MJM INVESTMENT ADVISORS, LLC

Third Quarter 2013 Investment Commentary

Halfway There?

Oh, we're halfway there,
Oh, living on prayer
Take my hand, we'll make it I swear
Oh, living on a prayer
LIVING ON PRAAAAAYEEEERRRRRR!

Bon Jovi – Living on a Prayer

Right up front, let's address the most difficult news of this past quarter. Richie Sambora was sacked (or did he quit?, inquiring minds want to know) as lead guitarist of Bon Jovi. This news is a devastating event for all big hair rock fans, especially in New Jersey where Bon Jovi is from and where big hair has never gone out of style. Can a hand function properly without its thumb? Would Bill Murray's platoon in Stripes really have been a lean, mean fighting machine without its big toe, Sergeant Hulka? Not only did Richie Sambora create all of the awesome guitar riffs on every major Bon Jovi hit for 30 years, he was also married to Heather Locklear. In short, the guy is a stud. I was never a fan of Jon Bon Jovi but as a fellow musician and lead guitarist in a one-man air band (I studied at Air Berklee College of Music and also play airbase, airdrums, and airkeyboard), I always respected Richie. If Richie's departure was Jon's doing, he clearly has been hit one too many times in the head by flying panties and bras. Without Richie, Bon Jovi has earned its place as the headliner act on the Has Been Tour. Also on the bill are Vanilla Ice (Ice Ice Baby), Right Said Fred (I'm Too Sexy), and Tommy Tutone (867-5309). It is rumored that Ben Bernanke has been booked as the opening comedy act for the Has Been Tour.

Let's move on to less serious matters. Congratulations! You have made it to the five-year anniversary of the Great Financial Crisis that started the U.S. and global economy on its current path of economic malaise. The collapse of Lehman Brothers in mid-September 2008 sent U.S. and global stock markets into a tailspin. Lehman didn't cause the Great Financial Crisis, but became the symbol for it and was the most public victim of the collapse of credit markets. The dominoes had been falling before Lehman's collapse, but Lehman was the biggest domino to fall and created major after shocks. Shortly after Lehman failed, the $700 billion TARP was quickly pulled together by Congress and then Treasury Secretary Hank Paulson. The most prominent part of TARP was requiring some of the largest financial institutions in America, those deemed Too Big To Fail, to sell securities to the U.S. government, a major black eye event in the history of capitalism. Financial markets continued to decline into early March 2009, when the Federal Reserve initiated the Quantitative Easing (QE) program, expanding its balance sheet by buying $750 billion of U.S. Treasury and mortgage-backed bonds to help mitigate the effects of the credit crunch. The start of QE in March 2009 marked the low point for global stock markets and the economic "recovery" began. In a classic case of government overreach, the re-regulation of the financial sector in America was pulled together in a legislative monstrosity called the Dodd-Frank Act, signed into law by President Obama in July 2010. Without a doubt, Dodd-Frank has had a major hand in adding to the current economic malaise in the U.S.

The QE program has expanded from the original $750 billion of bond purchases to a cumulative $3.5 trillion (headed to $4 trillion). The Fed has also kept short-term interest rates near 0% since December 2008 and has pledged to hold rates there until at least 2015. Both programs represent highly stimulative and unprecedented monetary policy actions. Yet, nearly five years later, the U.S. economy struggles to

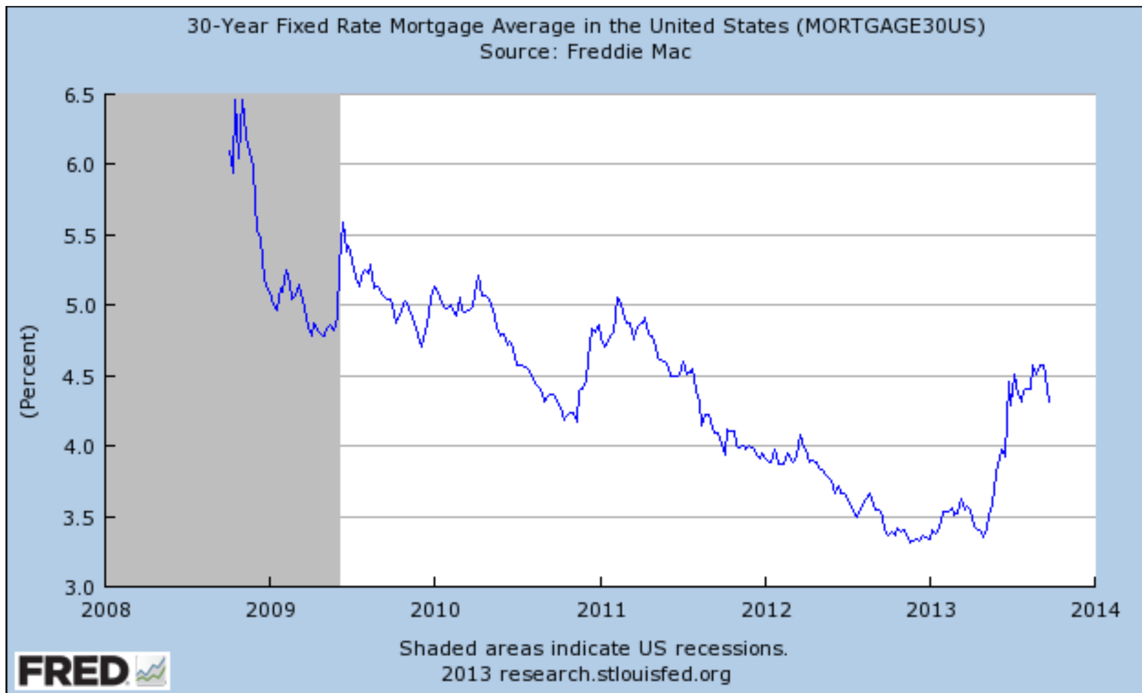
achieve decent levels of real GDP growth, the unemployment rate remains above 7% (the U6 unemployment rate, which is more reflective of reality, is above 13%), and the Federal debt level has reached $16+ trillion. The Federal debt ceiling has been raised twice and now requires another increase by October 17th to avoid a default. Despite all these pimples, the U.S. is looked upon as the "safe" place to invest globally and has benefited tremendously from the flight to "quality" trade the past two years. Europe has zero GDP growth, 13% unemployment, 25+% youth unemployment, and has had to deal with the financial collapse of Ireland, Greece (in need of 3rd bailout, after having received at least €240 billion so far), Portugal, Spain, and Cyprus. Italy is constantly teetering and don't look now but here comes France (the French are always fashionably late-more on France later). Japan is a basket case (you think five years is long? Japan has had economic malaise since 1990). China is dealing with a growth slowdown as its export markets have slowed dramatically and it is facing its own domestic credit crisis. The Middle East is a cauldron waiting to boil over.

Since 3/31/09, the U.S. stock market has substantially outperformed the rest of the world, returning 133% vs. 99% for developed international markets and 96% for emerging markets. This outperformance must reflect the fact that the U.S. is doing much better, right? America is headed in the right direction once again, right? The outlook for the future is better, right? We feel more secure in our jobs and income, right? Detroit declaring bankruptcy five years after the credit crisis started is a non event, right? Who's with me on this?

At risk of sounding like a broken record, a broken record, a broken record, have any of the U.S.'s long-term structural problems been resolved over the past five years? Has the Fed's aggressive monetary policies made a meaningful impact on the economic or employment growth outlook for the U.S.? Has Congress or the President made any difficult decisions or enacted meaningful legislation to address the long-term fiscal problems of the U.S? Do U.S. companies or consumers have increased confidence in the future? Has Europe resolved its excessive debt overhang or shored up its banks? Unfortunately, the answer to these questions is clear. So, five years after the Great Financial Crisis began, the more things change, the more they stay the same. It is not going far out on a limb to suggest that we may only be halfway back to the Old Normal, and that we are living on a prayer of hope that current monetary and fiscal policies will help the U.S. economy heal and get us there. But, take my hand, we'll make it I swear, even if it takes another five years.

Third Quarter Review

After reading the Fed tea leaves (has a more transparent Fed really been helpful?), the vast majority of investors expected the Fed to begin the QE tapering process at its September meeting. The market was shocked when the Fed decided not to taper despite all the public commentary from Fed officials suggesting tapering was coming sooner rather than later. The Fed clearly does not believe the labor market recovery is strong enough yet. Also, the prospect of another government shutdown and fight over the raising of the debt ceiling almost certainly was a factor on the Fed's decision to push out the beginning of QE tapering. Additionally, all summer, longer maturity bond yields continued to move higher in anticipation of the start of QE tapering. The Fed had to be concerned that rising bond yields would have a negative impact on the still shallow economic recovery, particularly in the housing sector, one of the few bright spots in the U.S. economy. The following chart shows the rapid rise in the 30-year mortgage rate since early May when the Fed began telegraphing that QE tapering was on the horizon.



Source: St. Louis Federal Reserve

The third quarter marked a large shift in asset flows, as investors accelerated the liquidation of their bond holdings and moved more assets towards stocks. Bond funds saw over $50 billion of withdrawals during the third quarter while domestic stock funds saw $13 billion and international stock funds saw $24 billion of inflows. Retail investors now have 69% of assets in equity funds, which is slightly above the average since 1992 and up from 65% in 2012. Within stocks, international funds are starting to see more inflows. With money markets still paying close to 0%, and bonds now suffering negative returns from rising yields, stocks are winning by default.

The table below highlights key benchmark returns for the third quarter and year to date through 9/30/13.

Index	**3Q13 Return**	**9 Month Return**
S&P 500 Index (large cap U.S. stocks)	5.3%	19.8%
Russell 2000 Index (small cap U.S. stocks)	10.2%	27.7%
MSCI EAFE Index (developed int'l mkts)	11.6%	16.1%
MSCI EM Index (emerging int'l mkts)	5.8%	-4.4%
Barclays Aggregate Bond Index (invt. grade)	0.5%	-1.9%
Barclays High Yield Bond Index (below invt. grade)	2.3%	3.7%
Barclays Short-term Treasury bills (cash)	0.0%	0.1%
Gold	8.0%	-20.1%
Brent Crude Oil	6.2%	-2.4%

Stocks once again put on a very strong quarter of performance with international equities and U.S. small caps leading the pack. European economic indicators appear to have bottomed and showed better than

expected results during the summer and the euro strengthened against the U.S. dollar during the third quarter.

Source: Stockcharts.com

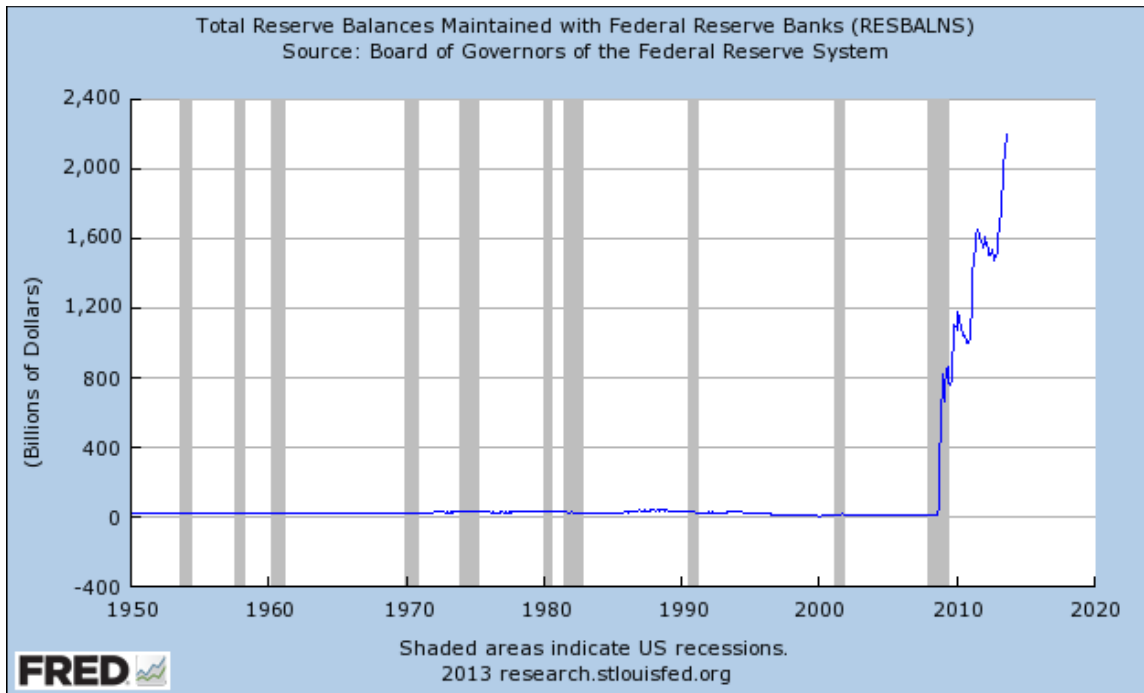
The strengthening of international stocks vs. U.S. stocks began right at the start of July as shown in the chart above. It also coincided with the strengthening of the euro relative to the U.S. dollar as shown in the chart below.

Source: Bloomberg

QE- The Indictment

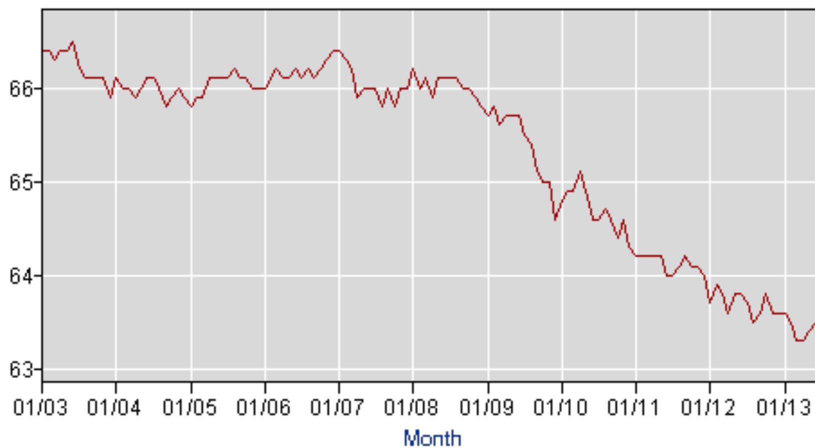
As shown in the next few charts, the Fed's QE policy has been unable to move the economy forward in a meaningful way. Even as the Fed has expanded the QE policy and its balance sheet to a mind numbing $3.5 trillion, credit expansion still remains poor. Data from the Federal Reserve Bank of St. Louis in the next chart shows that year-over-year credit growth in the U.S. peaked in early 2012 and has continued to decline into 2013 and is barely above 0%. A recent small business survey by PNC Financial indicated that only 20% of small businesses intend to take out new loans. Most large companies are using low rates to refinance existing debt or buyback stock instead of investing for growth. You can lead a horse to water but you can't make it drink.

Bank lending is tied directly to the Fed's policies. Banks are required by the Fed to hold a statutory level of reserve capital. Since the 2008 financial crisis, capital adequacy requirements have been raised not only in the U.S. but globally as well via the Basel Committee on Banking Supervision. Traditionally, banks will invest (lend) excess capital to make returns. The next chart shows total reserve balances maintained by banks in accounts at Federal Reserve Banks that are available to satisfy reserve requirements. Despite the Fed providing banks with extremely low cost of funds, the amount of excess reserves held by banks at the Fed has exploded during the QE era. There are a couple of reasons why. First, the Fed is paying banks interest on those excess reserves so banks are making some return and have some incentive to keep money at the Fed. Second, banks decide if lending and earning a potentially higher return on the loan is better than what they can earn from their reserves stashed at the Fed. The massive growth of balances at the Fed suggests that banks are not finding enough demand or qualified borrowers to lend their excess reserves and despite the Fed telegraphing that its zero interest rate policy (ZIRP) will be in place at least two more years and making lending quite profitable for banks. Despite the Fed dramatically expanding its balance sheet via QE and holding short-term interest rates at extreme lows, not much of this cheap money is ending up in the real economy. If it were, loan growth would be accelerating, capital spending would be improving, and companies would be hiring more labor.



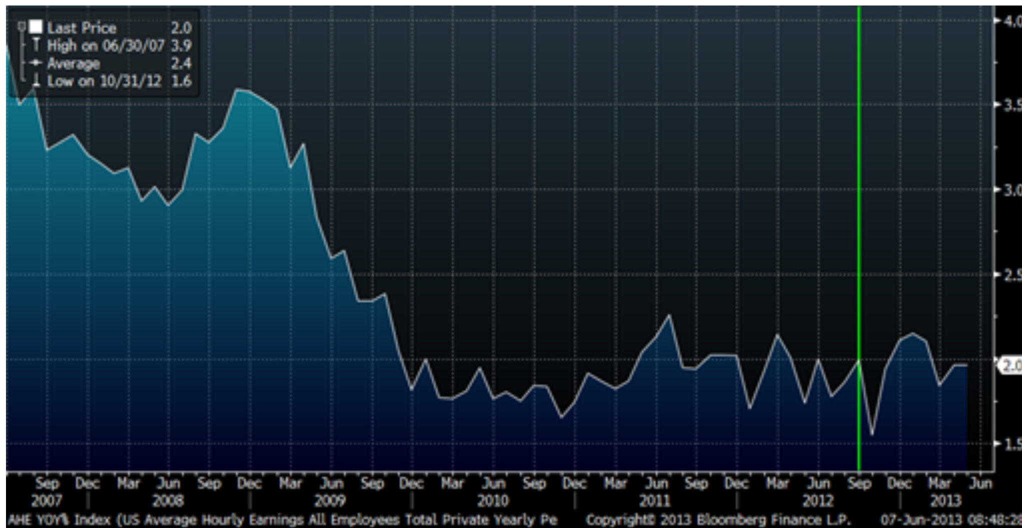
Source: St. Louis Federal Reserve

One of the key mandates of the Fed is to enact policies to achieve full employment. Despite its aggressive policy efforts, the Fed has been unable to meaningfully move the needle on the employment front. The next chart shows that the labor force participation rates continues to decline and has hit levels last seen in 1983. While the unemployment rate continues to nudge down ever so slowly, the main reason is that more people have dropped out of the workforce and are no longer looking for jobs. Monthly job increases remains stuck below the 200,000 level and are not large enough to put a meaningful dent in the unemployment rate. Additionally, many of the jobs being added are part-time. A recent survey of small businesses by PNC Financial indicated that 73% of small businesses have no plans to add staff.



Source: Bureau of Labor Statistics

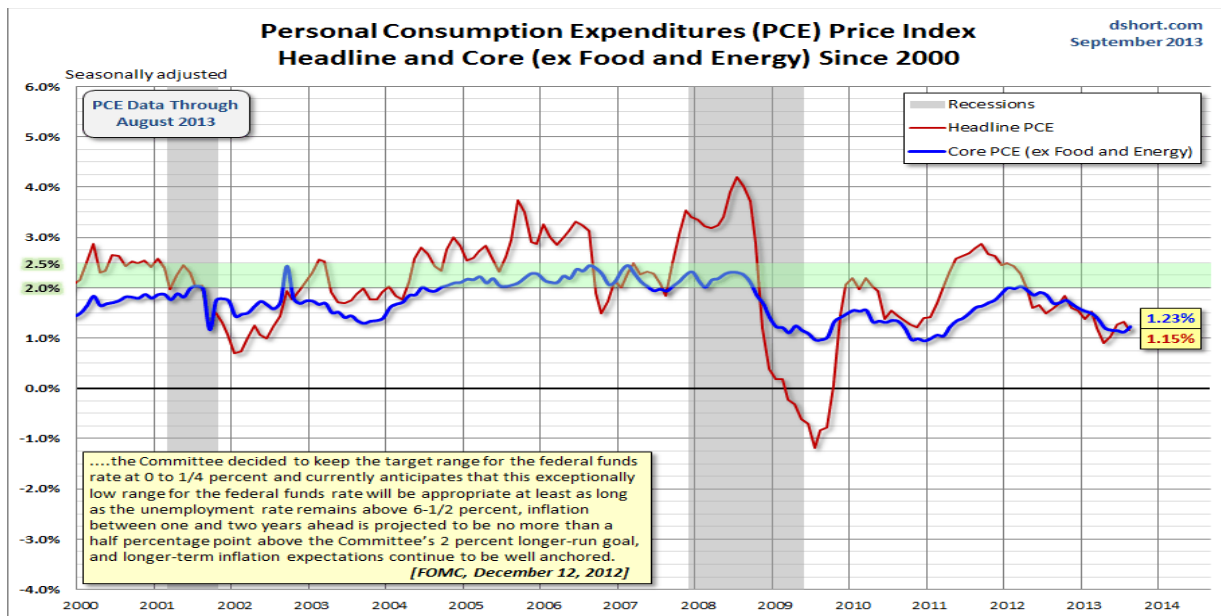
The next chart shows the year-over-year change in average hourly earnings for private payrolls from 2007-2013. One of the reasons that consumers in general are cautious with spending is they have not seen any meaningful improvement in income (particularly low and middle income Americans who generally are not benefiting from the stock market's rise) since the end of the Great Recession and its subsequent recovery. With average hourly earnings stuck in a 1.5% to 2.0% growth profile since late 2009, and with inflation levels near that same level, real wage growth has been non-existent for over four years.



Source: Bloomberg

The Fed uses the Core PCE (Personal Consumption Expenditures Price Index) as its primary indicator of core inflation. The Fed's mandate is to target long-term inflation at 2.0%. The next chart shows both headline and core PCE going back to the 2000. Core PCE excludes food and energy costs, which are more volatile. The Core PCE has been decelerating (disinflation) recently and despite the Fed's ultra aggressive monetary policies. The Fed has publicly stated that it has two key targets it wants to achieve before it pulls back on QE. The unemployment rate declines to 6.5% (the Fed now seems to be backing away from this one) or inflation consistently exceeds 2.5% or 0.5% above their 2.0% long-term target. Neither goal has been achieved.

A big component of inflation is labor costs. Wage inflation is well under control as employers are reluctant to hire given the uncertain economic environment and are under no pressure to increase wages to compete for workers given the large pool of unemployed labor available for hire.



Source: dshort.com

There is one final point to make on the failure of QE to provide any meaningful benefit to the U.S. economy. As shown in the graphic below….oh wait, uhhhh, gee, due to the government shutdown, apparently there is no recent data available to make another chart. Nonetheless, there is an important point to be made here. The federal government has done virtually nothing the past five years to help the Fed move the economy forward. Dodd-Frank, Obamacare, and three threats of government shutdowns since 2009 have done much to add to uncertainty, undermine private sector confidence, and extend the economic malaise.

U.S. Department of Commerce
Bureau of Economic Analysis

Due to the lapse in government funding, www.bea.gov will be unavailable until further notice. This includes access to all data and the e-File system.

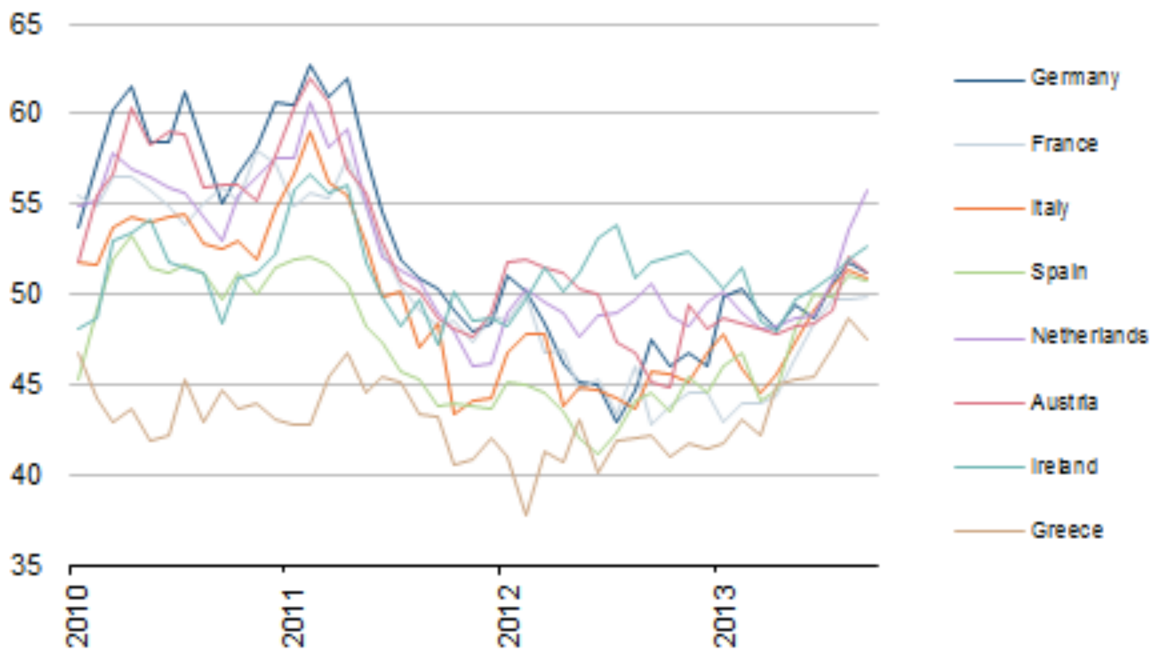
We sincerely regret this inconvenience.

Additional information can be found at link to PDF.

Updates regarding government operating status and resumption of normal operations can be found at www.usa.gov.

Europe – Not Even Halfway There?

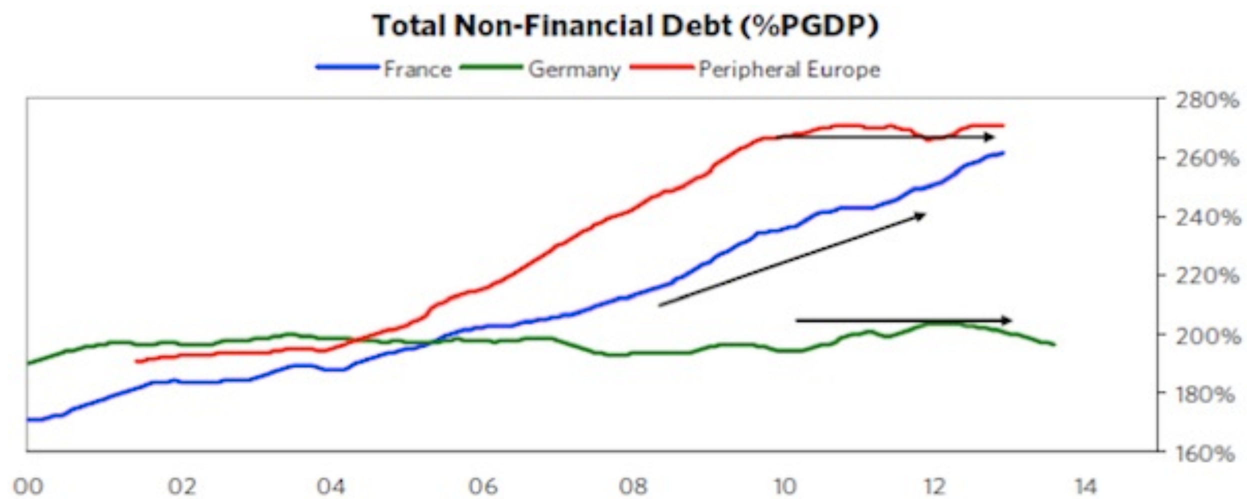
European stock markets had a very strong third quarter as some European economies appear to have turned an important corner. Europe has been in a "help I've fallen and can't get up" environment since early 2011 and investor sentiment hit extreme negative levels earlier this year relative to the positive vibes global investors have felt for the U.S. While not completely back on its feet, Europe was at least able to sit in an upright position during the third quarter, as its Purchasing Managers indices all started to improve with many readings now moving above the important 50 level, a level that marks growth. To the extent Europe is starting to pickup, this is important for China as well, as Europe represents its largest source of exports.



Additionally, Angela Merkel won an important election victory in Germany during September. Merkel has been a key backer of the euro and peripheral Europe bailouts and removing the uncertainty of her status has boosted investor sentiment towards Europe. Frau Merkel achieved an election victory while the electorate sacked every other major leader of other countries in Europe since the financial crisis began. Ja, das gut!

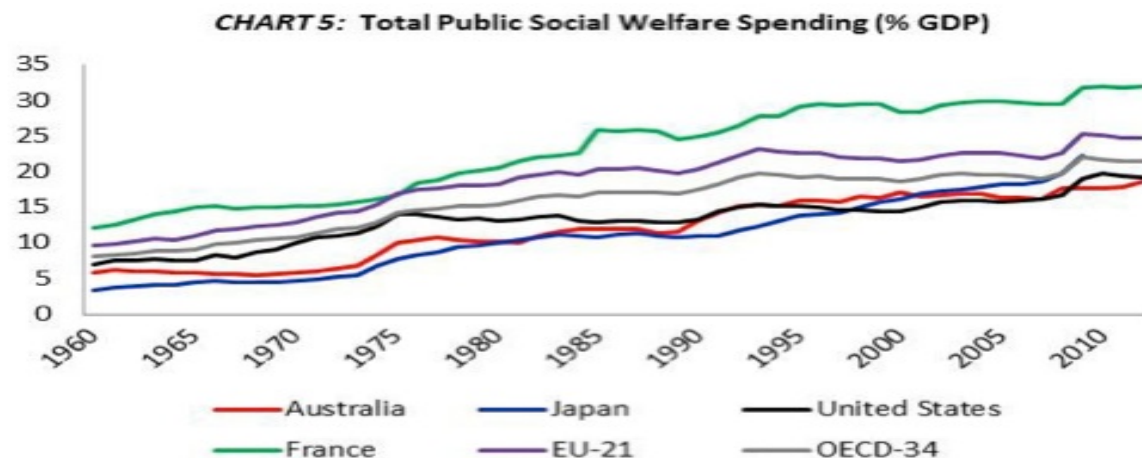
While Europe does have a pulse, there certainly is more difficult work ahead. European banks still remain under capitalized compared to their U.S. counterparts and hold large amounts of European sovereign debt. The excessive levels of debt in Europe have not been addressed or resolved. The sovereign body bags have piled up in Europe, with Ireland, Greece, Portugal, Spain, and Cyprus already zipped up. Italy remains a political mess and seems to always be teetering from crisis to crisis. The fiscal situation in France is not encouraging. France along with Germany are supposed to be the foundation of the European bloc and France is mostly dead weight at this point.

The level of French debt is at postwar highs and is beginning to approach that of the peripheral Europe. The next chart shows that French debt has risen sharply while German total nonfinancial debt has been decreasing the past few years and the debt of peripheral Europe in the aggregate has gone roughly flat. At the pace France is accumulating new debt, it will not be long before its financial situation looks similar to peripheral Europe. But don't worry too much, France is run by a Socialist, and he has everything under control.



Source: Bridgewater Associates

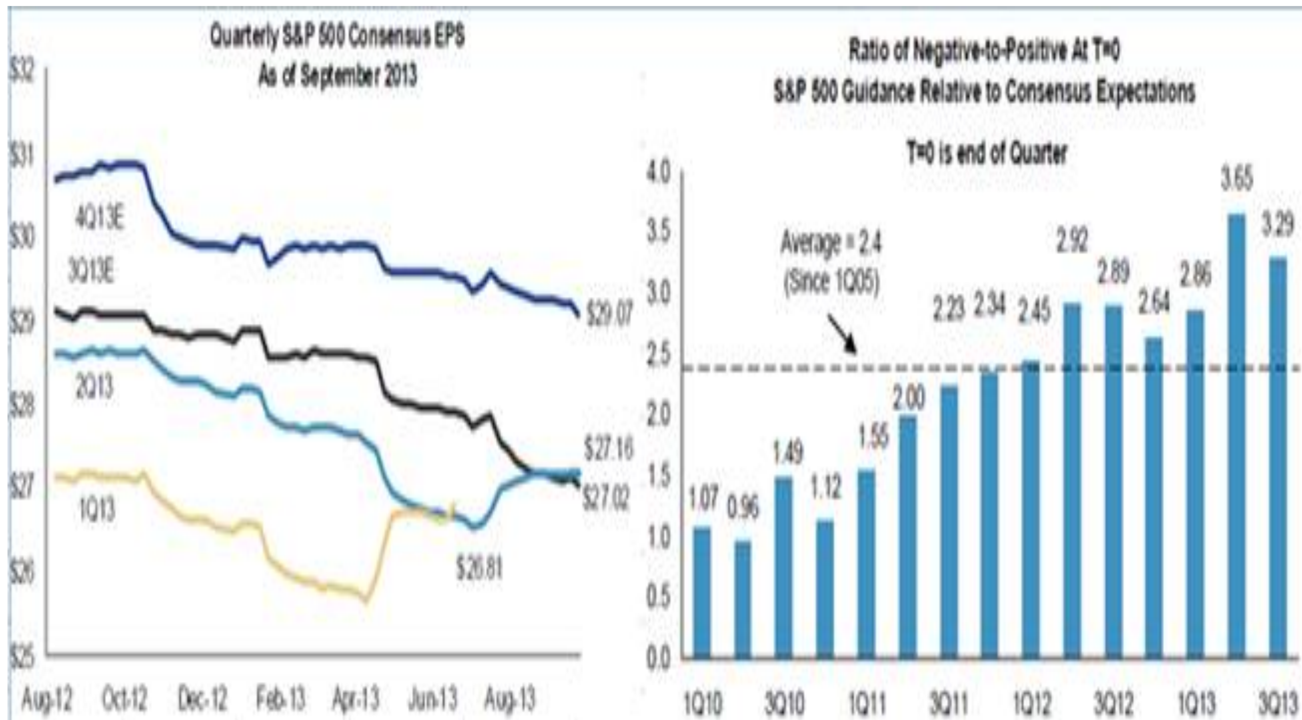
As seen in the next chart, French welfare spending as a percent of GDP exceeds the rest of the world by a considerable margin. Of course, the chart shows this has always has been the case, but given France's excessive debt situation, it has some very tough decisions to make on its social programs which are now exorbitant by global standards.



Source: Bridgewater Associates

Stock Market Fundamentals Update

Negative earnings announcements for the third quarter remain elevated as companies continued to guide sell-side analysts lower. The left side of the next chart shows third quarter aggregate earnings estimates for the S&P 500 companies have now dipped slightly below the actual second quarter earnings. Importantly, fourth quarter earnings estimates still appear to be too robust in light of the downward revisions trends in place. The longer the government shutdown remains in effect, the increased likelihood that fourth quarter earnings will see markdowns. Earnings warnings have increased every quarter since the second quarter of 2012, yet investors are not punishing stocks. This says a lot about the fact that stocks are really the only game in town. In a normalized world, the stock market may not have performed as well as the growth outlook is not robust enough to justify the market's strong move higher. Maybe some day the fundamentals will matter once again. But, in the QE era, they have taken a back seat.



Source: Barclays Capital and Factset

The 2013 earnings estimate for the S&P 500 Index is now at $110 (+7% year over year growth). The S&P 500 Index now trades at 15.2X 2013 earnings estimate. It would appear that fourth quarter earnings estimates need to marked lower given the likely negative impact the government shutdown will have on fourth quarter economic growth. The current 2014 S&P 500 Index earnings estimate is $122 (+11%) with an assumption of topline sales growth of 4.2% and margins expanding again despite already being at record levels and with wage costs below historical levels. Realistic?

Summary

The stock market owes much of its surprising strength this year to the Fed's QE policy. As proof, the Fed simply floating the idea of QE tapering in late May sent global financial markets into a tizzy, albeit a short lived one. Bond yields rose sharply and caused an immediate slowdown in housing activity. The Fed's decision to push out the start of QE tapering speaks loudly about the corner the Fed has painted itself into and the current state of the U.S. economy. The rapid rise in mortgage rates, weak labor market, and the possibility of a government shutdown were all reasons the Fed decided not to taper in September.

The idea that QE has done very little to pull the economy out of its multi-year funk seems to gaining traction. Now, the debate seems to be shifting towards the idea that QE is more of an albatross around the neck of the U.S. economy and perhaps is doing more harm than good via unintended consequences. Given the deep funk the economy was in five years ago, the initial QE program was definitely needed to give the economy a serious shot of confidence and to right the economic ship. But nearly five years later, and after $3.5+ trillion of asset purchases by the Fed, QE now looks bloated, aged, and well past its prime, like Kirstie Alley before her Dancing With the Stars gig.

When will things ever return to the Old Normal? Out with the New, in with the Old? As the title of this quarter's commentary suggests, it is conceivable that we are only halfway there and it could be another five years before things get back to the Old Normal. Unfortunately, we are still livin' on a prayer and much hard work and financial sacrifice lies ahead. But we are Americans, and accepting defeat is not in our creed. And if Richie returns to Bon Jovi and helps us make it back to the Old Normal, that will be icing on the cake.

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October 8, 2013

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