MJM INVESTMENT ADVISORS, LLC

Second Quarter 2013 Investment Commentary

The End

This is the end
Beautiful friend
This is the end
My only friend, the end

Of our elaborate plans, the end
Of everything that stands, the end
No safety or surprise, the end
I'll never look into your eyes...again

The End - The Doors

"He's already stayed a lot longer than he wanted or he was supposed to."

President Barack Obama on Ben Bernanke

Three major news events occurred during the second quarter that signaled major change ahead and roiled financial markets for the first time since last November. The volatility kicked off in late May after Ben Bernanke appeared in front of Congress as part of his periodic testimony in his duties as Fed Chairman. Big Ben made some comments about the potential end of Quantitative Easing ("QE") as part of the Q&A session. The stock market peaked for the second quarter on the same day of his testimony. In mid-June, President Barack Obama was interviewed on the Charlie Rose show. The President, whether known by Ben Bernanke or not, inferred that Big Ben wasn't coming back as Fed Chairman when his term ends in January 2014. Big Ben is the Father of QE, a policy which been has been a huge support mechanism for the economy and financial markets over the past four years. QE "worked" so well in the U.S. that every other major central bank in the world has adopted some form of QE. The President's signal that Big Ben would not be back adds a level of uncertainty that financial markets don't like.

The week following the Obama interview, the June Federal Reserve meeting and press conference took place with Big Ben himself at the podium. Big Ben provided a timeline for the end of QE. There were plenty of caveats in his comments as to when QE actually ends, but the financial markets got deaf to all of that and immediately sold off hard knowing that the end is nigh. Nothing was spared. Stocks down, bonds down (a big ass whoopin), precious metals down, oil down. Since financial markets have become addicted to QE, taking away the drug does not sit well with the addict. Big Ben was asked several times at the press conference about his status as Chairman, which he refused to answer, another nail in the coffin for Big Ben's government employment status.

Financial markets now have to deal with the fact that there is now a timeline for the end of QE and the Great Oz is no longer going to be pulling the levers behind the green curtain much longer. Here's the rub. If the economy continues on its current trajectory, Big Ben said that the tapering of QE begins by fall and ends outright by mid-2104. At the same time, the economy is muddling along, struggling to achieve 2% real GDP growth (1Q real GDP was revised down to 1.8% in June), and corporate revenue and profit growth is uninspiring. As indicated by the sharp sell-off in financial assets following the June Fed

meeting, QE has been a vital source of support for both stock and bond markets. Investors now have to contemplate the end of QE while underlying fundamentals are not strong enough to justify higher valuations. After a strong eight-month rally, stocks now have plenty of reasons to pause or head lower. The best outcome for financial market returns is for the economy and job market to continue to muddle along and for the end of QE to be pushed out. This perverse situation is a good example of the unintended consequences of QE and the era of financial repression. While everyone should be rooting for the job market to improve (higher consumer confidence, more disposable income to spend) and economy to get better (higher real GDP growth, higher profits), such an outcome likely means a stock market heading lower because QE goes away sooner rather than later and fundamentals are not robust. It most likely will be a rocky transition period.

The end of QE is a good thing in the long run, but not in the short run. QE has been an unprecedented grand experiment with tremendous risks and unintended consequences associated with it. It did take the large negative outcome off the table, allowing global risks to recede from elevated levels and for financial assets to recover and float higher. But, QE did not fix what ails the U.S. economy, improve real GDP growth, or improve business confidence. QE has given Congress the ability to shirk its duties and delay tough budget decisions. After four years, perhaps Big Ben and the Fed gang may have concluded that QE has done what it can and the time has come to signal an end to the QE Era and for the economy to stand on its own two legs again. Perhaps Big Ben's pending departure as Fed Chairman is another reason the Fed has signaled the pending end of QE, not wanting to hog tie his successor with that decision. Whatever the reason, this is the end, beautiful friend, the end.

Second Quarter Performance

Despite the increased volatility and pullback in global markets during June, second quarter performance up to that point was strong enough such that the U.S. stock market posted another positive quarter of performance and remains up nearly 14% through the first half of 2013. Unfortunately, the same cannot be said for most other major asset classes. The U.S. stock market's performance continues to stick out like a sore thumb, as it continues to benefit from the flight to safety trade. Given the ongoing negative news flow from overseas markets, it is hard to predict when this trend may reverse. But, it is important to keep one thing in mind. The extremely low interest rate environment brought on by QE has had a big impact on the revaluation higher of the U.S. stock market. Since the Fed indicated there is a timeline for ending QE, bond yields have moved dramatically higher in one of the most rapid moves in yields over the past 50 years. Higher bond yields without higher economic growth undermine the investment case that has supported the stock market's move higher during the QE era. The underlying fundamentals in terms of U.S. profit and revenue growth are not supportive of the stock market getting valued higher. The continuation of QE is what is supporting the market's current level. Remove QE, and there is likely to be some payback.

The following table shows how much the U.S. stock market's performance has exceeded all other asset classes so far this year.

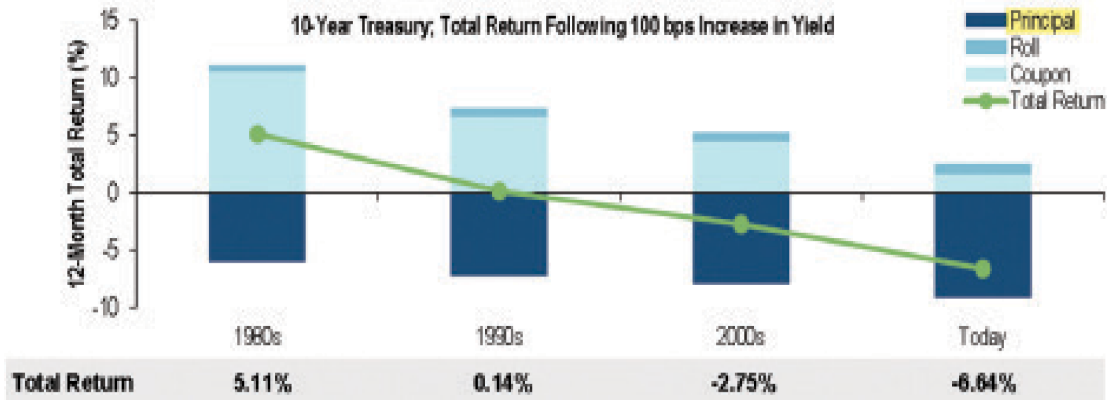
Index	2Q13 Return	6 Month Return
S&P 500 Index (large cap U.S. stocks)	2.9%	13.8%
Russell 2000 Index (small cap U.S. stocks)	3.1%	15.9%
MSCI EAFE Index (developed int'l mkts)	-1.0%	4.1%
MSCI EM Index (emerging int'l mkts)	-8.1%	-9.6%
Barclays Aggregate Bond Index (invt. grade)	-2.3%	-2.4%
Barclays High Yield Bond Index (below invt. grade)	-1.5%	1.4%
Barclays Short-term Treasury bills (cash)	0.0%	0.1%
Gold	-23.0%	-26.0%
Brent Crude Oil	-8.1%	-8.1%

Bombs (I mean bonds)

In our 2013 Investment Outlook, we discussed how the Fed's repressive monetary policy actions via QE was artificially suppressing bond yields and bond volatility and making bonds a very poor risk/reward asset class. With the Fed now providing a roadmap to the end of its QE policy, the biggest story of the second quarter was the dramatic and rapid rise in bond yields. Given the large move higher in bond yields, we are republishing the following excerpt from that 2013 Investment Outlook piece below because the message is worth repeating.

Investors continued to pile into bond funds in a desperate search for yield (any yield, please!) in this era of repressive central bank policies. The Ben Bernanke lead Fed is pile driving (one of the nastier "professional" wrestling moves) U.S. savers and risk-averse investors with a bias towards low risk, income-producing assets. With the Fed a large, unnatural buyer of bonds in the market, bond volatility and yields are artificially depressed and make bonds appear to be an attractive risk/reward investment vehicle. What happens when and if the Fed declares victory and begins to reverse its current policy position? If the Fed is successful and the economy gains traction and unemployment falls such that the Fed can claim victory (Pyrrhic?) and disengages from QE Infinity, bonds are a far riskier proposition than most investors can comprehend.

The following chart shows what a 100 basis point (1.00%) move higher in the 10 year U.S. Treasury bond would do to total return of the bond starting to today's low yield levels. With the current 10 year U.S. Treasury bond yield at 1.8%, this would mean a move up to 2.8% yield. The total return for an investor would be -6.5% should such a scenario occur and even worse for bonds with longer maturities. The risk/reward profile for a long maturity U.S. Treasury bond is akin to picking up pennies in front of a steamroller. For most bonds today, except those with much higher credit risk and thus higher yields, the real return (current yield-inflation rate) is already close to 0% or negative. Of course, with a massive buyer like the Fed in the market buying bonds, unless the QE policy is halted or reversed, or U.S. economic growth is stronger than expected (Do you believe in miracles, Yes!!), it is hard to see how bond yields are going to jump aggressively higher.



Source: Soberlook

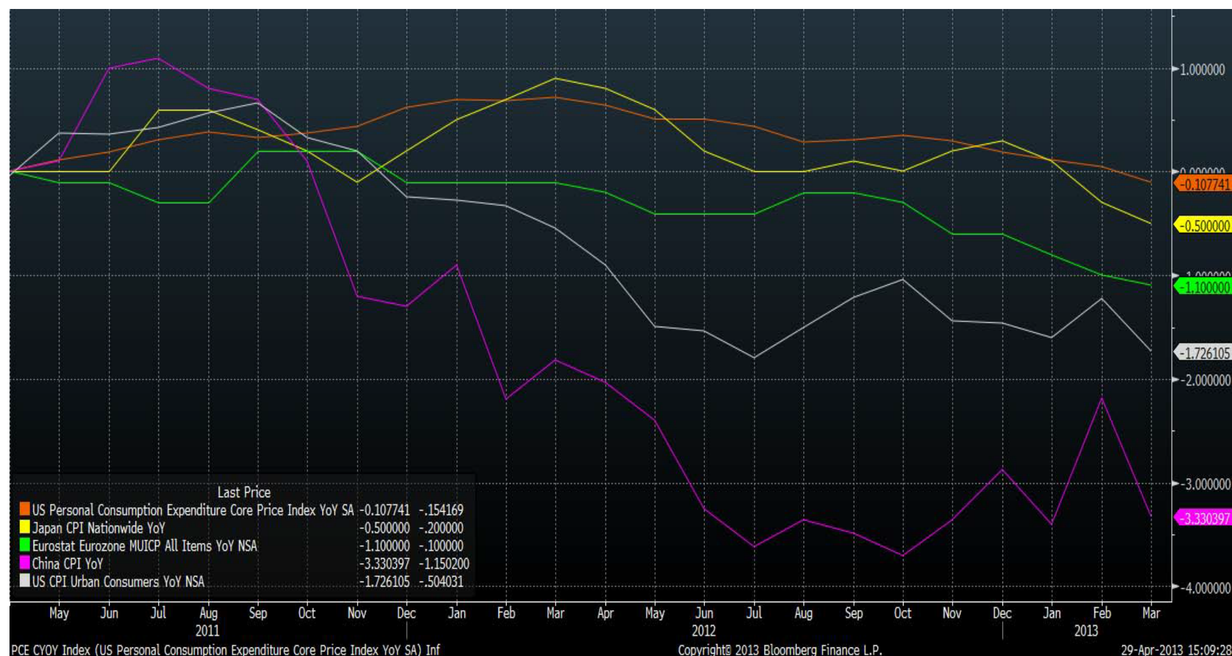
The rapid rise in bond yields during the second quarter has a lot to do with how crowded a trade bonds have been for a long time. $1.5 trillion has gone into bond funds and ETFs since 2007. The 10-year U.S. Treasury bond yield hit a low near 1.6% in early May. After a better than expected April jobs report came out in early May, bond yields started their move higher (see right side of the chart below which is as of 7/5/13). Then came Big Ben's comments before Congress on May 22nd regarding potential plans to end QE. Investors leveraged to the bond trade started to head for the exits, which caused an accelerated move higher in yields as the bond market sell-off gained momentum. The June Fed meeting was the straw that broke the camels back and added fuel to the fire. According to TrimTabs, $80 billion exited bond mutual funds and ETFs in June. Once investors see the negative returns on their bond investments through June 30th, there is likely to be additional selling to come.

Source: Stockcharts.com

Two key areas of the economy that have benefited from low rates are housing and autos. Housing prices have recovered nicely off the lows and auto sales have rebounded to the 15.5 million annual sales level. Rates on 30-year mortgages have risen 1.0% since early May, which is a big deal to consumers looking to refinance or purchase a home. For example, on a $500,000 30-year loan, the monthly payment increases nearly $300/month. Yes, even after the recent rise in mortgage rates, the absolute level of mortgage rates is still quite low (30-year is now 4.6%) from a historical context. But, the housing needed those extremely low rates to generate buyer interest and activity, whether through new builds, refis, or move ups (George and Wheezy Jefferson). It will be interesting to see how the housing and auto markets react in the months ahead to the recent rate increases. According to the Mortgage Bankers Association, refi activity declined 16% from previous weekly levels and was at the lowest level since July 2011. Mortgage refis comprise 65% of mortgage applications.

Inflation

As seen in the chart below, standard measures of inflation are falling across the world's major economies. When this occurs, it is typically a result of decelerating growth. Bonds typically do well under such a scenario, as falling inflation increases the real yields earned by bond investors. But things are far from typical in today's investment world. Inflationary expectations are falling and yet bond yields more recently have increased dramatically with the U.S. 10-year Treasury yield moving from 1.6% to 2.7% over a 60-day span. The main reason for bond yields moving higher is the latest news on the possible end of QE. However, declining levels of inflation could be another reason for the Fed to push out its end of QE plans. Remember that the Fed had previously indicated that QE policy would remain in place until the unemployment rate declines to 6.5% (now 7.6%) or inflation expectations exceed 2.5% (core PCE now just over 1%). Neither target has been reached yet.

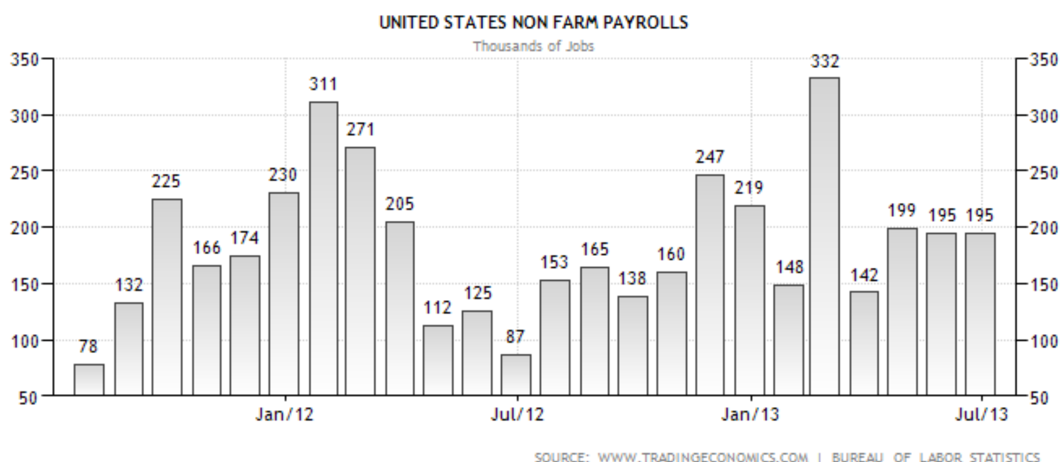


Source: Bloomberg

Does the new higher levels of yields, combined with falling inflation expectations, make bonds a decent investment again at these higher yield levels? Is the economy really strong enough to justify these higher yields? If it is, and the Fed moves towards the end of QE as planned by mid-2014, then investors who are heavily exposed to bonds in their portfolio may start to reconsider their strategy. Bond yields and volatility have been artificially suppressed during the QE Era and the May-June bond market action may be a precursor of what is to come in the years ahead for bonds as interest rate levels normalize without QE. If it is not, and the Fed pushes out the end of QE because job growth remains weak, bonds at current yield may be good for a short-term trade given higher yields combined with declining inflation.

Jobs

The key focus of the Fed and its decision to end QE appears to focus on jobs. In his June comments, Big Ben stated that if the economy stays on its current course that the Fed would begin to taper QE by fall and end it by mid-2014. The following chart shows the job gains by month over the past year through June 2013 including the latest revisions for prior months. Anything in the 150,000-200,000 range seems to be the area where Fed would be comfortable ending QE. While historically these levels of jobs gains are still very weak, after four years of QE, the Fed may have determined it is good enough and that QE is not going to make job growth better at this stage of the game.



Source: tradingeconomics.com

The June 2013 jobs report came in at 195,000 compared to consensus expectations of 160,000. April and May monthly jobs data was also revised higher to around the June level. The unemployment rate stayed steady near 7.6%. The bond market's immediate reaction to this number was the 10-year yield increasing from 2.5% to near 2.7% or a continued negative hit to bond prices as the Fed plan to end QE seems more likely based on the June jobs data. The stock market popped 1% on the news, as the stronger jobs data was viewed more positively. It should be noted that this report was released during the 4th of July vacation week, when many investors are on vacation and trading volumes are low. The rest of July should be more revealing as to the bond and stock market's near-term direction and as second quarter earnings season plays out. As a caveat to better than expected jobs data, the profile of the jobs gains continues to be poor as hourly, part-time jobs are the predominant adds. Also, the discouraged workers data also increased as did the U-6 measure, which captures the broader set of those currently unemployed.

China

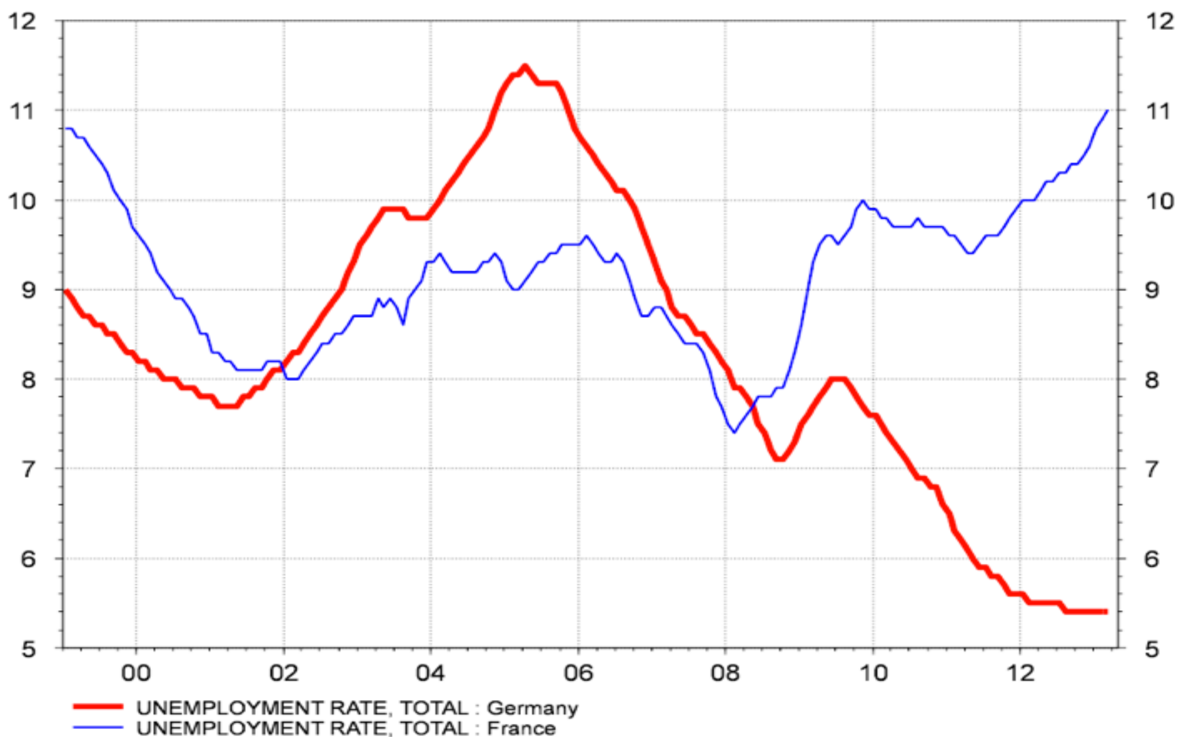
In past investment commentaries, we have discussed how world GDP growth has been overly dependent on China growth as developed markets like the U.S., Europe, and Japan struggle to generate the levels of GDP growth (>2.5% real GDP growth) necessary for the Malaise Era to end. The news out of China during the second quarter was mostly negative and there is a clear deceleration of economic growth in China. Big picture, China is in the midst of transitioning its economy from one lead by infrastructure investment spending to one lead by consumer spending. Given the magnitude of infrastructure spending over the past decade and the still nascent consumer spending in China, the transition is likely to be a rocky one. China's Purchasing Managers Index has dropped below 50, the demarcation line between growth and contraction. As a result, China's GDP growth forecasts are being lowered. The decline in global inflationary pressures, as noted in the chart on page 5, is partially a reflection of China's economic transition as its voracious appetite for commodities (copper, met coal, etc.) has waned. More importantly, China has a credit problem. Its banks are loaded with bad debt and its bank-to-bank lending (called SHIBOR in China, LIBOR in the West) has shown increasing signs of stress similar to what the U.S. and European banks experienced at the start of the financial crisis in 2008. The following chart shows how SHIBOR and the 7-day repo rate have recently skyrocketed in China.

The weakening PMI readings and increasing signs of credit stress have negatively impacted the Shanghai stock composite benchmark, which has declined to new 3-year lows as shown in the next chart.

The slowdown in China growth has had a large negative impact on the prices of commodities, which are highly sensitive to Chinese GDP growth. The following chart shows the Reuters/Jefferies Commodities Index over the past three years. The CRB Index captures the price trends of 19 commodities including petroleum, agriculture, and metals. Note that the peak in the CRB Index in early 2011 coincided with the peak of the Chinese stock market.

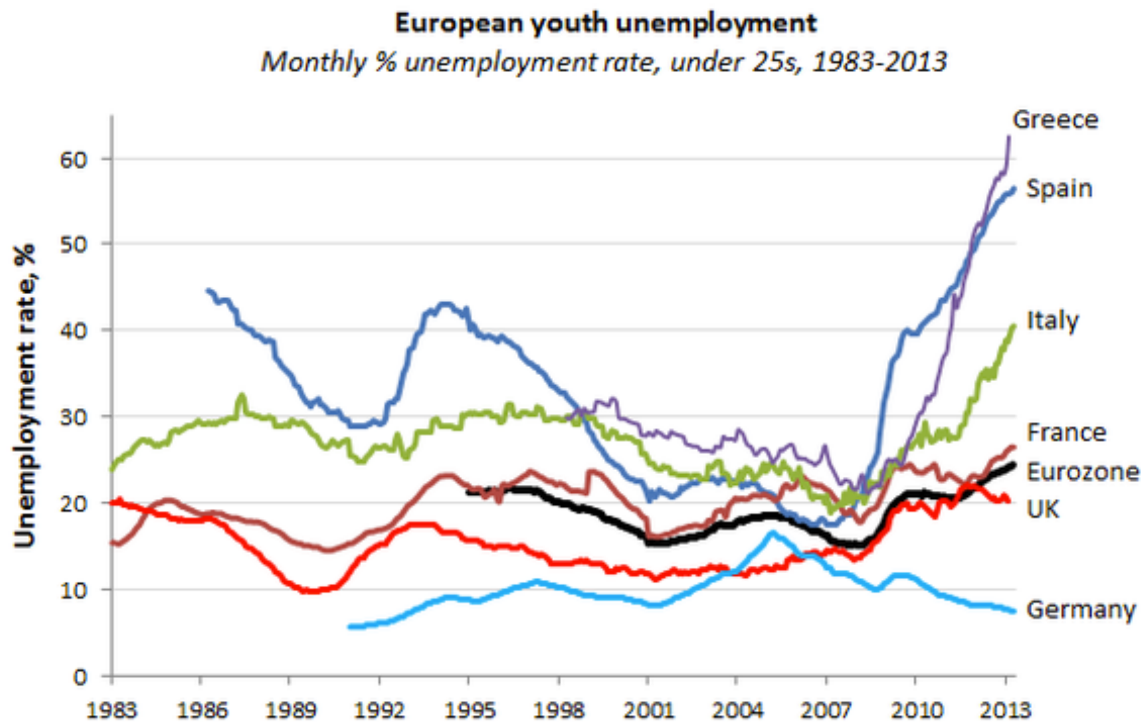
Divergence in Core Europe

The U.S. economy continues to muddle along at around 2.0% real GDP growth and China's economic growth is decelerating. In Europe, the economic outlook remains difficult although has likely reached bottom (I've Been Down So Long It Looks Up To Me) unless a new banking or currency crisis emerges. The euro area seasonally adjusted unemployment rate was 12.2 % in May 2013, up from 12.1% in April, and 11.3 % in May 2012. In contrast, the U.S unemployment rate has declined from 8.2% in June 2012 to 7.6% (wink, wink, nudge, nudge) in June 2013 so Europe is still moving in the wrong direction. The latest country in Europe to be under duress is France. The following chart shows an unemployment picture of the two key countries that back the euro, Germany and France. Since the global recession hit in 2008, the employment picture in France has worsened materially compared to Germany. The latest large move higher in unemployment can be attributed to the Socialist government that was elected in May 2012 and promptly tanked the economy with a plan to jack personal tax rates on the wealthy to 75% (actor Gerard Depardieu renounced his French citizenship-sacreblue!) and failing to reign in large government deficits created by a combination of overly generous social spending programs and slightly negative GDP growth. French President Francois Hollande is an unabashed Socialist and only the French populace can explain why they bothered to elect him. Most can't, as evidenced by his 29% popularity rating. I guess the French are getting what they asked for and no doubt the Germans are feeling schaudenfreude over it. We can now add France into the unstable bucket in Europe along with the other zombie countries. Similar to the U.S., the European Central Bank's own QE program has taken the worst-case scenario off the table in Europe (for now) but it has not solved any of the major structural problems of this region.



Source: Eurostat

After government debt levels, the next chart could be the scariest one on the planet. An entire generation of European youth is at risk if these employment trends don't begin to improve.

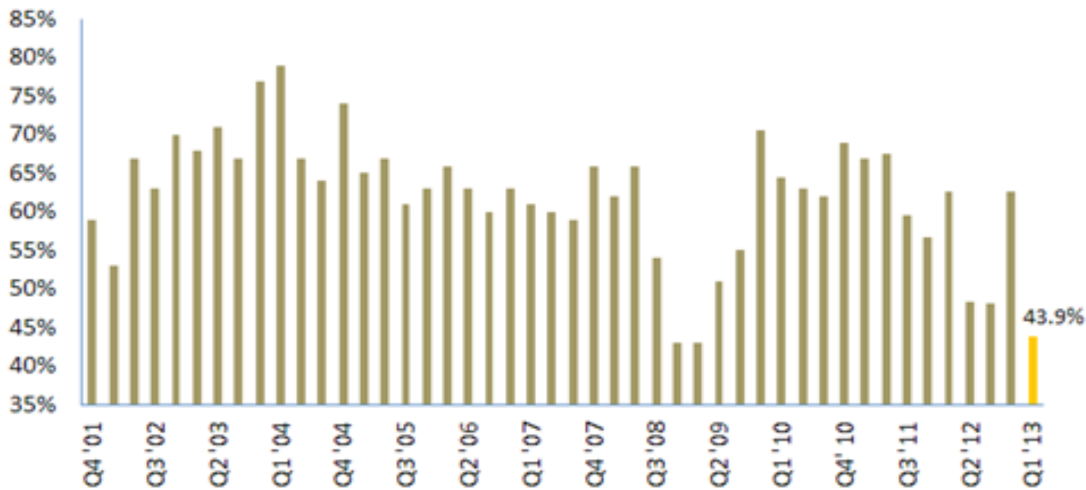


Source: Theatlantic.com

Fundamentals

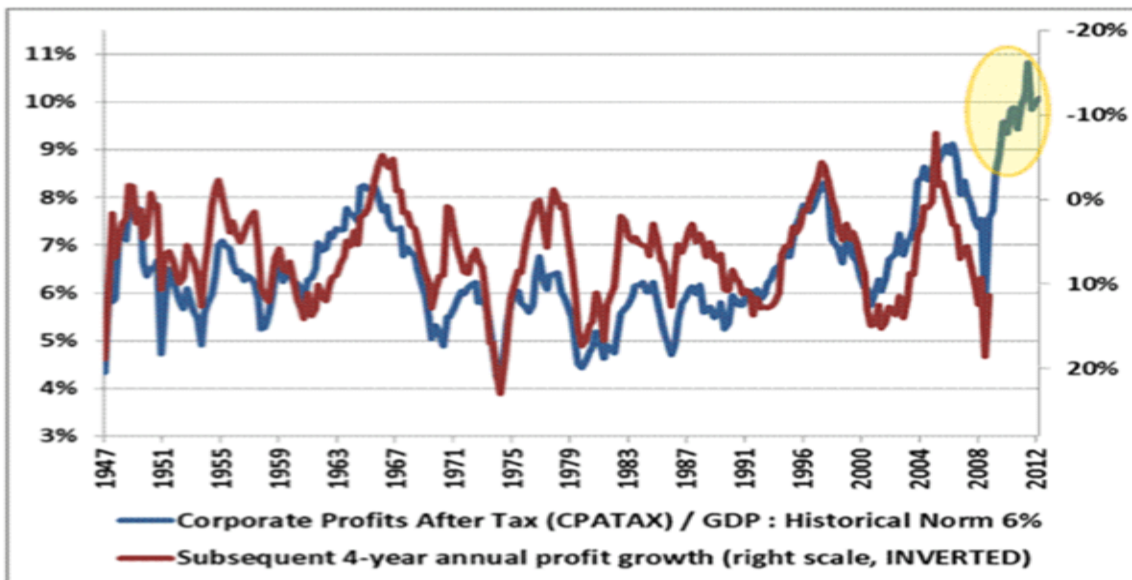
With the prospect of the end of QE in the U.S., investors will now increasingly focus more on the fundamentals of the market to determine the fair value of stocks. In the short-term at least, the profits data is going to be challenging. According to Factset Research, since the start of the second quarter (April 1), analysts have reduced earnings growth expectations for the second quarter of 2013 from 4.2% year-over-year growth to just 0.8% with eight of the ten sectors having lower expected earnings growth rates today relative to the start of the quarter. Additionally, many investors were banking on the fact that the second half of 2013 was going to see earnings growth re-accelerate as evidenced by the higher earnings estimates later in the year. In light of the deceleration occurring in China and other emerging markets, the continued difficult conditions in Europe, and the sub 2.0% real GDP growth in the U.S., it will be challenging for U.S. companies to meet second half earnings expectations. This is particularly true if the housing and auto sectors, key areas of strength for the U.S. economy in the first half, take pause with the recent uptick in interest rates.

Companies have been guiding the Street lower for both earnings and revenue growth. Again, from Factset Research, for the second quarter (April-June), the number (87) of companies issuing negative EPS guidance and the percentage of companies issuing negative EPS guidance relative to the total number of companies issuing EPS guidance (81%) are at record highs. Perhaps the expectations bar has been lowered enough such that a weak second quarter earnings season won't be a negative surprise. Revenue growth has been a key challenge in a world of weak GDP growth.



Source: Bespoke Investment Group

The next chart shows that U.S. after-tax corporate profit margins as a percent of GDP have never been higher (blue line and left hand scale), currently near 10% compared to the long-term (70+ years) average of 6%. There is no doubt that U.S. companies in general have done an excellent job managing through an extremely difficult environment over the past five years. If things are so bad, how can this be? Profit margins are at record highs because businesses have aggressively managed costs and are squeezing out profit growth despite weak revenue growth. However, you can only stretch the rubber band so far before it snaps. Companies have delayed hiring to the extreme and containing labor costs is unlikely to be a source of further profit margin expansion. How many people do you know, perhaps including yourself, who are working harder and longer for the same pay and sometimes doing a job that includes duties that had previously been done by someone else who was laid off?



Source: John P. Hussman, PhD

The previous chart also shows how the trailing 4 year average of annual profit growth overlays with current profit margins. The right hand scale is inverted so the red line shows that 4-year average profit growth is at the highest levels since 1974. However, should this cycle repeat as in the past, then profit growth has peaked and most likely will decelerate in the coming years.

As of early July, the current forward 12-month P/E ratio for the S&P 500 index is 14X. This P/E ratio is based on the July 5th S&P 500 Index close of 1625 and forward 12-month S&P 500 EPS estimate of $116.12. Going back to the mid 1980's, the average 12-month forward PE multiple for the S&P 500 Index is 14.9X but this includes the tech bubble era (1998-2000) when PE multiples went into the mid 20's before the market tanked with three straight years of negative returns from 2000-2002. Stocks are neither expensive nor are they cheap. The question is if investors are willing to pay a higher multiple for a market where earnings growth is most likely to decelerate in the months and possibly years ahead without a better economic backdrop. If business confidence improves, leading to better job growth and higher consumer confidence, then investor confidence is likely to improve and the answer to that question is most likely yes. But, if things stay status quo, where real GDP growth struggles to exceed 2.0%, job growth stays so-so, and uncertainty continues to pervade throughout the economy, the answer to that question is no.

Summary

The halfway point of 2013 has been reached. U.S. stocks have put up strong performance while bonds have rolled over and cash is still trash. The U.S. stock market remains the crème de la crème of global markets but that is not saying much. Europe remains a basket case, and growth is decelerating in Asia and Latin America. The U.S. jobs market is modestly improving but the profile of those jobs gains is low quality as companies still remain hunkered down. We are going to have a new Fed Chairperson nominated by year-end and the Fed has signaled that the end is nigh for the QE Era. QE has been a big leg of support for the financial markets and has artificially suppressed volatility, particularly in the bond market. There will now be a transition period where fundamentals come back to the forefront and the historical relationships between asset classes starts to normalize. The end of QE is a good thing, but we need to get from here to there and the transition period is likely to be choppy.

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