MJM INVESTMENT ADVISORS, INC.

Third Quarter 2022 Investment Outlook

Pack The Dramamine

“In the stock market, the most important organ is the stomach.”

– Peter Lynch – former portfolio manager of Fidelity Magellan.

“Market debate has focused on the balance of transient inflation versus more persistent inflation, and ultimately the degree of monetary policy response required to bring inflation to the Federal Reserve’s target.”

– Rui De Figueiredo – Eaton Vance

Oh, can't you see the morning after? It's waiting right outside the storm, Why don't we cross the bridge together, And find a place that's safe and warm?

– Maureen McGovern – The Morning After - theme song from The Poseidon Adventure

Boating is one of the top summertime activities and is very appealing to most people. Sun and blue above, calm soothing water sounds below, wind blowing through your hair, all the while enjoying the beautiful 360 degree vistas. Maybe do some water skiing or tubing or fishing with some cold beers and a sub and chips packed in the cooler. Periodically, another boat will pass by close enough and there is the requisite hand wave between people on both boats, which is unspoken code for, this is pretty sweet, right? Like other summertime activities, boating has its downside, just like sunbathing has sunburns and camping has bugs. The enjoyment of the boat outing is usually dictated by the weather and more specifically the wind speed and size of the waves. Reasonable levels of both and good times are had by all. However, if the weather turns bad and the knots really kick-up, then being out on the water is the last place you want to be. Even on good weather days, the tide creates a natural wave effect. Some people are highly susceptible to motion sickness and being on a boat accentuates that issue to the point where too much movement can cause someone to get seasick and possibly another not so pleasant outcome.

Investing is a good analogy with the boating experience. Over longer periods of time, an investor will typically enjoy a good investment experience and wealth creation. The beauty of compounding returns math is that a 7% annualized return over 10 years will double the value of your portfolio today. 80% of the time the investing weather is good and the returns are fair, sometimes great, and the overall experience is an enjoyable one. However, investors will periodically experience that bad investment boat ride, the one where the volatility winds pick up and returns go negative and it feels like your stomach is in your mouth and you can’t get your sea legs under you. Sometimes the rogue waves created by these investing storms will cause a big hit to your net worth, like the first half of 2022. During such times, a prudent investor should act like a smart captain and hightail it back to port and batten down the hatches and wait for the storm to pass before venturing back out onto the investment waters again.

Investors faced one doozy of an investment storm in the first half of 2022. The wave that hit financial markets wasn’t as big as the rogue wave that flipped over the cruise ship in the 1972 disaster movie The Poseidon Adventure but lots of water was taken on and heavy bailing was required to keep the boat afloat.

After the past six months being like a 1970's disaster movie, most investors are now wondering if there is going to be a morning after. Eventually there always is, but for now, pop another Dramamine, keep moving closer to the shore and hold on through the night.

The first half of 2022 was a very difficult time period for balanced portfolios containing both stocks and bonds, with a total return of -16.1%, the worst first half going back to 1972 or 50 years. As shown in the next table, the last time a 60/40 balanced portfolio return for the first six months of the year was worse was in 2008 during the Global Financial Crisis when a 60/40 portfolio returned -6.7%. The second half of 2008 was much worse at -14.6% and 2008 for the year was an abysmal -20.1%. The next worst year for a 60/40 balanced portfolio was 2002 at -9.2%. Both 2002 and 2008 were during recessions. According to Vanguard Group research, over a six month time period, a 60/40 balanced portfolio only generates a negative return 18% of the time and stocks and bonds both having negative returns over a six month period has only happened 3.6% of the time, which makes the first half of 2022 was a rare financial storm.

Worst US 60/40* Returns Through June (1976 - 2022)

Rank	Year	Total Return
1	6/30/2022	-16.1%
2	6/30/2008	-6.7%
3	6/28/2002	-6.4%
4	6/29/1984	-3.6%
5	6/30/1994	-3.6%
6	6/29/2001	-2.6%
7	6/30/1982	-2.0%
8	6/30/2010	-1.9%
9	6/30/1977	-1.7%
10	6/30/1981	-0.5%

*60/40 = 60% S&P 500/40% Bloomberg US Agg

COMPOUND @CharlieBilello

Source: Charlie Bilello

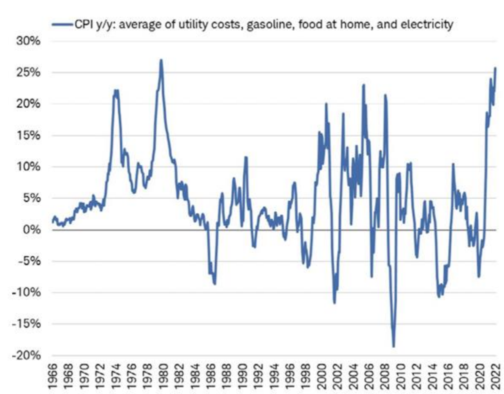
The major difference between 2008 and 2022 is equities collapsed in 2008 but bonds had positive returns, benefiting from a flight to safety trade and the Fed cutting interest rates. In 2008, the S&P 500 Index was -37.0% but the Bloomberg Aggregate Bond Index was +5.2%. Going back in history, during times of market stress, bonds have typically served as an offset and provided a balanced portfolio some downside protection when stocks performed poorly. Bonds provided the risk diversification exactly when it was needed the most. During the first six months of 2022, the Russell 3000 Index declined 21.1% and the Bloomberg Aggregate Bond Index returned a dismal -10.4%. Bonds had their worst performance since 1974. Unlike 2008, bonds did not act as a flight to safety trade or an offset to the stock market decline for a balanced portfolio. Only investors heavily weighted towards cash avoided poor returns during the first half of 2022. In 2008, more conservative investors suffered modest declines because bond returns were positive and they had less exposure to stocks. In 2022, even conservative balanced portfolios couldn't avoid the storm.

Although stocks have declined twice as much as bonds year to date, the bigger surprise this year for most investors has probably been how poorly their bond investments have performed. As shown in the table below, no segment of the bond market was positive and a 30-year U.S. Treasury bond had the most negative returns and declined over 23%.

	Yield		Return
U.S. Treasuries	**6/30/2022**	**12/31/2021**	**2022 YTD**
2-Year	2.92%	0.73%	-3.05%
5-Year	3.01%	1.26%	-7.15%
TIPS	0.65%	-1.04%	-8.92%
10-Year	2.98%	1.52%	-11.71%
30-Year	3.14%	1.90%	-23.57%
Sector			
U.S. Aggregate	3.72%	1.75%	-10.35%
IG Corps	4.70%	2.33%	-14.39%
Convertibles	7.63%	3.66%	-19.41%
U.S. HY	8.89%	4.21%	-14.19%
Municipals	3.21%	1.11%	-8.98%
MBS	3.77%	1.98%	-8.78%
ABS	4.38%	1.96%	-2.87%
Leveraged Loans	8.83%	4.60%	-4.06%

Source: Bloomberg, JP Morgan Asset Management

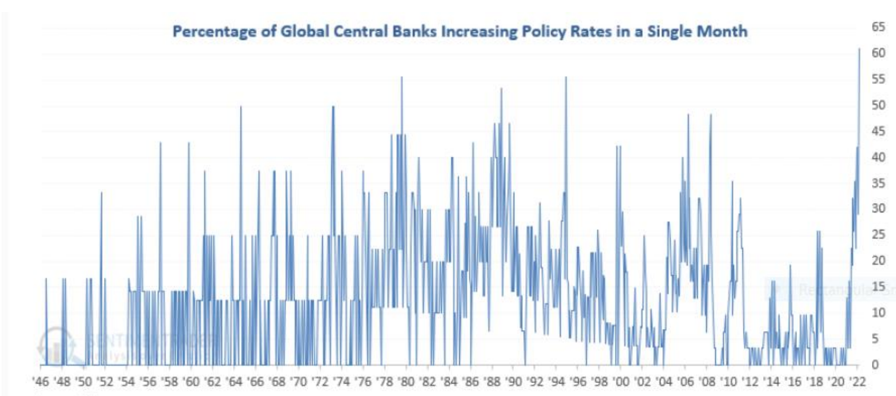
The are several factors that have played into the unusually poor performance for bonds. Historically high levels of inflation is the biggest factor. The next chart shows the year over year cost increases in some of the most important consumer spending categories including utilities, gasoline, and food. Note that the year-over-year price increases have moved dramatically higher and exceed any other time period going back to the mid-1960s. Only in 1978 during the OPEC oil crisis did consumers face similar extreme inflationary pressures over such a short time period. For these three spending categories alone, consumers have seen year-over-year inflation increases of 25%. While the broad CPI reading for June on a trailing 12-month basis was 8.6%, the inflation in items that matter the most to a family budget are significantly higher.



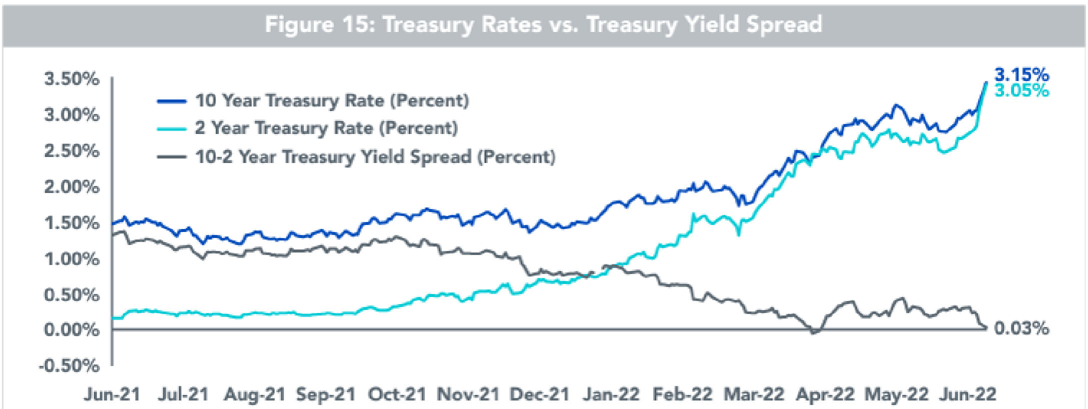
Source: Liz Ann Sonders

As inflation levels have risen dramatically over the past year, consumer confidence has plunged as a result. The next chart plots the Conference Board Consumer Confidence reading of future expectations going back to 2006. Expectations are more important that present conditions because it provides a perspective into how future consumer spending patterns may play out. A consumer who is less confident about the future will reduce spending and the risk of a recession increases since consumer spending is around 70% of U.S. GDP. Note how low future expectations declined during the 2008/2009 recession caused by the Global Financial Crisis. Back then, it was the severity of the recession rather than inflation which caused consumer confidence to plunge so low.

Since inflation has accelerated at a rapid pace, central banks across the world have been forced to aggressively raise interest rates in order to try and break the inflation fever. As shown in the chart below, there has never been a period in time going back to the mid-1940's when more central banks were raising interest rates. Importantly, many central banks like the Fed were slow to react to rising inflation levels and only recently started the process of raising interest rates but are trying to catch up by making larger interest rate increases. For example, the Fed raised interest rates by 0.75% in June after having raising interest rates by 0.25% in March and 0.50% in May. However, inflation levels have not started to recede yet in a meaningful way and so more interest rate increases will likely be required for the rest of 2022. Two major central banks, the European Central Bank and Bank of Japan, are way behind the inflation curve and haven't even raised interest rates once yet, which helps to explain why the Euro and the Yen have fallen dramatically versus the U.S. dollar over the past 18 months.

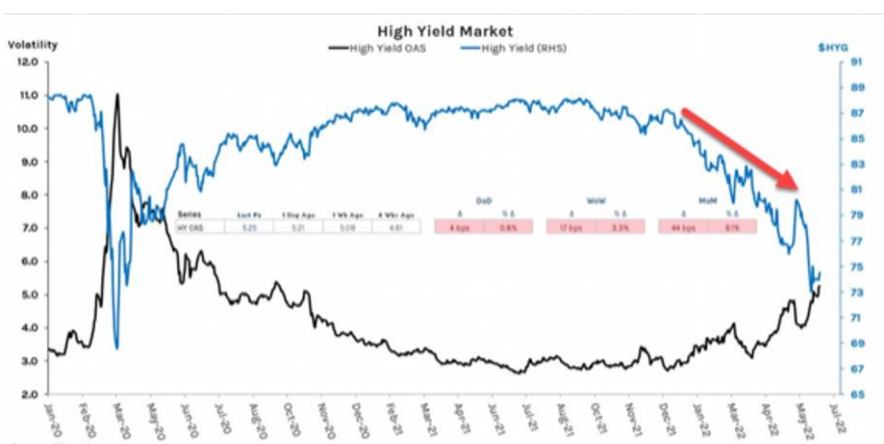


The combination of rising inflation and higher interest rates has created the dreaded double whammy setup for bond investors. The next chart shows yields for the 2-year and 10-year U.S. Treasury bonds over the past 12 months. Starting in the summer of 2021, bond yields started to move off of historically low levels but in early 2022 bond yields really accelerated higher as inflation levels worsened. The 10-year U.S. Treasury yield doubled between Jan 1st and June 30th, while the 2-year U.S. Treasury yield increased from 0.25% to over 3.0% in less than nine months, an unprecedented increase over such a short period of time. Even short maturity bonds produced negative returns during the first six months of 2022 because yields moved higher so quickly.

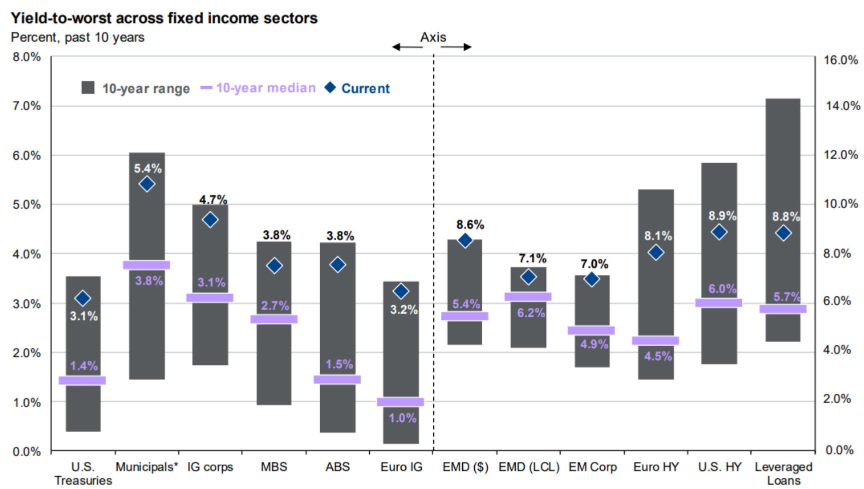


Source: YCharts, 12-month data though 6/13/22. You cannot invest in an index and past performance is no guarantee of future results.

Corporate bonds have been the worst performing fixed income sector because investors have moved assets out of higher risk segments of the debt markets including investment grade and high yield corporate bonds. The blue line in the next chart shows the price of HYG, a corporate high yield bond exchange traded fund. HYG declined by 13.8% during the first half of 2022. The black line shows the option adjusted spread of HYG, which is how much additional yield an investor receives for owning HYG compared to a similar maturity Treasury bond. In late 2021, HYG only offered around 3.0% of additional yield, a historically low yield spread for a higher risk bond investment. However, due to double-digit declines over the past six months, the yield spread of HYG widened by 66% to over 5%. With the 10-year U.S. Treasury bond now yielding near 3%, an investor buying HYG today gets a yield of over 8.5% compared to 4.2% at the beginning of 2022. Higher quality investment grade corporate bonds now yield 4.7% compared to 2.3% at the beginning of the year.



Since bond yields have reset much higher, fixed income investors can now receive much more attractive yields than just six months ago. The next chart shows how bond yields across fixed income sectors are now closer to the high end of the trailing 10-year yield range. Emerging market debt yields are trading at the highest levels of the past 10-years. All fixed income sectors are now above the 10-year median yield by a wide margin. Of course, with annualized inflation levels currently above 8%, real yields for most bonds are still in negative territory but the yield from fixed income assets is double the level it was just six months ago and makes bonds a much more attractive investment option for income biased investors.



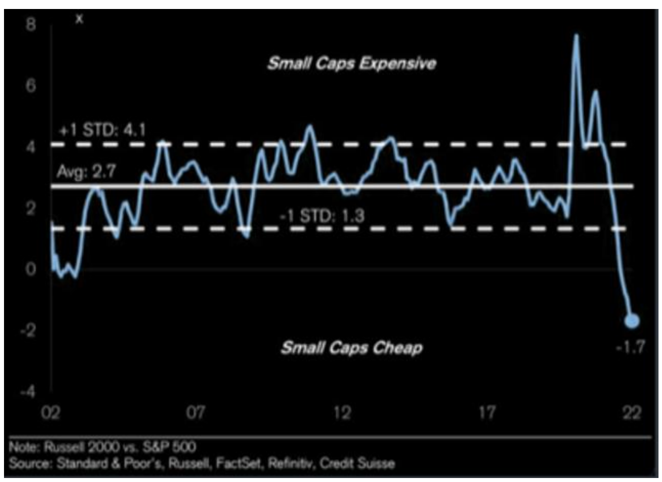
Source: Bloomberg, FactSet, J.P. Morgan Credit Research, J.P. Morgan Asset Management. Indices used are Bloomberg except for emerging market debt

Even after a big storm, most boat owners eventually go back on the water. Long-term investors should be no different because during periods of high market volatility and large negative returns, better future return opportunities are created. During down market cycles like the one we are currently in, investors begin to seek safer or more defensive investments and capitulate and sell higher risk assets. Low liquidity exacerbates the downside market moves in less liquid parts of financial markets as well. A good example is small cap stocks. Small cap stocks are a higher risk segment of the stock market because the companies are typically younger and have less operating history. During strong economic times, small caps generate the biggest returns but they typically decline the most during recessions or financial crises. The latest market decline in the first half of 2022 is no exception. The Russell 2000 Index of small caps stocks declined 23.4% during the first six months this year compared to the -20.0% return of the S&P 500 Index, an index which captures the 500 largest and more established companies trading on the U.S. stock market. In addition, small caps also lagged large caps by nearly 14% in 2021, indicating that investors were reducing exposure to higher risk assets and getting more defensive well in advance of this year’s broad market declines. The Russell 2000 Index of small cap stocks peaked in early November 2021, two months before the S&P 500 Index peaked in early January 2022.

Once the investors who can’t stomach the price declines and higher volatility capitulate and sell out, a better risk/reward setup gets created for more opportunistic investors. However, the best setup for making higher future returns often occurs when uncertainty levels are the highest and it feels the most uncomfortable to invest capital in higher risk assets. Nathan Rothschild, a 19th-century British financier and member of the Rothschild banking family, is credited with saying that "the time to buy is when there's blood in the streets.". During his lifetime it implied buying during revolutions but in today’s world it means bold investors buy after markets experience outsized declines, the average investor capitulates, and sentiment becomes very negative. When economic headline news seems terrible or the level of discomfort with investing is the highest is often the time when investors who invest in higher risk assets get rewarded with the highest future returns.

One of the important prerequisites for earning higher future returns is attractive starting valuations. The next chart plots a relative valuation comparison of the Russell 2000 Index (small caps) vs. the S&P 500 Index (large caps) going back to 2002. The data shows that small caps have not traded this cheap relative to large caps going for 20 years and by a significant degree. When the line is high, it means small cap valuations are expensive relative to large caps and it would be prudent to reduce exposure. When the line is towards the bottom of the chart, it means small cap valuations are cheap relative to large cap valuations, and an opportunistic investor should take advantage and put more cash to work in small caps or rotate some capital out of large cap stocks towards small cap stocks.

Similar to the first half of 2022, 2002 and 2008 were also bear markets and small caps experienced large negative returns. In times of market stress like the past six months, investors typically sell regardless of valuations because they just want to avoid the pain of more losses. The excessive selling creates cheaper valuations, which greatly improve future return opportunities. Such is the case today for U.S. small cap stocks. There are other higher risk areas of global financial markets that have much improved future return prospects given the magnitude of the declines in financial assets across the world including emerging markets stocks, emerging markets debt, and U.S. high yield bonds.

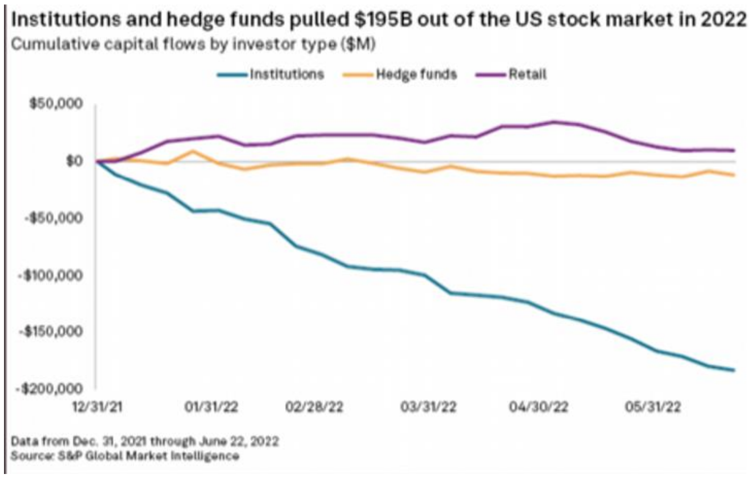


However, perfectly timing a stock market bottom is an impossible task, often referred to as trying to catch a falling knife. Even if valuations are reasonable, it is possible an investor may incur more negative returns before markets stabilize and eventually head higher. For the stock market to stop feeling like being on a boat ride in rough waters, investors need to have conviction that the U.S. economic outlook is stable and future corporate earnings are not going to get worse. In today's investment environment, they also want to see inflation rates start moving lower and the Fed back off of its aggressive rate hike bias.

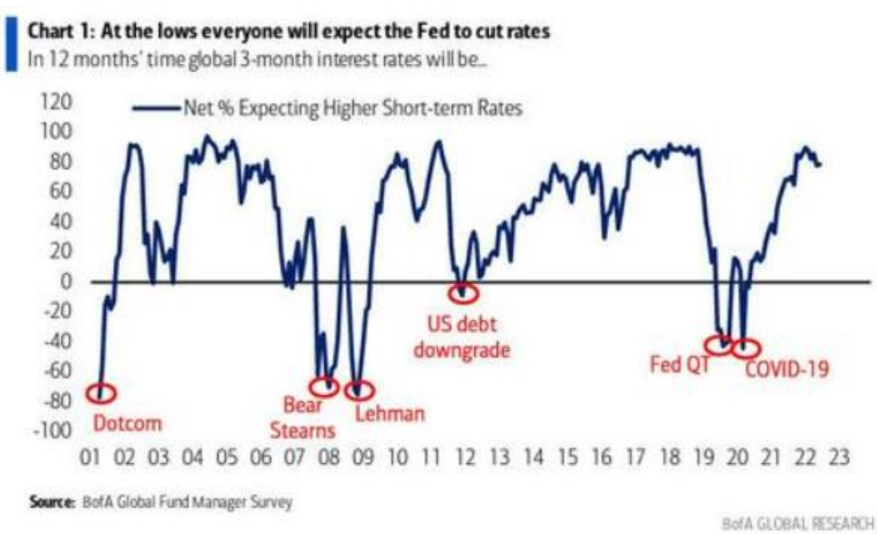
In addition, corporate earnings estimates don't necessarily need to go up, they just need to stop going down. As the U.S. economic slowdown has become more pronounced in recent weeks, it is unlikely that U.S. corporate earnings estimates have bottomed yet. The following chart shows the S&P 500 Index earnings revision breadth, a calculation of positive earnings revisions compared to negative earnings revisions. When analysts are raising their future earnings estimates, it means expectations of future profits are improving and it is a good omen for the stock market. Unfortunately, the opposite scenario is occurring right now as more Wall Street research analysts are cutting earnings estimates than they are raising them. Positive earnings revision breadth peaked in June 2021 and has been heading lower since and recently turned negative. Today, S&P 500 Index earnings estimates for 2023 are nearly 10% higher than for 2022. If the U.S. economy continues to slow or falls into a recession, there will more negative earnings revisions for both years in the months ahead, which will be a headwind to the stock market moving higher. The majority of the stock market decline to date has been related to valuation compression brought on by higher future interest rate expectations. The next phase of the stock market will be about how much companies guide revenues and earnings lower and how much Wall Street research analysts cut forward earnings estimates and company stock price targets. The next six weeks will provide more clarity in this regard but even before the end of June a number of companies were negatively pre-announcing earnings guidance for the remainder of 2022 given slowing economic activity and rising costs.

Another important aspect of finding a true bottom for the stock market relates to retail investor capitulation. Unlike bond funds, which have seen $200 billion of withdrawals year to date (remember, bond returns are the worst in 50 years), retail investors have yet to fully abandon stocks. The next chart shows the three main categories of investors and the year to date asset flows in U.S. stocks for each. Retail investors didn’t seem to hear the storm warning announcement as institutional and hedge fund investors have been selling and retail investors keep buying.

This is a good example of behavioral finance as retail investors are usually the last in and the last out. They often chase returns and put money into stock or bond funds after returns have already been quite positive and they usually pull money out of stock or bond funds after returns have become very negative and the boat is listing. In all likelihood, once many retail investors read their 6/30/22 401k statements, the U.S. stock market may experience additional headwinds in the second half of 2022 as retail investors finally start to pull money from stock funds. During periods of ugly returns, mutual fund companies start heavily promoting the benefits of maintaining a long-term perspective, an attempt to stop retail investors from doing what they do best: selling low and buying high. Once asset flow data shows retail investors are withdrawing funds and have much lower exposure to stocks, it will be a sign that sentiment towards stocks is more fully negative and a positive sign for future stock market performance.



Another important component to the stock market finding a bottom is when the expectations of professional money managers about future interest rate increases is low. Today, the opposite setup is in place. The next chart shows a recent Bank Of America survey of global money managers and their expectations of future interest rate cuts. Because inflation levels today are at historical highs, more professional money managers expect the Fed to raise interest rates than to lower interest rates. The BofA survey has 20 years of data history and shows the stock market typically bottoms out when the net number of professional money managers expecting the Fed to raise interest rates hits a low. For example, during the Global Financial Crisis, when Bear Stearns and Lehman Brothers went bankrupt, and financial markets were in a free fall, the survey showed the lowest net number of professional money managers thought interest rates would be higher in 12 months. Historically, the Fed cuts interest rates during difficult economic times to stimulate the economy. However, with inflation is at its highest level in over 40 years, it much more difficult today to make that call even as the risk of a recession has increased. As a result, the most recent survey indicates that more professional money managers believe the Fed will raise interest rates than cut interest rates. If inflation data wanes and more investors believe the Fed has less pressure to raise interest rates, the line in the chart can quickly fall like it has done in the past when uncertainty levels were elevated.



Summary

Boating is a great summertime activity but only when the winds cooperate. Boating can turn into a much less enjoyable experience if one ignores the weather forecast and gets caught on the water when the wind picks up and the waves get bigger. Investing over the long run is usually an enjoyable experience too due to the power of compounding returns and its positive impact on wealth creation. However, like in boating, there will always be periodic investment storms to deal with, some of which come about unexpectedly and can be severe. Investors who can weather financial markets storm and maintain a long-term investment outlook will eventually be rewarded with higher future returns. That being said, until the inflation outlook improves and the Fed backs off of its aggressive interest rate hiking pace, choppy seas will remain in the investment forecast. Pack the Dramamine in case its needed.

Mark J. Majka, CFA
Chief Investment Officer

July 7, 2022

IMPORTANT DISCLAIMER: