

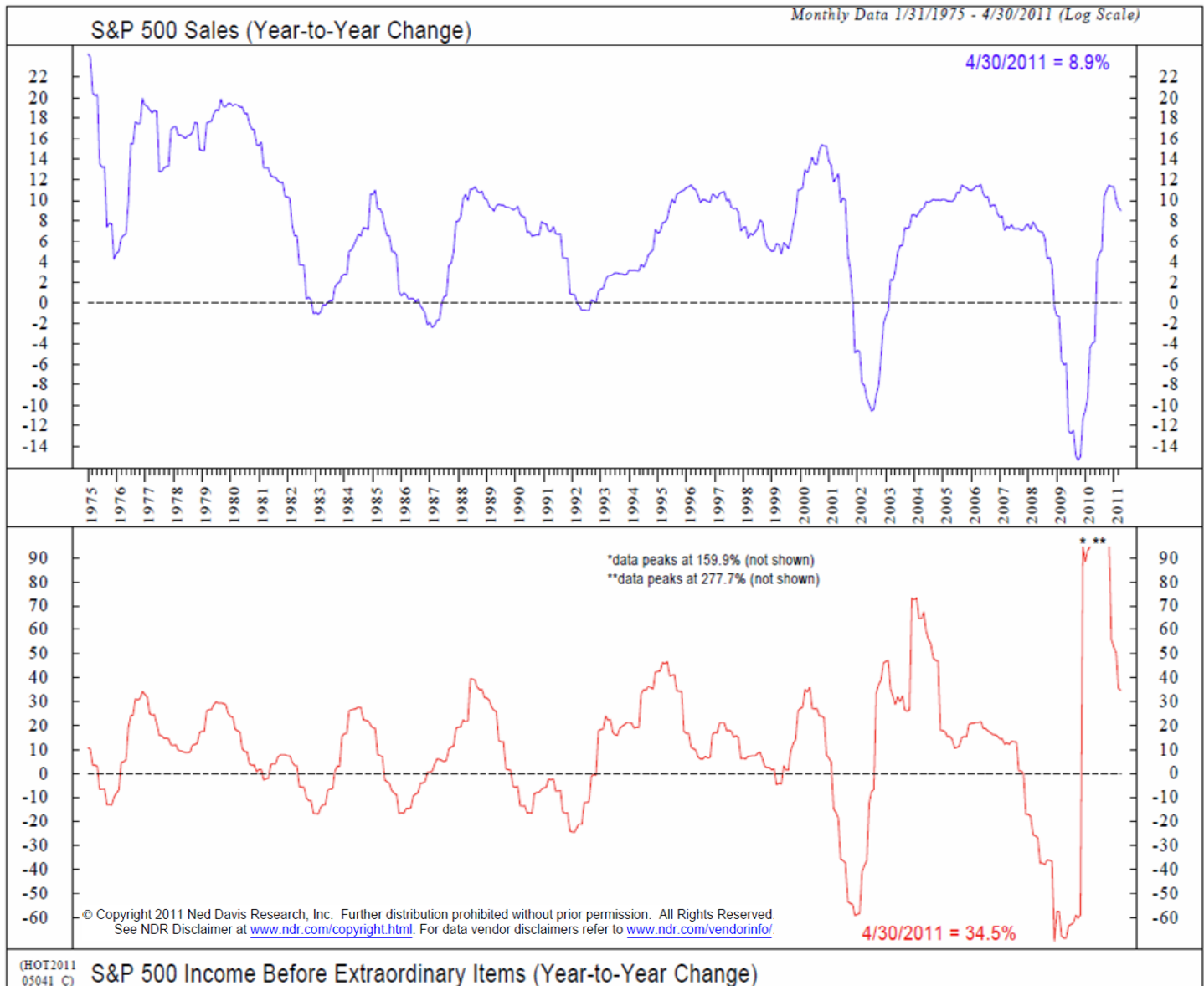


Strong Earnings Despite Mixed Economic Picture

- The current economic expansion has been characterized by a 'normal' recovery in revenues, an exceptional rise in profits off a low base (see Weekly Chart), and a persistent belief by companies that they can meet expected demand with only modest additions to their labor force. A recent *Wall Street Journal* article reports: "Chief financial officers at large North American companies polled by Deloitte LLP said it would take a 20% surge in revenue before they felt comfortable adding to their payrolls [and yet] respondents estimate top line growth at North American companies will be just 8.2% this year." If accurate, we find this rather remarkable since our chart clearly shows that revenue growth of 8.2% is healthy by the standards of the last 20 years, but it speaks to the determination of US companies to remain competitive. We suspect that for employment to improve substantially smaller companies' confidence in the domestic economy will need to improve, and we believe this will be a slow process.
- Nonfarm payrolls increased by 244,000 in April, according to the Bureau of Labor Statistics' employment report (based on its 'establishment survey') released last Friday. Furthermore, the prior two months' job gains were revised higher by a net 46,000, bringing the three-month average to 233,000. Job creation was broad based with private goods-producing sectors up 44,000 and private service-providing sectors up 224,000 with all categories contributing except, notably, temporary help services, while losses continued in the government sector, which fell by 24,000. April's unemployment rate, however, rose to 9.0% from 8.8% as the 'household survey,' which tends to be more volatile, posted a 190,000 decline in the number of people employed, contradicting the establishment survey this month, although still consistent with it on a three-month average look.
- Somewhat troubling for the jobs picture, in our view, was the most recent 43,000 increase in weekly initial jobless claims to 474,000, which brought the four-week average to 431,000. We expressed concern last week as claims moved back above 400,000, which we consider evidence that the economy is moving towards a slower pace of expansion. The Department of Labor, which reports the unemployment insurance data, was quick to point out that the surge in claims was due to 'one-off' factors, which hopefully will be reversed in the coming weeks. However, based on other recently reported data, particularly the purchasing manager surveys (PMIs) and the first-quarter GDP report, we believe economic growth is decelerating, and sales and earnings with it.
