Capital Management, LLC

www.smscap.com

6575 West Loop South, Suite 603 • Bellaire, Texas 77401
Phone 713-623-1534 • Fax 713-589-9496 • Email info@smscap.com

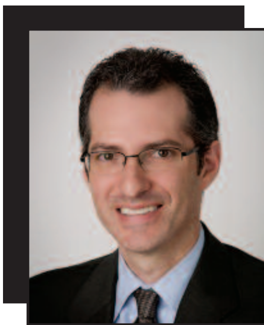
Second Half 2011 Commentary

June 2011

By Steven M. Sheldon, CFA

About SMS Capital Management

SMS provides investment management services to individual investors desiring to preserve and build long-term wealth. As a fee-based firm, SMS has an independent, objective and sound approach to portfolio management. The firm is a Registered Investment Adviser.



About the Author

Steven Sheldon has more than 15 years of professional experience analyzing and managing investments. Prior to founding SMS, Mr. Sheldon worked as a senior member of a corporate principal investments group. Mr. Sheldon has an MBA from Tulane University and a BBA from The University of Texas. In addition, he is a CFA charterholder and a member of both the CFA Institute and the Houston Society of Financial Analysts (HSFA). He is also a Past-President of the MBA Council of Houston.

As we head into the summer months and the second half of the year, the U.S. economy continues to show clear signs of cooling. The question now is whether or not this slowdown is nothing more than a temporary "soft-patch" or the start of a more significant downturn.

Disruptions to the global manufacturing and supply chain caused by the earthquake in Japan, the continued decline in residential housing, tepid job growth, bad weather, and higher gas prices have taken a toll on the economy and consumer confidence in recent months. While acknowledging that these factors have slowed the economy, Fed Chairman Bernanke believes they are mostly "transitory". He expects that some of these growth impediments (particularly Japanese supply constraints and high gas prices) will reverse course in the months ahead, giving the economy some much needed relief. **Given Bernanke's "wait and see" view and the growing chorus of congressional leaders calling for budget cuts, it is unlikely that any new government stimulus programs will come to the rescue in the very near term.**

Anxious investors, not willing to bet that Bernanke's forecast for a rebound in the second half of the year pans out, have sent the stock market tumbling roughly 7% from its three-year high set in April, erasing most of the S&P 500's gains for the year. As of close on June 13th, the S&P 500 is now only up 1.87% for the year; about the same as international developed markets. Small caps are flat and emerging markets are slightly down for the year.

At this point, investors should remain invested, but with a more defensive posture. Large cap, dividend paying stocks should continue to be favored over small caps in this environment and "value" over "growth". In addition, high quality fixed income investments, including corporate, U.S. Treasury and municipal bonds, should be held. **However, investors should wait to add to fixed income as prices have rallied in the last few months.**

Summer Doldrums Again?

Given the traditional summer weakness and the multitude of negative overhangs, the stock market will likely be volatile, but not make significant gains in the near term. There is key support at the S&P 1,250 level (March's low and 200-day moving average) and resistance to the upside at 1,350 (the market peaked at 1,363 in April). As I write this (June 13th), the S&P is hovering around 1,272.

The next couple of months may be as revealing as a Tweet from Anthony Weiner as investors get a lot more clarity on some big economic issues. Second quarter earnings announcements will indicate how well profits are holding up amidst this recent slowdown; and the congressional showdown over the U.S. debt ceiling will be coming to a head. The U.S. is poised to hit its statutory limit on federal debt on Aug 2. Without raising the debt ceiling, the U.S. will be in technical default; something that has never occurred.

Capital Management, LLC

www.smscap.com

6575 West Loop South, Suite 603 • Bellaire, Texas 77401
Phone 713-623-1534 • Fax 713-589-9496 • Email info@smscap.com

Since the stock market rally began over two years ago, investors have had a "buy the dip" mentality. So far, despite several corrections (including a big 16% correction last summer), buying on weakness during this spectacular "Bull Run" has paid off. Surging corporate profits have been the key driver for the rally. Even though GDP growth has been below that of previous recoveries, corporate profits have grown to an all time high and are still forecast to grow 16% in 2010 and 14% in 2012. While these forecasts might prove unrealistically high given recent headwinds, we are unlikely to see earnings contract in the near term given the still expansionary government policies in the U.S. Given the Presidential election next year, those expansionary policies should stay in place well into 2012 providing support to stock prices.

Portfolio Positioning

In my "First Half Forecast" for 2011, I suggested that investors remain invested but wait for a better opportunity to get overweight in equities. **Long term investors should use additional weakness to start adding to equities.**

At its current level, the S&P 500 is trading at roughly 13x this year's expected earnings. Many forecasters believe the market can trade up to 1,450 or 15x this year's earnings. This scenario is possible, particularly if the economy reaccelerates in the second half. However, my expectation for the next 12-18 months is that earnings will grow, but the market's P/E ratio will contract as that growth becomes less certain. The result may be more muted overall returns than the consensus forecast. Investors, however, may enhance their total returns by overweighting attractively priced large caps with above market dividend yields. In addition, investors should utilize some actively managed, "value oriented" and "balanced" funds with solid long-term track records of generating superior returns in what has been over a decade with a relatively flat stock market.

With regard to fixed income investments, in my earlier forecast I suggested that investors take advantage of the selloff in municipal bonds to increase or establish high quality positions. Since February, municipals have recovered nicely and have outperformed most fixed income securities over that period. **Investors should stick with their fixed income holdings, but wait to add more**. The rapidly approaching U.S. debt ceiling might cause a temporary spike in interest rates, hurting bond prices. If this occurs, investors may have an opportunity to increase exposure to high quality fixed income investments.

*None of the information or data presented herein constitutes a recommendation by SMS Capital Management, LLC or a solicitation of any offer to buy or sell any securities. Information presented is general information that does not take into account your individual circumstances, financial situation or needs, nor does it present a personalized recommendation to you.

Although information has been obtained from and is based upon sources SMS Capital believes to be reliable, we do not guarantee its accuracy and the information may be incomplete or condensed. This report is for informational purposes only and is not intended as an offer or solicitation for the purchase or sale of a security. Past performance is no indication of future results.