MJM INVESTMENT ADVISORS, LLC

2014 Year In Review and 2015 Investment Outlook

2014 Year In Review

- It was a narrow stock market during 2014. If you weren't heavily invested in U.S. stocks and, more specifically, the large/mega cap stocks found in the S&P 500 Index, it was a disappointing year of performance. Large cap U.S. stocks outperformed all other asset classes by a wide margin as noted below.

S&P 500 Index (large cap U.S.)	**+13.7%**
Russell 2000 Index (small cap U.S.)	**+4.9%**
MSCI EAFE Index (large cap int'l)	**-4.9%**
MSCI EM Index (emerging mkts)	**-2.2%**
Barclays Aggregate (invt grade bonds)	**+6.0%**
Barclays High Yield (non-invt grade)	**+2.5%**
Barclays Short-term Treasury bills (cash)	**+0.1%**
Gold	**-1.5%**
Brent Crude Oil	**-47.0%**
Lipper Average Balanced Fund	**+5.8%**

- After a -2.9% real GDP print during the first quarter due to a harsh winter, the U.S. economy recovered and accelerated as the year progressed. Job growth was the best in 15 years and consumer confidence hit its highest level since 2007.
- The biggest surprise of 2014 was the sizable decline in long maturity U.S. bond yields despite an economy that saw accelerating growth. The 10-year U.S. Treasury bond yield declined from 3.0% to 2.2% and long maturity bonds returned over +15%. The main reason for the decline in U.S. bond yields was plummeting bond yields outside the U.S., most notably in Europe. Global investors rotated towards U.S. bonds, which offered higher yields and more safety than other major sovereign bond markets.
- The U.S. dollar saw a significant rally starting in mid July due to weaker growth outside the U.S. and more aggressive central bank actions in Europe and Japan. The relative stability of the U.S. and its better growth profile drew global investors to U.S. dollar assets. U.S. based investors who owned foreign assets were negatively impacted by weakening foreign currencies as noted in the negative returns of the MSCI EAFE and MSCI EM indices in U.S. dollar terms.
- Oil prices collapsed (as did many other commodities) with Brent crude declining an incredible 50% starting in mid-June. A drop of this magnitude over such a short period of time is typically a sign of a major slowdown in global growth. This time, other factors were also at play including a strengthening U.S. dollar, wrong directional bets by leveraged traders, and an oversupply of oil on global markets partially due to rapidly rising U.S. oil production.
- Collapsing oil prices translated into plummeting gasoline prices, which has given global consumers a back-door tax cut. In the U.S., gasoline prices dropped around $1.25/gallon during 2014 which will mean several hundred billions of extra dollars in the pockets of U.S. consumers if oil stays at current levels.
- Slowing global demand caused most commodities prices to decline during 2014. Disinflationary trends took hold globally, a disconcerting outcome to central banks and contrary to one of the goals of aggressive monetary policies.

2015 Investment Outlook

Once In A Lifetime

And you may ask yourself, what is that beautiful house?

And you may ask yourself, where does that highway go to?

And you may ask yourself, Am I right? Am I wrong?

And you may tell yourself, MY GOD! WHAT HAVE I DONE?

- Once in Lifetime – Talking Heads

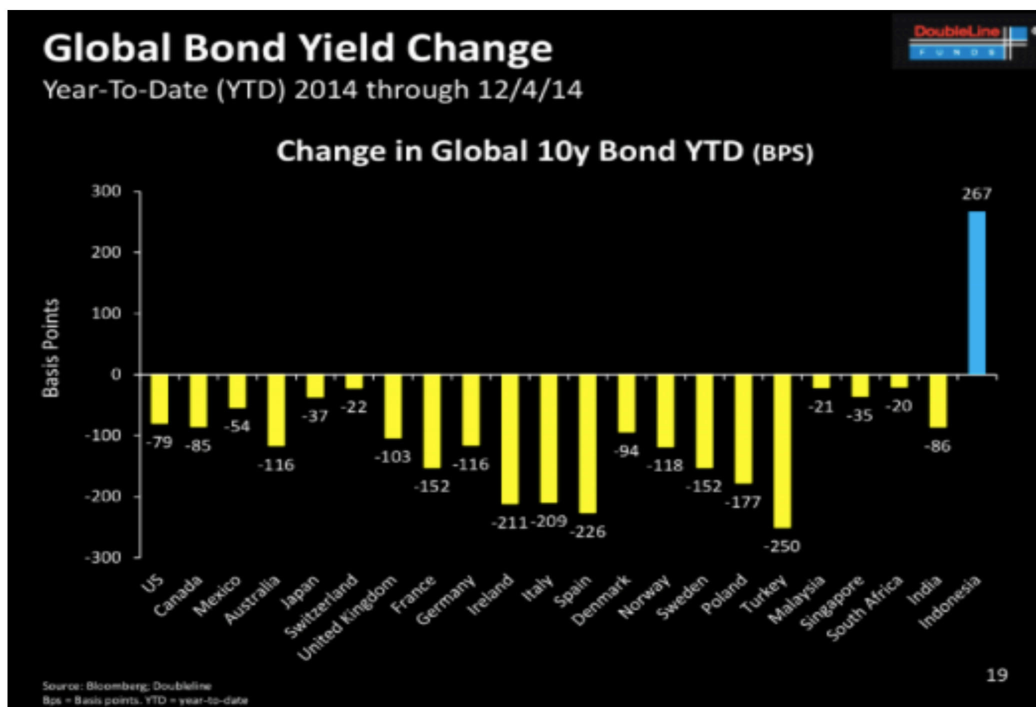
Federal Reserve Board Chair Janet Yellen is no groupie but she is a huge Talking Heads fan. Rumor has it that the most played song on her Ipod is Once in Lifetime, the band's early 1980's classic. The Talking Heads went from being a quirky NY City based band playing the CBGB Club to a nationally recognized headliner leading the 1980's punk, New Wave music scene after they released Once In A Lifetime and the accompanying video became a major hit on MTV. Time Magazine (yes, it still exists) named the Once in the Lifetime video as one of the 30 All Time Best Videos. The Talking Heads were inducted into the Rock N Roll Hall of Fame in 2002.

