MID-CONTINENT CAPITAL

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*advice; judgment; resolution; wisdom

Déjà Vu...All Over Again

In an odd case of stock market "déjà vu", the second quarter of 2011 has ended under circumstances similar to the second quarter of 2010, with equities "held hostage" by exogenous events. Last year, investors fretted about the oil markets (in the wake of the BP disaster), developments in Europe (especially Greece), major legislation pending in Washington (the Dodd-Frank financial reform bill), and the prospect for a "double dip" in the economy. This year's list of worries is nearly identical:

- **Oil:** Markets have been roiled by the government's decision to release oil from the Strategic Petroleum Reserve at a time of already high inventories. If this step was deemed necessary a mere two years into an economic recovery worldwide, when demand is hardly robust, what does this suggest for oil prices under normal, longer term circumstances?

- **Europe:** Investors are rightly concerned about the ramifications for the European banking system from a Greek debt restructuring or default, and whether similarly-situated countries, such as Portugal and Ireland, can even remain part of the Euro currency bloc.

- **Washington:** With the government already having reached its statutory borrowing limit, negotiations over an increase in the limit are more intense than ever before. Unlike past efforts at deficit reduction, this negotiation faces a deadline, virtually guaranteeing brinksmanship and an absolutely-at-the-last-minute agreement.

- **Double Dip Watch:** Real GDP growth slowed sharply over the winter and early spring, accompanied by a decline in the already meager pace of job creation. Even Fed Chairman Ben Bernanke recently expressed puzzlement at the disappointing pace of economic expansion. With the Federal Reserve's program of "quantitative easing" ending, short term interest rates already near zero, and no possibility whatsoever of additional stimulus spending (see bullet number three above), concerns that the economy may lapse back into recession are rising.

In the end, it took a sharp market rally in the last week of June to produce a second quarter return of 0%, leaving the S&P 500 Index with a gain of 5.9% on the year.

Equity investors seem to focus on two different sets of factors, depending on whether the market is rising or falling. When declining, external macro factors such as those noted above appear to trump company fundamentals and justify selling. When rising, solid corporate profit performance and reasonable valuations are uppermost in investors' minds and justify buying, regardless of the macro environment. We believe both sets of factors require full attention at all times, as we seek out investment opportunities that are attractive on their own merits, and that can perform well either due to, or in spite of, macroeconomic conditions.

With corporate earnings running 10% higher than they were just six months ago, while prices are flat, the S&P 500 Index now trades at its most attractive valuation in more than two decades (other than the panic-driven lows of 2009). At the same time, yields on government bonds have pulled back to the 3% level, a prospective rate of return that would be acceptable only in the context of along, dismal economic slump.

While our current economic expansion may leave much to be desired, it is still an expansion, not a recession, and one accompanied by robust growth in earnings at that. Although there is plenty of bad news to overcome, we continue to believe that stock valuations and earnings growth leave ample room for investors to be positively surprised, particularly later in the year.

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