THE Weekly View

RIVERFRONT INVESTMENT GROUP

Asset Management • Investment Strategy • Advice

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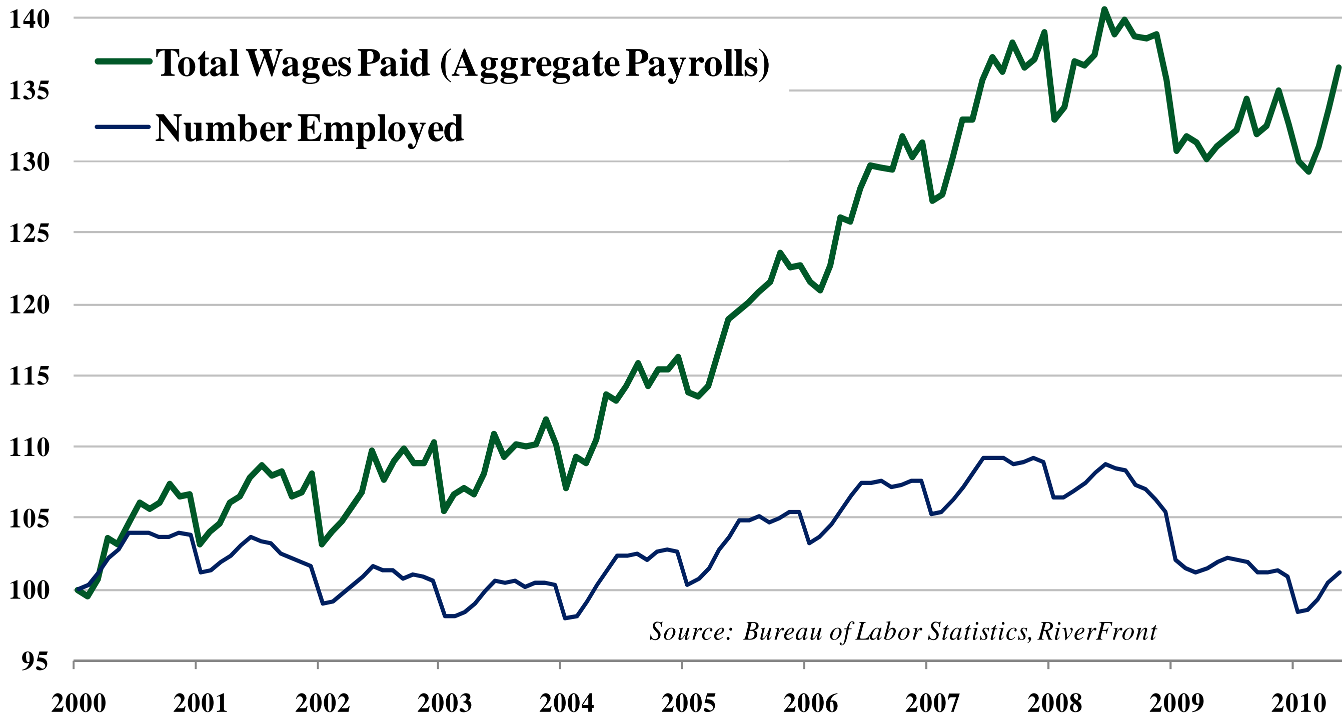
# Prepared for the Bottom of the Decision Box

- Disappointing employment news last Friday sparked a sell-off in stocks after rallying most of the week. We think support for the S&P 500 lies between 1000 and 1050, the bottom of the 'decision box' that we identified in our last weekly. We maintain that a double-dip recession is unlikely and that earnings growth remains on track. Thus we expect support to hold, particularly with crowd sentiment extremely pessimistic, but we think investors should brace themselves for another test of the bottom of the box. Today RiverFront's portfolios were reshaped to reflect our updated strategic forecasts (please see "RiverFront's Updated Capital Market Assumptions," *The Strategic View*, 5/5/2010). We have reduced international stocks and high yield exposure and plan to reinvest in emerging market and microcap stocks when we feel more confident that the current correction is over. We are prepared to reduce risk assets further if either markets or events suggest we are wrong.
- Despite a gain of 431,000 jobs last month, the most in over a decade, the employment report disappointed markets since consensus expectations were about 500,000. Given distortions from the hiring of 411,000 temporary government census workers, most of the focus was on private job growth, which increased by only 41,000 compared with 290,000 in April. Moreover, excluding census hiring, there were 21,000 government job losses, all at the state and local level. Nevertheless, there were some encouraging aspects of the report. Most importantly, in our view, is that aggregate hours worked continued improving, up 0.3%. That, coupled with a 0.3% increase in average hourly earnings, means that total wages paid to the US hourly workforce is approaching the peak levels it reached in 2008 (see Weekly Chart).
- The forward-looking Institute for Supply Management (ISM) surveys released last week show ongoing business expansion in the manufacturing and service sectors. The manufacturing survey moderated slightly to 59.7 from 60.4, but is still at a level that implies robust activity (a reading above 50 indicates expanding activity). The services survey held steady at 55.4 for the third consecutive month. The combination suggests that, although economic growth is unlikely to accelerate from here, there is no evidence that activity is about to contract. Furthermore, global surveys also point to ongoing expansion. Hence, our view that the economic environment remains favorable for business, profits, and further stock market appreciation, which should in turn support continued private sector job growth.
- Adding to our positive view of the economy and markets is that China appears to be engineering a de facto revaluation of its currency, which we believe is essential for global rebalancing and sustainable growth. While we have focused on a revaluation via currency appreciation, wage appreciation is another avenue that would achieve similar and more politically palatable results. On that front, sparked by growing labor unrest, China is allowing substantial wage concessions. Foxconn, a contract manufacturer for Apple, raised wages by 30% last week after a spate of suicides at its factories, while Honda increased pay by 25% to quell a strike at a plant in southern China. Moreover, Beijing raised the minimum wage in the city by 20%. While not evident in the exchange rate, wage appreciation causes a real revaluation that, in effect, raises Chinese purchasing power and makes foreign goods and services (like in the US) more attractive, which should help rebalance global trade flows.
- In contrast to encouraging developments in China, the Eurozone and the European Central Bank (ECB) in particular appear unable (or too reluctant) to get out in front of a mushrooming sovereign debt crisis. The latest turn of events was an announcement by Hungary's incoming government that "there is nobody in the country apart from the previous government who still says the budget deficit of 3.8% of gross domestic product can be reached," and that talk of default was "not an exaggeration." Although Hungary is not currently in the Eurozone and while some analysts view these statements more as political maneuvering by the new government to build support for budget cuts, it nonetheless renewed fears that Greece's sovereign debt crisis is spreading and helped send the euro to four-year lows against the US dollar. Furthermore, this prompted investors to shed risk assets in a flight to safety with

the US dollar and Treasuries the main beneficiaries. We think the ECB needs to aggressively expand its balance sheet more than it has in order to stem the panic. Since the ECB announced it would begin buying the bonds of at-risk countries (and companies) in the Eurozone a few weeks ago, it has only purchased €35 billion ($42 billion). In comparison, the Federal Reserve bought well over $1 trillion in mortgage-backed securities and Treasuries during its campaign to "to promote a smooth transition in markets." We believe the ECB can, should, and will do more.

## The Weekly Chart: Incomes back near peak levels




This chart compares US income and job growth in the new millennium. Our proxy for income, aggregate payrolls, is a product of the number of hourly workers, their average hours per week, and average hourly earnings. As the chart shows, the number of hourly workers is close to the same as in January 2000. This is in stark contrast to their total wages, which have risen sharply in the past three months and are just 3% below their June 2008 peak. Last week's chart highlighted the remarkable rise in US productivity, or output per hour, during this period, which means that even though our income proxy has risen almost 40% since 2000, US workers have become more efficient and per-unit labor costs have fallen. Thus while US unemployment is still too high and job growth is likely to be sluggish, aggregate income is close to its high, which makes a significant drop in consumption and a double-dip recession less likely.

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