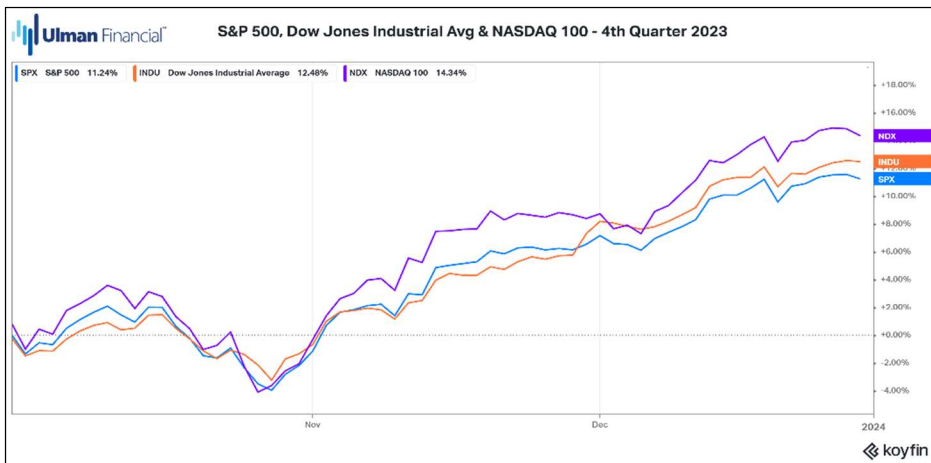


## January 5, 2024 – Time for a Breather

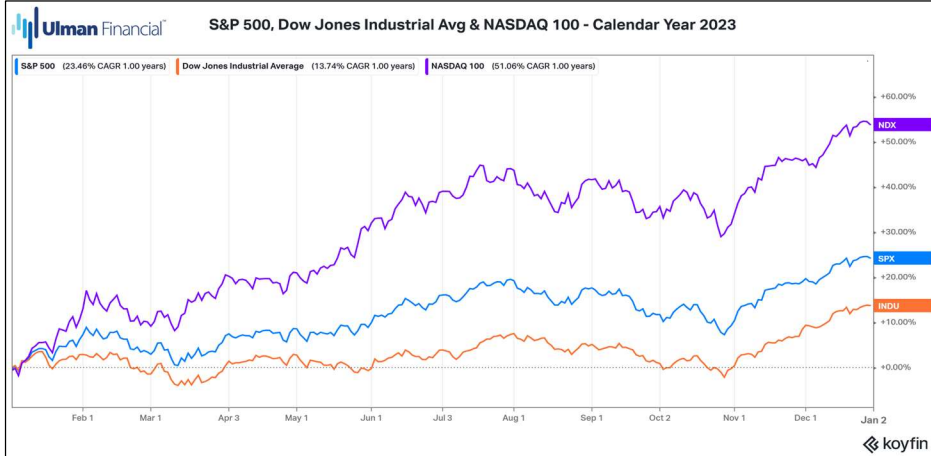
We hope that you enjoyed your year-end celebrations and that 2024 is off to a strong start. After a lackluster third quarter, which bled into late October, the US equity markets finished 2023 at a gallop. Coming into the year, following the worst combined year for stock and bond markets on record in 2022, expectations were for more of the same in 2023:



*Almost no one thought 2023 would be a blockbuster year for stocks. They could hardly have been more wrong. The Federal Reserve raised interest rates at the fastest clip since the 1980s, a regional banking crisis felled Silicon Valley Bank, and war broke out in the Middle East. Yet stocks kept climbing.*

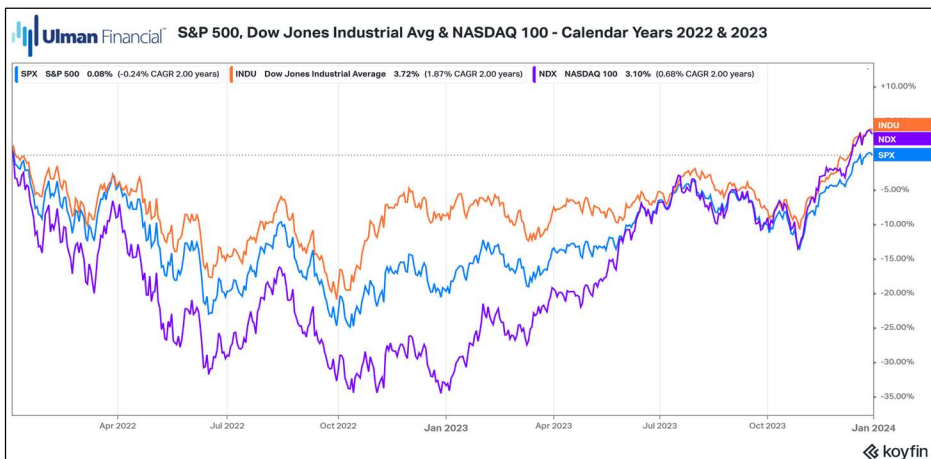
*The S&P 500 is ending the year on a nine-week winning streak, its longest such rally since January 2004.*

