MID-CONTINENT CAPITAL

CONSILIUM*

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*advice; judgment; resolution; wisdom

UNCERTAINTY *(noun):*

the state of being subject to change frequently, suddenly, or unexpectedly

"Uncertainty Zaps Early Stock Rally" -- headline, wsj.com, 9-20-11

"We can help lift the cloud of uncertainty hanging over small and large employers" -- Rep. Eric Cantor, 8-29-11

"Uncertainty drove August trading" -- headline, marketwatch.com, 8-31-11

"Uncertainty has gained ground in recent years as a partial explanation of the economy's failure to recover quickly" -- Robert Higgs, the Independent Institute, 9-5-11

At Mid-Continent Capital, we have no doubt that "uncertainty" deserves to be a finalist for Merriam-Webster's 2011 "Word of the Year". It may have become the most frequently used term for describing everything that happens in the financial markets and the economy. Each time a commentator or politician employs it, he or she seems to be implying that a new, never-before-seen force is at work, wreaking havoc with stock prices and the plans of businessmen and consumers.

Recently, a prominent Wall Street strategist told his clients "I am not comfortable investing in an environment that is so driven by policy decisions when I don't understand how those decisions are being made." He was referring to the fact that financial markets seem to be fluctuating in response to external factors, such as the European sovereign debt crisis and governments' actions to address it, rather than to traditional and fundamental factors such as companies' sales and earnings. But even if we knew precisely what policy decisions were forthcoming, could we really declare with confidence – with "certainty" – what market response to expect, and therefore how to invest?

For that matter: if we knew precisely what any given company would earn for the next three years, could we accurately predict its stock price in response?

In truth, investors, collectively, know less than they think they know. Not only do they not know what fundamental developments will occur, they do not know how markets will respond to those developments once they take place. Yet millions of times a day "buy" and "sell" decisions are made as though the future was somehow obvious. Economic, financial, and even scientific models attempt to provide confidence that if "X" happens, "Y" will follow. But a dirty little secret from the sciences is that actual results lead to constant adjustments to "the model" so that reality conforms more closely to that which was predicted. Users of such models are supposed to be impressed that they have accurately forecast subsequent events, and encouraged to make future decisions with confidence – to overcome their uncertainty.

But what happens when we rely excessively on models, particularly models that are constantly in flux? Not surprisingly, bad outcomes are the frequent result. With stocks and bonds, overconfidence in forecasts usually leads to overpaying for an asset. (As Warren Buffett once said, "you pay a high price for a cheery consensus".) In risk management, overconfidence leads to vulnerability to low-probability, meaningful events ("Black Swans"). But the reverse is also true: **undue skepticism usually leads to selling assets at low prices**.

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The price of any security is itself a forecast, representing the discounted value of an expected stream of future cash flows. The riskier the forecast, the higher the rate investors use to discount those cash flows, and the lower the current price of the security. This is simply the way we compensate for risk: we demand a higher rate of return. When we are very confident, we use lower discount rates, raising the prices we are willing to pay.

It is no surprise then that extreme levels of conviction among market participants tend to coincide with extremes of valuation. High confidence leads to high stock prices – and lower potential future returns. Low confidence (or should we say, "uncertainty"?) leads to low stock prices – and higher potential future returns.

The word "potential" is important in this context. Buying stocks at low prices does not guarantee immediate subsequent profits. Investors today face an unusually wide range of possible outcomes, including a renewed recession, default by European governments, and failure by the US government to address our unsustainable fiscal position. **Long term investing in this environment is difficult; but that which is difficult to do ought to be *and is* ultimately highly rewarded**. The reason gutsy investors and .300 hitters in baseball make plenty of money is the same: because they are both doing something very hard.

Although it will ebb and flow – and models may even persuade us that it can be controlled or eliminated -- investors can never be free of uncertainty. But they can use it to their advantage by recognizing that uncertainty is a precondition for good returns. To despair over how uncertain things are, therefore, is to grumble about the very act of investing itself: assuming risk, and earning a return.

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As the third quarter wore on, equity markets around the world became despondent over the prospect of a European debt and banking crisis and the potential economic fallout in other regions. There simply were no places to hide (percentage returns as of September 30):

US (S&P 500)	-11.7%	Germany	-23.5%
Australia	-12.7%	Japan	-11.0%
Brazil	-14.5%	Russia	-27.1%
China-Shanghai	-14.4%	South Korea	-15.8%
China-Hong Kong	-19.6%	UK	-12.6%

Source: *Baseline*

Even previously-resilient precious metals fell sharply, with gold and silver prices declining 15% and 26%, respectively, from their recent highs.

Absent a return to recession and, more importantly, a deep decline in corporate profits, stocks are inexpensive and likely to deliver good returns to long term investors from current levels. Over a shorter time horizon, the markets appear poised for improvement as investor sentiment has become extremely negative and soon-to-be-reported third quarter earnings could be quite strong. We are optimistic that the good values created by current "uncertainty", along with a refocus on solid company fundamentals, can provide the impetus for a strong finish to the year.

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