THE Weekly View
RIVERFRONT INVESTMENT GROUP
Asset Management • Investment Strategy • Advice

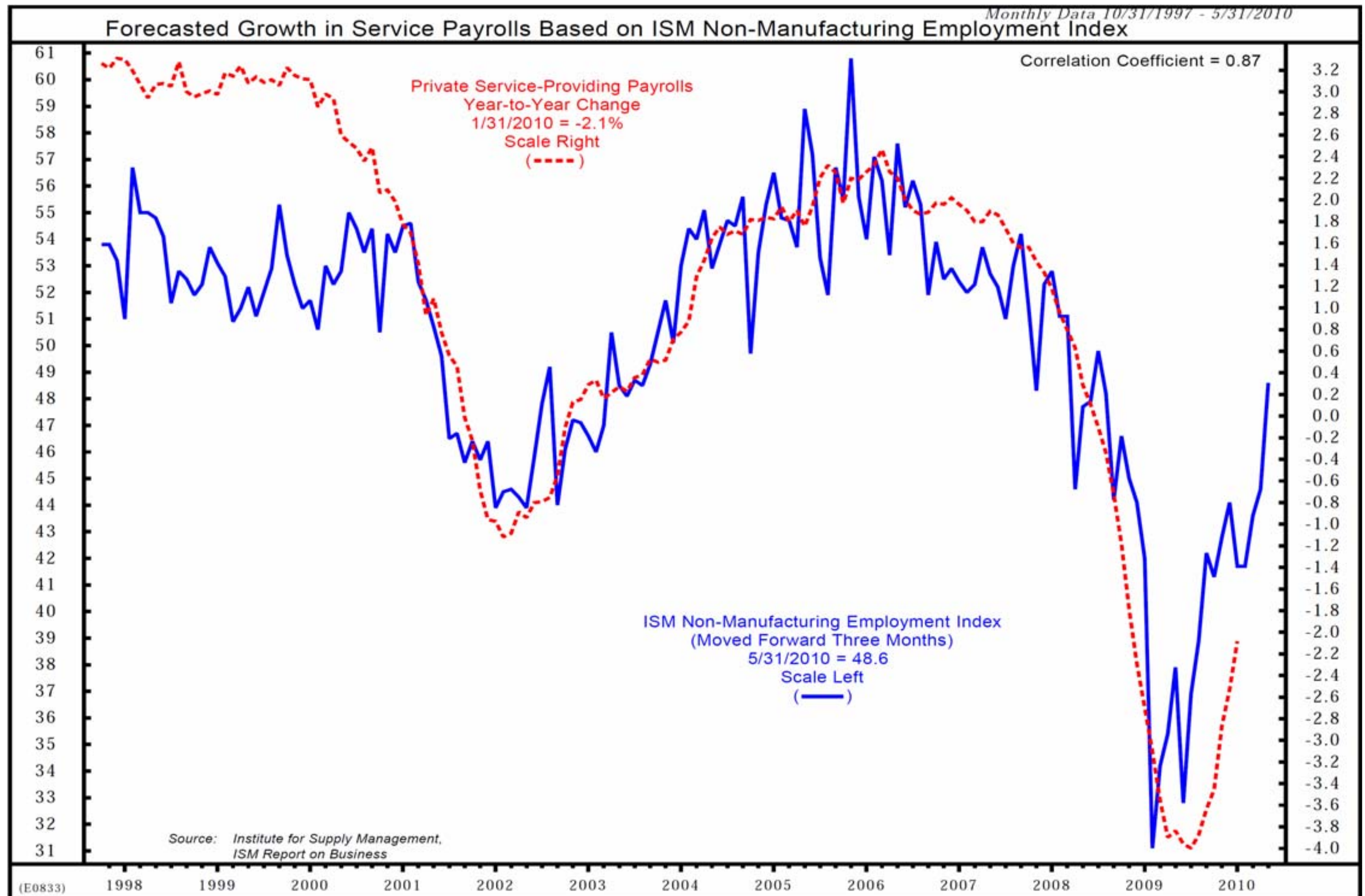
Rod Smyth • Bill Ryder, CFA, CMT • Ken Liu March 8, 2010

A Good Week

- The S&P 500 rose over 3% last week, led by the consumer discretionary sector which made an upside breakout, and is back near its 2010 high of around 1150. Crowd sentiment is not overly optimistic (as it was in January) and therefore we believe new highs for the major averages are likely. If 1150 resistance is breached, our near term technical objective is 1170 to 1200. Fundamentally, concerns surrounding a potential Greek default and Chinese policy tightening have been abating. In the wake of announced austerity measures, Greece had no trouble selling long-term debt last week, partially allaying fears of imminent default. The latest Chinese purchasing manager surveys indicated a slowdown, but not a contraction, in activity — evidence that the government is successfully engineering a soft landing for the economy. As a result, risk assets have started to outperform safe haven assets again. We remain concerned about sovereign debt risk but our tactical indicators, which have kept us invested, remain bullish. We believe the bull market in risk assets will continue as long as policy mistakes are avoided.
- The Institute for Supply Management (ISM) and the employment situation reports underscored positive economic progress last week. Both the ISM manufacturing and non-manufacturing indexes remained above 50 in February, indicating continued expansion in activity. The manufacturing index fell 1.9 points to 56.5, while the non-manufacturing index (which represents nearly three quarters of the economy) rose 2.5 points to 53. Perhaps most importantly, the employment components of both ISM indexes continued rising. Although non-manufacturing employment is still below 50, its recent gains suggest that services jobs — over 80% of private sector employment — are on the verge of finally growing again (see Weekly Chart).
- Nonfarm payrolls fell by 36,000 in February, while the prior two months were revised higher by a cumulative 35,000. Due to severe winter weather, job loss expectations were for about 75,000, hence the positive market reaction to the report last Friday. The weather did appear to affect aggregate hours worked, which declined 0.3%, but this would imply a rebound as the weather improves. Furthermore, the unemployment rate held steady at 9.7% even as the labor force rose by 342,000. Job gains remain concentrated in temporary help and health services, whereas job losses continued in construction.
- While job growth remains elusive, another key employment metric — unit labor costs (worker compensation less productivity) — has been highly favorable for corporate earnings. Abundant labor has suppressed wage growth, while managers have been able to utilize smaller workforces (and technology) to produce the same or greater amounts of goods and services. Fourth quarter unit labor costs were revised to a -5.9% annual rate from -4.4% last week; the year-over-year decline of -4.7% is the lowest since records began in 1948.
- The dichotomy between the relative health of corporate earnings and weakness in labor (income) has been a hallmark of the Great Recession and creates the impression that business gains have come at the expense of the workforce. However, over the long run, we think painful but necessary corporate restructuring increases the likelihood that existing employment can be maintained, as nonproductive assets are shuttered, and profitable new investment eventually supports greater hiring activity. We believe this process is ongoing and hence are optimistic about future prospects for earnings and financial markets. To be sure, the recovery is likely to be subpar given the enormity of the dislocations heading into the downturn and the remaining overhang of debt and unproductive assets to be worked and/or written off. However, given the extraordinary policy response and *commitment to keep policy accommodative* (making needed adjustments as painless as possible) we expect a gradual return to full employment. Indeed, this is one of the Fed's mandates. The other is price stability and with labor costs (70% of business expenses) low and productivity high, we — and more importantly the Fed — do not believe that inflation is currently a threat.

- The expiration of the Fed's mortgage-backed securities purchase program at the end of this month is a more immediate threat for financial markets in our opinion, especially with recent weakness in new and existing home sales. As we wrote about last week, the Fed believes it can stop buying without a significant rise in mortgage rates. We are less sure, but are confident that the Fed will resume asset purchases to lower mortgage rates again if it is wrong. Moreover, we are encouraged by the consumer discretionary sector, which is leading the stock market higher. Retail sales and personal spending have been better than expected so far in the first quarter despite the weather, suggesting that consumers' confidence in their household wealth (much of which is in real estate) is either stabilizing or improving enough to offset declines in real income and employment. In short, markets appear unconcerned about any potential disruptions in the housing market when the Fed stops buying mortgages.

The Weekly Chart: ISM services suggests job growth



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Past performance is no guarantee of future results

The ISM non-manufacturing employment index is more volatile than the year-to-year change in service payrolls. However, it has historically provided a good lead indication of job growth and we believe the general trend is clear. A high 87% correlation when the index is moved forward by three months suggests continued improvement in service sector job growth through the spring, with actual year-over-year gains possible by the summer.

Rod Smyth, Bill Ryder, CFA, CMT & Ken Liu • 804-549-4800 • www.riverfrontig.com
Riverfront Investment Group, 9011 Arboretum Parkway, Suite 110, Richmond, VA 23236

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