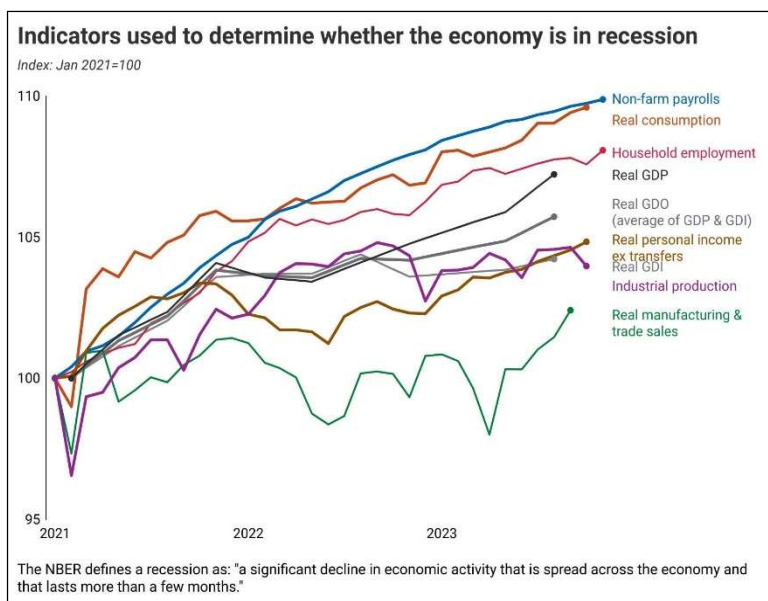
- Wall Street Journal,  
December 29, 2023



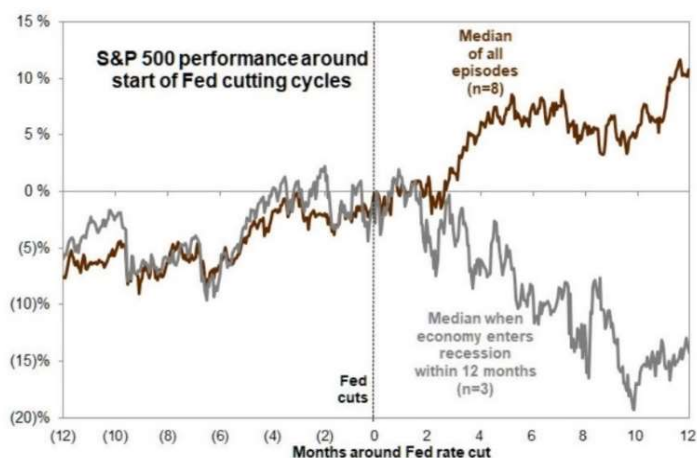
In our last letter in early October, while the markets were still in the midst of a three-month sell-off of greater than -10%, we suggested that the near-term weakness should be viewed as an opportunity to add exposure to equities. We expected that the market was likely to finish the year strong as investors that had missed the second quarter AI-inspired rally rushed to play catch-up.

With the Federal Reserve having halted their rate raising regime in the face of improving inflation data, and





**3. If the Fed is Done:** Following the 4th month of Fed pauses in November, the market is increasingly focused on rate cuts as the macro sentiment pendulum swings. What that could mean for markets will depend on whether the Fed fine tunes policy in the face of fading inflation (brown line) or whether they are forced into cutting rates in response to recession and/or crisis (gray line).



Source: @Mayhem4Markets

the economy holding up better than expected to higher interest rates (top left chart), we remain cautiously optimistic for both the economy and markets for the whole of 2024. In the next month or two, however, we expect that the broad equity markets may take a breather to digest the massive gains of 2024.

*After a few months of stubborn inflation, rising gas prices and interest rates, and a falling stock market, the last month or so has brought excellent economic news. The stock market has gone up nearly 15 percent since... late October. The inflation trajectory looks good. Mortgage rates are falling. Gas prices are down. Once-skeptical economists have declared that a "soft landing" seems at hand. And now the Fed is forecasting rate cuts, which augurs growth, confidence in lower inflation and eventually a return to a more normal economy.*

- New York Times, December 14, 2023

At the risk of stating the obvious, how the market does over the course of the year will depend greatly on whether we experience the "soft landing" many economists are predicting or if the lagged effects of higher interest rates or some unforeseen economic shock pushes the economy into recession.

The Federal Reserve hiked interest rates by more than 5% in the 15 months between March 2022 and July 2023 to dampen economic activity and tame the highest inflation we've seen in decades. Rates are now in what would be considered restrictive territory, and while it seems to have done the trick with regards to inflation, leaving rates too restrictive for too long risks nudging the economy into full blown recession.

Fed Chairman Jerome Powell in December indicated that the Fed had likely reached the end of its hiking cycle and that it would be appropriate to begin to take it foot off the proverbial brake by beginning to cut rates at some

