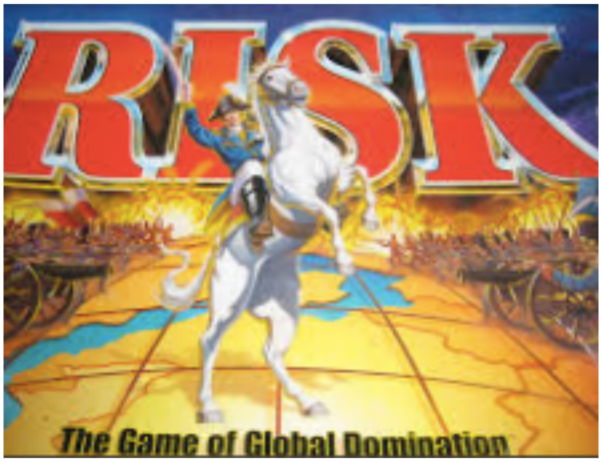
MJM INVESTMENT ADVISORS, LLC

First Quarter 2014 Investment Commentary



The game of Risk was a favorite growing up. Not only does it have a world domination angle to it (every child has a dream), it also has a risk/reward angle to it as well, which was an early lesson in understanding the basic premise of financial markets. You're going to invade (go long) Kamchatka from Alaska? Well, before you roll the dice (invest), you better have some kind of troop superiority (proprietary research edge) and plenty of reserve troops (cash) in the Northwest Territory in case your attack (investment thesis) fails and your opponent (short sellers) counterattacks (piles in). Nothing was more satisfying than moving troops into a newly seized territory and watching your opponent's face break out in sweat as their right flank crumbled and they realized they were a miserable failure at such an early age. With Kamchatka secured, it was onto Yakutsk and then the World!!

Interestingly, a Frenchman invented the game of Risk (originally called La Conquête du Monde) in 1957. Clearly, after the French embarrassments of WWI and WWII, the only way a French person could be affiliated with the term global domination or succeed in invading another territory was to invent a board game about it. The game sold like hotcakes in France, especially amongst the French military.

Land grabs, a key objective of Risk, have existed throughout history, whether through military or political acts. When I hear the term annexation, I think of the Sudetenland (who doesn't?), the western and northern areas of the former Czechoslovakia that were inhabited by mostly German speaking peoples. Germany entered and annexed the Sudetenland in October 1938 after Neville Chamberlain, the Prime Minister of (Not So) Great Britain signed an agreement (without the Czechs approval or participation) with Herr Hitler giving Germany the Sudetenland and claimed "peace for our time" afterwards. Nice call, Neville. Hitler was just getting warmed up.

Annexation now has an updated image in the form of the Crimea Peninsula where a tug-a-war between West and East is at hand. Another whacko is involved by the name of Vladimir Putin, who is taking a page out of Hitler's strategy book to achieve his agenda. The Crimea Peninsula is located in the present day Ukraine. As an aside, the Risk logo above was most likely based off of the Charge of the Light Brigade (immortalized by Alfred, Lord Tennyson), a British cavalry unit that was decimated charging the Russian lines during the Crimea War. But, I digress.

Ukraine in the east is populated with ethnic Russians who mostly affiliate with old Soviet Union types while western Ukraine wants to join the European Union. The Crimea Peninsula in the east has provided the Russians with an important deep water port for its military fleet. Given this fact, the idea that the Ukraine could fall under Western control is a non-starter for Russia. To counter western influences and maintain the Ukraine as an important land buffer between the west and itself, Russia initially used economic threats like cutting off important gas supplies, which flow via pipelines from Russia through the Ukraine to Europe. Next they used outright military intimidation by amassing troops on the Ukraine border. To further enhance their position, Russia helped facilitate a quick vote for Crimea to secede from the Ukraine, which passed with 97% approval. Once that deal was sealed, Russia quickly moved their troops into Crimea and took over all of the military bases located there. The United Nations declared the Crimea vote invalid and western powers are now trying to enact sanctions to penalize Russian aggression. So far, it matters little to Putin and the momentum is in his corner. More eastern Ukraine provinces, with Russian encouragement, are now looking to hold referendums about seceding from the Ukraine and rejoining Russia (the theme song being played at the rallies is Back In The U.S.S.R.).

Putin is an apparatchik in the old Russian style, ex KGB, and not someone who wilts under global pressure. He is now negotiating from a position of strength. Wait, this just in. Secretary of State John Kerry is trying to facilitate a resolution of this crisis. Will John Kerry be this era's Neville Chamberlain? Don't bet against him.

