MID-CONTINENT CAPITAL

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*advice; judgment; resolution; wisdom

2011: Consider the Possibilities

One cannot help but be impressed in every way by the strong returns generated by the US equity market in 2010, with the S&P 500 up 15.1%.

The big gains of 2009 were built on the assumption that a "normal" economic expansion was set to begin (and indeed, the recession was deemed to have ended in June of last year). As noted in our 2009 year-end issue of *Consilium*, we believed 2010 would be marked by a "tug-of-war between gradually improving business conditions and gradually rising interest rates", leading to a period of modest rates of return. In actuality,

- the economic expansion was plodding: real GDP is barely 2% higher than it was at year-end, housing starts declined for the fifth consecutive year (to the lowest level ever recorded), and unemployment remained near 10%

- bad news dominated the headlines throughout the year: fiscal crises in Greece, Ireland, Portugal; an environmental disaster in the Gulf of Mexico; political upheaval surrounding the mid-term elections; and the two Koreas moving closer to outright war

- the "pessimism bubble" continued to inflate: gold prices rose another 27%, and interest rates sank to 50-year lows by October

But the equity market closed a very solid year on an upbeat note.

We believe an important message in stocks' ability to withstand these headwinds is that investors are increasingly willing to look beyond the short term and focus on a backdrop that we called "overwhelmingly favorable" in our last issue of *Consilium*. The critical fundamentals of strong and rising corporate profits and dividends, along with moderate valuations, remain in place. In addition, US economic growth looks poised to accelerate to a more normal pace of at least 3.0-3.5%, adding a tailwind to the strong breeze already blowing from emerging market economies. Balance sheets remain flush with cash which, along with a buoyant stock market, will encourage company managements to become more aggressive acquirers.

History also suggests that 2011, which will encompass both the third year of the economic expansion and the third year of the presidency, should be a period of above-average stock market returns. Since 1900, the stock market has risen 81% of the time during the third year of a presidential term, by an average of 13.3%. This seems to be the result of presidents and Congresses pursuing more economic- and market-friendly policies in anticipation of the next election. The stock market has risen 71% of the time during the third year of economic expansion, by an average of 7.2%. But when these cycles coincide, the stock market has risen 100% of the time, by a remarkable 20% on average.

This is also the stage of a market/economic expansion during which sector performance becomes more differentiated. During the first half of 2010, stock performance across industry groups was fairly highly correlated, indicating a lack of conviction. This began to abate in the last few months, however, as shown

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in the table below.

In the first half of 2010, the worst performing sector (energy) and the best performing sector (industrials) were both within about 5.5 percentage points of the index itself, resulting in a high-to-low range of about 11 percentage points. But in the second half of the year, the worst performer (health care) trailed the index by 10.4 percentage points, while the best performer (energy) beat the index by 13.7 percentage points, and the high-to-low range was over 24 percentage points.

S&P 500 Index and Sector Price Changes for 2010

	1st Half	2nd Half
S&P 500 Index	-7.6%	22.0%
Consumer Discretionary	-2.3%	28.7%
Consumer Staples	-4.3%	15.6%
Energy	-13.2%	35.7%
Financials	-4.2%	15.7%
Health Care	-9.8%	11.6%
Industrials	-1.9%	26.4%
Technology	-11.0%	22.6%

Sector exposures clearly had a much bigger impact on portfolio performance in the second half of the year, and we expect this will continue to be the case in 2011. As we enter the New Year, we favor companies in the technology and energy sectors, as well as select financials, but market and business conditions will undoubtedly call for adjustments to our exposures as the year progresses.

Longer term, we would like to reiterate the viewpoint we expressed a year ago in *Consilium*: that valuation matters, and buying stocks at low prices, even when prospects appear questionable, offers patient investors an opportunity to do well. We believed then, and still believe, that equity investors would be well rewarded in the decade ahead, especially compared to bond alternatives. The prospective real "equity risk premium" – the additional return, after inflation, over that available from a risk-free alternative – is nearly double its average level of the past 50 years, at about 6%. Despite a dramatic rebound in the stock market in the last 21 months – up more than 80% from its lows – skepticism still seems to be the order of the day for most investors.

But what if things don't turn out as badly as expected? Human beings are all susceptible to what behavioral psychologists call "recency bias" or "availability bias". Put another way, our most recent or most vivid experiences disproportionately influence our expectations for future outcomes. After the last few years, pessimism is therefore understandable, and there is still a strong consensus that the US economy is destined to a long period of mediocre performance. But keep in mind that stock market surprises are not necessarily the result of good outcomes, but outcomes that are merely better than expected. We believe these circumstances leave substantial opportunity for investors to be positively surprised.

Sources: JPMorgan, Baseline, Bank of America Merrill Lynch

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