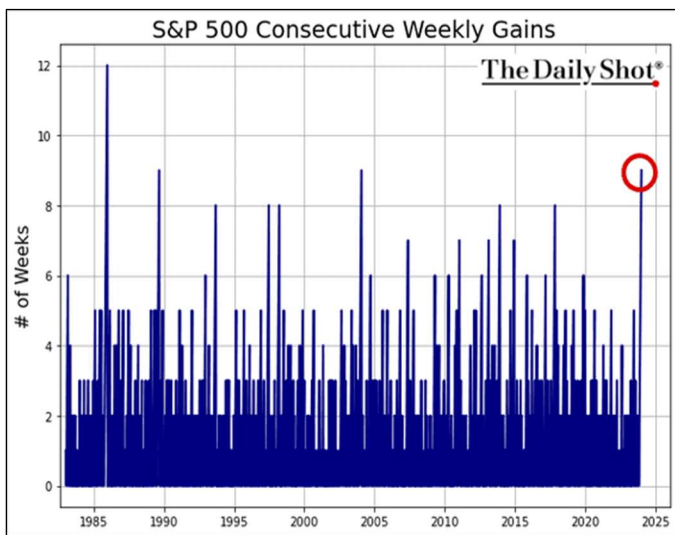
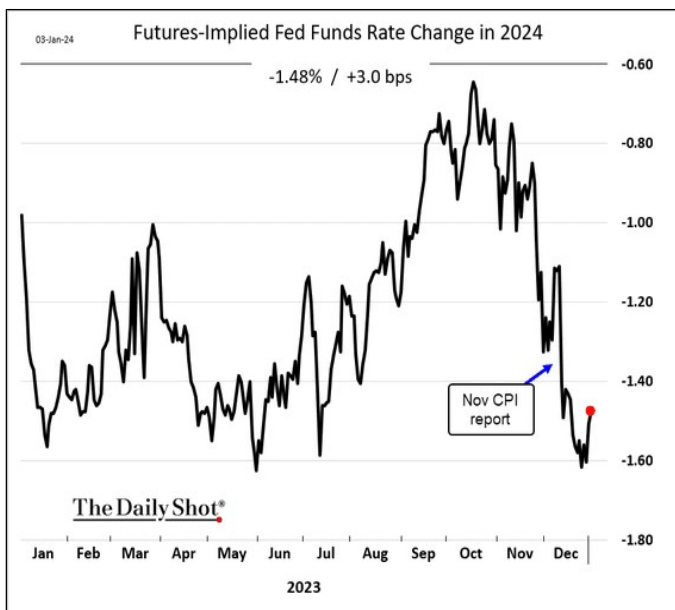
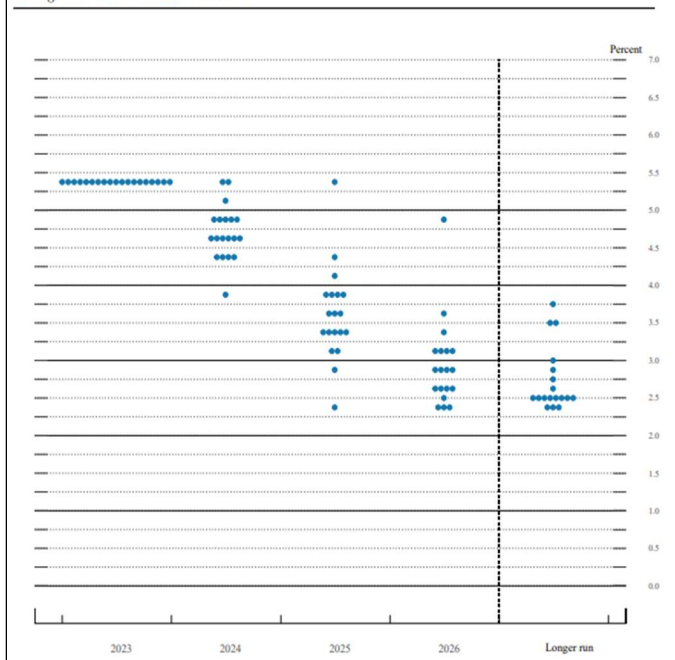


Figure 2. FOMC participants' assessments of appropriate monetary policy: Midpoint of target range or target level for the federal funds rate



point in 2024. This of course added fuel to the fourth quarter market rally. If the Fed is able to walk the fine line between keeping rates restrictive enough to keep inflation headed towards its 2% target but not so restrictive that the economy begins to contract, history suggests that the market will do well over the next 12 months (bottom right chart, prior page).

One of the reasons we expect the market to take a breather in the coming weeks is that much of the “soft landing” enthusiasm has already been priced in. As mentioned in the Wall Street Journal quote on page one, the S&P 500 ended the year with a nine-week winning streak, which the chart on the top left confirms is a rare occurrence.

The bond market appears to have gotten a bit ahead of itself, as well. At the FOMC’s latest meeting in mid-December, they released their Summary of Economic Projections which outlines where each member (anonymously) expects the fed funds rate, unemployment, inflation and GDP to end the next several years. These are of course only projections and are subject to change as the facts on the ground change, but as you can see in what is called the “Fed Dot Plot” (middle left chart) the majority of participants expected that it would be appropriate to cut rates by a total of 0.5-1.00% in 2024.

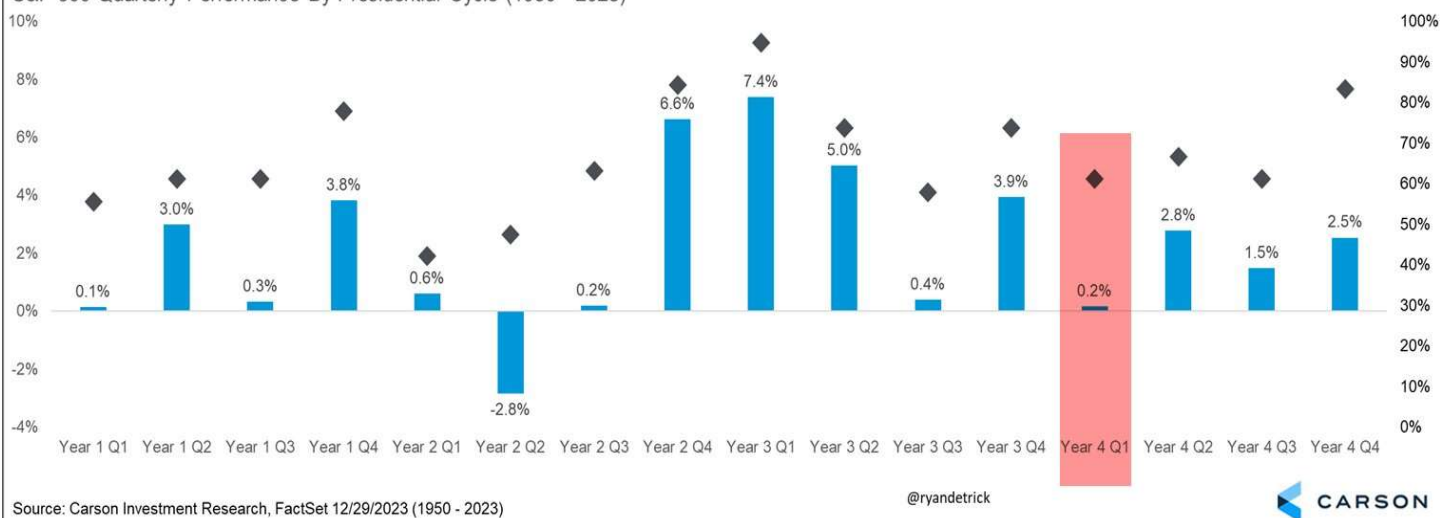
Interestingly, two members (the highest dots in the 2024 column) saw no cuts coming this year, which means they expect persistent inflationary pressure requiring the continuation of the current restrictive stance. At the other end of the spectrum, one member saw the probable need to cut by 1.25%, which could represent an expectation for either a much faster drop in inflation than other members foresee or a recession and the need for monetary stimulus.

