THE Weekly View

RIVERFRONT INVESTMENT GROUP

Asset Management • Investment Strategy • Advice

Rod Smyth • Bill Ryder, CFA, CMT • Ken Liu

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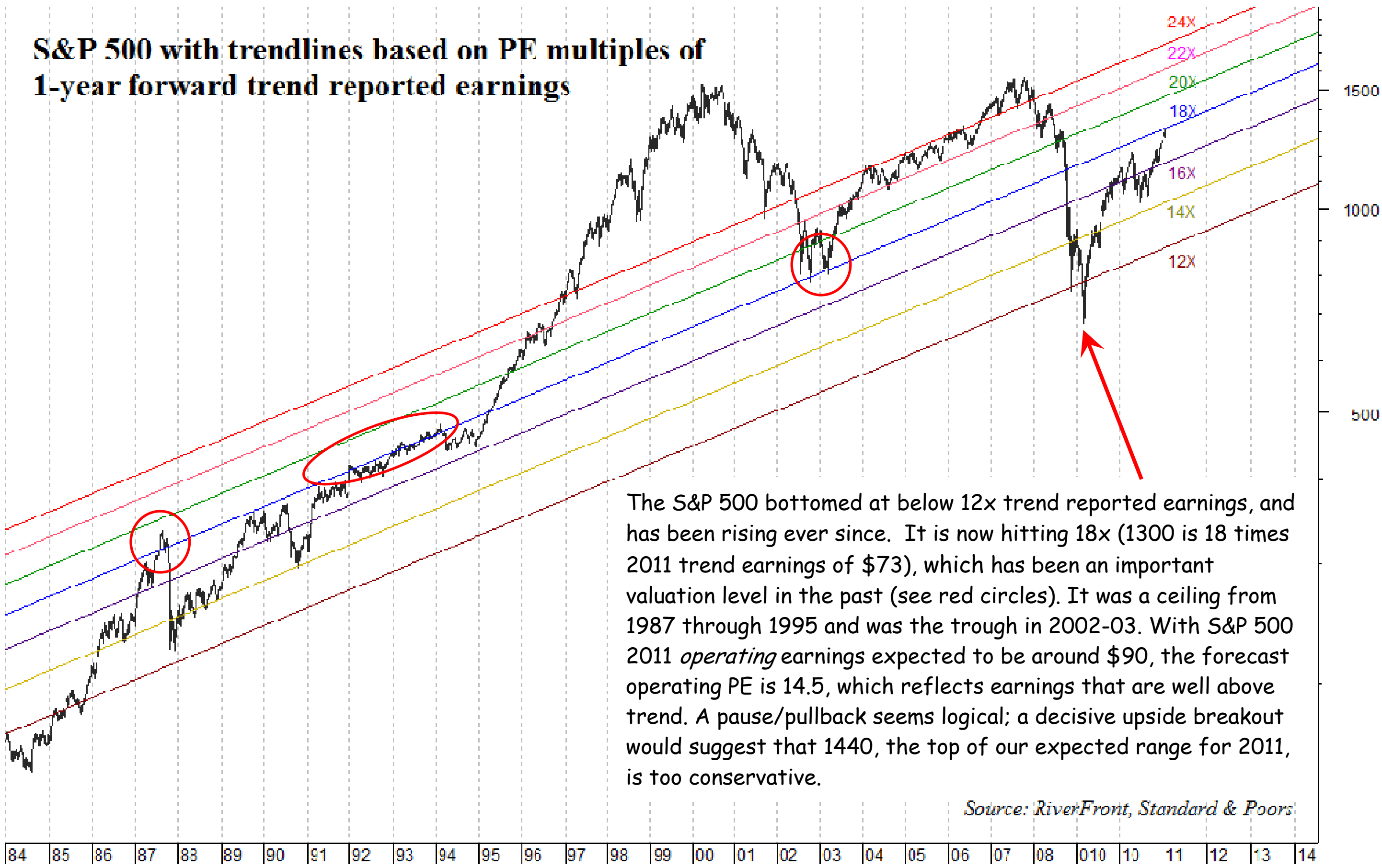
Bond Prices Break Down as Economic Data Firms

- Stocks largely shrugged off a weak but weather-impacted jobs report last Friday, which belied underlying economic strength evident in purchasing manager surveys. Bond prices broke down, however, as 10-year Treasury yields rose decisively above 3.5%, closing the week at 3.65%. While the minor stock market correction we have been expecting has yet to occur, the secular bear market in bonds that we have been adamant about is underway and has further to go, in our opinion. Longer term, we think stock valuations are reasonable based on two critical conditions: (1) 10-year Treasury yields remain below 5%, and (2) earnings continue to grow. Since 2011 *operating* earnings are now forecast to be about 30% above trend *reported* earnings (our preferred measure of core earnings power), there is little room for error. We have no argument with the consensus earnings forecast for 2011, but we disagree with using $90 earnings to conclude that stocks are cheap (see Weekly Chart). We are stock bulls and bond bears for 2011, because we believe stock valuations are reasonable and bond valuations are not. Short term, our best guess is that bond yields will rise to 4% before pausing and that stocks will not rise much above current levels before a mild correction.
- Regarding the events in Egypt, we think it is premature to make an informed assessment of the investment implications. However the situation is an excellent example of the 'Black Swan' (theoretically implausible, unpredictable, and often utterly random) nature of the world. Egypt has had the same president for 30 years, but suddenly a social uprising in Tunisia awakened latent unrest in Egypt and the Middle East, likely ending the tenure of one of the regions' most entrenched rulers. At the very least, volatility in stocks and commodities, especially oil, will likely increase. We took advantage of a steepening crude oil futures curve to sell our oil position.
- January payrolls rose by only 36,000 versus expectations for around 140,000. However, significant declines in construction, transportation, and temporary help services suggest that absent the effects of severe weather, employment growth would have been closer to consensus. We think a 'catch-up' period in the next couple of months is likely if weather effects normalize. Indeed, the employment components of the ISM manufacturing and non-manufacturing indexes, which have a close correlation with national employment, implied a 280,000 gain in payrolls. A substantial drop in the unemployment rate to 9.0% from 9.4% added to the confusion. Unfortunately, the lower unemployment rate can be attributed mostly to a 504,000 drop in the labor force, due to a population control adjustment by the Census Bureau. It is possible that those 'seeking work' (who are included in the labor force) are simply no longer being counted since the maximum of 99 weeks' unemployment benefits are running out for the bulk of workers who lost their job during the height of the recession – the first quarter of 2009. Until the labor force participation rate stabilizes, we view the decline in the unemployment rate as misleading.
- Productivity — which accelerated slightly to 3.6% in 2010 from 3.5% in 2009 — puts the apparent disconnect between record profits and sluggish hiring in perspective. That is, over the last two years workers were able to cumulatively produce 7% more per hour worked. Increasing business efficiency doesn't always translate into vigorous economic growth, but we think it does support the expansion's sustainability. If companies can continually produce more with less, managers will likely have the confidence to keep expanding their businesses. Higher profits are leading to sustainable hiring increases in our view, but only for workers with the requisite skills to improve productivity. The result is a widening stratification between skilled workers (where the job market is improving) and unskilled unemployed workers. While long-term unemployed workers will continue to burden the economy, sapping aggregate demand and contributing to deficits, those with jobs are enjoying a larger slice of a pie that is finally growing again.

- Increasing productivity also helps dampen inflationary pressures. Roughly speaking, if a product's value increases relative to the cost of making it, then the producer's final cost has actually declined and unit labor costs (ULC) are negative. ULC fell 1.5% in 2010, which we believe has anchored core inflation. This is because consumer price increases are difficult to sustain if labor costs are not rising. Looking ahead, if food and energy prices continue to rise and wages don't, then commodity price hikes will act as a tax, thus pricing out more people from their current level of consumption. Since labor accounts for approximately 70% of total unit costs, falling ULC negates the chance of a so-called 'wage-price spiral' — the primary transmission mechanism for inflation in the US in the 1970s. Therefore we see both a two-tier labor market and two-tier inflation, where pricing power increases returns for certain sectors but not others. Fed Chairman Ben Bernanke's remarks last week show he is relying on labor and capacity slack to justify his aggressive quantitative easing: "Wage growth has slowed ... with average hourly earnings increasing only 1.8 percent last year. These downward trends in wage and price inflation are not surprising, given the substantial slack in the economy." We expect core inflation to remain reasonably well contained in 2011. Our bearishness on long-dated bonds is based on their lack of a price cushion if the Fed can generate either faster growth or rising inflation. US wage compensation trends, with high unemployment and spare capacity, contrast with much of the emerging world where wage-price spirals are firmly in effect, necessitating central bank tightening and prompting financial market underperformance (for more details, please see the January 24th *Weekly View*).

The Weekly Chart: To pause or not to pause, that is the question



Past performance is no guarantee of future results

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