MJM INVESTMENT ADVISORS, LLC

First Quarter 2018 Financial Markets Review

- 2018 started where 2017 left off. Stocks raced higher as the momentum trade continued unabated. At one point the S&P 500 Index was up 7.5%. In late January the market environment changed and the low volatility world of last year quickly disappeared. Volatility exploded higher and stocks plunged 10% lower. For the rest of the first quarter stocks tried but failed to regain the January high and had more 1% daily prices moves than occurred in all of 2017.
- The swift decline started when a short volatility ETF blew up in early February. Next up were Trump's steel/aluminum tariff announcements, which introduced the prospects for a tit-for-tat trade war and slowing global growth. In March, short-term credit funding index LIBOR showed signs of stress and the growth stock complex started to underperform as Facebook had a data privacy public relations nightmare and other tech stocks began to rollover with it.
- The S&P 500 Index had its first negative quarterly return in over two years with a -0.8% return. Small caps also struggled but did better than large caps with a -0.1% return as investors rotated towards domestic companies and away from large cap multi-nationals which could be more negatively impacted by retaliatory tariffs from foreign governments.
- International developed stock markets trailed U.S. stocks for the quarter as a weaker U.S. dollar hurt foreign exporters and U.S. tariffs spooked investors. The MSCI EAFE Index returned -1.5%. Emerging markets was the best risk asset class during the quarter and the only one that managed to stay positive with a +1.4% return.
- The Federal Reserve raised the Federal Funds rate 0.25% at its March meeting. It was the sixth 0.25% rate hike since December 2015 and reflects a steady and improving economy and job market. New Fed Chairman Powell is now at the helm of the FOMC and financial markets are sizing him up and adjusting to a possible change in the tone of Fed policy under his leadership.
- Rising bond yields started to negatively impact stocks during the first quarter as inflationary data perked up and investors debated whether the Fed would have to raise interest rates more than expected. The U.S. Treasury 10-year bond yield finished the quarter at 2.74%, up from 2.41% at the end of 2017 and after peaking at 2.95% in mid-February. The broad fixed income benchmark Bloomberg Barclays Aggregate Index returned -1.5% for the quarter. High yield bonds struggled as well, returning -0.9% for the quarter.
- With both stocks and bonds in the red for the quarter, balanced portfolios struggled to perform as the average balanced mutual fund returned -1.3% for the quarter. For the first time in a long time, cash was a top performing asset class. Each Fed interest rate hike makes cash a more attractive alternative for investors, particularly those on fixed income that have been forced into riskier asset classes due to extreme Fed interest rate policy over the past nine year.
- The following table shows key market benchmarks for the first quarter.

	First Quarter		2017		2016	
S&P 500 Index (U.S. large cap stocks)	-0.8%	↓	21.8%	↑↑↑	12.0%	↑↑↑
Russell 2000 Index (U.S. small cap stocks)	-0.1%	↔	14.7%	↑↑↑	21.3%	↑↑↑
MSCI EAFE Index (large cap int'l stocks)	-1.5%	↓	25.0%	↑↑↑	1.0%	↑
MSCI EM Index (emerging markets stocks)	1.4%	↑	37.3%	↑↑↑	11.2%	↑↑↑
Bloomberg Barclays Aggregate Bond (invt. grade bonds)	-1.5%	↓	3.5%	↑	2.7%	↑
Bloomberg Barclays High Yield (below invt. grade bonds)	-0.9%	↓	7.5%	↑↑	17.1%	↑↑↑
Bloomberg Barclays Short-term Treasury (cash)	0.3%	↔	0.8%	↔	0.5%	↔
Gold	1.1%	↑	12.5%	↑↑↑	8.6%	↑↑
WTI Oil	8.2%	↑↑	12.5%	↑↑↑	44.8%	↑↑↑
Bitcoin	-48%	↓↓↓↓	1318%	↑↑↑↑↑↑↑	120.0%	↑↑↑↑
Morningstar Balanced Funds Average (50% to 70% stocks)	-1.3%	↓	13.4%	↑↑↑	7.3%	↑↑

Second Quarter 2018 Investment Outlook

It Ain't Easy

" It's not supposed to be easy. Anyone who thinks it's easy is stupid."