Bond market futures participants have essentially done that low outlier one better by placing bets suggesting the probability of 1.48% of cumulative cuts in 2024. This may very well be what comes to pass, but the bottom left chart illustrates the amount of volatility we’ve seen in fed funds rates expectations since the middle of 2023. Each new piece of economic data or speech by a member of the FOMC could swing this expectation widely, which will affect stock and bond markets.



## Q1 Of An Election Year Tends To Be Weak

S&P 500 Quarterly Performance By Presidential Cycle (1950 - 2023)



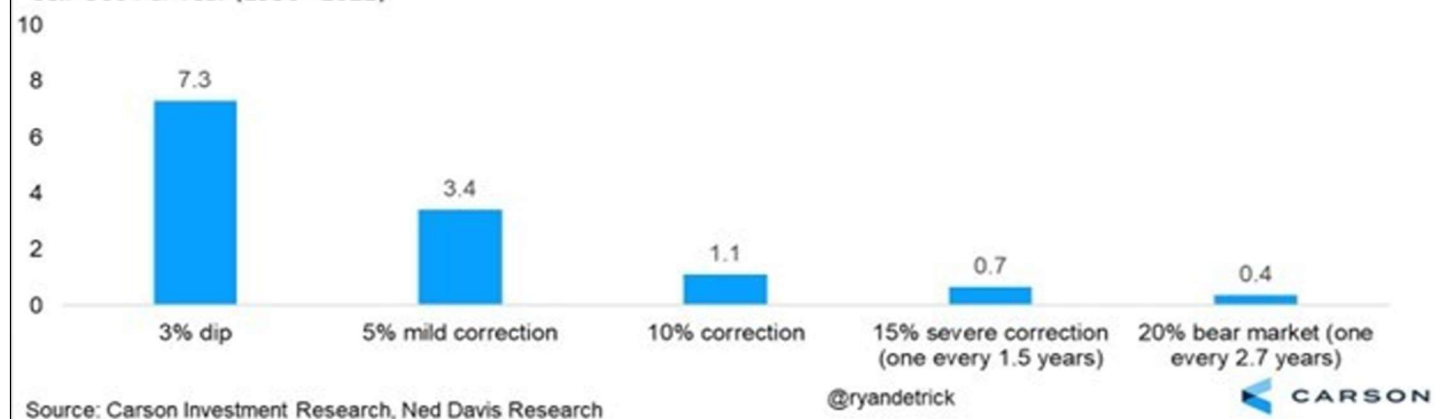
Another reason to expect an uptick in volatility in the coming months is the four-year presidential cycle, which we mentioned in our October letter. Per Ryan Detrick of The Carson Group, formerly of LPL Financial and from whom we have borrowed both charts on this page: "This [Presidential Cycle] has played out so well lately. Q4 midterm year then first half of pre-election years are super strong. Q3 pre-election break, then big Q4 pre-election year. Be aware Q1 of an election year tends to be weak, but the rest of the year is solid."

