MJM INVESTMENT ADVISORS, LLC

First Quarter 2013 Investment Commentary

Welcome to the Grand Illusion

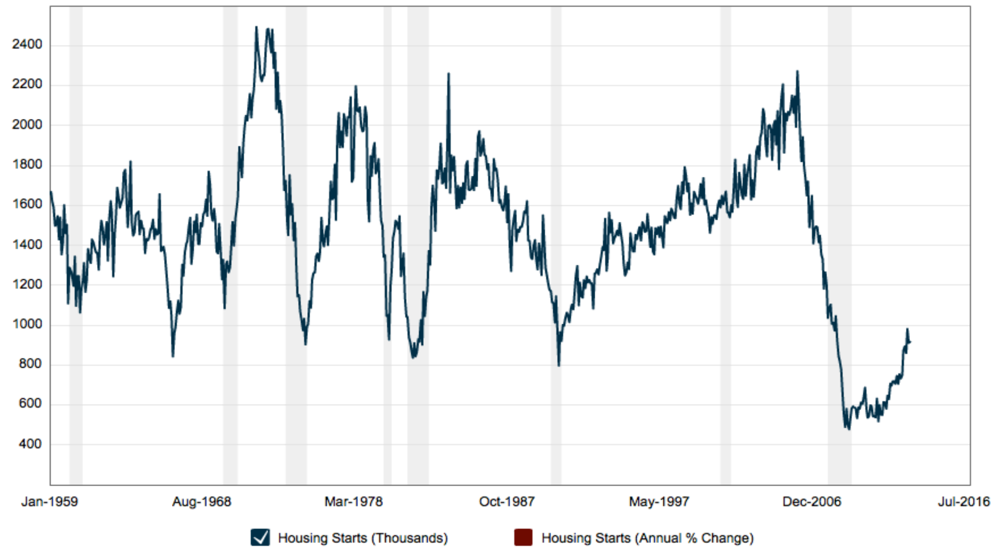
> **Welcome to the grand illusion, come on in and see what's happening, pay the price, get your ticket for the show. Styx-The Grand Illusion**

Don't be fooled by the radio, the TV, or the magazines. There is an endless desire to celebrate the "it's not as bad as we thought" achievements of this current economic "recovery". The Lake Wobegon town motto of "where all the women are strong, all the men are good looking, and all the children are above average" was adopted by the U.S. stock market during the first quarter as stocks advanced mostly unabated. The market gains were based on a foundation of less than 4% earnings growth and a subpar U.S. economic outlook and a deteriorating outlook in Europe. The main reason for the market advance continues to be the aggressive Quantitative Easing policies lead by central bank sensei Ben Bernanke. The only potholes during the first quarter came from Europe, but more on that later.

The first quarter of 2013 was eerily similar to the first quarter of 2012 when stocks moved strongly higher and finished with a +12.6% return (full year 2012 was +16.0%). The U.S. stock market returns are head and shoulders above what was offered in other major asset classes. The table below provides a snapshot of key market index returns during the first quarter of 2013.

S&P 500 Index (large cap US)	**10.6%**
Russell 2000 Index (small cap US)	**12.4%**
MSCI EAFE Index (large cap int'l)	**5.2%**
MSCI EM Index (emerging mkts)	**-1.6%**
Barclays Aggregate (invt grade bonds	**-0.1%**
Barclays High Yield (non-invt grade)	**2.9%**
Money Markets	**0.0%**

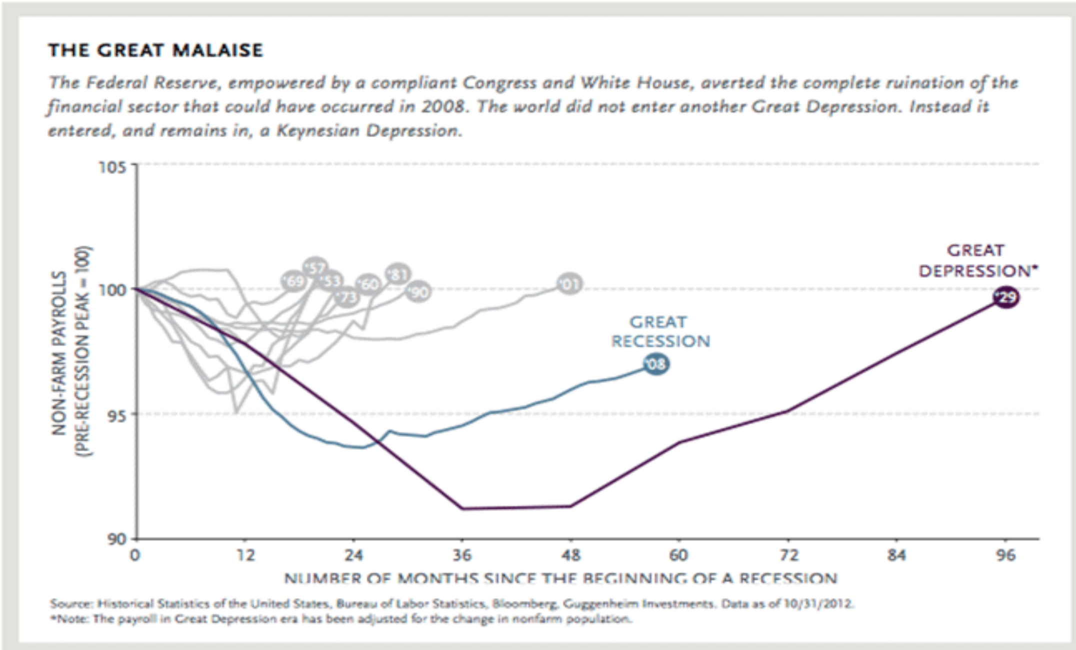
The stock market's robust returns were helped by the fact that U.S. housing starts are exceeding expectations, which is whipping up excitement that the housing market is finally on the mend and prices are now headed higher. Should it be that surprising that housing starts are surprising to the upside when the Fed's Zero Interest Rate Policy and mortgage-backed bond buying as part of its QE policy means that 30-year mortgages are being written at 3.0% rates? Annualized housing starts at these artificially low mortgage rates are now near the 900,000 level, but still weak in the context of historical data (next chart). If interest rates were not being artificially suppressed and a 30-year mortgage rates were normalized, would housing starts be surprising to the upside? Not likely. Should we mention that U.S. government agencies (and indirectly, the U.S. taxpayer) back nearly 90% of mortgages issued today, up from 30% in 2006. A grand illusion.



