This newsletter's focus will be a bit longer term in focus. I'll still run through some recent events and possible directions for this year, but then I'll look at larger trends and directions that could last five, ten and even 20 years.

May Malaise

During May, the equity market dropped about 7 percent before heading back up a bit. The year's run-up had been strong enough that bad news had increasing capability to disrupt the markets. And May delivered enough unsettling news to drive shares down for a while. Europe continues to struggle, China's growth numbers raise concerns about a hard landing for their economy, and the U.S. faces its own challenges, particularly in Washington.

May's tumble illustrates our country's gloomy mood and the human tendency to extrapolate from recent history. Market moves over the past year plus have been nearly all headline driven with little attention paid to underlying fundamentals. Whether it was the Greek crisis, debt ceiling, credit downgrade, or Japan tsunami, investors are reacting to immediate events. By one common volatility measure, 2011 was the most volatile year since 1932 and correlations among various sectors spiked as investors largely reacted to the same, usually irrelevant, data.

As bad news has surfaced again recently, investors seem to be repeating the same pattern, almost like they're being driven by muscle memory. The last few years have traumatized investors and it will take time until more rational behavior predominates. Recoveries normally feel like the recent past with starts and stops. This one is complicated by the skittishness of investors fearing another calamity that appears very unlikely to happen for many, many reasons.

Looking beyond very near-term challenges, longer term trends look very good. In reviewing the three pillars I like to use as a framework for the market's future strength, only one pillar shows any cracks while the other two look pretty good. And several broader trends are also encouraging.

Three Pillars

Concerns that economic momentum may be peaking could introduce cracks to the corporate earnings pillar. Record profits and strong profit margins have been achieved largely through cost-cutting rather than growth. Corporate America may be able to continue driving profits higher, but the pace of increase seems likely to slow at some point. Still, corporations are now sitting on over $3 trillion in cash which gives them tremendous flexibility and capability to adjust strategy and invest for the future.

The second pillar, inflation and cheap money, looks strong for the foreseeable future. Inflation remains low, and Europe's deleveraging will further contribute to weak commodities prices. Interest rates will likely remain at the current, near-zero, rate through this year with potential increases probably coming in 2013 or 2014. Low inflation and near-zero rates will continue to help corporate profits.

The last pillar, equity market valuation, still looks good. The price for a dollar of earnings across many different sectors and markets remain reasonable or low by most measures. Stocks remain cheaper than bonds, and investors can actually increase income by moving out of government bonds and into stocks. This has never happened before, and the market's higher yield relative to bonds creates a solid base under stock prices that should provide an ongoing upward bias.

Longer-Term

Looking bigger picture, the U.S. is poised for sustained, stronger growth which should help profits over an extended time period. The recovery may be slow, but it's very broad based. Housing usually leads economic recoveries, but it's been completely absent from this one. Eventually it will contribute as we add population and housing stock declines. Manufacturing jobs are up for the first time since the mid-1990s and non-technology manufacturing jobs are up for the first time in more than 30 years. Around 80 percent of foreign direct investment is going into manufacturing, and the Midwest is experiencing a genuine manufacturing renaissance.

But the major game changer that could easily impact the U.S. for the next 20 plus years is natural gas. In 2008, natural gas was $14 per metric cubic foot (MCF). It's now around $2 per MCF versus $10 in Germany and $16 across most of Asia. Access to cheap energy provides the U.S. a tremendous cost advantage and fundamentally changes outsourcing logic as U.S. workers become comparatively more attractive. Dow Chemical recently built a plant in Texas that had been slated for China. UPS and Fedex are converting their fleets to natural gas. America will likely be energy independent in the not too distant future (5-20 years) with the timeframe largely determined by government policy.

Cheap energy's impact can't be overstated because it affects nearly everything. Much lower cost inputs can cover a multitude of problems in various sectors of government and the economy. It can also help the U.S. continue to lead an increasingly integrated and expanding global economy.

Global Growth

Global Economic participation is way up. Countries growing by more than 3% reached a high of 124 in 2007 and remains at 90 this year versus less than 25 countries in the system 30 years ago. In 1979, 35 countries were experiencing hyperinflation, and today none are. Across the globe we have been building an advanced, resilient economy for 25 years that is bigger and more complex. Yet, it's also much more resilient. Productivity is going up and will likely ramp up even faster as we continue to leverage the microchip. If you take away smart phones, cell phones, ipads, laptops, and the Internet, U.S. business couldn't survive, yet that only takes us back to the dark ages of 1990. In this thriving and growing global boom, the U.S. will remain the primary driver and leader for the foreseeable future.

In the near-term, markets will likely be driven by more immediate events with investors attributing far more importance to them then deserved. None of these should derail the economy or the market's upward trend, but they will inevitably create some chaos in the short-term. The big three we're likely to hear about are Europe's problems – for which they are developing coping mechanisms, China's potential hard landing – which is likely overstated, and Washington's struggles – which are most concerning, but are likely to be addressed in a manner that eventually calms markets even if the journey is rocky.

Very simply, the economy and markets look very promising if we can get past a few short -term cliffs. Volatility, related to muscle memory that has programmed investors to panic at first sight of anything, should decline over time. We may see short-term sell-offs, but they shouldn't be too drastic. The next decade should see solid U.S. growth. U.S. equities, emerging markets and non-European economies should do well, with extra returns coming from today's lower valuations. If Washington can avoid complete catastrophe, the U.S. economy and private sector appear to be very well positioned.

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