MID-CONTINENT CAPITAL

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*advice; judgment; resolution; wisdom

Pain Before Gain

As this is being written in mid-December, investor attention is focused on the progress, rumors, and/or rumors of progress in the "fiscal cliff" negotiations taking place in Washington. We brought this matter to the attention of *Consilium* readers nine months ago and highlighted it as a key risk to the markets and the economy. It remains an important factor in the near-term direction of the markets, because our mediocre economy is not well-positioned to withstand the stress of significantly higher taxes and/or significant near-term spending reductions.

We do not know how these issues will be resolved, or when. However, we do know that investing is fundamentally an attempt to make decisions under conditions of uncertainty. There is always some source of worry that can prevent an investor from taking action, and as Warren Buffett has remarked, a "cheery consensus" is likely to be very expensive indeed. So rather than bemoan the existence of so many unanswered questions, we thought it useful simply to recount a few of the most pertinent things that could go wrong, or right:

- The S&P 500 index is completing its fourth consecutive year of gains, up 14.9% year-to-date as of this writing. Prior to the 1980s, a four-year winning streak for stocks was extremely rare, having not occurred since 1949-1952. In the last 85 years, a five-year run has only occurred twice, both times during periods of vigorous economic growth. With our feeble economic expansion as a backdrop, can 2013 be the third?
- The ink barely dry on its last round of "quantitative easing" – announced in September – the Federal Reserve announced earlier this month that it would now be pursuing unconventional monetary stimulus until such time as the unemployment rate fell to 6.5% (from 7.7% today) or inflation expectations (not explicitly defined) rose above 2.5%. Progressively larger and more frequent such steps have failed to ignite faster economic growth. Is the Fed out of "ammo"? Is the traditional, statistical definition of unemployment even relevant today?
- Consumer incomes and spending have been among the notable weak spots during the current recovery, barely budging even as employment has shown some modest improvement. Consumer confidence measures are well below average levels of the last 30 years. When consumers spend, businesses invest and expand, driving job gains and a virtuous circle. When and how will consumers snap out of their funk?
- Corporations are flush with cash, and stock prices are close to their highs. In the past, this has always been a "green light" for merger and acquisition activity, but a long-predicted wave of buyouts has not materialized. When and how will CEOs and boards of directors snap out of their funk?
- Europe is now in recession and the headlines seem to be the same, every day. The fundamental structural problems facing the Euro countries remain unaddressed, with temporary measures – "can-kicking" – the only solution on offer. Yet European stocks have been sharply outperforming since July. Can Europe get any worse, or is it so bad that it can only surprise on the upside?
- Although still at a high level in absolute terms, corporate profit growth has stalled as margin expansion seems to have run its course. Acceleration in the economy, and revenues, in turn, is needed to propel earnings growth. Yet a lack of earning momentum proved no obstacle to the stock market this year. Can stocks rise again solely on higher valuations?

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There are few obvious answers to any of these questions. What we do know is that expectations are not particularly high and that lower-risk investment alternatives offer no competition for stocks for the long term investor. The economy and the stock market have been erratically advancing for over two years now mainly due to prodding from the Fed every stumbling step of the way. Market and economic cycles do not die of old age – it usually takes an external shock, or hostile financial conditions, to do the trick. Therefore, while caution remains justified, we are not negative. Our caution keeps us alert to positive surprises, as well.

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On behalf of everyone at Mid-Continent Capital, we would like to thank our clients and readers of *Consilium* for their support, and we offer our best wishes to everyone for a happy holiday season, and for a healthy and prosperous 2013.

Sources: Baseline, Ibbotson Associates

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