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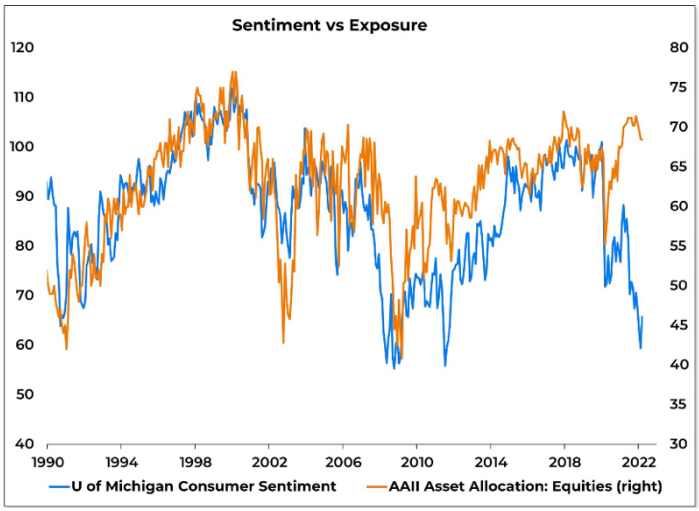
Why I Believe the Markets Have Farther to Fall

Bear Markets are brutal. Some are longer and some are shorter in duration. But they all have one thing in common – rallies within them suck investors in too early. Generally, they do not end until investors reach their "puke point", giving up and selling right as the Bear Market is ending. I do not believe we have reached that point. There are numerous reasons why;

1) While most investors are responding to surveys saying they are bearish, their allocations are still heavily invested in stocks. Saying you are bearish and acting like you are bearish are two very different things. The U of Michigan Consumer Sentiment Index is usually tightly correlated to the AAII Equity Asset Allocation; the lower the sentiment, the lower the equity exposure and visa versa. Currently the picture looks like this;



With Sentiment (blue) as low as it is, Equity Exposure (orange) is significantly out of kilter with the historical relationship. Something has to give. Either Sentiment has to shoot significantly higher, Equity Exposure has to shoot significantly lower, or they need to meet somewhere in-between. With continuing energy price spikes, food cost spikes, and falling wages on an inflation adjusted basis, which action do you think more likely?

2) The declining P/E ratio (Price-to-Earnings), which makes stocks look more in line with historical averages rather than elevated will, in my opinion, be short lived. The calculation is correct in terms of "e" being forecast earnings divided by "p". However, note that the decline is based on the fact that the "p" has gotten smaller (prices have come down) relative to **forecast** "e". It is very likely that these forecasts are going to be reduced, perhaps significantly, as inflation & higher funding costs are shrinking profit

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margins and the consumer is not nearly as robust as talking heads blather on about. When the "e" shrinks, the P/E ratio rises again, unless & until the "p" falls as well. Earnings forecast cuts have not really started yet. They will, and they will be significant.

3) The "Fed Put" is linked to inflation this time, not market prices. Investors have gotten used to the Fed stepping in to "save the day" with rate cuts or quantitative easing programs any time the stock market took a deep dive over the past 13 years. Today the Fed is more concerned with taming inflation than they are with "saving the stock market". Chairman Powell has been explicit as possible about this. Cutting rates or embarking on QE before inflation is under control will send inflation sky high and the Fed knows this. Inflation must be tamed – that is job #1. That means rate hikes will continue and anyone waiting for the old Fed Put to save the stock market is going to be sorely disappointed. Furthermore, one of the best tools to tame inflation is to crush demand. A falling stock market is a tool to crush demand; gains evaporate and money to spend shrinks. In the eyes of many, the Fed wants and needs the stock market to continue falling, knowing a falling market hits the wealthy hardest as they own 80% of the market, creating a "reverse wealth effect"; a lessening of the wealth gap. And remember, **the Fed has not even begun the 2nd phase of monetary tightening** – unwinding QE.

4) We've entered a new "phase" of the Bear Market. Up until about a week ago, the downward pressure on the markets was inflation/interest-rate driven. Stocks & Bonds both fell together. This appears to be changing. Bonds are now rallying as the stock market declines. In my opinion this indicates we have entered the "slowing-growth-fear" of the Bear Market. Bond investors are now confident that longer-term rates will fall in accordance with long-standing historical relationships reasserting themselves. I agree. The "pricing-in" of Fed rate hikes has gone too far, and while the Fed will indeed continue raising the Fed Funds Rate, the longer-term rates will decline (bond prices up) as flight to safety kicks in.