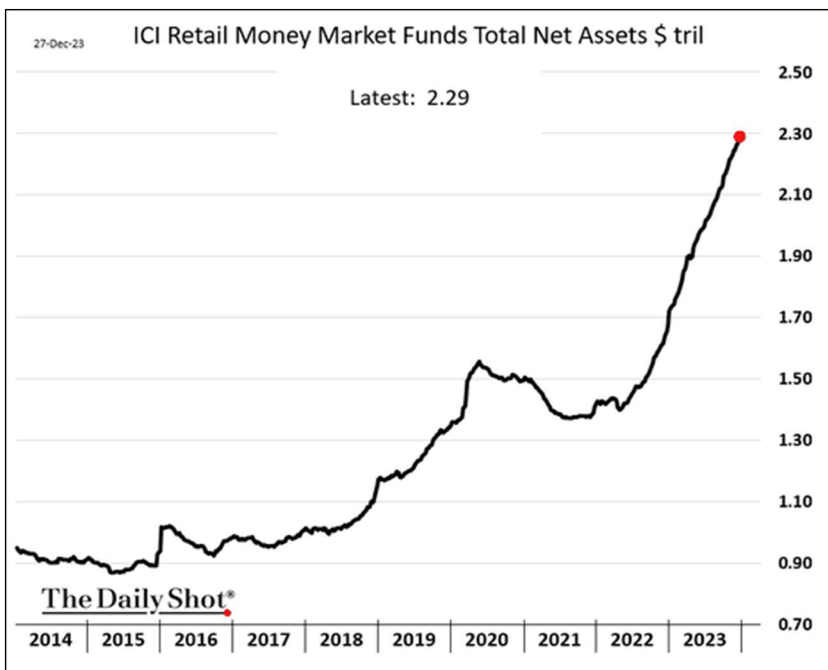
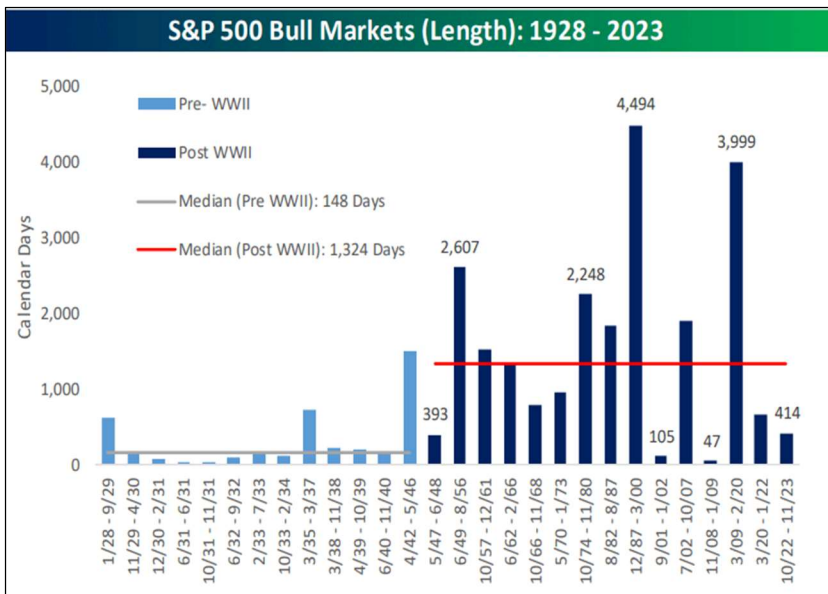
The presidential cycle, like all seasonality charts, should not be taken as the sole reason to be in or out of a particular market at a particular time, but it does add historical support to our forecast for volatility in the coming months. Our expectation that the market is likely to take a bit of a breather, and potentially retrace a good bit of the November-December gains, is not a call to head for the hills.

Ryan Detrick reminds us below that volatility is the toll we pay to invest. Mild corrections of around 5% occur more than three times per year, on average, yet the S&P 500 has averaged an annual gain of just over 10% since its inception in 1957. As we just experienced in the second half of 2023, even a 10% correction, which occurs more than once a year on average, does not preclude a positive medium-term return. By managing our expectations, we can keep our heads and treat short-term volatility as an opportunity, as we did last quarter.

## Volatility Is The Toll We Pay To Invest

S&P 500 Per Year (1950 - 2022)





We'll finish with a handful of charts that we feel support our current outlook and asset allocation recommendations, many of which we've discussed in prior letters.

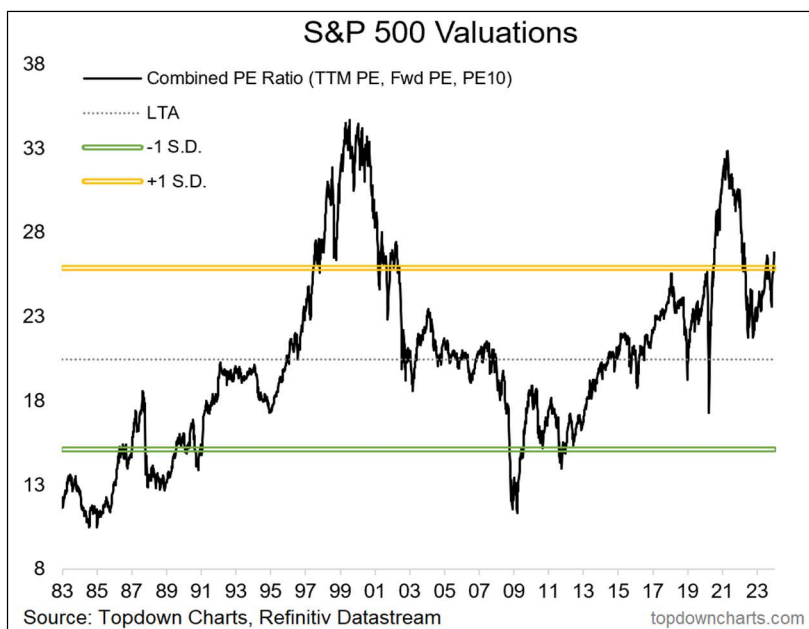
The bear market of 2022 officially ended in October of that year, which is of course when the current bull market began. The average post-WWII bull market has lasted 1,324 days, and we are less than 500 days into this one. The economy is digesting higher rates surprisingly well thus far, and because of those higher rates the Federal Reserve now has plenty of ammunition with which to potentially lower rates in support of the economy and financial markets. Absent a severe recession, which we readily admit is always a possibility, we expect certain pockets of the equity market to perform well for the foreseeable future.

As the Fed gradually lowers rates in the quarters to come, we would expect the deluge of cash that piled into higher yielding money market funds and short-term Treasuries over the past year to slowly reverse course. From Reuters:

*Investors wondering whether markets can continue their torrid rally are eyeing one important factor that could boost assets: a nearly \$6 trillion pile of cash on the sidelines.*

*Soaring yields have pulled cash into money markets and other short-term instruments, as many investors chose to collect income in the ultra-safe vehicles while they awaited the outcome of the Federal Reserve's battle against surging inflation... If borrowing costs fall in 2024, yields will likely drop alongside them. That could push some investors to deploy cash into stocks and other risky investments, while others rush to lock in yields in longer-term bonds.*

- Reuters, December 15, 2023



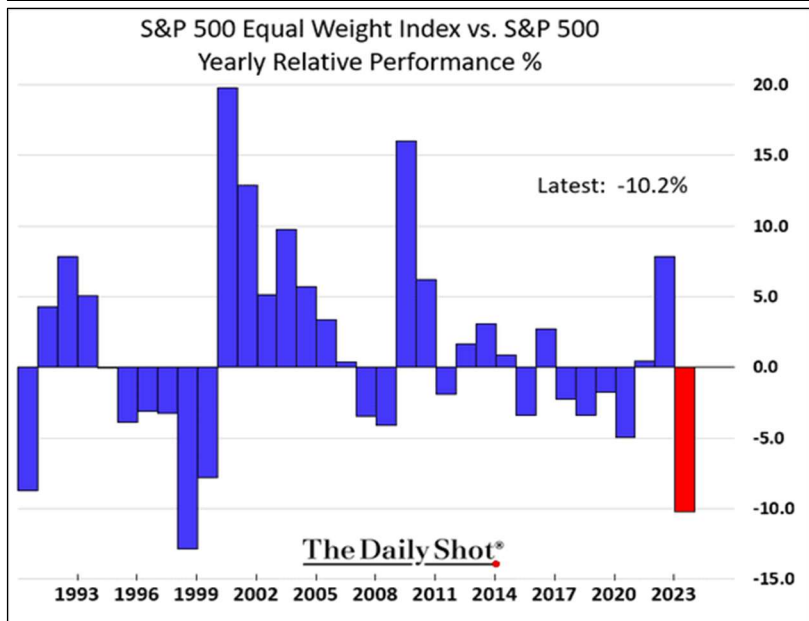
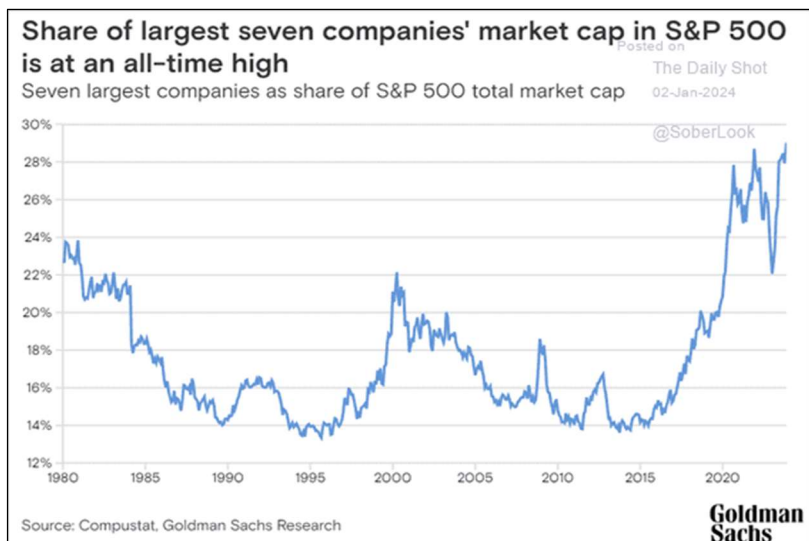
Like the millions of investors mentioned in the above Reuters article, we have been happy to take advantage of the greater-than-5% rates offered by money market funds and short-term Treasuries. As we see lower rates on the horizon, we plan to use coming periods of volatility as opportunities to shift some of that exposure to stocks and bonds with greater long-term growth or income potential.

Areas of the market that we currently own and plan to add to opportunistically in coming months include S&P 500 Equal Weight Index (as opposed to the traditional market cap-weighted index), small cap US stocks, international stocks, industrials, infrastructure related investments, and commodity producers.

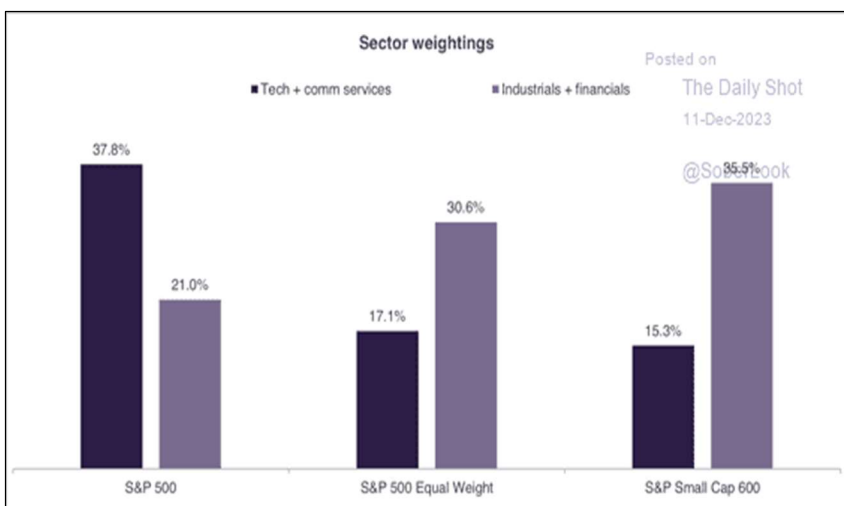
As opposed to investing in the market-weighted S&P 500 index, which is overvalued (top left chart) and highly concentrated (middle left chart), we have chosen to focus on the equal-weighted S&P 500 index, which strips out sector or stock-specific concentration by weighting all constituents equally.

As shown in the bottom left chart, the relative performance of the S&P 500 Equal Weight vs the traditional S&P 500 can vary widely, and periods of great under- or over-performance tend to be reversed in subsequent years. While the Equal Weighted Index under-performed by greater than 10% in 2023, all of that under-performance took place in the first half of the year.

The performance chart at the top of the next page plots the two indices since we began focusing on the Equal Weight in June of last year. As you can see, they performed similarly in the second half of the year, and Equal Weight has outperformed Market Weight by greater than 3% since the recent market bottom in late October. If this outperformance

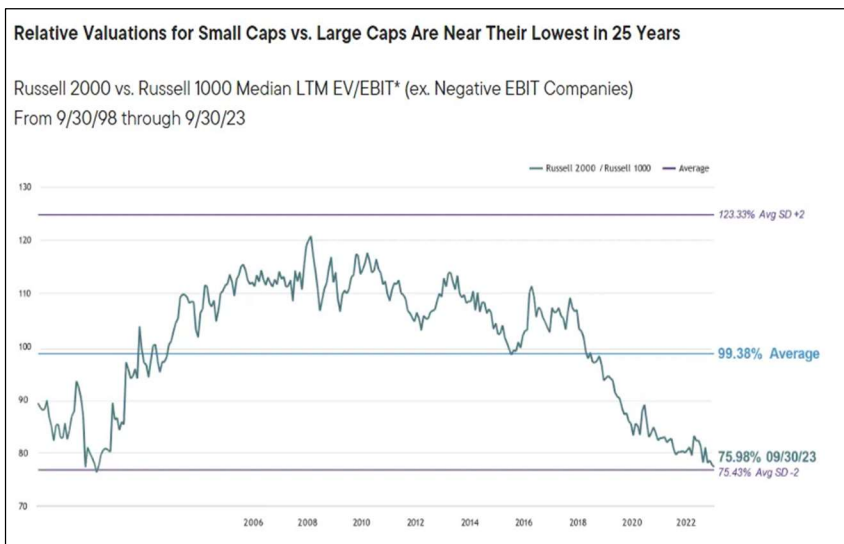


# Equal Weight S&P 500 & Market Weight S&P 500 - 6/16/2023-12/31/2023



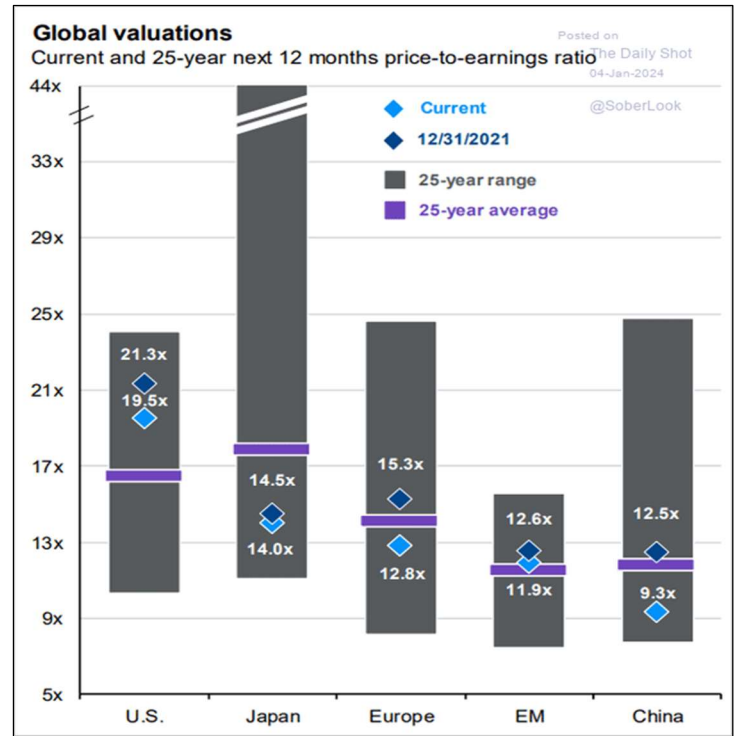
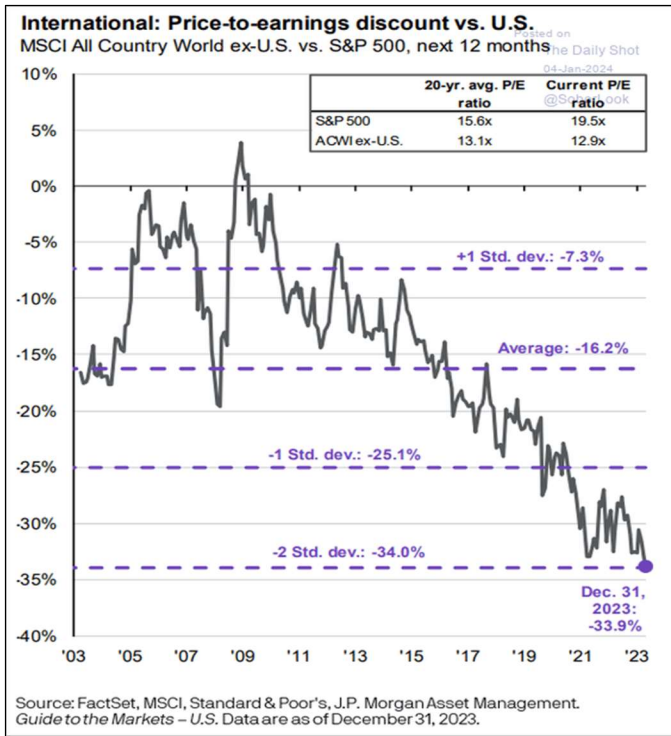
continues into 2024 as we expect, the largest seven companies that dominate the traditional S&P 500 could give back some of last year's meteoric rise and the Equal Weight could continue to plug along as investors rotate out of big tech and into areas of the market that are under-owned and undervalued.

