MJM INVESTMENT ADVISORS, LLC

First Quarter 2015 Investment Environment

- Increased volatility in bond yields, currencies, and oil prices were the main highlights of the first quarter. Increased volatility is a theme that may be with us for some time after several years of suppressed volatility.
- The U.S. stock market was modestly positive for the first quarter but full valuations, a weakening earnings outlook, and a central bank poised to raise rates at some point during 2015 are all headwinds for U.S. stocks. The strengthening U.S. dollar is hurting large multinational companies found in the S&P 500 Index. Small cap stocks outperformed large cap stocks during the quarter after lagging by quite a bit last year.
- After several difficult years, Europe now has multiple tailwinds, which allowed international stocks to have a strong quarter and outperform U.S. stocks. In March, the ECB officially started its own QE bond-buying program, the Euro has seen a significant drop lower (it had its worst quarter in its history), and lower oil prices are helping European consumers and companies. The earnings outlook for European based companies has bottomed and is starting to improve.
- Bond yields were quite volatile during the first quarter, with the U.S. 10-year Treasury bond starting the year at 2.17%, hitting a low of 1.68% and finishing the quarter at 1.93%. U.S. bond yields continue to have downward pressure due to weak inflation data and the rapid decline in global bond yields, particularly in Europe, where some bond yields are now negative. The 10-year German bund yield was a measly 0.15% at the end of the first quarter, which helps to explain why U.S. bond yields continue to remain at historically low levels.
- Oil prices continued to decline during the quarter, with WTI (the U.S. oil benchmark) declining from $53 to $43 per barrel before settling at $47.60 per barrel at the end of March. However, Brent crude (the non-U.S. oil benchmark) was flat for the quarter.
- The table below shows the returns for major asset classes during the first quarter.

Asset class	Return
S&P 500 Index (large cap U.S.)	**+1.0%**
Russell 2000 Index (small cap U.S.)	**+4.3%**
MSCI EAFE Index (large cap int'l)	**+4.9%**
MSCI EM Index (emerging mkts)	**+2.2%**
Barclays Aggregate (invt grade bonds)	**+1.6%**
Barclays High Yield (non-invt grade)	**+2.5%**
Barclays Short-term Treasury bills (cash)	**+0.0%**
Gold	**0.0%**
Brent Crude Oil	**0.0%**
Lipper Average Balanced Fund	**+1.8%**

- The final revision for fourth quarter 2014 U.S. real GDP growth came in at 2.2%. The economy will likely be weaker in the first quarter and may barely eek out positive growth. A strengthening U.S. dollar is hurting exports and another severe winter, particularly in the Northeast, had a negative impact on economic activity during the first quarter. However, it is likely there will be some catch-up effect over the next two quarters, similar to what happened in 2014. That being said, the Fed has downgraded its assessment of the U.S. economy for 2015 to a new forecast range of 2.3% to 2.7% compared to its prior growth forecast of 2.6% to 3.0%. The forecasts for 2016 and 2017 were also revised downward and are now slightly below the 2015 forecast range.

Second Quarter 2015 Investment Outlook

We Should Have Listened To Ben

"The second vice is lying, the first is running in debt."
"Creditors have better memories than debtors."
"Rather go to bed supperless, than rise in debt."
-Benjamin Franklin

Can we all agree that Benjamin Franklin was the smartest man who never became President? The creator and publisher of Poor Richard's Almanac, Ben Franklin also invented bifocals, the Franklin stove, mapped the Gulf Stream, came up with the idea to put an odometer on his carriage wheel to calculate distance traveled, and made large advancements in the understanding of electricity and invented the lightning rod as a result. Who influenced and cajoled Thomas Jefferson to step up and write the Declaration of Independence? Ben Franklin. Who was the first U.S. Ambassador to France? Anyone? Anyone? Ben Franklin. Who had a major role in the establishment of the University of Pennsylvania? Ben Franklin. Ben was a Founding Father, publisher, inventor, civic statesman, diplomat, politician, and lived to the ripe old age of 84 during a time when the life expectancy of the average male in the U.S. was considerably shorter. Ben had one heckuva life. Ben eventually got his due and is one of three non-presidents on a major currency note of the U.S., the $100, or as it affectionately called, the Benjamin. Growing up, I wish more people would have slapped a Benjamin on me every now and then, you know what I mean, Vern?

Wise was the most appropriate description for Ben. Remember early to bed, early to rise, makes a man healthy, wealthy, and wise? Yup, that was Ben. Whenever I hear another wise saying like that one, I figure Ben probably came up with it. The one liner "You know what I mean, Vern?" probably would have been created by Ben too but no one back then was named Vern.

If Ben were alive today, he would likely have one of the largest Twitter followings (he most likely would have invented Twitter) and come up with some classic tweets to throw out there for public consumption including:

> "It was billions of debt, now it's trillions. Gazillions, anyone?"
> "I'm embarrassed enough that I have officially requested my likeness be removed from the $100."
> "Back in our day, 56 of us created the greatest nation on Earth. Today, 535 + 1 are ruining it."
> "Harry Reid, addition by subtraction. #goodriddance"
> "Even me, the original Postmaster, knows it's time to deep six the USPS. #Redinkforever"

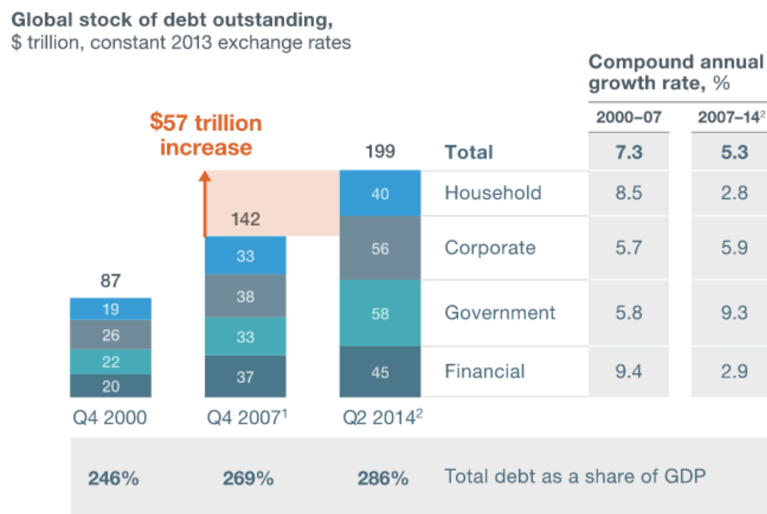
Ben was one sharp cookie and his sage one-liners on debt were spot on. We sure could use more wise men around today like Benjamin Franklin. Men willing to publicly state how embarrassing and inappropriate it is for any nation to be buried in debt up to its neck like most major countries are today. We need more wise men like Ben to explain how today's low economic growth environment is a direct result of too much debt in the system. It may surprise you to know that global aggregate debt, including government, corporate, financial, and personal, has gone UP $57 trillion since 2008. Excessive debt is the scourge of the entire world economy and explains why growth everywhere has not been able to move to a higher level despite the best intentions of central banks, which are trying every old monetary trick in the book (and some new ones too) to make it happen.

It is never fun to be a Debbie Downer (although the SNL sketch featuring Rachel Dratch sure is), the Party Pooper, or the Bearer of Bad News, but this low growth world is going to be with us for a LONG time until some critical changes are made. 1) Governments stop going more into debt and do some serious belt tightening, raise taxes or some combination of both to reduce outstanding debt; 2) any tax increases are used specifically to pay down the national debt; 3) entitlement programs and the tax code get a complete overhaul; 4) voting citizens realize the Federal government's $18 trillion of debt is bankrupting our children's future and elect politicians dedicated to making hard and difficult choices now to get this massive debt albatross off from around our neck and put America back on the path towards fiscal responsibility.

Some people like to stick their head in the sand and ignore reality. The cold, hard truth is that the global economy cannot get out of the gates despite unprecedented and extreme central banks policies because there is simply too much debt in the global financial system.

Global Debt

There is a popular chart published recently by McKinsey & Co. that shows how dramatically global debt has grown since 2000. From 2000 to 2014, aggregate global debt increased from $87 trillion to $199 trillion. Debt as a percentage of global GDP increased from 246% to 286%. The table to the right of the graph below shows growth of debt by issuer category and breaks down the debt growth rate profile into pre Financial Crisis and post Financial Crisis buckets. The table shows that Households and Financial companies had the biggest growth rates of debt from 2000-2007. A big part was mortgage debt from the real estate bubble. Since the Financial Crisis hit, governments have taken the baton and are now the biggest culprits in terms of debt growth. Households and Financial debt growth rates have declined substantially since 2007 (housing bust) while corporate debt growth rate has remained steady.



Source: McKinsey & Co.

The preceding table provides a sobering view of the Number 1 financial problem in the world today: excessive levels of debt. Debt in it of itself is not always bad. Most people could not purchase a home without mortgage debt and most businesses could not be formed without borrowing from a lender such as a bank. However, when debt levels get excessive, it begins to have a perverse effect on future growth. Debt is a pulling forward of future demand and if debt is excessively high today, demand in the future will be lower as a result. Lower demand, lower growth.

Bad debts (debt unlikely to be repaid in full) that remain in the financial system act as a tether on growth. The artificially low interest rate environment brought on by extreme central bank policies has enabled this bad debt to be rolled over at lower rates or kept on the books of lenders even though some of it will never be paid back. Does anyone seriously think that Greece will ever repay most of its massive $350 billion of outstanding debt? No, but its creditors pretend it can to avoid a negative event for the global financial markets and to kick the can down the road. The same is true in the private sector. RadioShack is a recent example of a company that filed for bankruptcy and should disappear but doesn't because cheap debt is available to keep it alive. The Greece and RadioShack situations play out while never being put on a realistic path to resolution because artificially low interest rates allow these bad debts to fester like an open wound. It probably wouldn't surprise you to hear that the current Greek government says that Germany owes Greece and its private citizens $305 billion in reparation for the Nazi atrocities/occupation during WWII. In other words, we may owe $350 billion but you owe us $305 billion so we really don't owe you what you think we owe you and our debt situation is not as bad as you think it is. There is a famous saying from renowned British economist John Maynard Keynes that comes to mind here. If you owe a bank 100 pounds, you have a problem. But if you owe it a million, the bank has a problem.

The Global Financial Crisis was brought about excessive growth of credit and leverage in the private sector. Today, governments are now the primary source of excessive debt growth. Keep in mind that governments are issuing large amounts of debt in an era of historically low interest rates. So, the interest expense on the debt is artificially low and extremely low rates make it easier for all borrowers including governments to rollover debt rather than pay it down. What if governments had to issue debt at interest rates 2X to 3X higher than the current level of 10-year U.S. Treasury bond yield? Budget deficits would explode even more as interest expense would grow dramatically. How long the door of low interest rates is kept open remains to be seen.

It should be clear to everyone by now that central banks have engaged in extreme policy actions since 2008 in order to try and juice economic growth and offset the negative effects of excessive debt. Has it worked? Not yet, but let's give it another decade and see what happens. The U.S economic growth rate has not exceeded 2.5% in any year since the Global Financial Crisis hit and despite lengthy and unprecedented levels of intervention by the Federal Reserve. Central bank policies in the fall of 2008 and early 2009 averted a more worst-case scenario for sure. But, the magic elixir of higher growth from these extreme policies is just not there. The Japanese and European Central Banks are now attempting to implement the Fed playbook. How do you think that will turn out?

Negative Bond Yields

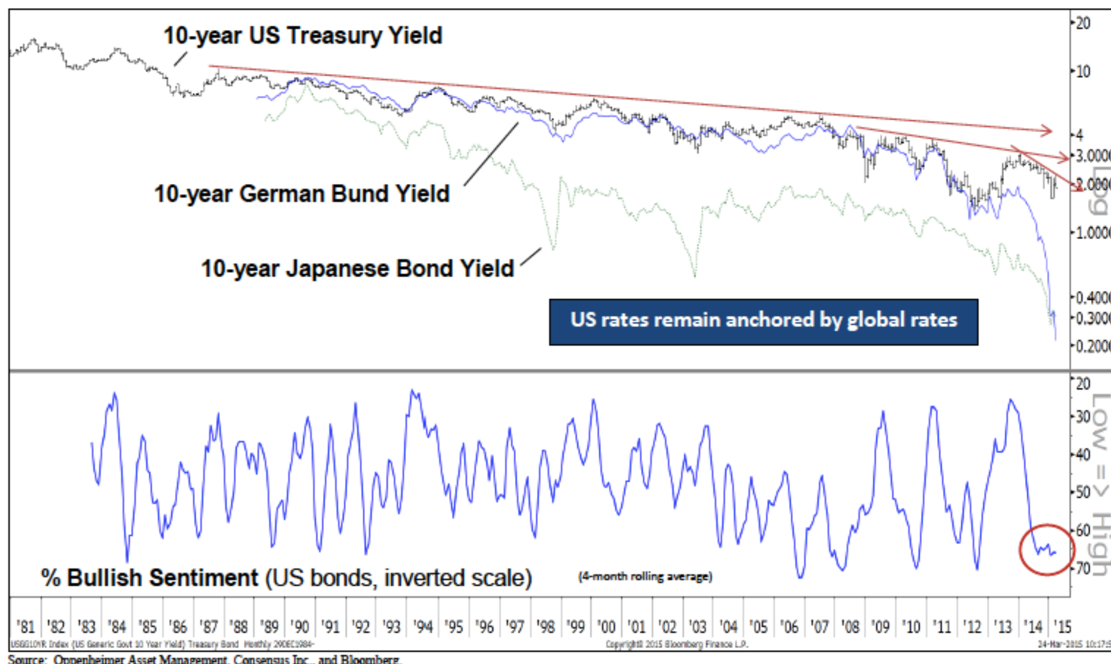
Currently, 30% of the bonds issued in Europe or $5 trillion worth of bonds yield less than 0.0%. That's never happened before in the history of lending. As European and Japanese central banks implement their own QE programs and bond yields crater and head lower as a result, it puts downward pressure on U.S. bond yields because investors view U.S. bonds as offering good value compared to the low or negative yield alternatives available to them. Despite our own bond yields hitting historical lows, the

U.S. still offers some of the highest bond yields globally in a universe of historically depressed or negative bond yields.

Why would anyone want to buy a bond that has negative yields which means you the investor would pay the borrower to buy its debt? First, if an investor expects disinflation or deflation, buying negative yield bonds may make sense. Under deflation, real (or inflation-adjusted) yields could be positive even if nominal yields are negative. Second, yields may become even more negative, which would create a profit for investors willing to sell before maturity. This scenario could happen if a large, unnatural buyer like the European Central Bank is struggling to find enough bonds to buy in order to meet its 60 billion euro Quantitative Easing (QE) monthly quota.

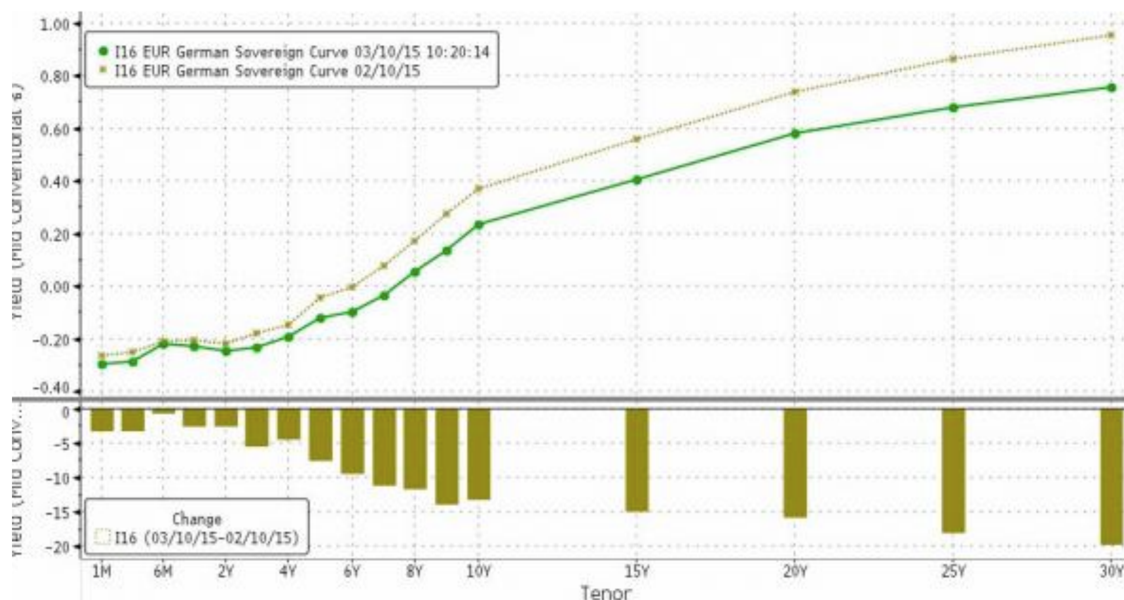
The following chart compares the 10-year Treasury bond yields of the U.S., Germany, and Japan going back to 1981. Over 30 years ago when Fed Chairman Paul Volcker was trying to break the back of inflation in the U.S., an investor buying a 10-year U.S. Treasury bond could receive a 13%-15% yield! My Grandma Mulligan, who came from nothing and was a prolific saver, was always happy to announce to everyone the one-year CD she got at the local bank was paying double digit yields.

Over the ensuing 30 years, bond yields have more or less been on a continuous decline including an outright collapse during the past few years as global central banks initiated their Quantitative Easing programs. If you think getting less than a 2% yield for a 10-year maturity U.S. Treasury bond is bad (you're right, it is), you could get 10X less yield if you owned a similar maturity German Treasury bond, which now yields just under 0.2%. The 10-year Japanese Treasury bond yield is not much higher at 0.37%. If Grandma Mulligan were alive today she would be complaining about the fact that she can't earn much yield from buying a CD and probably would have a few choice words for Janet Yellen and the Fed.



Source: Oppenheimer Asset Management, Consensus Inc., and Bloomberg.

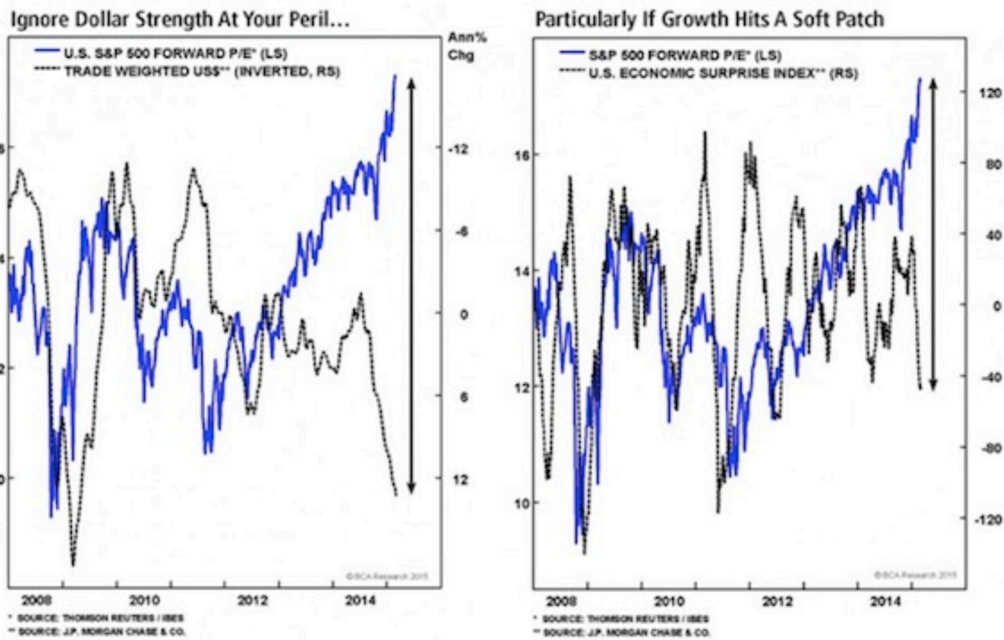
The next chart compares the yield curve of the German bond market in February and March 2015. By March 2015, an investor had to buy an 8-year maturity German bond in order to earn a positive yield. Any bond maturities below 8 years paid negative yields and very long maturity bonds offered yields below 1%. The same is true for most major government bond markets of countries in the Eurozone. The ECB's initiation of its own Quantitative Easing program starting in March has had a large impact on the phenomenon of negative bond yields in Europe.



Currency

Let's revisit the topic of Currency Wars discussed in the 2015 Investment Outlook piece. Wow, did this issue play out in a big way right out of the blocks in 2015. The U.S. dollar has been on a tear, ripping higher by 9% during the first quarter after a big move higher over the last six months of 2014. The converse of the U.S. dollar move higher is the rapid decline of the Euro, declining from $1.22 to $1.07 at the end of the first quarter or a decline of 11%.

A weaker U.S. dollar is typically positive for U.S. stocks since it helps make U.S. goods and services cheaper and increases our exports. The next chart shows the relationship between the traded weighted U.S. dollar and the PE multiple of the S&P 500 Index. A declining U.S. dollar trend often means an expanding PE multiple. However, this changed in 2012 as the PE multiple continued to move higher while the trend in the U.S. dollar flat lined. Since mid-2014, this relationship has really gotten out of whack when the U.S. dollar started a major rally (gray line going down) while the S&P 500 PE multiple continued to move higher. Please note this widening disparity is also shown in the chart on the right, which shows the same PE multiple but this time against the U.S. Economic Surprise Index that took a sharp turn lower during the first quarter. These charts suggest that if the U.S. economy does not see a rebound in economic surprises and if the U.S. dollar maintains its strengthening trend, the PE multiple of the stock market is really out of whack with historical relationships and has risk to the downside.



Source: Bank Credit Analyst / Mauldin Economics

The Citi Economic Surprise Index hit a low in mid-March and is now seeing some recovery into early April, which should be expected coming out of a tough winter that negatively impacted commerce.

Source: Bloomberg, Barclays Capital

Volatility

Since July 2014, the sharp rise in the U.S dollar has had an effect on the volatility of other financial assets. The next chart shows the implied volatility of stocks, interest rates, foreign exchange, and oil going back to late 2013. Volatility hit its lows in mid-2014 before the U.S. dollar began to rally. Since then, the strengthening U.S. dollar since has had a meaningful impact on the volatility of other financial assets. Bond yields and oil are more sensitive to large U.S. dollar price moves so the volatility of each has exploded. The scale of the chart makes it appear that stocks were less impacted by the rising volatility environment but that is not the case. According to SunTrust Research, during the first quarter, the U.S. stock market as measured by the S&P 500 Index moved at least +/- 1% for nearly 1/3 of the trading days during the quarter compared to only 15% of all trading days during 2014.

Source: Bloomberg

China

The ongoing slowdown in China is an important factor contributing to the headwinds facing global economic growth and a hard landing in China remains one of the key risks to the global economic outlook. During the first few years following the 2008 global recession brought on by the credit collapse in western economies, China had a snapback recovery that helped support global growth. Since mid-2010, China has joined the rest of the world in an economic slowdown as real GDP growth in China is decelerating and is now at its lowest levels since 2000. It is a challenge to obtain transparent economic data from China and sometimes the anecdotal evidence often doesn't match the official data being provided by the government. The next chart compares China's official GDP data with a non-government calculated economic activity proxy index. China's official government issued data shows China is near its official 7% real GDP growth target while the CE China Activity Proxy suggests the real economic growth is now moving below 6%. Economic growth below 6% in China would be defined as a recession while the rest of the world would be ecstatic to have that type of recession.

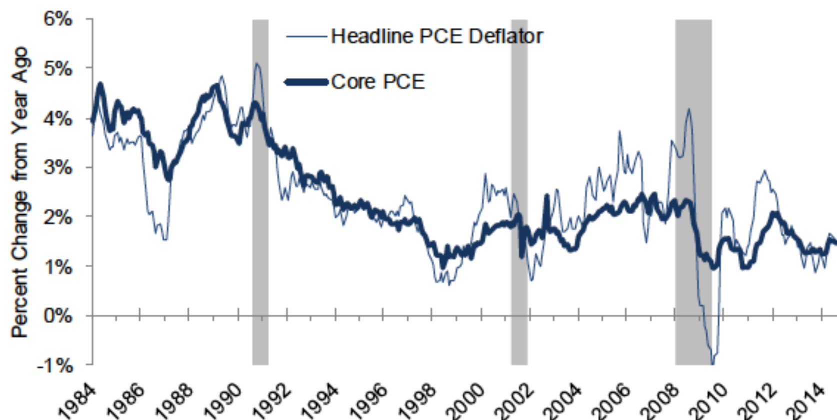
China's transition from a capital investment driven economy to one placing more emphasis on consumption and consumer services is a major factor behind its slowing economy. The rest of the world's anemic growth is also hurting China's exports and is another major reason behind China's slowing growth. China is also dealing with the after effects of the massive overinvestment made during the past decade where local governments funded real estate and infrastructure projects via debt even though there was no viable economic basis for the projects. Now, China has a massive debt overhang in its economy.

The economic slowdown in China has had major ramifications for global commodity demand as most commodities have seen significant price declines since China adapted a change in its economic focus. The strong U.S. dollar is also a factor too. Countries such as Australia, Russia, and Brazil that had large commodity exports to China now have low or negative economic growth rates given the large decline in commodity demand from China. The world economy is already skating on thin ice as developed markets struggle to produce decent economic growth. Now, China is joining the weaker economic growth bucket too. China does have two tailwinds to help it during this challenging transition process. China's central bank has much more room than Western central banks to lower interest rates to stimulate its economy. Additionally, China is the second largest importer of oil and the large decline in oil prices is providing a back door tax cut for its economy.

Disinflationary Trends

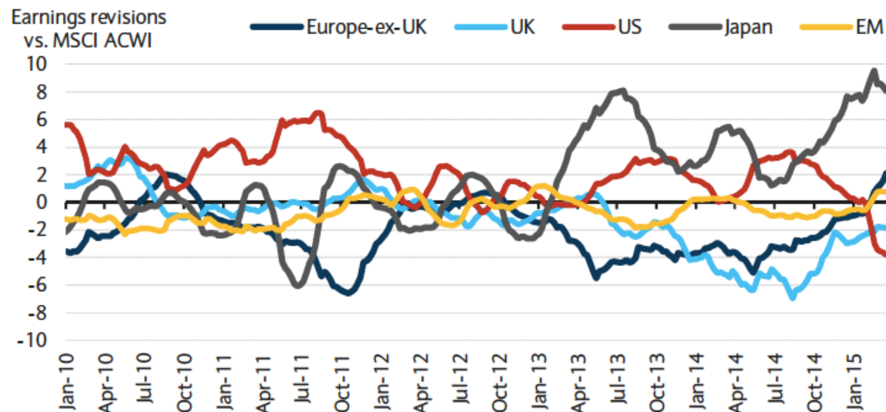
Weak economic growth rates in the West, slowing economic growth in China, a world that has much too much debt, and declining commodity prices are all putting downward pressure on global inflation. Debt by its nature is deflationary as it lowers future demand. The collapse of oil and other commodities is also deflationary. A strong U.S. dollar makes foreign good cheaper to import, which imports cheaper prices into the U.S. and adds to our disinflation trends. Keep in mind that the Federal Reserve has a dual mandate: full employment and inflation control. To the extent that inflation is falling, which causes real rates to rise, the Fed is less inclined to raise rates during this type of environment. With disinflation trends in place, the Fed may be reluctant to raise rates even though its other mandate of full employment is closer to being achieved with the U.S. unemployment rate at 5.5% (wink, wink, nudge, nudge).

The next chart shows the PCE Index, which is the Fed's current preferred gauge of inflation. Since 2012, the PCE has been headed lower and is below the Fed's 2% inflation target. With the collapse of oil prices and the ensuing decline in gasoline prices, there is more downward pressure on the PCE as products with oil as a key input cost see downward price pressure.



U.S. Earnings Update

Over a year ago the market forecasts for 2015 S&P 500 operating earnings stood near $128/share. The staggering collapse of oil prices combined with the dramatic rally in the U.S. dollar (which hits the earnings of U.S. multinational companies) have combined to create some severe headwinds for 2015 earnings. Today, the current S&P 500 operating earnings estimate is near $120.50/share. The final 2014 S&P 500 operating earnings came in at $118.80/share. A year ago, investors expected 2015 earnings growth of approximately 9%. Today, earnings growth for 2015 vs. 2014 is now at 1.4%. Should oil continue to go lower or the U.S. dollar strengthens even more, there is more downside risk to the 2015 earnings outlook. For the first time since 2010, the earnings revisions picture in the U.S. is worse than other major regions.



The key issue is that the U.S. stock market is fully priced without an improving outlook for earnings. Based on the 3/31/15 S&P 500 Index level of 2070, the S&P 500 Index trades at a 17.2X multiple (2070/120.5). There is no case to be made for the U.S. stock market to see a higher PE multiple at this stage of the game, especially with a low single digit earnings growth outlook and the Fed poised to raise interest rates this year.

Summary

Benjamin Franklin had the right view on debt. A solid economic foundation is not built on the excessive use of debt. At some point, economic growth needs to reach levels where the debt becomes a smaller portion of the economic pie. If the current stagnant economic growth environment continues, debt must be written off or paid down in order to reset the bar and improve future prospects for economic growth. Instead, what we have today is what Ben observed over 225 years ago: “Tis against some men’s principle to pay interest, and seems against others interest to pay the principal.”

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

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