MID-CONTINENT CAPITAL

CONSILIUM*

Volume 6 ~ April 2011

*advice; judgment; resolution; wisdom

Sticking With The Game Plan

Equity markets have made erratic forward progress thus far in 2011, with the S&P 500 Index generating a 6.1% return in the first quarter. The outbreak of civil unrest in the Middle East and North Africa, and the jump in oil prices that followed (up 25% in three weeks), finally provided an excuse for the markets to "take a breather". The tsunami and subsequent nuclear reactor crisis in Japan then added to the list of global worries, considering that country's importance in the highly-integrated multinational supply chain for manufactured goods (especially electronics). But investors continue to digest these and other negative headlines with an eye on strong corporate profits, healthy balance sheets and reasonable valuations. The result has been a continuation of the trends established in 2010.

Sector differentiation, which only emerged in the second half of last year, has continued in 2011, with energy stocks again leading the way. They were by far the best performers in the second half of last year (up 35.7%), and are in the same position at the end of the first quarter (up 16.3%). This remains one of our favorite groups both in the short term and long term on the basis of steady demand growth from developing markets and the need for high prices to ration supply.

As the economic recovery matures and gathers self-sustaining momentum, we expect merger and acquisition activity to surge. Corporate cash flows and cash balances are at record high levels, and CEOs can remain patient for only so long under such circumstances. Even Warren Buffett, who has urged investors to always "wait for the fat pitch", has gone public with his appetite for large deals. There are excellent consolidation opportunities in every sector of the market, and we believe takeovers, share buybacks, and restructurings will be a prominent feature of the remainder of this market cycle.

The economy still faces daunting challenges, however, that the financial markets will not ignore forever. Two such problems are inexorably linked: our unsustainable fiscal imbalances and the possibility of higher inflation. We highlighted these issues in our April and July issues of *Consilium* last year. There is no progress to report on the former, and that lack of progress may well culminate in a federal government shutdown by the time you are reading this letter. (Many have argued that our government only takes meaningful action when confronted with a crisis, and that may be true again in this case; but attempts at problem-solving during crises usually produce sub-optimal solutions.)

There is also no evidence that policymakers view the inflation threat seriously. They are comforted by the fact that (a) wage pressures are modest and unemployment is still high, and (b) "core" inflation measures (excluding food and energy) remain subdued. Unfortunately, our monetary policy leaves considerable room for interpretation of what constitutes "modest" or "subdued", and provides ample opportunity to ignore surging food and energy prices before they have seeped into the broader economy. But they almost always do – over the last 50 years, sharply rising food and energy prices have usually presaged a jump in other inflationary indicators. Will this time be different, or if not, will the Fed act in time?

Please turn to next page

Fortunately, a good argument can be made that US stocks are cheap because they are already anticipating higher inflation and higher interest rates. This highlights the continued attractiveness of equities as an asset class compared to bonds, particularly government bonds, which we have systematically deemphasized in client portfolios over the last 18 months. At current levels, then, bad news and all, stocks still offer an opportunity to be positively surprised. We believe our "game plan" of the last year or so is still appropriate, and we're sticking with it.

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