# MJM INVESTMENT ADVISORS, LLC

**Second Quarter 2014 Investment Commentary**

**Beware The Siren Song**

*The Siren*, Edward Armitage, 1888

Sirens were beautiful but dangerous, known for their enchanting voices that lured boats closer to shore and caused shipwrecks on the rocky coast of their island. Sirens are mentioned throughout Greek literature and mythology, most famously in Homer's Odyssey. The term "siren song" refers to an appeal that is hard to resist but if heeded will lead to a bad event or outcome. There have been paintings, Broadway musicals, songs, TV shows, books, sports teams, Supreme Court cases, and ships (either not too bright or really witty) named after the infamous siren. In present day, the siren acts as an advance audible warning for danger or caution ahead.

Presently, global investors find themselves entranced by the siren song of central bankers, lured by steady and positive asset returns combined with the extremely low levels of volatility. Who doesn't like to own investments that seem to steadily and consistently move higher without any tangible declines, increasing the net worth of those drawn in and providing for a euphoric state of mind? Rocks? What rocks? Just keep singing, baby! It's so beautiful!

We can thank the Federal Reserve Bank (the "Fed") and other major central banks for the current state of affairs in financial markets. They have placed themselves upon the rocks for all investors to see and hear and are singing like there is no tomorrow. Artificially suppressed interest rates and bond yields caused by Quantitative Easing ("QE") and other central bank monetary policy actions are the underlying reason why global financial assets are experiencing this unusual period of calm and low volatility in the midst of a global macro picture that is well short of being defined as strong or robust. We're talking Napoleon or Danny DeVito short here.

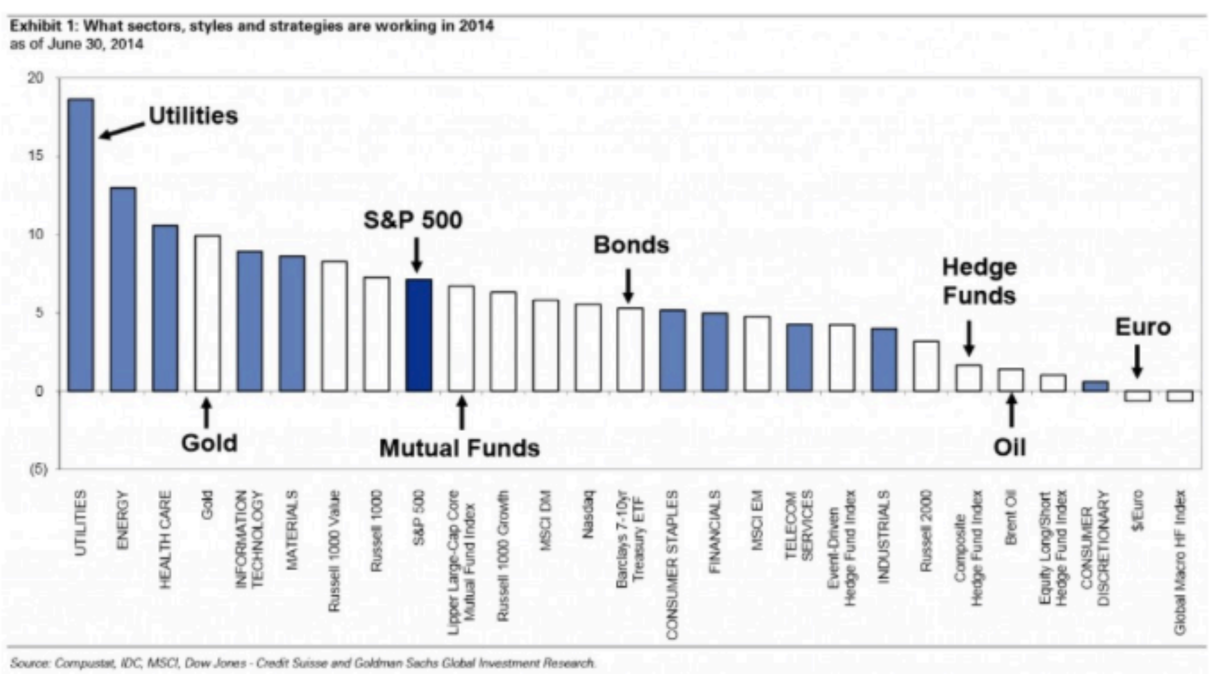
Ironically, Greece has been one of the major stress points of the recent global financial crisis, as investors were smashed upon the rocks when its bonds collapsed in early 2012. Excessive levels of debt built up throughout the world in the years leading up to the 2008/2009 global financial crisis are a key factor behind the ongoing suppressed global growth outlook and deflationary trends in place today. Central banks have had no choice but to keep singing their siren song, as escape velocity out of the economic funk has remained elusive for over five years. Central banks hope the allure of increased investment values will help to drive increased spending (via the wealth effect) and the artificially low interest rate environment will facilitate the refinancing of debt (particularly government debt) at lower rates which will also help pull the world economy out of its funk.

Despite the allure of the central bank siren song, don't ignore the sirens in your head. The allure of higher asset prices is so appealing, but the mispricing of risk is the hidden rocks. Keep your wits about you, maintain a steady helm on your ship, and don a life preserver just in case. The central bank siren song may sound beautiful, but as with most beauty, it is fading fast with age. And the shore is right there over yonder.

**Second Quarter Market Commentary**

After a shaky first quarter, global financial markets rallied during the second quarter and most major asset classes are comfortably in the black through the first half of 2014. Most global stock markets rallied during the second quarter, as dovish forward interest rate comments from Fed Chair Janet Yellen, new monetary policy actions by the European Central Bank, and large declines in global bond yields gave investors the green light for owning risk assets. The 2014 global growth outlook was marked down during the second quarter due to a large negative GDP print for the U.S. economy for the first quarter (-2.9%) combined with continued weak growth in both Europe and Asia. The weaker than expected growth has not scared investors. Rather, it has emboldened their belief that central banks will either do more or maintain current policies for longer in order to stimulate future growth. It is the continuation of the good news is good news and bad news is good news era. Despite being in the unchartered waters of the Sea of Intervention, the central bank siren song is just too beautiful and alluring for most investors to ignore.

The following chart highlights the performance of various investments during the first six months of 2014.



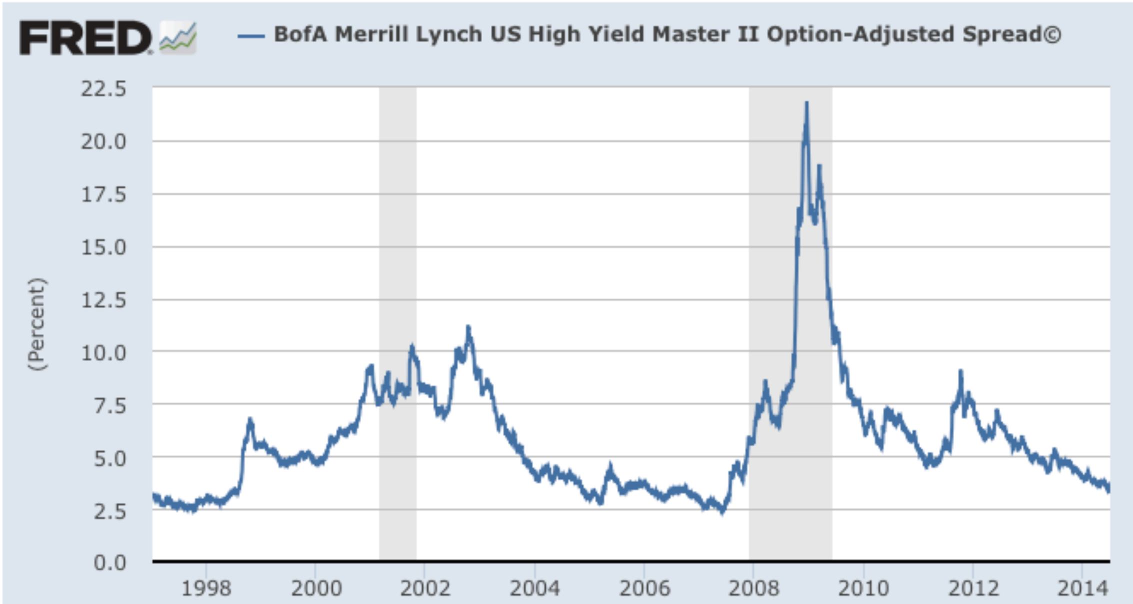

Source: Goldman Sachs Investment Research

The surprise story of the first half of 2014 has been declining global bond yields. Going into 2014, most investors believed the U.S. economy would gain strength and the Fed's QE tapering (buying fewer bonds) would put upward pressure on bond yields. Instead, weak inflation indicators and a brutal polar vortex winter (the Winter Warlock was downright giddy) negatively impacted the U.S. economy and caused the 10-year U.S. Treasury yield to decline from 3.0% at 12/31/13 to near 2.5% by 6/30/14. Additionally, the impressive rally in European sovereign debt markets resulting in much lower bond yields was also a factor on the decline in bond yields in the U.S.

The following table shows how sharply the yield for the benchmark 10-year maturity government bond has declined for a select group of sovereign bond markets during the first six months of 2014. While the U.S. bond market saw a meaningful 50 basis point decline in yields, the decline pales in comparison to some of the declines that occurred in European bond yields. Is it normal to see yield declines of this magnitude outside of a global recession scenario? Should a French bond yield nearly 1.0% less than a comparable maturity U.S. Treasury yield? Is the siren song of global central bank policy actions the cause of such unusual bond market price action? Inquiring minds want to know!

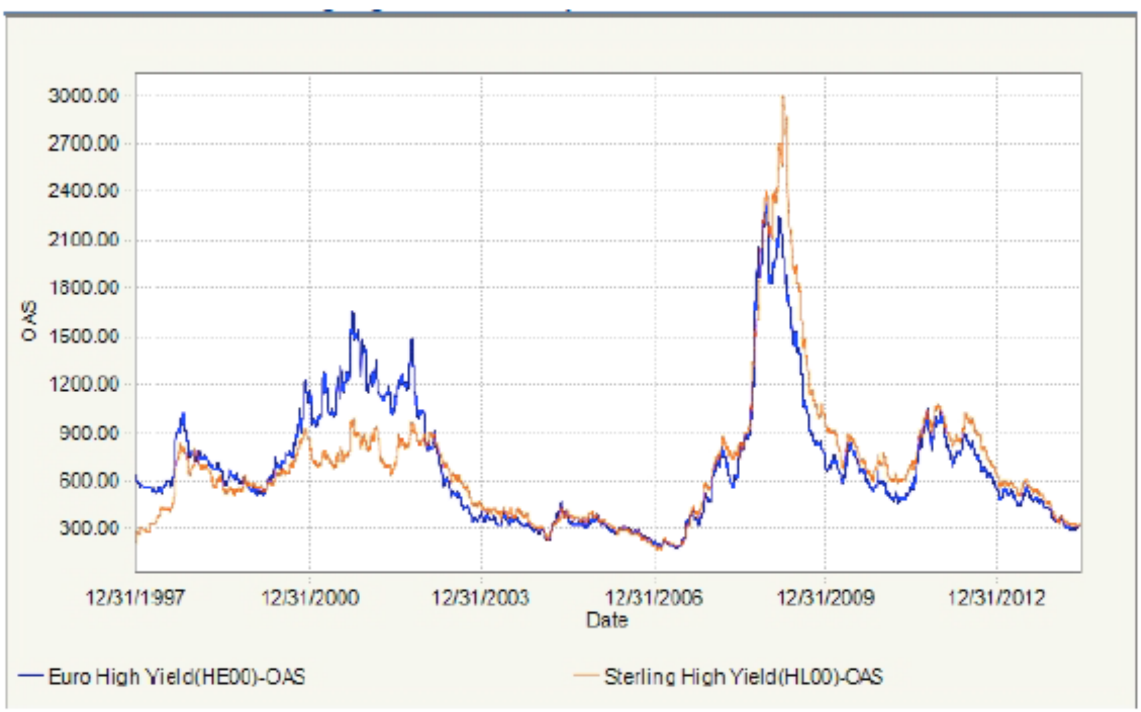
| **Country** | **Yield @ 12/31/13** | **Yield @ 06/30/14** | **Change** |
|---|---|---|---|
| Germany | 1.94% | 1.24% | -0.70% |
| France | 2.38 | 1.59 | -0.97 |
| Greece | 8.66 | 6.38 | -2.28 |
| Italy | 4.11 | 2.73 | -1.38 |
| Portugal | 5.98 | 3.64 | -2.34 |
| Spain | 4.18 | 2.66 | -1.52 |
| UK | 3.02 | 2.67 | -0.35 |
| U.S. | 3.03 | 2.52 | -0.51 |

As the yields on government debt headed sharply lower, corporate bond yields have followed suit. Since global central bank policies have made owning cash-like investments a worthless proposition, investors have been forced to invest in more aggressive strategies in order to capture decent yields. The riskiest of corporate bonds, known as high yield or junk bonds, have also seen dramatic declines in yields. In addition, the yield spread, or the difference in yield between a high quality Treasury bond (if you can call them high quality without laughing) and a low quality corporate bond, has declined quite significantly since the peak of the 2008 global financial crisis. The yield spread represents a risk premium an investor will earn for taking on more credit risk. The next chart shows this relationship going back to 1996. The average spread has been nearly 6% over this time period, ballooning out to 20% at its peak and now just at 3.5% or close to the all time lows of 2.5% in 2007 before the bond market blew up. The current level of yield spread suggests there are some unnatural forces at work in financial markets and indicates that investors, in their desire to earn a decent yield on bonds, are underpricing risk in order to get the extra yield they desire.




Source: St. Louis Federal Reserve / BofA Merrrill Lynch

This mispricing of risk is not a U.S. only event. The next chart shows the same yield spread chart as above but for European and UK high yield bonds. Similar to the U.S., global bond investors are accepting a low level of excess yield in higher risk bonds in order to earn a decent yield on their investment.

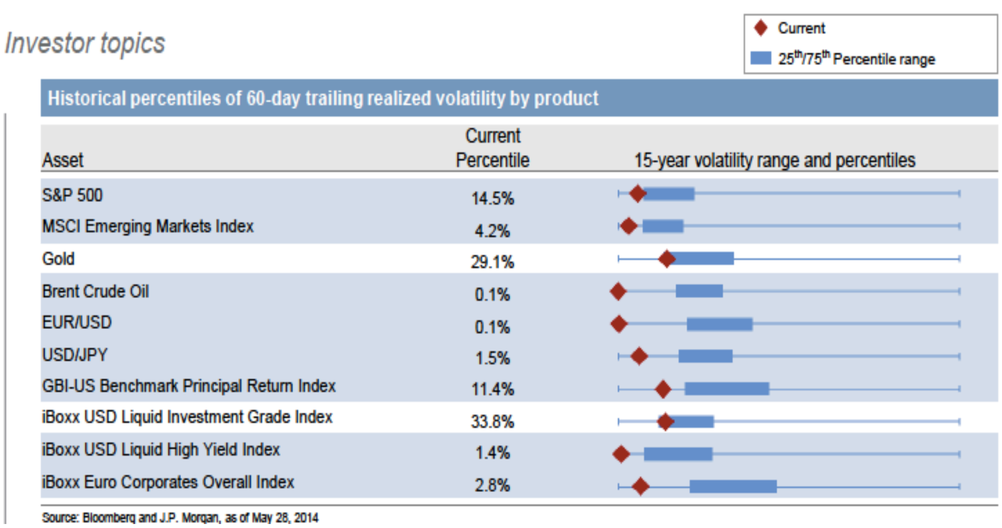



Source: BofA Merrill Lynch Bond Indices

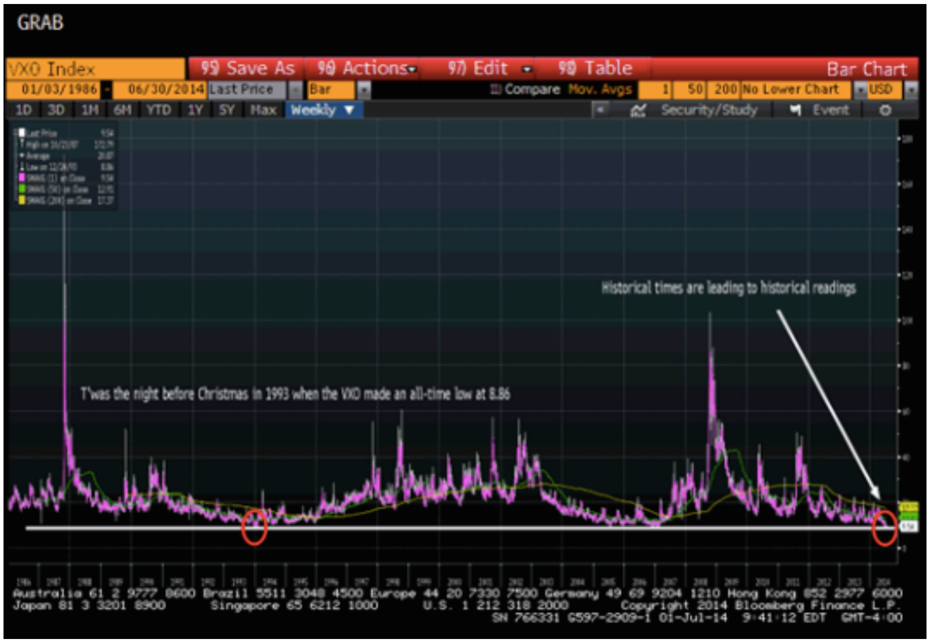
**Volatility**

The risks of unintended consequences being created by central bank policies during the QE era are everywhere to see if you look close enough. Low yield spreads are one. Another to keep a close eye on now is market volatility. Some volatility measures are hitting all time lows. This is not a one-off phenomenon for stocks, but rather an observation that can be seen across most major asset classes as depicted in the next two charts.

The volatility of returns are hitting all-time lows for many assets classes, not just stocks. Market prognosticators and observers debate the reasons behind such low volatility but the evidence is irrefutable. The next chart shows the typical range of volatility for major asset classes over the past 15 years and includes the global financial collapse when volatilities hit all-time records. The blue shaded bar represents the range of volatility between the 25th & 75th percentile and the red diamond is the current volatility reading. Current volatility readings for many asset classes are at extremely depressed levels and well below the normal ranges. The chart on the next page shows the VXO Index readings going back to 1986. The VXO is an index that measures options volatility on the largest 100 stocks. The most recent large spike higher was the financial markets collapse in late 2008 and early 2009. The two more recent blips higher in 2010 and 2011 were European sovereign debt crisis flare-ups. Since the summer of 2011, and after European Central Bank head Mario Draghi said publicly that the ECB would do whatever it takes to save the Euro, market volatility has been on a downward trajectory and now resides at the lowest levels seen since 1993. Oooooh, that central bank siren song is sweet music to the ears.




Source: JP Morgan Asset Management




Source: Bloomberg & Minyanville

Such low volatility readings give investors a false sense of security and create an allure similar to a siren song. The main reason for such low volatility readings is that extreme central bank monetary policies have been ongoing for so long now that financial markets have come to expect this type of environment as the new normal. Whenever global economic growth disappoints, like in the first half of 2014, investors now just assume that central banks will extend their current policies for longer and the present situation gets justified. There are some market observers who argue that low volatility is actually a good sign and forward stock returns can actually be strong even from a low volatility level based on past experience. However, during those prior periods, the global economy was running under more normalized central bank policies. Clearly, the current level of reduced volatility now, not just in stocks but also in all asset classes, is being created by aggressive central bank monetary policies. Should these policies be removed or reversed, the current low volatility environment would likely reverse course and volatility would increase and there would be a much different game on hand for global financial assets. No one can predict when the worm will turn but someday volatility will begin to increase again and return to more normalized levels.

**What's left in the tank?**

A critical question for any investor today is how much longer can this present state of affairs go on? Highly stimulative central bank policies have been a dominant backdrop behind financial market returns for over the past five years. A lot of fuel has been spent by central banks in an attempt to first stabilize and then stimulate the global economy back to health. As global economic growth continues to be sub par (look no further than the -2.9% real GDP for the U.S. during the first quarter), central banks have extended existing programs or created new programs to try to stimulate economic growth. The European Central Bank ("ECB") recently created negative deposit rates for bank reserves in order to try to incentivize European banks to do more lending. The ECB has not yet engaged in a Fed like QE program but that remains an option should its other policy measures not produce improved economic growth. Both Japan and the U.S. have employed massive QE programs although the Fed is now winding down its

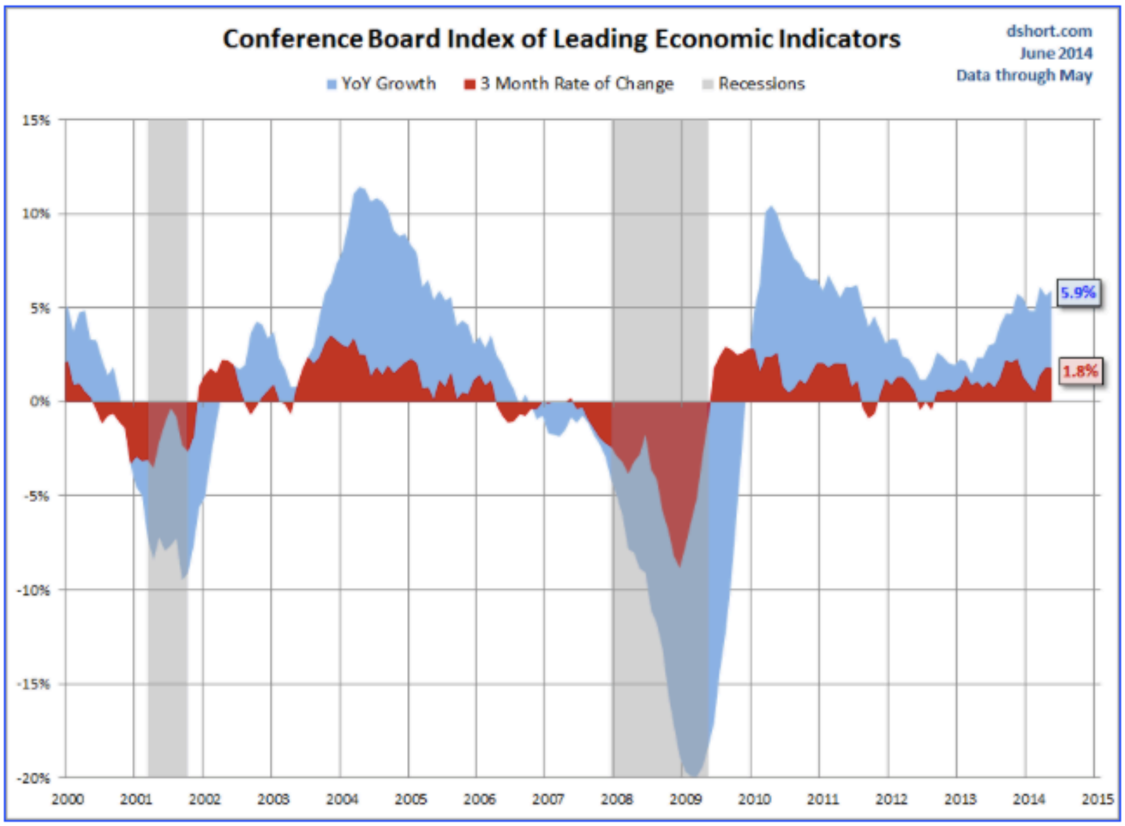
QE program (tapering) and should end QE by the end of this year. However, the Fed has indicated that its Zero Interest Rate Policy (ZIRP), in place now for over five years, will not end until there is a notable improvement in labor force growth, real GDP, or a sustained level of inflationary pressures.

Despite weaker than expected growth, and QE tapering, investors remain entranced, knowing the Fed will keep interest rates lower for longer in order to stimulate economic activity. The conundrum is that the longer these policies stay in place, the more obvious it becomes that they are not working and unable to generate the outcomes central banks are so desperately trying to achieve. While they won't say it publicly, it seems the Fed has determined that the effectiveness of QE has diminished with time and to maintain or increase the program at this point offers little to no benefit to the U.S. economy.

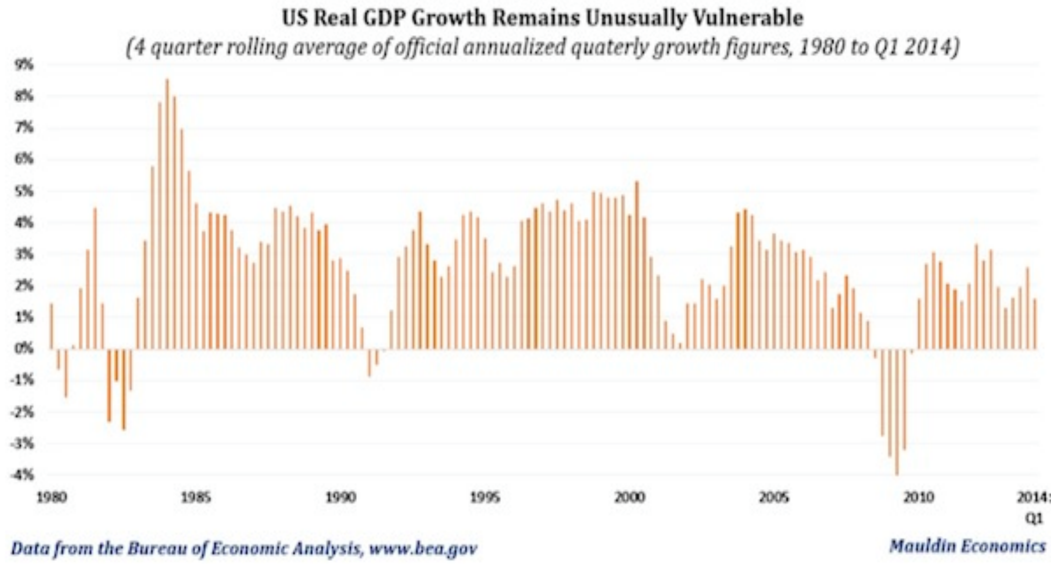
The following graph provides a depiction of where global monetary policy levels are relative to history and shows that the current levels of central banks actions are so aggressive that there is little or nothing left for central banks to do in terms of incremental policy actions in order to stimulate more economic growth. This situation is also known as the zero bound problem. In terms of the degree of policy stimulus, monetary policies are at levels comparable to the Great Depression. The monetary policy accelerator has been pressed to the floor and can't be pushed any harder.


Source: Bridgewater Associates

Despite massive central bank intervention and extreme monetary policy measures, the global economic growth profile since 2008 has remained in fits and starts mode since these measures were enacted. The next graph depicts the Conference Board of Leading Economic Indicators going back to 1999. The red bar shows the 3-month rate of change. By any definition, the policy actions implemented and maintained by the Fed and other central banks since 2008 would be considered extreme. Yet, the growth generated from the global economy due to these policy measures has been moderate at best. It has also been very uneven, with a decent quarter or two followed by growth rolling over once again. Case in point being the first quarter real GDP reading of -2.9% which was well below expectations, partly due to very rough winter weather across most of the U.S. Nonetheless, in light of how hard the Fed and other central banks have their feet pressed on the collective gas pedal, they have been unable to push the global economy to a higher and sustained level of growth. When one considers how little central banks have left in the tank in terms of additional policy measures to stimulate future economic growth, it is clear that the global economy is going to have to start producing organic growth on its own from here on out.




What has all of this very aggressive central bank policy intervention done for the U.S. economy? Not a heckuva lot. The next chart shows the rolling one-year (four quarter) real GDP profile of the U.S. economy going back to 1980. The early 1980's recession was a real doozy too, including a double dip recession, but the 2008/2009 was a Category 5 hurricane. Note the growth profile of the U.S. economic recovery coming out of the early 1980's recession. The economy saw 6-8% real GDP growth during that time and then an extended period of solid growth afterwards. Coming out of the 2008/2009 economic collapse, one that was even worse than the early 1980s recession, a reasonable expectation would have been for a similar snapback level of growth, especially since the Fed used far more aggressive monetary policy actions to stimulate growth off of such a depressed base. Yet, the chart shows that economic growth has struggled to achieve a 3% real GDP growth profile on a rolling one-year basis. The U.S. economy has exceeded 4% quarterly growth only twice since 2009.



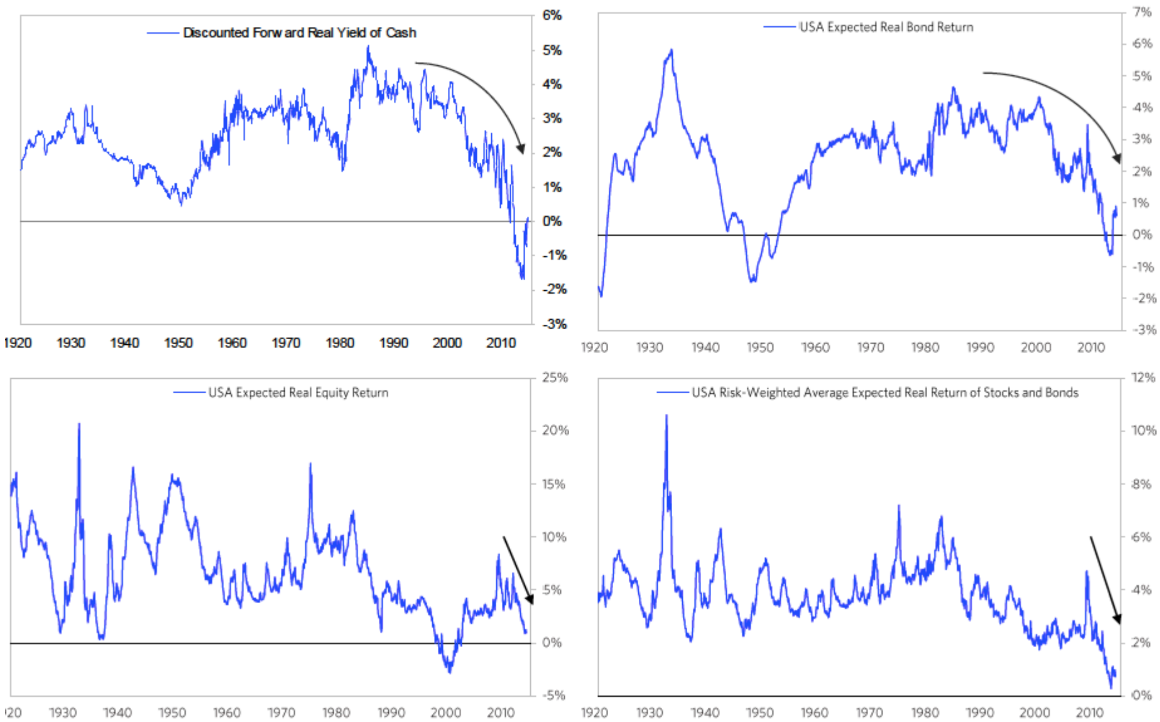

Wouldn't it be a fair argument to say that an economy that is running at a lower level of real GDP growth is by definition more susceptible to unexpected shocks (like a severe winter, for example) and therefore has an inherently higher level of risk associated with its growth outlook? This is not only true for the U.S. but other global economies as well. Yet, low current levels of volatility suggest a much more sanguine outlook for future economic growth and stock market performance. It is a disconnect that won't matter until it does.

**Robbing Peter to Pay Paul**

Who doesn't like higher investment returns and growing portfolio values combined with low levels of volatility? Too good to be true? Unless we are in a new and exceptional era of financial markets, history has always taught some very hard lessons to investors who assume the current state of affairs has become the new normal and this time is different. Despite central bank policies that are creating the ultimate artificial investment world, and unless capitalism as we know it has forever changed, risk/reward is the ultimate axiom of investing and will come back with a vengeance one day once the artificial central bank policies are deemed a complete failure or reversed. It remains to be seen when the day of reckoning will come, if it comes at all.

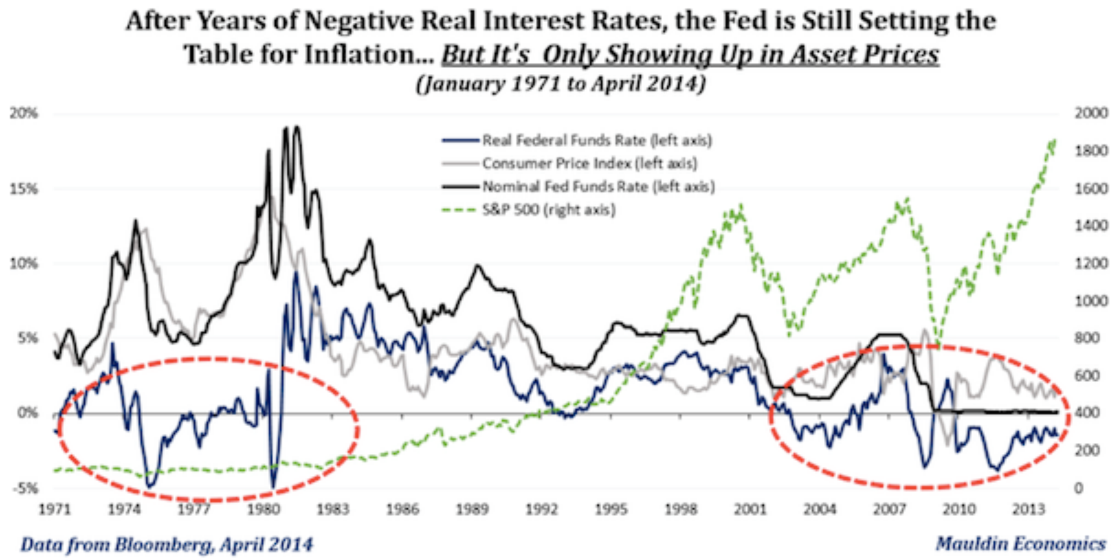
In the meantime, what is the current robust returns investment environment leaving on the table for the future? Bridgewater Associates, one of the most respected investment firms in the world, produced the next chart. It graphically depicts their expected returns of cash, bonds, stocks and a balanced portfolio of bonds and stocks on a current basis and going back to the 1920s. On the right hand side of each chart, the large blip higher in each blue line represents the 2008/2009 market crash. As assets values plunged, the future expected return of those assets moved higher. Since March 2009, when the S&P 500 Index level touched its low reading of 666 (hmmmm, coincidence?), U.S. stocks have made significant gains with the S&P 500 Index level near 1960 at the end of the second quarter. As asset values have risen, the future expected returns of those assets have moved lower. While it has been great to experience rising equity values and strong returns over the past five years, the level of economic and profit growth has not been commensurate with the rise of financial assets. As such, the future expected returns of financial assets have moved lower and forward return expectations are now in the very low single digits. What this indirectly suggests is that the risk/reward equation of financial assets is skewed more towards risk and the upside reward is constrained for the risk being taken. Combine this chart with the previous charts showing extremely low market volatility levels and you have a decent picture of the present state of affairs. The prospect of low future absolute levels of return at a time when the volatility of asset returns seems to have nowhere to go but up.

**LOW EXPECTED RETURNS**




Source: Bridgewater Associates

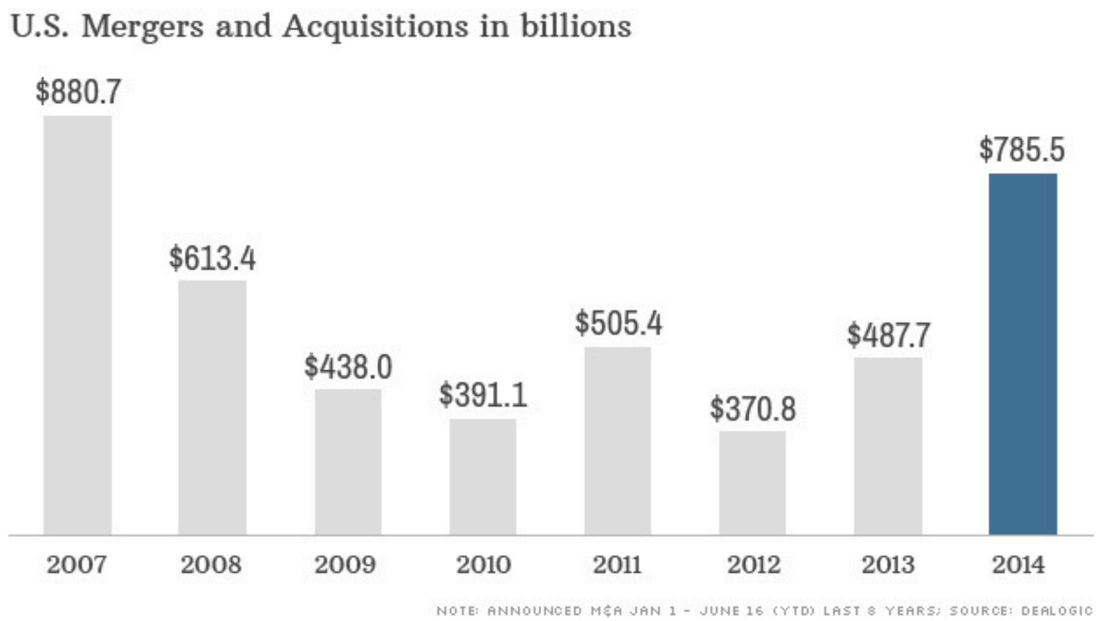
Under normal economic circumstances, highly stimulative monetary policies (easy money) such as those presently employed by the Fed and other central banks have lead to strong inflationary pressures in the global economy. If there is one thing that freaks out a central banker, it is deflationary trends taking hold in an economy. In addition to trying to stimulate economic growth, the Fed and other central banks are purposely trying to induce higher levels of inflation. The problem is that inflation is only showing up in asset prices, and not just in large-cap equity markets, but in many asset classes. The following chart captures the relationship between Fed interest rate policies, inflation, and stock prices as measured by the S&P 500 Index. Please note the large disconnect currently in place starting with the 2008/2009 global financial crisis. Despite highly stimulative monetary policies (including the ongoing ZIRP or zero interest rate policy), inflationary pressures remain benign while asset prices have made a strong upward trajectory move.




Most asset classes have been driven higher by artificially suppressed interest rates, quantitative easing, and forward interest rate guidance. Eventually, these policies must reverse course to some extent and interest rates will then begin to normalize. For now, nothing is going to change the investment return equation presently in place. The Fed has made cash trash through its zero interest rate policy. The Fed has made bonds a terrible risk/reward option due to the artificially suppressed yield curve from the bond buying via its QE policy. By default, the Fed and other central banks have made risk assets the only game in town for global investors to earn a decent return. The disconnect in equities versus the realities of the economy appear to get more extended as the stock market continues its steady climb higher under the siren song of central bank policies and the false sense of security being created by very low levels of volatility.

**M&A En Fuego**

The low levels of yields brought on by extreme central bank policies provide companies with an incentive to either refinance existing debt or to take on more debt at cheap rates to grow. Since the low growth economic backdrop has made it challenging for companies to grow earnings, mergers and acquisitions (M&A) supported by cheap financing provides an alternative source of growth for companies. Some recent M&A deals have U.S companies offering to acquire foreign companies in order to gain the lower tax rate profile of the acquired company (called inversions). When a company is doing M&A for the main purpose of gaining a lower tax rate to juice its earnings growth outlook, you know the current economic incentives environment has been tossed on its head. For whatever reasons, M&A deals are taking off, as the next chart shows the value of M&A deals in the U.S. since 2007. 2014 is only half over and M&A transaction values are almost exceeding the last peak of 2007 before the you-know-what hit the fan.



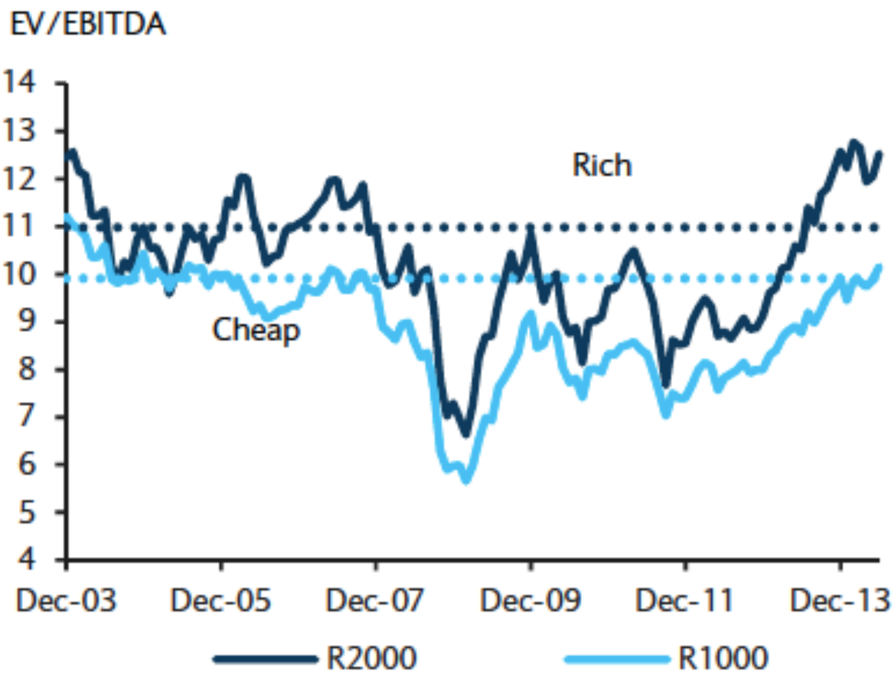

Source: Dealogic

**Valuations: Getting Stretched**

As the U.S. stock market marches higher, without any meaningful upward revisions in forward earnings, stocks continue to push the upper bounds of valuations. The next two charts show how market multiples have increased and compare the current valuations to recent historical averages. The first chart shows the EV/EBITDA valuation multiples for the Russell 1000 (the largest 1000 companies by market cap) and Russell 2000 (the next largest 2000 companies). The data indicates that small cap stocks are more extended or have richer valuations than large caps but large caps are also slightly above the average going back to 2003.

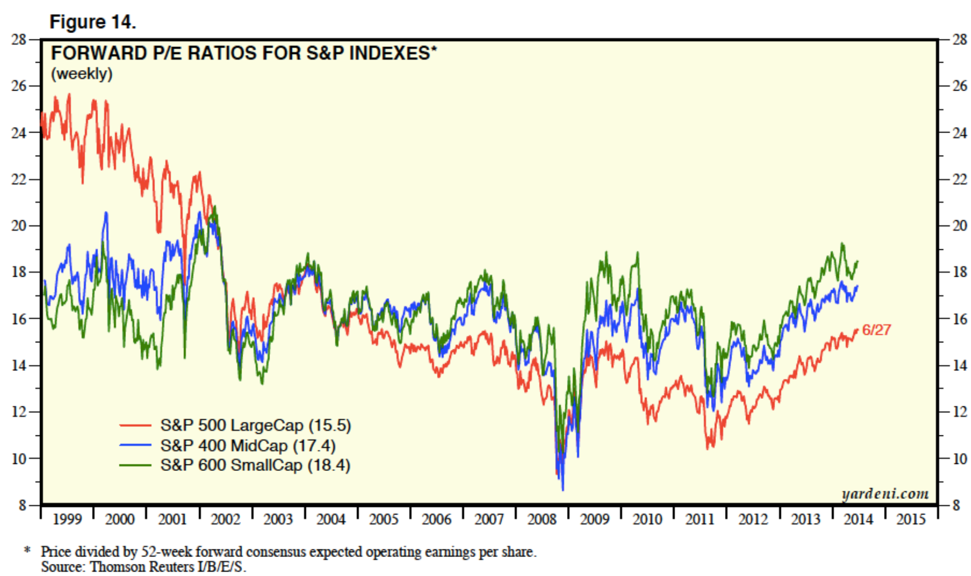
The second chart on the next page shows the forward PE multiples for the S&P large cap, mid cap, and small cap indices based on the next 12 months earnings and using today's valuation levels. The S&P 500 Index forward PE multiple is approaching 16X while the mid and small cap forward multiples are even higher. The chart shows where the current levels are compared to history going back to 1999.

If the economy snaps back from its polar vortex induced coma earlier this year, then forward earnings may start to improve and the latest run higher in stocks can be supported. Additionally, the investment alternatives available to investors have been made worthless by central banks. Bond yields are at extreme suppressed levels, making the risk/reward in bonds highly unattractive, and cash earns zero. If the economy truly rebounds and puts up some >3% real growth numbers in the back half of the year, owning bonds is going to be a painful experience once again as it was in the back half of 2013.




Source: Barclays Capital / Factset Resarch

S&P 500/400/600 P/Es




Source: Ed Yardeni Research

**Summary**

An extremely bad winter contributed to an unexpectedly large -2.9% decline in U.S. real GDP during the first quarter. That being said, more recent economic data shows the U.S. economy recovering and getting back on track. Monthly job gains have exceeded 200,000 for five consecutive months (but with more part time, low wage jobs as a key component), manufacturing data has rebounded, and auto sales are surprising to the upside. However, the weak performance of many retailing and restaurant stocks and weak U.S. consumer spending patterns (ex the high net worth crowd benefiting the most from rising financial asset prices) sticks out like a sore thumb on this latest move higher in stocks.

It was Sir John Templeton that said bull markets are born in despair and end in euphoria. It doesn't feel like financial markets are at either extreme today. Typically, recessions cause bear markets. Despite an ugly first quarter of GDP, it doesn't appear at present that we are at that stage of the economic cycle. Eventually the time will come when it makes sense to switch from capital generation to wealth preservation mode. However, the central bank siren song suggests the time is not quite here. There are warning signs and mini bubbles forming out there if you look hard enough, such as the price action in art and high-end real estate markets. The affluent are enjoying the current central bank sponsored party and the siren song of central banks is as beautiful and alluring as ever. However, for most American, the siren song is loosing its allure and this party is a bust.

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