The chart on the middle left indicates the difference in sector weightings between the S&P 500 and the Equal Weight, which is lighter in the expensive technology and communication services sectors and heavier in industrials and financials. Small Cap stocks indices are also less concentrated in tech and communication services.



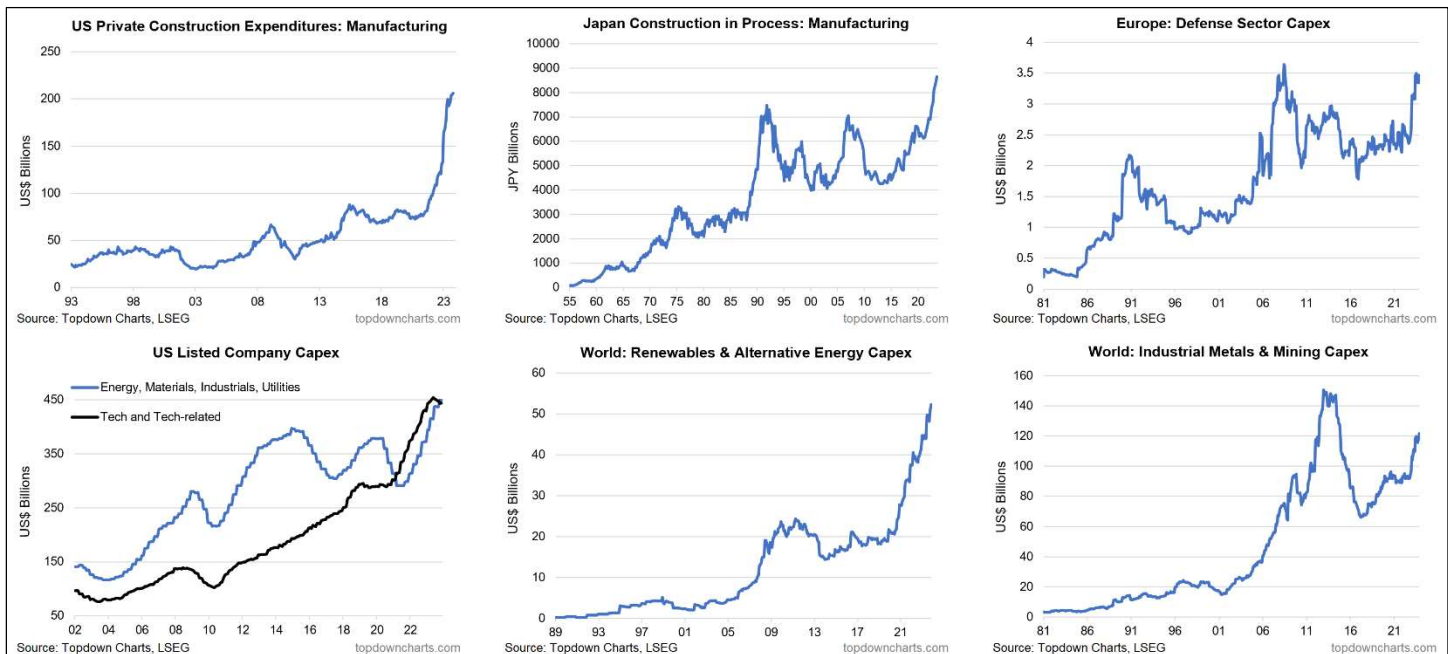
When compared to the valuation of Large Cap stocks, Small Caps are enticingly cheap (bottom left chart). Not only does this provide an attractive opportunity for long-term appreciation, if the market hits an air pocket in 2024 their lower valuation should provide Small Caps with a greater margin of safety.





International stocks also present a much more favorable valuation profile to large cap US stocks. The MSCI All Country World ex-US index is cheaper relative to the S&P 500 than it has been in decades (top left chart) and when compared to its own past 25 years of valuation, Japanese stocks present a particularly attractive buying opportunity (top right chart).

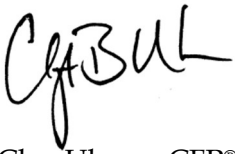
Finally, the below series of charts demonstrates the trillions of dollars that are being allocated to capital expenditures (Capex) around the world for projects related to defense, green energy, manufacturing and resources extraction. This boom has been and should continue to support the revenues and earnings of the industrial, infrastructure and mining sectors, all of which should perform well as big tech takes a breather and the rest of the market catches up.





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.

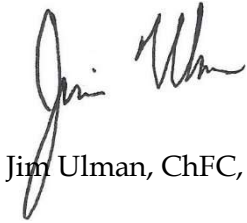
Sincerely,



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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.*

*Morningstar US Core Bond: The index measures the performance of fixed-rate, investment-grade USD-denominated securities with maturities greater than one year. It is market-capitalization weighted. This Index does not incorporate Environmental, Social, or Governance (ESG) criteria.*

*The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. All performance referenced is historical and is no guarantee of future results. All indices are unmanaged and may not be invested into directly.*

*Investing involves risk including loss of principal. No strategy assures success or protects against loss.*

*The economic forecasts set forth in this material may not develop as predicted and there can be no guarantee that strategies promoted will be successful.*

*The fast price swings in commodities will result in significant volatility in an investor's holdings. Commodities include increased risks, such as political, economic, and currency instability, and may not be suitable for all investors.*