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Expanding U.S. Economy Brings Down Unemployment Rate, Initial Jobless Claims; Exogenous Shocks (Oil, Japanese Quake) Increase Risk of Momentum Slowdown

The U.S. economy, which grew at a 2.9% annualized rate in 2010, the most in five years, is creating more jobs while reducing the unemployment rate and first-time filings for jobless benefits. Nonfarm payrolls increased 216,000 in March, the most since May 2010, and the unemployment rate fell to 8.8%, the lowest level in two years. Initial claims for unemployment benefits have also been experiencing an encouraging trend. In March, the weekly reading for first time jobless benefits registered a downside breakout below 400,000, marking the lowest levels since July 2008.

U.S. real gross domestic product (GDP) is now above the previous cycle peak from the fourth quarter of 2007, though the expansion has not translated into a complete recovery in jobs. The U.S. economy produced the same level of output as in the peak of 2007, but with 6.8 million fewer workers. Several factors are negatively impacting labor markets including employers having learned to operate more efficiently over the course of the downturn, the manufacturing sector requiring fewer workers per unit of output, and a more moderate recovery in labor intensive services, such as retail. However the biggest "hole" in employment remains housing, with housing starts registering around 500,000/year, approximately one million below normal. An average of five jobs per housing start accounts for five million of the missing jobs in the economy.

In March, Federal Reserve (Fed) Chairman Ben Bernanke testified on Capitol Hill that, "we have seen increased evidence that a self-sustaining recovery in consumer and business spending may be taking hold." Additional corroborating evidence includes the U.S. manufacturing sector recording its strongest performance in February 2011 since May 2004, as measured by the Institute for Supply Management's (ISM) manufacturing index. Similarly, the ISM Services index, a survey of multiple industries including healthcare, finance, retailing and transportation, increased to the highest level in February since August 2005. Also, total U.S. household debt, including mortgages and credit cards, fell for the second straight year in 2010 to \$13.4 trillion, or 116% of disposable income, down from a peak debt burden of 130% in 2007. Lastly, U.S. consumer borrowing increased by over \$5 billion in January, marking the fourth straight monthly gain. Barring a significant turn in the economy or inflation, it seems likely the Fed will end its securities purchase program known as quantitative easing two (QE2) as scheduled in June.

With improving growth, inflation pressures are increasing and we are closely analyzing the economic and margin impacts of rising input costs from commodities, food and energy. Long-term rates have gradually been moving higher in response to better job growth, the expected unwinding of the Fed's asset purchase program and the potential for higher inflation. After falling to near 2.4% in October 2010, benchmark 10-year Treasury yields rose to over 3.6% for the first time in nearly a year in the first quarter. A weaker U.S. dollar and record federal government budget deficits of over \$1 trillion per year represent additional potential headwinds for Treasury yields. We will continue to monitor the Treasury market for any signs of an upside breakout in yields, especially on the short end of the yield curve, which could be a harbinger of potential future Fed rate increases.

In March, a flight to safety due to turmoil in the Middle East and North Africa (MENA) led to a decline in 10-year Treasury yields from the highest levels in a year. Social uprisings in the region have toppled presidents in Tunisia and Egypt and led to a civil war and oil supply disruption in Libya. Antigovernment demonstrations calling for moves to democracy and action to improve living standards were also held in Algeria, Bahrain, Jordan, Iran, Iraq, Oman, Saudi Arabia, Syria and Yemen. Fears of further demonstrations and potential supply shortages have priced an estimated \$15 per barrel geopolitical risk premium into crude oil prices. In the U.S., a \$10/barrel rise in the price of oil translates into roughly a 25 cent increase in the price of a gallon of gasoline. If gasoline prices were to remain elevated, the resulting negative impact would slow growth, especially during the peak summer demand season.

We will be closely monitoring the situation for any signs of the civil unrest in the region increasing in Saudi Arabia, the world's largest oil exporter, which could cause a more severe oil disruption. The Saudi Arabian government has increased spending on welfare and public services, in an attempt to quiet unrest. The Saudi government also plans to spend \$400 billion on infrastructure, education and job creation measures through the end of 2014. While we think a broad uprising in Saudi Arabia is a low probability scenario, geopolitical events and volatile global energy markets are impossible to predict, so such an event cannot be ruled out. It would potentially result in a much more significant oil price spike, with significantly negative impacts to our economic growth outlook, which would undoubtedly impact our current portfolio positioning.

The U.S. Energy Information Administration raised its 2011 forecast for West Texas Intermediate crude oil to \$105 a barrel, up 15% from its previous outlook of \$91 a barrel in March, due to continuing unrest in MENA. While crude oil prices above \$100 a barrel and gasoline prices of more than \$3.50 a gallon are unwelcome, and act like a tax on consumer's discretionary income, we believe that they are manageable. U.S. oil consumption has dropped 5% since 2005, many vehicles are more fuel efficient than just five years ago, and energy dependent industries tend to pass on higher costs immediately to end users in the form of fuel surcharges before they negatively impact profits. Our price elasticity analysis indicates that demand destruction would begin should crude oil prices make a protracted move to the \$120 - \$130 a barrel range.

While Libya's light, sweet crude blends are relatively more attractive from a refining standpoint, especially in Europe, we believe that the current spare production capacity from the Organization of Petroleum Exporting Countries, and Saudi Arabia in particular, can replace the lost production from Libya. Saudi Arabia's oil minister has indicated that it will rectify any shortage in supply immediately. Ultimately, we believe that oil price shocks are self-correcting and that while higher oil prices may reduce global economic growth temporarily at the margin, economic growth should remain on track.

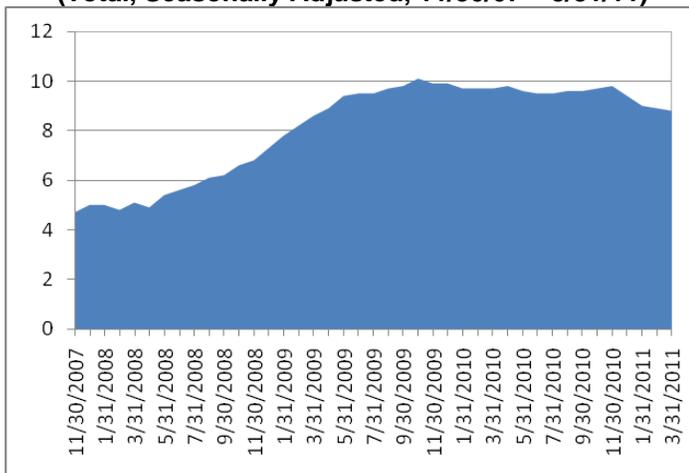
On March 11, a magnitude-9.0 earthquake and subsequent 10-meter tsunami demolished Japan's northern Pacific coast. The earthquake and subsequent 30-meter tsunami damaged the Tokyo Electric Power Co. nuclear plant approximately 135 miles north of Tokyo, leading to radiation leaks. While the human costs are forefront in everyone's minds, the government's estimate for the economic damage from the earthquake and tsunami is 16 trillion to 25 trillion yen (\$198 billion - \$309 billion), which covers damaged roads, homes, factories, and other infrastructure, but excludes lost economic activity from power outages and costs arising from damage to the Fukushima nuclear power plant.

The Bank of Japan injected a record amount of cash into its financial system, increased its asset purchase program, and the Group of Seven nations jointly intervened in foreign exchange markets for the first time in over a decade to discourage Yen speculators, all in an effort to minimize the adverse economic impacts of the disaster. In the short term, lower demand and supply chain disruptions will subtract from global growth, especially in the automobile and electronics industries, however the subsequent relief efforts and rebuilding of the power grid and transportation infrastructure should add to output levels.

While recent events in the MENA and Japan will slow global economic growth in the short-term, we continue to believe that the economic expansion and the related rally in risk assets are self-sustaining. Since the recession officially ended in June 2009 the U.S. economy has produced six quarters of positive growth, despite the European sovereign debt crisis, the municipal bond predicament in the U.S., and an inflation surge generated in the rapidly expanding emerging economies. Moreover, S&P 500 profits have topped estimates for eight-straight quarters, and, in a sign of renewed confidence by corporate executives, mergers and acquisitions activity is increasing.

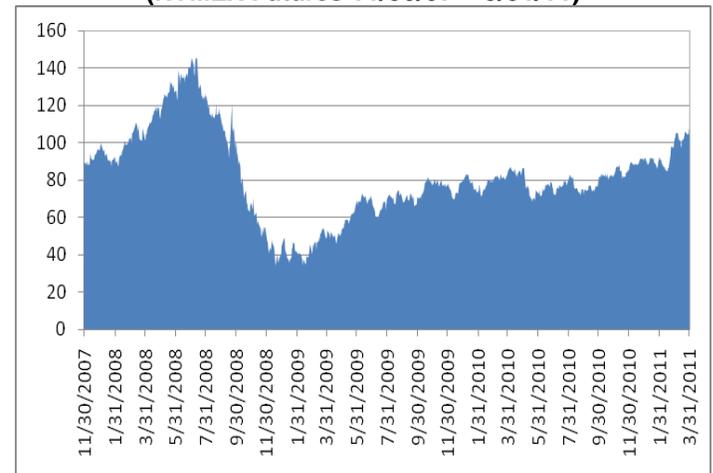
Given the positives, we continue expect a trend-level pace of growth this year and believe large cap, global companies will continue to be beneficiaries of the economic expansion. We continue to strive to participate in rising markets, while holding up better in down markets. While maintaining a focus on high quality, financially sound companies, due to the re-acceleration in economic data, we have increased our preference for exposure to cyclical growth. After having replaced a number of holdings over the past six months, with what we believe are better opportunities, we are optimistic, as S&P 500 earnings are forecast to surpass the 2007 peak of \$90 a share later this year. In our analysis, the recent additions maintain higher growth rates than their respective peers and have stock prices that may not fully value their long-term potential.

Monthly U.S. Unemployment Rate (%)
(Total, Seasonally Adjusted, 11/30/07 – 3/31/11)



Sources: U.S. Bureau of Labor Statistics, Bloomberg

Light Sweet Crude Oil Price (\$) Per Barrel
(NYMEX Futures 11/30/07 – 3/31/11)



Sources: New York Mercantile Exchange, Bloomberg

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