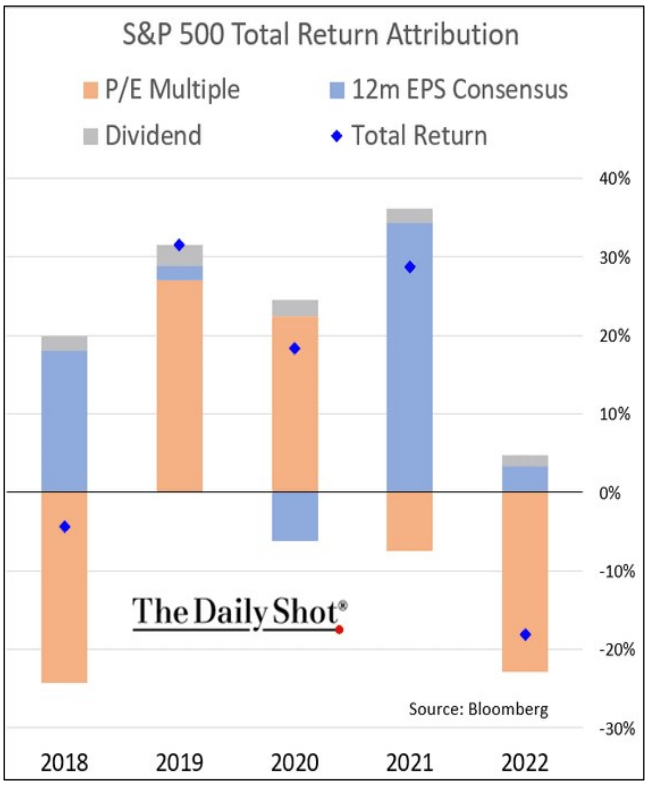
Source: NYU

Happy New Year! We hope that your year-end holiday celebrations were pleasant and that you are facing 2023 refreshed and with an optimistic spirit. After what was demonstrably one of the most difficult calendar years for diversified investors ever, we are happy to turn the page and bid farewell to 2022. However, a new year doesn't necessarily mean a new, more amenable environment for financial markets.

In this quarter's letter we will review the historic last twelve months and highlight what we are waiting to see before we become more constructive on risk assets. Our long-term shopping list which we've discussed in recent letters, available at our website www.UlmanFinancial.com, has not changed materially. We are eager to reinitiate or increase allocations to the broad US and global equity markets with particular focus on heavy industry, commodities and the producers of energy and hard assets, all of which should benefit from the reshuffling of global supply chains and the West's renewed focus on regional self-sufficiency revealed to be sorely lacking by both the supply shocks of the Covid-19 pandemic and the ongoing Russian invasion of Ukraine. But first, we will need to weather what we expect to be persistent short-term market volatility wrought by increasingly tight monetary conditions and the potential for a global recession should those conditions remain too tight for too long.

As you can see from the chart on the bottom left, this was the worst year for a diversified investment portfolio - consisting of 60% stocks (S&P 500 Index*) and 40% bonds (US Aggregate Bond Index*) – since the 1930's. The US stock market performed better in the fourth quarter than we anticipated, after bottoming in mid- October and embarking on a six week, 13.7% rally. We have discussed many times the prevalence

