MJM INVESTMENT ADVISORS, LLC

2016 Year In Review and 2017 Investment Outlook

2016 Year In Review

- The Shock Heard Round The World (no, not the Cubs winning the World Series) occurred in early November with Donald Trump's unexpected election as the nation's 45th President. Up to November, the U.S. stock market meandered back and forth without much conviction. From 11/8 onward, U.S. stocks went on a significant year-end rally and turned a mediocre, mid single-digit return year into a much more profitable one for stock investors.
- U.S. small caps disproportionately benefited from Trump's victory as some of his proposed policies, if enacted, will benefit smaller companies with a primary focus on the U.S. The Russell 2000 Index gained +13.7% from 11/8/16 thru year-end and finished 2016 with a stellar +21.3% return. Gains were aided by $13 billion of inflows into small cap ETFs starting in early November.
- Large cap stocks also rallied after Trump's election (+4.9%) but nothing like small caps. The U.S. dollar rally after Trump's win creates additional headwinds for large cap multinational earnings in 2017. Even so, the S&P 500 Index still finished the year with solid gains and a +12.0% return. The best performing sectors were financials, materials and energy and the worst performing sector was healthcare.
- International markets underperformed U.S. stocks for the fourth year in a row with negative currency returns and poor returns from some European markets contributing to the weak results. The MSCI EAFE Index of developed international markets returned just +1.0% in U.S. dollar terms while in local currency terms it returned +7.1%. As was the case in 2015, currency hedging was very important to protecting international investment returns during 2016. Emerging markets rebounded from a terrible 2015 as the MSCI EM Index returned +11.2%.
- Bond markets experienced a very volatile 2016. The 10-Year U.S. Treasury yield declined to a low of 1.38% in early July and then experienced a dramatic reversal higher into year-end and finished 2016 at 2.44%. Trump's unexpected victory lead to a big gap higher in bond yields as investors believe Trump's pro-growth policy initiatives will lead to a reacceleration in real GDP growth and inflationary pressures. Bonds underperformed stocks by a wide margin and were slightly positive for the year.
- Commodities also saw a large rebound in 2016 despite a rising U.S. dollar. Rising expectations for improved global GDP growth, increased trade tariffs, and rebounding Chinese demand all contributed to higher commodity prices during 2016. Oil had major gains.
- Below is a summary of key market indices for the fourth quarter and full year 2016 compared to 2015 performance.

	QTR		2016		2015
S&P 500 Index (U.S. large cap stocks)	3.8%	↑	12.0%	↑↑↑	1.4%
Russell 2000 Index (U.S. small cap stocks)	8.8%	↑↑	21.3%	↑↑↑	-4.4%
MSCI EAFE Index (large cap int'l stocks)	-0.7%	↓	1.0%	↑	-0.8%
MSCI EM Index (emerging markets stocks)	-4.2%	↓	11.2%	↑↑↑	-14.9%
Bloomberg Barclays Aggregate Bond (invt. grade bonds)	-3.0%	↓	2.7%	↑	0.6%
Bloomberg Barclays High Yield (below invt. grade bonds)	1.8%	↑	17.1%	↑↑↑	-4.5%
Bloomberg Barclays Short-term Treasury (cash)	0.1%	←→	0.5%	←→	0.1%
Gold	-12.5%	↓↓↓	8.6%	↑↑	-10.1%
WTI Oil	11.3%	↑↑↑	44.8%	↑↑↑	-30.5%
Morningstar Balanced Funds Average	1.0%	↑	7.3%	↑↑	-1.6%

2017 Investment Outlook

It's Going To Be YUUUUGE!

"We are in a big, fat, ugly bubble. But if you raise interest rates even a little bit, that's going to come crashing down."

- Candidate Donald Trump commenting on the U.S. stock market during the late September 2016 debate.

"You campaign in poetry but you govern in prose"

- Mario Cuomo – Former Governor of New York

"We are about to experience a profound, president-led ideological shift that will have a big impact on both the U.S. and the world. This will not just be a shift in government policy, but also a shift in how government policy is pursued. The question is whether this administration will be a) aggressive and thoughtful or b) aggressive and reckless. The interactions between Trump, his heavyweight advisors, and them with each other will likely determine the answer to this question. We are pretty sure that it won't take long to find out.

- Ray Dalio – Founder of Bridgewater Associates

Except for the seasonal (but dreaded) Polar Vortex, hurricanes, and tornadoes, La Nina and El Nino have been the main weather patterns affecting the U.S. in recent decades but a newly named storm called Donald is about to hit the U.S. Donald isn't a weather pattern, but a highly unpredictable political storm that will engulf the entire U.S. over the next four years and could very well spread to other parts of the world too. Donald is scary because it doesn't play by any conventional political rules that have been followed for over a century and it strikes without warning and is impossible to track or predict where it is headed next.

Donald seemingly came out of nowhere in the middle of 2015. At first, Donald was dismissed as a political lightweight and became Late Night joke fodder but then things slowly began to change. Over the next year and a half, Donald wreaked havoc wherever he went, leaving political heavyweights strewn in its path and confounding the political and media establishment. As his Republican primary opponents painfully figured out, there is only one standard operating procedure to prepare properly for Donald. Double-check the batteries on your safety beacon and flashlight and have plenty of backups.

Donald became a surging wave that destroyed 16 other well-known Republican candidates. After winning his party's nomination, he completely bypassed the traditional print and TV media and took his message directly to the American people via non-stop tweets and an endless road trips to sold out rallies aboard his personal Boeing 757. Donald spent $66 million of his own money during the political campaign. Donald called the media covering his election rallies a bunch of liars and low life scum. He called his Democratic opponent a crook on live TV and said when elected he would appoint a special prosecutor to try to get her thrown in jail where she belonged. After winning the Presidency, Donald continued to call China a massive currency manipulator and took a congratulatory phone call from the

President of Taiwan, thumbing his nose at the U.S.'s long standing One China Policy. Donald praised Russian President Vladimir Putin via Twitter at the same time the outgoing President was throwing Russian diplomats out of the country to retaliate for its supposed election interference via hacking. Donald could care less about protocol.

2016 marked the beginning of when political risk became a much more important risk for investors to consider in the years ahead. It began with the unexpected Brexit vote outcome in June (which Donald supported). Next, the Shock Heard Round The World occurred in the U.S. with Donald knocking out political heavyweight Hilary Clinton, the most shocking upset in the history of American politics (replacing the Truman/Dewey 1948 surprise). This political storm may hit Europe next. In late November, Italy's Prime Minister lost a key election referendum and resigned from office (Italy is a complete disaster but that's a story for another time). In 2017, there are major elections scheduled for France, Germany, Italy, and the Netherlands. Lead by Donald, nationalism is on the rise. The UK Brexit Vote was the first attack on the concept of the European Union and there may be more political storms brewing on the horizon. Donald may be the political storm that shakes up the status quo globally for years to come.

Financial markets dissect risk into components. There is broad market risk and its components include business cycle risk, company specific risk, currency risk, and interest rate risk. Political risk is also a risk but one rarely given much attention by investors because historically, politics tend not to have a large impact on financial markets. Well, Donald is about to change all that. Political risk is about to become YUUUUUGE!!! Unlike virtually every other President before him, Donald is not concerned whatsoever about getting re-elected. Donald is a businessman first and being a politician is a distant second. Donald is about shaking up America and trying to reenergize it again or go down hard swinging, politics and the media be damned.

Donald's principle message is Make America Great Again (whatever the cost?). Donald represents the most pro-growth policy agenda in a generation. He will relentlessly pressure American companies to keep jobs in the U.S., put up more trade barriers to ensure fair trade and competition, keep out and deport unwanted immigrants who don't follow the proper rules to becoming citizens, increase respect for the law, increase defense spending, upgrade America's infrastructure, and enact trade deals with other governments only if the U.S. is getting a better deal than we have now.

Donald's cabinet appointments have been heavily biased towards people with business experience first, political experience second.

How Experienced Is Each Incoming Administration?
Years of Relevant Experience

	Cumulative	Government/ Military	Business (C-Suite)
Kennedy	96	77	19
Nixon	95	67	28
Carter	79	58	21
Reagan	96	51	45
HW Bush	132	79	53
Clinton	123	101	22
Bush	152	80	72
Obama	122	117	5
Trump	138	55	83

High overall number

Most years of business experience, fewer years of governmental

**Counting the President, Vice President, Chief of Staff, Attorney General,*
and secretaries of State, Defense, Treasury, and Commerce.

Source: Bridgewater Associates

The stock market LOVES it! The post election rally in the U.S. stocks has been significant, turning 2016 from a mediocre year into a very good year. It was the biggest post election stock market rally since Herbert Hoover was elected in 1928 as the S&P 500 Index gained 4.9% and the Russell 2000 Index of small cap stocks gained 13.7% from 11/8/16 thru 12/31/16. Speaking of Hoover, he was the last Presidential candidate to take office without any prior elected office experience (he was appointed Commerce Secretary in the Harding Administration). The Great Depression started during Hoover's Presidency and ended as an abysmal failure.