For the past several years, financial markets have been all about reward and mostly looked through many risks. Risk has taken a back seat, mostly due to the fact that global central banks have provided game players, via extreme monetary policies, with the confidence to know that every roll of the dice would come up a 12. Now, we may seeing the early stages of where risk once again matters, as does risk management in portfolios. So, for those of you that have not played the game of Risk in a long time, it may be a good time to pull out your old board game and get a Risk tune up. The game of Risk is just about to begin.

First Quarter Markets Commentary

After a straight moonshot year during 2013, the U.S. equity market settled into consolidation mode during the first quarter. As has been the case for some time, the U.S. still looks like the best house in a bad neighborhood, relatively speaking. Global issues created more market volatility as emerging market currency volatility, the Crimea Peninsula affair, and Chinese economic slowdown and debt concerns were negative factors during the first quarter. Weak U.S. economic data helped bonds rally, contrary to most expectations.

An ugly winter in a majority of the U.S. played havoc with economic activity, from car sales to housing starts to retail sales to school openings. The only robust areas of economic activity in the first quarter were municipal pothole fillings and snow blower sales. Given that that the U.S.

economy has been in a fits and starts mode for several years, the big question is whether or not weather has been the main reason behind the most recent soft patch of economic activity or if this was just another periodic slowdown that has been typical over the past five years. In light of all that occurred during the first quarter, equities still managed to finish in positive territory. The Fed and QE remain a critical support mechanism for risk assets. The Bernanke (now Yellen) put remains a big factor on market dynamics.

The following table highlights performance of major assets classes during the first quarter.

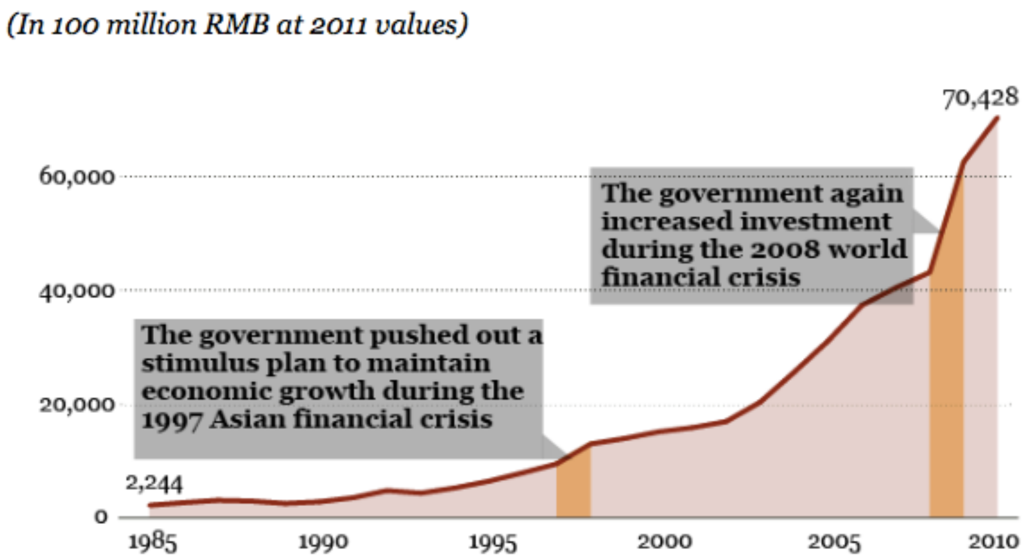
	First Quarter
S&P 500 Index (large cap US)	**+1.8%**
Russell 2000 Index (small cap US)	**+1.1%**
MSCI EAFE Index (large cap int'l)	**+0.7%**
MSCI EM Index (emerging mkts)	**-0.4%**
Barclays Aggregate (invt grade bonds	**+1.8%**
Barclays High Yield (non-invt grade)	**+3.0%**
Barclays Short-term Treasury bills (cash)	**0.0%**
Gold	**+6.0%**
Brent Crude Oil	**-5.0%**

China

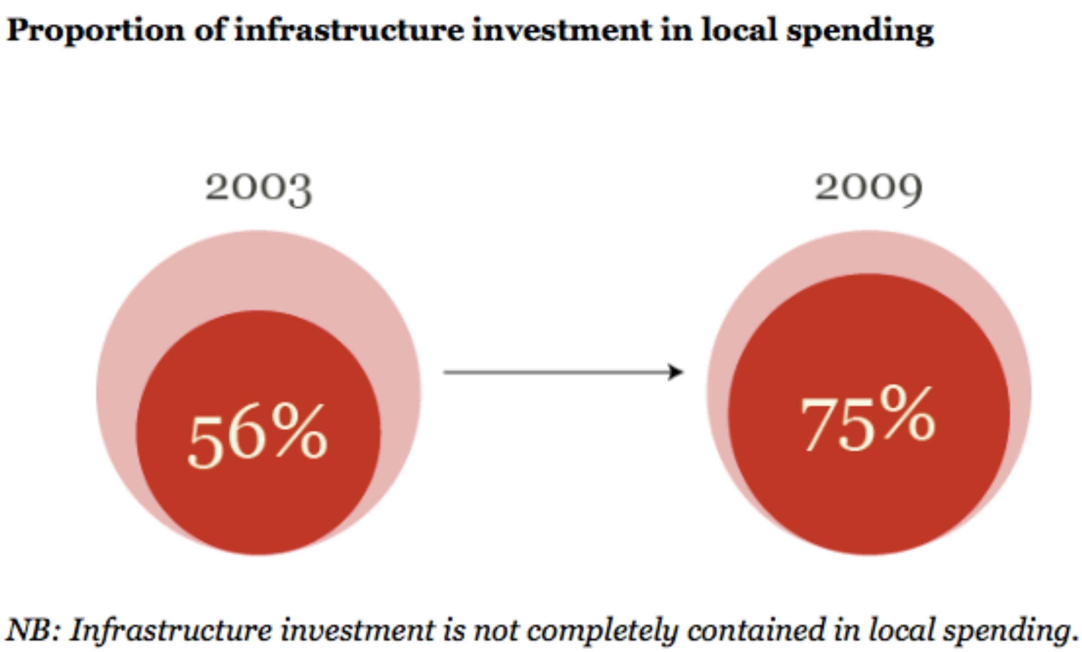
In the game of Risk, a successful player constantly evaluates the game board to know where the greatest risks to ones territories reside. The Investment Outlook has endlessly discussed global central bank monetary policies and how QE and other similar programs have created a huge support mechanism for risk assets like stock markets. Make no mistake. QE remains the most important factor that will influence financial asset returns in the short and medium term. However, now that the Fed has begun the process of QE tapering, and it appears it will end its QE related bond buying by later this year (assuming it keeps on its current reduction path), other risk issues are now moving to the top of the list for investors to consider. China is clearly a big one.

Since the Great Financial Crisis, as western economies have struggled to deal with the economic fallout of the global debt crisis and economic growth has suffered, the world has relied heavily upon China GDP growth to help support global GDP growth. Going back to 1991, China's annual real GDP growth has ranged from high single-digit to low double-digits, which are mind-blowing numbers when compared to the U.S., which has not seen 3% real GDP growth since 2006. European growth has been even worse. How has China produced such high levels of economic growth? As shown in the next two charts, over the past 15 years, China has spent massively on infrastructure projects, with infrastructure spending almost doubling since 2008.

China Infrastructure Spending



source: tealeafnation.com



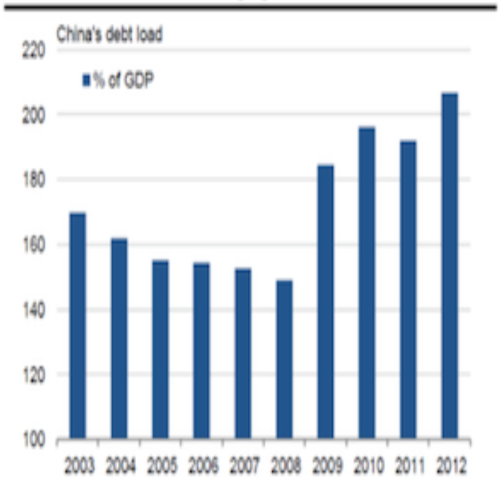
source: www.tealeafnation.com

During this period, China overspent and overbuilt. For example, it is well known that large cities (large by western standards, not Chinese standards) were built in China, some of which, like Ordos, are ghost towns today. Another over-the-top project is the New South China Mall, in Dongguan, another massive project that stands nearly empty. It is 7.1 million square feet of upscale retail space that resides in a city whose residents are mostly low wage factory workers. By comparison, the Mall of the Americas in Bloomington, MN has 4.87 million square feet of space. There are plenty more of these examples in China.