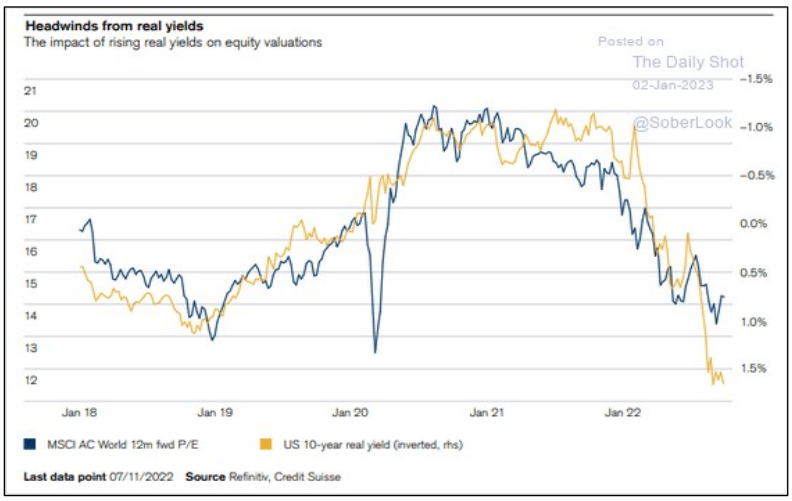


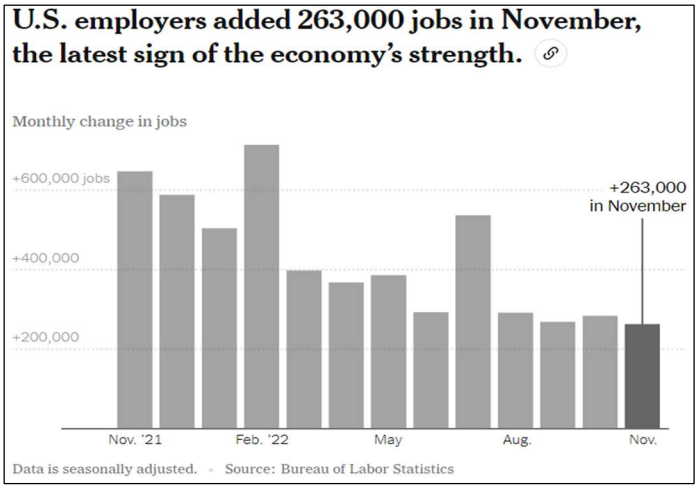


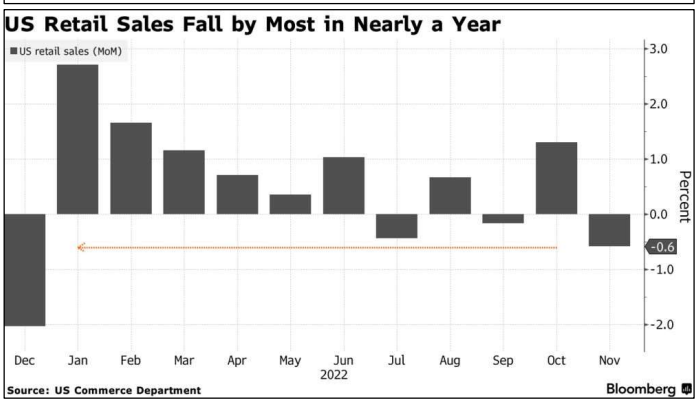
of short and sharp rallies during secular bear markets. The equity surge that began early in the fourth quarter proved to be the third double-digit bear market rally of 2022. Not surprisingly, the surge halted right at the trend line that had been formed by the all-time high in the S&P 500 achieved on the first trading day of 2022 and the peaks of the prior two bear market rallies ending in late-March and mid-August (top left). It remains to be seen if the mid-October low holds as the ultimate low of this cycle, but our expectation is that it will not. Let us explain.

