

Market Outlook

Midland Financial Strategies

2nd Quarter 2010

Dow Industrials Confirm Bullish Trend

The Dow Jones Industrial Average (DJIA) moved well above its January 19 high closing above the 10,932 mark – both the DJIA and Transports are at 17-month highs. The broad market continues to trend higher as corporate profits improve, inflation remains mild, and yields remain somewhat contained. While the stock market seems to have found its footing, many market observers still fear a double dip recession.

Does A Slow Recovery Foretell Double Dip Recession?

With today's stubbornly slow recovery, the above question is often asked – we think that a double dip recession is unlikely. That said, the recovery will probably not be anything like those witnessed in the mid 1970's or early 1980's. We have often heard the axiom that, 'the bigger they are the harder they fall.' The opposite, is generally true for recessions: the harder and faster the fall, the quicker and more robust the recovery. Thus far, this has not been the case for this recession.

We do seem to be on a road to recovery, as the economy probably set its seeds for expansion in the third quarter of 2009. Coming off its weakest point, the economy is likely expanding at an annualized pace of about 4%. However, we suspect that growth will probably taper to a 3% level in the second half of 2010, as consumers remain financially strapped and hesitant to spend. Consumers face two major headwinds – a dreary employment outlook, coupled with a depressed housing market. Both of these areas negatively impact consumer psyche: a weak employment market impacts confidence, as more workers fear losing their jobs, while a weak housing market impacts the ability to tap home equity lines of credit.

Figure I contrasts the current drivers of recovery with the catalysts of the prior seven recoveries. Noticeably, consumer spending has not been as robust, and, due to the overhang of the difficult real estate market, housing has not participated either. From a positive perspective, one of the drivers of the recovery has been U.S. businesses (exports), whose ability to sell goods abroad has been buttressed by the weakness in the U.S. Dollar.

Uncertainty

There is always uncertainty, but we remain in uncharted territory as the Government deficit continues to bulge. The Government intervention into banking and healthcare could also play a pivotal role as to the size, shape, and longevity of the recovery. One thing does seem highly likely – over the long haul, budget deficits and consistent government borrowing generally lead to inflation and burgeoning interest rates. Thus, the capital market system we are witnessing today – with low interest rates and low inflation – will not last indefinitely.

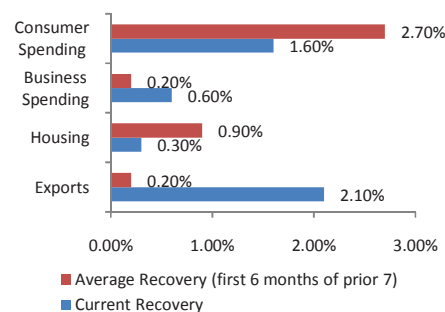
Portfolio Positioning

In light of changing economic demography, we have been adding Treasury Inflation Protected Securities (TIPS) to portfolios. Of course, one of the benefits is that if inflation rears its head, these types of securities tend to hold their value and offset principal deterioration. At the same time, we are also focused on yield. From a fixed income perspective, many corporations have right sized their balance sheets, making corporate bonds stronger and thus more viable fixed income candidates – corporate bonds also pay a premium relative to U.S. Treasuries. Also, we seek to increase our weight in equities that pay dividends. We believe that this strategy cushions market volatility and capital market history shows that companies that grow dividend yields tend to outperform over time.

Will the Health Care Bill Negatively Impact the Economy?

This is the trillion dollar question. Undoubtedly, the spiraling increase of medical costs have been of increased concern for all Americans. Interestingly, upon the passage of the bill, numerous fortune 500 companies revised downward their profit outlooks. To that end, many economists suggest that numerous businesses delayed adding to payrolls due to the uncertainty of the pending bill – the particulars of which still remain unclear. We will surely address the bill and the key determinants as they become more resolute.

Figure I
Recovery Comparison



Data: National Bureau of Economic Research

College Costs Rising Quietly and Quickly

While the health care debate has grabbed the headlines, the cost of college education continues to soar as shown in Figure II. Given the condition of the economy, most Americans would probably say that their number one priority would be finding work, or keeping their present job. Interestingly, those that have a bachelors degree or higher are less likely to be out of work, and earn considerably more as shown in Figure III. Moreover, numerous studies suggest college graduates live longer and healthier lives than those who do not have advanced education. With this in mind, we are advising our clients to revisit their commitment to planning for the children, or grandchildren's college education. There are numerous ways to do this such as 529 plans, Coverdell accounts, savings bonds, trusts, etc. Please contact us if you have questions or need planning advice.

Inflation, Really?

The inflation we have witnessed during the past half century can be broken down into two distinct periods – with two disparate results. To compare these time periods, we used rolling ten-year time periods for U.S. Treasury notes and consumer prices (CPI). Since 1982, there has been a decline in inflation and both the return of Treasuries and inflation has been about 4%. Contrast this with the years leading up to 1982. While the average inflation rate was also about 4% the average return for Treasuries was flat – hence, after inflation, investors lost purchasing power.

One of the primary goals of investors should be to outpace inflation. Over the last 25 years, as inflation rates fell, this objective was relatively easy. However, with the aggressive monetary policy the Government is employing, and the inflation that might result, this goal will likely become more cumbersome.

Remedies for Inflation

Historically, there are numerous antidotes for inflation protection including non-Treasury Bonds (corporate bonds), dividend growing stocks, and commodities. In addition, a tool was added in 1998, in the form of Treasury Inflation Protected Securities (TIPS), which we discussed previously. TIPS have the added benefit of principal adjustment relative to the rate of inflation. While TIPS provide diversification, we advise that a well diversified portfolio that employs numerous asset classes is the best strategy if a secular inflation environment reoccurs.

Conclusion

There are many challenges that we face given the current economic turbulence. Your Midland Financial Strategies representatives are ready to serve you. If you have questions, or comments, please feel free to contact us.

Figure II
Inflation Comparison

Increased college tuition costs top the list
(Cumulative percentage increase in overall prices)

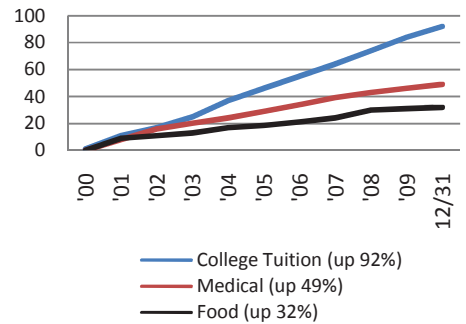
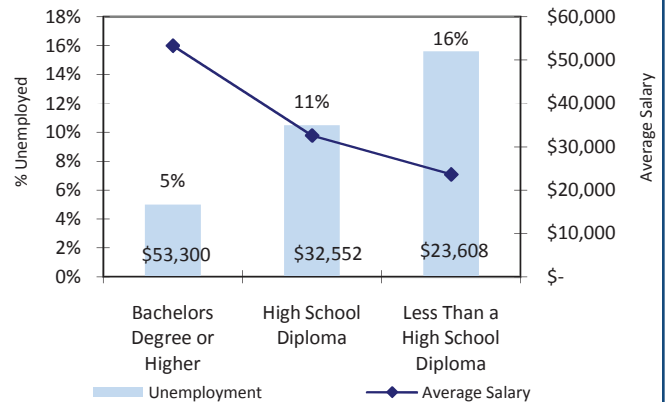


Figure III
Benefits of Education



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