3rd Quarter 2011 Commentary

“Nobody told me there’d be days like these, strange days indeed, most peculiar momma”
John Lennon-Nobody Told Me

Don’t feel bad, John, the rest of us didn’t get the memo either. We sure are in some interesting (not in a good way) and confounding times. There’s no TripTik or GPS for this one, folks. It’s not like we don’t know what the problem is, because we do. The global debt overhang is as daunting as a Mike Tyson roundhouse left coming at your head. But, as the rounds of this fight go on, we have lost the ability to shuck and jive to avoid the punches and are absorbing a lot of headshots as a result. The big issue is there are no quick fixes or easy solutions, as evidenced by a weak economy, shaky financial foundation, and unstable investment environment four years after the crisis first started. So, the drama builds and builds. It remains to be seen whether we continue with the drip, drip, drip of the current Chinese water torture environment or if we get the cathartic blow-off that clears the deck and allows the healing process to begin.

As the British trio Bananarama sang in 1983, it’s a cruel (it’s a cruel), cruel summer. The summer of 2011 was indeed quite a cruel one across many levels. The U.S. experienced a 5.8 earthquake on the East Coast, a major hurricane created massive flooding damage in the Northeast, wildfires and drought conditions hit the Southwest, the U.S. received a historic debt downgrade, economic conditions weakened, consumer confidence plunged, and a significant stock market decline all hit in the span of the last three months. It seems the only thing we did not endure was the locust swarm swooping in to eat all the vegetation.

There are a lot of holes in the dike and not enough fingers to go around. For now, it remains very uncertain as to what is the most effective solution to end the crisis. Uncertainty is the crux of the problem because markets and economies can’t function normally on a steady diet of uncertainty. Something meaningful and definitive needs to come out of Europe to allow the situation to stabilize/bottom and for the future path of stable growth to start again. As one of my favorite financial writers, Todd Harrison of Minyanville, says frequently, to get through it, we need to go through it. The good news is we are four years into the end game, but its timing remains uncertain and it will be quite a painful path to reach the final destination.

I Just Had to Include This One

If you’re wondering why Europe seems unable to craft a timely solution to its sovereign debt crisis, consider the following:

Pythagorean theorem: 24 words
Lord's prayer: 66 words
Archimedes' Principle: 67 words
Ten Commandments: 179 words
Gettysburg address: 286 words
US Declaration of Independence: 1,300 words
US Constitution with all 27 Amendments: 7,818 words
EU regulations on the sale of cabbage: 26,911 words
Source: Grant Williams-Things that make you go hmmmmmmm

The Era of Animosity

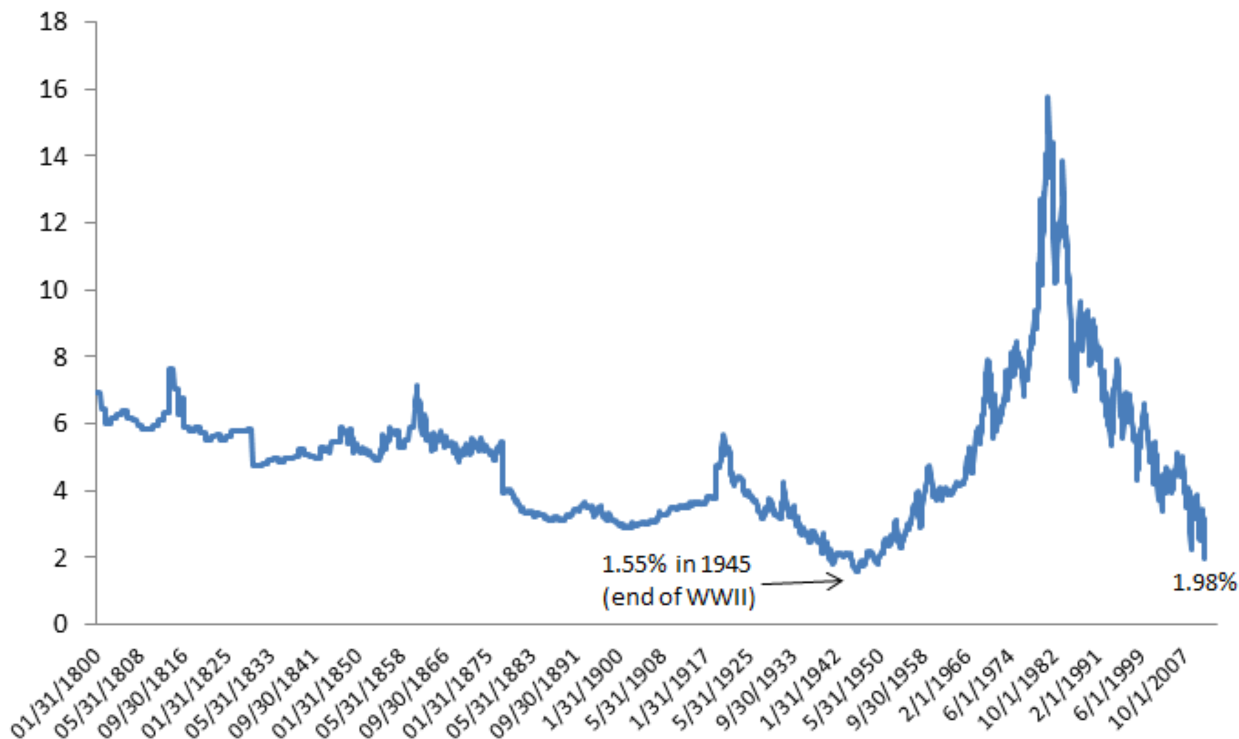
Here are some highlights of a recent Gallup Poll, which captures the embedded sentiment of the American public.

- A record-high 81% of Americans are dissatisfied with the way the country is being governed, adding to negativity that has been building over the past 10 years.
- 82% of Americans disapprove of the way Congress is handling its job.
- 69% say they have little or no confidence in the legislative branch of government, an all-time high and up from 63% in 2010.
- 57% have little or no confidence in the federal government to solve domestic problems, exceeding the previous high of 53% recorded in 2010 and well exceeding the 43% who have little or no confidence in the government to solve international problems.
- 53% have little or no confidence in the men and women who seek or hold elected office. Americans believe, on average, that the federal government wastes 51 cents of every tax dollar, similar to a year ago, but up significantly from 46 cents a decade ago and from an average 43 cents three decades ago.
- 49% of Americans believe the federal government has become so large and powerful that it poses an immediate threat to the rights and freedoms of ordinary citizens. In 2003, less than a third (30%) believed this.
  Source: Gallup

The Best Performing Investment No One Wants to Own

It may surprise you to learn that even in this ugly market there is an investment this year that has returned north of 30% through September 30th. It would seem a bit odd, wouldn't it, given that the news flow from financial markets seems universally bad? Well, believe it or not, long-term U.S. Treasury bonds are a huge performance winner so far this year. The Barclays 20+ Year US Treasury Index has returned +31.4% year-to-date through September 30th, almost **+40%** better than the return offered by US stocks as measured by the S&P 500 Index. Yes, the best investment in this lousy year for investing is in the securities of a government that couldn't get its act together on a credible deficit reduction/debt deal in early August; the same government that has racked up over $14.5 trillion of debt for which we will be paying as far as the eye can see; the same government whose debt lost its vaunted AAA rating as a result.

The chart on the next page provides a 200+ year perspective on the yield of the 10-year US Treasury bond.



Source: Bespoke Investment Group

This chart is a shocking reminder of just how low yields are today in the context of the past 200+ years. There was only one other brief period at the end of WWII where absolute yields were lower. During the third quarter, the 10-year yield reached a low of 1.70%.

The incredible performance of long-term U.S. government bonds this year has nothing to do with attractive fundamentals. Its business (the U.S. economy/tax revenues) stinks, its outstanding debt level is at all-time highs, and its debt rating was downgraded to AA+. If this were a corporate bond, the bonds would have tanked under this type of scenario. All else being equal, this would not be an attractive investment. But, all else is not equal. The Fed has been forced to implement extraordinary monetary policy (QE I, QE II, Operation Twist) to drive interest rates to extreme lows because the economy is in such dire straights and not functioning properly. In Europe, the situation is even worse. So, for global investors, the U.S. actually looks like a better place to ride out the storm. All of these factors have combined to increase demand for U.S. Treasuries and drive long-term U.S. Treasury yields to historic lows (due to bond prices being bid up). We are reaching the end of an epic era of declining bond yields, a 30-year period starting in the early 1980's where bond yields peaked near 17% to now where long-term bond yields are in the 2-3% range. How long the era of low rates lasts is anyone's guess, but we do know that bull markets don't go on forever. When the worm turns, it will be very ugly show for investors owning long-term U.S. Treasury bonds.

The Weakening Economic Trends

In addition to the European sovereign debt crisis, a key factor increasing market volatility and adding to the summer swoon is that U.S. economic trends have stalled and rolled over. The following charts capture economic activity and indicate the economy has decelerated and the risk of recession has increased.

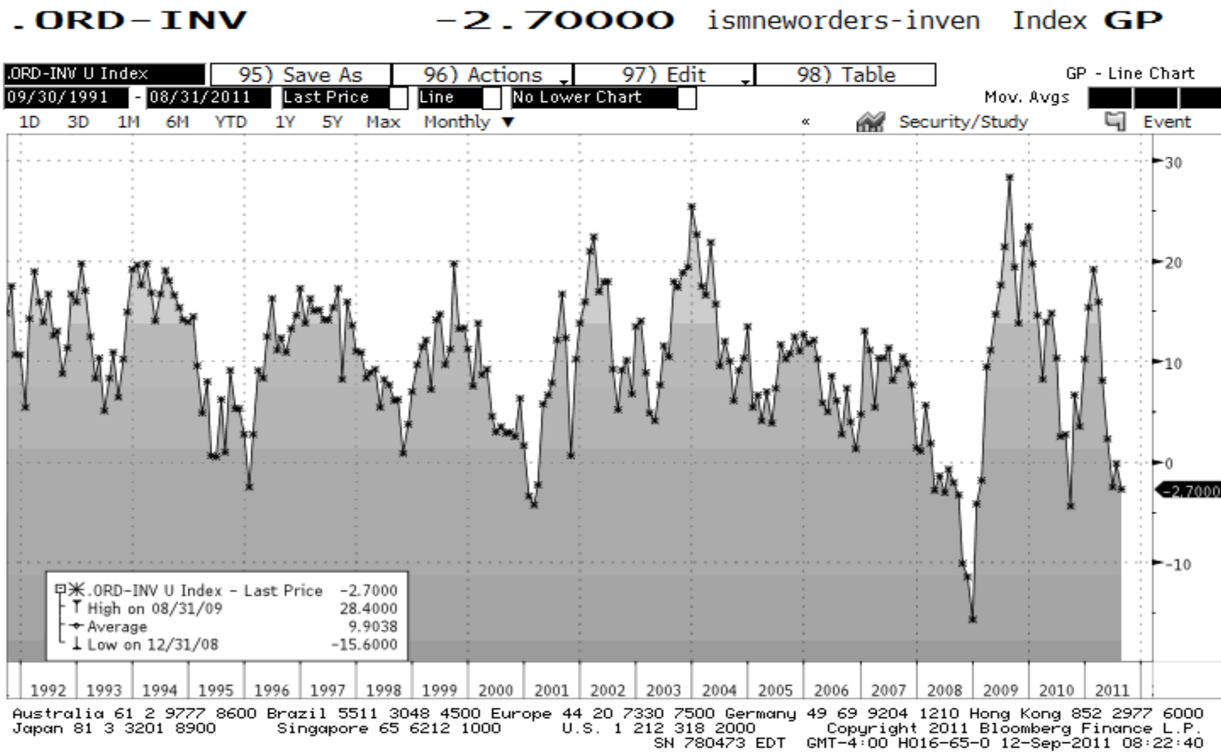
ECRI – Leading Indicators

Source: ECRI and Bloomberg

The chart above shows the Economic Cycle Research Institute (ECRI) Leading Indicators growth rate. The horizontal line represents the growth rate where the economy is typically in a recession. You can see from the chart that in the middle of 2010 the economy had another slowdown with the stock market experiencing a sizable pullback before recovering into year-end. We are seeing a similar pattern in 2011. However, based on the most recent data, it is hard to make the case that we will see a similar recovery into year-end without stabilization or a reversal of the decelerating trends. It is worth noting that ECRI in late September announced that the U.S. has again entered a recession (the dreaded double dip). ECRI has correctly called the last three recessions and the 2009 recovery so their track record is solid on these calls.

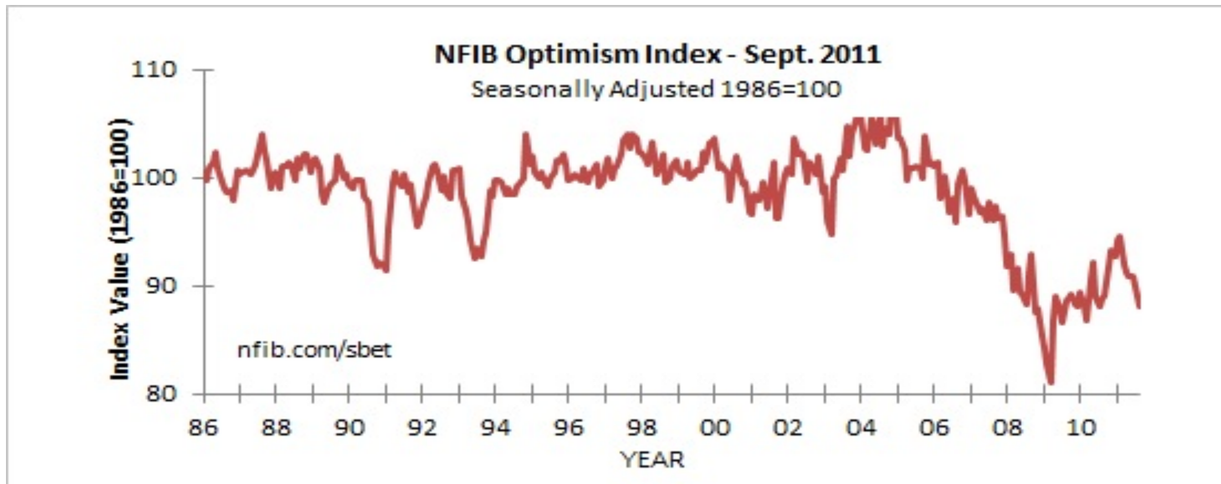
Another data point that has historically been helpful for identifying recessions is the ISM New Orders minus Inventories data from the manufacturing sector. We can see from the next 20-year chart just how significant a downturn we had in late 2008. Since then, we have had a snapback recovery and two decent sized dips. The first dip was last summer about the time the first round of the European sovereign crisis hit. The second one is now with the European sovereign debt crisis and U.S. budget/deficit crisis being the key catalysts.

ISM New Order Minus Inventories



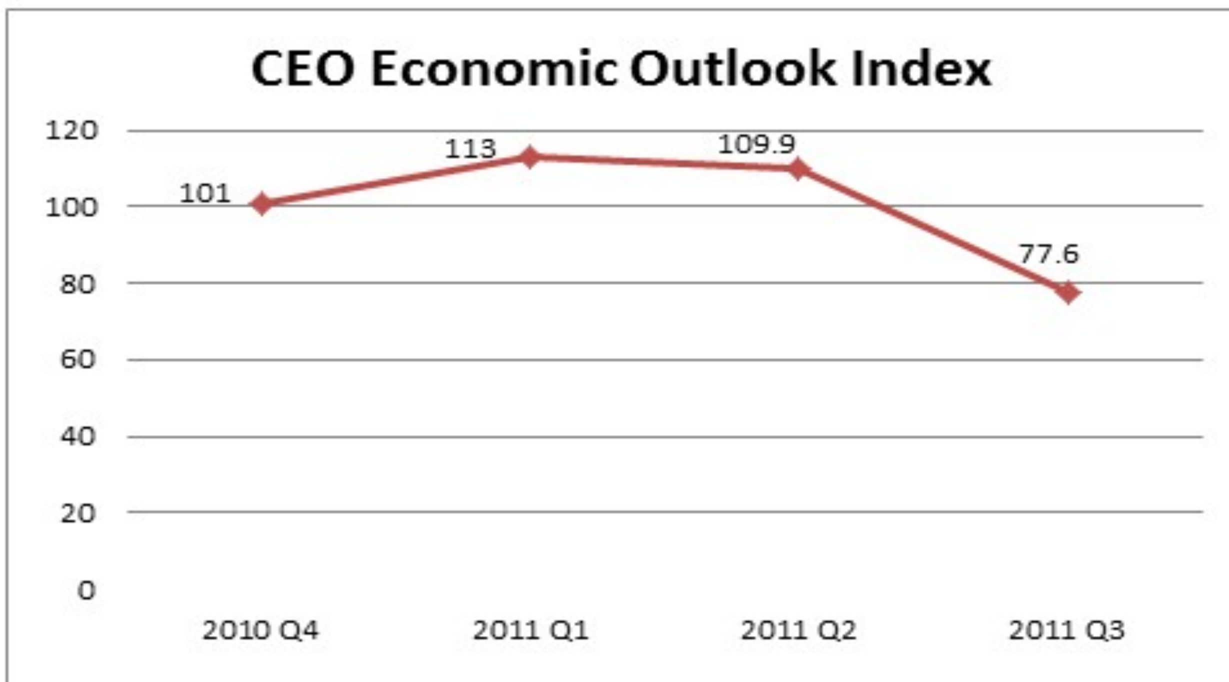
Source: Bloomberg

An important source of job growth for the U.S. economy is the small and medium business sector. The National Federation of Independent Business (NFIB) puts out a monthly survey of small business owners to get a pulse on economic activity and sentiment in this important segment of the economy. The following chart captures the data through September 2011 and paints a similar picture as the previous two charts. 41% of survey respondents said that they expect business to be worse six months from now. Low confidence means limited/no hiring plans. Note that over the past 20+ years, when the U.S. economy was healthy, the NFIB survey reading was north of 100. Even with the rebound off the 2009 lows, the survey never reached that level in this “recovery” and it is now rolling over again back below 90.



Source: National Federation of Independent Business; www.nfib.com

CEOs are worried like the rest of us. While they do have jobs and are rarely fired, CEOs are not feeling very confident either, which is also bad for hiring. The Business Roundtable recently published its third quarter 2011 CEO Economic Outlook survey of forward looking views on the economy. There was a significant decline in the recent survey from the second quarter reading and another data point confirming a sizable decline in confidence.



Source: Business Roundtable; www.businessroundtable.org

Earnings - The Next Shoe to Drop?

Now that weakening economic trends appear firmly in place, the next phase of the market reset process is occurring, and that is the earnings revisions process. Wall Street research analysts are not reactionary, and they often wait until trends are firmly in place before they go and make changes to their “long-term” earnings models. As we start the earnings season for the third quarter, we should begin to see negative earnings revision trends become more pervasive although the 2012 earnings reset process has already begun. This is very important because since the mid-2009, companies have consistently exceeded analyst earnings estimates and analysts were constantly revising their earnings estimates higher. The market loves positive earnings revisions (a key factor driving stock prices higher) and the positive earnings trends of 2009 through 2011 were then extrapolated into 2012. Now that the economic tide is moving out again and the U.S. economy is struggling to generate 1.5% real GDP growth, 2012 earnings estimates are probably too high because many were established in early 2011 when the economic outlook for 2012 was much better.

As we enter third quarter earnings season, the current 2011 EPS estimate for the S&P 500 Index is $98/share and for 2012 the estimate is $111/share or an expectation of 13% year over year earnings growth. The S&P 500 Index ended September at 1131. Based on the current 2012 earnings estimate, the stock market tradesw at 10.2X earnings multiple, which in a historic context is at the low end of its forward PE multiple range.

Let’s conduct a basic what-if scenario to frame an initial stock market outlook for 2012. If you are optimistic and believe the current 2012 estimate should hold up, then you have to believe the market is cheap, particularly in the context of historical valuation ranges. Assigning a reasonable 12X multiple on the 2012 earnings estimate of $111/share would put a fair value for the S&P 500 Index at 1332 or 17% upside from September 30th close. If one assumes the S&P 500 Index has no earnings growth in 2012, or earns $98/share (the same as the current 2011 estimate), and using the same 12X multiple, then fair value of the S&P 500 Index would be 1176 or 4% upside. If you are in the bear camp and believe the economy is in a double dip recession and earnings will decline next year, then fair value for the market is lower unless the market multiple expands.

In my opinion, the market is pricing in a moderate recession already and already discounting a lower earnings number for the S&P 500 than the current consensus earnings estimate of $111/sh. However, 2012 earnings visibility had notably deteriorated and conviction levels are low and the market multiple will not expand until major macro risks are resolved one way or another.

Can We End on an Optimistic Note, Please?

Okay, here is my best shot at it, at least in the short-term. The next chart shows the number of stocks trading above their 200 daily moving average (DMA), a key technical metric used by market players. Using this metric, over longer periods of time, the stock market typically trades in a wide range of 20% to 80% and has an average reading of 54%. When we touch extreme levels is when you consider going in the opposite direction of market sentiment. So, when it hits

80%, or 80% of all stocks are trading above their 200 DMA, the market has had a meaningful rally and its time to consider booking some profits. When it hits 20%, the market has experienced a broad sell-off and it may be time to consider putting some money to work in stocks. As of the last day of September 2011, this metric hit 11%. The low of the last decade of 5% was reached in March 2009 when the S&P 500 Index hit 666. At September 30th, the S&P 500 Index hit 1131. In the short-term, this may be a valuable perspective for those who are just now thinking about getting more defensive. Ladies and gentlemen, Elvis has left the building.

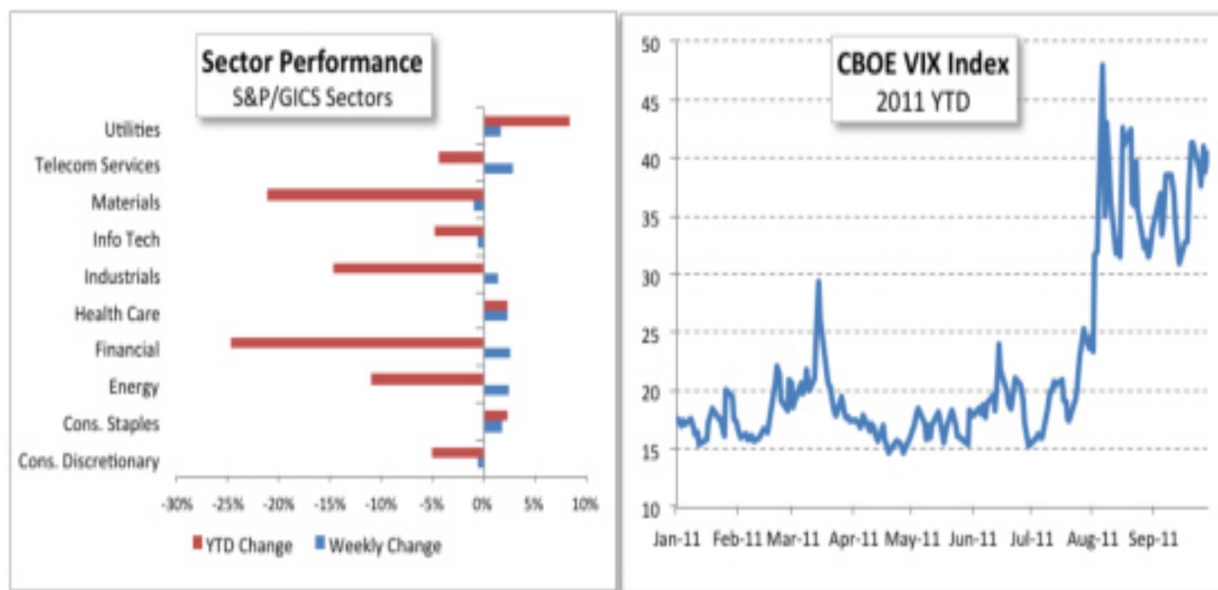
Source: JP Morgan

3rd Quarter Market Review

The table below shows some key market benchmarks for the third quarter and year-to-date through September 30th. It was the worst quarter for stocks since 4Q08.

	3Q11	YTD
S&P 500 Index (large cap stocks)	-13.9%	-8.7%
Russell 2000 Index (small cap stocks)	-21.9%	-17.0%
MSCI EAFE Index (international stocks)	-19.0%	-15.0%
MSCI EM Index (emerging markets stocks)	-22.6%	21.9%
Barclays Aggregate Index (fixed income)	3.8%	6.7%

The following chart shows the performance of each market sector year-to-date and the VIX Index, a measure of market volatility. Cyclical sectors are the worst performers year-to-date lead by Financials and Materials while defensive sectors are outperforming lead by the Consumer Staples and Utilities sectors. Since June, market volatility exploded to the upside.



Source: Bloomberg

Listed below are changes since the end of last year for a few key financial market indicators.

	12/31/10	9/30/11
10-Year US Treasury Yield	3.29%	1.92%
Gold/ounce	$1421.00	$1623.90
Oil/barrel (WTI)	$91.38	$78.72
Eur/USD FX Rate	1.34	1.3385

The top of the next page shows the charts of WTI Oil and Gold over the past several months. As fears of a double-dip recession have increased and demand has weakened, oil has seen a big decline from its peak near $114/barrel earlier this year. Declining oil prices eventually translate into lower gasoline prices, easing the burden on consumers and freeing up extra cash for other spending purposes. In a tough year for many, this decline will be a welcome respite just in time for holiday shopping season. So, we have that going for us.

Gold benefited significantly this summer as the most recent wave of the financial crisis hit but experienced a technical correction in September 2011 after it made a massive and rapid move in one months time from $1500/ounce to above $1800/ounce and had become overbought short-term.

Source: StockCharts.com

Summary

Undoubtedly, this market is not for the feint of heart. It is incredibly difficult to invest with confidence when the market swings wildly over very short periods of time, sometimes in hours or less. The type of daily volatility the market is now experiencing keeps long-term investors on the sidelines and allows traders to dictate the price action and move the markets rapidly in either direction. Professional traders are complaining too as they get whipsawed back and forth, a telling sign that no one with skin in the game feels in control.

During the third quarter, there were 34 trading days, or just over 50% where the market moved +/- 1.0% and 14 trading days or nearly 20% where the market moved +/- 2.5%. On the worst day, the market was down 6.5% and on the best day (of course, the next day) it was up 4.7%. Correlations of individual stocks and asset classes have increased to high levels as macro factors dominate the investment landscape.

This too shall pass, but macro risks (European sovereign debt situation tops of the list) need to recede significantly, which will allow market volatility to decline, and then the market psyche will switch to focusing again on the fundamentals.

Finally, Steve Jobs of Apple passed away this week at the young age of 56. He is a testament to how one person can profoundly change the world. Do yourself a favor, take 15 minutes, and watch this video of his inspirational commencement speech in 2005 at Stanford University.
http://www.youtube.com/watch?v=UF8uR6Z6KLc

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October 2011

Mark J. Majka, CFA is Chief Investment Officer and Managing Partner of MJM Investment Advisors, LLC. Mr. Majka has over 22 years of investment industry experience working for Mellon Bank (now Bank of New York Mellon), Wilshire Associates, Baring Asset Management, Scudder Investments (now Deutsche Asset Management), and BNP Paribas Investment Partners (formerly Fortis Investments). Before opening his own investment firm, Mr. Majka was co-Portfolio Manager and Research Analyst for the BNP Equity Small Cap USA fund with small cap research responsibility for the industrials, information technology, and telecom sectors and autos & suppliers industry group. Mr. Majka was also Portfolio Manager for the BNP Equity World Industrials fund and Senior Research Analyst covering the large cap Industrials sector on the BNP Large Core, BNP Equity Best Selection USA, and BNP USA Growth funds.

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