5) The volatility index (VIX) and action on the options markets have been providing some support to the stock market as options trading has been quite bullish, or at least, not bearish. Most of the action centered around supporting the S&P 500 at the 4,000 level. Now that 4,000 has been breached to the downside, the options market may flip to more bearish positioning, removing price support for the indexes.

When do I think the decline will end? When we see real, meaningful reductions in inflation. Exactly what that number is I don't know. However, I believe the Fed will act to try to

rejuvenate markets quickly once they believe they have tamed the inflation monster. Time will tell.

Thoughts on Food, Energy, & Water
(a bit of a rant)

There are no more necessary items for life than water, food, and energy. There is a growing shortage of all three and the extent of the shortage is not only underappreciated, but the "global policy makers'" solutions are grotesquely unserious and show a shocking ignorance of their supposed areas of expertise. Telling people struggling with gas prices to purchase an electric vehicle is bad enough; but pretending that there is enough lithium, copper, cobalt, & nickel to satisfy other economic needs while also creating enough electric car batteries to replace all fossil fuel engines without causing impossible supply disruptions and enormous cost increases is downright dangerous. Also dangerous is the current USAID Administrator stating that the global fertilizer shortage could be a good thing as it will hasten the adoption of "more natural" solutions like manure & compost – only someone who has zero familiarity with agriculture could make such a gobsmackingly stupid statement in the face of significant projected global grain shortages, cooking oil shortages, & protein shortages. On water, the current drought covering most of the Southwestern US could cripple cities & agriculture alike. The Colorado river is simply not able to provide enough water to the Southwest without a massive increase in rainfall over the next few years. Some of the intake pipes to feed parts of Nevada are now ABOVE the water line. Inter-State battles over water rights have already begun. And all this was nearly 100% avoidable had ANY water planning been done over the past 25 years.

The short-term ramifications of food & energy shortages are dire. We will of course get through them, but not without serious & potentially deadly consequences for the "third world nations".

Food
Ukraine is known as the "breadbasket of Europe". It is the 3rd largest exporter of grain to the world. Put simply, without Ukraine's grain people may very well starve, especially in poorer nations as wealthier nations compete for grain, driving prices higher and out of reach of poorer nations. Putin knows this. Timing the invasion to coincide with planting season in Ukraine is no accident. The significant reduction in Ukraine grain production due to missing the planting season in some areas creates a serious problem for European nations as they must put

significant time & resources into securing grain supplies from elsewhere while also trying to support & arm Ukraine. Bear in mind, Europe needing to enter the global-grain-grocery-store means less supply for those who traditionally "shopped" there; more demand and less product. The grain shortage further strains what were already stretched national balance sheets and has a negative impact on economic circumstances both in Europe & globally as food inflation rises.

We are already seeing riots in some countries suffering food shortages or rapidly rising food costs. In Sri Lanka citizens have begun burning the homes of politicians and heaving their vehicles into the rivers. On May 20th, India, an exporter of 2.5 Million tons of grain annually, has outlawed the exporting of wheat, further shrinking the remaining global supply. Food shortages are the kindling of revolution and we should expect to see more violence spread in impoverished nations.

On the food front Putin's cunning runs further, or rather, the short-sighted sanctions leveled against Russia also created a fertilizer shortage as Russia is one of the world's largest suppliers of fertilizer ingredients. To better understand the importance of this shortage consider that without fertilizer, crop yields decline approx. 40% on average. That is a significant reduction in grown food supply, and while a shortage is not the same as having absolutely no fertilizer, the crop yields will definitely decline and the cost to produce the crops will rise, leading to rising food prices. Telling farmers to shift to manure and compost is a clear indication that those in charge are grotesquely unserious and/or have no understanding of agriculture, which is supposedly their area of expertise. Thus, the food problem is more than "just" grain, it extends to nearly every food the world grows.

Energy

It wasn't long ago that German diplomats at the UN openly laughed at President Trump's warning that Europe was becoming too dependent on Russia for energy – they literally laughed at him during his address to the UN. Love or hate Trump, the guy knows A LOT about leverage and how to use it and he saw clearly that Europe was willingly putting itself over a barrel when it came to energy. Putin seized this European self-immolation and, thanks in part to sanctions, has completely upended the European energy markets. Despite sanctions, Europe still buys Billions of $'s of energy from Russia, and further, looks ready to capitulate to Putin's demand that they pay for their energy in Rubles, strengthening Russia's currency – a currency that initially crashed in value upon sanctions but which shot right back up and sits stronger than before the invasion. There is some chatter that Europe will boycott entirely all energy from Russia. This would be economic & political suicide – there is no alternative source to replace what Russia currently supplies. There is no magic spigot that can be turned on immediately – it will take time.

We've all experienced the result of rising energy prices but it is important to recognize that higher energy prices affect every step of economic activity from procuring raw materials, shipping them to the manufacturer, the manufacturing process itself, shipping to the distributor, etc…. The higher energy costs compound on top of each other with every step, driving prices of goods higher. As you know, energy prices were well on the rise before Putin launched the Ukraine offensive. The "Putin Price Hike" is another example of grotesque unseriousness in the face of a significant energy shortage. In the US, the East Coast is already dangerously close to running out of diesel. Diesel is the fuel that gets goods from point A to point B and is, even more importantly, the fuel of farming.

Our current energy shortage is, in my opinion, entirely of our own making. "Green energy" is simply not ready for "prime time", but many Western nations have cut back on or penalized fossil fuel production as though solar and wind were capable of producing anywhere near what an advanced economy needs. Some areas have even banned natural gas in all new construction, perhaps not realizing that the majority of electricity production that will be needed to power the new neighborhoods comes from fossil fuels anyway (again the "experts" are gobsmackingly stupid). Making matter worse, many Western nations have shut down or severely limited nuclear power generation – the cleanest energy source available. **It is truly stunning how much energy the world – mostly the West – has taken offline as it charges headlong off a "green energy" cliff**. We are now facing the consequences of these decisions and the Russian invasion of Ukraine only exacerbates what was an already growing problem.

There is no easy fix to the energy shortage. Apparently recognizing the error of their ways, much of Europe is moving towards re-opening and building new nuclear power plants and, in a nod to reality, are redefining nuclear as a "green energy" source. Even Gov. Gavin Newsom in CA, who was personally involved in negotiations to shutter the last working nuclear power plant in CA is now reversing course and even asking the DOE's help to keep it open. CA is in dire straits – few recognize that CA is the US's largest electricity importer, unable to generate enough of its own electricity because of its stance against fossil fuels. So instead of producing its own, it relies on other States who generate electricity (by burning fossil fuels) to sell it to CA on the Spot-Market, which is MORE expensive. CA is expected to have its worst summer of rolling blackouts ever. Some regulators are warning of blackouts stretching across the entire Nation. And it was ALL avoidable.

Despite rising oil prices, oil production is not really rising. Much of the shale area in the US is at diminishing returns levels of production and the political environment of the past 20+ years has made oil companies skittish to get new production going. All the talk of the federal government granting drilling permits is smoke & mirrors, again grotesque unseriousness, as,

while it is true there is a *drilling* permit, the oil company cannot get the permits to build the roads to the site, or to have water, electricity, or any of the other necessities required before drilling can even be dreamed of. This is again, a self-inflicted wound.

I apologize if all of this comes across as a bit of a rant. But is does have bearing on the investment world. Consider the negative consequences that "well-intentioned" rules and regulations have wrought. Consider how short-sighted and truly ignorant the people "in charge" have shown themselves to be. The energy & food crisis (and water crisis in the South West) was all caused by wishful thinking powered by unicorn farts & bubble gum theories, and they've now crashed headlong into physics and reality. There is an investment theme here: the bull market in energy, the "dirty" kind, has a lot more room to run.

Thanks for Reading & Please Feel Free to Share,

Tom Ellis

Disclaimer:
I of course, could be wrong, so I disclaim that nothing herein contained is specific investment advice. The views presented are my own and any projections or statements about the future may not come to pass. I feel silly writing something so obvious, but blame the lawyers…

Another important note: LPL Financial's economics team puts out some great content and is really quite good. You may have seen e mails or postings from me sharing their views. At this time I have a difference of opinion with them. They are more Bullish, I am more Bearish. I believe you may find it useful to read both their commentary and mine to see both sides.

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