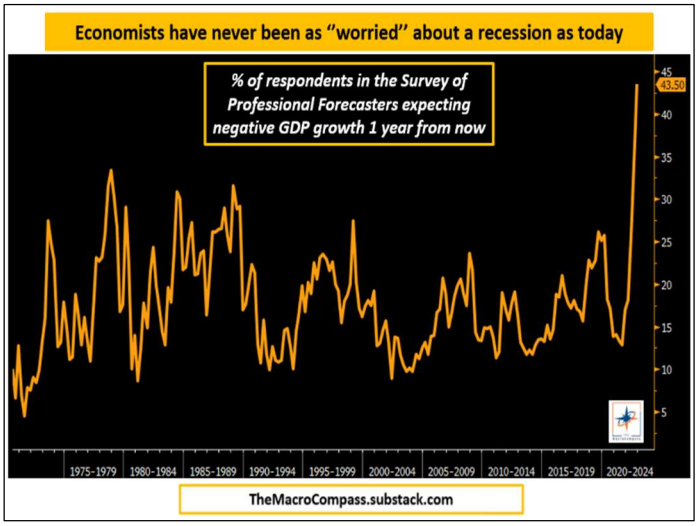
We all know that over the last year the Federal Reserve has been hiking rates aggressively to tamp down inflation (middle left). The chart on the bottom right plots the last five years of global equity valuations as measured by the forward price-to-earnings ratio (blue line) and the real, or inflation-adjusted, yield on 10-year US Treasuries ***inverted*** (yellow line). Because of this tight inverse relationship between interest rates and equity valuations, this past year's rapid increase in interest rates has had a dampening effect on the price-to-earnings multiple that investors have been willing to pay.

This relationship and its effect on equity returns is borne out in the chart on the bottom left, which breaks down the attribution of the total return of the S&P 500 Index in each of the last five calendar years. The orange in each of the bars is the change in valuation (P/E Multiple) and the blue is the change in expected future earnings per share (12-month EPS Consensus). Analysts' expectations for 2023 S&P 500 earnings were a positive addition, meaning the stock market losses experienced in 2022 were all due to interest rate moves and **did not price in an earnings recession at all.**









In a recession, earnings decline for 5 quarters and on average by 30%

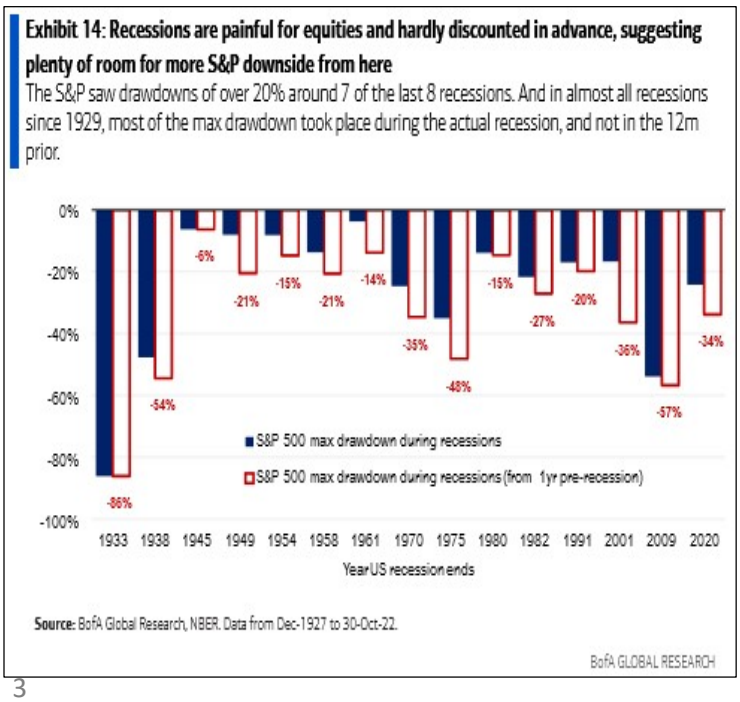
Economic Peak Month	Economic Trough Month	Quarters of EPS Decline	*EPS Change*
August-57	April-58	4	*-17,0%*
April-60	February-61	7	*-11,7%*
December-69	November-70	5	*-12,9%*
November-73	March-75	4	*-14,8%*
January-80	July-80	4	*-4,6%*
July-81	November-82	4	*-19,1%*
July-90	March-91	10	*-36,7%*
March-01	November-01	5	*-54,0%*
December-07	June-09	7	*-91,9%*
February-20	April-20	4	*-32,5%*
Average # of Quarters EPS Declined		5,4	
Average EPS Decline			*-29,5%*

TheMacroCompass.substack.com

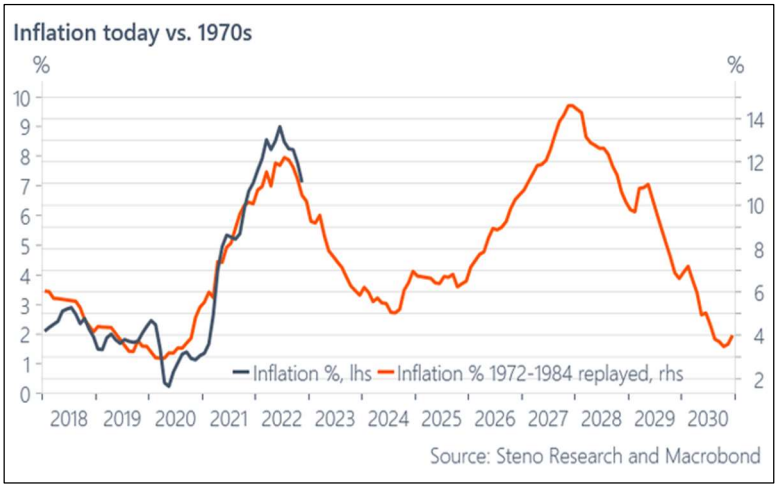
Despite registering negative GDP growth in each of the first two quarters of 2022, the US economy did not experience an official recession. According to Investopedia.com, "Economists at the National Bureau of Economic Research (NBER) measure recessions by looking at nonfarm payrolls, industrial production, and retail sales, among other indicators, going far beyond the simpler (although not as accurate) two quarters of negative GDP measure."

The US labor market has remained resilient (top left), and US consumers have only just begun to rein in their spending (second left), but because of the increased burden of higher interest rates and the Fed's insistence that they will stick to their guns, Wall Street economists have never been as certain as they are now that a recession is right around the corner (third left).

Historically, corporate earnings per share (EPS) have fallen by an average of almost 30% during economic recessions (bottom left) 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 (bottom right) suggesting the likelihood for considerably more downside to come.



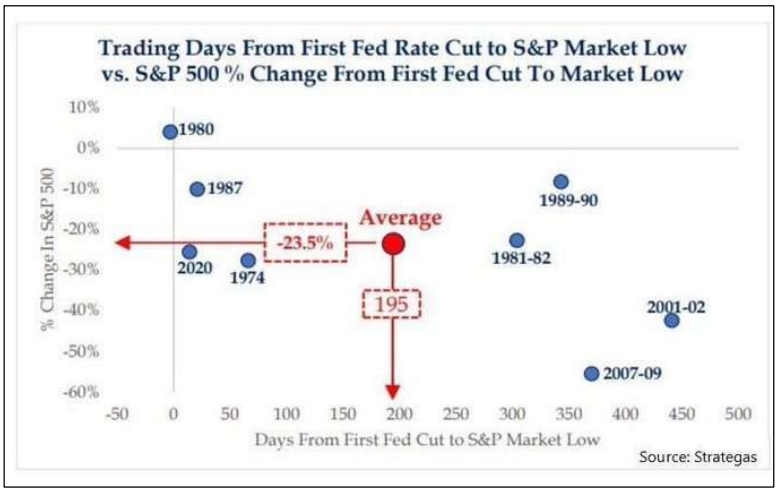
For those investors hanging their hopes on the Federal Reserve to come riding to the rescue with rate cuts if the market deteriorates further, today's release of the minutes from the Fed's December FOMC meeting should disabuse them of that notion. From CNBC.com, bold emphasis ours:

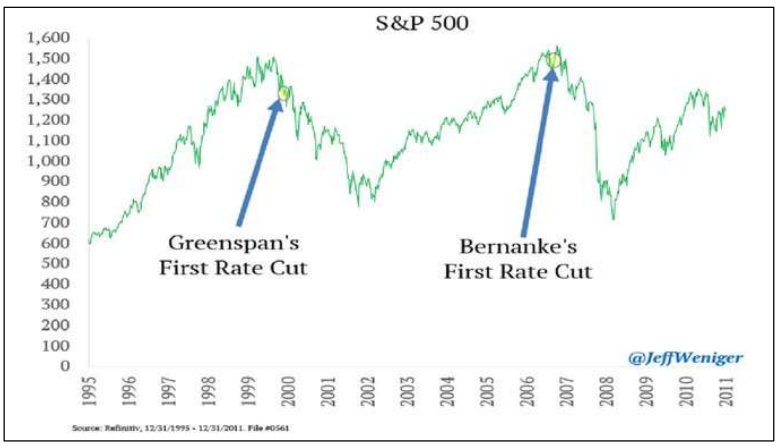


"Participants generally observed that a restrictive policy stance would need to be maintained until the incoming data provided confidence that inflation was on a sustained downward path to 2 percent, which was likely to take some time. In view of the persistent and unacceptably high level of inflation, several participants commented that **historical experience cautioned against prematurely loosening monetary policy.**"

"A number of participants emphasized that it would be important to clearly communicate that a slowing in the pace of rate increases was not an indication of any weakening of the Committee's resolve to achieve its price-stability goal or a judgment that inflation was already on a persistent downward path," the minutes said.

The minutes noted that officials are wrestling with two-pronged policy risks: One, that the Fed doesn't keep rates high long enough and allows inflation to fester, **similar to the experience in the 1970s** (top left, our addition); and two, that the Fed keeps restrictive policy in place too long and slows the economy too much, "potentially placing the largest burdens on the most vulnerable groups of the population."





However, members said they see the risks more weighted to easing too soon and allowing inflation to run rampant.

- CNBC.com, January 4, 2013

To make matters even more dicey for those praying for a Fed pivot, the average duration from the Fed's first "rescue" rate cut to the market's eventual bear market bottom has historically been 195 trading days and the average loss an additional -23.5% (middle left). In fact, the last two times the market was cut in half, during the bear markets of 2000-2002 and 2007-2009, the vast majority of those losses occurred ***after*** the Fed had pivoted from hiking rates to cutting them (bottom left).

We expect that a Fed pause or pivot will initially be met with market euphoria, but unless the fundamentals are supportive we will be patient and wait for the attractive valuations that have always accompanied a true market cycle bottom.

We have outlined our expectations for markets and the economy in the coming quarters, but we are committed to staying nimble. Our willingness to shift our target allocations as unanticipated events unfolded last year enabled us to outperform our benchmarks, and we expect that a similar flexibility will be necessary this year.

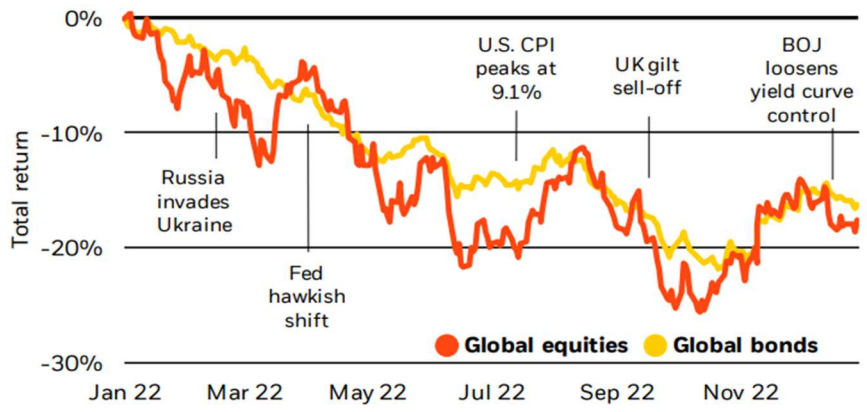
Three investment lessons for 2023

- A historic 2022 taught us to widen the lens of possible scenarios, factor in geopolitical risk and use a new playbook for more frequent portfolio changes.
- Global stocks ended the year down 18%, while bonds fell 16%. This marked the biggest market storm in decades amid inflation and hawkish central banks.
- U.S. jobs data this week are set to jolt market expectations of the Fed's rate path. PMI data is likely to show further slowing in manufacturing activity.

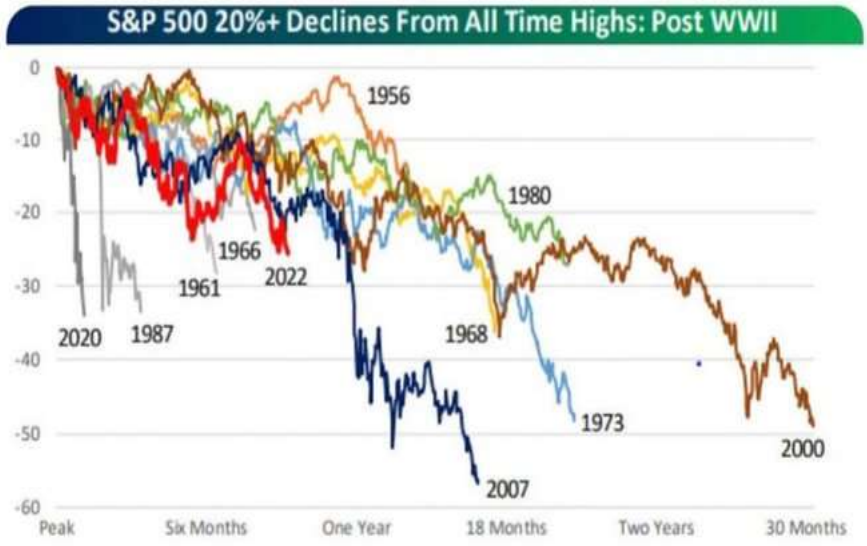
The historic shocks of 2022 – war, soaring inflation and a perfect market storm – shape our three investment lessons for the new year. First, widen the lens of possible scenarios and beware of inertia and other behavioral biases. Second, factor in compensation for geopolitical risk. Third: We need a new investment playbook – the key theme of our 2023 Global Outlook. That means more frequent portfolio changes in the new regime of greater macro and market volatility.

A historic year

Global equity and bond total returns, 2022



Sources: BlackRock Investment Institute with data from Refinitiv Datastream and Bloomberg, December 2022. Notes: The chart shows year-to-date to returns for the MSCI ACWI index (orange) and Bloomberg Global Aggregate index for bonds (yellow) since the start of the year. Data as of Dec. 29, 2022.



From BlackRock Investment Institute:

"We must widen the lens of possible scenarios because the new regime of higher macro and market volatility entails a wider range of outcomes. And it requires quick reactions. We must fight behavioral biases like inertia that make it hard to embrace change or carry out too little to make a difference…

We need a new investment playbook in the new regime. This means not being lulled into thinking what worked in the past will work now, like automatically buying the dip. We see stock rallies built on hopes for rapid rate cuts fizzling. Why? Central banks are unlikely to come to the rescue in recessions they themselves caused to bring inflation down to policy targets. Earnings expectations are also still not fully reflecting recession, in our view. But markets are now pricing in more of the damage we see – and as this continues, it would pave the way for us to turn more positive on risk assets."

- BlackRock Investment Institute, January 3, 2023

Despite our frequent reference to historical averages, we acknowledge that all bear markets are unique, in both duration and depth (bottom left). The one thing they all have in common is that they eventually end, creating the conditions necessary for the next cycle to begin. Patience and discipline in the meantime will enable us to take full advantage when that time comes.

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.