MJM INVESTMENT ADVISORS, LLC

First Quarter 2017 Review

- After his Inauguration, President Trump pushed forward an aggressive agenda right out of the gates. In mid-March he hit his first major setback with the initial failure to repeal and replace Obamacare. However, risk assets shrugged off the event and experienced only a minor decline that was erased by the end of the quarter.
- As expected, the Federal Reserve raised interest rates 0.25% at its March meeting and reiterated its intent to raise interest rates two more times during 2017. Investors were concerned about a more aggressive (hawkish) rate increase stance by the Fed. When the Fed signaled no change to its rate outlook, the stock market rallied on the news.
- Stock price volatility during the first quarter was at its lowest levels since the 1950s and the stock market experienced one of its longest streaks ever without a 1% correction.
- U.S. large caps stocks as measured by the S&P 500 Index delivered a robust 6.1% return as the 2016 year-end rally continued for most of the first quarter. However, the broader stock market was not as strong with small cap stocks, as measured by Russell 2000 Index, returning a more modest 2.5%. There was a wide gap between growth and value investment styles during the quarter with growth stocks outperforming value stocks by 5%.
- International stock returns exceeded U.S. stocks as the MSCI EAFE Index returned 7.3% and the MSCI Emerging Markets Index produced a very strong 11.4% return. Global growth ex U.S. showed improvement, particularly in Europe, and the U.S. dollar weakened 3% during the quarter.
- Bond markets had more action than stocks during the quarter. The 10-year U.S. Treasury bond yield traded in a range of 2.3% to 2.6% and ended the quarter at 2.44%, near where it started the year. High yield bonds benefited from a risk-on trade while the broad U.S. bond market as measured by the Bloomberg Barclays Aggregate Index finished in slightly positive territory.
- The weakening U.S. dollar impacted commodities as oil prices declined while gold moved higher.
- The following table shows key market benchmarks as of March 31, 2017.

	Quarter		One Year		2016	
S&P 500 Index (U.S. large cap stocks)	6.1%	↑↑	17.1%	↑↑↑	12.0%	↑↑↑
Russell 2000 Index (U.S. small cap stocks)	2.5%	↑	26.2%	↑↑↑	21.3%	↑↑↑
MSCI EAFE Index (large cap int'l stocks)	7.3%	↑↑	11.7%	↑↑↑	1.0%	↑
MSCI EM Index (emerging markets stocks)	11.4%	↑↑↑	17.2%	↑↑↑	11.2%	↑↑↑
Bloomberg Barclays Aggregate Bond (invt. grade bonds)	0.8%	←→	0.4%	←→	2.7%	↑
Bloomberg Barclays High Yield (below invt. grade bonds)	2.7%	↑	16.5%	↑↑↑	17.1%	↑↑↑
Bloomberg Barclays Short-term Treasury (cash)	0.1%	←→	0.4%	←→	0.5%	←→
Gold	7.7%	↑↑	2.7%	↑	8.6%	↑↑
WTI Oil	-6.5%	↓↓	37.0%	↑↑↑	44.8%	↑↑↑
Morningstar Balanced Funds Average	3.9%	↑	10.6%	↑↑↑	7.3%	↑↑

Second Quarter Investment Outlook

Bridging The Viagra Divide

"Tax reform is rare because it requires resolution of difficult trade-offs."

- William Gale – Brookings Institute

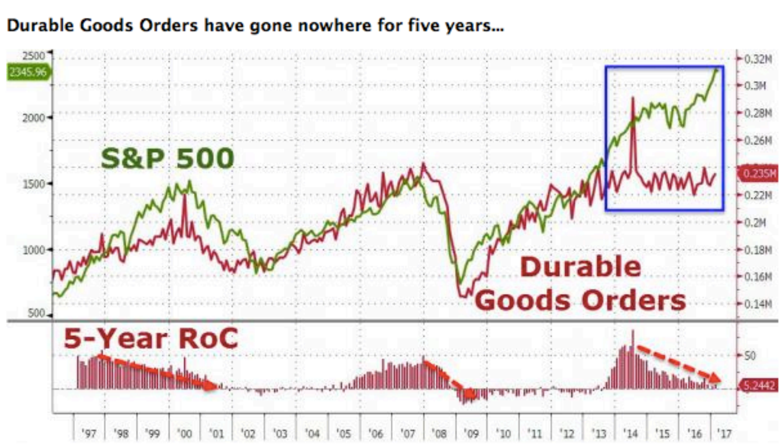
"We're going to … lower the overall tax burden on American businesses big-league. That's coming along very well. We're way ahead of schedule, I believe.

- President Donald Trump

After taking office, the Trump administration decided to focus on the repeal and replace of Obamacare as its initial legislative foray. Surprisingly, it was handed a publicly embarrassing defeat by the Freedom Caucus wing of the House Republicans. The Trump Administration started with Obamacare first because repeal and replace would have "raised" approximately $300 billion of revenues over ten years, which could then be used as part of broad tax reform including tax cuts for corporations and individuals. Instead, the President ended up with a black eye on his Obamacare failure and he now starts the tax reform negotiations with fewer resources in which to drive tax rates aggressively lower. It is a setup for tax reform to much less sweeping than originally anticipated. Tax reform is a much more complicated endeavor and is likely to take much longer than expected. The failure to kill Obamacare creates meaningful risk to the timing and success of tax reform. Speaker Paul Ryan publicly acknowledged as such in early April, saying that the White House and Senate and House Republicans have yet to come up with an agreeable tax platform to date. The stock market immediately declined following his comments, an indication that expectations for meaningful tax reform are already embedded in U.S. stocks.

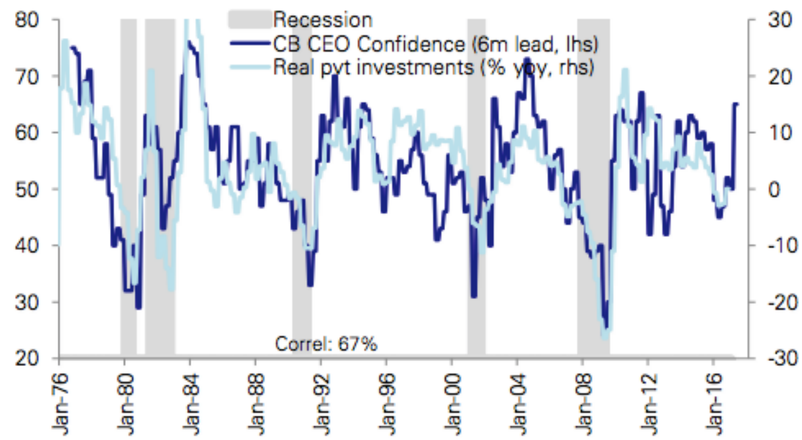
Since the election in November, expectations have risen that Trump policies will lead to higher economic growth, reduced regulations, and lower taxes for both corporations and individuals. These high expectations are reflected in many surveys including the CEO Confidence survey and consumer oriented surveys such as the University of Michigan Consumer Confidence survey. Surveys, which are deemed "soft" data, have seen a dramatic spike higher since last November. This surge is reflected in the following chart, which shows "soft" data exploding higher following Trump's election. The economy doesn't change on a dime and improvements in economic data take much longer to show up but the overall trajectory of broad economic data, or "hard" data, still remains muted. The large gap between "hard" and "soft" data is the Viagra Divide. It is not unusual post a major election for Americans to grow hopeful for change and a better future. However, sentiment change since Trump's election reflected in the "soft" data versus the actual "hard" economic data has created one of the biggest Viagra Divides in U.S. history. Bridging the Viagra Divide will be a key factor impacting U.S. financial markets for the remainder of 2017.

There are other examples of the Viagra Divide dilemma. The next chart plots the S&P 500 Index (soft) vs. U.S. durable goods orders (hard) going back to 1997 or the past 20 years. Historically, positive/negative durable goods orders were tightly correlated to the strength/weakness of U.S. stocks. Rising durable goods orders reflect higher spending and improving economic trends, which translates in higher revenues and earnings for companies, which then translates into higher stock prices. Of course, the opposite is true too as shown in the 2000-2002 and 2008-2009 recessions in the next chart. However, the blue box on the far right captures the Viagra Divide where durable goods have basically flat lined for several years while the S&P 500 Index climbed to new heights. The previous tight correlation between these two variables is now way out of whack and suggests that U.S. stocks no longer reflect true economic reality in the U.S., which is a low economic growth, low earnings growth world.



Source: Zerohedge

It is not unusual for "soft" indicators to lead "hard" indicators. The important question is will the gap up in "soft" data eventually be confirmed by real tangible follow-through in the "hard" data. The next chart is another good example of the Viagra Divide. It shows CEO confidence (soft) (dark blue line) compared to real private investment (hard) (light blue line). As noted in the chart, CEO confidence has soared over the past six months, more or less the timeframe since Trump was elected. This gap-up in confidence is indicated by the vertical pop higher in the dark blue line on right side of the chart. If historical precedent holds, real private investment (aka capital expenditures) should see a meaningful move higher over the next six months as this CEO confidence translates into higher corporate spending patterns. Or will it? It remains to be seen. It is fair to say that a big factor behind the jump in CEO confidence is expectations for lower corporate taxes, foreign cash repatriation, reduced regulations, and improved business environment from Trump's policy initiatives. However, many C suite executives will not sign-off on higher spending/investment until they see some tangible proof of the successful progress on corporate tax reform.



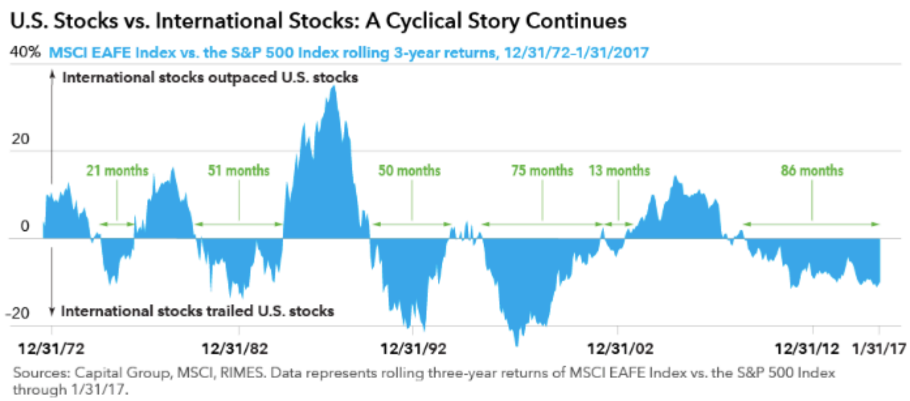
Source: Conference Board, BEA, Haver, Deutsche Bank

Bridging the Viagra Divide is one of the key risks for U.S. financial markets for the remainder of 2017. If the Trump Administration and Republican controlled Congress can't push forward with a pro growth agenda including major tax reform, then sentiment surveys will eventually decline. Waning confidence may lead to pullbacks by both corporations and consumers in their future spending expectations as they lose confidence that real change is coming out of Washington DC. Since U.S. stocks have experienced a very strong rally on the basis of a sharp rise in "soft" data since Trump's election, the U.S. stock market is particularly susceptible to declines should the "soft" data retreat or the "hard" data doesn't show improvement. This is one situation where a magic blue pill won't solve the problem.

Is the Extended Outperformance of U.S. Stocks About to End?

The persistent outperformance of U.S. stocks over the rest of the world since the 2008 Global Financial Crisis has been heavily impacted by the Federal Reserve leading all other central banks in the aggressive use of Quantitative Easing and other extreme monetary policy actions. The Bank of Japan and the European Central Bank eventually implemented their own aggressive monetary policy actions as well. However, the U.S. economy, despite its below average economic growth profile, has put up stronger GDP growth than other developed economies of the world since 2009. In addition, the U.S served as a safe haven for foreign investors to invest capital at a time when economic uncertainty and turmoil outside the U.S. remained high. All of these factors help to explain why the U.S. stock market has significantly outperformed the rest of the world since 2009.

The next chart shows how relative performance trends between non-U.S. stocks and the U.S. stocks can go on for extended periods of time. The chart captures the rolling 3-year performance of the MSCI EAFE Index vs. the S&P 500 Index. On the far right of the chart, the current trend of U.S. stocks outperforming non-U.S. stocks on a rolling 3-year basis reached 86 months or over seven years through 1/31/17. Going back to 1972, there has never been a longer period of time that U.S. stocks have outperformed non-U.S. stocks on a rolling 3-year basis.



Source: Capital Group/American Funds

The next chart shows the cumulative performance of U.S. and non-U.S. stock going back to 1950. Once the 2008 Global Financial Crisis hit bottom (March 2009), U.S. stock outperformance exploded higher and is now significantly ahead of non-U.S. stocks (green circle to the right).

Source: BofA/Merrill Lynch

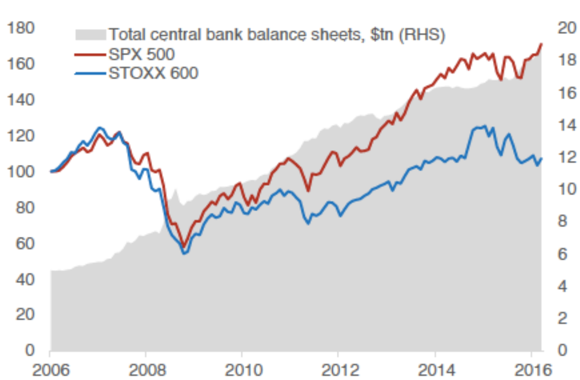
The key question is what are the catalysts that will cause the current streak of U.S. stock outperformance to reverse. Valuation spread extremes would be one catalyst. As U.S. stocks continue to go higher while earnings growth remains soft, the valuation profile of U.S. stocks has become more expensive relative to non-U.S. stocks. The next chart shows the cyclically adjusted price/earnings (PE) ratios for the U.S., developed international, and emerging markets stocks. The U.S. is currently trading at the top end of its 10-year valuation range and well above its average cyclically adjusted PE valuation profile. In contrast, international developed markets are trading at a much lower PE than the U.S. and below the 10-year average. Emerging markets are even cheaper, trading at just 11X their cyclically adjusted PE and at the bottom of the 10-year valuation range.

Sources: MSCI, RIMES, Thomson Reuters Datastream. Cyclically adjusted P/E ratios are from MSCI USA, World ex USA and EM indexes and are the index price divided by the average of the previous 10 years of inflation-adjusted earnings for the 10 years ended 1/31/17.

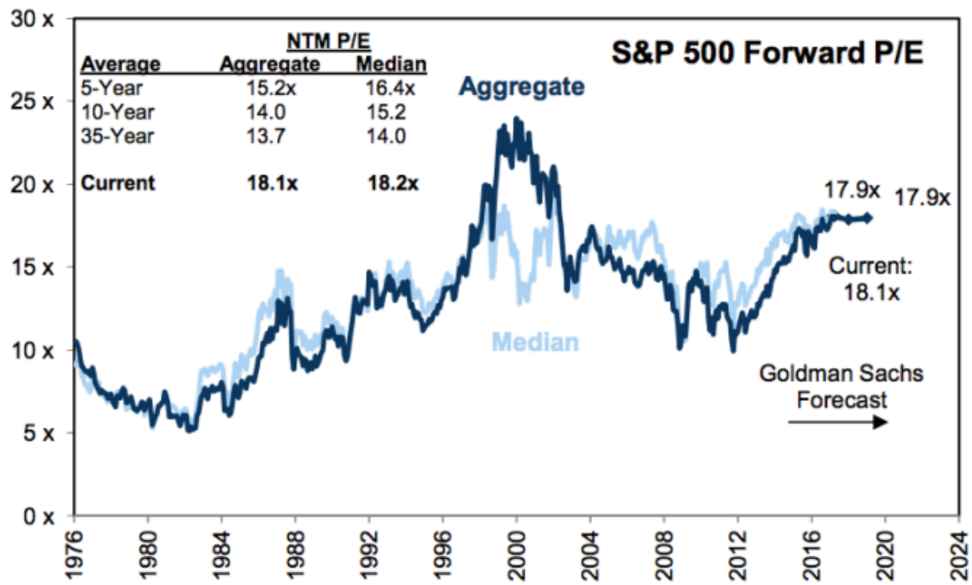
Source: Capital Group/American Funds

Another key factor that could jumpstart the reversal of this extended period of U.S. stock outperformance is where major central banks stand on a relative basis in terms of monetary policy actions. With its March 2017 interest rate hike, the Fed has now raised interest rates three times since it ended its Zero Interest Policy stance in December 2015. In addition, the Fed has telegraphed to global financial markets that it intends to raise the Fed Funds rate two more times during 2017. The latest release of Fed meeting minutes indicated the Fed has begun to discuss internally the timing of when it will begin to reduce its balance sheet, which exploded to $4.5 trillion via bond buying under its Quantitative Easing policy. In contrast, neither the European Central Bank (ECB) nor the Bank of Japan (BOJ) has a timetable to either raise rates or end bond-purchasing actions under their own respective Quantitative Easing programs. On a relative basis, the Federal Reserve is becoming less accommodating (tightening) while the ECB and BOJ are keeping a foot on the monetary gas pedal. This relative policy stance change could also be an important catalyst that causes non-U.S. stocks to outperform U.S. stocks.

The next chart shows that global central banks collectively have increased the size of their balance sheets from $7 trillion to $19 trillion starting in 2009 and this has been a major factor driving global stocks higher over the past nine years. During this period, the S&P 500 Index has significantly outperformed the Europe Stoxx 600 Index since central bank expanded their balance sheets. The fact that the Fed is now ahead of other central banks in reversing its extreme monetary policies should mean greater headwinds for U.S. stocks in the years ahead, especially if it begins to reduce the size of its balance sheet ahead of other central banks.



The next chart shows the 12-month forward PE ratio of the S&P 500 Index going back to 1976 or 40 years. The middle of the chart shows how excessively valued U.S. stocks became during the Tech Bubble years when stocks peaked at 25X. As of today, U.S. stock valuations are not at Tech bubble levels but they are well above the 5, 10, and 35-year median forward PEs and the S&P 500 Index is at the most expensive forward PE level going back to 2003 or 14 years ago.



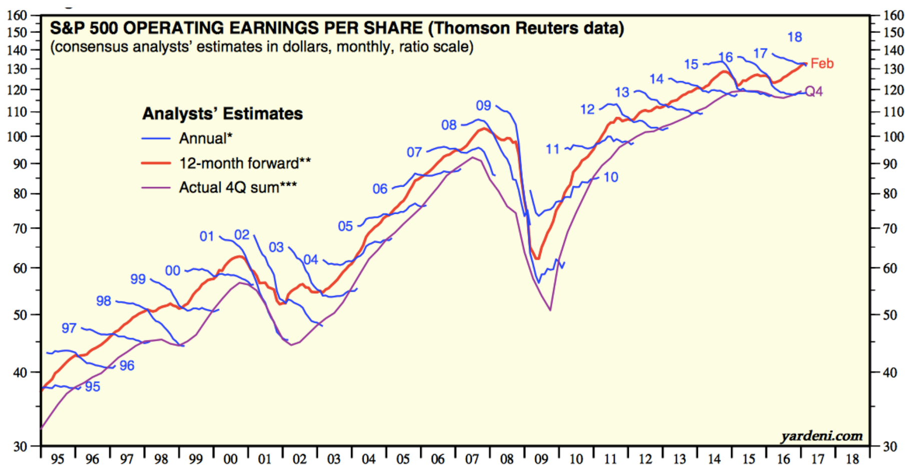
Source: Goldman Sachs

Overvaluation situations can go on far longer than they make sense. The setup for U.S. stocks today is rich valuations combined with low volatility. It is really the opposite setup of what one would prefer in order to make strong investment returns. It suggests the return outlook for U.S. stocks in the years ahead will be much lower than investors have experienced since 2009 and better return opportunities may reside outside the U.S.

The Math of Fair Value for U.S. Stocks

There are two key factors that matter when determining fair value for any stock market or individual stocks. The first is earnings estimates and the second is the PE multiple to apply to value those earnings. Using the S&P 500 Index as an example, the 35-year median 12 month forward PE multiple for the S&P 500 Index is 14X (table in previous chart). Generally speaking, when stocks trade below this multiple, the stock market is defined as cheap and when they trade above this multiple the stock market is defined as trading rich or expensive. During the tech bubble years of 1998-2000, the stock market forward PE multiple traded as high as 25X. During the depths of the 2008 Global Financial Crisis (GFC), stocks traded down to a forward PE multiple of 10X and in the early 1980s recession U.S. stock valuations went as low as 6X. So, investor euphoria (tech bubble) or investor depression (GFC/recessions) will have a large impact on the stock market's valuation.

The 2017 earnings estimate for the 500 companies in the S&P 500 Index is currently $130.60/share. The earnings estimate fluctuates each year as global economic trends play out. More often than not, analysts overestimate earnings at the beginning of the year and mark down their earnings estimates as the year progresses. The following chart is an example of how earnings revisions trends have played out each year from 1995 to today.



Source: Yardeni.com

Each blue line represents the earnings estimate trends by year starting with 1995 on the far left and 2018 on the far right. Recessions cause the greatest negative revisions to earnings estimates. The blue lines for 2000, 2001, 2002, 2003, 2008, and 2009 are examples of when earnings estimates were aggressively cut due to recessions. Once a recession ends, analysts are often too negative and begin to revise their earnings estimates higher as noted in 2004, 2005, 2006, 2010, and 2011. For the past six years (2012-2017) analysts have revised initial earnings estimates lower every year. Economic growth has consistently disappointed coming out of the 2008 GFC and is the main reason for this multi-year negative earnings revision trend. Revenue growth has been hard to come by which makes achieving earnings growth targets a challenge.

Let's look at the current year 2017 earnings estimates. Back in late 2015, analysts started to calculate forward estimates for 2017 operating earnings for the S&P 500 Index, which started at around $145/share. Over time, estimates have trended lower such that the current 2017 estimate for S&P 500 operating earnings is now $130.60/share. We are only three months into 2017 so analyst earnings estimates for this year are all forecasts because actual first quarter (Jan to March) earnings won't be known until companies begin reporting first quarter earnings from mid-April into early May.

As of March 31st, the S&P 500 Index was trading at 2362.72. The index/earnings = multiple. 2362.72/130.60 = 18.1X. An 18.1X forward multiple is 29% above its 35-year median forward multiple of 14X. It should be noted that if corporate tax reform passes this year it would benefit 2018 earnings more than 2017 earnings. If the S&P 500 Index were trading at its long-term median forward multiple of 14X, fair value for the S&P 500 Index today would be 14X $130.60/sh or 1,828 or 23% below its 3/31/17 value. If earnings estimates get revised lower than the current $130.60/share estimate or the PE multiple does not remain at18X then the U.S. stock market has significantly more downside risk than upside reward.

However, the upside reward case for U.S. stocks would be enhanced if meaningful corporate tax reform package passes Congress and is signed into law by President Trump. Today, the current 2018 S&P 500 Index operating earnings estimates is $146/sh. According to Jefferies Research, if the U.S. adopts a straight 25% corporate tax rate, then 2018 earnings estimates for the S&P 500 Index could increase to $165/sh or 13% higher than today's estimate. Optimism over corporate tax reform is to some extent reflected in today's S&P 500 level and with the market multiple trading significantly above its long-term average. Nonetheless, if there is a positive outcome for corporate tax reform, U.S. stocks could offer more upside potential assuming the stock market PE multiple remains at its current elevated level.

Summary

One way or another, the Viagra Divide needs to be bridged. The best outcome is if the elevated "soft" data begins to be reflected in rising "hard" data as the economy gains momentum. However, unless GDP growth improves above the 2% growth profile of the past eight years or without meaningful progress towards corporate and personal tax reform, the sharp rise in "soft" data since Trump's election is likely to fade as 2017 plays out. Despite the inability of Republicans to get on the same page to repeal and replace Obamacare, expectations remain high that broad tax reform will be successful. This optimistic view flies in the face of the fact that tax reform is a much more complicated endeavor and divisiveness is the status quo in Washington DC. The excessive optimism reflected in the "soft" data partially explains why U.S. stocks trade well above their historical PE multiple. The risk/reward setup for U.S. stocks at current levels is unattractive due to rich valuations combined with the risk of further tightening actions by the Fed later this year. At the same time, international and emerging market stock valuations are well below the U.S. and their own long-term averages. Global growth outside the U.S. is surprising to the upside and foreign central banks remain in accommodative mode. The combination of these factors makes the risk/reward setup for international stocks more attractive than U.S. stocks at this time.

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