MJM INVESTMENT ADVISORS, LLC

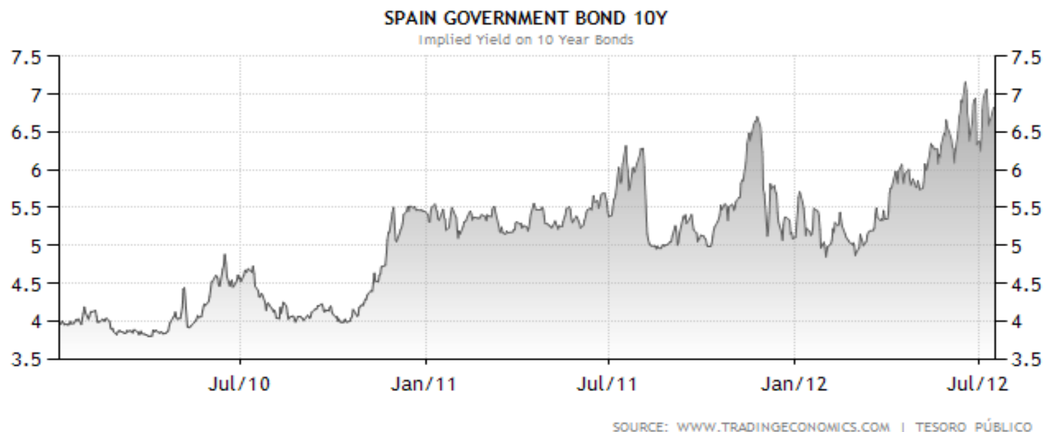
Second Quarter 2012 Investment Commentary

This is like déjà vu all over again. - Yogi Berra

Yogi Berra is not only famous for his Hall of Fame baseball career but also for his humorous, yet convoluted sayings that made him such an appealing American icon. I wonder if Groundhog Day is Yogi Berra's favorite movie? It certainly seems like the world is stuck in a déjà vu, Groundhog Day scenario, where every few months there is another bout of European oriented financial crisis that sends global markets into a tizzy until politicians attempt to pull another rabbit out of the hat to stave off a more ominous outcome. Wash, rinse, repeat. If it seems like we have been here before, we have, too many times now that everyone has lost track of the count.

The Pain In Spain Falls Mainly on the Plain

Actually, the pain in Spain is everywhere. Spain is the fourth largest economy in Europe and it is in a heap of trouble. Unemployment is pushing 25%, its 10-year bond yields are now near 7.0% (compared to US 10 year bond yield near 1.5%), bad loans hit an 18 year high in May, its stock market has tanked and is the worst performing market in the world over the past year (-41%). Many of its regional banks are in dire straits as Spain's real estate bubble and collapse has lead to substantial losses for the banks. Its third largest bank by assets, Bankia, said its needs a €20+ billion bailout (only a month before it was €13 billion but what's a few billion here and there) and many of its major banks need to be recapitalized to offset large loan losses. Given the extremely high yields on its debt, the Spanish government doesn't have the financial wherewithal to provide bailout money so European financial leaders are trying to figure out a plan to bail out the banks and determine where the funding will come from to do it. In the meantime, the rest of Europe demands more austerity from Spain to cut its spending in order to get the bailout money. The protests and riots against austerity have begun in Madrid. Poor King Juan Carlos. Even he is taking a 7% pay cut to help pay for the austerity. Spain's fiscal tightening is around €62 billion or 6% of GDP and most of it hits in the second half of 2012 which means things are going to get worse before they get better. Sound like déjà vu? It should, since we were talking the same story about Greece last summer and look at what has happened there. Greece is more or less in a depression.



Source: Stockcharts.com

It's Déjà Vu Here Too

The U.S. is having its own Groundhog Day moment. Just when the it seemed like the Financials were starting to pull out of their four year slump, and lead the market higher earlier this year, two major headline events hit this past quarter smacked the market in the face and further undermined investor confidence. The first was JP Morgan's announcement of a large loss in their investments office that was originally announced at $4 billion. On its recent earnings call, that number was updated to $5.8 billion and could reach $7 billion in a worst-case scenario. JP Morgan is a highly profitable bank and has the ability to easily weather such a loss. However, the crux of the issue here is that JP Morgan was considered the crème de le crème of the global banking world, having come through the 2008 financial collapse in good shape and with not many scars compared to its major competitors. CEO Jamie Dimon used his golden boy image and industry standing to beat back Washington's desire to reduce Too Big to Fail risk. Then, its investment office in London was found to be making "investments" that weren't necessarily tied to its core banking business. Rather, they were more about betting capital to make money instead of using capital to help grow its business lines. It also looks like there some internal cover-up within the investment office to hide these trading losses from management. Whether the "investments" were speculative in nature or were supposed to act as hedges against risk in their other businesses, they went bad quickly and the JP Morgan and its CEO had major egg on its face. Of course, Congress used that as an opportunity to bring Mr. Dimon in front for a public beating so that it could try to make it look like it was on top of situation (unlike 2006-2009). Hey Washington, why don't you stick to what you are good at, like bankrupting the country, and let the private sector worry about bankrupting themselves?

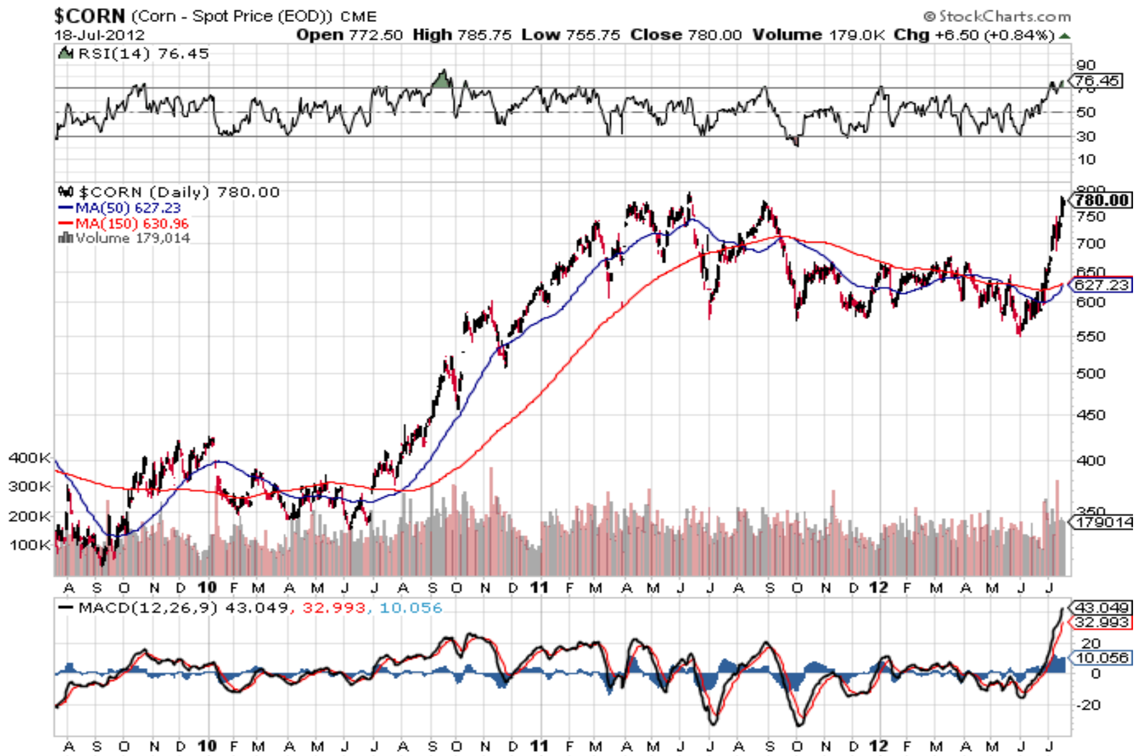
The second financial scandal that is more insidious in nature and potentially far reaching is the LIBOR fixing scandal. LIBOR is the London Interbank Offer Rate, which is an interest rate at which banks charge each other for overnight loans and a base rate to which many financial transactions around the globe are set. For example, one entity may lend money to another entity at LIBOR plus some additional markup. Let me make an analogy to make this point more clear. LIBOR is to banking/finance like peanut is to peanut butter. Even consumer loans like mortgages can be tied to LIBOR. LIBOR was supposed to be sacrosanct. Barclays in the UK got caught with its hand in the cookie jar for overcharging for LIBOR. This is such a big deal that the Chairman of its Board of Directors and its Chief Executive Officer resigned under pressure. Unfortunately, Barclays may be just the tip of the iceberg in this scandal as more banks are likely to be investigated and Congress (that sharp gang down in DC) is going to hold hearing and conduct an investigation. There is likely to be criminal charges filed at some point in the future.

Déjà vu? You bet. Remember all of the financial scandals and hearings post the 2008 financial crisis? These events are certainly not what the market needs, five years after the biggest financial crisis since the Great Depression era started. The integrity of our financial system is the foundation for investor confidence. Sadly, five years later, the financial sector is still swimming in controversy. Investors are looking for a level playing field to have the confidence to invest, and this, that, and the other thing continue to undermine investor confidence. Fidelity Investments conducted a recent survey that noted that 70% of the respondents are taking less risk in their portfolios and 40% think the economy will stay the same or get worse. Not confidence inspiring numbers but reflective of the attitude of the broad population. Add in the sad state of our country’s fiscal situation and the weakened growth outlook and it’s not hard to understand why the average investors has better things to do with their time and money, like go to the beach and stare at the ocean.

The Consumer is Pulling The Purse Strings Again

June retail sales were much softer than expected, which has negative implications for second quarter (April-June) real GDP growth. Headline retail sales fell -0.5% as motor vehicle sales were down -0.6%. Excluding autos, sales were down -0.4%, with weakness being broad-based. On the positive side, gasoline spending was down (-1.8%), which negatively impacts the headline sales number but is a benefit to consumers over time. The deceleration in consumer spending is also reflected in the Cass Freight Index, which measures trucking activity and volumes. The trend in freight shipments continued upward for the year, but volume compared to June 2011 was down 1.3 percent. For the second quarter, the number of freight movements is only 0.3 percent higher than in the second quarter of 2011, and down from a first quarter increase of 1.8 percent. The net effect of weaker-than-expected retail sales is less consumption, which negatively impacts real GDP. With first quarter real GDP revised down to 1.9%, and economic activity deteriorating since then, we are most likely to see a second quarter real GDP number below 1.5% when considering various economic inputs that have all come in weaker than expected.

Another issue that will hit the consumer going forward is food prices. The Midwest is experiencing its worst drought since 1956, which is sending corn and some other crop prices to record levels. These prices increases, should they be sustained, will show up in the price of major food items in the future after harvest season is completed. See the following charts of which show the pricing of corn and soybeans over the past three years.



Source: Stockchart.com

China

The Achilles Heel of 2012's global growth forecast was China. Global real GDP forecasts were heavily dependent on China maintaining a real GDP growth rate greater than 8.0%. A bigger slowdown in China seems all but certain, as its second quarter year over year real GDP growth rate was 7.6%. Perhaps this shouldn't be a surprise, when a substantial part of China's GDP growth is dependent on exports, particularly to Europe. Nearly 40% of China's GDP is tied to exports. Various China economic indicators have been weak. HSBC 'flash' China PMI fell to 48.1 in June from the final 48.4 in May. New orders fell as did export orders to the lowest level since March 2009 (thank you Europe). China's central bank cut its benchmark interest rate in early June in response to slowing economic activity, its first cut since the 2008/2009 financial crisis. Debate rages on about the degree of housing bubble in China, how its government controlled banks continue to push out taking loan losses to hide the severity of its non-performing loans, and how economic data is manipulated by apparatchiks in order to portray a better economic situation than is reality.

China is rapidly losing is competitive edge, which was all about low cost labor and foreign companies outsourcing to China to take advantage of it. Over the past five years, minimum wage growth in China has averaged low double-digit increases annually (I'd like that kind of pay hike!). This wage growth is off a an extremely low base but when your competitive advantage is cheap labor and wages increase over 75% over five years, your competitive advantage quickly fades. Also, the significant increase in oil prices has increased the cost of shipping product from China to the West as well. So, in addition to recessionary conditions in many of its major export markets, China is dealing with a decline of its long held competitive advantage of cheap labor, which is causing Foreign Direct Investment to also decline. This is good and bad news for the U.S. consumer. On the good side, it means U.S. companies, which formerly outsourced to China, are now increasingly looking at the U.S. as a destination to add to production capacity and make capital investments. More investment in America means more jobs. On the bad side, the prices at Walmart and all the places that sell cheap China sourced products will begin to move higher as the higher costs of China sourced products move through the supply chain.

China is a voracious consumer of commodities and metals. The following is a chart of Zinc stockpiles, which are now approaching historical highs, evidence of economic slowdown.

If you want another picture of how global investors view the situation in China, look no further than its stock market, which currently trades near its 3-year lows.

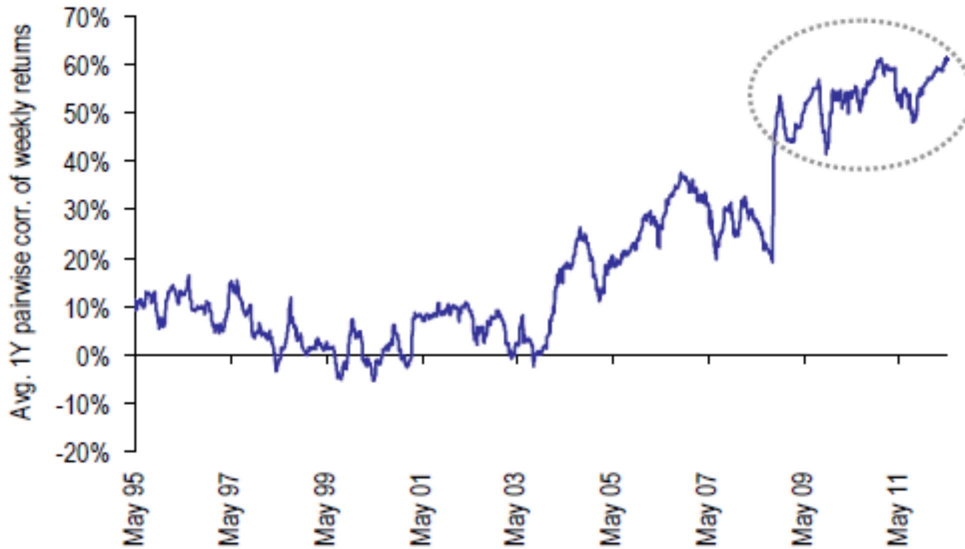
Diversification – Not

Portfolio management was based on the foundation of diversification, such that when an investor combines different asset classes (stocks, bonds, etc.) together, it reduces overall portfolio risk. Correlation is the simultaneous change in value of two numerically valued random variables. Assets with a correlation of 1 move in perfect sync with each other while assets with a correlation of -1 move in opposite directions. As shown on the chart on the next page, starting around the financial crisis of 2008, asset class correlations started to increase meaningfully and remain elevated. Higher correlations means portfolio diversification isn't reducing overall risk as it has in the past as assets increasingly move in the same direction. High correlations are a feature of the low-growth, low-rate environment as now exists today. Macro-oriented events are dominating the current investment environment, another key factor impacting correlations and thus portfolio diversification. International stocks used to be an asset class that would help diversify risk with U.S. centric portfolios. Today, global stock markets, under the current macro driven environment, all move together in tandem and provide limited diversification benefits.

One asset class that remains a good diversification tool is cash, which has maintained a low correlation with all other major asset classes. The conundrum with cash (money market funds) is that as global central banks have kept interest rates at extremely low levels (or almost zero as is the case with the U.S.

Federal Reserve), cash as an asset class that generates little to no return. So, it becomes a challenging choice for investors. Use cash to help diversify because it is one of the few asset classes not trading along with most other asset classes when macro driven events occur, but having to accept a nearly zero percent return for doing so.

Chart 4: Cross-asset correlations are near all-time highs because markets all respond in unison between risk-off and risk-on.



Source: BofA Merrill Lynch Global Research (Daily data from 26-May-95 to 22-May-12. 1Y average pairwise correlation between the weekly returns of the Dollar Index (DXY, inverted), S&P Goldman Sachs Commodity Index (SPGSCITR), MSCI All Country World Index (MXWD) and the BofA Merrill Lynch US High Yield Master II Index (H0A0 Index).

Off the Cliff

The dreaded fiscal cliff is quickly approaching. The fiscal cliff represents the end of numerous temporary tax law changes that were enacted to stimulate the economy over the past 4 years. When Congress originally enacted the tax changes, they were not made permanent and had expiration dates. The expiration date hits 12/31/12 and then all of these taxes revert back to their prior levels starting 1/1/13 which effectively means broad based tax increases on everyone. The table below shows the main components of the fiscal cliff and estimated dollar impact.

The January 2013 fiscal cliff	**$ bn**	**% of GDP**
Sunsetting of Bush tax cuts	$280	1.8%
Expiration of payroll tax holiday	$125	0.8%
Expiration of emergency unemployment benefits	$40	0.3%
Budget Control Act spending cuts	$98	0.6%
Total	$543	3.5%

Source: JP Morgan

If Congress were to do nothing and all these tax reversals hit starting 1/1/13, it would mean $543 billion of tax "increases" hitting the economy which would have the impact of reducing real GDP growth by 3.5%. Obviously, a reduction in GDP growth of this magnitude would put the U.S. back into a recession. The U.S. is already in a soft recession, with real GDP growth trending below 1.5%, but the fiscal cliff hitting completely without some negotiated phase-ins would put the nail in the coffin on a recession outcome.

When these tax law changes were enacted, no one in Congress expected the economy to be this weak four years later such that allowing these tax reductions to end would mean a huge economic hit to the economy. The issue of dealing with the fiscal cliff is now a major topic for the upcoming Presidential election and for the U.S. 2013 economic outlook. Even if Congress (in a lame duck session no less) were able to work out some kind of deal before 12/31/12 to push out the expiration of some of these tax cuts, there is going to some negative impact to the economy in 2013. The U.S. fiscal situation requires either spending cuts, tax hikes or some combination of both to get the U.S. fiscal house in order. The question is how big a negative impact it will be. Importantly, the fiscal cliff is just one more issue to put into the uncertainty column, along with the European debt crisis, China growth outlook, and U.S. employment growth. The U.S. economy has been viewed globally as offering a better economic outlook and more stability than other major economies. The U.S. stock market performance has benefited from this view and has significantly outperformed other global markets over the past year as a result. The façade could begin to quickly fade on that view.

The Bond Market Says……

Recession. The U.S. 10-year yield is now below 1.50% (note: on following chart 14.60 is 1.46% yield) and reflects a very weak economic outlook, a disinflationary environment, and the U.S. Treasury bond benefiting from the flight to safety trade. There is still a wide gap between what the bond market is saying and what the stock market is saying about the outlook. It was only in mid-March that the 10-year U.S. Treasury yields backed up to 2.4% level on expectation of a stronger U.S. economy. Since then, it has been a swift and rapid decline as U.S. economic data has continually disappointed and the European financial crisis continues.

Summary

The malaise persists. It's reflected in weak global economic growth, caused in part by frequent and disruptive financial blow-ups and uncertain government policies that undermine the confidence and willingness of both corporations and individuals to spend for the future. For corporations, it means deferring capital investment and hiring. For individuals, it means hunkering down and making do with the current house, furniture, car, or clothes for a bit longer. The average age of automobiles on the road today is 11 years, up from 8.4 years in 1995, and a sign of how consumers continue to defer big-ticket purchases due to worries about jobs, income, and the future. Let's not kid ourselves. The road ahead is a challenging one and leadership out of Washington DC has been non-existent (okay, pathetic). The Fed is now hinting that the abnormally low interest rate environment that they said would be in place into 2014 could now extend into 2015. While the prospect of QE III has kept a bid under the stock market, it's pretty clear the Fed's extremely low interest rate policy is not stimulating demand because the demand is not there to stimulate. In 2007, U.S. housing was at its most unaffordable levels ever. Five years later housing is as affordable as it was back in the early 1960's thanks to pricing declines and super low mortgage rates. Yes, housing starts are improving, but off of a depressed base and remain at extremely low levels even with 30 year mortgages near 3.5%. With interest rates already at extremely low levels, and with the U.S. deficit situation tying the hands of government, what's left to drive growth? Do you remember the 1929-1938 era? Déjà vu?

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

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