MJM INVESTMENT ADVISORS, LLC

First Quarter 2016 Investment Environment

- The U.S. stock market displayed whipsaw action during the first quarter as stocks had their worst start to a year ever, only to stage a meaningful recovery starting in mid February and through March. It was the largest reversal rally for U.S. stocks during a quarter since 1933. Another round of central bank policy actions lead by the European Central Bank and diminished prospects for interest rate hikes in the U.S. helped to once again save the day.
- Investors remained cautious as U.S. large cap stocks continued their recent dominance over small cap stocks and finished slightly positive while small caps continued to struggle and were slightly negative for the quarter.
- Developed international equity market returns continued to trail U.S. stocks as economic data overseas continue to lag the U.S. and a terrorist attack in Belgium hurt investor confidence. A stronger Euro and Yen hurt foreign exporters while benefiting U.S. multinationals.
- Emerging markets benefited from the weakening U.S. dollar and outperformed all other asset classes, lead by commodity-biased companies.
- Due to extreme central bank policies, some international government bond yields are now in negative territory. This unnatural phenomenon has pulled U.S. bond yields lower as the 10-year U.S. Treasury bond yield declined to 1.80% at quarter end from 2.25% at the beginning of the year. Long maturity U.S. Treasuries had the best performance in fixed income.
- Similar to stocks, high yields bonds saw a large decline into early February before recovering and finishing in positive territory for the quarter.
- Oil prices plummeted 25% to $27 per barrel into early February before staging a significant recovery to $40 per barrel by the end of March.
- The table below shows the returns for major asset classes during the first quarter.

S&P 500 Index (large cap U.S.)	**+1.3%**
Russell 2000 Index (small cap U.S.)	**-1.5%**
MSCI EAFE Index (large cap int'l)	**-3.0%**
MSCI EM Index (emerging mkts.)	**+5.7%**
Barclays Aggregate (invt. grade bonds)	**+3.0%**
Barclays High Yield (non-invt. grade)	**+3.4%**
Barclays Short-term Treasury bills (cash)	**+0.2%**
Gold	**+16.1%**
Brent Crude Oil	**+6.6%**
Lipper Average Balanced Fund	**+0.8%**

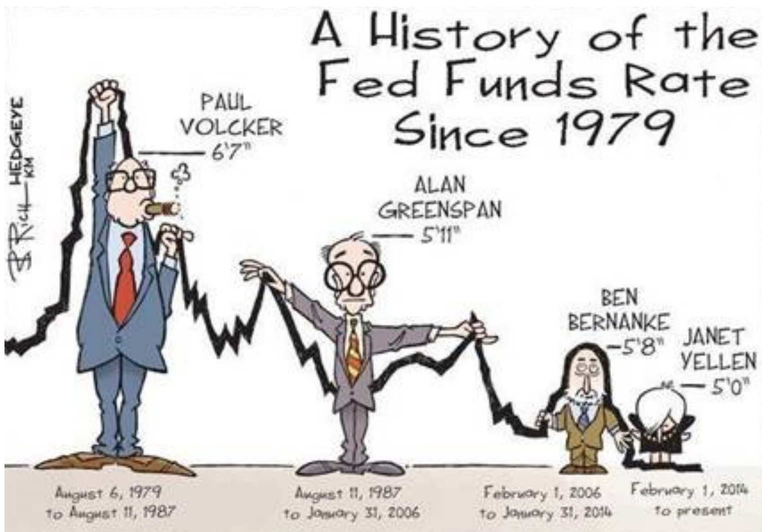
- Global economic growth struggles to find firm footing. Fourth quarter 2015 U.S. real GDP finished at a mere 1.4% and the preliminary estimate for first quarter 2016 real GDP is below 1%. The International Monetary Fund continues to mark down global GDP growth estimates. The U.S. is considered one of the more stable economies in the world but our economy is struggling to achieve 2% real GDP growth. Despite unprecedented levels of global central bank policy intervention, economic growth remains sub-par with a massive debt overhang and deflationary pressures keeping a lid on growth all around the world.

Second Quarter 2016 Investment Outlook

It's An Upside Down World

"20 years ago we had Johnny Cash, Bob Hope and Steve Jobs. Now we have no Cash, no Hope and no Jobs. Please don't let Kevin Bacon die!"

—Anonymous/unknown



Bacon and bacon. Life would be much less satisfying without them in it. Whether it was his small roles in such movie classics as Animal House (remain calm, all is well!!) and Diner, his supporting role in A Few Good Men, his lead role in Footloose, or his very creepy part in The River Wild, Kevin Bacon has had an impressive acting career. He is considered one of the better actors to never win an Oscar. The public can't get enough of one Bacon so that's why Kevin is in a rock band with his brother Michael and call themselves the Bacon Brothers. As Jonny Depp, Ryan Gosling, and Jack Black can attest, nothing except an Oscar creates a bigger aura around an actor than having a second career in a band.

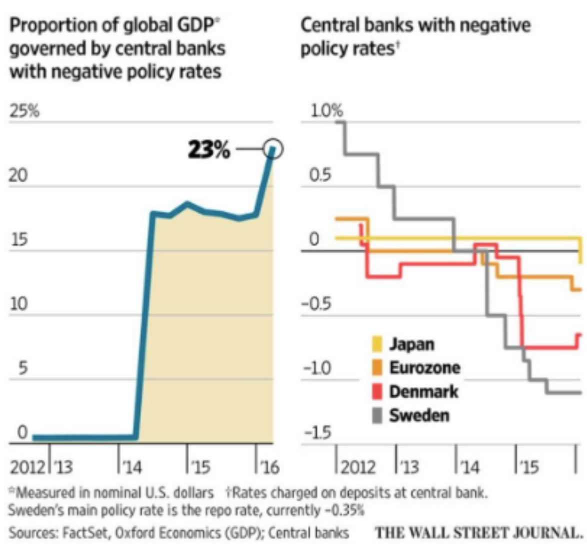
What about the edible bacon? Sure, we could get into a heated debate about whether Canadian bacon or strip bacon goes better with the two eggs and toast at Cracker Barrel but what's the point? Just eat a ton of both and die happy. Meat lovers delight in the smell and taste of bacon. Once you get one strip of bacon down the hatch, you can't wait to start gobbling down the next one. Like most young adults nowadays, my daughter Sydney is a health conscious young woman but she's constantly looking in the fridge for that box of pre-cooked Oscar Mayer bacon. Does she eat one or two strips to keep fat and sodium levels down? Uh, no. It's a whole slab on the plate and into the micro for a quick and satisfying Makin' Bacon Fest. What disappears at breakfast gatherings faster than Jeb Bush's Presidential aspirations? Bacon. What's the biggest whine during breakfast? "Who ate all the bacon!?"

Given all the world's woes, Bacon & bacon can provide us with at least some degree of happiness. But, besides more of both, what else can be done to lighten up the collective dour mood that permeates the national psyche? Humor, of course. The previous cartoon cleverly portrays the history of the U.S. Fed Funds rate over the past 36 years under the last four Federal Reserve Chairs. Paul Volcker, the 6'7" giant who broke the back of inflation by jacking up interest rates to unprecedented levels (remember CD rates at 16%?-oh to be young again), which put the U.S. economy into a severe recession, but broke inflation's grip on the economy and ultimately laid the foundation for the next 15 years of economic prosperity. Alan Greenspan, significantly smaller in stature (and aptitude) than Paul Volker, made many mistakes in leading the Federal Reserve. The most damning one was establishing the precedent of maintaining interest rates at too low a level for too long such that financial bubbles were created and debt levels rose, both of which significantly damaged the U.S. economy for years (decades?) afterwards. The Greenspan housing bubble popped and Ben Bernanke had to deal with the greatest financial crisis since the Great Depression and the serious after shocks. He also introduced the world to Quantitative Easing. QE has now been copied by nearly every central bank in the world and has put the global financial foundation on even shakier ground. He didn't learn anything from Alan Greenspan and also kept interest rates too low for too long. Janet Yellen has had to deal with the unintended consequences of the prior monetary policy decisions of her two predecessors including below average economic growth and rising debt levels. What has been her main policy position? You got it, maintaining interest rates near zero for too long. It remains to be seen if the house of cards (speaking of which, Season 4 of House of Cards on Netflix was awesome!) comes tumbling down under her Federal Reserve Chair reign or if some other unlucky sod will be left to shovel the barn floor.

The current Upside Down world is a not too pleasant one for investors. Global GDP growth estimates are still looking for a bottom, China growth estimates are highly suspect, many emerging market economies are getting killed by the collapse of commodity prices, global debt levels are at unprecedented levels, interest rates are near zero everywhere, low or negative bond yields are becoming the norm, stock market valuations are pricey, terrorism is running rampant, trade and currency wars are on the rise, and one of the ugliest Presidential election cycles in U.S. history lies ahead us for the next six months. It's a good time to avoid cliffs, stay up late watching a Kevin Bacon movie, and rise every day to the sweet smell of cooked bacon.

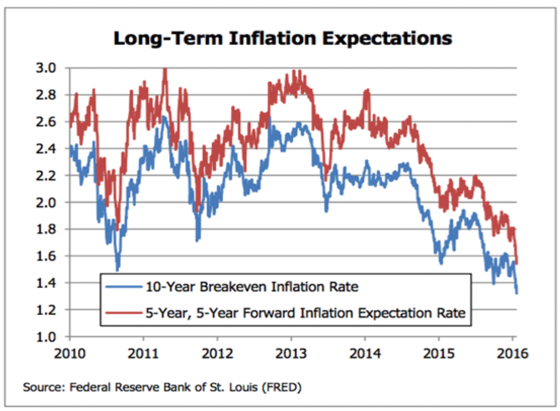
NIRP (Negative Interest Rate Policy)

The world has experienced extreme monetary policy actions by central banks over the past 8+ years, all of which were designed to juice economic growth. The problem is they haven't worked but that doesn't mean the central bankers think they should stop trying (they should). The latest extreme policy action implemented by central banks is Negative Interest Rate Policy or NIRP. NIRP is the ugly cousin of ZIRP, or Zero Interest Rate Policy. The chart below shows that four major central banks in the world have instituted NIRP and now 23% of the world's GDP is under NIRP. NIRP is an extreme policy action designed to create new incentives to lend and at the same time penalize savers. Under NIRP, if a commercial bank parks too much of its excess reserves with the central bank, the central bank will now charge it interest to do so (deposit $100, get back $99.50, so the bank earns negative interest). NIRP is an example of the Upside Down world we live in because banks have historically always earned some level of interest on their excess reserves deposited with a central bank. Central banks tried QE and ZIRP to jump start economic growth with little to no success. So, now they are trying NIRP as the latest policy tool to try and stimulate economic growth. NIRP is designed to provide banks with more incentive to lend and not hoard their reserves. The idea being that lending leads to more spending which leads to higher economic growth. Whether it works or not is a different matter. We are now in uncharted territory in world history because NIRP has never been used before by central banks. Of course, there has to be demand for loans in order to lend. As they say, you can lead a horse to water but you can't make it drink.

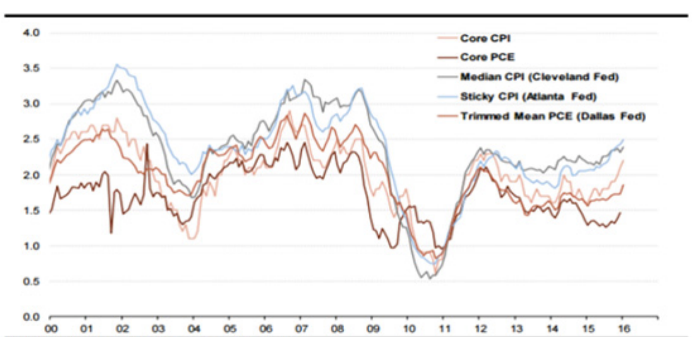


Inflation (or Lack Thereof)

One of the major issues in the financial world today is declining inflation expectations, which has a negative impact on current demand and thus economic growth. If someone believes prices will be lower in the future than today, they are more inclined to put off purchasing something now in order to get it cheaper in the future. Normally, highly stimulative interest rate policies (i.e. ZIRP or NIRP) should create demand for credit (loans), which then get spent in the economy, which increases the demand for goods and labor, which leads to rising prices and wages and eventually filters into inflation expectations. In this Upside Down world, as the level of aggressiveness by central banks has increased, inflation expectations have headed lower. As the next chart shows, forward U.S. inflation expectations (what investors think inflation will be in the future, not the current inflation profile) have declined quite a bit since the last peak in 2013. The most recent sharp downward move in inflation expectations coincided with the global collapse in commodity prices including the price of oil, which has seen a precipitous drop since its peak at $110 per barrel in late 2013. Japan has suffered under a long-term deflationary cycle since the early 1990s (25 year, gulp!). No matter what policies the Japanese central bank has instituted to push inflation higher, nothing has worked to date. The rest of the world may now be falling into the same deflationary trap. As the Japanese can attest, it is not a place you want to be.



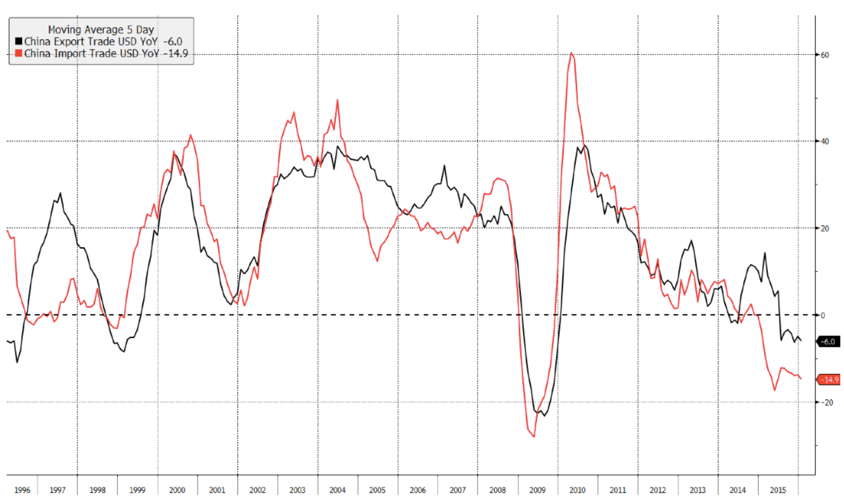
More recently, current U.S. inflationary statistics are starting to see a modest uptick, but off of a very low level as shown in the next chart. The Fed's favorite inflationary statistic is Core PCE, which is still below the Fed's 2% inflation target. A low PCE reading is one of the main reasons the Fed has been reluctant to raise interest rates. Low inflation or deflation is a global phenomenon and despite extreme monetary policies that have been in place a long time, broad inflationary pressures have yet to show up.



Global Growth – The China Syndrome

Given depressed economic growth rates across the developed world since the 2008 Global Financial Crisis, global GDP became increasingly dependent upon China economic growth. A major reason for the recent markdown in global growth estimates is because China's economic growth outlook is increasingly uncertain and in flux.

China proclaims that it has a 6.5% to 7.0% real GDP growth target for 2016. As a centrally planned communist economy, making such pronouncements is part of its dogma DNA. However, anyone that takes anything the Chinese say at face value doesn't understand the Chinese, where saving face is more important than telling the truth. Real economic data suggests China is not even close to its GDP growth target. The next chart shows the moving average of Chinese export and import growth from 1996 to 2015. The dotted line in the middle of the graph is the 0% level. Starting over a year ago in early 2015, Chinese import/export growth began to roll over hard to the downside and by the end of 2015 the readings were -6%/-15%, respectively. The negative import growth is corroborated by China's major trading partners like South Korea, which sends 23% of its exports to China and is experiencing negative double digit export growth in its economy. China's economic miracle was built on export growth and it is experiencing -15% export growth year over year, a key indicator of the economic slowdown in the rest of the world.

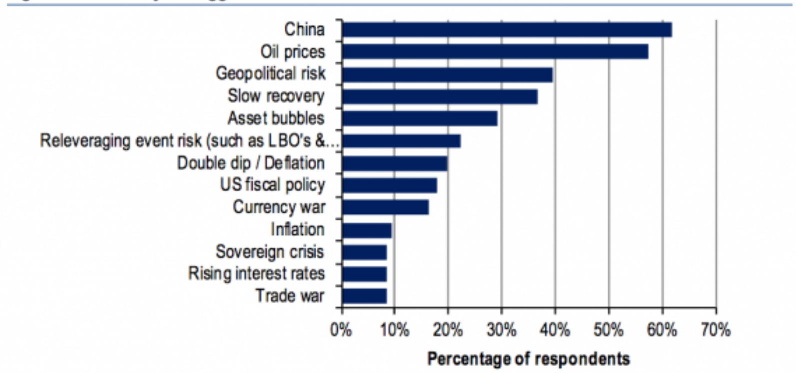


Source: Bloomberg and Doubleline

China is about 16% of world GDP. If it were at zero growth, then global growth would be approximately 2.0% and not the current 2.9% the World Bank estimates for 2016. The IMF estimate for 2016 global growth is slightly higher at 3.2%. Either way, what happens with China's economy is going to be a big swing factor on whether the global growth outlook stabilizes and improves. The U.S. is struggling to achieve 2.0% real GDP growth, Japan is struggling to stay above 0%, and Europe would be happy to get to 1.3% this year. The collapse in commodity prices over the past 12 months is a sign of a major economic slowdown going on in China and its negative impact on growth for the rest of the world.

The next chart shows a BofA Merrill Lynch survey of U.S. credit investors and provides an indication of how much China is a major concern of investors at present.

Figure 2: What are your biggest concerns?

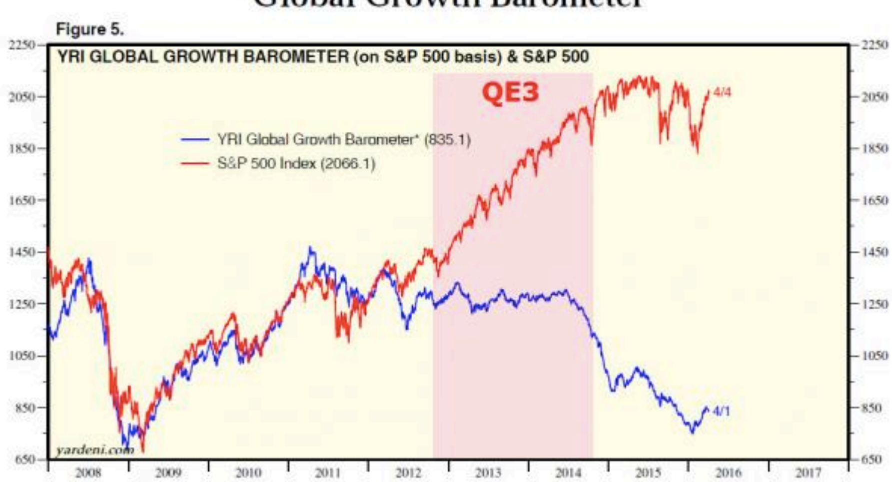


Source: BofA Merrill Lynch Global Research Mar '16 US Credit Investor Survey

The Disconnect

The next chart produced by Ed Yardeni shows how much the U.S. stock market (represented in red or top line by the S&P 500 Index) has diverged from global growth (blue line), mostly due to massive central bank intervention policies. The chart goes back to the beginning of 2008. Note how these two variables had a very tight correlation from 2008 through mid 2012 when all of a sudden they diverged in a big way. The divergence began about the time of the onset of QE3 by the U.S. Federal Reserve. QE3 was a huge intervention program that supported risk assets like U.S. stocks. Ben Bernanke was not shy about saying that a wealth effect (rising asset prices makes people feel richer so they spend more) was one of the goals of QE. QE3 was important because all other major global central banks followed with their own large monetary intervention programs. To date, these extreme monetary policies have not had much positive impact on global economic growth even though stock market valuations make it appear conditions are better than reality. The gap now between the S&P 500 Index level and the global economic growth picture is so wide you can drive a truck through it.

Global Growth Barometer

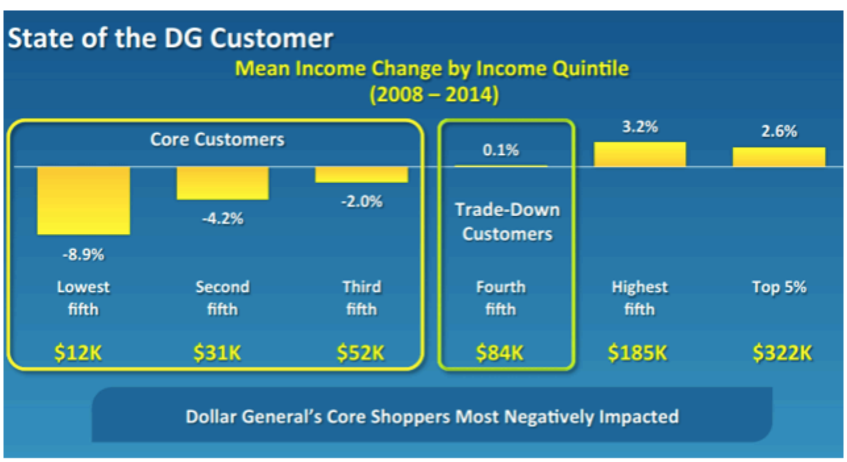


Source: Yardeni.com

State of the America Consumer

The growth trajectory of the U.S. economy is heavily biased by the spending trends of the American consumer. Job and wage growth are major factors on spending trends and have been muted since the 2008 global economic meltdown. The income trends for low-end consumers have been substantially worse than for high-end consumers, who have benefited exclusively from the wealth effect of the stock market's rise since the March 2009 low. There is an increasingly heated debate over widening income inequalities in America, which are at record levels in U.S. history. Several states have substantially raised minimum wages in order to address the income inequality gap. What substantial minimum wage increases do to job growth is a topic for another day. Rising income inequality in our Upside Down world is a major reason why there have been record turnouts for the Presidential primaries as the level of anger and dissatisfaction with the status quo is so high at present.

Dollar General is a U.S. retailer that mostly caters to low-end, price conscious consumers. They recently published a very interesting chart that breaks down the income profiles of U.S. consumers by income buckets. The next chart shows changes in income of U.S. consumers from 2008 to 2014 by income quintile (the working population grouped into five income buckets plus segregating out the Top 5% of wage earners on the far right). The data shows the top 20% of consumers have seen the highest average income gains (+3.2% annually), the next 20% have see no wage gains, and the bottom three quintiles of wage earners have actually experienced negative income growth the past six years. Another way to look at this data is that 80% of the U.S. population has seen flat to negative wage growth during this six year window.



The next chart corroborates the DG data and shows the number of Americans on Food Stamps from 2006 (27 million) to present (45 million). Despite the positive monthly job gain figures (averaging 233,000 over the past 12 months) being reported by the Department of Labor, the number of Americans on food stamps has remain elevated since 2011 and has barely moved lower over the past four years. The quality of monthly job gains has been poor as more part-time, minimum wage jobs are being added while higher paying manufacturing and professional jobs are being lost. Both of these charts show a quite distressed income picture for most Americans since 2008.

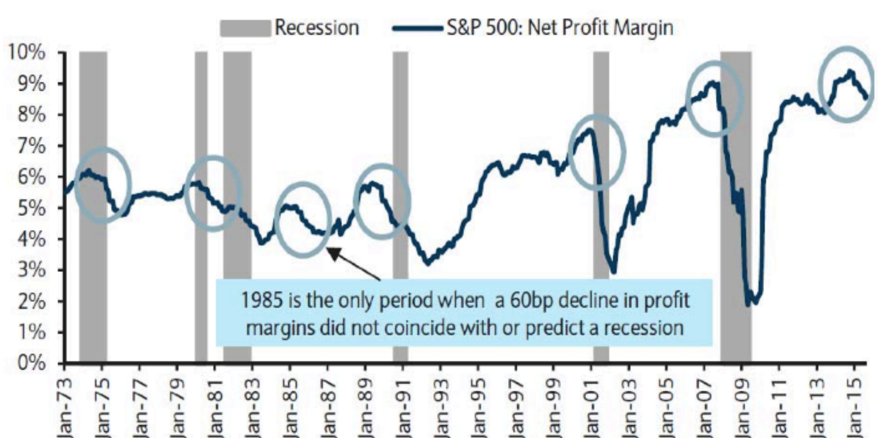
Both charts are more examples of the Upside Down world in which we find ourselves in America. Eight years into an economic "recovery", the vast majority of Americans have seen negative wage trends and 14% of the U.S. population rely on government food stamps to help feed their families. Thanks to excessive Fed monetary policy actions, senior citizens have had their incomes squeezed because they can't earn a dime on their savings and are being forced into riskier investments just to pick up some level of yield. Many large company stocks have higher dividend yields than the yields available on investment grade bonds, the exact opposite of what occurs in a normal investment world but not in the current Upside Down world.

The Day of Reckoning Gets Pushed Out

At one point during the first quarter, U.S. stocks had declined over 10% as U.S. economic data disappointed and uncertainty outside the U.S. increased. Commodity prices were collapsing, with oil the most prominent one falling all the way to $27/barrel at one point in early February. Anxiety was hitting Xanax popping levels until the world's central bankers made public comments to soothe investor fears or initiated new policy actions designed to save the day once again and allow global stock markets to put on a substantial reversal rally into quarter-end.

The next chart shows the S&P 500 Index (green or top line) and compares it to the earnings profile of the 500 companies in the index. Please note that it is typical for the stock market to trade in a similar direction as the trend line for actual earnings. This was the case from 2012 to mid-2014. Since then, and as global central banks have turned to more extreme policy actions to jump start economic growth, the stock market has diverged from earnings reality. The next chart shows the 12 month forward S&P 500 Index earnings estimate at $122.90/share. The stock market's dramatic drop during January and into early February brought the S&P 500 back down to the forward earnings trend line. However, the reversal rally since then, brought on by heavy handed central banks, has pushed the S&P 500 Index back towards its previous highs and well above the earnings trend line. If you believe that fundamentals win out in the end, then the stock market will eventually revisit the earnings trend line. Of course, earnings could recover and the trend line could head higher to catch up with stock valuations. Unfortunately, that is not likely to happen in an economy struggling to achieve 2% real GDP growth. The more likely outcome is that stocks prices need to reset lower to better reflect the true earnings outlook.

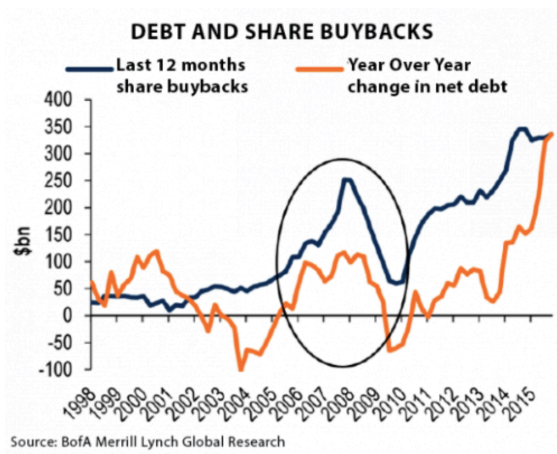
A key factor starting to hit corporate earnings is declining profit margins. The next chart shows how corporate profit margins peaked in 2014 and have rolled over since then. The amount of recent profit margin decline (as shown the last circled area on the far right) has been a leading indicator in the prior instances the U.S. fell into a recession (grey vertical bars). With one exception (1985) over the past 40+ years, every period when corporate profit margins have declined like they are doing now, a recession occurred. This time could be an exception but the odds suggest a cautious approach to investing is the most prudent approach at this time given the challenging outlook for corporate profit margins and earnings growth.



Source: Thomson Reuters, Barclays Research

The quality profile of corporate earnings is another problem. Debt issued by U.S. companies is increasingly being used to support corporate earnings as companies use the cash from debt sales to implement share buyback programs. As evidence of how pervasive this trend has become, 94 of the top 100 companies in the U.S. now have share buyback programs in place. The Fed is completely responsible for this phenomenon as its ZIRP policy makes it almost stupid for a company not to take on low interest rate debt (tax law allows them to deduct the interest expense which reduces taxable income!) to help support earnings.

The next chart shows how much corporate debt has exploded higher in recent years. Ideally, corporate profits go higher because revenues increase due to solid business conditions. In today's Upside Down world, companies are issuing low interest rate debt and using the cash generated from the debt sales to reduce the number of shares outstanding as a means to support earnings instead of using debt proceeds to reinvest in their businesses in order to drive future revenue and profit growth. It is just another example of how perverse extreme central bank policy actions like ZIRP and NIRP are ruining the economy.



Summary

The constantly shifting and increasingly volatile investment landscape will be with us for some time until central banks normalize interest rate policies and remove extremely accommodative policy measures. The Fed and other central banks still believe they can stimulate economic growth and stave off a worse case economic scenario. In reality, they have been unable to elevate economic growth rates and instead have created many negative unintended consequences. What they have achieved is creating an Upside Down world, where investment axioms that existed since investing began have been thrown on their heads. In times of uncertainty and woe, Eat, Drink, and Be Merry is a sound approach to life. Make it a point to hang out more with family and friends, watch Kevin Bacon movies, and eat more bacon.

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April 11, 2015

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