It's not exactly clear why Ms. Yellen loves to listen to Once In A Lifetime so frequently. Perhaps the lyrics Am I right or Am I wrong? and MY GOD, WHAT HAVE I DONE? resonate strongly with her since she probably asks those questions to herself on a daily basis. 2015 will mark the seventh straight year (same as it ever was) of global central banks employing aggressive and unprecedented monetary policy actions in order to stimulate growth and end the economic funk that has plagued the world since the 2008 Financial Crisis. Does it feel like central banks, who are driving the bus, know where this highway goes to? The U.S. economy is the outlier and is outperforming the rest of the world by a wide margin. But, it took $4 trillion of bond buying and maintaining interest rates at 0% for six years to get us to the point where unemployment rate finally moved below 6% (wink, wink, nudge, nudge). At the same time, real GDP growth is still struggling to achieve greater than 2.5% annual growth. That's a pretty expensive bar tab. The key question is whether we are into the blue again, now that the money's gone? The massive liquidity injection and cheap cost of debt derived from Fed policies has definitely shown up in the value of financial assets and in the financial engineering of corporations. The real economy? Meh.

Hopefully, you don't find yourself in another part of the world where things are notable worse. The end game still remains highly uncertain and one can make the case that the prospects of a Black Swan event (very rare but extremely nasty) have not diminished at all. Let's hope that our beautiful house doesn't turn into a shotgun shack before this all plays out.

Bonds - Lower For Longer?

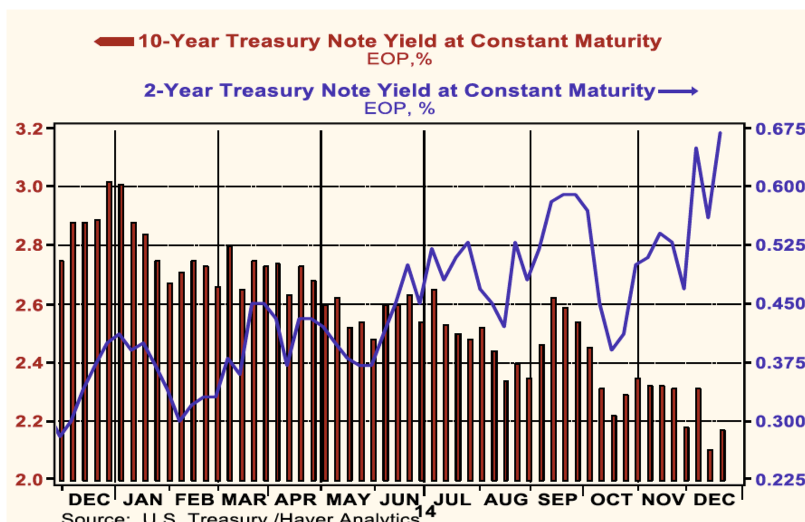
Without a doubt, the situation in global bonds remains a case of picking up pennies in front of the steamroller. Even after six years of abnormally low rates and bond yields at historical lows, there could be several more years of low bond yields ahead of us. As shown in the next chart, global bond yields plummeted during 2014 as slowing global growth and disinflationary trends took hold. Remember that bond yields decline due to rising bond prices and vice versa. Bond yields were already near historically low levels entering 2014 due to extreme central bank policies. Almost no one in the investment industry predicted bond yield declines of this magnitude during 2014. Given the unprecedented amounts of monetary stimulus central banks are pumping into the global financial system and the extended period of time the stimulus has been in place, Spok would tell Captain Kirk that it is logical to expect growing GDP growth and growing inflationary pressures at this stage of the economic cycle. Yet, just the opposite is happening. Many global economies (not the U.S.) are experiencing decelerating economic growth and large declines in commodity prices of all kinds have added a disinflationary bias to the global economy and have also been a contributing factor to declining bond yields.



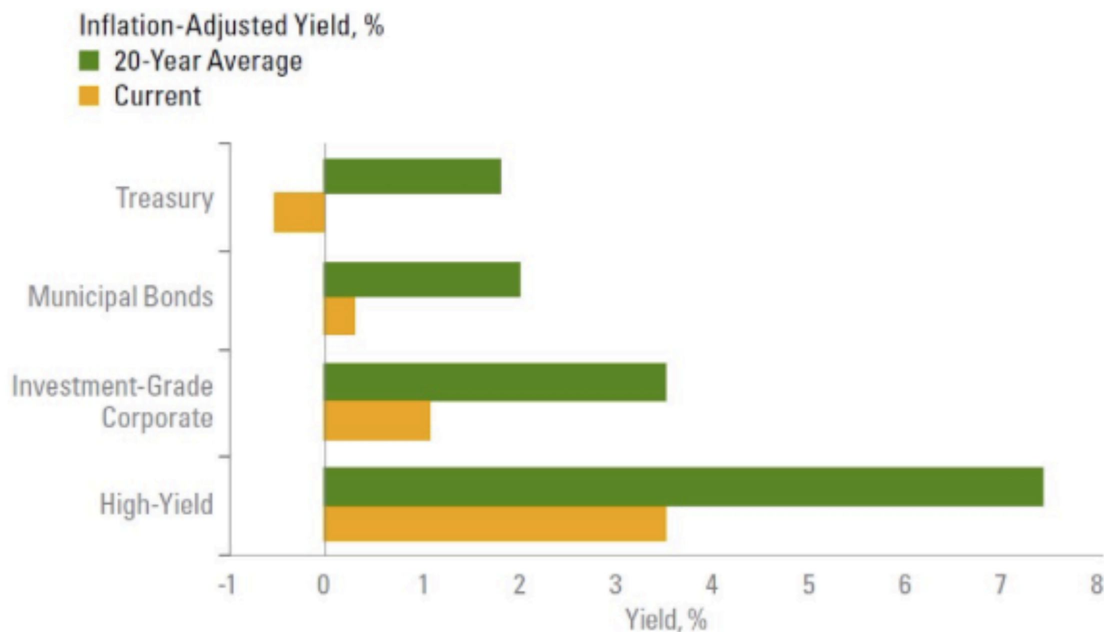
Source: DoubleLine

The following chart shows the 10-year U.S. Treasury bond yield going back to 1979, representing the healthiest (supposedly) major economy on the planet. With recent job growth and economic growth showing a healthy pickup, U.S. bond yields would normally be rising at this stage of the economic cycle. But, as shown in the previous chart, when bond yields are collapsing all around the globe, U.S. bond yields are simply playing follow the leader and heading lower too. If a 10-year German bund offers a 0.50% yield and the 10-year U.S. Treasury bond offers a 2.0% yield, which bond which you rather own?

The one segment of the U.S. bond market that experienced rising yields were shorter maturity bonds. The next chart compares the yields of the 2-year U.S. Treasury note (right hand scale) and the 10-year U.S. Treasury bond (left hand scale) during 2014. The yields on long maturity bonds are not controlled by the Fed but are controlled by financial markets and are influenced by factors other than short-term interest rate policy set by the Fed. The 2-year note is more directly impacted by investor's expectations of future Federal Reserve interest rate policy decisions. During 2014, the yield on the 2-year note saw a meaningful move higher with yields almost doubling from extremely low levels at the start of the year. The strengthening of the U.S. economy as the year progressed increased investor expectations that the Fed was moving closer to ending its Zero Interest Rate Policy and begin to raise short-term interest rates. The current market expectation is for the Fed to raise the short-term rates by mid-2015.



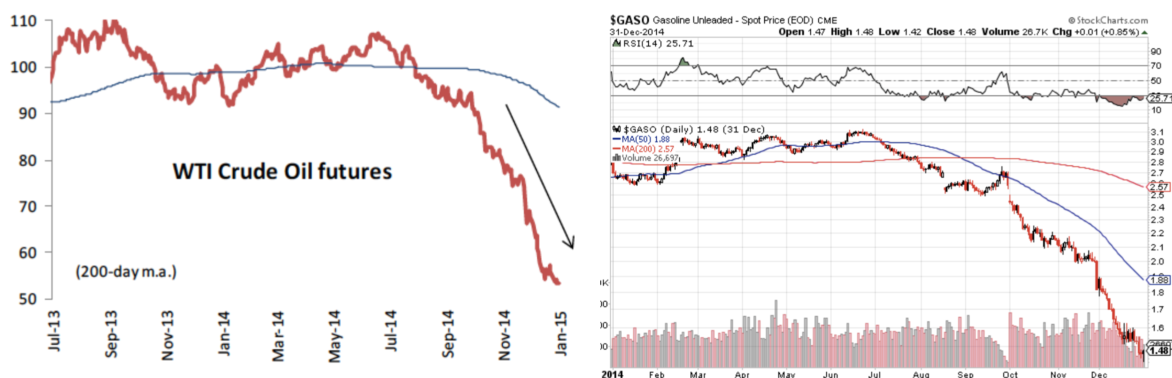
When taking into the account the effects of inflation, most major segments of the bond market offer little to no real return for investors. The only way to earn decent returns in bonds is to take on more risk and invest in lower quality, high yield bonds.



With global growth in many regions of the world subpar and with disinflationary trends in place, a few well-regarded bond investors are forecasting the 10-year U.S. Treasury bond yield to eventually go back below 1.5% this year. If that happens, 2015 would be another year of positive returns for bonds as there would be more price appreciation even with the miniscule yield offered. However, you can only lunge for that penny in front of the steamroller so many times before the odds catch up to you and you lose in the most ugly way imaginable. It is not going to be pretty for bond investors when bond yields eventually reverse from very low levels. The outcome all investors should fear the most is if bond yields rise rapidly because central banks are unveiled as the Emperor With No Clothes and investors completely lose faith in the ability of central banks to control the situation. No sir, that scenario would not be a pretty outcome at all. The outcome everyone should be rooting for is rising bond yields due to improving global economic growth and the end of disinflationary trends currently in place. There is no doubt that all central bankers are praying every night for such an outcome.

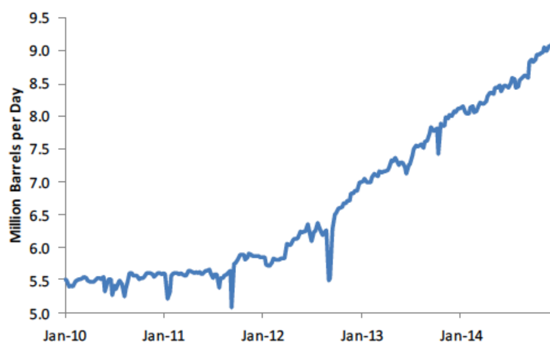
Oil – A Slippery Slope

Most Americans don't pay attention to the price of oil, but they do pay attention to its most important derivative, gasoline. The left chart below shows the dramatic collapse in the price of oil starting in mid-July and the right chart shows how gasoline also had the same degree of price collapse. The decline in gasoline is a major positive for U.S. consumers, who were paying over $3.50 per gallon of gasoline at the retail level at the beginning of 2014 and are now paying an average of $2.25 per gallon. If you fill up a 17-gallon tank once a week, a typical household will save around $1,000 per car in 2015 vs. 2014 from lower gasoline prices.



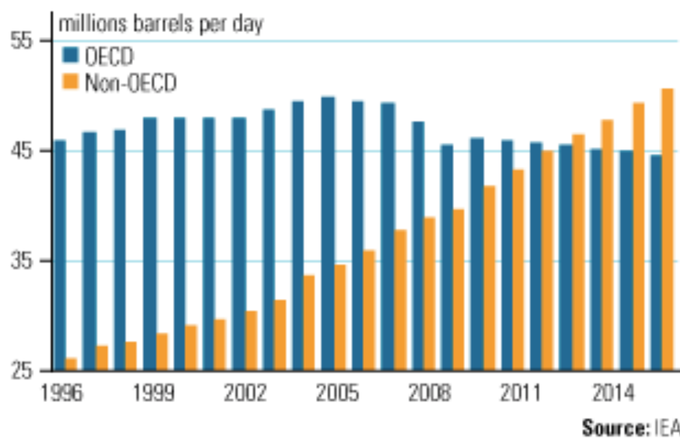
Source: Oppenheimer & Co., Stockcharts.com

The Average Joe is also unaware of how much oil (and natural gas) production has increased in the U.S. over the past several years. The next chart shows daily oil production in the U.S. since 2010 has increased 68% from 5.5 to 9 million barrels per day. New technologies such as fracking and improved drilling techniques have been a major factors on the large increase. The International Energy Agency did not expect the U.S. to get to this level of oil output until 2020. Significant capital investments have been made in new oil producing areas such as the Marcellus, Bakken, and Eagle Ford shale areas of the U.S. The states and communities in these regions have seen strong employment growth well above the national average. Some estimates suggest the U.S. energy boom is responsible for a meaningful amount of job gains since the 2008 recession and has been a contributing factor towards U.S. GDP outperforming many other major world economies.



Source: U.S. Dept. of Energy, Bloomberg, Oppenheimer & Co., Inc.

Given the slowdown in the global economy during 2014, oil demand growth has also slowed. It should be noted that developed markets oil demand has been on a downward trend since 2005. All the incremental demand growth that drives total global oil demand comes from emerging market economies, which includes China. The next chart from the International Energy Agency shows global oil demand by developed (OECD) and emerging (non-OECD) economies. Total DAILY global oil demand is around 94 million barrels, of which less than 50% now comes from developed markets. The increase of oil production in the U.S. since 2010 has added 4 million barrels of daily oil production to global supplies. For the price of oil to stabilize, either emerging markets demand improves or oil producers shut down production and bring the oversupply situation back into balance with current demand levels. So far, oil cartel OPEC has declined to cut production, which has put significant downward pressure on the price of oil. The rapid rise in the U.S. dollar has also pressured oil prices since oil is priced in U.S. dollars globally. The dramatic and rapid collapse in the price of oil also points to the lack of liquidity in the commodities market.

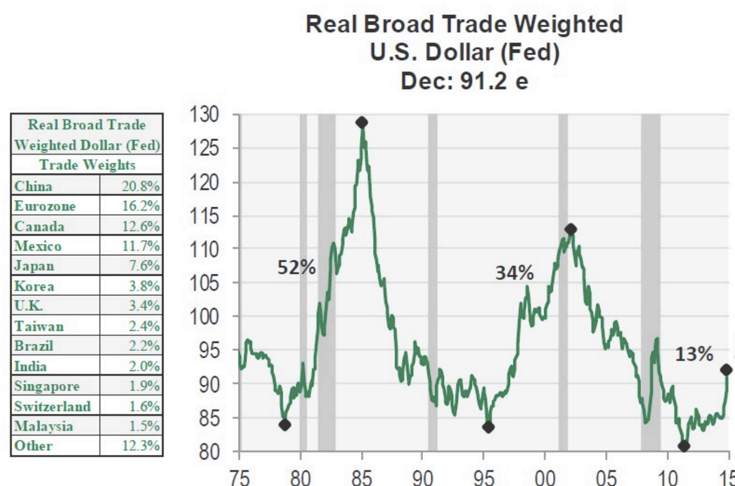


Let's assume oil remains around its current level at near $50 per barrel during 2015. The U.S. consumer will benefit and likely spend some of the gasoline "savings" but this will be offset to some extent by energy sector layoffs and the resulting drop off in spending by consumers whose jobs are tied to the energy sector. A recent example is U.S. Steel laying off 750 workers in Ohio and Texas at plants that produce steel piping used in energy projects. At current oil prices, exploration companies on average are expected to cut their capital spending budgets by 30% during 2015. Lowered capital spending will negatively impact the ISM Index, which captures business trends for the manufacturing sector. While most talking heads suggest the impact of lower oil prices is a net positive to the U.S. economy, it remains to be seen just how big of a factor a slowdown in the energy sector will impact U.S. job growth and GDP growth in the coming year. Keep an eye out on the job growth numbers during the first three months of 2015. If monthly job gains begin to fade due to an energy sector slowdown, the Fed will have another reason to push out short-term interest rate increases the market has already priced in.

King Dollar and The Currency War

Starting in July 2014, the U.S. dollar went on a major tear, increasing by over 10% vs. other major currencies. A >10% price move for a currency over a short period of time is a significant change. Key to this move was the fact that the U.S. economy strengthened as 2014 played out while other global economies weakened.

The next chart shows the U.S. dollar price movement against a broad basket of foreign currencies from 1975 to today. The U.S. dollar experienced two major periods of strengthening: 1979 to 1984 and 1995 to 2002.



Real Broad Trade Weighted Dollar (Fed) Trade Weights	
China	20.8%
Eurozone	16.2%
Canada	12.6%
Mexico	11.7%
Japan	7.6%
Korea	3.8%
U.K.	3.4%
Taiwan	2.4%
Brazil	2.2%
India	2.0%
Singapore	1.9%
Switzerland	1.6%
Malaysia	1.5%
Other	12.3%

Source: Oppenheimer & Co.

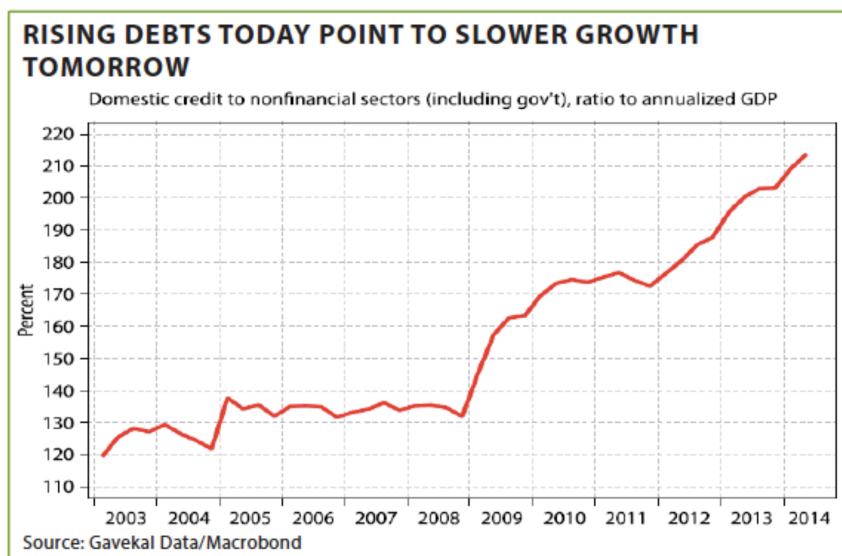
The last time period the U.S. dollar weakened ended in 2011 when it began to slowly grind higher. Then, starting in July 2014, the U.S. dollar made an abrupt and significant move higher into year-end. In the last two periods when U.S. dollar started to strengthen and had a large and massive reversal higher, it experienced a multi-year strengthening trend. The odds are high that this will happen once again. The main reason is that the Fed has ended its QE program and is close to reversing its Zero Interest Rate Policy while Europe, Japan, and some other global central banks are engaging in new rounds of monetary stimulus in renewed efforts to invigorate growth in their economies.

A weaker currency makes a country's exports more attractive which helps stimulate local demand and economic growth. The relative policy actions of central banks have a large influence on currency prices. In this era of massive central bank policy interventions, currency price movements may become even more pronounced given the magnitude of the monetary stimulus being undertaken. When many areas of the world are generating below trend growth, and every central bank desires a weaker currency in order to try and juice growth in their own economy, the probability of currency volatility increases. The last two major U.S. dollar-strengthening periods ended with +52% and +34% moves higher. Even with the recent large pop higher, the U.S. dollar has only gained 13% off of its recent lows. A strengthening U.S. dollar has negative implications for the returns U.S. based investors earn from foreign investments. It also is an earnings headwind for U.S. based multinational companies that derive a meaningful amount of revenues

from overseas markets. A strong dollar also makes U.S. exports (14% OF GDP) more expensive, which could potentially slow our economy if the dollar strengthens too much too fast.

Debt – The Dirtiest 4 Letter Word Ever

The world economy has had a very difficult time finding its mojo since 2008. Why has global growth been so elusive despite prolonged and unprecedented levels of monetary stimulus provided by central banks? It's mainly because no progress has been made in reducing the level of global aggregate debt in the global financial system. In particular, sovereign debt, which was issued for bailouts and fiscal stimulus programs during the Global Financial Crisis and to cover deficit spending since then, has grown dramatically since 2008. In addition, artificially low interest rates have provided huge incentives for the private sector to take on debt since the cost of the debt is suppressed well below natural levels. The next chart shows how much debt has accumulated in the financial system, now exceeding 210% of annualized GDP. Debt was too high going into the 2008 financial crisis and it has become an even bigger problem since then. The U.S. government debt situation is a classic example where it (we) now owes $18 trillion even though our economy is (supposedly) one of the better ones in the world. Until the excessive debt problem is addressed, it will continue to keep a lid on global economic growth.

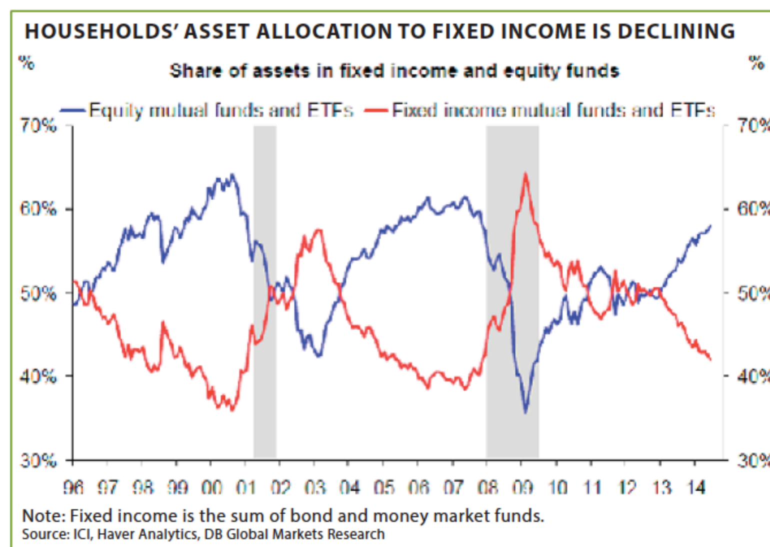


Stock Market – The Only Game In Town

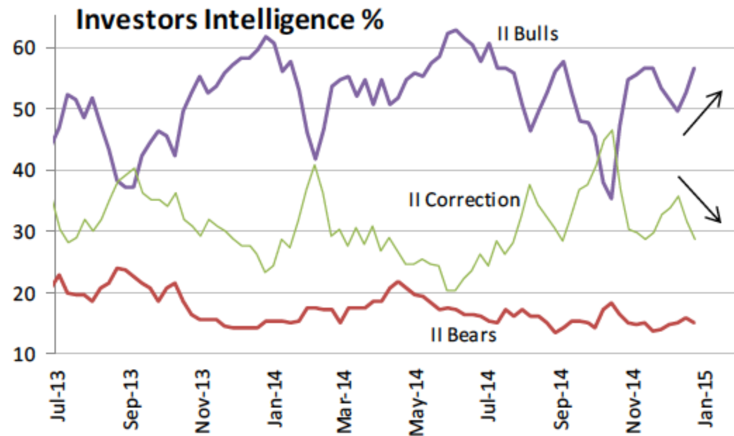
One of Warren Buffett's favorite valuation indicators is the U.S. total stock market capitalization divided by U.S. GDP. Buffett considers this indicator the best single measure of where valuations stand at any given moment because it compares the relationship between the stock market and the economy.

The current market cap/GDP ratio is dangerously high at 127% of GDP, which is its highest reading since the Tech Bubble in the late 1990's. What can fix this overvaluation? Higher levels of GDP growth combined with a stock market that stops going higher for a period of time or if the stock market has a correction lower. And you may ask yourself, why are stocks so overvalued?

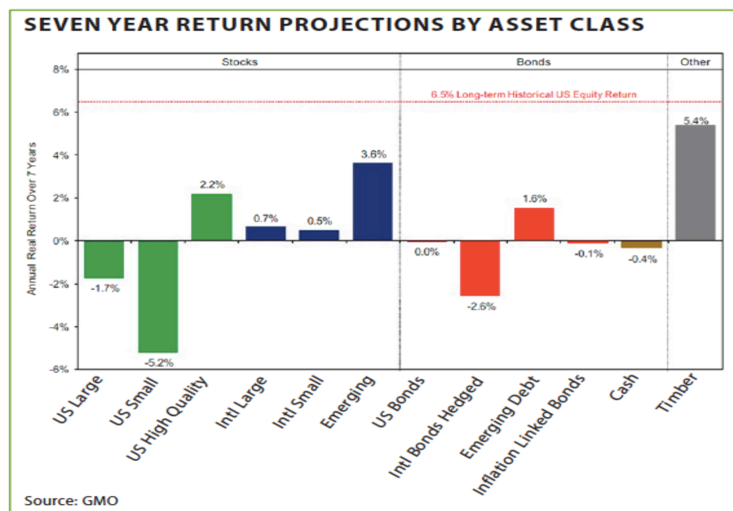
Since 2008, the artificially suppressed interest rate environment created by extreme central bank policy actions has distorted the traditional relationships between asset classes that have existed in the past. Fed policy has made it virtually impossible for U.S. investors to earn decent returns from bond and cash-like investments. The Fed, by keeping its Zero Interest Rate Policy in place for seven years, has driven income-biased investors into the stock market. The trend of household assets flowing out of fixed income and into equities is shown in the chart below. Note that household assets allocated to equity mutual funds and ETFs (dark line) are once again approaching the levels of the Tech Bubble and 2007 stock market peak. According to Ned Davis Research, when investors were similarly allocated to equities in the past, forward 10-year returns for stocks were well below the long-term average return.



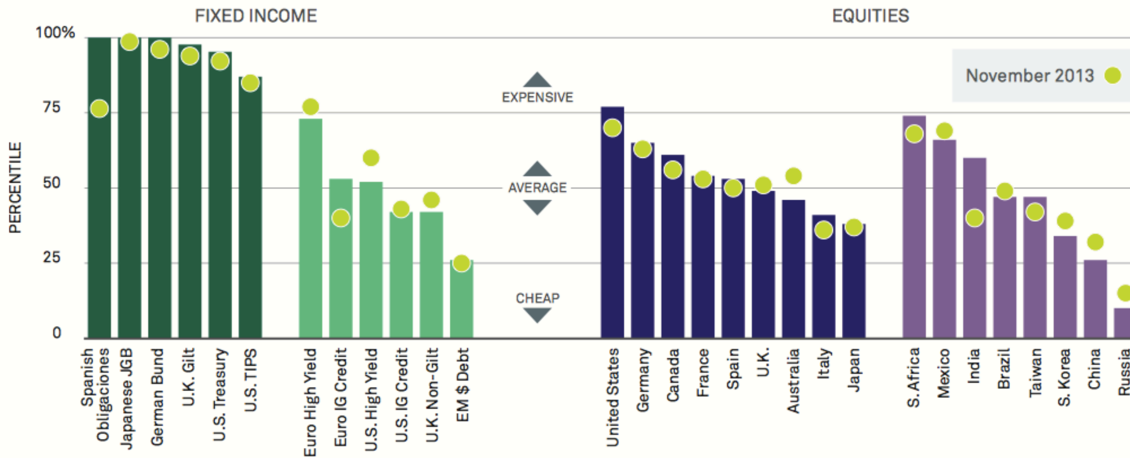
After six consecutive years of positive returns from the U.S. stock market, below average levels of price volatility, and substantially reduced return opportunities in bonds and cash, it is not surprising that investors are predominately bullish on the U.S. equity market. The following chart shows that the level of investor bearishness on the U.S. stock market is bouncing along near all-time lows. There is a high level of complacency in the stock market, which has grown accustomed to (and demanding of) central banks willingness to step in and save the day any time growth falters.



Due to extreme global central bank policies, stocks have become the only game in town by default. The U.S. stock market, given more challenging economic conditions overseas, has become the safe haven of choice for global investors and now a rising U.S. dollar has made U.S. assets even more attractive. What does this mean for prospective investment returns? It's dramatically lowered them, that's what. As shown in the next chart from global investment firm GMO, which forecasts 7-year forward return for major asset classes, the pickings are pretty slim unless you want to buy a forest.



The next chart provides another perspective on the valuations of major asset classes and how those valuations compare to historical norms. It shows that many major asset classes are at the top end of their valuation ranges with most major bond markets as the most expensive in their histories. U.S. stocks are the most expensive of the major global equity markets despite the torrid love affair everyone has with them now. Just the opposite is true of Russian stocks, which are close to their cheapest valuations in history (Once In A Lifetime?) and which investors hate as much as the capital gains tax.



Source: BlackRock Investment Institute and Thomson Reuters

As global investors have piled into U.S. stocks the past few years, the risk/reward setup for U.S. stocks has deteriorated. The next chart shows another way to evaluate current valuations for U.S. stocks within a long-term context. The upward sloping line from the far left to the far right is the inflation adjusted trend line for long-term S&P 500 composite stock returns. The bottom of the chart shows in percentage terms how much the current trend is above or below the long-term trend line. The current stock market level is now 90% above the trend line, which is similar to the level hit in 2007 before the 2008 Global Financial Crisis hit (when the stock market declined 37% in 2008 it went back to the long-term trend line) but not quite as extreme as in 1999 at the peak of the Tech Bubble. An interesting factoid: the 10-year S&P 500 Index annualized return post the 1999 Tech Bubble Peak was close to 0%.

In this era of massive global central bank policy intervention, it is impossible to know when the current upward trend for U.S. stocks will end or when the tipping point may be reached. The point of presenting these charts is to provide a historical perspective and to reinforce the idea that the level of returns you should expect from your financial assets is likely to be much lower than returns earned in more recent years. In fact, keeping most of what you have gained since 2009 may be a best-case scenario over the next several years.

Summary

Despite six years of aggressive central bank policies designed to jumpstart growth, the level of macro risks has not diminished and the unintended consequences of central bank policies still present major risks to investors. The U.S. economy remains the outlier as the rest of the global economy still faces major headwinds. The major question for 2015 is whether the slowing global economy and rising U.S. dollar will negatively impact U.S. growth. Global growth is not at the level it needs to be for central banks to retreat from their massive monetary stimulus policies. In fact, some of them are pushing the pedal to the metal even more. As the old saying goes, in for a penny, in for a pound. In Las Vegas it's called doubling down.

The ending lyrics of Once In A Lifetime are particularly apropos at this time.

same as it ever was,
same as it ever was,
same as it ever was.

Let's just hope the next Talking Heads song cued on Ms. Yellen's Ipod isn't Burning Down The House.

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