Charlie Munger – Berkshire Hathaway

" Only when the tide rolls out do you discover who has been swimming naked."

Warren Buffett – Berkshire Hathaway

'Listen to the cold, bloodless verdict of the market."

Ned Davis – Ned Davis Research

At what age does one lose all inhibition of caring what you say to others and live a life of pulling no punches? When we're younger we go through life under a constant struggle of when to speak our minds and when to let sleeping dogs lie.   This struggle is especially true at work, where the idea of keeping your job versus telling someone you work with or for what a moron or jerk they truly are is an ongoing challenge. Eventually most people decide that the truth, even if it's cold and hard, is the way to go. As they say, the truth will set you free! This metamorphosis usually occurs over the age of 60 when a person nears retirement and they have put up with enough BS in life to no longer care what others think or worry about getting sacked.   It helps to have enough FU money socked away such that speaking ones mind has limited financial consequences. Most people eventually get there. It could be Grandpa Joe or Grandma May sitting in the corner chair in the living room at a holiday gathering throwing bombs left and right as they pontificate on people, life, or politics. Usually the phrase "back in my day" precedes the salty stuff that is about to spew forth. Once you hear that phrase, you know the person is officially in the Tell It Like It Is or Call Them Like I See Them phase of life. It is often an amusing change for the younger generation to observe. After family gatherings the texts fly back and forth between them. "OMG-can you believe he/she said that?"   They're enjoying it because they know they have something to look forward to about growing older.

Berkshire Hathaway is one of the most successful investment partnerships in history. Originally a textile manufacturer, it had a metamorphosis over the years to where it is now a holding company that has investments across many industries and is valued at nearly $500 billion. $1,000 invested in Berkshire Hathaway stock in 1964 would be worth $16 million today. Its famous leader is Warren Buffett, the folksy, aw shucks, daily Coke drinking Nebraskan who is considered one of the savviest investors in history. Even if he is the less famous of the two, Charlie Munger has been there with Warren every step of the way. Warren and Charlie are disciples of Benjamin Graham, the father of value investing. These investment icons fall firmly in the Tell It Like It Is camp now that they both have billions of FU money and are well above 60. The annual Berkshire Hathaway meeting (a full weekend event) in Omaha has become their platform for talking about the state of the investment world and Berkshire Hathaway in particular. Warren and Charlie sit on a stage in front of a jam-packed auditorium and answer questions directly from shareholders on a variety of topics for several hours. It is a rare and unique corporate governance event in America and shareholders love it. At ages 87 and 94, there are not many years left of refreshing candor coming from this dynamic duo.

The It in the prior quote from Charlie Munger refers to investing. At his age, Charlie pulls no punches in telling others that if you think investing is easy then you are stupid. When stocks go straight up, every casual investor thinks they are a genius and that investing is easy work. Over the past decade, most investors have been falsely lead to believe they are smart as stocks have racked up returns in excess of 200% since the Global Financial Crisis ended in early 2009. Just buy any dip with an index fund or ETF that captures the broad stock market returns and you'll do just fine. In reality, the aggressive policies of the Federal Reserve and other global central banks have been a dominant factor supporting the surge higher in risk assets. PE multiple expansion has been the biggest factor contributing to rising stock prices in the U.S. and the zero/low interest rates and Quantitative Easing (QE) policies of central banks have had a significant influence on PE multiple expansion. Investors today assume that stocks trading well above the historical PE average is the new norm and that this time is different. It is, until it isn't.

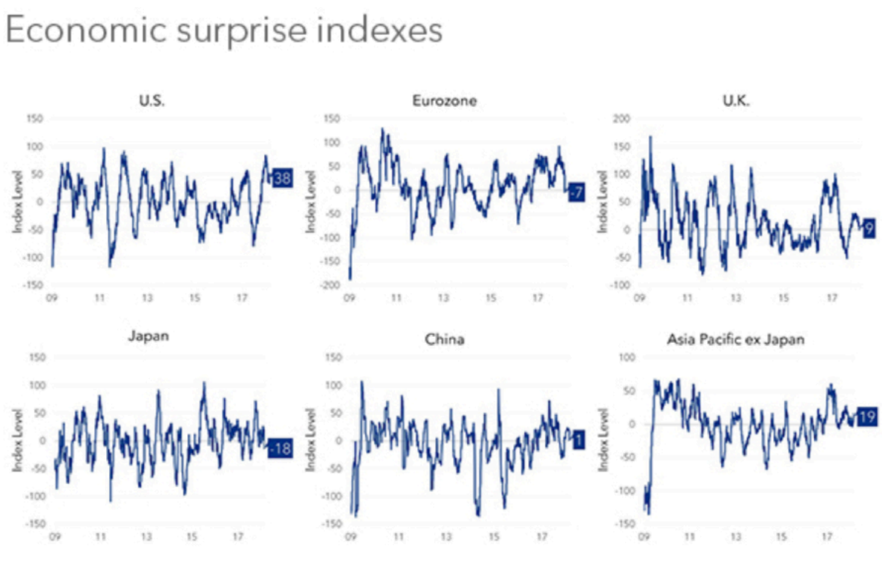
What happens when central banks reverse course (even in a deliberate manner) and begin to remove the ultra easy policy accommodations they have kept in place for too long? As Warren says, were about to find out who has been swimming naked. The first quarter marked a notable change in the stock market tone. Volatility, dormant for all of 2017, exploded higher in early February. A short volatility ETF blew up and in just a few hours time investors owning it lost 81% of their money. One former military guy had found a new, lucrative career as a short volatility portfolio manager and boasted about making himself $1 million just playing volatility on the short side. He convinced others to give him money to manage for them and made them strong returns over the past few years as volatility plumbed to new lows. That is, until it all ended in a few hours and he lost most of his client's money. Poof! He posted his story on social media asking for advice on what to do or if he should end his life. It was pathetic and sad at the same time. It is just the beginning of the end for many of these types of "investors" who have convinced themselves they are smart and that investing is easy. In fact, as Charlie pointed out, they are just stupid.

As central banks normalize monetary policy and continue to withdraw excess liquidity and the tide begins to roll out then we are going to see who the real investors are. In March the Fed raised rates for the sixth time since December 2015 (with two more 0.25% rate hikes expected later this year) and announced its Quantitative Tightening (QT) plan remains on track. All of a sudden tariff wars have become the economic backdrop and synchronized global growth is at risk. Facebook had a data privacy disaster and Trump is making Jeff Bezos/Amazon out as Public Enemy #1. Investors have been crowded into tech stocks and now they are rolling over. If you thought it was easy, well it's not, and it's about to become a lot harder to navigate financial markets. It's a good time to consider getting a professional second opinion on how your portfolio is invested because what worked over the past nine years is unlikely to work in the years ahead. The first quarter is only the start of it. Make sure you have your swimsuit on because no one is interested in seeing you naked when the tide rolls out.

Peak Performance

2017 was marked by a synchronized global economic cycle that helped to propel global stock markets to all-time highs. It appeared that this trend would continue into 2018 but the global economic data has begun to soften pretty much around the world. The Trump Administration decision to start implementing tariffs and get much more aggressive on the trade front will undoubtedly cause further softening. In response, China recently announced retaliatory tariffs on hundreds of U.S. goods. The first quarter U.S. real GDP forecast started off on fire but more recently the forecast is now closer to 2.5% growth.

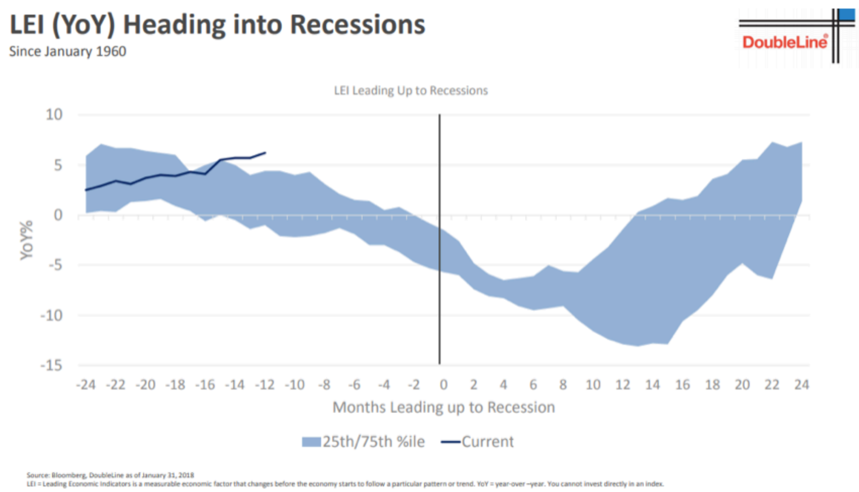
The following chart captures economic surprise indexes for six major economic regions/countries of the world. After rising strongly from the latter part of 2016 through 2017, the surprises are starting to become less positive. This doesn't mean a recession is imminent but it does mean less momentum and not as strong of a tailwind to global growth as existed last year. The data does not yet reflect the potential impact of tariff wars.



Source: Thomson Reuters Datastream, Citigroup and BlackRock Investment Institute. Mar 07, 2018

Notes: Citigroup Economic Surprise Indices measure the strength of economic data relative to economists' forecast. An index level above zero shows that data are, on average, beating expectations.

How far away are we from a possible recession? It's probably at least a year away. If we get through 2018 without one, the current economic expansion will be the longest on record. The length of the current economic expansion is largely due to the extreme policies of central banks since 2008. However, growth for this economic cycle has been subpar and well below that of prior economic expansions although recently enacted tax cuts should provide a boost to economic growth during 2018. The following chart shows where we stand in the current cycle (dark blue line) for Leading Economic Indicators (LEI) and compares it to historical economic cycle experience (light blue range). The vertical line marks when a recession is officially announced. The LEI data shows we are at least 12 months away from a possible recession. Economic data will need to deteriorate from here in order to follow the path of prior cycles towards a recessionary event. So far, the LEI line has not started to move lower.

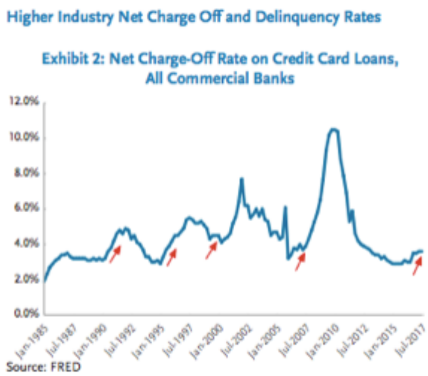


Source: DoubleLine Capital

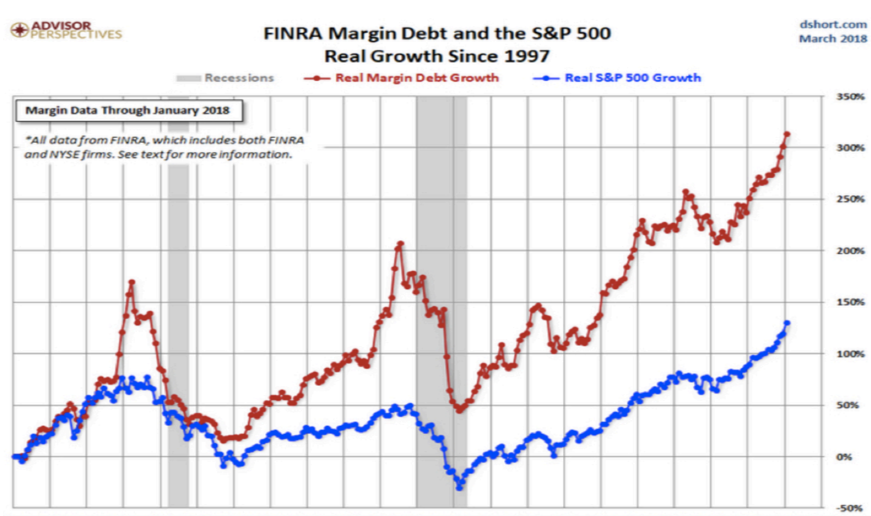
The Era of Cheap Debt is Over

An important component of any economic expansion, especially in the U.S., is consumer confidence. When consumers are confident, they spend. When they spend, the economy improves, as evidenced by the uptick in economic growth since Trump was elected. However, consumers can also get ahead of themselves and borrow (either through bank loans or rising credit card balances) to support higher spending habits. Rising debt acts as a pull forward of spending. When consumers borrow to spend, the savings rate goes down. As noted in the next chart, consumer confidence has skyrocketed higher since Trump was elected while the savings rate as a percent of disposable personal income (DPI) has seen a significant decline to near a multi-decade low level. There have been a few other times when a peak consumer confidence and low savings rate dynamic occurred. The first time was right before the dot.com bubble hit (remember day trading mania?) and the second time was right before the housing market crashed (cash-out refis and 2nd homes or condos with little/no money down were all the rage) and then the Global Financial Crisis hit. Once consumers get overextended, they are forced to reduce spending and pay down debt.

The first signs of overextended consumers are showing up in credit card delinquency and charge-off data from credit card issuers. The chart below on the left shows that net charge-offs are starting to move higher for all U.S. commercial banks. Outside of the Top 100 banks, charge-offs have moved meaningfully higher as well (right side chart). The Top 100 banks have more super prime and prime borrowers than smaller banks so their charge-off rates are lower as a result. Outside the Top 100 banks, where there are more sub-prime borrowers, charge-offs have soared higher. This data suggests that the U.S. consumer has used debt to support spending but more and more are tapped out and the falling behind on payments. As a result, banks are experiencing rising delinquencies. Upturns in credit card charge-offs often coincide with a peak in consumer confidence. As interest rates rise, debt repayments become more expensive and delinquencies begin to rise. The 1.5% increase in interest rates by the Fed since December 2015 is beginning to raise the cost of debt for borrowers.



An important aspect of why stocks have had a strong bid in a low interest rate world has been the ability of investors to access cheap debt. In the case of stock investors, margin debt, or borrowing money to buy stocks on credit, has been a big factor in supporting the stock market. The chart below shows how margin debt growth (red line) has reached all-time highs. Margin debt has been rising since 2009 (the start of QE and ZIRP) but after Trump was elected it exploded even higher with stocks rocketing (blue line) higher as well.



The roaring stock market and rising real estate market of the past nine years, brought on by a backdrop of cheap debt thanks to Fed policy, has lead to household net worth as share of personal disposable income (DPI) hitting all time highs. As the next chart shows, the prior peaks of HNW/DPI were reached in the dot.com bubble and housing bubbles. In both cases, the peak of this ratio preceded recessions. Keep in mind that this chart reflects mostly the affluent because they own most of stock and real estate assets in the U.S. Let's just say that the Fed has been a real good friend to the Top 1% since 2009. If or when the stock or the real estate markets turn over, then the affluent will also pullback on spending and economic growth will weaken. This may be more of 2019 story given the tax cuts enacted for 2018 but the chart below suggests caution for financial assets looking forward.

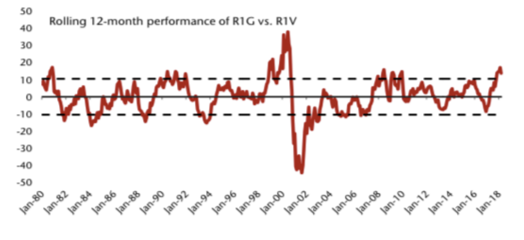
Source: Gluskin Sheff

Growth Vs. Value: At A Peak?

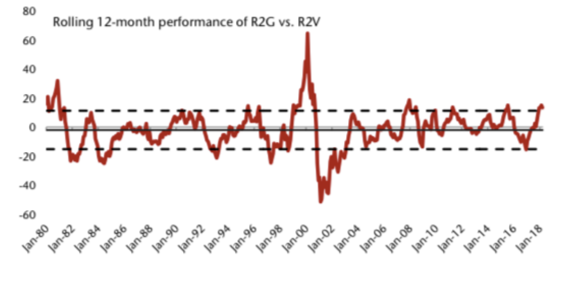
There are two major investment styles. Growth is generally defined as companies with higher revenue and earnings growth. These companies often trade at a premium to the broad stock market as investors are willing to pay a higher valuation for the prospects of higher returns. Value stocks are companies that trade at a discount to the market multiple through a cheaper PE multiple or cheaper asset valuations like price/book value. There is no right or wrong between these two styles of investing. They both exist and investors with different approaches or views on how to make money utilize both.

Over time, the relative valuations between both investment styles can trade in wide ranges. Today, growth is trading at an extended valuation to value. The economic backdrop often influences the change in relative valuations between growth and value. Economic growth has been at low levels (2% real GDP growth per year on average) since the Global Financial Crisis such that investors have been willing to pay a higher premium for companies that can deliver above average earnings growth. There is also the issue of internet and social media stocks dominating the high growth sector of the economy as the FAANG stocks (**F**acebook **A**mazon, **A**pple, **N**etflix, **G**oogle) have massively outperformed the broad stock market for many years. All of these stocks are in the growth indices. In 2017, the spread between growth and value was extreme with the Russell 1000 Growth Index returning 30% versus 14% for the Russell 100 Value Index. This outperformance continued during the first quarter of 2018 with growth outperforming value by another 4.2%. As the following charts show, the relative returns between growth and value are now quite extended for both large cap and small cap stocks. Since 8 of the top 10 stocks in the S&P 500 Index are now tech (growth) stocks, the broad stock market benchmark has a higher level of risk than most “smart” investors understand. In fact, the tech sector now comprises 25% of the S&P 500 Index, the highest level since the dot.com era. If tech stocks begin to underperform, then broad market benchmarks will as well and all those “smart” investors owning S&P 500 Index funds are going to feel the pain when (not if) this happens.

Chart 1: Rolling 12-month difference between growth and value was well above one-standard deviation line in large...



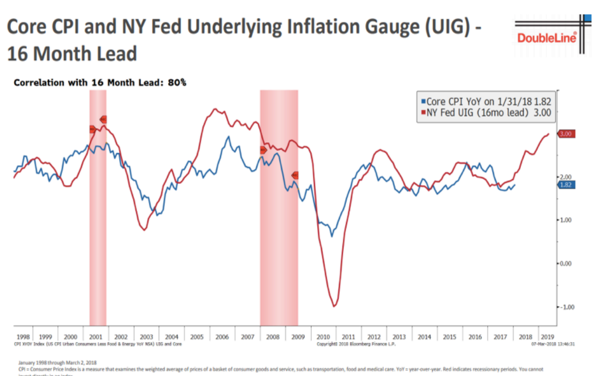
Source: FTSE; FactSet; Jefferies



Source: FTSE; FactSet; Jefferies

Inflation Creeping Higher

Bond yields made a big move higher during the first quarter. What got the bond market riled up was stronger than expected wage inflation data. In addition, the prices paid component of the ISM Index (right side table below) has made a meaningful move higher in recent months. Inflation has been running soft for a long time, below the Fed’s 2.0% target level. As can be seen in the left side chart below, except for some brief interludes, the CPI (blue line) has been running mostly below 2% since the Global Financial Crisis hit in 2008. Trailing 12-month CPI is still slightly below 2% today. However, the NY Fed’s Underlying Inflation Gauge (UIG) Index is projecting out in 16 months that CPI should start to push higher and possibly towards 3% as we move into 2019. Should this occur, it will be a major headwind for bonds. As the 10-year U.S. Treasury bond yield rises towards 3% (as it did in February), U.S. stocks struggle to perform well.



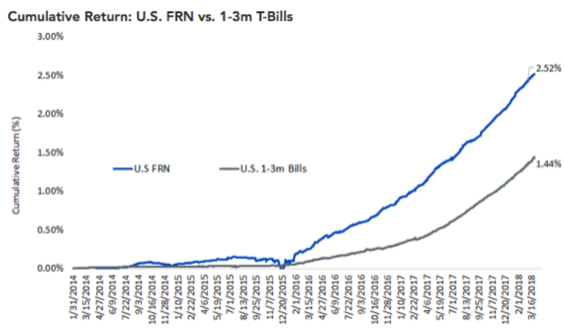
Prices	% Higher	% Same	% Lower	Net	Index
Mar 2018	57.1	42.1	0.8	+56.2	78.1
Feb 2018	51.0	46.4	2.7	+48.3	74.2
Jan 2018	46.6	52.1	1.3	+45.3	72.7
Dec 2017	40.4	55.8	3.9	+36.5	68.3

Source: DoubleLine Capital

Source: Institute for Supply Management

Cash Is No Longer Trash

With its March 2018 0.25% rate hike, the Fed has now raised interest rates six times since December 2015 when it ended its Zero Interest Rate Policy position. It is expected to raise rates another 0.5% during the rest of 2018 with two more 0.25% rate hikes. Should this occur, short-term interest rates will be targeted between 2.00% to 2.25%, which means that money market funds will be earning over 2% by the end of 2018. After a long period when money markets earned close to 0% and Fed policy pushed investors into higher risk investments in order to earn any return, cash-like investments are once again a legitimate return option for investors. The next chart shows yields for 1-3 month Treasury bills and 2-year maturity floating rate Treasury notes going back to 2014. Once the Fed began its interest rate increase process, short-term cash and bond yields have moved steadily higher. After six 0.25% rate hikes, money market funds now yield close to 1.5% and a two-year Treasury note yields near 2.5%. The rise in short-term yields means all those fixed income investors who had to abandon cash and short-term bonds in order to get paid a decent yield now have less risky investment options once again. On the margin, rising bond yields will reduce demand for high dividend yield stocks and stocks in general.



Source: Wisdom Tree Investments

Summary

Financial markets experienced a major change of tone during the first quarter. Stocks peaked in late January, had a swift 10% decline, and have struggled since. There are several dynamics coming into play all at once. Central banks, lead by the U.S. Federal Reserve, are reversing their QE policies and moving towards QT. QT means excess liquidity is coming out of financial markets, removing a leg of support for risk assets. Unlike the past two Fed Chairs, Powell seems much less concerned with how the stock market performs. Inflationary concerns increased during the first quarter. It's possible inflation could push higher as the rest of the year unfolds. The bond market doesn't like inflation and bond yields have moved higher as a result, which is undercutting the stock market's valuation level. Short-term corporate financing costs have skyrocketed at a time when corporate debt outstanding is at record levels. U.S. companies have used cheap debt to buyback a significant amount of their own stocks, a key source of demand that also may be waning. In 2019, there is $350 billion of corporate debt that has to be refinanced plus there were will be record amounts of U.S. Treasury bonds issued due to the Federal budget deficit. Undoubtedly, these factors will put more upward pressure on bond yields. Lastly, we have the beginnings of a tit-for-tat trade war that could begin to negatively impact global growth. So, it ain't easy anymore. Both bonds and stocks have multiple issues in front of them. Cash is looking like a better alternative in an increasing uncertain investment world. Grab your swimsuit. No more skinny-dipping.

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

April 10, 2018

IMPORTANT DISCLAIMER: