MID-CONTINENT CAPITAL

CONSILIUM*

Volume 9 ~ January 2012

*advice; judgment; resolution; wisdom

# Off The Treadmill in 2012

Although financial markets, at least in theory, do not know that one year has ended and that another is beginning, it's fair to say that most of us are happy to see 2011 come to a conclusion. In many important respects, it was a year to forget, with a shortage of positive highlights and an oversupply of challenging obstacles. Optimism at this time last year seemed well justified, as corporate profit growth was solid, stock valuations were reasonable, and the broad economy (as defined by real GDP) had just enjoyed its best year of growth since 2005.

But investors were soon being pummeled with a storm of bad news that continued throughout the year:

- Uprisings (and eventually successful revolutions) in Libya and Egypt roiled oil markets, sending prices more than 30% higher by the end of April.
- The devastating tsunami and subsequent nuclear accident at Fukushima stopped the Japanese economy in its tracks and noticeably disrupted global trade.
- Disagreement over how to address the nation's unsustainable fiscal situation turned into a major public spectacle, leading to the first-ever downgrade of US debt by a major ratings agency.
- European leaders struggled to cope with the inability of Greece to service its debts, and the prospect of widespread sovereign defaults, major bank failures, and the possible end of the common Euro currency.
- A leading futures brokerage, MF Global, fell into bankruptcy, leading to the still-unexplained disappearance of $1.2 billion in segregated customer funds, to which no outside party should have had access.

Given this backdrop, some have argued that it was miraculous that the US equity market (which did fall by as much as 17% at one point in October) was able to hold up at all, and end the year roughly where it began (with the S&P 500 generating a total return of 2.1%). Indeed, returns in other major markets generally were much, much worse[(1)]:

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| Germany | -15% | Canada | -11% |
| UK | -7% | Brazil | -18% |
| France | -20% | China | -20% |
| Japan | -19% | India | -24% |

The standout performers in the US financial markets were an odd couple: 10-year US Treasury bonds, up 16%, and gold, up 12%. Record low Treasury yields partly reflect our uninspiring growth prospects, but also are indicative of a flight from risky assets. But this year's gains were almost certainly a last hurrah: to generate comparable returns in the year ahead, yields on the 10-year Treasury would have to drop to a hard-to-imagine 0.44% from today's 1.88%. Gold stood near the top of the major asset class heap for the tenth straight year; but with only speculative demand behind it, we find it difficult to expect an eleventh. Within the US equity market, only highly defensive sectors performed well, again reflecting investor squeamishness about growth prospects and risk.

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Few of the major events noted above were predictable, and the events that will drive 2012 financial market results will likely differ from current expectations. Still, we would like to highlight three positive and three negative factors that might be in play this year:

Positives:

- + Corporate profits remain robust, and dividends, share buybacks, and merger activity seem likely to increase.
- + Valuations on equities are even more attractive today than a year ago – indeed, near the lowest in the last 25 years or more.
- + The American electorate will have an opportunity to tell Washington policymakers which approach it favors in addressing our fiscal imbalances: higher taxes or reduced spending. Whichever solution seems best to the reader, at least investors can look forward to a much greater chance of real and meaningful action starting a year from now.

Negatives:

- – There is virtually no chance that our barely-growing economy will receive a boost from new government fiscal stimulus. Fiscal restraint (slower spending growth, not spending cuts) will be a headwind for the foreseeable future.
- – Real austerity measures will be implemented in large economies such as Italy and Spain, and the entire Euro zone is almost certainly in, or is about to enter, a recession. This will be a further drag on the US, and even more importantly, on China, which will find it difficult to maintain strong export-led growth.
- – China's financial condition will be a subject of greater concern and scrutiny, as the results of massive over-investment in real estate are just beginning to emerge.

While the outlook for the US equity market in 2012 is indeed murky, we believe the positives will outweigh the negatives, thereby providing an opportunity for real asset growth this year. It is very easy to imagine fear giving way to optimism, should events unfold in a favorable manner. We will continue to identify and invest in companies that can withstand economic pressure and uncertainty while also shining in better times. As long- term investors, rather than traders, we continue to gravitate to higher quality organic growth companies that are trading at very attractive valuations. Companies with stable and growing dividends and solid management teams provide us with an engaging prospect for future positive absolute and better relative returns.

On behalf of the entire team at Mid-Continent Capital, please accept our best wishes for a happy, healthy and prosperous New Year!

(1) Source: Baseline