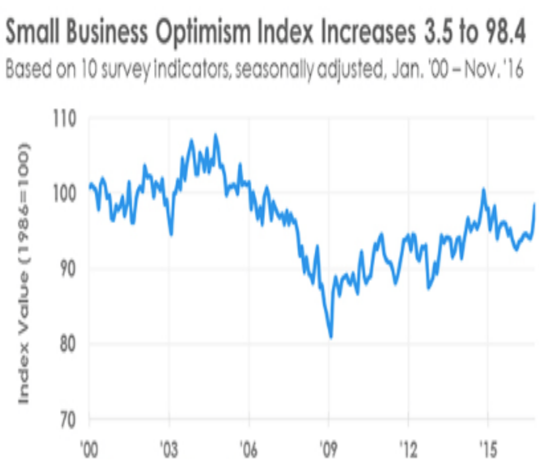
Investors now need to consider political risk as one of the more important risks to assess for 2017 and beyond. Not only is Donald a highly unpredictable political force, but before he has taken the oath of office, financial markets have already converted his policy proposals into expectations of higher GDP growth, improved employment, lower corporate and personal tax rates, rising inflation, and higher earnings. Although Trump has selected Cabinet members with the most business experience of any Administration in modern history, it also true that Trump's Cabinet appointments have the least amount of prior government experience of the last eight Administrations. This fact does not appear to be on the radar screen of most investors.

The variability of potential outcomes over the next four years is quite large. Is it smart to assume that Trump, a political novice with a cabinet loaded with other political novices, will gain almost certain victory with all of his pro-business policy initiatives and that there won't be a few political setbacks and stumbles along the way? Will a Congress that has been completely dysfunctional for over a decade and unable to find common ground on important policy decisions suddenly become a cooperative, rubber stamp to the new President's pro-business policy agenda? Is the Democratic Party, severely wounded from its abysmal election night showing, going to roll over and acquiesce to Donald and his new pro-business administration? The only thing that appears certain right now is that Donald is about to upset the status quo in a big way and political risk is going to be much bigger factor for global financial markets in the years ahead.

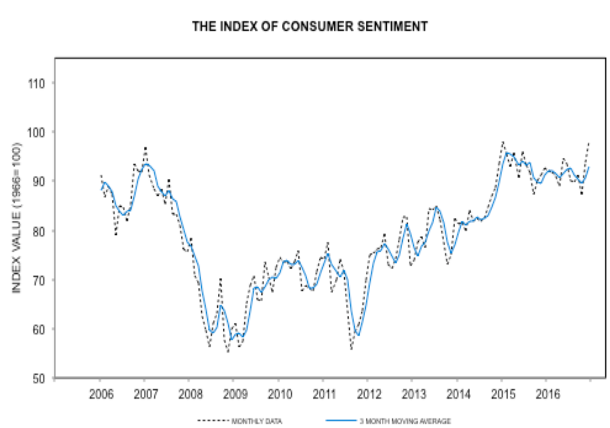
Oh Boy, Is This Great!

In the iconic movie classic Animal House, Ken “Flounder” Dorfman was ecstatic once Delta House initiated its attack on Dean Wormer and the Faber College Homecoming Parade. Flounder and his fellow Delta House members were angry and seeking revenge after their expulsions from Faber College. Similarly, the American people have grown increasingly angry with the political establishment such that they kept their voting intentions secret from the pollsters and dissed the (supposed) heavily favored but highly unlikeable political heavyweight for the equally unlikeable political novice, businessman candidate. In retrospect, perhaps it shouldn’t have been so shocking. 62% of Americans have less than $1,000 in savings. Half of all American workers make less than $30,000 a year. Over the past eight years, the Federal debt has increased 65% to nearly $20 trillion, the labor participation rate remains at its lowest level since the 1970s, home ownership is at the lowest level in 50 years (despite the lowest mortgage rates in the nation’s history), 32% of Americans age 18-34 live with their parents, and there are now more government employees than people employed in manufacturing. With the exception of the liberal West Coast, Boston, New York City, Chicago, and Philadelphia, the vast majority of Americans believed the country needed a serious intervention and voted accordingly. Democrats not only lost the White House but by the end of Obama’s second term, Democrats lost over 1,000 elected positions nationally during his years in the Oval Office. The unbridled optimism of Yes We Can! in 2008 turned into massive disillusionment by 2016.

Now that the U.S. has a Republican controlled federal government the next two years (Republicans also control 32 state houses and governorships), heavily repressed animal spirits during the Obama years have quickly reappeared in force. Since 11/8, numerous sentiment indicators have roared to life. The National Federation of Independent Business monthly survey conducted after Trump was elected saw the biggest monthly gain since April 2009. The University of Michigan Consumer Sentiment survey also saw a notable pop higher. An all-time record number of consumers (18%) spontaneously mentioned the expected favorable impact of Trump's policies on the economy. This was twice as high as the prior peak of 9% recorded in 1981 when Reagan took office after four dreadful years under Jimmy Carter.

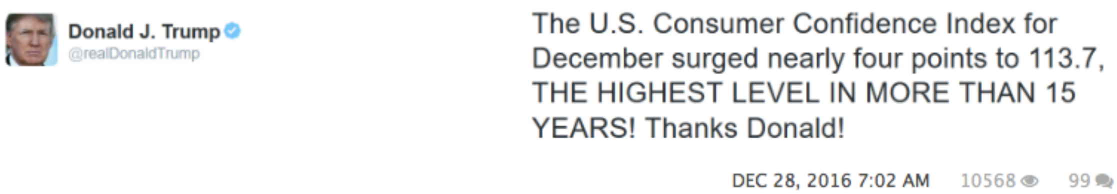


Source: NFIB



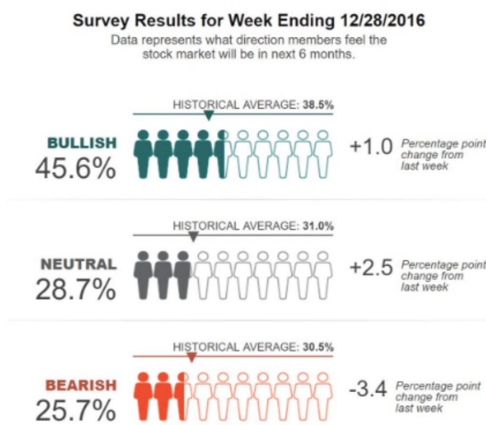
Source: University of Michigan

Of course, the massive shift in sentiment is not lost on the President Elect, who is taking full credit for it.



The Gallup Poll of Economic Confidence blasted upwards to a new all-time high after Trump won the election, higher that any point during the Obama Administration years. The AAII investor's bullish sentiment survey saw a significant pop higher after Trump won and finished 2016 at a 5-week high and on the longest streak of >40% Bullish readings of the past two years.

Source: Gallup.com

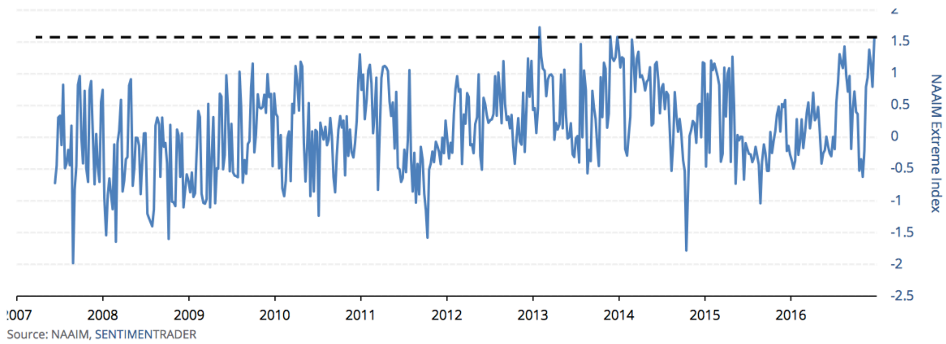


Source: American Association of Independent Investors

One of the key issues for 2017 is whether the massive shift in sentiment has become too positive too fast such that U.S. stocks are now setup to disappoint. The CNNMoney Fear & Greed Index has rocketed higher and has reached a level where euphoria appears to be fully priced in. The red circles in this chart indicate times when the stock market peaked and moved lower after hitting Extreme Greed levels.

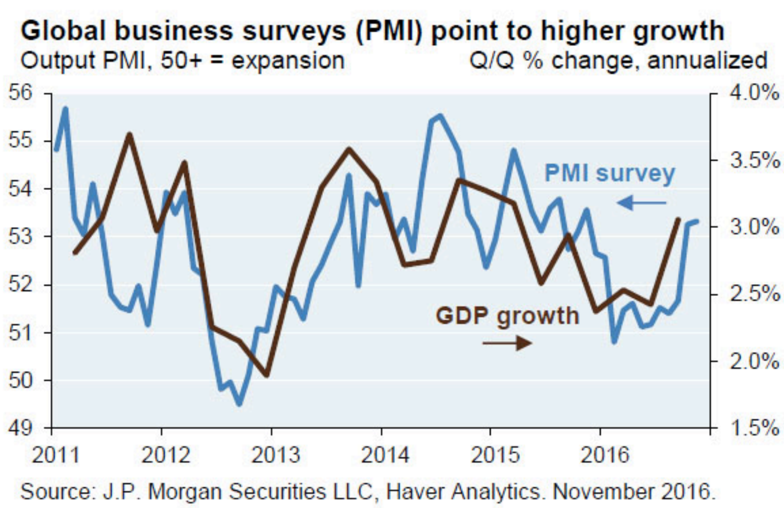
Source: CNNMoney

The latest survey of active money managers conducted by NAAIM shows respondents at their highest bullish reading since late 2013. Historically, a reading above 1 and stocks tend to struggle.

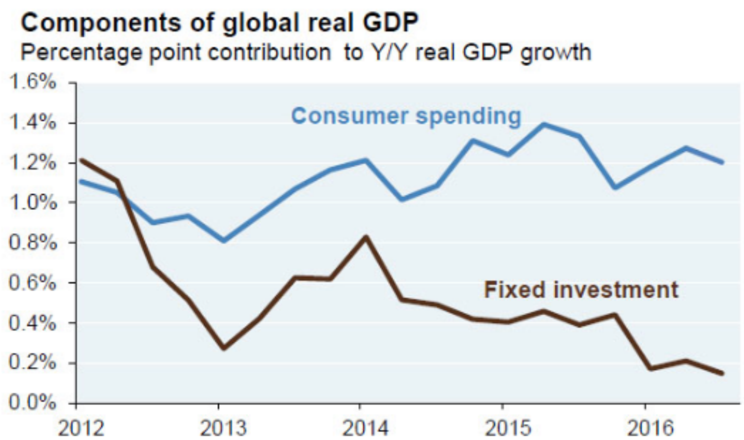


It's fair to say that except for the most liberal college campuses and cities (where Xanax prescriptions have exploded higher), the shift in sentiment across America in response to Trump's election has been yuuuuuge. However, the positive sentiment shift has quickly become extreme and before members of the Trump Administration have even been assigned office space and warmed their office chairs. A sentiment shift is one thing, but a shift towards better fundamentals for the economy is another thing altogether. It will take time before we see any actual fundamental change occur but sentiment can quickly disappear. Another key question for 2017 is whether this massive shift towards positive sentiment will be followed up with real economic progress.

One area to watch for whether sentiment turns into real economic benefit is in the area of fixed investment. Global purchasing manager (PMI) surveys have seen a strong rally in the latter part of 2016 and point to stronger economic growth for 2017.



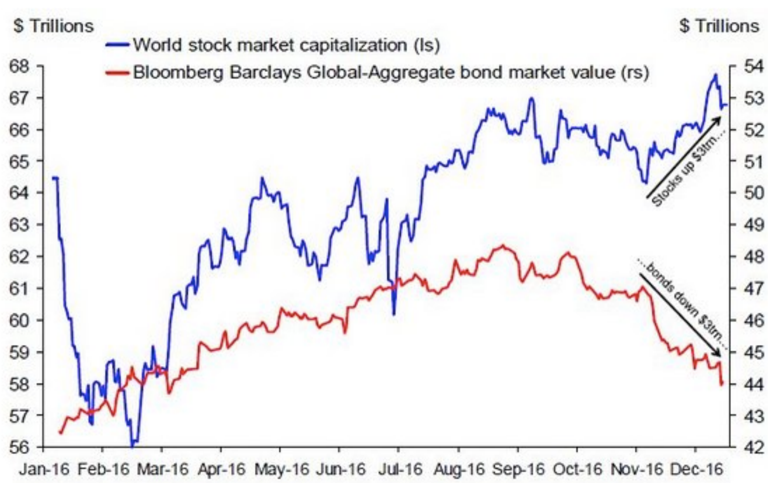
Fixed investment spending is a key component of GDP growth and has been weakening for many years, which partially explains why the U.S. has struggled to achieve a 2% real GDP growth rate. An anti-business Obama agenda and a lack of confidence by CEOs in the future have negatively impacted fixed investment and GDP growth. A key question for 2017 is whether the switch to a pro growth government policy agenda will reverse this trend and lead a rebound in capital investments that flow through to improvements in real GDP growth.



Source: J.P. Morgan Securities LLC. Q3 2016.

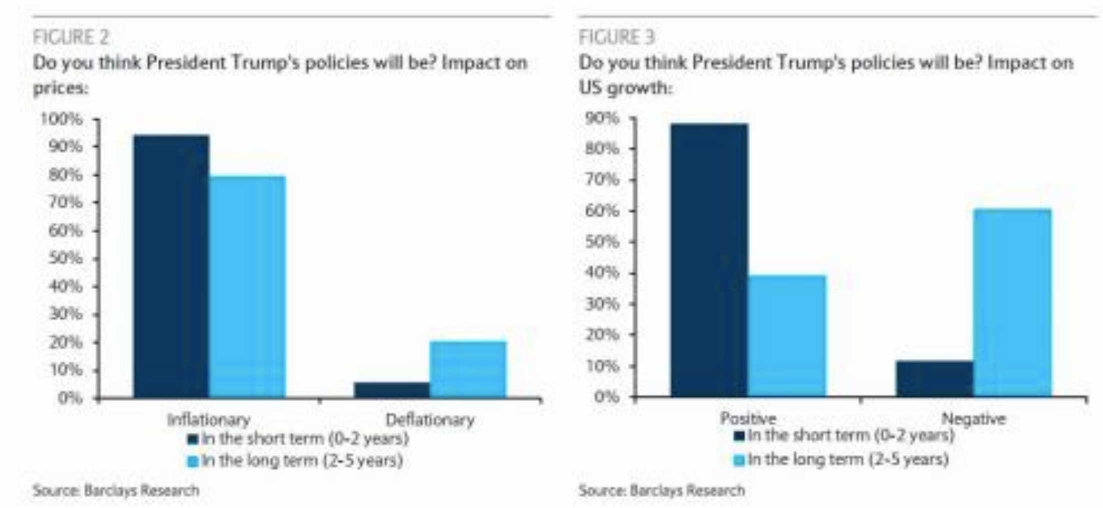
Will Higher Yields Eventually Undermine Stocks?

As good as it has been for stock investors since Trump was elected, the opposite is true for bond investors. The chart below shows that since November, global stocks have increased by $3 trillion in value while global bonds have declined by a similar amount.

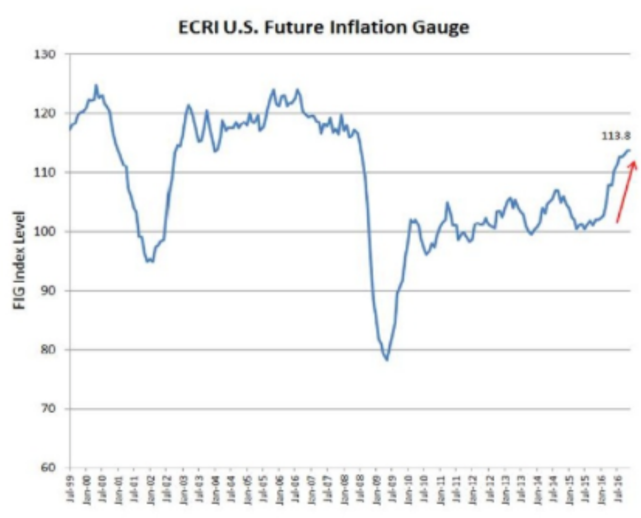


Trump's pro-growth policy initiatives have created rising economic growth and inflation expectations in bond markets. In addition, the Fed's decision to raise short-term interest rates in December and adopt a slightly higher expectation of more rate hikes in 2017 also spooked bond investors. As a result, bond yields have blown out quickly and bond returns have plummeted since 11/8. The Bloomberg/Barclays Aggregate Bond Index return hit a high near 6% in July and declined to a 2.7% return by 12/31/16. There was a significant shift of fund flows into equity funds after Trump's election. November saw $49 billion of inflows into stock ETFs, the greatest monthly amount ever. It is important to note that traders with short-term mentalities typically use ETFs to quickly gain market exposure. Caveat emptor. These fund flows can reverse just as fast.

Another key question for the U.S. economy during 2017 is at what level do higher yields undermine the stock market rally. Rising inflationary expectations have been a key part of the large move higher in bond yields. The next chart shows a survey of institutional investors and their expectations of what Trump's policies will do to inflation and economic growth. The embedded market view post election is overwhelmingly biased towards higher economic growth and higher inflation over the next two years.

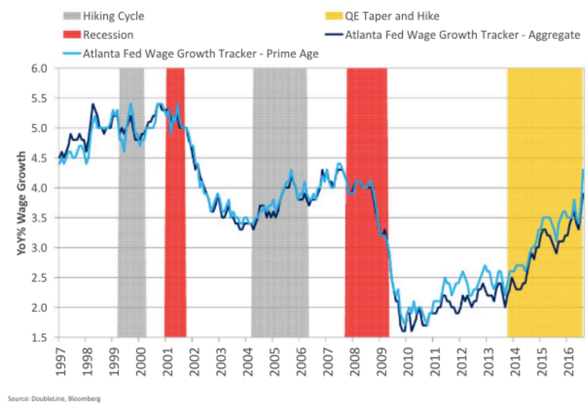


These expectations played out in both stock and bond markets in the weeks following Trump's election. U.S. stocks have surged ahead on higher economic growth expectations and bond yields have surged higher on rising inflation expectation. The next chart shows how rising future inflation expectations have surged higher over the course of 2016.



Source: DoubleLine, Bloomberg

A big component of rising inflation expectations is wages. Trump has made strong comments against illegal immigration and has also championed bringing higher paying jobs back to the American middle class. He is using the bully pulpit to stop U.S. companies from moving jobs overseas and getting foreign companies to commit to make investments in the U.S. and hire American workers. Rising wage expectations are beginning to filter into the job market as shown by the significant jump in the Atlanta Fed Wage Growth tracker on the far right side of the left chart below. Additionally, U.S. workers are gaining more confidence about job security as voluntary quit rates move higher while the firing rate moves lower.

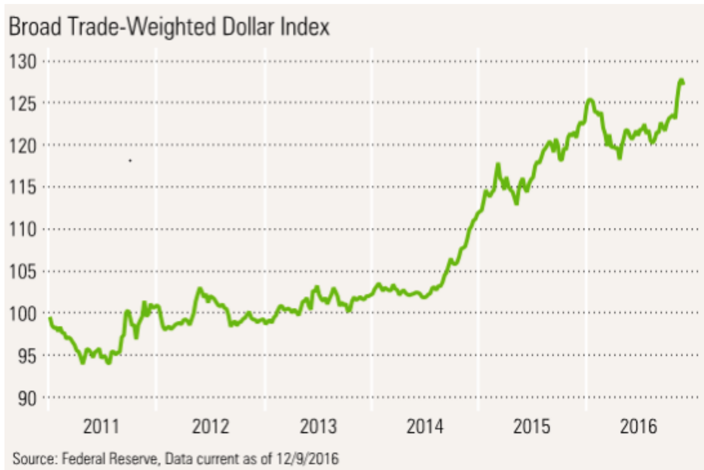


Numerous states have already enacted higher minimum wage laws. In 2017, 20 states will see a rise in minimum wages, impacting an estimated 4.4 million workers. The Fed has taken a very slow and deliberate approach to raising interest rates even as the unemployment rate has continued to drift lower. The Fed has been slow to raise rates because broad inflationary pressures remain soft. However, should the wage growth pressure start to take hold in the economy, the Fed is more likely to come off of its lower for longer mentality and begin to raise rates more frequently going forward, especially if the fiscal spending side kicks in via Trump's policy initiatives. If the Fed gets more aggressive with rate increases, a key catalyst to stock markets moving higher over the past several years will be removed from the equation.

Rising wages are positive for consumer spending trends, which contribute to GDP growth. However, rising wages also create a big headwind for corporate profit margins. The weak GDP growth environment over the past eight years has not given companies much leverage to raise prices. However, rising wages are now hitting companies and may put pressure on profit margins.

Will The U.S. Dollar Undermine U.S. Stocks?

Expectations of higher interest rates and rising economic growth under the Trump Administration have lead to a major surge higher in the U.S. dollar as shown in the next chart.



The chart above shows that the U.S. dollar has increased over 25% against a broad basket of foreign currencies since 2013 and is now at a 14-year high. For overseas buyers, U.S. goods and services now cost 25% more than in 2013. Nearly 50% of the revenues generated by companies in the S&P 500 Index come from outside the U.S. compared to just 21% for small cap U.S. companies in the Russell 2000 Index. As the U.S. dollar strengthens, it creates a negative headwind for corporate earnings as income from foreign operations converted back to U.S. dollars take a hit. Right now, the U.S. stock market only seems to care about the higher economic growth expectations that they believe Trump's policies will deliver to the U.S. economy. However, should the U.S. dollar continue to strengthen, it will ultimately create a significant negative headwind for earnings forecasts that will eventually be recognized by financial markets.

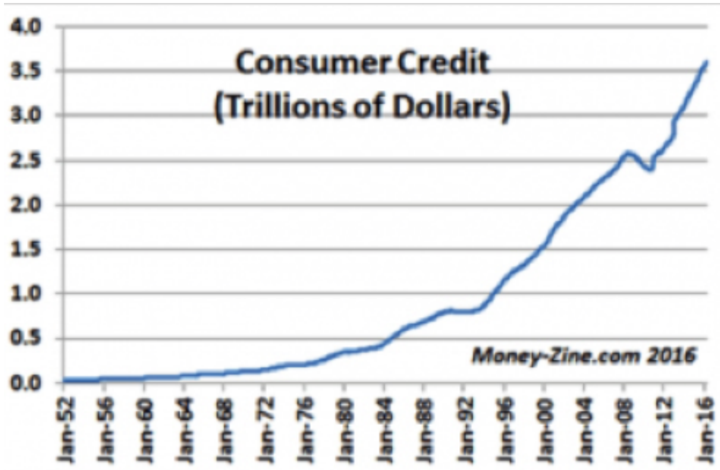
A strong U.S. dollar policy is not necessarily a bad thing, especially if the U.S. wants to continue to be the world's key reserve currency. However, when the U.S. dollar strengthens rapidly over a short period of time, it can play havoc with the earnings of U.S. multi-national companies and the earnings outlook for U.S. stocks.

The Fly in the Ointment

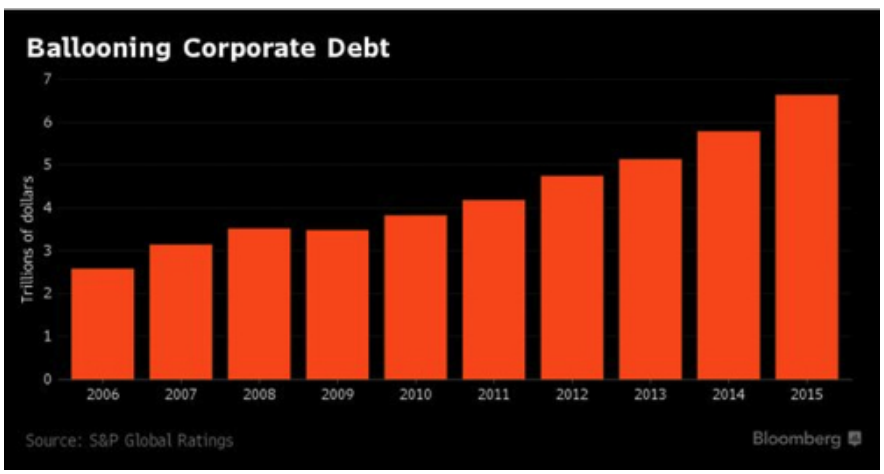
In the short-term, stock markets have experienced a wave of euphoria since 11/8. However, taking the 10,000-foot view, the U.S. is still a massively indebted economy. Global debt to GDP is 35 percentage points higher today than in 2008. According to Dealogic, global debt increased $6.6 trillion during 2016. There is more debt outstanding today than existed back in 2008 at the time of the Great Recession, which happened because of….wait for it, wait for it, too much debt. Low rates of global economic growth and deflationary pressures are symptoms of excessive debt levels, which has been the prevailing economic environment since the Global Financial Crisis hit in 2008.

A key goal of the Fed's Zero Interest Rate Policy the past eight years was to juice economic growth (not achieved). The unintended consequence of this policy is that incentivizes everyone to take on more debt.

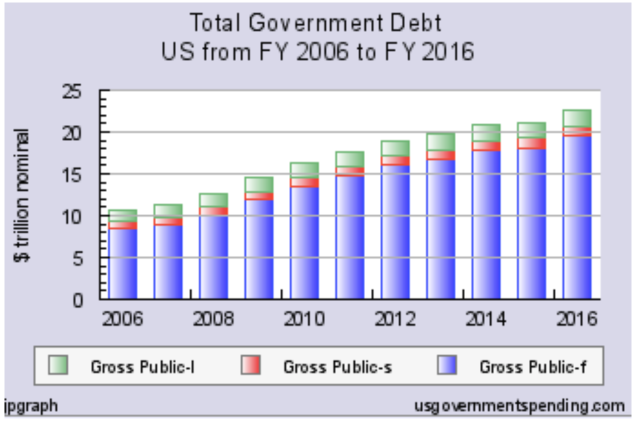
The next chart shows how U.S. consumer credit has continued to explode higher after a brief pullback following the 2008 Global Financial Crisis.



Half of the global debt raised during 2016 came from the corporate sector. Companies are using cheap debt to finance mergers & acquisitions, pay dividends, or repurchase shares. Unfortunately, one thing corporations are not doing with their increased debt is making capital investments in their businesses, most likely due to a lack of conviction about the future. It remains to be seen if Trump's election will begin to change the corporate executive suite mentality in this area.



U.S. Federal government debt is nearing $20 trillion and growing. If Trump is able to push forward his corporate and personal income tax reform, increase defense spending, and get an infrastructure spending program passed, it all but guarantees that Federal government debt will increase higher in at least the first few years of Trump's term.



If Trump's major policy initiatives get enacted and they create higher rates of real GDP growth above our current pathetic 2.0% annual real GDP growth rate, then these debt levels will become less of an issue over time. But, that is a big IF, and it is not a sure thing in a way that investors seemed to have priced it in to the stock market in the latter part of 2016.

Summary

There has never been anything in U.S. politics like Donald. Perhaps his boldness and unpredictability will eventually earn him a choke chain and be tempered over time by the political quagmire of Washington, DC. But, out of the gates, it is going to a bucking bronco ride of major proportions. It will elevate political risk to a much higher level than the U.S. has seen for a very long time and make it a key risk for investors to consider during 2017 and beyond. Additionally, the boldness of change that the British voted for in Brexit and Americans voted for in the 2016 U.S. election may translate into more political surprises out of Europe in 2017 as the political status quo gets upended and anti-globalization and rising nationalism trends play out.

Post the Trump election, the U.S. stock market's year-end rally and bond market sell-off is more about shifting sentiment, trader positioning, and short-term technical factors. Hope rallies are very typical post Presidential election cycles where the incumbent party loses and a new party gets swept into power. However, it's where the rubber meets the road that real change occurs in government policy and it is very dangerous to make investment decisions on the presumption of policy victories. Elevated political expectations are now priced in and it may take much longer than expected for Trump's policy initiatives to get enacted and to take effect. Remember the Hope and Change optimism of Obama's election in November 2008? After eight years there was no hope left and there was no change. Ronald Reagan, as revered as he is today for raising America up again and defeating Communism, achieved only 50% of his policy platform goals. The perception now is that Donald will be very bullish for America. However, do not underestimate the uncertain and highly unpredictable nature of this new political storm.

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