MJM INVESTMENT ADVISORS, INC.

Fourth Quarter 2022 Investment Outlook

Goodbye TINA, Hello TARA!

"Price stability is the responsibility of the Federal Reserve and serves as the bedrock of our economy. Without price stability, the economy does not work for anyone."

– Jerome Powell – Chair, U.S. Federal Reserve

"There are few good asset allocation choices against this backdrop…...the repricing has been far larger in bonds, and we believe Western central banks will stay the course in tackling inflation, regardless of how poor growth is."

– Ajay Rajadhyaksha – Barclays Capital

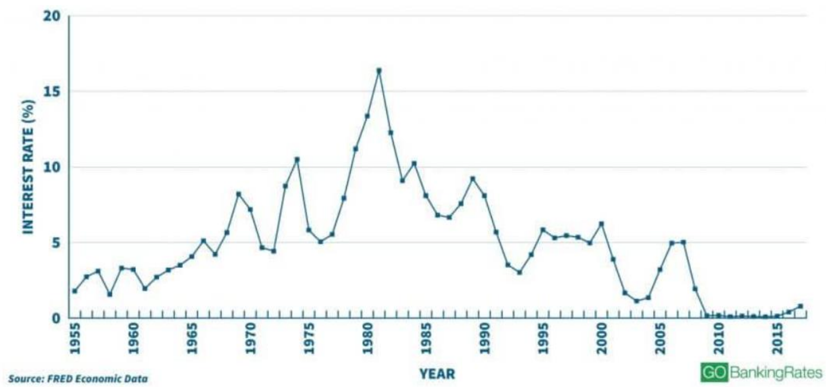
She's my best friend's girl, but she used to be mine.

– The Cars – Best Friend's Girl

It was October 1979 when I attended my first concert and saw The Cars in Buffalo, NY. Their debut album The Cars ended up a six times platinum LP and launched the Boston band into SiriusXM First Wave classic alternative history. As a 10th grader I was still oblivious about many things including the economy. It was a time of high inflation and a three year recession was about to start. The nasty double-dip recession ran from 1980-1982 or the entirety of my high school years. It was a simpler time, working at Burger King and riding my 10-speed bike home at midnight after the closing shift. Due to high inflation, New York State raised the minimum wage from $2.65/hour to $2.90/hour and so I was getting paid more for doing the same thing and that was pretty sweet. Plus, I was also acquiring important skills such as placing frozen burger patties on the broiler conveyor belt (flipping burgers was for the losers working at McDonald's), cleaning out cooking oil in the deep fryers, and calculating proper change in my head at the drive-thru window. Employees got 50% off their break orders, a fringe bene I banked on every shift. Have It Your Way, that's what I'm talking about!

My good friend Lip drove to the concert since the rest of us at age 15 didn't have our driving permits yet. We probably should have thought more about the hidden risks of a high inflation instead of finding a free parking spot in downtown Buffalo because when we returned to his parent's car later the passenger front window was smashed out. Someone had pilfered the inside looking for money while we were rocking out to You're All I've Got Tonight in the Buffalo Memorial Auditorium. Even though it was only early October, it was already very cold at night (global warming? Ha!) and we drove back home with the inside of the car strewn with broken glass and the radio blaring, Moving In Stereo with the passenger window open as we Let The Good Times Roll. The wind chill coming through the passenger window felt like 5 degrees traveling at 60 mph (Lip Can't Drive 55!-oh wait, that's Sammy Hagar) even with the heater on full blast. Next to me trying to keep each other warm was my girlfriend and it was Just What I Needed. Alas, our rock-n-roll love story didn't last long as it was Bye Bye Love shortly thereafter. Don't Cha Stop became my official 10th grade theme song for finding another girlfriend, preferably one wearing Love's Baby Soft.

In 1979, Paul Volcker was the 6'7" stogie smoking Chairman of the U.S. Federal Reserve ("Fed"). The Fed was hiking interest rates aggressively to break inflation, but in doing so was causing serious damage to the U.S. economy. As shown in the next chart, starting in 1977, the Volcker led Fed aggressively increased interest rates, which more than tripled from 5% to an eventual peak of 16% by early 1981. Inflation was over 13% in 1979, propelled higher starting in the mid-1970's by soaring energy prices, and Volcker was determined to crush it. Sound familiar? The only way to break inflation was to aggressively increase interest rates, which ultimately caused a deep recession lasting several years. We didn't know it yet but it marked the end of the steel industry in Buffalo NY, which sent the local economy into a long and difficult decline. The 1980 recession combined with high inflation cost Jimmy Carter the 1980 election and started the Reagan Revolution.

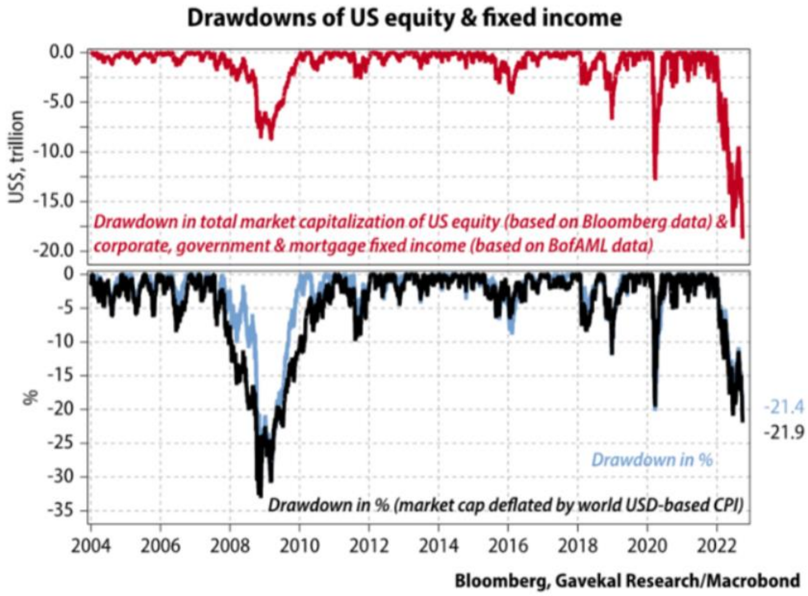


Since 2008, when the Fed under then Chairman Ben Bernanke started its Zero Interest Rate Policy (ZIRP) and Quantitative Easing (QE) programs in response to the Global Financial Crisis, global investors have lived in a world where ultra-low interest rates had become the accepted norm. Conservative investments such as cash and bonds offered minimal return opportunities and higher risk assets became the forced option to earn decent returns. The past 13 years became known as the TINA era, There Is No Alternative. TINA referred to the fact that cash paid 0% and bond yields were at such minimal levels that cash and fixed income were unattractive investment options for most investors. The Fed's ultra-accommodative policies supported risk taking such that investors holding higher risk assets rarely experienced large drawdowns for any length of time. In fact, any time financial markets had a sizable pullback, the Fed and other central banks were overly willing to quickly adjust policies to bail investors out. This support became known as the Fed put and was a major contributing factor to strong investment returns in the decade ending 12/31/21.

In the crazy, upside down world that existed during the TINA era, an income biased investor could own the Vanguard High Dividend Yield ETF (VYM), a basket of blue chip, high dividend yield stocks with a dividend yield of nearly 3%, double the yield level available from owning a 10-year U.S. Treasury bond. Historically speaking, the yield relationship between bonds and dividend yielding stocks was flipped on its head. Not only did bonds offer much lower yields than a basket of blue chips stocks but the interest rate risk of longer maturity bonds increased as bond yields declined. Low yields and high interest rate risk was not a compelling risk/reward setup for bonds. By virtue of the market distortions created by the Fed and other central banks, TINA meant most investors had the highest exposure to stocks and the riskiest bonds right in front of the worst financial markets declines since 2008.

The next chart shows how the Fed's misguided policy decisions impacted investor behavior. Back in 2008 at the start of the Global Financial Crisis and when interest rates were more "normal", the average U.S. household had an allocation of around 30% to stocks. As the Fed maintained ZIRP for the majority of the next 13 years, the average household allocation to equities rose steadily and eventually went over 50% by the end of 2021. The main reason this happened is that most investors were reducing cash and bond holdings because they couldn't make decent returns on those investments and put more money into stocks as the stock market was generating higher returns. Stocks were helped substantially by the Fed maintaining low interest rates, much to the detriment of bonds and cash. The last time investor allocations to stocks hit a similarly high level was at the peak of the Tech bubble during 1999/2000. From 2000 to 2002, the U.S. stock market had three consecutive years of negative returns and a total cumulative decline of -37.6%. History seems to be repeating now as investor allocations to stocks peaked again at 50% and the stock market has declined 25% so far in 2022.

Similar to what happened in the late 1970's, the Fed earlier this year was forced to end its ZIRP and aggressively raise interest rates due to persistent and elevated levels of inflation. The U.S. financial market, accustomed to the Fed being overly accommodative since 2008, was shocked into reality as the Fed has raised interest rates by 3.00% so far in 2022 with plans to increase interest rates two more times by the end of the year. This dramatic shift in interest rate policy has forced a major reset in financial asset valuations and investor expectations. The next chart shows that the financial asset declines through 9/30/22 have exceeded $15 trillion and are the largest in dollar terms since 2008. On an inflation adjusted basis, the 2008/2009 Global Financial Crisis related market decline is still larger in percentage terms. Concurrent declines for both stocks and bonds in the same year is a very rare event. 2022 is just one of five years in modern history when stocks and bonds were both down simultaneously. Even worse, 2022 is the only year when both stocks and bonds were both down over 10% and is the worst year for a 60/40 balanced portfolio since 1931 during the Great Depression.



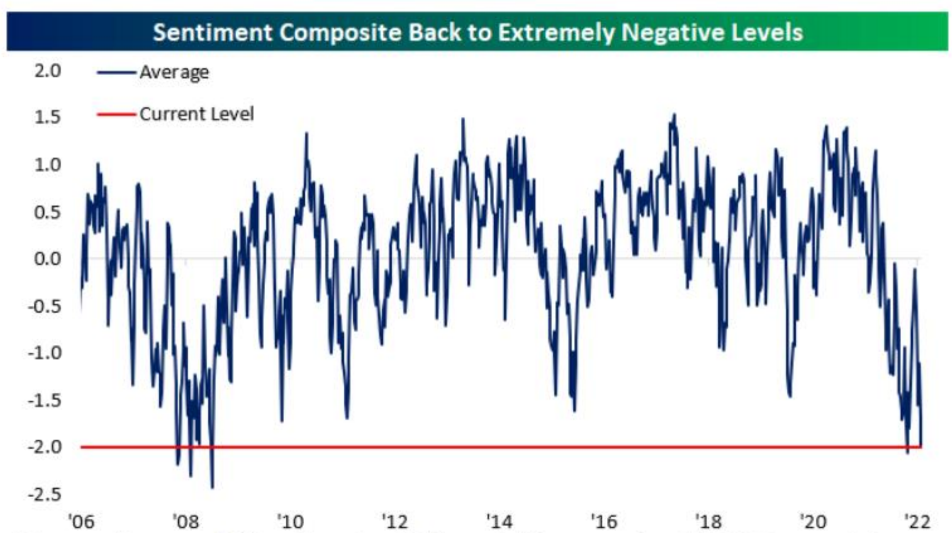
Unfortunately, excessive central bank policies during the TINA era forced investors to hold a higher than normal percentage a riskier assets. This setup has played out in very painful fashion during 2022 for all investors, even those with more conservative asset allocation profiles. Bond yields have surged higher as inflation soared. The 10-year U.S. Treasury yield surged from 1.51% on 1/1/22 to 3.83% on 9/30/22, creating large negative returns for bonds. The Bloomberg Aggregate Bond Index declined nearly 15% year to date through 9/30/22, one of the worst return years for bonds on record. At the same time, international stocks have also had significant declines as other central bank interest rate increases caused economies to slow down, global recession risks to increase, and corporate earnings to decline. The broad U.S. stock market as measured by the Russell 3000 Index declined 25% and the MSCI ACWI Ex US Index of non-U.S. stocks has declined 27% year to date through 9/30/22.

Given the dramatic reversal in the Fed's interest rate policy, the TINA era is now over as cash and bonds offer investors more compelling yields. In addition, the interest rate risk of holding longer maturity bonds has decreased as yields have surged higher. We have started a new investment era, TARA, or There Are Reasonable Alternatives, which heralds a return to a more balanced investment environment. Asset classes that only nine months ago offered investor little to no return opportunities are once again offering attractive alternatives to stocks, especially for income biased investors. As the Fed aggressively increased interest rates, yields on money market funds have soared higher, from 0% at the start of 2022 to just under 3% today and heading to 3.5% by the end of the year. Investment grade bonds, which had yields of under 2% at the start of 2002, now offer yields near 4.5%. Investment grade corporate bonds now yield close to 6% and higher risk bond sectors like emerging markets debt and U.S. corporate high yield now have yields above 9%. Importantly, the yield advantages of bonds and cash over stocks has been restored for income biased investors. TARA has come dancing down the street, in her suede blue eyes, and every new investor TARA meets is pleasantly surprised.

The downside of rapidly rising interest periods like the late 1970s and today is higher interest rates negatively impacts the economy by slowing demand, increasing unemployment, and increasing the odds of a more severe recession. As shown in the following chart of CEO confidence, we can see how the Fed's policy pivot is negatively impacting CEO expectations of the future. CEO confidence was never higher in 2021 and this survey data goes back to 1976. The chart shows that CEO confidence for the next six months ahead has plunged over a short period of time is now at the low end of the survey's history. Low CEO confidence means pauses on hiring and reduced spending and eventually increased layoffs if the economic outlook doesn't improve.

Source: The Conference Board, Goldman Sachs Global Investment Research

Similarly, the sizable declines in both stock and bond markets during 2022 has had a major negative impact on investor sentiment. The next chart shows a composite of two investor sentiment surveys going back to 2006. The latest composite reading is also at the extreme low end of the survey's history. Negative wealth effects cause consumers to tighten household budgets and curtail discretionary spending.

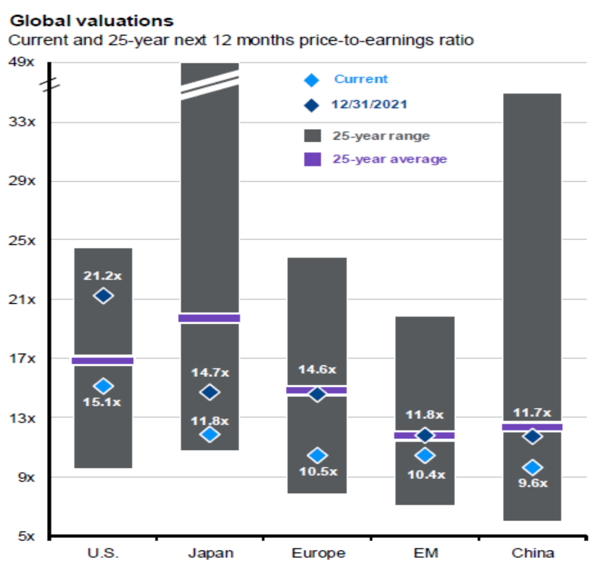


* Average of z-scores of AAII and Investors Intelligence bull-bear spreads and NAAIM Exposure Index.

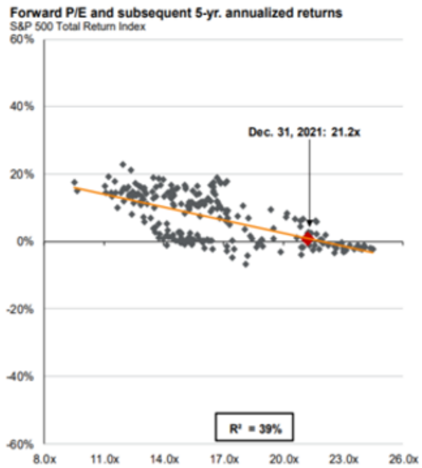
Even as investor and CEO sentiment drops to extreme lows, it may seem odd but it is good time to consider potential positives when things feel the worst. It's analogous to high school and feeling down in the dumps after getting dumped by TINA only to get excited again when TARA stops by your locker to flirt between classes.

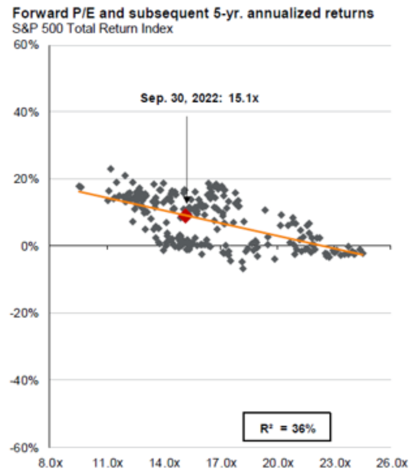
Let's look at asset valuations beginning with stocks. One of the key items discussed in the 2022 Investment Outlook from January was the poor performance of stocks during periods of rising interest rates. Surprisingly, the Fed ended up being much more aggressive in hiking interest rates than investors expected at the beginning of 2022 and the main reason stocks declined 25% through the end of September. The Fed has indicated the interest rate hiking cycle is not over and it intends to increase interest rates several more times by the end of the year. Even if it does, the market has already priced in those future interest rate hikes today. By virtue of large price declines, valuations for all global stocks are now much more attractively priced than they were at the beginning of the year, which bodes well for prospective returns from stocks.

The next chart shows a comparison of the PE (price/earnings) multiples of regional stock markets. The bar for each region shows the last 25-year PE range, the average PE over the 25-year period (purple line), the PE at the end of last year (dark blue diamond) and the current PE (light blue diamond). Each region now has a PE multiple below its 25-year average PE and some regions like Japan and Europe are at the low end of their 25-year history. The major takeaway here is that excessive valuations are no longer a major risk for global stocks.

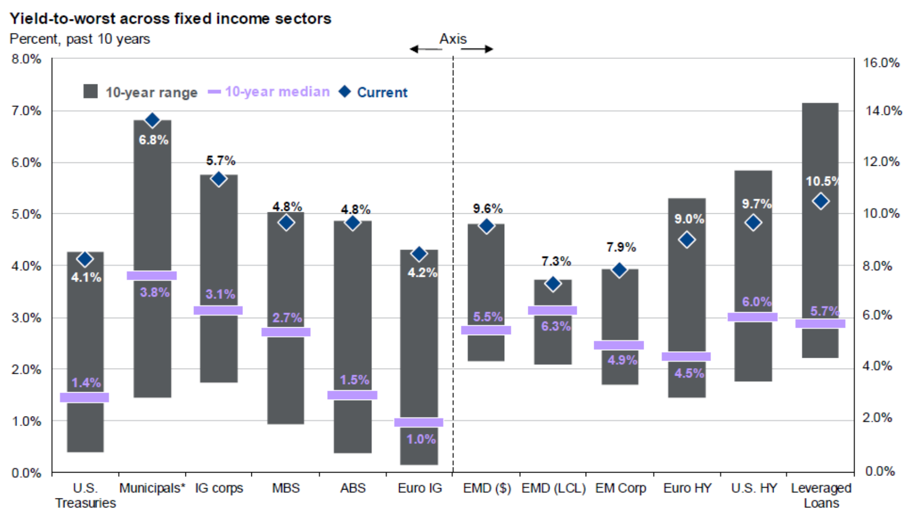


What we know from stock market history is that investors will experience higher future returns when starting valuations are lower. 2022 is a good example to show how this math works. The following two charts are snapshots in time of what investors could expect from future investment returns for the S&P 500 Index. On the left is the snapshot from 12/31/21. At that time, the S&P 500 Index was trading at 21.2X PE multiple. Based on stock market history, at previous times the S&P 500 Index traded at that PE level, the forward 5-year annualized return was close to 0% as reflected in the red dot. The chart on the right is nine months later as of 9/30/22. With the 25% decline in the S&P 500 Index for the first nine months of 2022, the S&P 500 Index PE multiple has declined from 21.2X to 15.1X. During past periods when the S&P 500 Index traded around a 15X PE level, the next 5-year annualized return for the S&P 500 Index was around 10% as indicated by the red dot. In just nine months, stocks went from offering very little prospective return opportunity to now offering a much better prospective return outlook. Note in the chart above that the S&P 500 Index currently has the highest PE multiple and all the other regional stock markets are lower and trading at the bottom end of the 25-year history, offering investors potentially higher prospective return opportunities from non-U.S. stocks over the next five years.





Not only are stock valuations and prospective return opportunities much improved but so are bonds. The next chart compares all major bond sectors and for each one it shows the 10-year yield range, the median yield for the past 10 years (purple line), and the current yield (blue diamond) as of 9/30/22. Let's use U.S. Treasuries as an example. For the past decade, bond yields have been suppressed by central bank ZIRP and QE. The chart shows the median yield of U.S. Treasuries the past 10 years was a meager 1.4%. Today, U.S. Treasuries yield 4.1%, the highest level of the past decade. The same is true for other bond sectors as well. Investment grade corporates yield 5.7%, emerging markets U.S. dollar based debt yield 9.6%, and U.S. Corporate High Yield bonds yield 9.7%. These levels of bond yields haven't existed in a long time and now offer investors, especially income biased investors, more attractive yields and total return potential compared to just nine months ago.



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

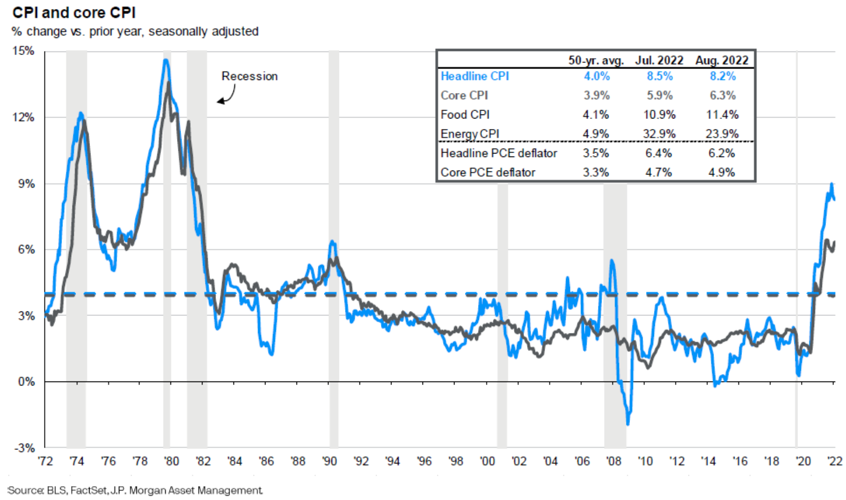
It is true that these more attractive prospective return opportunities now exist because investors have absorbed outsized declines in 2022 across all asset classes except cash. However, at the end of 2021, investors had also earned outsized returns for the prior five years and despite a C-19 pandemic that crushed the world economy. The table below shows how the trailing 5-year annualized returns of major financial assets changed dramatically in just nine months.

	Five Years Ending 12/31/21	**Five Years Ending 9/30/22**
Stocks	18.0%	8.5%
Bonds	3.6%	-0.3%
60/40 Balanced	12.2%	4.3%

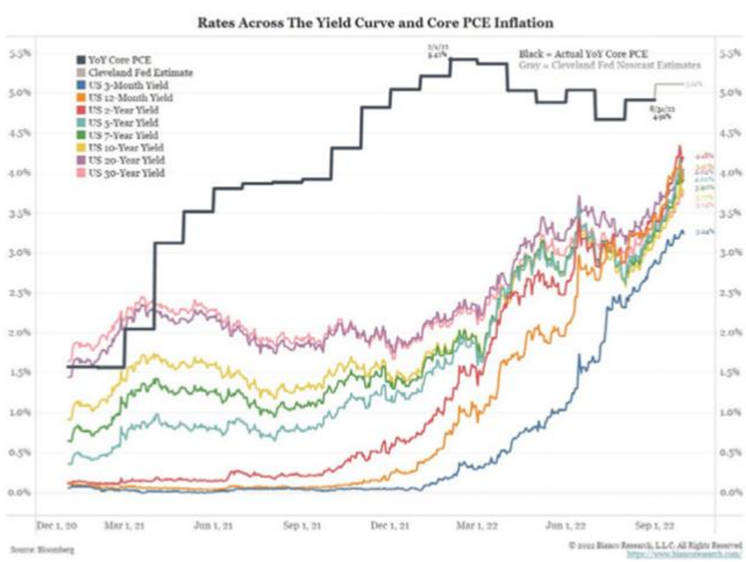
Investing is not a one way street of positive returns and it is completely normal (and healthy) to have periods of negative returns. In fact, extended periods of strong positive returns and shallow declines are often created by misguided policies, whether fiscal or monetary. Since 2008, recessions have been mild and short because of the interventionist policies of central banks. These policies created even bigger bubbles and distortions because financial markets lost their important risk clearing mechanisms and excessive risk takers didn’t get punished the way they did in the past. This was clearly evident in 2021 when IPO issuance soared and meme stock trading became all the rage. Bitcoin soared to $65,000 and people were buying Non Fungible Tokens of ape cartoon characters for over $1,00,000. Matt Damon was on a Super Bowl ad for a crypto company telling viewers that fortune favors the bold. Those bold investors then lost 70%. Novice investors thought they were brilliant stock pickers or day traders and could not lose as the stock market soared higher. 2022 has reintroduced the importance of risk management and a new generation of investors are learning the hard lesson of what a real bear market feels like and what excessive risk taking can do to your net worth.

Despite more attractive valuations for both stocks and bonds, we are not out of the woods just yet. Time will tell when cheaper stock valuations and higher bond yields accrue to the benefit of investor portfolios. What most likely will determine when the clouds clear is when inflation recedes enough such that the Fed stops raising interest rates and then assesses how the economy reacts. The Fed has made it clear that even after it pauses, it intends to hold interest rates steady until inflation moves back towards its 2% target. If interest rates are higher for longer, it may take well into 2023 before this situation fully plays out.

The only thing that matters to the Fed right now is inflation. The next chart shows year-over year headline and core (ex food and energy) CPI going back to 1972. As bad as inflation feels now, it was much worse in 1979. It wasn’t until the 1990s that inflation dropped below 3% on a consistent basis, which happened to be a booming decade for stocks. The C-19 pandemic caused supply chains to become broken, the Russia/Ukraine conflict caused energy prices to surge, and then rising costs started to become more pervasive across the global economic landscape. The most insidious aspect of inflation is once it becomes embedded it is difficult to break and so it may take some time for aggressive interest rate hikes by central banks to make an impact. The Fed’s preferred inflation indicator is the Core PCE deflator and the table in the next chart shows the latest reading in August was 4.9%, well above the Fed’s 2.0% inflation target. Core PCE will probably need to decline substantially before the Fed considers pausing on interest rate hikes. In addition, the labor market will need to weaken quite a bit because wage inflation is now a major contributor to inflation. The Fed wouldn’t mind at all if the unemployment rate rose above 4.5% (now 3.5%) and the labor market softened as it would allow them to end their rate hiking cycle sooner rather than later.



Another way to determine when the Fed may pause in hiking interest rates is related to the Fed's goal to raise interest rates to a level such that bond yields exceed the rate of inflation and real bond yields turn positive. The next chart plots the Core PCE (black line) compared to yields of various maturities of U.S. Treasury bonds (colored lines) since December 2020. The latest Core PCE reading is 4.9% but yields on all maturities of Treasury bonds are still below this level. The Fed can get to its goal either by the Core PCE declining or bond yields moving above the Core PCE rate. The main reason we are in the present difficulties is that inflation began to accelerate dramatically starting in early 2021 but it wasn't until a year later the Fed began to hike interest rates. Once the Fed changed course, bond yields began to rise steeply, which explains why bond returns have been so negative this year. The next CPI reading on October 14th will help investors gauge if the Fed is closer to a pause on hiking interest rates. When the Fed finally pauses, financial markets will be able to settle down and downside pressure from rising interest rates will subside. The next hurdle the market will then have to deal with is the negative impact on corporate earnings from the rapid slowdown in economic activity caused by the Fed's aggressive interest rate hikes. Despite much more attractive valuations for financial assets, uncertainty and market volatility will remain high.



Summary

The TINA era may have felt great while it lasted but it was also the setup for the outsized declines investors have experienced during 2022. The TINA era forced investors into portfolios with higher allocations to stocks and to stretch for yield in riskier bonds. When the Fed finally determined inflation wasn't transitory, it shocked the markets with its fast pivot to an aggressive interest rate hiking path. The Fed's major policy change has meant Bye Bye Love for TINA. TARA is now what We've Got Tonight as cash and bonds have once again become attractive investment options for all investors. In addition, the risk diversification and income benefits of holding cash and bonds in a balanced portfolio have been restored. At the end of the day, it's a positive change for investors and financial markets, even if its mass confusion and clouds inside our heads right now.

Mark J. Majka, CFA
Chief Investment Officer

October 10, 2022

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