MJM INVESTMENT ADVISORS, LLC

2015 Year In Review and 2016 Investment Outlook

2015 Year In Review

- It was a topsy-turvy environment all year with meager, if any, returns to show for most major asset classes. The investment environment remained dominated by global central banks and the public pronouncements of those involved in monetary policy-making decisions. After seven years, the U.S. Federal Reserve finally ended its Zero Interest Rate Policy and raised rates 0.25% in December.
- China was the largest source of global financial market volatility as its economic growth continued to decelerate, it unexpectedly devalued its currency, and the Chinese stock market experienced unprecedented bouts of daily volatility.
- It was a very narrow U.S. stock market during 2015 with a select few of the largest companies generating outsized gains. Despite a strong fourth quarter, 75% of the stocks in the S&P 500 Index were negative for the year. The S&P 500 Index returned only +1.4% and was negative on a price return only basis. Small cap stock returns lagged large caps stocks by nearly 6% for the year. The narrow returns of the stock market helps to explain why most investment managers trailed the broad market indices during 2015.
- Only four sectors had positive returns during 2015 with Consumer Discretionary (+8.4%), Healthcare (+5.2%), and Technology (+3.8%) leading the U.S. market. The worst performing sectors for 2015 were Utilities (-8.4%), Materials (-10.4%), and Energy (-23.6%).
- International markets underperformed U.S. stocks once again with negative currency returns a key factor. The MSCI EAFE Index of developed markets returned -0.8% in U.S. dollar terms but in local currency terms returned +5.3%. Hedging out currency exposure was a very important factor for U.S. investors with foreign investments during 2015. Emerging markets suffered from severe currency declines and recessionary conditions in some major markets and returned -14.9%.
- Bonds had a rollercoaster ride all year although U.S. Treasury yields ended up pretty close to unchanged for the year. The 10-Year U.S. Treasury moved from 2.17% to 2.26% by year-end. The big story in bonds during 2015 was in the high yield or junk bond sector, where a deteriorating outlook took hold as the year progressed. Junk bonds fell (especially energy related) and yields ramped higher, increasing by about 2.0% from the start of 2015.
- Commodities everywhere got crushed in 2015 due to the impact of China's economic slowdown and the strengthening U.S. dollar. Many commodities are trading near all-time lows and reflect a recessionary environment in many parts of the world.
- Below is a summary of key market indices for the fourth quarter and 2015.

	QTR	2015
S&P 500 Index (large cap U.S.)	**+7.0%**	**+1.4%**
Russell 2000 Index (small cap U.S.)	**+3.6%**	**-4.4%**
MSCI EAFE Index (large cap int'l)	**+4.7%**	**-0.8%**
MSCI EM Index (emerging mkts.)	**+0.7%**	**-14.9%**
Barclays Aggregate (invt. grade bonds)	**-0.6%**	**+0.6%**
Barclays High Yield (non-invt. grade bonds)	**-2.0%**	**-4.5%**
Barclays Short-term Treasury bills (cash)	**-0.1%**	**+0.1%**
Gold	**-4.6%**	**-10.1%**
WTI Oil	**-17.8%**	**-30.5%**
Lipper Balanced Funds Average	**+2.6%**	**-1.6%**

2016 Investment Outlook

More Of The Same

"We have two classes of forecasters: Those who don't know – and those who don't know they don't know."

- John Kenneth Galbraith

"We really can't forecast all that well, and yet we pretend that we can, but we really can't."

- Alan Greenspan

At this time of the year, making predictions about how financial markets will perform over the next year is standard operating procedure in the investment business. Stock market strategists are all expected by their employers to provide to the decimal point predictions on the next year's returns for stocks for their clients so that it looks like they actually know something they really don't. The ability to accurately predict future returns is a folly, yet the industry goes through the process every year only to look pretty clueless most of the time 12 months later. Economic forecasts? Harry Truman had it right about economists.

At the end of 2014, most stock market strategists forecast U.S. stocks would generate 10% returns for 2015. In reality, most stock returns were far worse and only a limited number of very large companies like Facebook, Amazon, Google and Netflix delivered outsized returns, which kept the S&P 500 Index return slightly positive for the year. However, the S&P 500 Index price only return was negative and only ended up slightly positive due to the return contribution of dividends.

Once again for 2016, many stock market strategists are predicting 10% returns for U.S. stocks during 2016. To stay employed on Wall Street, one needs to be an eternal optimist. One could easily argue that the economic outlook by the end of 2015 was worse than it was at the beginning of 2015. Given a slower global economic environment, the earnings outlook for the broad stock market is still resetting lower, yet strategists somehow believe the market is capable of returning 10% when the S&P 500 Index stock market multiple is already slightly above its long-term 16X average and earnings estimates are being cut. If the stock market multiple is already at 16X, which is fully valued on a historical basis, how exactly does the math work that the stock market will rise 10% during 2016? The view from here is that it can't and it won't, making the setup for 2016 similar to 2015 in that unreasonable return expectations won't be met. More of the same.

At the beginning of 2015, many economists forecast the U.S. economy would generate +3.0% real GDP growth for the year. If stock market forecasts by investment strategists are frequently wide of the mark, the accuracy of economic forecasts is downright abysmal. As 2015 played out, the U.S. economy took on an almost recessionary vibe. Fourth quarter 2015 GDP forecasts are being cut to less than 1% growth and 2015 could finish the year below 2% real GDP growth. A year ago in our 2015 Investment Outlook, we highlighted how oil's collapse beginning in the summer of 2014 could have serious ramifications for the U.S. economy given how important that industry had been since 2009 to supporting U.S. economic growth. The ISM Manufacturing Index dropped below 50 by December, indicating contracting business conditions in the manufacturing sector. The CEO of Fastenal, a distributor with exposure to virtually every corner of the U.S. and Canadian economies, unequivocally stated in October that the U.S. industrial sector was in a recession. The data later backed him up.

China's transitioning economy has caused a collapse in commodities across the board as copper, aluminum, steel, coal, oil, gold, and dry bulk shipping all suggest a global recession is upon us even if it hasn't been officially declared yet. China became an outsized contributor to global growth in the years following the Great Recession. Today, the rest of the world is still struggling with subpar growth and now China's economy is decelerating and it is causing another difficult adjustment period for the global economy. Major commodity exporting countries that relied heavily upon China's previously insatiable commodities demand are all in the tank at present. China's export economy experienced substantial pressure such that its central bank was forced to devalue its currency, which lead to a new bout of global market volatility. U.S. leading indicators such as trucking volumes, high-end retail same store sales growth, new Initial Public Offerings, junk bond prices, and subprime lending delinquencies all began to worsen as the year progressed. The situation in many emerging markets countries is far worse.

The crux of the issue is that global central banks have tried for seven years to utilize extreme policies to stimulate global growth and the game is finally up. It's called pushing on a string. Decelerating global growth is upon the world and central banks have run out of monetary policy ammo to stave off another slowdown. Apparently, the natural economic cycle can only be distorted for so long and is as inevitable as the sun rising and setting, even if global central bank heads believe otherwise. It has been seven years since the Great Recession hit. Based on the average age of past economic cycles, this recovery has been longer than most and we are just (over)due for another recession.

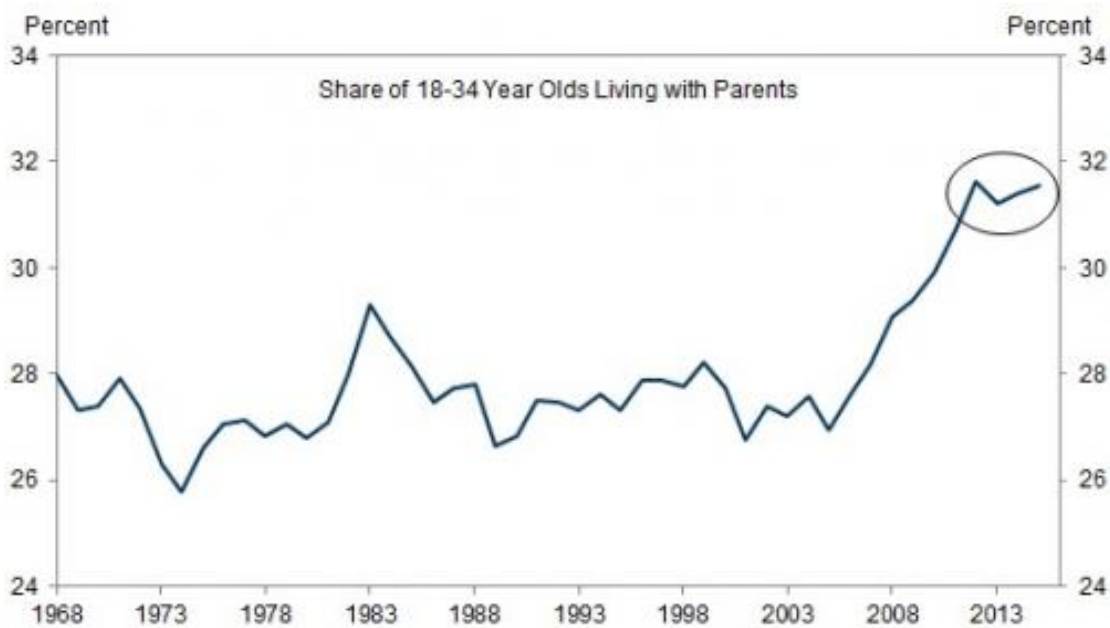
While stocks went nowhere during 2015, they also didn't adjust meaningfully lower to reflect a weaker than expected earnings growth outlook and a decelerating global growth conditions. That could be 2016's business. After seven years of unprecedented and aggressive global central bank policy actions, getting the addict (investors) to admit to the addiction (low rates) is very hard indeed but a face slapping intervention may have finally arrived. In the inner sanctum of the Federal Reserve, Janet and the boys may have concluded they can no longer justify 0% interest rates and that its current policy is now doing more harm than good to the U.S economy. U.S. investors may be coming to the realization that a sea change in the Fed's highly accommodative policy stance is finally at hand.

Full stock valuations, too high earnings expectations, and a Fed no longer in full-blown accommodative policy mode suggest that 2016 will most likely be another difficult year for investors. There is a decent level of risk of a more meaningful decline for stocks with an upside scenario much less compelling. The risk/reward setup remains poor absent a meaningful pullback, which may have already begun with stocks down 6% for the first week of the year, the worst opening week for stocks on record. If the Fed has concluded that it can no longer justify low rates and raises rates 3-4 times this year, and if the earnings outlook for U.S. stocks is lower than current expectations, 2016 has the makings of a much uglier year for U.S stocks than many investors realize.

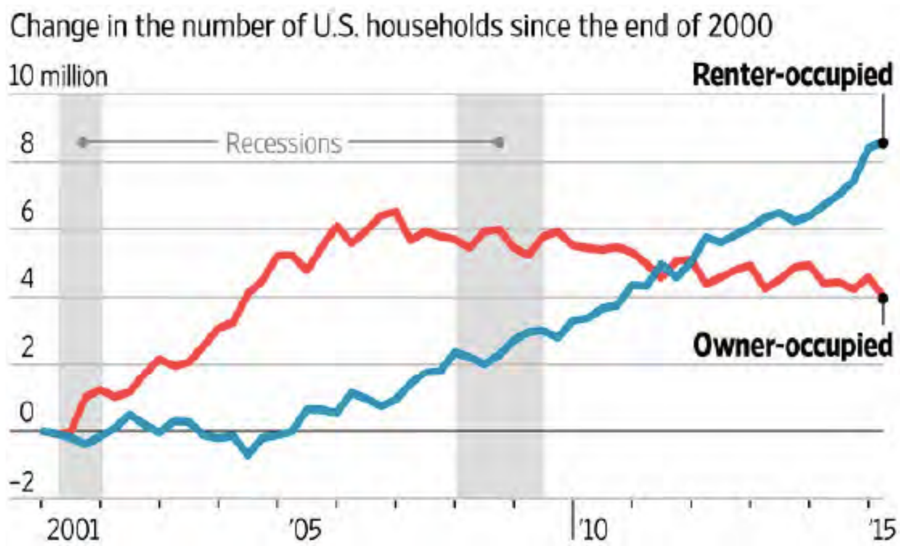
Perhaps the silver lining is that many stocks had a quite poor year in 2015 and that many stock valuations now reflect a much more subdued profit outlook. However, if global growth decelerates even more during 2016, more earnings cuts are in store and stocks will struggle to overcome such a headwind. Bonds and cash still offer a pittance of return opportunity although cash has a benefit of being a store of value in a declining asset world. Keeping some dry powder in today's challenging times is a wise move that could pay off as 2016 unfolds.

Signposts on the State of the U.S. Economy

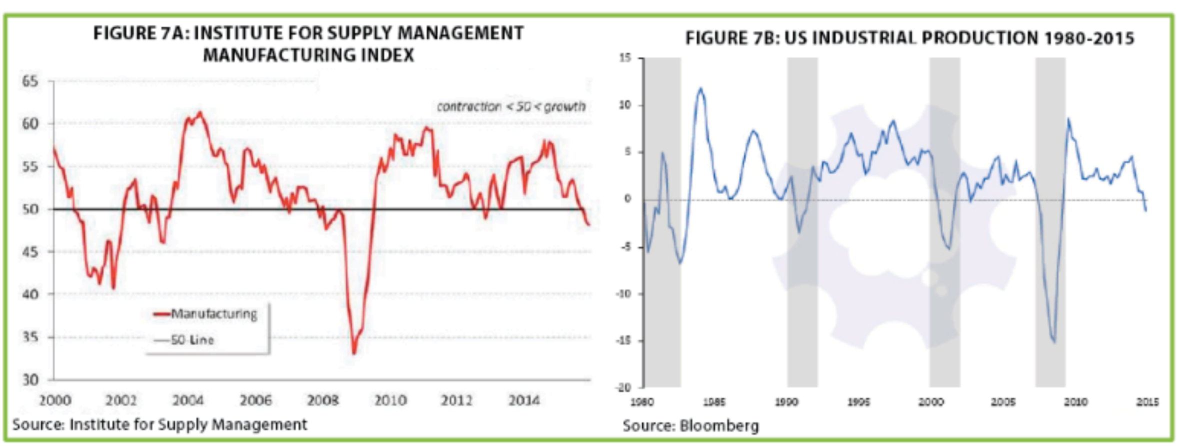
As usual, our 2016 Investment Outlook will run through some of the more interesting graphs and charts we have come across in our readings that provide a mosaic on the state of the U.S. economy. The first two charts capture one of the key demographic issues facing the U.S economy and help to explain why the U.S. economy struggles to achieve decent growth. Good paying job opportunities for those in the 18-34 year old demographic have been quite poor since the Great Recession. Young adults are coming out of college laden with significant educational debt and those lucky enough to get a job often receive one that pays poorly for the education and skill level attained. The combo of these two issues means U.S. household formations are at all time lows (as are U.S. birth rates). The first chart below shows that starting in 2006, more young adults remained living in their parent's homes. This trend exploded starting in 2008 to where now just under 32% of young adults in this age group still live with their parents.



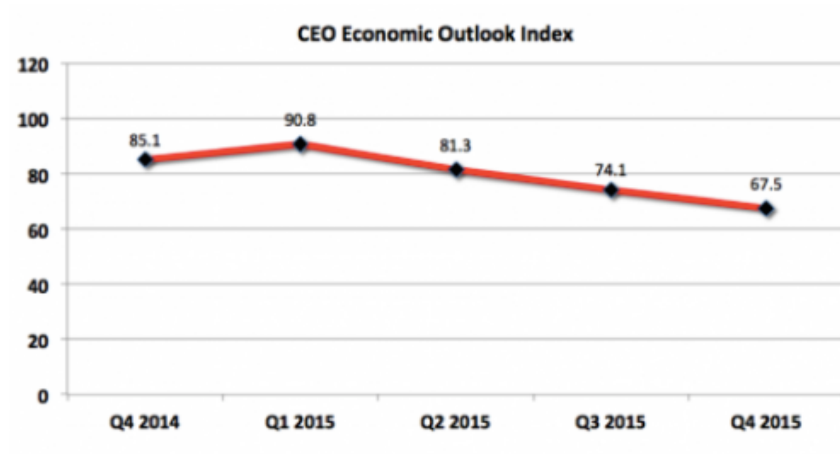
Additionally, those young adults that have moved out are renting more than purchasing a home. The next chart shows that the number of U.S. Households in owner occupied homes have steadily declined since 2006 while the number of U.S. Households that are renting has exploded. If you have too much debt and your job is not paying you enough or if you lack confidence in the future, you will defer a purchase of a home. If you don't buy an existing home or purchase a new home, you don't buy new appliances, furniture, carpeting, beds or all the things that help to drive economic growth. The inventory of homes available for sale remains unusually low throughout the U.S., another indicator of the lack of confidence in current homeowners to move up and purchase more expensive homes and a lack of new buyers for entry-level homes. On the other side of the coin, these trends do bode well home improvement stores as more homeowners upgrade their homes as opposed to moving into a newer home. Landlords are also happy as they increase rents due to unusually high demand. But, overall, the current housing trends are more of a sign of an economy that is not functioning properly and not in good health, despite historically low mortgage rates.



While the industrial economy is not the main driver of the U.S. economy, it is another indicator of the poor health of the U.S. and the global economy. Two factors are currently hurting the U.S. industrial economy. The U.S. dollar has strengthened considerably over the past 18 months, which makes U.S. exports more expensive for foreign buyers, which reduces demand for U.S. produced goods. Another factor hurting the U.S. industrial economy is the precipitous drop in oil prices. As oil prices collapsed from just over \$100/barrel in mid 2014 to \$37/barrel at the end of 2015, energy related companies aggressively cut costs including significantly reducing capital investment budgets. As these budget cuts took hold, the ISM Manufacturing Index and industrial production indicators began to rollover as indicated in the next chart below. The U.S. now has negative year-over-year growth in industrial production and the ISM Index is now at 48.2. These are important indicator to watch because if oil prices continue to decline below current levels, energy companies will continue to cut their spending budgets, which will further negatively impact the U.S. industrial economy.

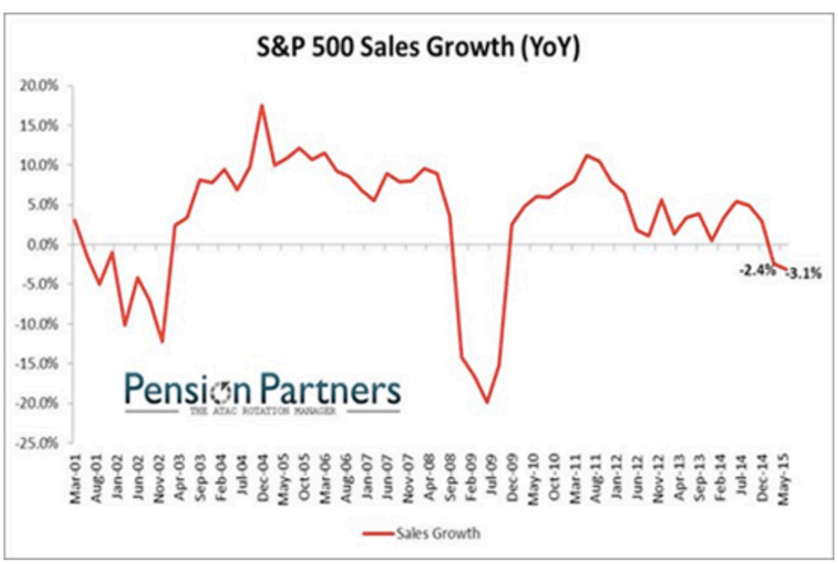


The CEOs of U.S. companies are becoming less optimistic about the future economic outlook. The Business Roundtable CEO Economic Outlook Survey, conducted quarterly since the fourth quarter of 2002, provides a forward-looking view of the economy by Business Roundtable member CEOs. The survey is designed to provide a picture of the future direction of the U.S. economy by asking CEOs to report their expectations for their company's sales, capex, and employment over the next six months. The chart below shows that by the fourth quarter of 2015, CEOs had become much less positive on the economic outlook compared to the beginning of the year.

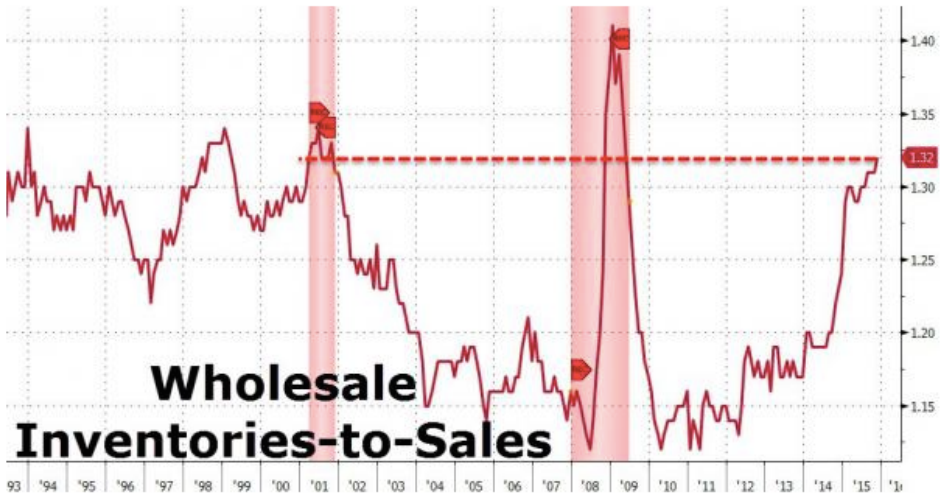


Source: Business Roundtable

The declining confidence of CEOs is brought about by the difficult sales trends they see in their businesses. The chart below shows the year-over-year sales growth of companies in the S&P 500 Index going back to 2001. You can see the dramatic effect the Great Recession had on sales starting in mid-2008 into early 2009. We are not anywhere near that level of decline, but sales growth has moved back into negative territory for the first time since early 2010.

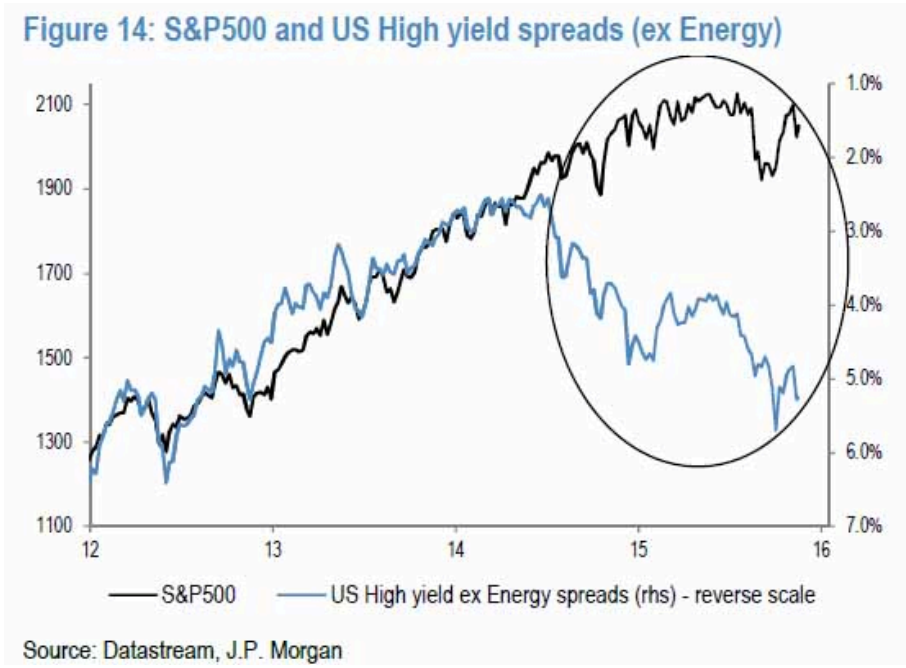


Another indicator that provides some perspective on the health of the economy is the wholesale inventories to sales ratio. During an economic slowdown, sales weaken and inventories begin to grow because there is not as much demand, which causes the I/S ratio to rise. As shown in the chart below, this happened during the 2000-2001 and 2008-2009 recessions. The chart below shows the I/S ratio has moved rapidly higher during 2015. To reverse this trend, either sales need to pick up or production needs to be cut in order to bring inventories down to current demand levels. Right now, manufacturers are cutting production in order to bring inventory levels down, which is a drag on economic growth.

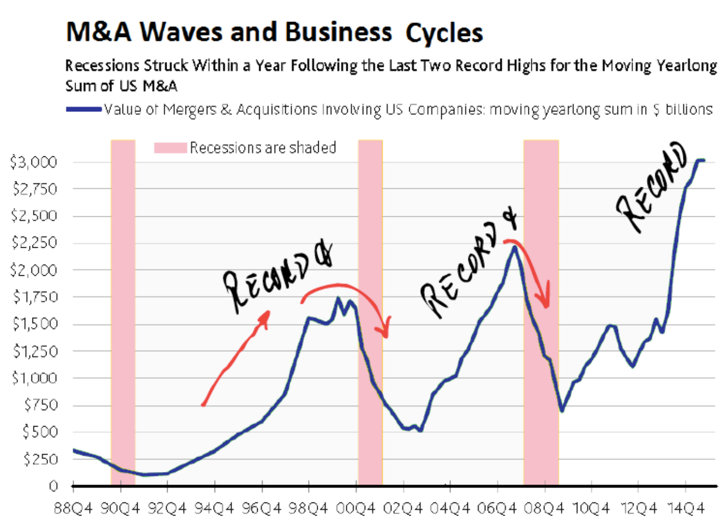


What Are High Yield Bonds Telling Us?

There is something disturbing about what the high yield bond market is saying that is not yet reflected in the stock market (until the first week of January when stocks finally plummeted). The next chart plots the S&P 500 Index return compared to the high yield bond spread. A high yield bond spread (also called credit spread) is the difference between the yield of a bond rated below investment grade (BB or lower) and a comparable maturity U.S. Treasury bond. The spread narrows during times of rising investor confidence in risk assets and widens when investors start to worry about increasing credit risk. Both stocks and high yield bonds are risk-on asset classes, meaning they go up when investors want to take on more investment risk because they are more confident about the future outlook for the economy and corporate profits. During such times, high yield bond prices go up, which causes the yields on high yield bonds to decline. As the next chart indicates, the dynamic between these two assets classes began to diverge in a material way starting around mid 2014. High yield bond spreads started to widen and decouple from the S&P 500 Index returns, which continued to march higher. The chart shows that these two factors moved nearly in lock step from 2012 to mid 2014 and then the high yield bond spread decoupling began. Had these two factors remained tightly correlated to each other, the S&P 500 Index would be trading substantially lower than where it is trading today (around 1500 on the S&P 500 Index compared to 1920 in early January). Since bond investors become more concerned about the return of capital than the return on capital during worsening economic times, one can argue that high yield bonds more accurately reflect reality than stocks. The message from high yield bonds suggests a more cautionary stance for stock investors is warranted.



A key factor supporting stocks during 2015 was a record level of mergers and acquisitions. M&A, as it is known, often accelerates as companies become more concerned about future growth. Cheap financing, which the Fed created since moving to near zero interest rates in December 2008, also creates higher levels of M&A activity as deals can get financed on larger amounts of cheap debt. As the next chart shows, M&A activity accelerated to all time highs during 2015. What the chart also shows is that the peak in M&A activity can also be a precursor to an ensuing recession. If the Fed raises rates several times during 2016, it could negatively impact the amount of M&A activity and take away one of the key support legs for the U.S. stock market.



Key Risks For 2016

Here are some of the major macro risks facing global markets in the year ahead.

Brazil

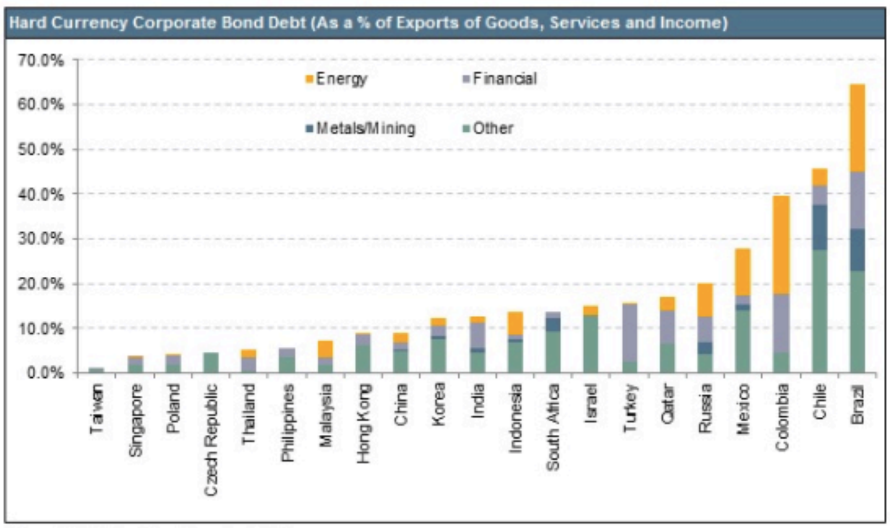
Brazil is a total mess, both politically and economically. The collapse of global commodities prices (the past 10 years have been the worst since the Great Depression) has disproportionately hurt Brazil due to its reliance on selling oil and iron ore into global markets. Since early 2014, there has been a 40% collapse of its currency, the real, which has created significant inflationary pressures inside Brazil and pushed the economy into a hard recession. Then there is politics, where President Rousseff has a less than 10% popularity rating but won't resign and stands on the precipice of impeachment proceedings. The political rival leading the charge to impeach her is under investigation for bribery. The Petrobas (one of the world's major oil companies) bribery scandal has taken down major public figures and shaken the country to its core. The country is hosting the 2016 Summer Olympics at the most inopportune time, just as the country's financial collapse, political scandals, and political gridlock are all reaching new heights.

The next chart shows how rapidly Brazil's manufacturing economy has declined during 2015. It is conceivable that Brazil's PMI reading may hit the lows it experienced during the 2008 Global Recession when it collapsed down to 40.

Brazil is not the only emerging market that has major issues, but it certainly is the poster child for many of the problems facing numerous emerging markets. Emerging market stocks were down 15% during 2015 and have lagged developed markets by 10% annualized over the past five years. Until commodities stop going down, until currencies stop depreciating against the U.S. dollar, and until the risk of debt default declines, emerging markets will continue to be challenged to perform well even if stock prices have already seen substantial declines and valuations look attractive relative to developed stock market valuations.

Emerging Markets Debt Defaults

In recent years, many emerging market countries issued large amounts of U.S. dollar denominated debt. Since many emerging market currencies have experienced substantial declines vs. the U.S. dollar, the cost of servicing U.S. dollar denominated debts has skyrocketed. This has put significant downward pressure on the economies of some emerging markets countries. If the U.S. dollar continues to strengthen during 2016, a not too far-fetched possibility, it could push several emerging markets towards default on their U.S. dollar denominated debts, which would create a very large negative reaction in global financial markets like the Russian debt default did in 1998. The chart below shows the emerging market countries with the largest amounts of hard currency corporate debt outstanding. Brazil leads the pack by a wide margin.



Source: BAML Index Data, Haver, CreditSights

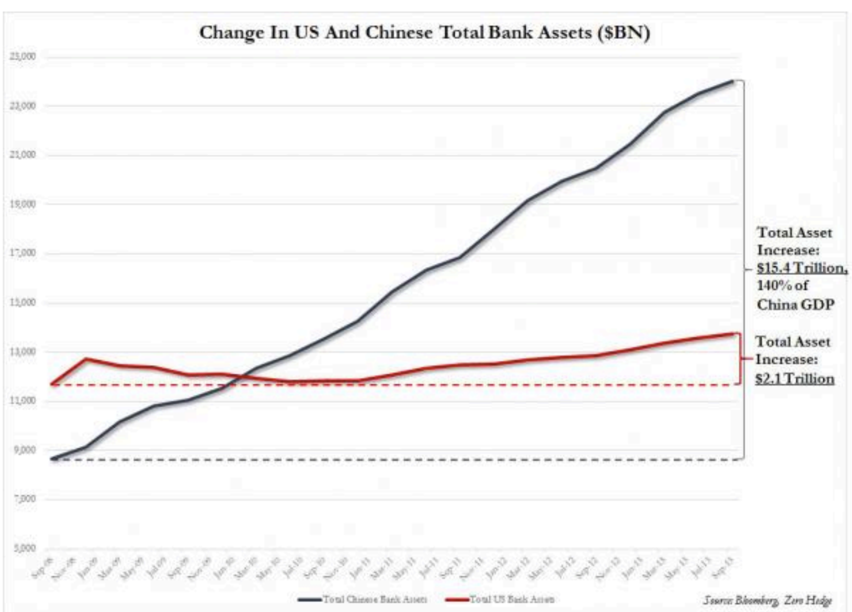
Source: CreditSights

Chinese Yuan Devaluation and Debt Crisis

China is the largest weighted country in the emerging markets index. China rocked the global financial markets in August 2015 when it unexpectedly changed from its tightly controlled currency policy and devalued its currency, the Renminbi (also known as the Yuan). The next chart shows the Yuan vs. the U.S. dollar going back to the early 2000's. A declining line is the Yuan strengthening against the U.S. dollar and vice versa. From 2005, the Yuan appreciated 60% against a basket of global currencies. As global growth experienced a notable slowdown in 2015, China was forced to devalue its currency as it exports were falling dramatically and its costs were too high compared to other export oriented countries. A big risk to global financial markets is how much further the Chinese central bank will allow the Yuan to decline to stimulate its economy and how much volatility this will create. At the start of 2016, the Yuan has fallen another 1.5%, which created additional pressure on Chinese stocks and has spread to global stock markets. It is fair to say that what is happening with China's slowing economy and weakening currency is having a significant degree of negative impact on the rest of the world. If China decides to accelerate its currency devaluation (say another 10-15%) then global financial markets are in store for tremendous amount of increased volatility ahead.

Source: Yahoo Finance

Another major risk that could negatively impact global financial markets is a brewing debt crisis in China. As a centrally planned Communist country, China uses State Owned Enterprises and the banks it controls to implement its centrally planned policies. Since the Global Financial Crisis, China's bank debt growth has been enormous. The next chart shows China's bank assets have increased by $15.4 trillion since 2008. This compares to the $9.8 trillion of assets the U.S. Federal Reserve, European Central Bank, Bank of Japan, and Bank of England have accumulated in aggregate since 2008 via their Quantitative Easing programs. Despite 400% loan growth, China has accrued a very low level of non-performing loans relative to the size of its bank assets. It is estimated that China could be sitting on $3.5 trillion of non-performing loans (out of a total of $30 trillion). Remember the pain U.S. banks created when the Global Financial Crisis hit and banks had to write-down the value of their assets and were forced by the Fed to raise capital? A similar situation could be facing China and its banks in the years ahead.



Federal Reserve Rate Hikes

The Fed officially ended its Zero Interest Rate Policy in December with a 0.25% rate hike. In light of weakening economic data, particularly in the manufacturing sector, there was an immediate debate as to whether this rate hike was a one and done event. In early January, the December jobs report was a stronger than expected 292,000 job gains although unseasonably warm winter weather undoubtedly put a large upward bias to the seasonally adjusted component of the numbers. October and November job gains were also revised higher by 51,000. The strength of the jobs data immediately put the possibility of multiple rate hikes back on the table for 2016. Several Federal Reserve Board members, including Vice Chairman Stanley Fischer, have publicly stated that 3-4 rate hikes could be a distinct possibility during 2016. As the U.S. stock market's advance over the past several years has been supported by an extended period of extremely low rates, this change in the Fed's mentality towards rate hikes could create a substantial headwind to the U.S. stock market. If economic growth stays anemic but the Fed decides it can no longer justify its highly accommodative policy stance and raises rates several times anyway, the stock market will not react well to such an outcome.

U.S. Earnings Outlook

Another potential risk to U.S. stocks is a deteriorating earnings growth outlook. With sales for S&P 500 Index companies now at negative year-over-year growth and CEO optimism heading lower, the sales outlook for 2016 could remain quite muted and by extension the earnings outlook for stocks will be weaker than currently expected. As of early January, the 2015 S&P 500 Index operating earnings estimates stood at $117.26/share although the actual fourth quarter numbers need to be reported to finalize the actual 2015 earnings number. 2015 earnings will be lower than 2014, which helps to explain why most stocks struggled mightily during 2015. 2016 estimates currently stand at $126.91/share or 8.2% growth before heading into the important fourth quarter earnings season starting now and lasting into early February. It would be very surprising if earnings can grow near 8% in 2016 with the global economy performing quite poorly, the U.S. dollar showing strength, and the U.S. economy struggling to generate 2.0% real GDP growth.

Summary

The first week of January saw global stocks dive 6%, the worst start of the year ever for U.S. stocks. There still remain substantial risks to global financial markets. While 2015 was not a good year by any stretch of the imagination, financial assets also did not fall materially either. Nonetheless, many investors will get their year-end statements and not be too pleased. The Achilles heel for stocks during 2016 is that despite a poor year of returns during 2015, stock valuations did not improve and the risk/reward setup for stocks did not improve either. The earnings growth outlook for 2016 is mostly likely too high and needs to be lowered. The prospect of the Fed raising rates during a weak economy is another potential negative headwind for stocks. 2016 could be a More of The Same type of year. Subpar growth, low bond yields, increased volatility, and poor stock returns. Of course, that's not a forecast, just an opinion.

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

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