China's financial institutions (most are state controlled) and local regions are loaded with large amounts of unperforming loans from this period of overinvestment. China is not a transparent economy, so getting an accurate picture of its total debt profile is difficult but some estimates of the size of the debt problem exist. The China Academy of Social Sciences estimates that China's total debt in 2012 was $18 trillion or over 200% of GDP. In China, its debt problem resides in its private sector. Since regional authorities are not allowed to issue debt, many of them set up off-balance sheet financing vehicles to fund infrastructure projects. This is why their debt is categorized as private instead of government. Some of these distressed debt situations are coming to the fore in recent months through highly publicized defaults or bailouts.

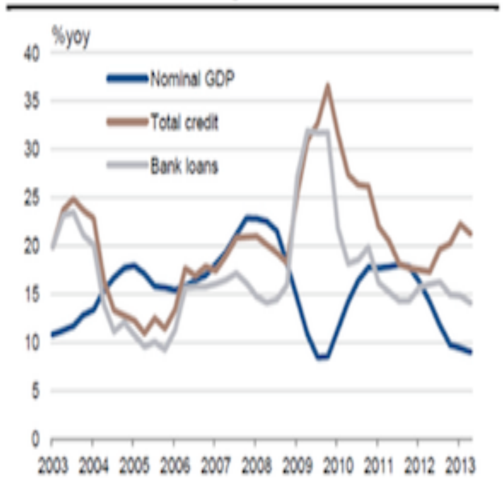
As shown in the next two charts, China debt has ballooned since 2008. From 2003-2013 China's year-over year debt growth has ranged from 10% to 35%. In the west, excessive sovereign debt has been a major factor behind poor/slow GDP growth. Now, China may be at the beginning stages of its own debt crisis, which could also have a major negative effect on GDP growth.

Chart 1: China's Great Leveraging since 2008



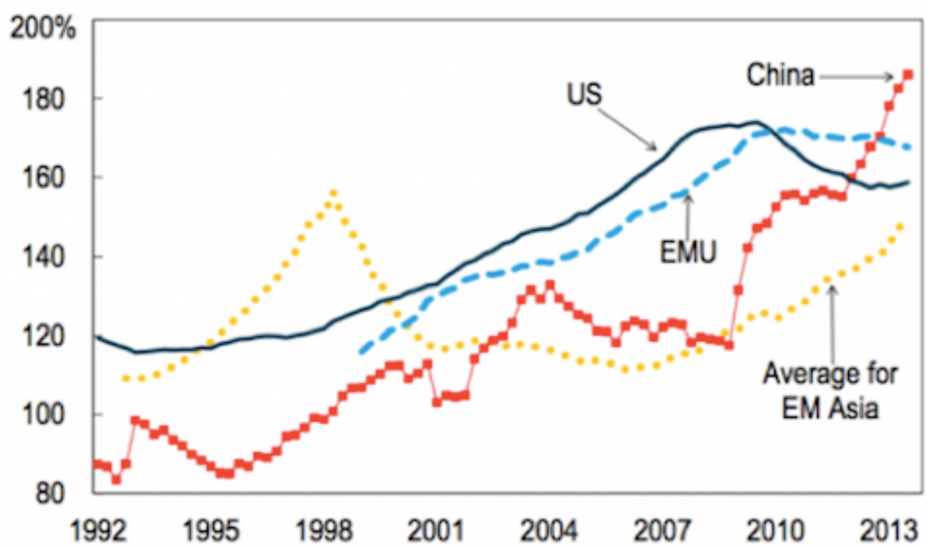
Source: PBoC, HKMA, NBS, CEIC, SG Cross Asset Research/Economics

Chart 2: More credit for less growth



Source: PBoC, NBS, CEIC, SG Cross Asset Research/Economics

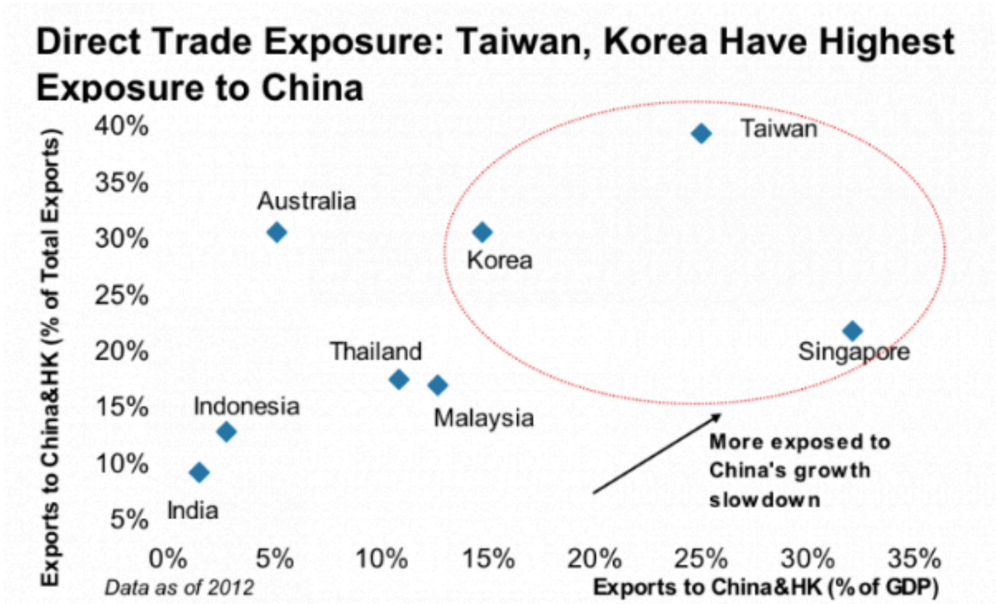
Figure 8. Selected Countries — Private Sector Debt as Pct GDP, 1992-2013



Today, China and the world economy are at an important crossroads. China is trying to transition its economy from one focused on investment spending to a more balanced economy where services and consumer spending are a bigger part of total GDP. But, after explosive growth of debt and misallocation of capital, there are increasing signs of credit stress. Debt fueled overinvestment has been the precursor to many financial crises through time. The financial markets have placed a lot of faith in China's ability to manage this situation. Perhaps they can, but history suggests that the risks are high and understated by global investors.

Since the West is still struggling to achieve decent GDP growth (3% real GDP growth, PLEASE!), having an important leg of growth start to wobble at this time is problematic and a downside risk for global markets. China has a public goal of managing its economy to a 7-8% real GDP growth target in 2014 and its leaders increasingly try to convince the rest of the world that it is on track to do so. Recent economic data is less convincing. China is now talking about new stimulus programs in key sectors like housing and railways in order to provide additional support to its economic growth targets.

The next chart shows how many emerging economies in the Asian region rely heavily upon China for growth. A big reason behind the major underperformance of emerging markets stocks over the past two plus years is the negative impact of China's economic slowdown on their economies as China transitions towards a more balanced economic growth model. Countries and companies that were major exporters to China during its infrastructure spending heydays have suffered the most.



Source: CEIC, Morgan Stanley Research

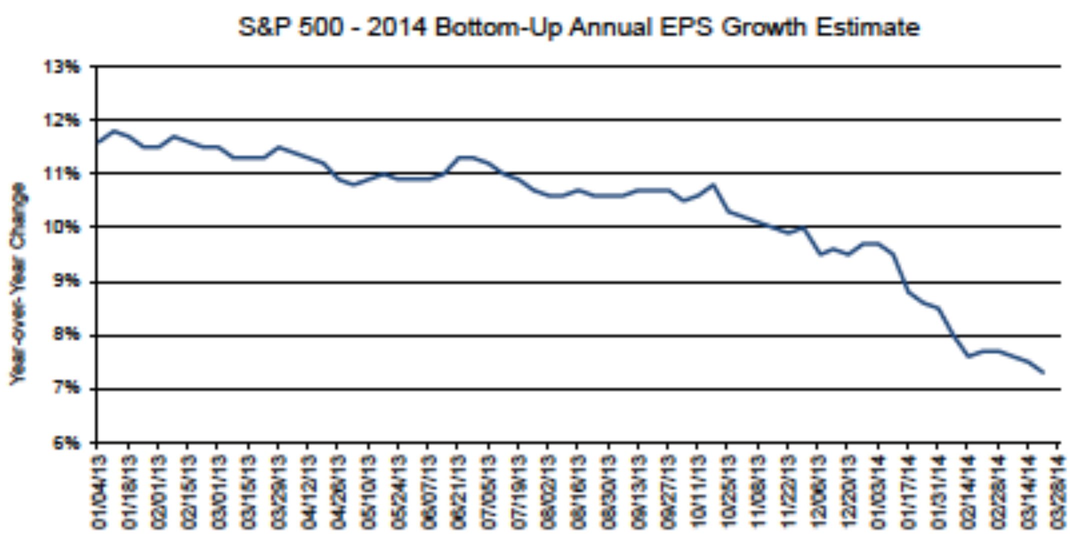
As China seeks to gain a better balance in its economy between capital investment and consumer spending, its manufacturing sector is struggling to grow. The next chart of China's Purchasing Managers Index shows that China's manufacturing sector has struggled to achieve growth since 2011 with a 50 reading the demarcation line between growth and contraction.

An important point to keep in mind about China is that it has the financial wherewithal to stimulate its economy should growth start to slow below their stated target. China's foreign currency reserves amount to $3.7 trillion compared to only $34 billion of externally issued debt (the U.S. should be so lucky). China's centrally planned economy gives it plenty of dry powder to control short-term demand. Additionally, a centrally planned economy with most of the banks under its control enables China to quickly implement potential stimulus programs.

Things are different in China than the rest of the world. KFC is the biggest and most popular fast food chain and Volkswagen and Buick are two of the biggest selling car brands. What other proof do you need? Even so, excessive spending and debt levels speak a common language.

Earnings Update

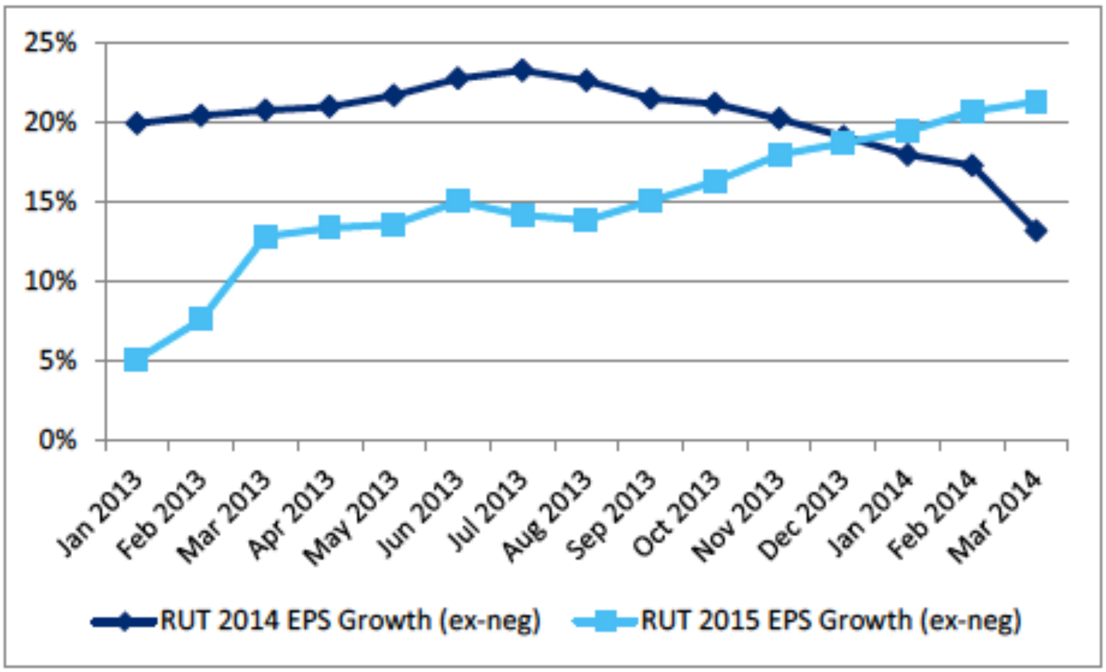
Since late 2013, S&P 500 Index earnings estimates for 2014 have seen a meaningful amount of negative revisions. As shown in the chart below, 2014 earnings growth has been cut to just over 7% from above 10% in late 2013. Over the past three months, first quarter year-over-year earnings growth has been cut from previous expectations of +4.3% to now -1.2% according to Factset Research data. Despite the cuts, the U.S. stock market still earned a slightly positive return through 3/31/14. Once again, we highlight the dichotomy between real fundamentals and stock market performance and believe that Fed and its policies are the major factor behind it.



Source: Bloomberg and Citi Research– US Equity Research

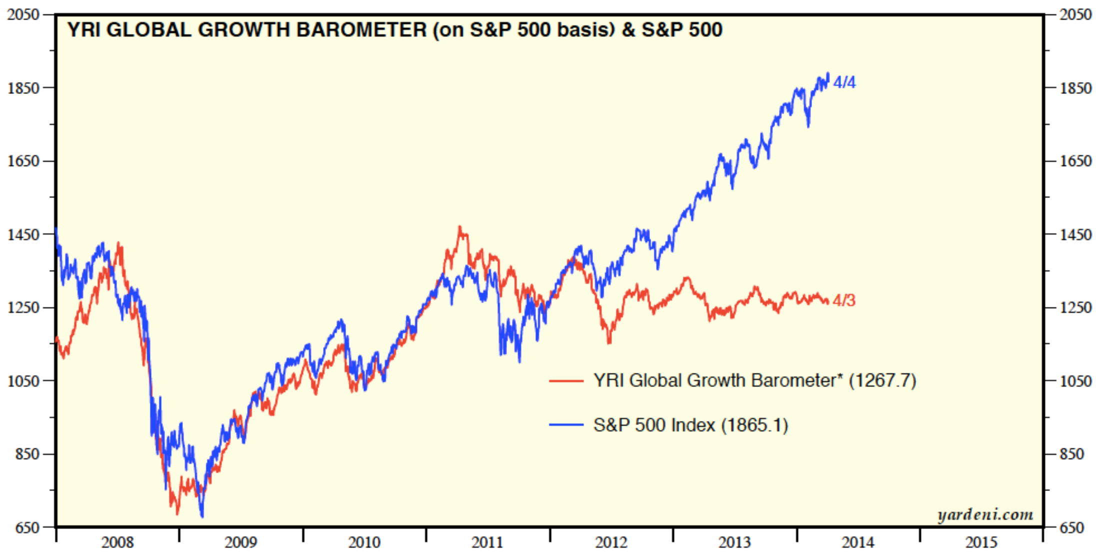
2014 earnings estimates in small cap stocks tell a similar story and have also seen large negative revisions, as shown in the next chart to the far right in the dark blue line. Earnings growth for small cap has declined from an over 20% year-over-year forecast to the current 13% y-o-y forecast. The small cap market as measured by the Russell 2000 Index trades at a forward PE multiple of 21.4X compared to 15.5X for large cap stocks as measured by the S&P 500 Index. When one compares the historical relationship between small cap and large cap stocks based on forward PE multiples, small cap stocks are trading at a large premium.

Figure 16. Russell 2000 Annual EPS (ex-neg) Growth History



Source: FactSet

How far have stock markets moved away from fundamentals? The following chart by Ed Yardeni Research provides some perspective. The chart shows the relationship between the S&P 500 Index and a global growth barometer. Obviously, there was a very tight correlation between these two factors from 2007 up to early 2012 and then something major changed. Hmmm. Anyone? Anyone? Buehler? Buehler? cough QE cough. Since 2012, risk assets like stocks have continued to move sharply higher but the move higher has not been confirmed by the actual data in the growth barometer.

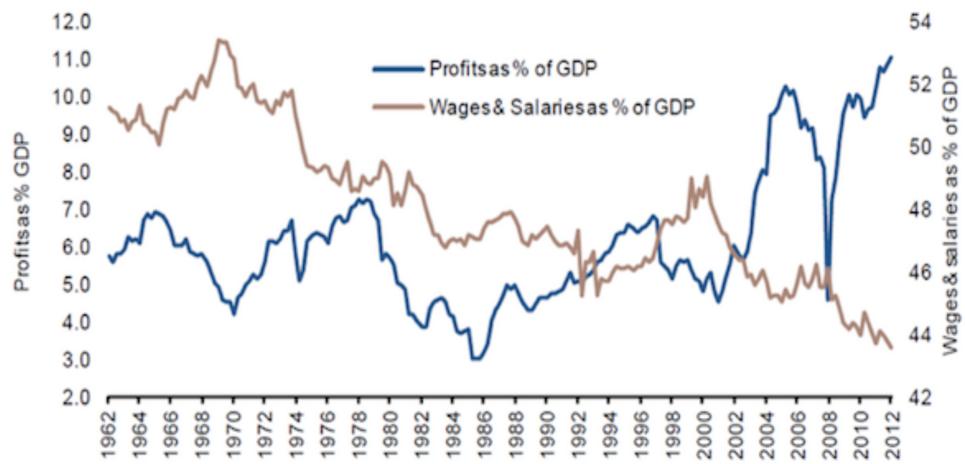


* Average of Brent crude oil and CRB raw industrials spot price index times 2 and divided by 10. Average then multiplied by 10 and 200 added.
Source: Standard & Poor's Corporation and Commodity Research Bureau.

Source: Ed Yardeni Resarch

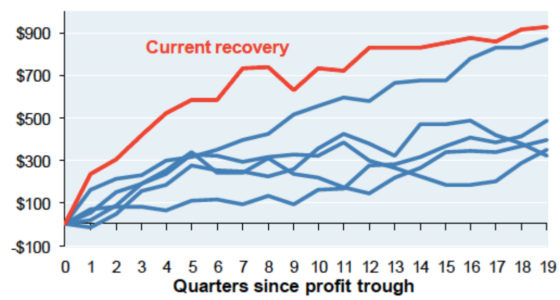
Corporate earnings have recovered strongly since the 2009 lows. U.S. corporate profits are now at the highest level relative to U.S. GDP and have seen the strongest growth when compared to five other post recessionary profit lows. But, it is not because of revenue growth, which has been the worst when compared to the five other post recessionary time periods. Rather, corporate profits are at all time levels as a share of GDP because employee compensation is now at all-time lows. The next two charts lay out this point in rather dramatic fashion. Despite low revenue growth and challenging economic conditions, companies have been able to deliver decent earnings growth over the past four years. But, it is mostly because they have not given employees any meaningful real wage growth or hired many new employees for that matter. Companies have also take advantage of the Fed induced artificially low interest rate environment to refinance their debt and reduce interest expense, another contributor to profits. In a sub 3% real GDP growth world with above average levels of uncertainty, who can blame managements? They are playing the hand they have been dealt. Shareholders (mostly the affluent) are disproportionately benefiting from the stinginess that managements are exhibiting in today's sub par growth economy.

US profits as a share of GDP is at all time highs while wages and salaries are at all time lows?



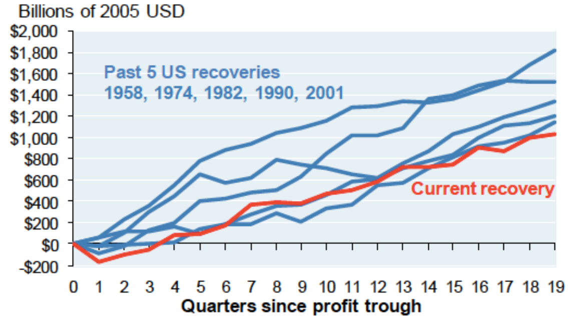
Source: SG Cross Asset Research, BEA

Profits
Billions of 2005 USD



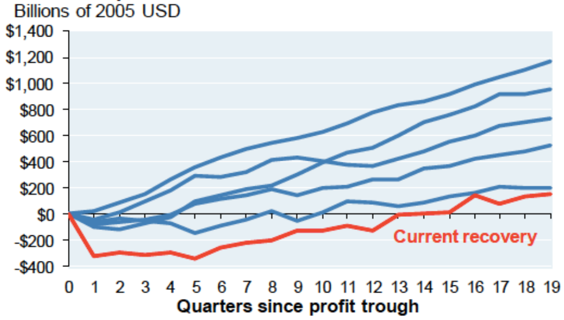
Source: BEA, J.P. Morgan Asset Management. Q3 2013.

Revenue
Billions of 2005 USD



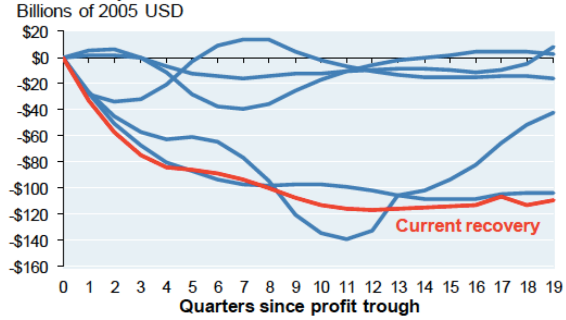
Source: BEA, J.P. Morgan Asset Management. Q3 2013.

Labor compensation
Billions of 2005 USD



Source: BEA, J.P. Morgan Asset Management. Q3 2013.

Interest expense
Billions of 2005 USD



Source: BEA, J.P. Morgan Asset Management. Q3 2013.

As usual, and before you know it, this quarterly Investment Outlook has hit the double digit mark for pages so it is time for the fun to end. To summarize, we may have finally reached the inflection point where central bank policies and their support of risk assets has peaked and normal market risk factors, which have been so hugely discounted by investors, become increasingly important going forward. Since 2009, it has mostly been about reward, but now risk should increasingly become the focus of investors. Just remember Kamchatka.

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

April 10, 2014

IMPORTANT DISCLAIMER: