MID·CONTINENT CAPITAL

CONSILIUM*
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*advice; judgment; resolution; wisdom

One for the Record Books

The US equity market, as measured by the S&P 500 Index, has closed out a remarkable year with a 32.4% total return – its best showing since 1997. The market has generated calendar year gains of over 30% only 15 times in the last 143 years, and in all but two of those instances the market rose further in the following year (by an average of over 19%). Stocks also completed a rare fifth consecutive year of gains, an event observed only seven previous times over that same time period. In all but two of those instances, the market rose further in the following year (by an average of over 13%). The message of this history lesson is that good years can follow great years; there is no reason why big gains have to be followed by big losses.

As we noted in our last issue of *Consilium*, the market's performance in 2013 can be attributed largely to declining perceptions of risk, reflected in rising valuations, and to a perceived lack of alternatives; corporate earnings growth was meager. Still, higher valuations make sense considering that the market's worst fears at the end of 2012 did not materialize: the "fiscal cliff" was averted, Europe's economy did not worsen further, and the US economy grew at a moderate enough pace to permit the Federal Reserve to continue its large bond-buying program. As the year progressed, evidence that risk avoidance was giving way to risk seeking became apparent in the performances of highly speculative issues such as Tesla (up over 470% at its highest point), Pandora Media (up 245%), Groupon (up 160%), and more recently, Twitter (up 187% from its early November IPO). In fact, the riskiest, lowest-quality stocks, carrying an S&P rating of "C" or worse, rose by an average of 56%, while those with "A" ratings rose by 24% (a result which would be considered outstanding under nearly all other circumstances).

Valuations have not yet reached dangerous levels, but as we also noted previously in *Consilium,* earnings ultimately must carry the day for investors, and a stronger pace of economic growth is now needed to propel earnings higher. Fortunately, for the first time in several years, there is reason for cautious optimism on this front:

- The largest impact from last year's tax increases and spending cuts is over.
- Household wealth is at a new high, while debt has declined sharply, putting consumers in a position to spend more freely.
- The recovery in housing is well entrenched, and a long period of improved housing activity seems likely based on clear signs of pent-up demand.
- Corporations have very high cash balances and there is a substantial need for new capital investment.
- Layoffs are down substantially, and new hiring has strengthened recently.

The Fed itself appears confident that the economy is set to grow more rapidly, having announced that it will begin to "taper" its bond-buying program. This process could last well into the year ahead, and while somewhat higher long-term interest rates seem likely, an actual and deliberate tightening of monetary conditions by the Fed is a remote prospect. If unopposed by the Fed, stronger economic growth can become a positive-feedback loop, with spending increases leading to more new jobs, higher incomes, and still higher spending. The stock market seems likely to respond favorably, as well.

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With a recent Gallup survey indicating that 76% of the public is dissatisfied with the country's direction, it is safe to say that such an environment would and should be greeted with unanimous enthusiasm. Considering the extent of our country's polarization over so many other issues, something positive that unites us should be on every investor's 2014 "wish list."

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Last year was an important one for Mid-Continent Capital as well. We crossed two milestones, completing 30 years as an independent investment management firm, and surpassing $2 Billion in Assets Under Management. The latter result was in part due to the strong market environment, but also due to the trust and confidence expressed by our clients and friends who referred a record number of new relationships. We also increased our professional staff by 20% and are very excited about the high caliber of people added to our team.

For all of the above, we thank you and offer our best wishes for a healthy and prosperous 2014!

Sources: Baseline, Ibbotson Associates, Prof. Robert Shiller, Gallup

150 S. Wacker Drive, Suite 400 ♦ Chicago, IL 60606-4101 ♦ Tel: 312.551.8200 ♦ Fax: 312.551.8780 ♦ www.mccllc.com