Source:macrotrends.org

Monthly job gains in February exceeded expectations, coming in at an upwardly revised 268,000. Job gains are the most important driver of consumer and investor sentiment so the big beat in February versus expectations was a big boost to stock market sentiment during the first quarter. However, March job gains at 88,000 were terrible and well below expectations for 190,000 of gains. In prior economic recoveries after severe recessions, the jobs recovery was quicker and more significant (see grey lines in next chart) than the current "recovery" (Great Recession line). Following past severe recessions, 400,000-700,000 of job gains per month was more typical as the economy regained momentum. Now, the stock market is getting excited about 250,000 of monthly job gains, five years after the financial crisis began. In addition, underneath the headline number, it is clear that most of those gains are hourly, low paying jobs and that there still is no meaningful improvement in the long-term unemployed problem in the U.S. At this pace of job growth, it could take 7+ years (2015) just to get back to the job levels that existed at the start of this past recession. A grand illusion.

What remains surprising (depressing) is the number of companies still announcing restructuring plans with major job cuts five years after the financial crisis. Companies are feeling intense pressure to produce earnings growth in a low revenue growth world so the main solution for many is cutting expenses (jobs).

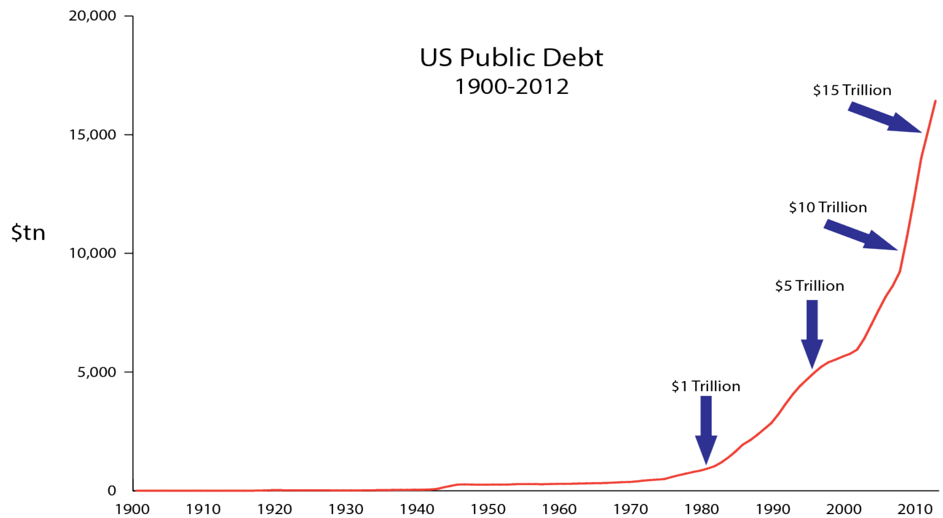


Source: Bloomberg

Source: Wall Street Journal

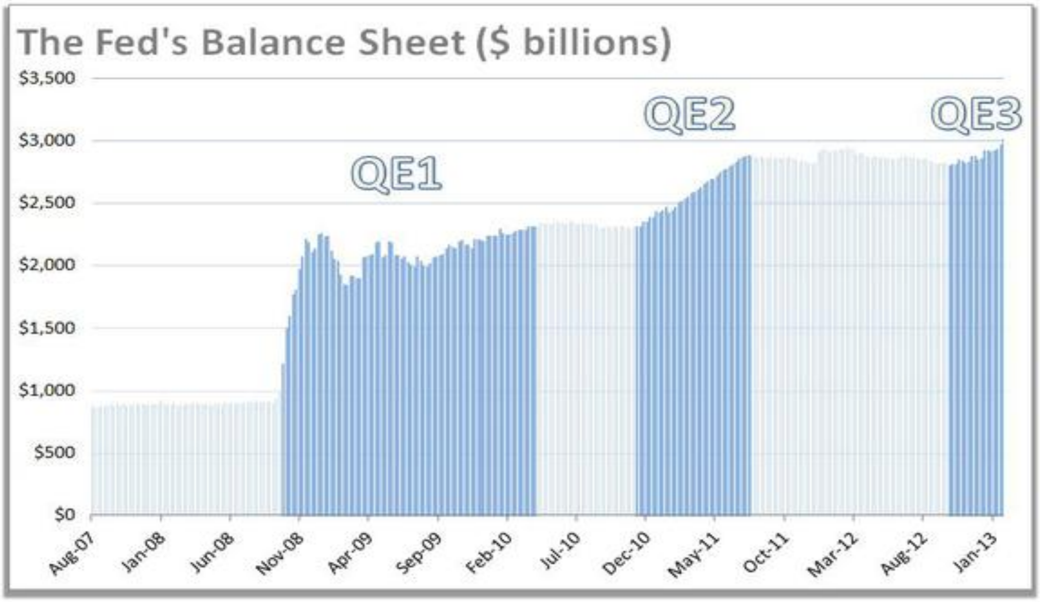
The unemployment rate dropped to 7.6% in March from 7.9% in January. This decrease is another sign of progress, right? Actually, given the drop in the labor force participation rate from those dropping out of the workforce from lack of success in finding work, the actual unemployment rate would be around 11.3% without the decline in labor force participation. This rate would put American unemployment a lot closer to the Eurozone's recently reported record high rate of 12.0%. The labor force participation fell further in March to 63.3, the worse reading since 1979. A grand illusion.

On the political front, the Senate actually passed it first budget in four years. Of course, that news helped investor sentiment and supported the stock market's first quarter advance. Congress also agreed to a budget deal that pushes out the hard choices AGAIN to September 2013 instead of the end of March deadline. But, hey, there will be no crisis, at least for another six months. Has there been any meaningful progress in a long-term deficit reduction plan to address the nation's $16 trillion debt problem. NO. A grand illusion.

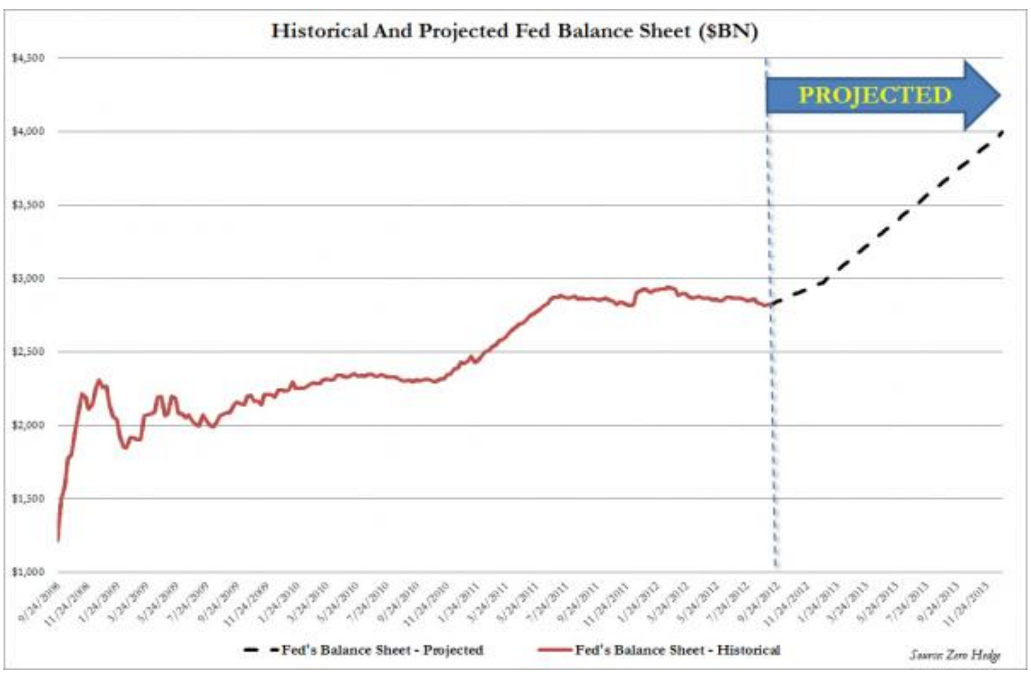


Pedal to the Metal

The Federal Reserve's QE policy is the main reason behind the stock market's advance and some of the improved economic data. The Fed is expanding its balance sheet at an $85 billion per month clip in order to artificially suppress long-term interest rates and jumpstart the economy and job market. The Fed is giving no indication that it is contemplating an end or reversal of its QE policy or a slow withdrawal from its bond-buying program. Assuming no change to its QE policy before year-end, the Fed will have expanded its balance sheet to nearly $4 trillion in order to support the economy. While the market is cheerful now, it is casting a leery eye to any discussion of the end or slowdown of QE. Whenever those headlines hit the market, the stock market has a rapid sell-off, an indicator of just how much support the Fed's QE policy has meant to this stock market's advance over the past several years. A grand illusion.



Source: Wall Street Journal



Source: Zero Hedge

Another One Bites the Dust

The only news that tripped up the stock market during the first quarter (and not for that long or that much) was some new cracks in the European foundation. The February Italian election, or lack thereof, was the first European pothole. Italy has an unstable political situation (former standup comedian Beppe Grillo's anti-establishment Five Star Party garnered over 25% of the vote; of course, Minnesota elected Al Franken to the U.S. Senate, so who are we to talk) and no one party has enough of a majority to form the next government, even as its financial situation deteriorates. The next election in Italy may not take place until September, creating a long period of instability and uncertainty. In Europe, it looks like another good year to take off the whole month of August for vacation.

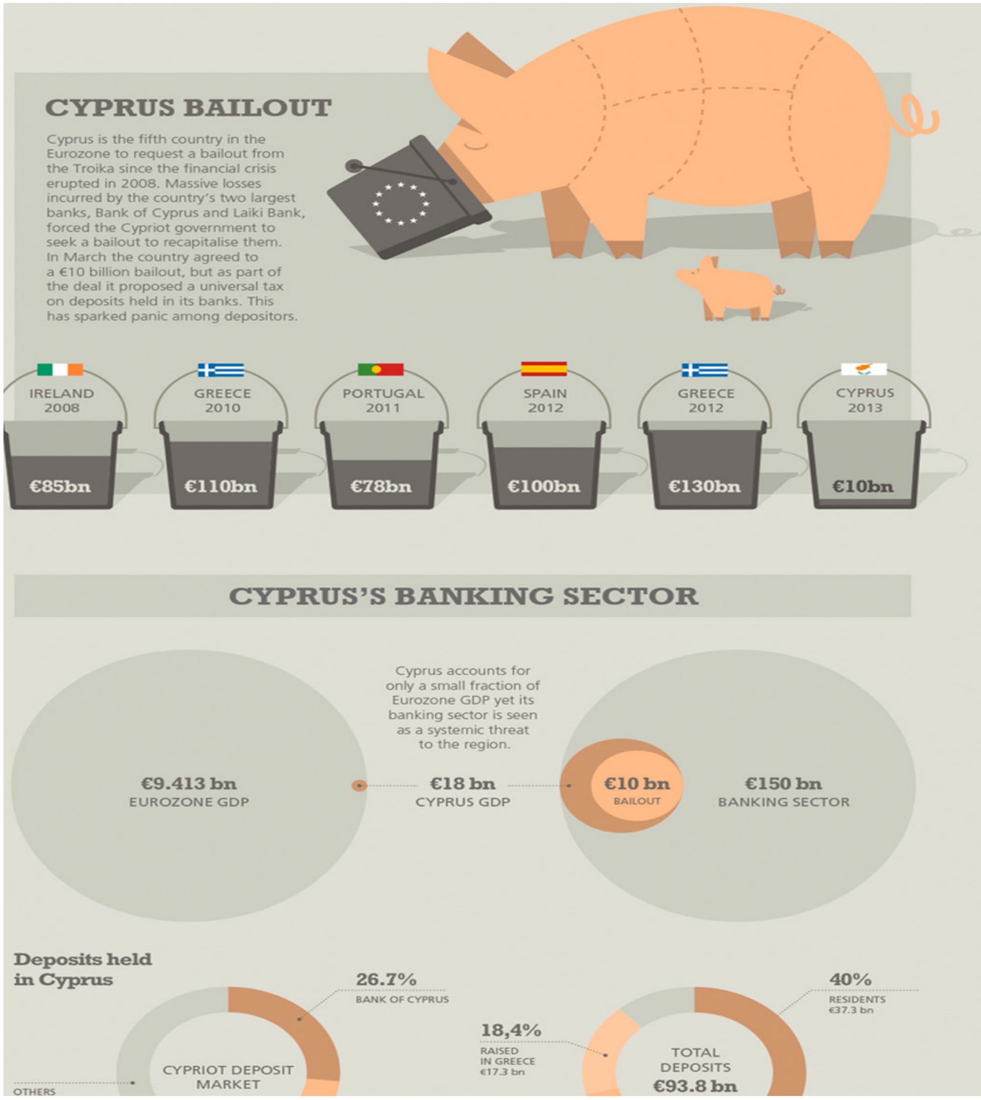
The others major issue was Cyprus, which was added to the list of European nations that required a bailout. Cyprus had only joined the Euro bloc in 2008 (brilliant!). The banks in Cyprus were loaded with Greek debt (facilitated and encouraged by ECB policies), which effectively made them insolvent since Greek bondholders lost 75% of their investment. Cyprus only has 1.1 million inhabitants and its GDP is (was) $18 billion but its banking system is $150 billion or 7X the size of its economy. Obviously, a lot of foreign deposits is (was) in its banks. Similar to prior crises, the ECB, IMF, and European Commission (the Troika) had to step in at the eleventh hour with another bailout. However, there was an important difference to the bailout terms this time. In all prior European bailouts, all depositors at the banks were 100% guaranteed. The Cyprus bailout terms demanded by that uninsured (large) depositors and bondholders/shareholders of those banks pay the price and cover some of the required bailout funds. Perhaps the fact that Cyprus, known as an offshore tax haven to many Russians that have not earned their money, ahem, legitimately, made it easier to propose such a solution. But, the fact of the matter is the well (German taxpayers) is running dry in Europe in terms of funds available for banking bailouts. Depositors in those Cyprus banks are paying a steep price for this change in bailout policy. It is projected that some uninsured depositors will lose as much as 60% of their savings.

To add on to the pile of concern, the Dutch Finance Minister Jeroen Dijsselbloem, head of EU Finance Ministers group, said publicly that uninsured depositors and bondholders in any European bank that fails should be parties to a recapitalization of the banks. I wonder how all the managements of U.S. companies that have large amounts of their offshore cash in European banks are feeling about this now? As you might expect, the markets reacted negatively to these comments and European bank shares and the euro took a hit. The Cyprus situation, and Dijsselbloem's comments, will most likely mean that large depositors at many European banks, but especially struggling banks in peripheral Europe, will start to withdraw deposits (you would have to be really stupid not to), which could facilitate the downfall of more weak European banks and create more financial distress or run on banks. Post Cyprus, it is now no longer clear in Europe how future bailout plans will be structured.

As shown in the next chart, credit default swaps on European financials have seen a large spike on this news, indicating increased demand for risk protection. So, once again, while time has marched on, there has been NO major progress in solving the European financial crisis. A grand illusion.

Source: Bloomberg

The following chart is a good graphic of where the bailouts currently stand in the Euro bloc. The next domino to fall could be Slovenia, as non-performing loans at its banks are now exceeding 20%. I'm sure all those depositors who have stashed their money in Slovenian banks aren't worried though. The new Slovenian prime minister had this to say. "Our banking system is stable and safe. Comparisons with Cyprus aren't valid. Deposits are safe and the government is guaranteeing them." Phew, that's a relief.



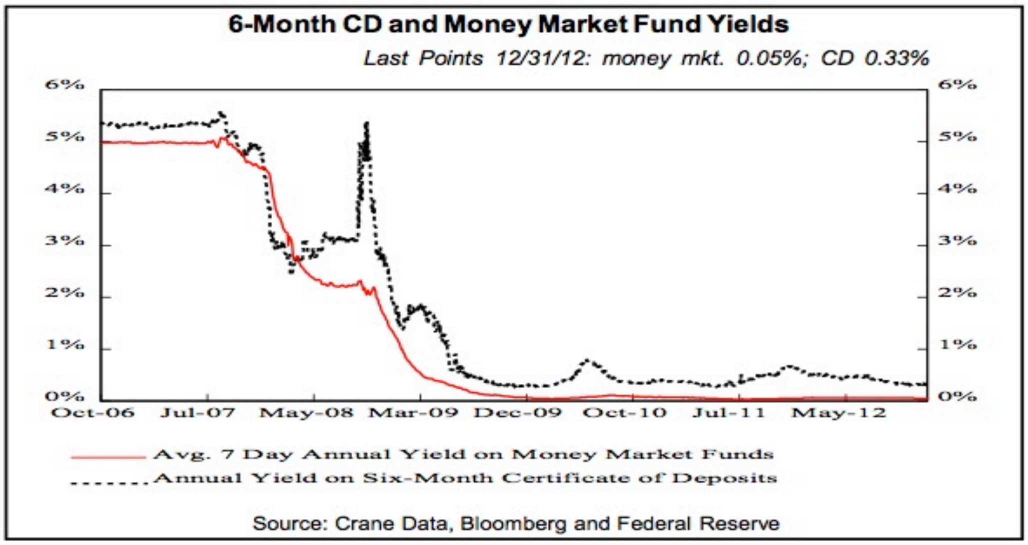
Source: Saxo Markets

Curb Your Enthusiasm

Don't count us in the giddy camp over the stock markets move higher. The U.S. stock market is benefiting from the best house in a bad neighborhood/flight to quality trade, an economy outperforming the rest of the world, and an aggressive central bank infusing massive liquidity into the system to support financial assets. Perhaps it is not too surprising that the stock market is performing so strongly, even if the underlying fundamentals are not as positive as the size of the move higher would indicate. We live in a world today where investors are desperate for any return on their investments. Here is what some of the alternative investment options in Ben Bernanke's Quantitative Easing Era are offering to investors today:

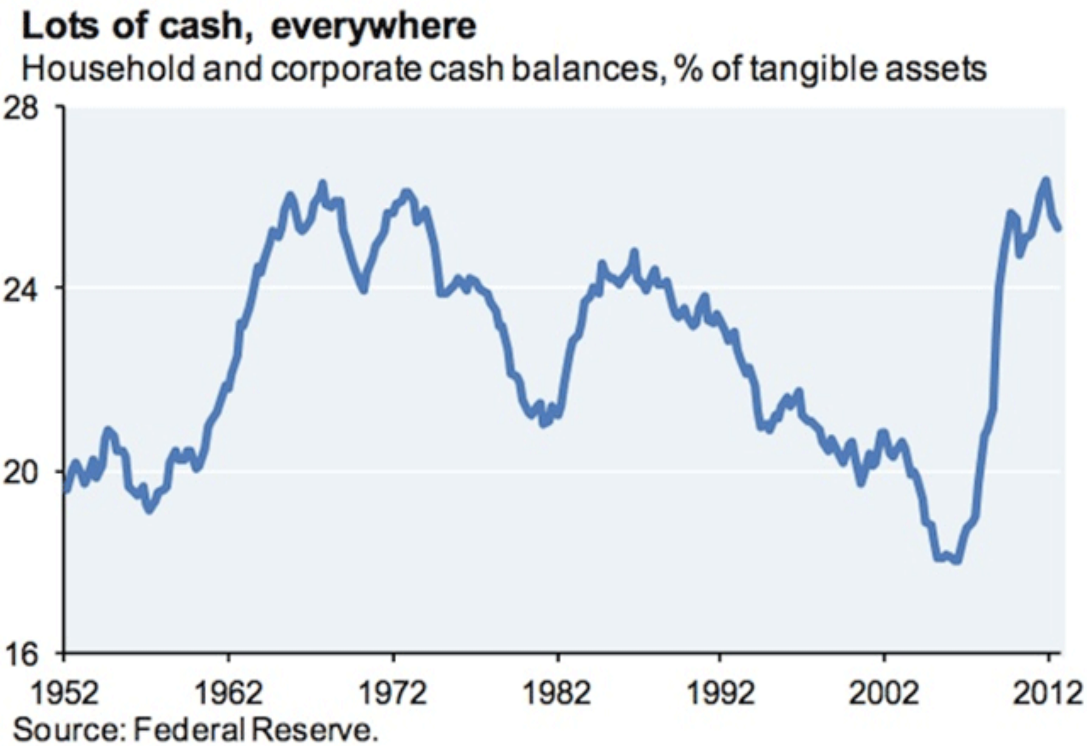
Short-term U.S. Treasury / Avg. Money Market yield: 0.1%
Six month bank CD: 0.3%
10-year U.S. Treasury yield: 1.7%
Total Bond Market Index Fund yield: 1.7%
High Yield Bond Fund: 4.4%

CHART 4



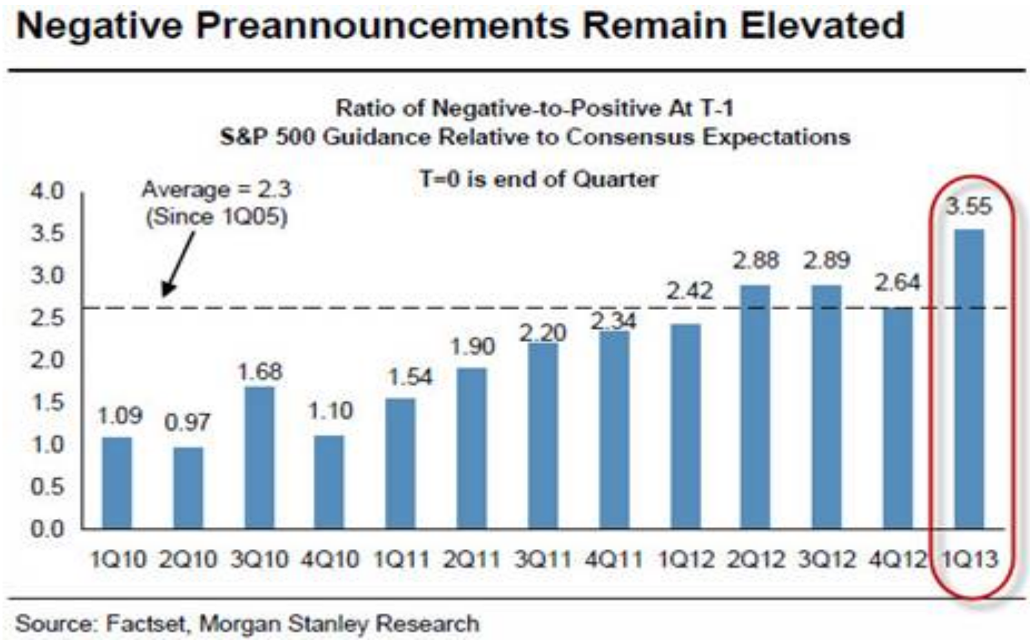
Despite a stock market that had a mostly unabated move higher since November 2012, sentiment readings are not yet extreme, as shown in the chart below of AAII Investor Sentiment readings. However, despite the strong performance of stocks and the piddling returns offered by money market and fixed income investments, it is interesting to note that retail investors are mostly missing out on this stock market rally.

Source: AAII



The chart above shows that businesses and households combined remain defensive, as cash balances as a percent of tangible assets reside near all time highs, even as those balances earn negative returns after the impact of inflation is taken into consideration. One of the arguments for the continuation of this rally is that there is still a lot of money sitting on the sidelines waiting to get in. While that is clearly true, it also true that the 2008 financial crisis and ensuing stock market collapse may have put a large number of investors on the sidelines forever.

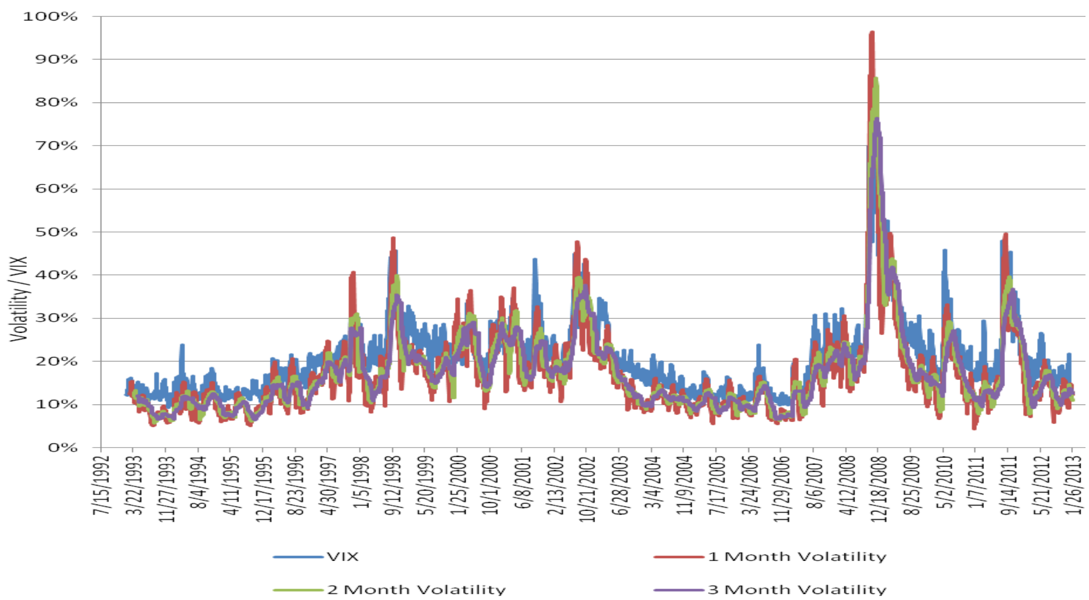
On the earnings front, the fundamentals are not as strong as the market move northward would seem to indicate. More companies are negatively preannouncing earnings and since the beginning of 2012, more companies are failing to meet earnings expectations. A grand illusion.



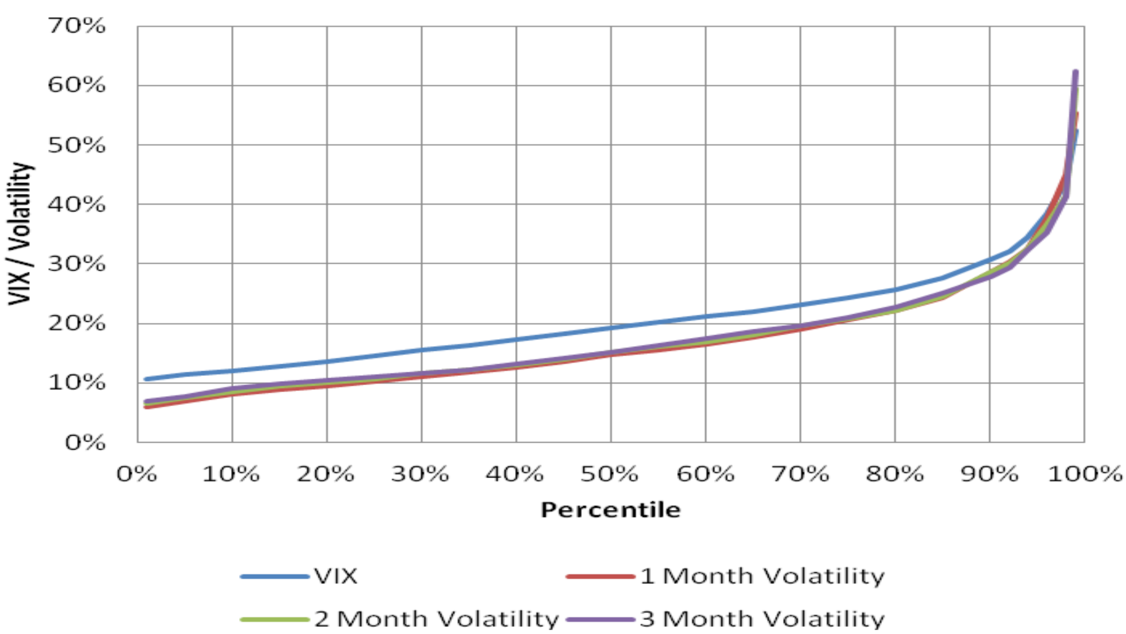
Volatility

Despite the fact that no major macro risks have been put to bed, volatility in stocks and bonds are near all-time lows. The VIX (a measure of short-term market volatility) is now 12.9%, and the current trailing one-month, two-month, and three-month volatilities for the S&P 500 Index are 12.2%, 11.0%, and 12.6%, respectively. These levels correspond to the 15th percentile for VIX and about the 35th percentile for S&P 500 historical volatility.

VIX vs. Trailing 1-, 2-, and 3-Month Volatility in the S&P500



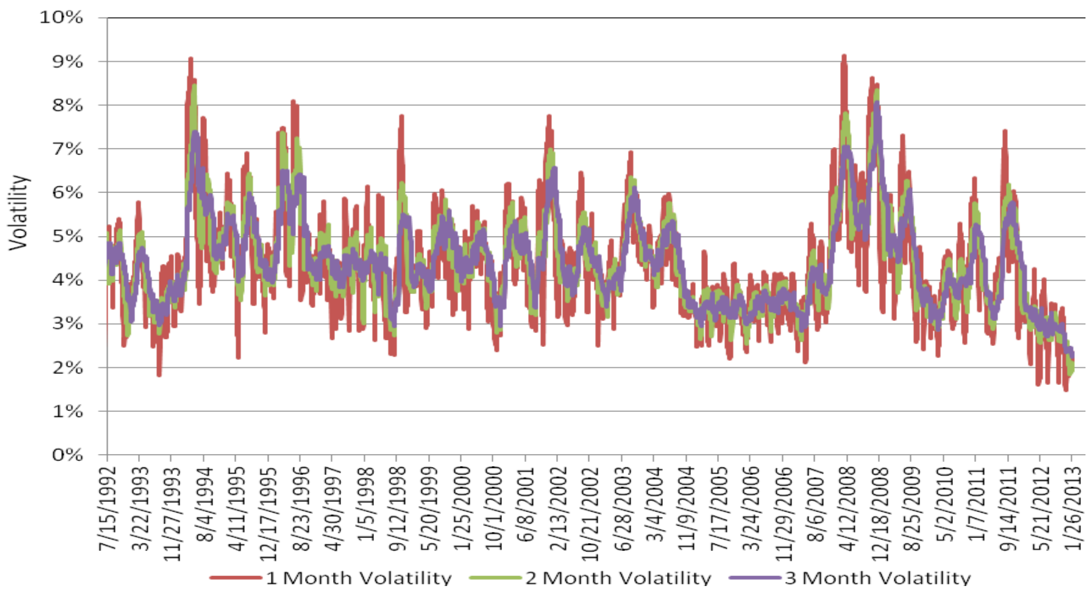
Percentiles for VIX and historical S&P 500 volatility



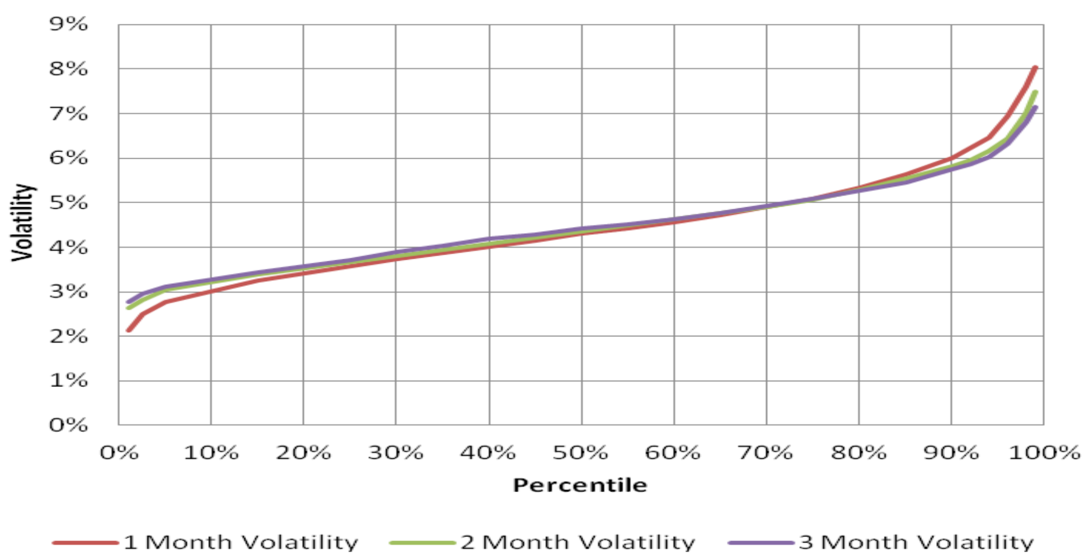
Source: Geoff Considine: Quantext

The situation in bonds is even more extreme, brought on by the Fed's unprecedented Zero Interest Rate Policy. The current volatility for VBMFX is first percentile, meaning that the volatility of this bond index has been greater than the current level 99% of the time. In layman's terms, the risk/reward of investing in bonds sucks.

Historical volatility of bond index (VBMFX)



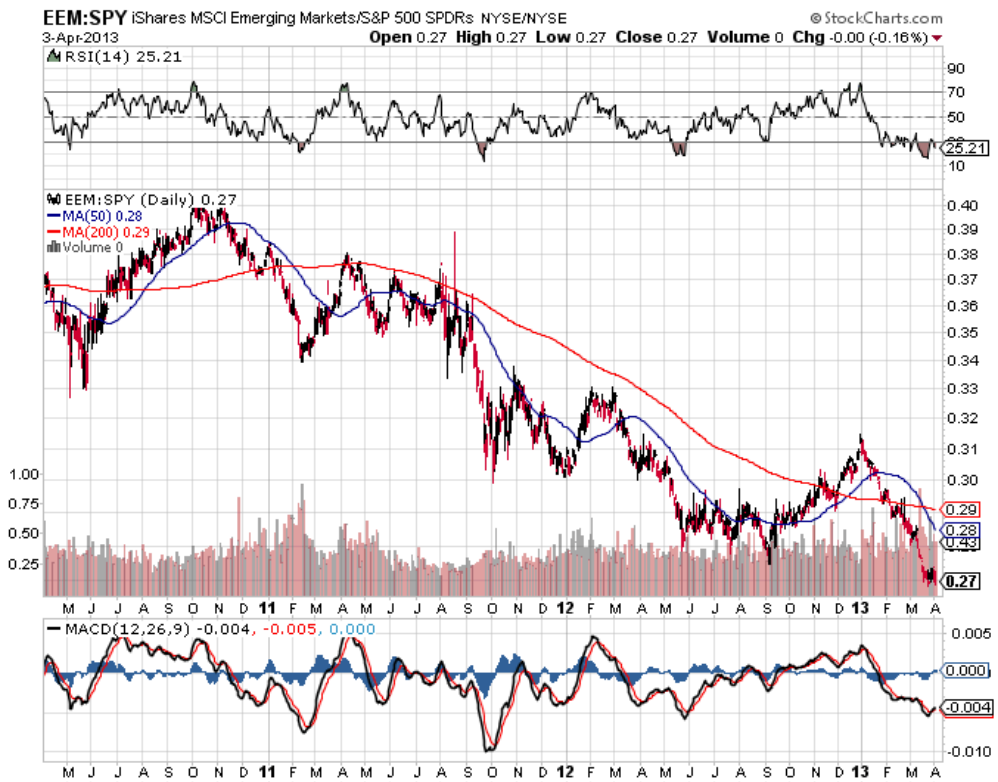
Percentiles for aggregate bond index volatility



Source: Geoff Considine: Quantext

Hmmmmmmmm

The following chart shows the relative performance of the MSCI Emerging Markets ETF vs. the S&P 500 SPDR ETF. If we were in a improving global GDP growth environment, emerging markets, which are highly sensitive to global GDP growth, would be outperforming the U.S. stock market and the line in the chart below would be moving higher. Since the beginning of the year, emerging markets stocks have dramatically underperformed the U.S. market by a whopping 12% and are near the lowest point relative to the U.S. market over the past three years. Global investors are flocking to the U.S. market as the best house in a bad neighborhood, driving the U.S. stock market higher relative to the rest of the world (and making U.S. investors feel much better than they really should be), and perhaps creating an overvalued situation in the U.S. stock market versus the rest of the world. Can it really be that much better here in the U.S. versus the rest of the world such that emerging markets should be underperforming to the degree they have over the past three years? Discuss amongst yourselves.



Summary

Like everyone else, I am all for seeing my net worth head higher. But, I for one would prefer to see markets head higher on improving fundamentals and decreasing risks. Alas, such is not the backdrop to the stock market's surprising first quarter advance. I am reminded of one of the intense scenes in the movie Platoon, right before the last big battle, where Sergeant O'Neill (Red), nearing the end of his tour, pleads with Sergeant Barnes to be given an early ride out on a helicopter. "Bob, I got a bad feeling on this one, all right? I mean I got a bad feeling! I don't think I'm gonna make it outta here! D'ya understand what I'm sayin' to you?" Sergeant Barnes (Tom Berenger-incredible role, but how did his career go kerplunk after?) responds, "Everybody gotta die sometime, Red." We'll see how the U.S. stock market fares through the next battle scene.

So, if you think your life is complete confusion, because your neighbor's got it made. Just remember that, it's a grand illusion, and deep inside we're all the same.

Mark J. Majka, CFA
Chief Investment Officer
www.mjminvtadvisors.com

April 2013

IMPORTANT DISCLAIMER: