MJM INVESTMENT ADVISORS, LLC

Third Quarter 2017 Financial Markets Review

- Broad based global growth, easy financial conditions, and historically low financial market volatility helped risk assets continue to generate positive returns during the third quarter. No amount of hurricanes, geopolitical risk, or a very public Donald Trump / Kim Jong-un tit for tat could knock the move higher off course.
- The Federal Reserve kept interest rates at current levels but formally announced the start of its balance sheet reduction program that has pumped $3.5 trillion of liquidity into the U.S. economy over the past nine years. QE withdrawal will start in October but be very deliberate to start. The Fed also telegraphed that its next rate hike would most likely come at its December meeting.
- The S&P 500 Index gained 4.5% during the third quarter and has now returned 14.2% during the first nine months of 2017, exceeding 2016 full-year results. Growth stocks continue to outperform value stocks by a wide margin. The tech sector leads the market with a 26% return with healthcare in second with a nearly 20% gain.
- Small cap stocks roared back to life in September after lagging large cap stocks by wide margin all year. Prospects for lower corporate tax rates under Trump's proposed tax plan were the main catalyst. The Russell 2000 Index returned 5.7% for the third quarter and is now up a respectable 10.9% year to date although still lagging large caps year to date by 3.3%.
- Foreign stock markets continued to produce strong results during the third quarter and continue to outperform U.S. stocks year to date. Developed markets international stock returns as measured by the MSCI EAFE Index returned 5.4% for the third quarter and are now up 20% year to date. The MSCI Emerging Markets Index continued its torrid pace during the quarter with a 7.9% return and is up nearly 28% year to date.
- The U.S. dollar weakening trend continued during the third quarter. Stronger foreign currencies provided a tailwind to international stock returns for U.S. based investors and have been an important contributor to their outperformance this year, especially emerging markets.
- The bond market remains mired in a low yield environment. Given the robust performance of stocks, bond investors are not exhibiting the same confidence in the economy or yields would be much higher. Instead, the U.S. Treasury 10-year bond yield finished the quarter at 2.33%, barely changed from the end of last quarter. The broad fixed income benchmark Bloomberg Barclays Aggregate Index returned a modest 0.8% for the quarter and only 3.1% year to date. High yield bonds had a fairly muted quarter as well, returning 2.0%.
- Oil prices rallied nearly 10% during the third quarter, helped by the continued weakening of the U.S. dollar and from production disruptions caused by Hurricane Harvey. However, the West Texas Intermediate Crude benchmark oil price is still slightly below where it began the year.
- The following table shows key market benchmarks as of September 30, 2017. It has been a significantly positive year to date for risk assets.

	Third Quarter		2017 Year to Date		2016	
S&P 500 Index (U.S. large cap stocks)	4.5%	↑	14.2%	↑↑↑	12.0%	↑↑↑
Russell 2000 Index (U.S. small cap stocks)	5.7%	↑↑	10.9%	↑↑↑	21.3%	↑↑↑
MSCI EAFE Index (large cap int'l stocks)	5.4%	↑↑	20.0%	↑↑↑	1.0%	↑
MSCI EM Index (emerging markets stocks)	7.9%	↑↑	27.8%	↑↑↑	11.2%	↑↑↑
Bloomberg Barclays Aggregate Bond (invt. grade bonds)	0.8%	↑	3.1%	↑	2.7%	↑
Bloomberg Barclays High Yield (below invt. grade bonds)	2.0%	↑	7.0%	↑↑	17.1%	↑↑↑
Bloomberg Barclays Short-term Treasury (cash)	0.3%	←→	0.6%	←→	0.5%	←→
Gold	5.4%	↑	13.7%	↑↑↑	8.6%	↑↑
WTI Oil	9.7%	↑↑	-1.1%	↓↓	44.8%	↑↑↑
Morningstar Balanced Funds Average	3.1%	↑	9.4%	↑↑	7.3%	↑↑

Fourth Quarter Investment Outlook

Inflection Point

"It's almost an embarrassment be an American citizen traveling around the world and listening to the stupid shit we have to deal with in this country and at one point we have to get our act together. We won't do what were supposed to for the average American."

- Jamie Dimon – CEO J.P. Morgan

"If one is going to invest in times like this, investment professionalism – knowing how to bear risk intelligently, striving for return while keeping an eagle-eye on potential adverse consequences – is the absolute sine qua non."

- Howard Marks – CEO Oaktree Capital Management

"In October, the Committee will initiate the balance sheet normalization program described in the June 2017 Addendum to the Committee's Policy Normalization Principles and Plans."

- The Federal Reserve – FOMC press release from September 20, 2017

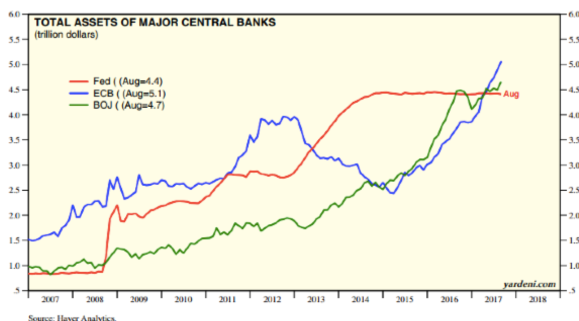
It's been a great run since March 9, 2009. On that day, the S&P 500 Index bottomed at 666 (you can't make this stuff up) and the recovery rally began. It's now 8½ years later and U.S. stocks have gone up by 275% from the market low point. Back then, every investor was experiencing shell shock and hiding out in a bunker, scared to take any risk and hoping the pain of investment losses and ear ringing would end soon. Today, the stock market is at an all-time high and investors everywhere are supremely confident that stocks will continue to rise. Interest rates remain at historically low levels and financial markets volatility for both stocks and bonds are also at historical lows. Everything is Peaches and Cream. We've recovered and it feels so good.

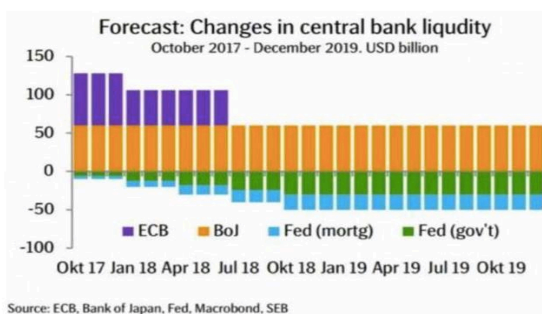
At the same time, the U.S. train is stuck at Dysfunction Junction. Jamie Dimon, CEO of J.P. Morgan, summed it up nicely on his last conference call to investors. It's rare to hear a public company CEO express such strong language in a public venue on the state of affairs in America but the facts bear him out. Economic growth over the past 8½ years has remained weak compared to past recoveries and income inequality is a record levels. The Federal government debt exceeds $20 trillion with no end in sight to budget deficits or political rancor. American society is heavily divided and it feels like we are back in 1968 at the height of the Vietnam War and race riots. Geopolitical tensions are high and there is a resurgence of nationalism globally. Just don't ask the stock market about any of this. It prefers the Sergeant Shultz of Hogan's Heroes approach to life. " I know nothing!".

As good as it feels to most investors whose financial assets have recovered and are at the highest levels of their lifetime, savvy market veterans are increasingly cautious. Yes, calling the top is a fool's game and in this era of central bank largesse it has been a career killer. But, the signs of market excesses are there if you want to look for them. Howard Marks of Oaktree Capital is one of the most respected investors on the planet and his sage advice is worth the attention of every investor.

We may be close to hitting the Inflection Point. Stocks have defied so many historical precedents in 2017 that the "this time is different" crowd is getting bigger by the day. The U.S. stock market has now gone 460 calendar days (at 9/30/17) without a 5% market correction, the longest such streak since 1996. Except for a brief flare-up in August, stock market volatility has remained near historical lows for most of 2017. While the present setup has been hugely beneficial to anyone invested in risk assets, we come back to one fact that is undeniable. Major support for this extended market advance over the past 8½ years has been due to extreme central bank policies such as Quantitative Easing (QE) where central banks buy bonds (the Bank of Japan and the Swiss Central Bank are buying stocks too) in the open market to increase liquidity and drive down long-term interest rates. By keeping an artificial lid on bond yields, the lower interest rate environment causes the present value of stocks to be higher than normal, pushing PE multiples ever higher. It also creates artificial demand for stocks, as the dividend yields on many blue chip stocks are higher today than the yields on U.S. Treasury bonds, forcing income biased investors to hold more stocks in their portfolios than in the past. Buy the dip (BTFD) has become the investing mantra of these unusual times.

The inflection point may now be upon us as the Fed announced at its June 2017 meeting that it was planning to start reducing its balance sheet of bond holdings from QE. The left side chart below shows how the Fed's bond holdings ballooned to $4.5 trillion today from $800 billion before the Great Financial Crisis hit. The ECB and BOJ also have made aggressive use of QE as well, now exceeding the size of the Fed's QE program. At its September 2017 meeting the Fed formally announced it would begin the QE reduction program in October 2017 with an initial 12-month target of $600 billion. The Fed is the first major central bank to announce the start of the withdrawal of QE (now called QT or Quantitative Tightening). The right side chart below shows how the Fed's bond reductions (in light blue) will start to reduce global central bank liquidity support out to the end of 2019. The ECB has suggested its QT will begin in mid-2018. Overall, the reduction of liquidity support by central banks represents an important inflection point as central bank liquidity has been a significant factor supporting the large move higher for risk assets since March 2009.





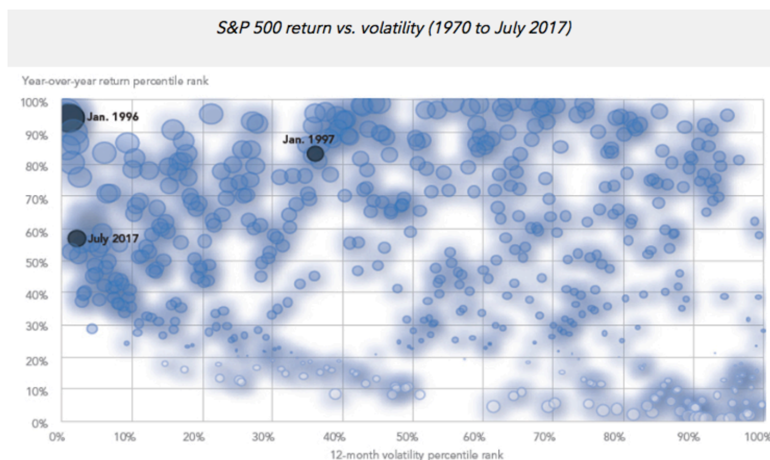
One key goal of QE was to get economies out of deflationary trends. That goal has failed, as global inflation has been benign throughout this whole period following the GFC. Should inflation finally begin to gain some traction, central banks (make no mistake, they would love to see it happen) would have a green light to remove liquidity support more quickly and increase short-term interest rates at a faster pace

or reduce bond holdings more quickly. Either way, both outcomes would not be good for financial assets whose valuations have grown heavily dependent on central bank support to justify current valuation levels.

The Best of Both Worlds

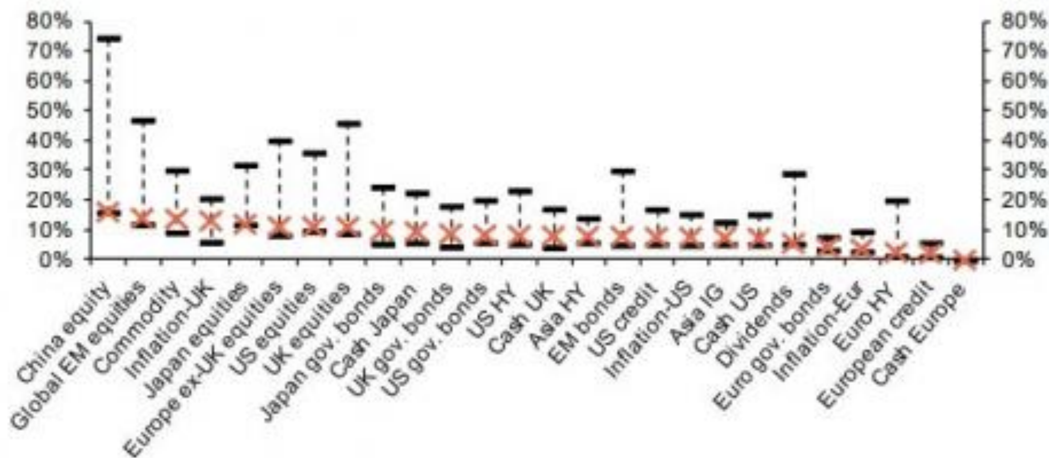
It is human nature to believe that present conditions, especially those in place for an extended period of time, will continue into the future and have become the new norm. Recall your own thoughts back in the fall of 2008 when the financial system was imploding, the economy was tanking, and the stock market was crashing. Many investors saw their IRA and 401k balances plummet and extrapolated those conditions at the time as the new norm and made some poor investment decisions as a result. A similar argument can be made today but in the opposite way. We are now going through an unprecedented streak of strong returns combined with low volatility for financial assets such that investors are now extrapolating these conditions as the new norm.

The graph below shows how rare the current conditions for volatility are over the past 47 years. The chart plots 12-month returns and volatility by percentile rank from 1970 to July 2017. The chart shows the July 2017 observation on the far left with 12-month volatility falling in the 2nd lowest percentile while 12-month returns are in the 58th percentile. In other words, investors are getting strong returns with extremely low volatility or a best of both worlds scenario. January 1996 (upper left hand corner) was nirvana for investors with 12-month returns at the top of that 47-year history while volatility was also at all-time lows. At that time, the Federal government went into a surplus budget situation and real GDP growth was 3.8%. For the next three years (1997-1999) real GDP growth exceeded 4%. There was something called the Internet that was starting to take off at that time and the Contract With America program brought on by New Gingrich and Republican majority significantly slowed down Federal spending. Today, the Federal government has over $20 trillion of debt and constantly runs a budget deficit. Real GDP growth has struggled to exceed 2% for the past eight years despite the Fed implementing a massive QE program and keeping interest rates near zero the entire time. Hmmmmmm. Any connection stick out to you there?



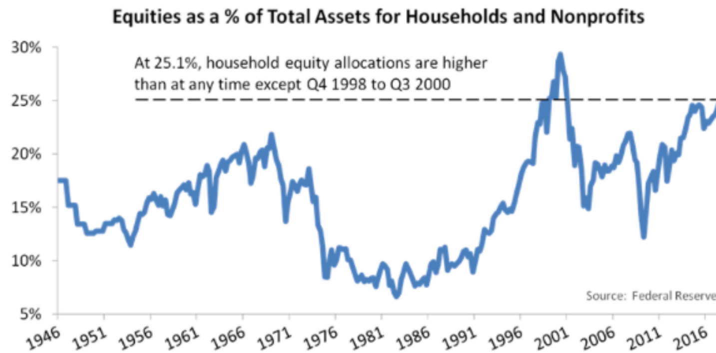
Source: Haver Analytics, MSCI, Fidelity

This rare, low volatility world is not just a U.S. only phenomenon. Because most of the major world central banks have engaged in QE programs, global asset prices everywhere are experiencing low volatility. The next chart shows how virtually all major asset classes today have volatility readings at the low end of their multi-decade historical ranges. The orange X for each asset class is the current volatility reading plotted against the historical max and min reading for each asset class between 1994 and 2017.



It would be wise to question whether the current world of high returns and low volatility will continue given that present conditions are very rare. If present conditions don't continue, how can an investor position a portfolio to be better prepared for a world of higher volatility with the strong possibility of lower returns? Most investors don't have an answer to this question.

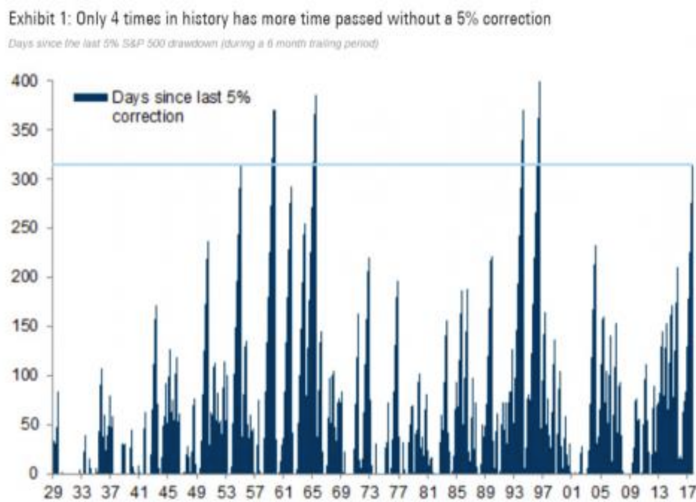
The next chart shows that U.S. households love the current low risk/high returns (who wouldn't?) being earned on their investments and have the highest allocation to stocks at anytime going back to 1946 except for the Tech Bubble window of 1998-2000.



The message of the previous chart is supported by the next chart below, which shows a survey of consumers in terms of their future expectations for higher stock returns. A record percentage (55%) of consumers expect stock prices to rise in the future, the highest reading going back to 1987. With 2017 set to become the 9th straight year of positive returns for the S&P 500 Index, it is not surprising that most Americans views stocks in a positive light and are extremely confident this trend will continue. The memories of 2008 have faded into oblivion. Time heals all wounds.

Rare Air

Periodic corrections are a standard part of the risk of investing in the stock market but it is very rare to go over 300 days without a 5% stock market correction, which is the present state of the U.S. stock market. Going back to 1929 or 88 years, there have been only 4 other times where the stock market has gone longer without a 5% correction. It has been 21 years since the last time the stock market has found itself in a similar situation. If the current run without a 5% correction extends as long as the other four occurrences, then U.S. stocks could continue without a 5% correction through the end of 2017. The Fed raising rates in December combined with the potential failure of Trump's proposed tax plan could be the setup for such a correction. Also, Janet Yellen's term as Fed Chair is expected to end by February.

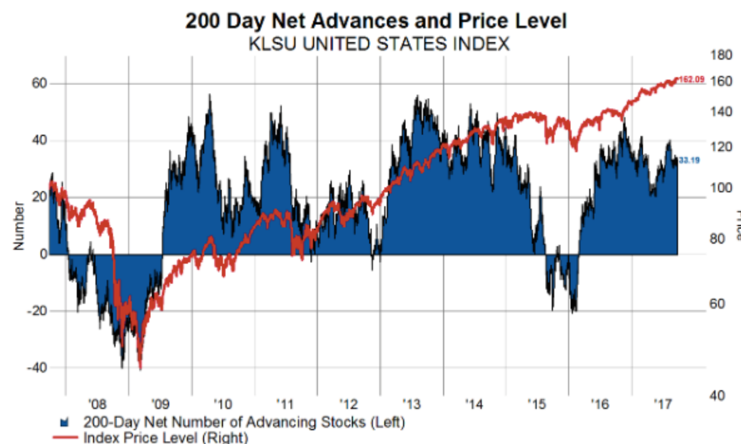


Source: Goldman Sachs

The next chart shows there have been very few meaningful drawdowns for U.S. stocks for the past four years. The last major one was in late December 2015 / early 2016 when stocks declined around 13% into early February but then quickly recovered and ended up in positive territory for the first quarter of 2016. Since then, there has been another six straight quarters of positive U.S. stock returns with barely any drawdowns over this time period.

Fewer Stocks Supporting the Advance

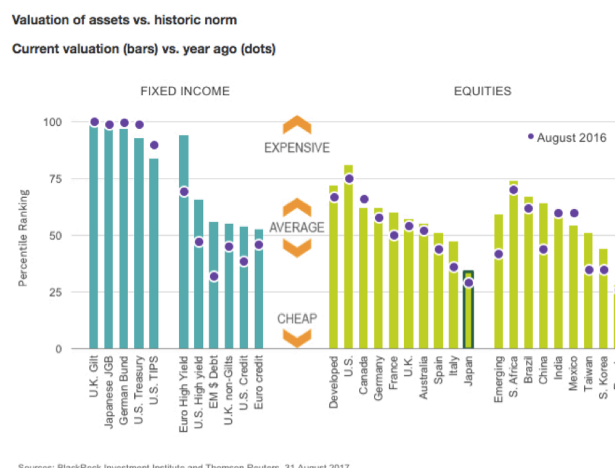
In stocks, there are fundamental factors such as PE multiples and there are also technical factors that capture the price movements and trends of the stock market. More stocks seeing price increases than decreases would define a healthy stock market advance as it means more stocks are participating in the rally. The blue area in the next chart shows the number of net advancing stocks, or simply the number of stocks trading higher now compared to 200 days ago minus the number of stocks trading lower now compared to 200 days ago. Since the last large pullback in U.S. stocks during the first 40 days of 2016, stocks with price increases exceeded stocks moving lower by a wide margin for the remainder of 2016 and after Trump's election. The blue area of the chart peaked most recently in December 2016. 2017 is a different story. Even though the broad market has continued to advance another 14%, a fewer number of stocks are participating in the market move higher this year.



Source: Knowledge Leaders

Nothing's On Sale

Who doesn't likes a good deal no matter what product you are buying? Unfortunately, if you are buying broad market index products then you are not getting a good deal at all. The next chart below shows different categories of investments with fixed income on the left and equities (stocks) on the right. The chart shows the current valuation of each asset class as of 8/31/17 compared to its historical percentile ranking and also plots the year ago valuation for each asset class (purple dot in each column). For example, the U.S. stock market is now in the 80th percentile of its valuation history, more expensive than one year ago. In other words, U.S. stocks have only been more expensive 20% of the time in history. Government bonds (far left) are even worse with most trading at all-time high valuations. Finding cheap assets to buy is a difficult endeavor. What has effectively happened is that all the QE programs the major central banks implemented did very little to help global economic growth and most of that liquidity ended up in global financial assets. High current valuations across all major asset classes means that future return expectations should be lower as a result.



Summary

We are in one of the longest bull market runs for stocks in recent history and every investor feels great when their portfolio balances are at all-time highs. Investor euphoria is compounded by the fact that volatility is running at extremely low levels at the same time. Investors are earning great returns with low volatility. What's not to like about that? Absolutely nothing. Enjoy it while it lasts. Just remember that financial markets are in very rare territory and the probability of this environment continuing is extremely low. Today's high valuation levels for most asset classes virtually guarantees that future returns looking out the next 7-10 years will be lower. With the Fed set to begin QT, the inflection point may now be upon us and a reversion to the mean process may unfold in the years ahead, meaning a lower return and higher volatility investment environment across most asset classes. It will be a different world, or a return to the old world, depending on your point of view and investment experience. Just be prepared. Be very prepared.

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