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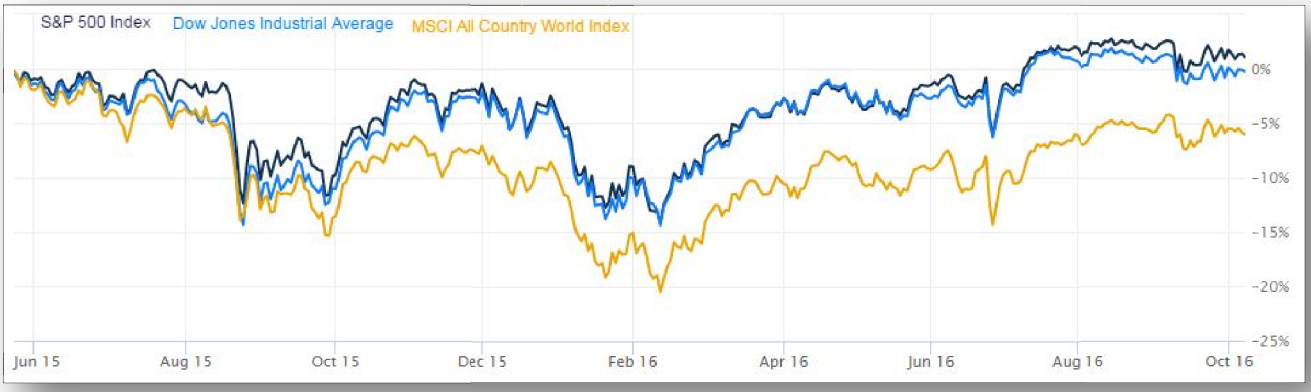
October 7, 2016 – ***Fourth Quarter Items for Consideration***

We hope that this letter finds you well. As we enter the final quarter of the year, one that is sure to be very interesting for a great number of reasons, we thought it would be appropriate to give an overview of some of the items on which we are and will be focusing in the coming months. We'd love to hear your feedback.

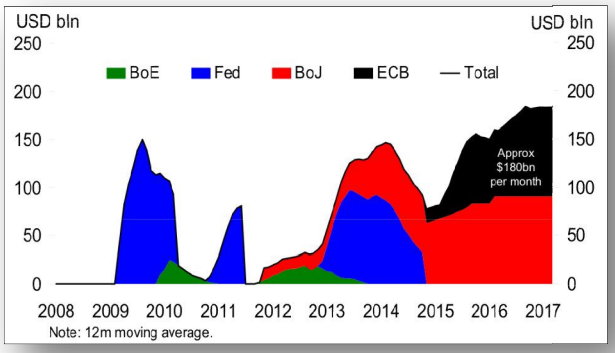
US equity markets have been unable in the last eighteen months to regain the head of steam gathered in the earlier stage of this now seven and a half year old bull market. As of the date of this letter, the S&P 500 Index* is trading just +1.08% higher than the interim peak set in late May 2015 that we have mentioned in the past several letters. In that same period of time the Dow Jones Industrial Average* and MSCI All Country World Index* are down by -0.25% and -6.01%, respectively, despite near or below zero interest rate policies around the world and continuing central bank asset purchases intended to stimulate economic activity and support asset prices.

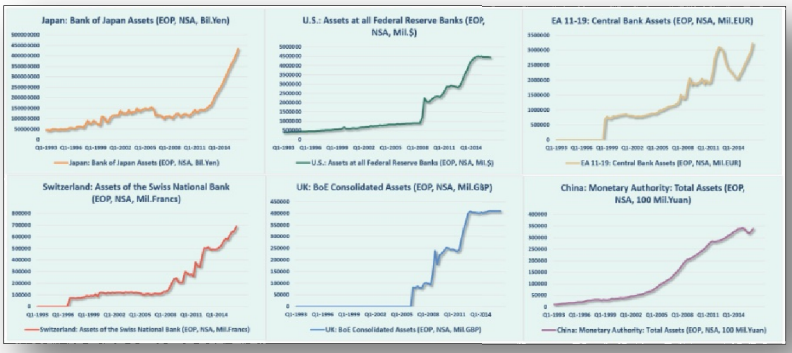
So we must ask ourselves as participants in these financial markets, and more importantly as risk managers entrusted with the safekeeping of our clients' hard earned savings, what potential opportunities and pitfalls should we presently have our eyes on that might drive market direction in this fourth quarter and beyond. What follows is a list, in no particular order, of just a few of the most pressing issues that occupy our thoughts.



Global Monetary Policy Effectiveness – Central banks have recently been signaling acceptance of the fact that they are running out of effective tools to support the global economy. For the past eight years, the major central banks of the world have been utilizing every tool at their exposure, and indeed have been inventing new tools along the way, in an effort to stimulate sustainable organic economic growth following the global financial crisis.

We have discussed at length in prior letters, all of which are archived on our website www.UlmanFinancial.com, the degree to which global interest rates have been pinned to the floor, and in many cases below the floor in order to reduce the costs to households and businesses to service existing debts and stimulate banks to lend and households and businesses to borrow and spend. Additionally, central banks' balance sheets have been exponentially expanded through asset purchase programs in an effort to strengthen banks' balance sheets and support asset markets.



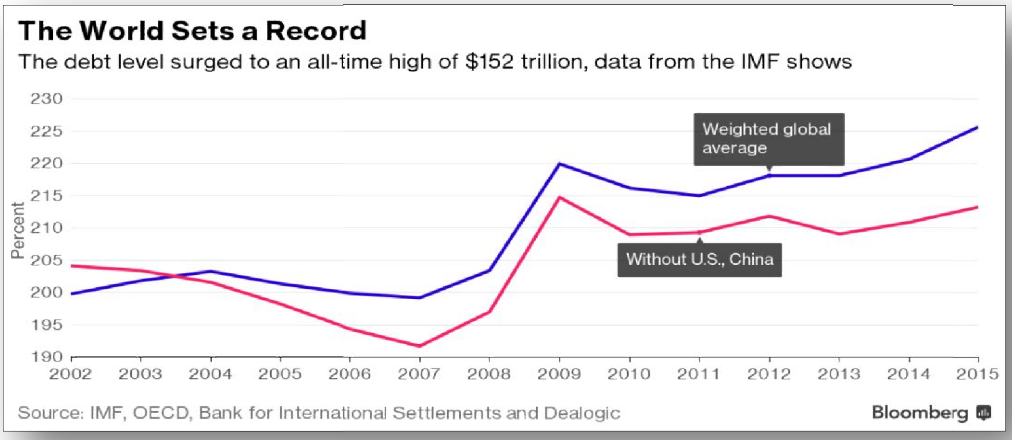


From the Wall Street Journal, October 4, 2016 (emphasis added):

> *Over the past couple of months, the capital markets have been especially antsy on the topic of the limits of monetary policy. A report this morning suggesting that maybe one key central bank is feeling the same way sent the euro surging…*
>
> *According to Bloomberg's report, the [European Central Bank] would start winding down its bond buying by $11 billion a month, ahead of the program's currently scheduled end in March 2017. If that is the case, it would be similar to what the Federal Reserve did with its QE3 program…*
>
> *Also on Tuesday, two ECB officials did publicly make comments casting doubt on the value of negative interest rates. That follows on actions the Bank of Japan took last month that were widely interpreted as a subtle abandonment of its own negative rates policy…*
>
> *In September the ECB disappointed the market by not choosing to expand its QE program, counter to expectations it would do just that. <u>The wider question for the markets is this: are central banks getting weary of their own monetary policies?</u>*

Market participants now place a two/thirds likelihood that the Federal Reserve will raise rates at one of their two remaining FOMC meetings this year, in an attempt to continue their ever so gradual normalization of interest rate policy. We are not so sure about those odds considering the recent reduction in 2016 and 2017 growth expectations, which we will touch on below. However, if the market's expectations prove to be correct, an increase in the Fed Funds rate will be a US Dollar strengthener and has the potential to rile equity, bond and commodity markets as occurred following the 0.25% hike in December 2015.

Global Debt > Slow Growth > More Debt – Despite the mountain of unprecedented monetary stimulus, many respected institutions are trimming their outlook for economic growth in 2016 and 2017.



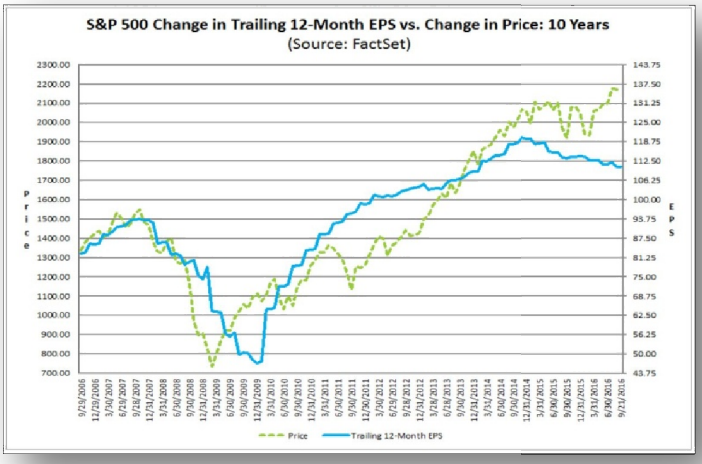
From NPR, October 4, 2016:

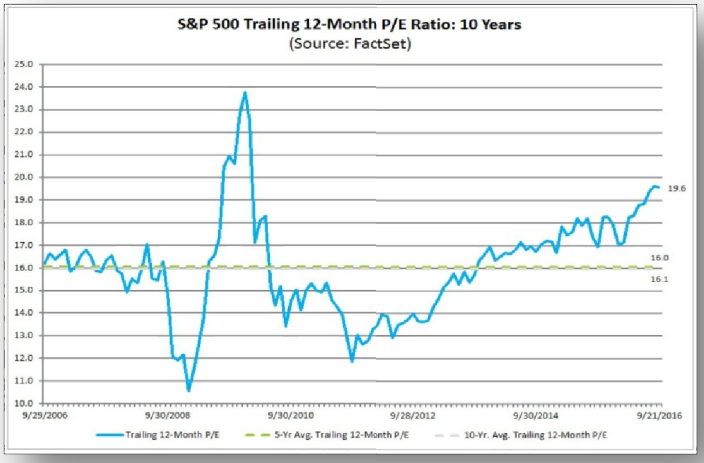
> *In its latest forecast, the International Monetary Fund says it sees global growth essentially moving sideways this year, with flat to slower growth in richer countries offsetting higher growth rates in emerging economies such as India…*
>
> *The IMF cut its economic outlook for the U.S. to 1.6 percent growth this year, down from 2.2 percent, citing weak business investment and lower demand for goods. It also cautioned the Federal Reserve to hold off raising benchmark interest rates until it sees "clear signs that wages and prices are firming durably."*

From Bloomberg, October 5, 2016 (emphasis added):

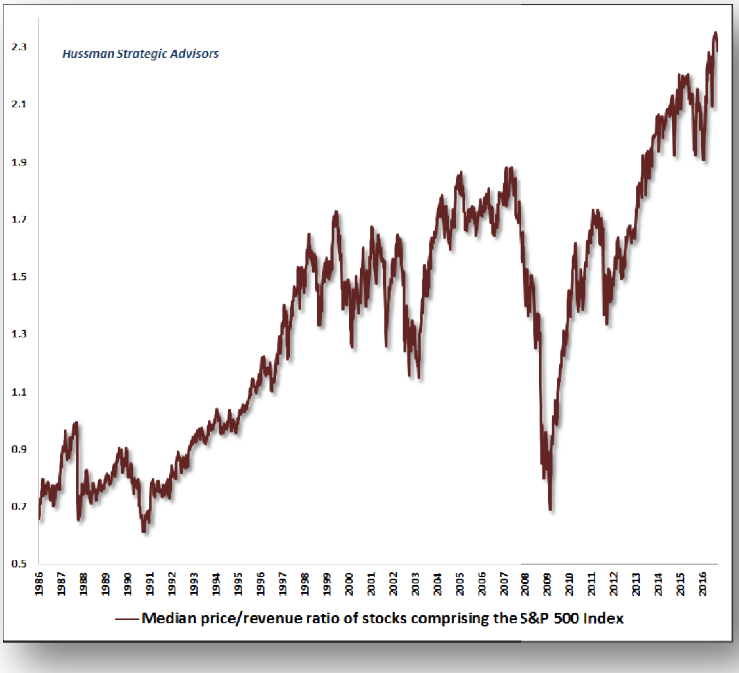
> *Eight years after the financial crisis, the world is suffering from a debt hangover of unprecedented proportions. Gross debt in the non-financial sector has more than doubled in nominal terms since the turn of the century, reaching $152 trillion last year, and it's still rising, the International Monetary Fund said. The figure includes debt held by governments, non-financial firms and households.*
>
> *Current debt levels now sit at 225 percent of world gross domestic product, the IMF said Wednesday in its semi-annual Fiscal Monitor, noting that about two-thirds of the liabilities reside in the private sector. The rest of it is public debt, which has increased to 85 percent of GDP last year from below 70 percent…*
>
> *<u>Slow global growth is making it difficult to pay off the obligations, "setting the stage for a vicious feedback loop in which lower growth hampers deleveraging and the debt overhang exacerbates the slowdown,"</u> said the Washington-based fund…*
>
> *<u>Financial crises tend to be associated with excessive private debt in both advanced and emerging economies</u>, the fund said. In addition, research has shown that high debt is linked with lower growth, even when a crisis is avoided… The IMF flagged the euro area and China as economies where it's particularly important for deleveraging to occur.*

Continuing Earnings Recession – By the time you receive this letter the third quarter earnings reporting season will have begun. Consensus expectations are for aggregate S&P 500 corporate earnings to have fallen by -2.0%, which would mark the sixth consecutive quarter of year-on-year earnings declines.





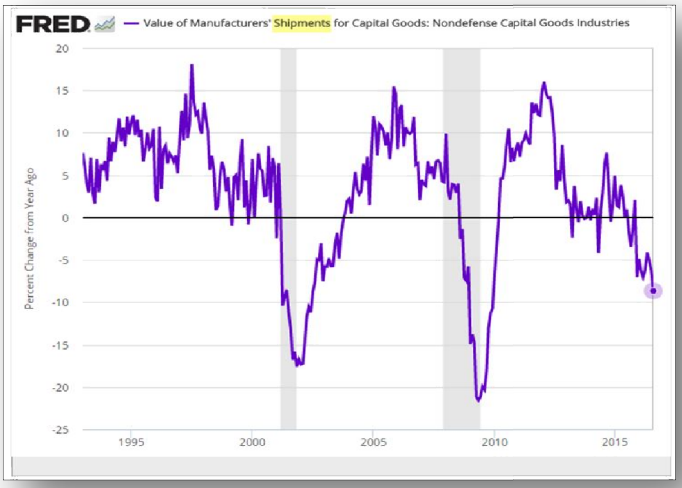
As earnings fall and equity prices remain in roughly the same range, as we have seen since this earnings recession began in Q2 2015, the relative valuation assigned to those equities increases. The trailing twelve month (TTM) price/earnings ratio of the S&P 500 is currently at 19.6, more than 20% above the 10-year average of 16.1. As we pointed out in our April letter, when compared to corporate earnings calculated using the Financial Accounting Standards Board's generally accepted accounting principles (GAAP) the trailing twelve month PE ratio balloons to 25.9.

