THE OTHER SIDE OF THE VALLEY

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It is easy to focus on the current behavior of the market. This is especially true when 100-point swings in the stock market are common, a major economic crisis is unfolding in Europe, and a disturbingly weak U.S. economy persists. The raucous political debate being conducted, as we approach the 2012 election, only increases the focus on the near term. Given this heightened worry and pessimism, we think it is useful to ask a question different from most posed today: Not, "what will the world look like today, next week, or next month," but, what is more likely to happen over the longer term?" What will be the investment climate three, five or ten years in the future?" The answer to these questions is more important than what happens tomorrow or next month.

> History does not repeat itself,
> but it does rhyme
>
> Mark Twain

The Current Crisis

The last ten years have been a disappointment to investors. Stocks have not performed well. In the overall economy, real incomes have not grown. The Great Recession, which began in 2007, and the collapse of the housing market, have devastated the wealth of individuals and crippled the balance sheet of cities, counties and states. The federal government has mismanaged its finances so badly that no easy solution is apparent. These problems are not unique to the United States. The limits of the Welfare State have been reached, if not exceeded, in almost all western developed nations. The promises made years, if not decades, ago cannot be kept in their present form. Issuing additional debt to finance those promises can no longer be supported. There are no easy or immediate solutions.

History Rhymes

There have been other long periods of severe economic distress in the U.S. Mark Twain famously said, "History does not repeat itself, but it does rhyme." His meaning was that the details of historical recurrence may differ, but the general outline remains the same. We could look at the severe recession of the early 1920s, or the Great Depression of the 1930s, but many of the structural features of the economy are so different now, that parallels are deceptive. However, the economy of the 1970s and early 1980s is close enough in time and memory to be instructive. Like all good stories, it is a tale of man's folly and redemption – the economic edition.

The 1970s

The 1970s were not good years for investment returns, or for America. In the ten years ending December 31, 1979, the compound, annualized, *inflation-adjusted*, return for stocks was -1.45% per year. The U.S. dollar, at the beginning of the decade, bought only 86 cents worth of goods and services ten years later. Moreover, because interest rates rose with inflation, the value of a bond portfolio fell dramatically during this period.

The World Changed

As poor as investment returns were in the 1970s, beginning in 1982, they were spectacular. From January of 1982 to the end of 1999, the annualized, inflation-adjusted return on stocks was 14.9 percent per year. In this seventeen year period, $1.00 invested in stocks at the bull market's inception, was worth $12.15 at the end. This marvelous period for stocks was long enough to convince many that these returns were the new "normal." They were not.

Back to the Future?

Will history repeat, or just rhyme? Answering that question involves a comparison of the 1970s and early 1980s, to today. Like today, the 1970s brought problems that were profound and seemed insolvable. From an economic perspective, the culprit was out of control inflation. Today, the problem is excessive debt at all levels of society: federal, state, city and individual. High and persistent unemployment is prevalent in both periods.

Both periods share a collapse of confidence in traditional institutions. The chaos of social change in the 1960s carried into the 1970s, with riots, the shooting deaths at Kent State, President Nixon's resignation, Iran's taking of American hostages, the Arab oil embargo and a new economic condition called, "stagflation." Today, the housing collapse has savaged the savings and buying power of the middle class, banks are distrusted, if not reviled, Congress' approval is an all-time low, and the President, who took office with great popularity, has seen that popularity erode dramatically.

In both periods, mistrust and deep pessimism accumulated, as one attempt after another failed to provide a solution. In the 1970s, fear and high short-term interest rates caused investors to carry large cash balances. Today, fear and memories of the market collapse of 2008-09 have had the same effect.

This suggests only some of the similarities between the two time periods, there are many more. This has not touched on China, Iran and Europe, currently making headlines today, or on Japan, Russia and the Middle East in the past. Each could merit a discussion far longer than we can write, or you likely care to read. The point is that these times, difficult as they seem, are not unique. They can last a long time, but they have happened before and they have an end.

Catalysts for Change

In the past, a change in political control has been the major catalyst for a change in the direction of the economy and the market. We think history will again repeat itself – or at least nicely rhyme. The improvement we anticipate is likely to come from three elements: a change in policies, a change in psychology and a redefinition of problems.

- Policy **-** The regulatory burden placed on business during the current administration is immense. Rightly or wrongly, the EPA, Department of Labor, FDA and the SEC, combined with new legislation, such as the Patient Protection Act (Obamacare) and the Dodd-Frank Wall Street Reform and Consumer Protection Act, have created major deterrents to economic growth. Not only have costs risen, but uncertainty about how these regulations will be implemented, and what new regulations may be coming, have fostered uncertainty and created a large burden to industry and job growth. Even a partial list of affected sectors (aerospace, autos, banking, farming, mining, oil exploration and pipelines) comprises much of American industry. Relief, even if only partial, from these regulations would be extremely positive for both the economy and the market.

- Psychology **-** It would be a mistake to underestimate how important psychology is to economic activity. The current atmosphere is toxic, bordering on despair. Notions of class warfare abound, and a long period of slow growth seems the best that can be hoped for. Remember, if you will, how refreshing it was to emerge from President Carter's *malaise*, from lowered thermostats and wearing sweaters, to Reagan's, "Morning in America." It can happen again.

- Problem Redefinition - Problems, which seem impossible to solve, become less so when they are redefined. A return to vigorous growth, that has led America out of previous recessions, would make both the debt and unemployment dilemmas easier to address. Instead of focusing on "fairness," or government control, a new administration is likely to focus on those changes in the tax code and other initiatives that would restore growth. This would be very positive for the economy and markets.

Will It Matter?

On the final page, you will find a chart of the history of the stock market. Easily seen are the long plateaus, when stocks did little, and the strong uptrend, when investors were well rewarded. These differences are dramatic, but quite logical. After periods of uncertainty and poor performance, companies, that have built large cash reserves, as is the case today, begin to invest. Profitability further increases because, after a period of slow demand, business has spare capacity that can be used to increase margins. Unemployment is high, so labor is readily available, keeping wage pressure in check. Investors take note of corporate America's increased earnings power and bid up stocks. Since this pattern takes time, a bull market is born. All it takes is a spark to begin a vigorous expansion. All it takes is a catalyst.

We think that spark is visible in today's opinion polls, which shows an increasing rejection of the idea of Big Government. Others have noted there are broad pendulum swings in American politics between left and right. The pendulum's latest movement became apparent after the 2010 election. We think it continues. Much can happen in the roughly twelve months before the next election, but once the pendulum begins to swing, it is almost irreversible.

Conclusion

While this paper deals with the future, we know that in many ways the future will be determined by events that are unknown and unknowable. Nevertheless, we think the effort to see ahead is worthwhile, even though we look "through a glass darkly." Hopefully, we can escape the tyranny of the present and begin to delineate, however imperfectly, the shape of things to come.

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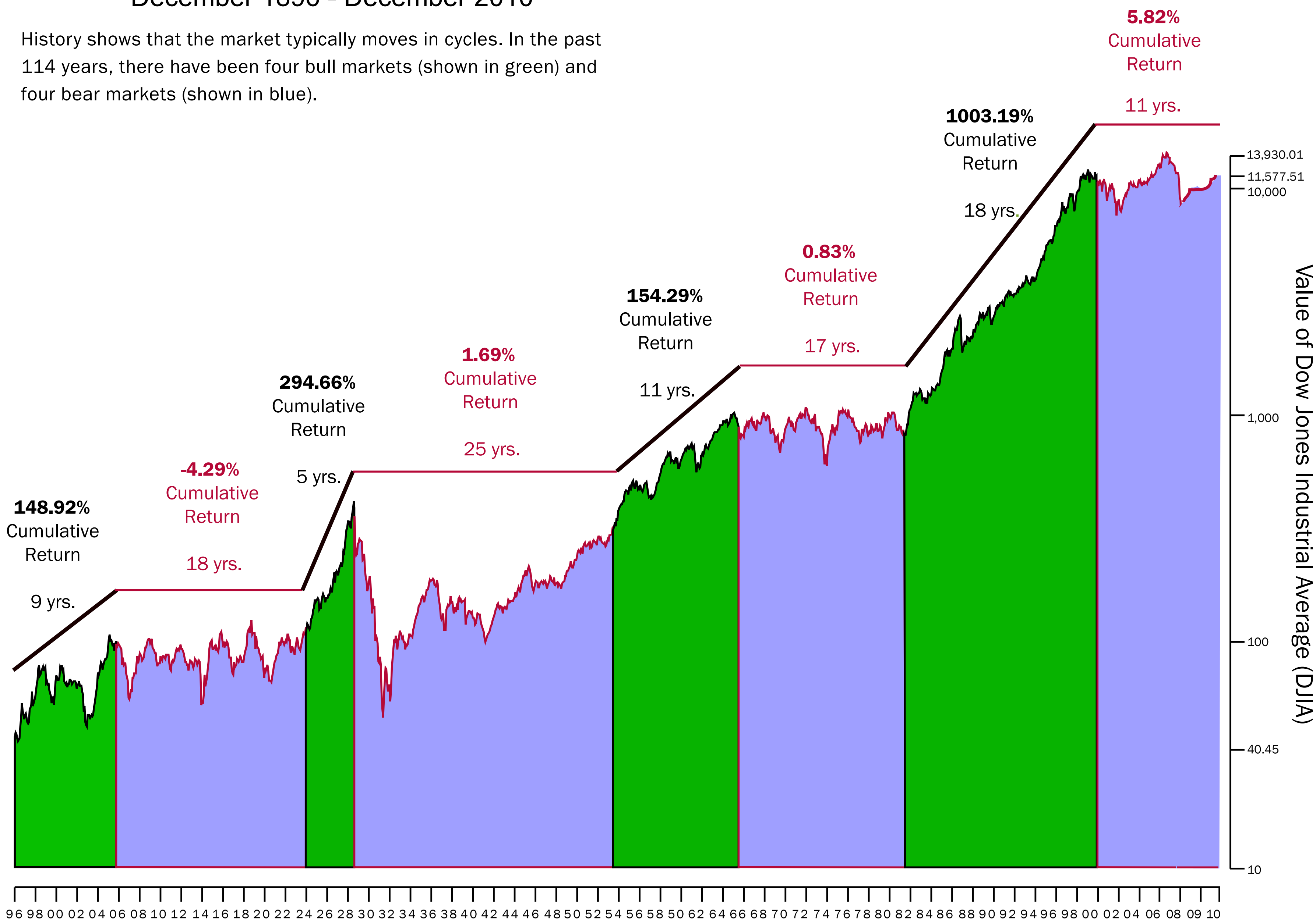
Mississippi Investment Management Company (MIMCO) is an independent, registered investment advisory firm, based in Jackson, Mississippi, that delivers customized portfolio management and investment consulting services for individual investors and institutions.

DOW JONES INDUSTRIAL AVERAGE

December 1896 - December 2010

History shows that the market typically moves in cycles. In the past 114 years, there have been four bull markets (shown in green) and four bear markets (shown in blue).



Logarithmic graph of the Dow Jones Industrial Average from 12/1896 through 12/2010.

Source: Graph created by MIMCO using data from www.dowjones.com.

Performance displayed represents past performance, which is no guarantee of future results. *The Dow Jones Industrial Average is unmanaged and unavailable for direct investment. Returns do not reflect dividends, management fees, transaction costs or expenses.*