- Manufacturing continues to benefit from a weak dollar, while the service sector is being weighed down by higher energy costs. The Institute for Supply Management (ISM) released April's PMIs for the manufacturing and non-manufacturing sectors last week. While manufacturing held up well, declining only 0.8 of a percentage point to a still-elevated 60.4 percent (recall that a level above 50 signals expansion in business activity), non-manufacturing PMI decreased 4.5 percentage points to 52.8. Although still above 50, the large drop is alarming to us because non-manufacturing PMI is representative of the services sector, which comprises almost 80% of GDP. In addition, a leading component of the non-manufacturing index — new orders — fell by a record 11.4 percentage points to 52.7. Again, this is still 'positive' and we wouldn't be overly worried unless it dipped below 50, but it is nevertheless a clear indication of slower growth, in our view. Additionally, the employment portion of the index fell 1.8 points to 51.9.
- Commodity prices seem to be responding to slower growth, with oil prices moving back to around \$100 a barrel and other commodities also down sharply. We think the pullback from recent highs is understandable, but that the magnitude of the sell-offs are more reflective of how 'crowded' the trades had become in recent weeks. With commodities 'overbought,' a correction was simply overdue; economic data, along with Osama bin Laden's death, provided a catalyst. Given the attention that the commodities rally has garnered and the attendant concern over its impact on growth, we view the correction — particularly in oil — as a relief for consumers and positive for financial markets.

- For stocks, we think the bottom line is that the cyclical bull remains intact, even with growth slowing, because the Federal Reserve is likely to keep interest rates ‘lower for longer.’ Until the Fed actually starts to tighten policy and not just remove accommodation, we see few reasons to become fundamentally bearish. That said, last week we lowered stock weightings in our three more conservative portfolios (Conservative Growth & Income, Moderate Growth & Income and Conservative Growth) bringing them back to more neutral levels as we believe the short-term risk/reward is less attractive at current market levels.

The Weekly Chart: Sales & earnings slowing from high levels



The S&P 500's earnings were up 34.5% year over year in the first quarter, based on the companies that have reported so far. Although the pace of earnings growth is down substantially from the 100%-plus gains in 2010 (off of a low base), first-quarter results still show greater growth than most of the earnings cycles have seen since 1975. In contrast, S&P 500 sales growth, while having recovered about 10%, remain historically in line (one can detect a slight secular downtrend, but we think this reflects the secular downtrend in inflation since the late 1970s).

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