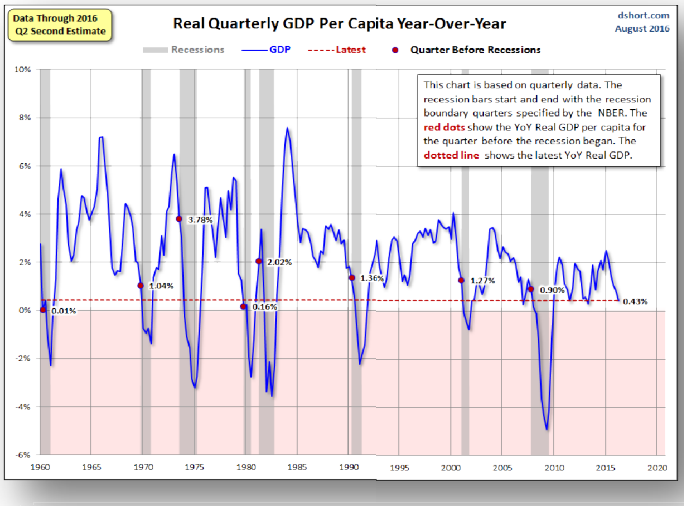


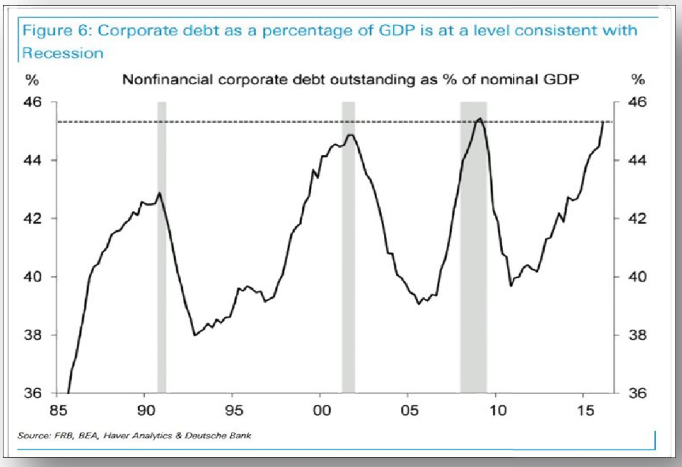
Trailing twelve month P/E is just one valuation metric used to determine whether a stock or collection of stocks is undervalued, fairly valued or overvalued. We have reviewed quite a few of these in past letters, most of which point to the current market environment as one of the most overvalued in market history. Because of the financial engineering that corporations often engage in to meet or beat each quarter's earnings projection, it can be helpful to review those variables that are less susceptible to being gamed. On the left is a chart of the current median price to sales ratio of the S&P 500, which greatly eclipses that of the 2000 and 2007 market peaks.

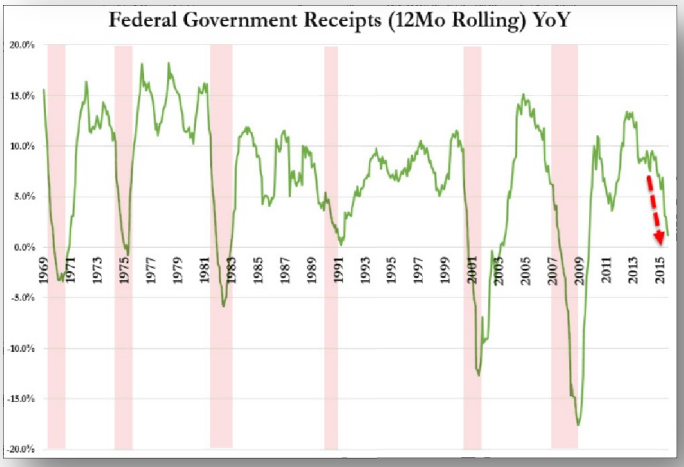
Potential for US Recession – The National Bureau of Economic Research defines a recession as "a significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in real GDP, real income, employment, industrial production, and wholesale-retail sales."

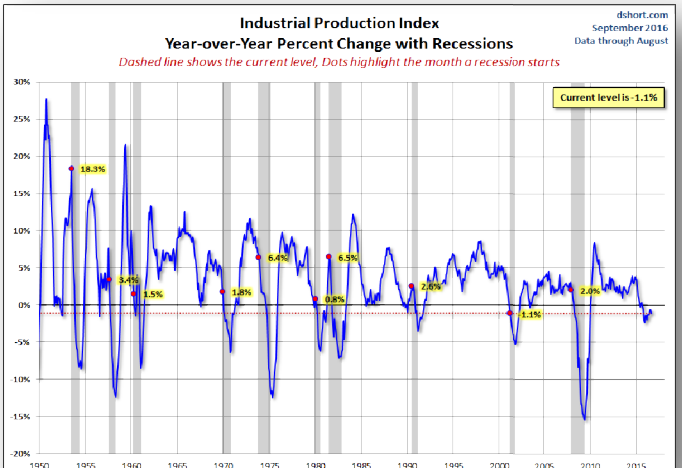
While we claim no innate talent for predicting recessions, it is important to monitor the coincident indicators that in the past have been particularly effective in warning that recession is imminent. This is especially important to investors and financial decision makers as bear markets (equity market contractions of greater than 20%) historically occur in and around recessions. We submit the following charts without comment other than to ask, looking at this data would you predict that we are likely approaching the next recession or that we are on the cusp of the organic economic expansion that would enable the Fed to safely normalize interest rates?

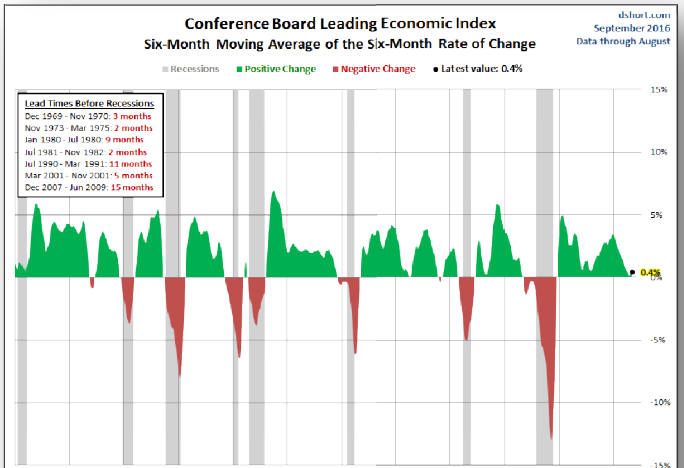






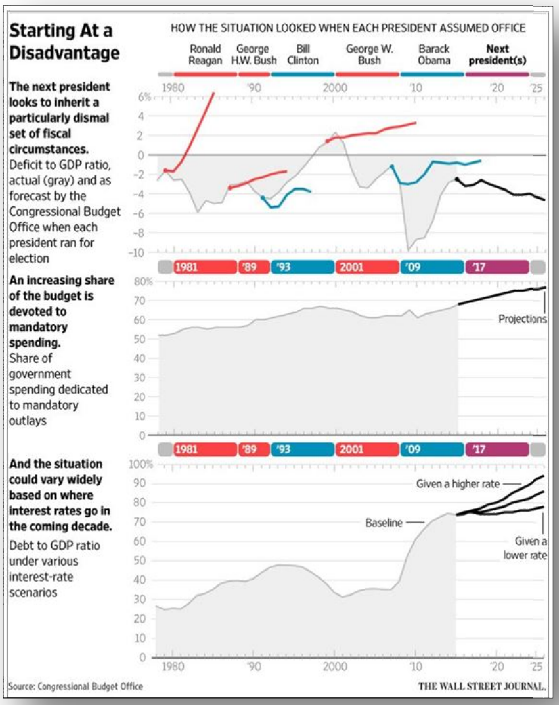






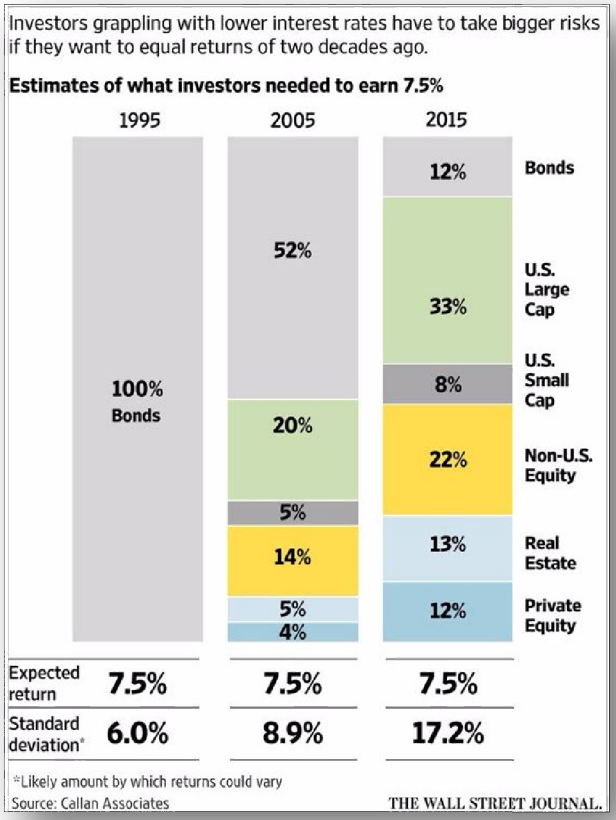
Potential European Banking Crisis – While a different situation to that of Lehman Brothers in 2008, there is a concern in global markets that the instability of many of Europe's largest banks has the potential to trigger a de-risking of portfolios as the perception of counter-party risk increases.

Ever since the European Central Bank implemented negative interest rate policy (NIRP) there has been concern about the financial sector's ability to remain profitable and hence their ability to support the broader economy in those regions. In just the last few weeks, European banks have announced plans to shed over 20,000 jobs in an effort to control costs. Add to this the increasing number of Non-Performing Loans, in the Italian banking sector specifically, and investors have been increasingly unwilling to ignore the risks. This ongoing turmoil in the European banking sector, where many of the region's largest financial institutions have seen their stock prices cut by more than 50% this year alone, has investors concerned that the failure of one or more systemically important banks would require a public bail-out at a time when populism and anti-establishment sentiment is reaching a zenith.



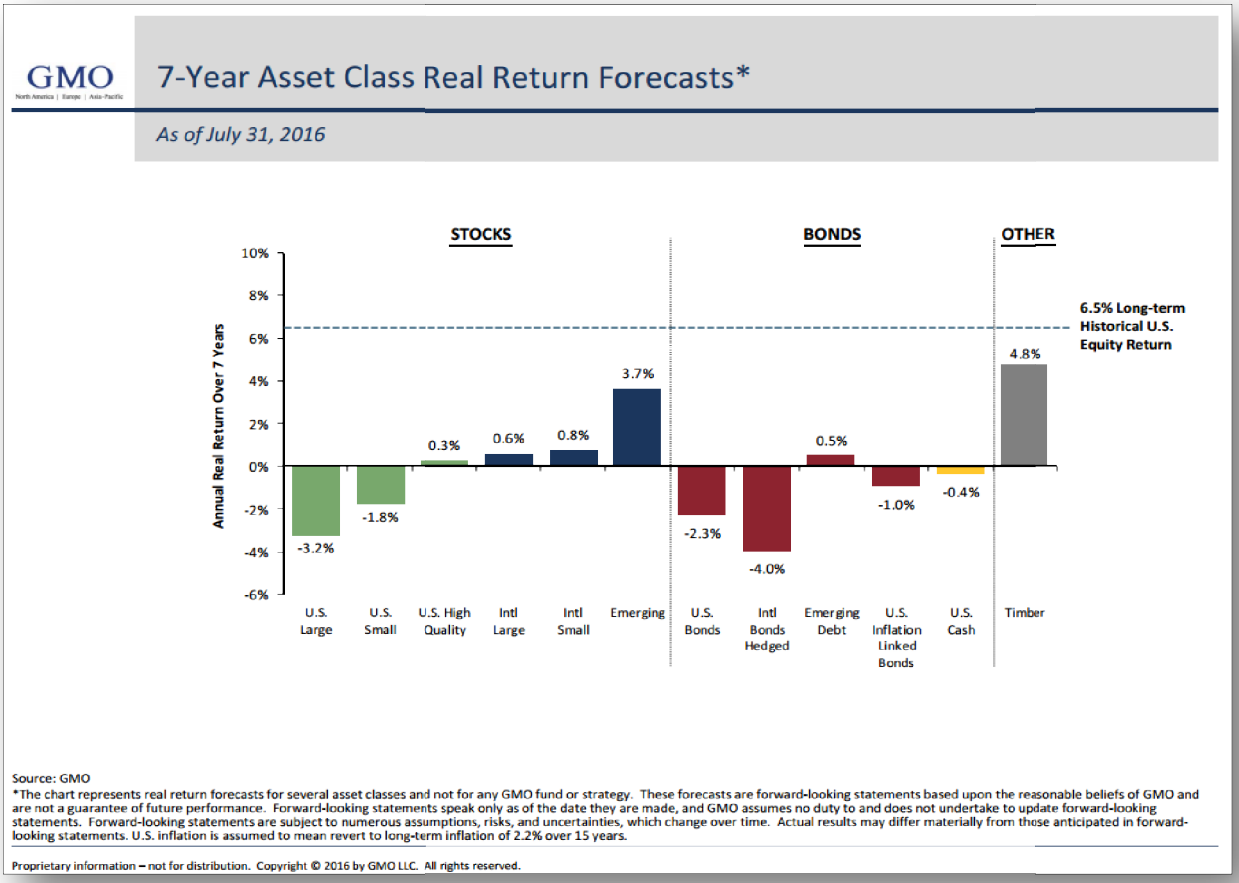
US Presidential Election Uncertainty – No matter which candidate wins the election on November 8th, it will be an historic outcome. If the race remains tight in the closing weeks, the uncertainty will keep financial markets on edge. If the outcome is other than polls predict, a la the Brexit referendum, markets would most certainly react negatively.

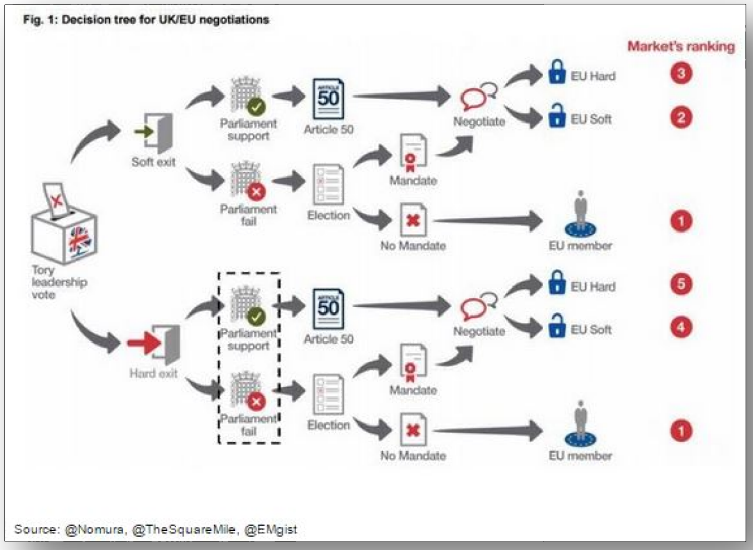
It is highly likely that the next president will be facing a recession in their first term, given that the average period of economic expansion since the end of the Great Depression has been 59 months and this current expansion is already beyond 85 months old. As discussed earlier, extraordinary monetary policy appears to have reached the end of its rope and it doesn't seem likely that the Fed will have enough time to hike rates sufficiently to face the next recession on its own. A strong fiscal stimulus package will be necessary. As indicated in the infographic to the left, there may not be a whole lot of room for fiscal maneuvering either.



Underfunded Pension Fund Liabilities – This item is a bit of a longer term issue, but one that should be informing asset allocation decisions today. As a result of the ultra-low yields on the safest of investment vehicles, the long term obligations of pension funds, insurance companies and endowments have been increasingly forced to use more risky investments to hit their annual growth targets. As depicted on the left, the type of portfolio composition necessary to generate the 7.5% average annual rate of return many long term investors have built into their growth models requires almost twice the amount of risk as was necessary ten years ago and almost three times the risk exposure as was necessary twenty years ago.

With valuations stretched on virtually all financial asset classes, largely as a result of the reach for yield caused by central banks' reliance on abnormally low interest rates, history suggests that the next decade will be characterized by rates of return dramatically lower than the long term average.





Other items that have our immediate attention include, but are not limited to:

- Possibility of a 'Hard Brexit' as proposed by UK Prime Minister Theresa May, in which the UK and EU sever all formalized trade relations. Since the Brexit referendum the British Pound has fallen to a 168 year low.
- Continued capital flight and currency depreciation in China, where the Yuan has fallen to a six year low against the US Dollar and a basket of international currencies.
- Further deterioration of relations between the US and Russia amid a worsening humanitarian crisis in Syria.

While the above items combine to paint a rather bleak picture, it is imperative that we as investors not bury our heads in the sand. With the 7-year inflation-adjusted return forecast from famed investor Jeremy Grantham's GMO showing few places to protect assets, let alone generate positive real returns, one might be tempted to take their ball and go home. Our recommendation instead, and that of some of the world's most respected wealth managers as discussed in our last letter, would be to increase your allocations to those safe haven assets to which funds have always flowed in times of economic panic: US Treasuries, gold and cash denominated in US Dollars.

US Treasuries and gold, like all traded asset classes, are subject to volatility and have in fact experienced a good deal of volatility in recent weeks. They have still, however, outperformed domestic and global equities year-to-date. Cash has the ability to protect you during a market downturn and gives you the option to dollar cost average back into risk assets once they have been repriced to more historically attractive valuations. As important as preservation of capital during a downturn is preservation of the psychological willingness to assume risk at that point in the future when history proves it is most beneficial to do so. That is the service we are attempting to provide.

Please feel free to share this newsletter and do not hesitate to call or email with any questions or comments or to schedule a face-to-face portfolio review.

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 Bloomberg Commodity Index is a broadly diversified commodity price index for the global commodities market distributed by Bloomberg Indexes.*

Indices such as the S&P 500 Index, the Dow Jones Industrial Index and the Bloomberg Commodity Index, and any others listed above, 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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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.

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