# MJM INVESTMENT ADVISORS, LLC

## Fourth Quarter 2017 Financial Markets Review

- The fourth quarter continued the trend of the prior nine months as strong stock returns combined with extremely low volatility served up a win/win scenario for investors with exposure to risk assets. 2017 marks the first year in history that the S&P 500 Index never had one negative monthly return during a calendar year.
- 2017 was also the LEAST volatile year for stocks in history. Records were broken for the longest consecutive days without a pullback of 3% or more and the streak is still alive (over 290 days and counting) heading into 2018. Realized volatility on the S&P 500 Index stands at 6.8 compared to 15.8 over the past 60 years. The more popular CBOE Volatility Index or VIX is about half its normal level.
- The S&P 500 Index gained 6.6% during the fourth quarter and finished 2017 with a surprising return of 21.8%. Literally nothing could knock the stock market's move higher off course. Growth stocks blew away the returns of value stocks for the year with the Russell 1000 Growth Index returning 30.2% while the Russell 1000 Value Index returned 13.7%. Small caps struggled to gain traction for most of the year until the odds of corporate tax reform passing went higher and then small cap stocks went on a tear. During the fourth quarter the Russell 2000 Index gained another 3.3% and returned 14.7% for 2017.
- Foreign stock markets outperformed U.S. stocks for the first time since 2012. Emerging markets was the best asset class during 2017 as the MSCI EM Index returned 37.3%. Developed markets international stock returns as measured by the MSCI EAFE Index returned 4.2% for the quarter and 25.0% for 2017.
- The Federal Reserve raised the Federal Funds rate 0.25% at its December meeting. It was the third rate hike of 2017 and reflects a steady and improving economy over the course of the past year. The current expectation is for three more 0.25% rate hikes during 2018.
- Real GDP growth has moved above 3% the past two quarters after a weak 1Q and fourth quarter real GDP is forecast near 3%. 2017 real GDP growth will likely end up around 2.5% for the year, and could end up near 3% during 2018. MAGA policies are starting to have a real effect on economic growth and the recently passed corporate tax reform will further solidify this trend. As proof, small business confidence improved dramatically during 2017 and hit record highs.
- Despite synchronized global growth, global bond yields remain at historical lows. The U.S. Treasury 10-year bond yield finished the year at 2.41%, up slightly from the end of 2016. The broad fixed income benchmark Bloomberg Barclays Aggregate Index returned 0.4% for the quarter and only 3.5% year to date. High yield bonds had a fairly muted quarter as well, returning 0.5% and returned 7.5% for 2017.
- The following table shows key market benchmarks for the fourth quarter and 2017. It was an exceptionally strong year for risk assets across the board and after a solid 2016 as well.

| | Fourth Quarter | | 2017 | | 2016 | |
|---|---|---|---|---|---|---|
| **S&P 500 Index (U.S. large cap stocks)** | 6.6% | ↑↑ | 21.8% | ↑↑↑ | 12.0% | ↑↑↑ |
| **Russell 2000 Index (U.S. small cap stocks)** | 3.3% | ↑ | 14.7% | ↑↑↑ | 21.3% | ↑↑↑ |
| **MSCI EAFE Index (large cap int'l stocks)** | 4.2% | ↑ | 25.0% | ↑↑↑ | 1.0% | ↑ |
| **MSCI EM Index (emerging markets stocks)** | 7.4% | ↑↑ | 37.3% | ↑↑↑ | 11.2% | ↑↑↑ |
| **Bloomberg Barclays Aggregate Bond (invt. grade bonds)** | 0.4% | ↔ | 3.5% | ↑ | 2.7% | ↑ |
| **Bloomberg Barclays High Yield (below invt. grade bonds)** | 0.5% | ↔ | 7.5% | ↑↑ | 17.1% | ↑↑↑ |
| **Bloomberg Barclays Short-term Treasury (cash)** | 0.2% | ↔ | 0.8% | ↔ | 0.5% | ↔ |
| **Gold** | 1.8% | ↑ | 12.5% | ↑↑↑ | 8.6% | ↑↑ |
| **WTI Oil** | 16.9% | ↑↑↑ | 12.5% | ↑↑↑ | 44.8% | ↑↑↑ |
| **Morningstar Balanced Funds Average (50% to 70% stocks)** | 3.5% | ↑ | 13.4% | ↑↑↑ | 7.3% | ↑↑ |

## 2018 Investment Outlook

**FOMO OR FUBAR?**

"This is a period when stock markets have the ability to seduce investors (into believing) that making money is easy," But to abandon investment principles and "buy what's going up, just because it's going up . . . is the route to penury"

Neill Woodford – Woodford Investment Management

" We've been living in a world for the last three years thanks to quantitative easing of negative net bond supply and that's gonna flip because the Fed is now letting bonds roll off, the budget deficit is increasing, a tax cut would increase the deficit further, and to the extent that a tax cut might be stimulative to the economy, that's bond unfriendly, because bonds don't like economic growth and also it's expanding the deficit, so even more supply (of bonds)."

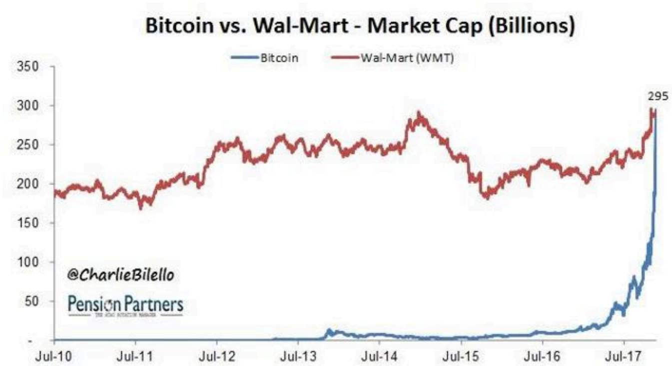
Jeff Gundlach – CEO DoubleLine Capital

"Bitcoin is 15-25x as volatile as the S&P 500, 20x-40x as volatile as gold, and even 5x-11x as volatile as oil as measured by the coefficient of variation."

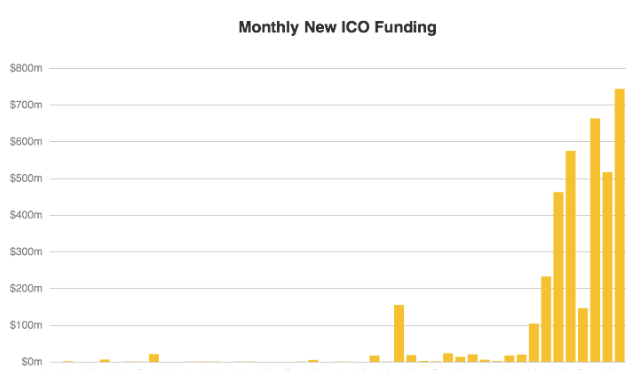
Barclays Capital

2017 Investment Outlook was titled "It's Going To Be YUUUGE" and boy was it. It was a surreal year for global financial markets across the board. Not one Wall Street market strategist predicted U.S. and global stock markets would return over 20% during 2017. Global growth surprised to the upside, political tensions eased in Europe, China growth did not disappoint, and investors ignored every major geopolitical risk event including North Korea's repeated ICBM launches and nuclear arms progression. A vast majority of bond market experts predicted longer maturity bond yields would rise but that didn't happen either. The yield curve flattened significantly as short rates rose while long rates stayed anchored. Asset volatility was non-existent with no negative monthly returns recorded by the S&P 500 Index, the first time that occurred in one calendar year in history. The VIX Index hit all-time lows. If you were fully invested, it was nirvana, as most investors enjoyed strong capital gains for the year with virtually no downside volatility. Unsurprisingly, in this perfect world, individual investors have the most stock exposure since 2000 and the AAII Bull Ratio is nearly 80%.

No financial story captured the Fear of Missing Out (FOMO) more than the explosive growth of crypto currencies (aka digital coins). Bitcoin and other crypto currencies were virtually unknown to the masses coming into 2017 but became the latest poster child for asset bubbles and risk chasing. Many crypto currencies produced mind-boggling gains of 1,500% or more during 2017, making the gains from the dot com bubble of the late 1990s look like child's play. The oldest crypto currency, Bitcoin, has been around since 2009 but it was in 2017 that crypto currency mania went through the proverbial roof. Bitcoin was a 14 bagger if you were a lucky holder at the start of 2017 (and up more than 110,000% since 2012), starting the year near $1,000 of U.S. dollar value and ending 2017 near $14,000 (it hit $20,000 at one point). Andrew Carnegie and Henry Ford must be dancing the jig up above (assuming they both made it in) because more prospective candidates are materializing for their exclusive Robber Baron Club (and who wants to hang out with Mark Zuckerberg or Jeff Bezos?). How fast has Bitcoin grown? The next chart compares the market cap of Bitcoin to Walmart. In math terms, that blue line is called a parabolic move and typical of bubble-like price movements.




Crypto currencies are quickly becoming mainstream and the next frontier (more like the Wild West) of investing. Bitcoin is the largest crypto currency but there have been nearly 1400 issued to date. 2017 was a historical year for Initial Coin Offerings (ICOs), as hundreds were launched in the back half of 2017 as the value of Bitcoin and other major crypto currencies exploded in value. Over 800 ICOs were issued during 2017, up from 46 in 2016, an indicative of the risk-taking appetite that now exists. Speculators couldn't get enough. Since many other financial assets are experiencing abnormally low volatility, the crypto currency market has attracted traders in droves who thrive on volatility and can't make a decent living trading other financial assets in a low volatility world. Crypto currency trading volumes are exploding and there is enough of a mania atmosphere to suggest that an outsized decline in crypto currencies prices could potentially bleed back into traditional asset classes when the bubble pops.



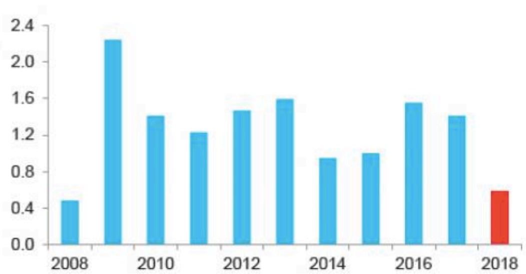

Source: Coindesk

Why are financial assets, high-end art, and crypto currencies all seeing record high prices and continual upward price movements? It may sound like a broken record but FUBAR global central bank policies remain a major driver of the current investment environment. Through ongoing liquidity pumping via both Quantitative Easing and extremely low interest rate policies, investors have come to expect that central banks will always throw them a safety line when needed. Cash and bonds offer such low returns that investors jump in elsewhere without hesitation to make a quick buck. It has been going on so long now (nine straight years in fact) that there is a whole new generation of investors who don't know any different. Central banks policies have perverted (but not in a Matt Lauer or Charlie Rose kind of way) the whole concept of investment risk for so long that it's hard to remember what experiencing declining asset values and normal price volatility feels like. There is a meaningful degree of overvaluation that exists today for most financial assets and it is the most pronounced in the U.S. So, will 2018 be more FOMO or FUBAR? Who knows, your guess is as good as mine. Let's flip a digital coin and you call it in the air.

**Central Banks Hold The Key**

With price momentum so strong in financial markets, it has been a fool's game to call the top. Since 2008, the current bull market in stocks (up 359% since 12/31/08) has been significantly supported by central bank policy actions but in 2018 we could be on the verge of an important change. In addition to raising short-term interest rates 0.75% during 2017, the U.S. Federal Reserve also moved from a position of Quantitative Easing (QE) to one of Quantitative Tightening (QT) late in 2017 by reducing its monthly bond-buying program. The Fed continues to do a great job of telegraphing its policy moves such that nothing has spooked U.S. financial markets for over a year. In addition, the Fed has taken a very deliberate approach with not only starting its QT program but also in the timing and pace of increasing short-term interest rates. The Fed projects three more 0.25% rate hikes during 2018. However, if U.S. real GDP growth stays above 3% and the labor market tightens further, the Fed could increase the pace of its QT moves. Elsewhere, the European Central Bank ECB decided to reduce its monthly pace of asset purchases by half to 30 billion euros from January 2018 onward but extended the program until at least September 2018. The ECB also pledged to continue reinvesting proceeds from maturing debt for an extended period of time after the end of net asset purchases. The Bank of Japan has also recently started modest QE reductions so in aggregate the world's three major central banks are beginning to reduce policy accommodations. The next chart shows there will be a meaningful decline in asset purchases projected for 2018 and compared to prior years since the Global Financial Crisis began in 2008.

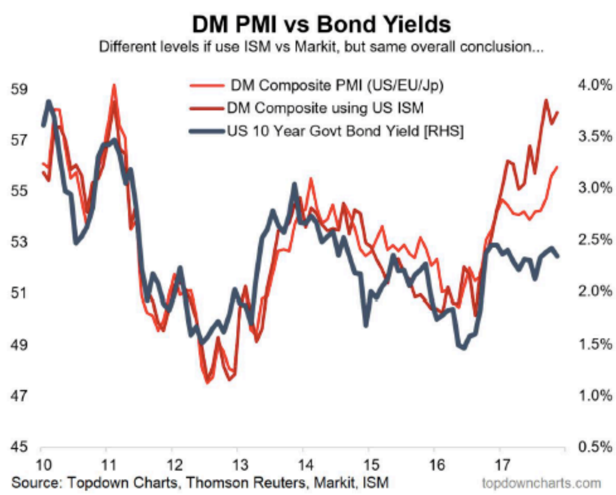
Figure 29. Central bank asset purchases by year w. 2018 forecast, $bn




Source: Citi Research, Haver, Markit. *: Fed, ECB, BoJ, SNB, BoE & reported FX reserves of 20 EM central banks, FX adjusted.

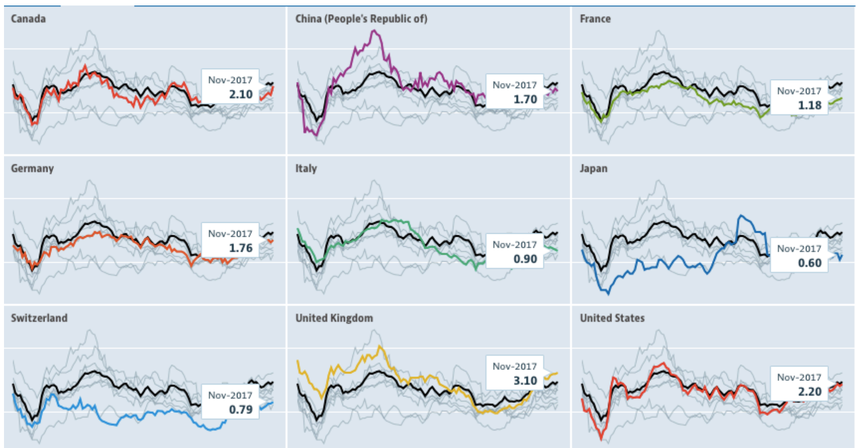
Even with the start of QT, central bank policies continue to distort financial assets to a great extent. Let's just take one prime example. Due to the ECB's QE policy of buying large amounts of European sovereign and corporate debt, the 10-year German bund has a yield of 0.43% compared to a similar maturity U.S. 10-year Treasury bond yielding 2.43%. It has been nearly impossible for U.S. bond yields to rise meaningfully as long as global fixed income investors believe it's a no brainer to buy a 10-year U.S. Treasury bond to pick-up 200 basis points of yield compared to a similar maturity German bund and without assuming any additional credit risk. A similar maturity 10-year Japanese government bond yields 0.05%. That's not a typo either. So, it is fair to say that global bonds are trading at absurd yield levels and this has been brought on by overextended central bank QE policies.

Where should U.S. bond yield levels really be trading based on the global economic growth profile of Germany, Japan, and the U.S.? The next chart compares a developed markets Purchasing Managers Index (PMI) for all three countries to the 10-year U.S. Treasury bond yield going back to 2010. The PMI is a good directional indicator of economic activity for any country. The thick red line shows a composite PMI for Europe, Japan, and the U.S. and it indicates that economic growth started to accelerate from mid-2016 onward. Note that the composite PMI line was tightly correlated to the 10-year U.S. Treasury yield until the end of 2016 but has since diverged widely from it. In other words, even though developed market PMI levels have improved greatly, the 10-year U.S. Treasury bond yield stayed pretty flat instead of moving higher along with rising PMIs. Based on the current composite PMI of these three countries, the prior tight correlation of the relationship suggests that the 10-year U.S. Treasury bond yield should be trading today closer to 3.7% than the current 2.4% yield. Just based on the U.S. PMI, which is the thin red line, it suggests that the 10-year U.S. Treasury bond yield should be trading closer to 3.2% rather than the current 2.4% yield.




There are two important points to make regarding the low global bond yield environment. First, low return opportunities in bonds have driven more investors into stocks, thus driving up stock valuations and gains. Second, the risk/reward setup for bonds is arguably worse than stocks. It's important to understand that global bond yields are a main source of distorting the proper vetting of valuations and risk in global financial assets and global central banks policies are the primary cause of this distortion. Lower interest rates have a direct impact on what investors are willing to pay for stocks in the form of higher PE multiples. Lower interest rates = higher PE multiples and vice versa. So, a key risk for not only bond investors but also stock investors is if global bond yields start to rise. The real key to this equation is European bond yields. If the ECB starts to move towards the Fed's position of ending its bond-buying program and begins to actually reduce its balance sheet, then European bond yields will start to rise and the entire excess globally liquidity environment will start to unwind. The main casualty under this scenario would be financial assets.

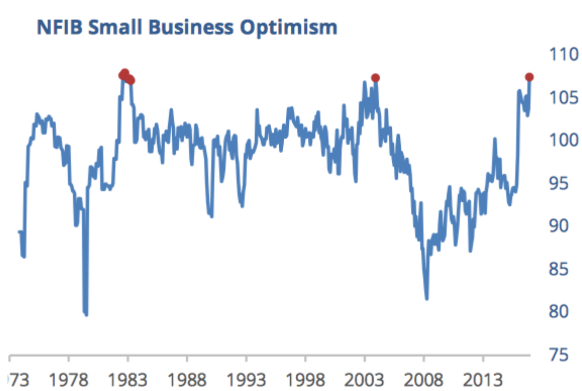
Another factor that could drive bond yields higher is if global inflationary pressures finally begin to gain traction. Since 2008 inflationary pressures have been quite muted. The following chart shows CPI readings over the past 10 years for nine major countries with large GDP profiles. Global CPI data remains low although it is starting to move higher everywhere as global economic growth forecasts have surprised to the upside although absolute CPI levels are still quite low when compared to history.



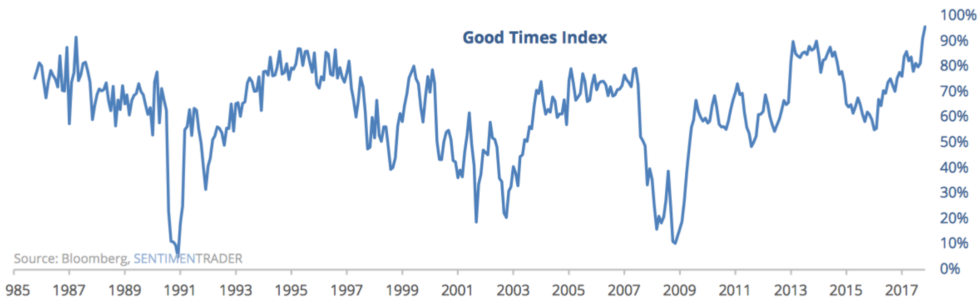

Source: OECD

The U.S. economy has seen two straight quarters of real GDP growth above 3% and the Atlanta Fed's GDPNow model for the fourth quarter (Oct-Dec 2017) is forecasting 2.7% real GDP growth. The U.S. labor market has tightened considerably. The current consensus forecast for 2018 real GDP growth is 2.6% but that seems likely to be revised higher. The U.S. unemployment rate could fall below the 4% level during 2018 and this could lead to higher inflationary pressures in the year ahead since wage growth is an important component of inflation.

An improved economic outlook is also showing up in sentiment surveys like the NFIB Small Business Optimism Index as shown in the chart below. The large and significant turn higher on the far right of the chart is about the time that Donald Trump was elected President. The NFIB survey is hitting the all-time high level going back to the early 1970's and NFIB Chief Economist Bill Dunkelberg said he's never seen anything like the 2017 rebound in small business optimism in the NFIB's 45-year history of conducting the survey.



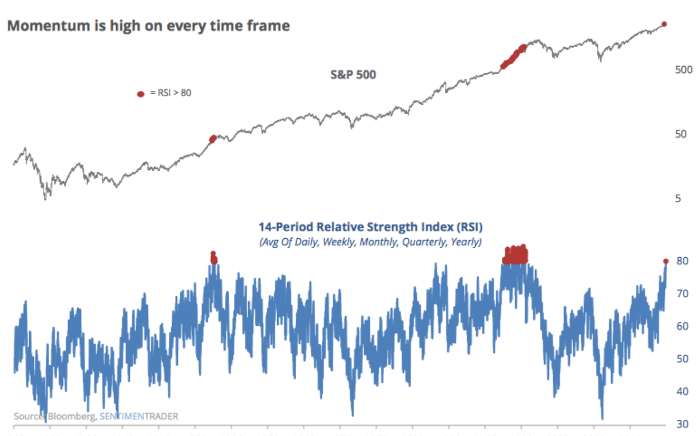
The Bloomberg Good Times (dynomite!!) Index is hitting a new high going back to the mid-1980s.



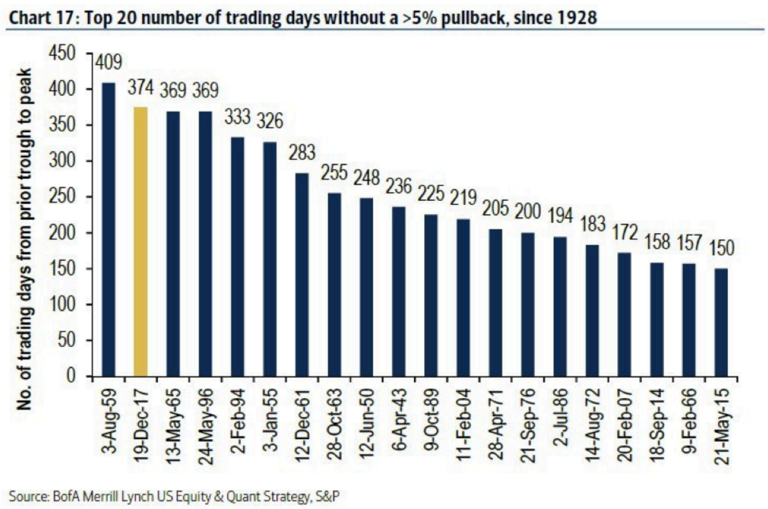

Moving from a business killing and increased regulations administration to a pro-business administration has a way of unleashing pent-up animal spirits. The corporate tax reform bill just signed into law should mean more tailwinds to growth during 2018. That's good for the economy but it may eventually be bad for financial assets if it means the Fed or other central banks reduce easy policy conditions faster than expected given stronger than expected economic growth or inflation.

**Rare Air**

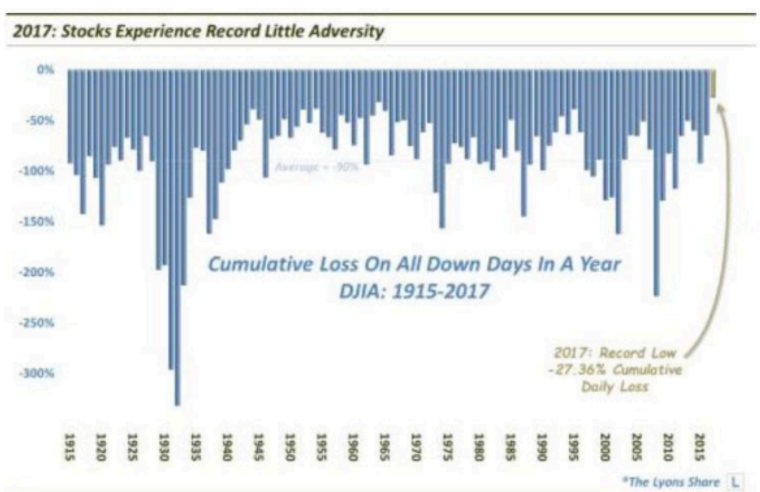
Let's take a look at both bonds and stocks and put into context how rare an investment environment we find ourselves today. The next chart shows a technical momentum factor called the Relative Strength Index. This chart shows the average of the 14-period RSI for the daily, weekly, monthly, quarterly, and annual timeframes for the S&P 500 Index going back to the 1920s. Please note the period with the most high momentum readings was during the tech stock bubble of the late 1990s. Today, the S&P 500 Index has now reached the same RSI readings as the dot com tech bubble. It is rare for all of those different time periods to be registering high RSI reading at the same time. Please note from the chart what happened in the years afterward when RSI readings reached these extreme levels. It is impossible to call the timing of the change of momentum but clearly we are at peak levels.



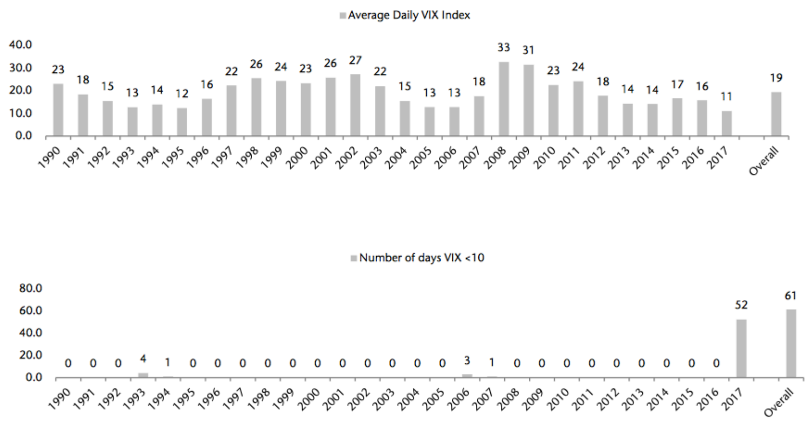
The next chart shows how many days the S&P 500 has gone without a >5% pullback (or as us grey haired types like to say, normal and healthy) and compares the current market with other similar time periods going back to 1928. We are now in the second longest time period without a 5% correction (yellow bar) with the late 1950s the longest such streak on record. The current streak will become the longest on record if there is no 5% correction during January.




The next chart shows how the Dow Jones Industrials Average during 2017 experienced a historically low level of cumulative losses compared to other years going back to 1915. As of December 27, the DJIA had lost a cumulative -27.4% on all of its down days throughout 2017. That result beat the prior record year of -31.5% set in 1965, which was the only other year since 1915 that saw less than -38% in total losses on down trading days.

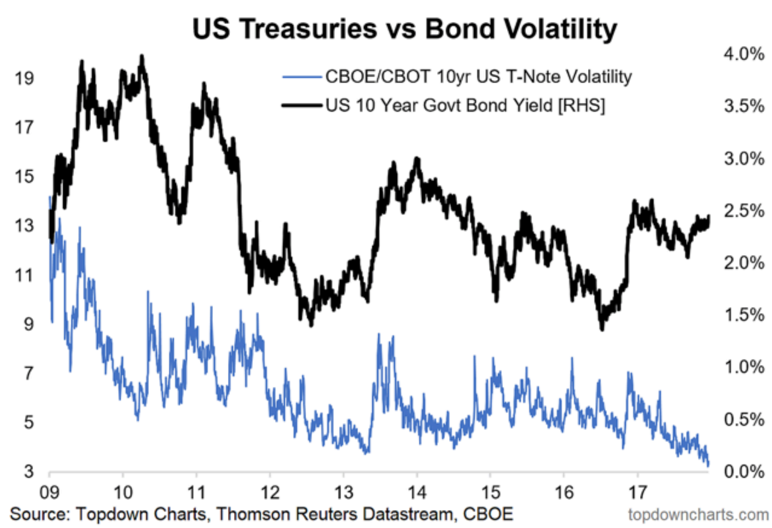



The next chart shows just how rare of a low price volatility environment that exists today. The VIX Index is the most popular reading of price volatility. The chart shows the average daily VIX reading by year going back to 1990. 2017 was the lowest volatility year of the past 27 years. The bottom half of the chart shows the number of days when the VIX Index reading was <10. It's clear from this chart that 2017 was a huge outlier year given that there were an extraordinary numbers of days of low volatility readings compared to prior years. Keep in mind that the average VIX reading over the long term is typically in the high teens compared to near 10 today.




Source: FactSet; FTSE Russell; Jefferies

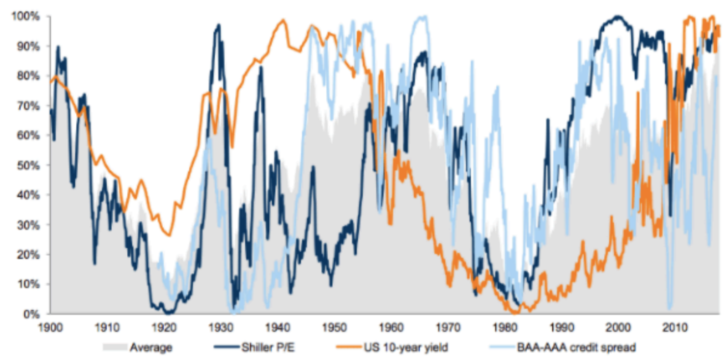
Low price volatility is also present in the bond market as well. The next chart shows the volatility reading and yield level on the 10-year U.S. Treasury bond going back to 2009. Volatility has been on a steady downward trend and is now sitting at its lowest level over this timeframe. With central banks as large buyers of bonds (in some cases stocks too) in the marketplace in order to implement their respective QE programs, they have distorted normal pricing volatility and suppressed bond yields at the same time.



## Is Anything Cheap?

The short answer is no. U.S. stock and bond valuations are now at the most extreme readings of modern history. The chart below plots the valuation percentiles of the Shiller PE ratio, U.S. 10-year U.S. Treasury yield, and the BAA minus AAA bond yield spread going back to 1871. Using these valuation measures, which are good representations of U.S. stocks, U.S. government bonds, and U.S. credit, valuations are near the highest on record.

**Exhibit 12: Valuation frustration - both bonds and equities appear expensive**
Valuation percentile (since 1871 for S&P 500 & US 10-year yields, 1919 for BAA spreads)




Source: Shiller, Goldman Sachs Global Investment Research

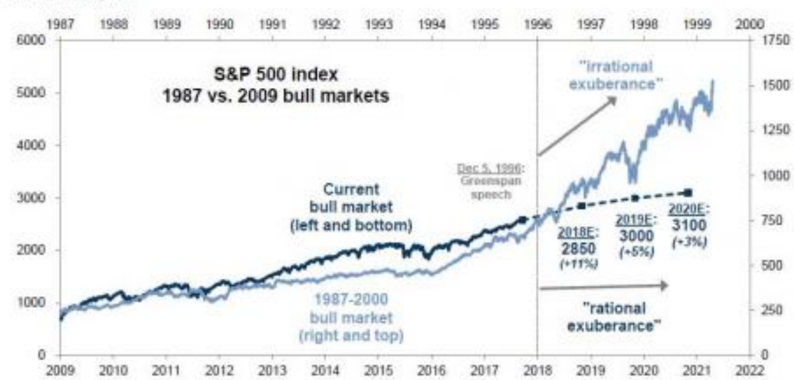
## Will FOMO Persist?

What could potentially knock this low volatility, high momentum FOMO stock market off stride? There are three to highlight. First, an unexpected negative geopolitical event that quickly gathers steam. Second, rising inflation expectations. Third, rising long bond yields. As it relates to the first item, there were rising global tensions during 2017 but none of them became a tipping point event. Part of the reason is that global central banks continued to provide easy monetary conditions and that was a more dominating factor than Kim Jong Un making progress towards a nuclear strike capability or our Twitter obsessed President constantly stirring the pot. With respect to the second and third items (closely related), under prior economic recovery cycles, inflationary pressures would be more prevalent at this point in the cycle (we are a 10 years into the current one), especially with an unemployment rate of 4.1%, a level in the past that indicated full employment. Full employment means companies start having to compete for labor and raise wages to attract workers. In this up cycle, rising wage inflation has been missing to date, suggesting that much of the job growth has been in low wage, entry-level jobs. Importantly, and without more significant inflationary pressures, the Fed has not been forced to raise rates more quickly and has been able to take a very gradual approach with its interest rate policy normalization moves. These moves have been well telegraphed by the FOMC and the market has not been spooked even once during a rate hike.

Without more pressure from these three factors, the stock market has been able to move higher big time (Trump's favorite euphemism) from a combination of expanding PEs and earnings growth. At the beginning of 2017, the S&P 500 Index forward 12-month PE multiple was 17.1X and it ended 2017 at 20.3X even though earnings estimates from the beginning to the end of the year did not move much higher. Most forecasts have the 2018 S&P 500 Index earnings estimate rising from the current $147/share level towards $151/share once company models get updated with lower tax rates. At 12/31/17 the S&P 500 Index level was 2673.61 and if we assume 2018 earnings end up at $151/share then the S&P 500 Index forward 12-month 2018 PE multiple today is 17.7X, higher than where we started at the beginning of 2017 and with the benefit of a corporate tax reform in the number. Certainly, if the new tax law spurs corporations to spend more on capex or use their excess cash flow from lower taxes on shareholder friendly stock buybacks, these factors could push the 2018 earnings growth rate higher. In 2017 valuations did not matter one bit to investors even though the U.S. stock market traded in the top 5th percentile of historical valuations all year.

It's fair to say that the vast majority of U.S. investors are all-in today, which shouldn't be too surprising when considering we are entering the ninth year of the current bull market and the annualized returns from U.S. stocks since 2008 have been significant. The next chart from Goldman Sachs presents an interesting What If outlook for U.S. stocks using the 1987 bull market starting point compared to the current bull market and if one were to use the timing of former Chairman Alan Greenspan's Irrational Exuberance comment as a starting point for the level that the S&P 500 Index could ultimately reach. The vertical line in the chart marks today and shows how the current bull market could potentially run further under two different scenarios. The first scenario would be if the current bull market experiences another bout of irrational exuberance similar to the 1997-2000 market melt-up, which includes the dot.com years when the S&P 500 Index eventually traded at 24X earnings at the market peak. This is the thick, light blue line that shows the value of the S&P 500 Index at around 5,000 (left hand scale) at the end of 2020 or a gain of another 86% from the end of 2017 levels on the S&P 500 Index. The second scenario is the darker blue line, which shows a case of rational exuberance, or if the S&P 500 Index just maintained its current PE multiple over the next three years and stocks moved higher on earnings growth alone. The rational exuberance scenario forecasts that the S&P 500 Index level will reach 3,100 by the end of 2020 or a gain of 16% for the next three years or about a 5% annualized return during this three year window.

**Exhibit 1: Comparison of bull markets: 1987 vs. 2009 — Index Levels**
as of November 17, 2017




**1987 - 2000 bull market**

| Period | # of months | Price return | Ending NTM P/E |
|---|---|---|---|
| 1987 trough to Dec 1996 | 108 | 232 % | 15 x |
| Dec 1996 to Mar 2000 | 40 | 105 | 24 |
| Total | 147 | 582 % | 24 x |

**Current bull market since 2009**

| Period | # of months | Price return | Ending NTM P/E |
|---|---|---|---|
| 2009 trough to Nov 2017 | 104 | 281 % | 18 x |
| **Nov 2017 to Dec 2020E** | **37** | **20** | **18** |
| Total | 141 | 358 % | 18 x |

Source: Goldman Sachs Global Investment Research

If one believes that current high valuations will be sustained or possibly move even higher over the next several years then there is no reason to tone down the risk profile of a portfolio despite the outsized gains made over the past nine years. If things get to dot com stupid valuation levels again, there is certainly much more potential upside. Of course, a very important part of this investment thesis is that global bond yields will remain low and that central banks will not increase the pace of reducing policy accommodations either through faster than expected rate hikes or QT moves. Since outsized stock returns and declining price volatility of the past decade was created by the overly accommodative policies of central banks, it may not be such a smart bet to expect no repercussions to prospective returns or asset volatility from less accommodative central banks. Greater or faster than expected QT would get us into a FUBAR environment faster than many realize in light of the high valuations that exist today.

## Summary

It's been a great nine-year run for investors that stayed fully invested after losing their shirts in 2008. Many investors today still have a strong case of FOMO and keep buying stocks given the exceptional environment of strong returns combined with unusually low volatility and negligible downside loss experience. Return opportunities in bonds and cash remain depressed and stocks, despite high valuations, offer the main hope of earning decent investment returns. The first year of the Trump Administration has ushered in a pro-business environment and the corporate tax reform bill will provide even further tailwind to companies and earnings as will MAGA policies in general. New fiscal stimulus may be good for the U.S. economy in terms of a higher economic growth rate during 2018 but it may not be good for financial assets, which have been able to move higher in a world of weak GDP growth but overly accommodative central banks. If we continue to see improved global growth and rising inflation during 2018, central banks may come off their accommodative policy stances faster than expected. In the U.S., stronger GDP growth and tightening labor markets could force the Fed (and its new Chairman) to either raise rates more than expected or accelerate QT at a faster pace than is now priced into financial assets. Should this occur, the peak price momentum and low volatility world that prevails today will end and FOMO could quickly give way to FUBAR.

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