Godsey & Gibb Associates
Investment Watch
January 2011

Multiple Indicators Signal U.S. Economic Recovery After 'QE2', December Tax Deal; China's Tightening, Europe's Crisis, U.S. Unemployment and Housing Remain Risks

Global economic growth reaccelerated in the fourth quarter and U.S. economic metrics, including leading, coincident and lagging indicators, showed improvement. In addition to the better than expected economic data set, the aggressive announcements on both the monetary and fiscal policy fronts added to the positive information flow, signaling a moderately positive growth trajectory for the economy, and a decline in the possibility of a second recession. After firming in the last quarter of year, we expect the U.S. economy to advance at a pace slightly higher than its 20-year average of 2.6% in 2011.

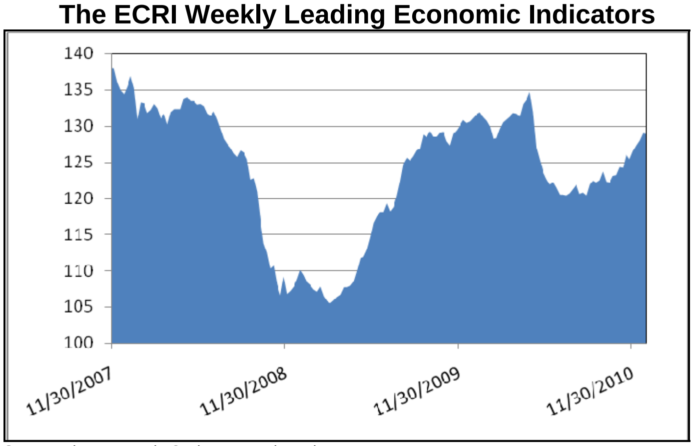
After a mid-year growth scare, the Economic Cycle Research Institute's (ECRI) weekly index of leading indicators such as money supply, initial unemployment claims, and stock prices, moved higher in the fourth quarter, indicating a resumpti0n in economic growth. Similarly, the Ned Davis Recession Probability Model (NDRPM), which is calculated using state coincident data such as average manufacturing hours worked, real wages and salaries from all 50 states, fell to 10% in late December. Readings for the NDRPM, which maintains a high level of overlap with the NBER official recessions, above 50% indicate a likely recession. Indicators that typically lag the economic cycle, such as employment, also moved higher in December. ADP's monthly private sector employment change index registered a robust increase of 297,000 in 2010's final month. While that number may be revised lower, the U.S. Labor Department's December Nonfarm Payrolls posted a gain of 103,000, including private sector payroll additions of 113,000 for the month, and the separate household survey showed an employment gain of 297,000 in December.

Additional labor market indicators such as initial unemployment claims also confirmed the slow but steady improvement in the economy. Initial unemployment claims were 409,000 for the week ending January 1, 2011, down 95,000 from the peak in mid-August 2010. The four-week moving average, a less volatile measure, dropped to 410,750 to end 2010, marking the lowest level since July 2008.

Both the manufacturing and services sides of the economy are contributing to the recovery. The manufacturing sector of the economy is delivering impressive growth. The Institute of Supply Managements (ISM) Manufacturing Purchasing Managers Index (PMI) rose to 57.0 in December, the highest level in seven months. Moreover, December's ISM Non-Factory (Services) Index, which covers about 90% of the economy, rose to 57.1, exceeding estimates, and representing the highest level since May 2006. The ISM Services index measures business activity, new orders and employment activity and readings above 50 indicate growth.

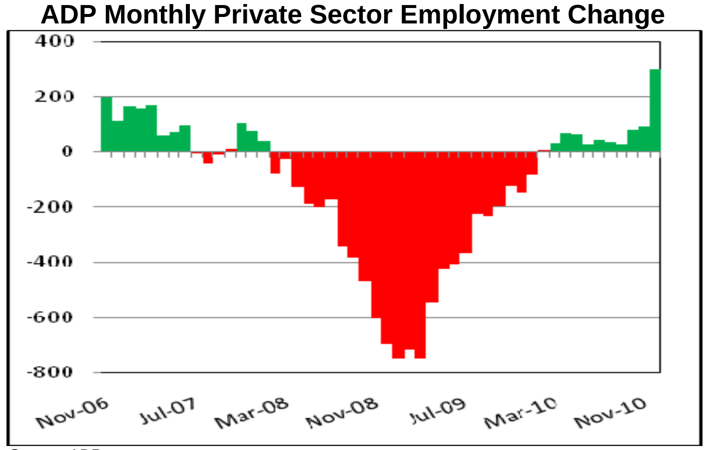
Policy makers continue to provide both monetary and fiscal stimulus. In his speech in late August from Jackson Hole, WY, Fed Chairman Bernanke indicated that the Fed was 'prepared to provide additional monetary accommodation through unconventional measures' if necessary, a move that was confirmed in November when the Federal Open Market Committee announced its second large asset purchase program, commonly referred to as quantitative easing, or "QE2." The Fed will buy $600 billion of Treasury securities through June 2011 in an attempt to reduce borrowing costs and support the value of homes and stock prices.

The ECRI Weekly Leading Economic Indicators



Source: The Economic Cycle Research Institute

ADP Monthly Private Sector Employment Change



Source: ADP

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The U.S. midterm election results in November were also generally perceived to provide a more business friendly environment in Washington. In December, the White House and Congress surprised most by agreeing to, then passing a fiscal package which preserved the current income-tax rates for all earners, gave a 2%, one-year cut in employee's payroll taxes, restored long-term employment benefits and provided for expensing of corporate capital investment in 2011.

While economic growth rates remain robust in developing markets like China and India, these countries are tightening monetary policy to control inflation. In its second increase in just over two months, China's central bank (the PBoC) increased its baseline interest rate by 25 basis points, to 5.81%, in an effort to rein in inflation. The PBoC also increased reserve requirements on banks six times last year. Additional rate increases by the PBoC in 2011 are also expected, which could increase global financial market volatility.

Contagion fears related to the sovereign debt crisis in the Eurozone also present potential risks for global growth. The unsustainably high debt levels of several European countries – Portugal, Ireland, Greece, and Spain (PIGS) – have led to credit rating downgrades, rising debt yields, increased foreign exchange volatility, austerity measures such as budget cuts, stricter retirement rules, and higher taxes, and the formation of a $1 trillion rescue package of government loan guarantees. European and U.S.-based banks own billions of sovereign bonds issued by the PIGS nations, which will keep investors cautiously focused on the European situation.

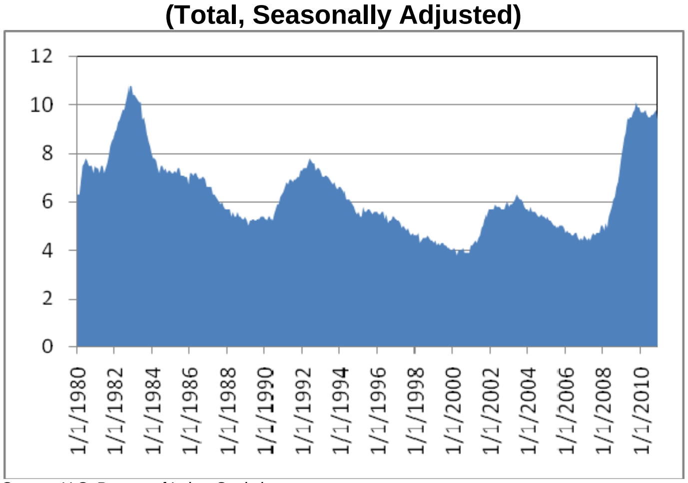
While consensus estimates are for U.S. GDP growth in 2011 to be at or near 3.0%, persistently high unemployment and a historically weak housing market are hindering a more robust pace of expansion. The growth rate to date has been insufficient to reduce the unemployment rate. Although the jobless rate fell to a 19-month low of 9.4% in December, from 9.8% in November, the decline was due in part to 36,000 people who terminated job searches and therefore left the labor force.

Job seekers tend to drop out of the labor force when jobs look scarce and reenter later when the market improves. In 2010, 1.1 million j0bs were created and the unemployment rate averaged 9.6%, the highest since 1983. At December's pace, it would take 70 months, or until late 2016, to create the remainder of the 8.4 million jobs lost in the deep global recession.

Housing remains an additional area of weakness. Monthly readings for housing starts, new home sales and existing home sales continue to bounce along at or near historically low levels. The average rate for a 30-year fixed loan rose to a seven-month high of 4.81% in the last week of 2010, which could limit home buying demand in the start of the new-year. Home prices, as measured by the S&P/Case-Shiller 20-City Home Price Index, fell in the final four months of the year, indicating housing remains a weak link due to the large supply-demand imbalance, even as the U.S. recovery reaccelerates. Funding strains on state and local government budgets and the potential inflationary impacts of the recent increase in gasoline prices are additional weak spots for the economy.

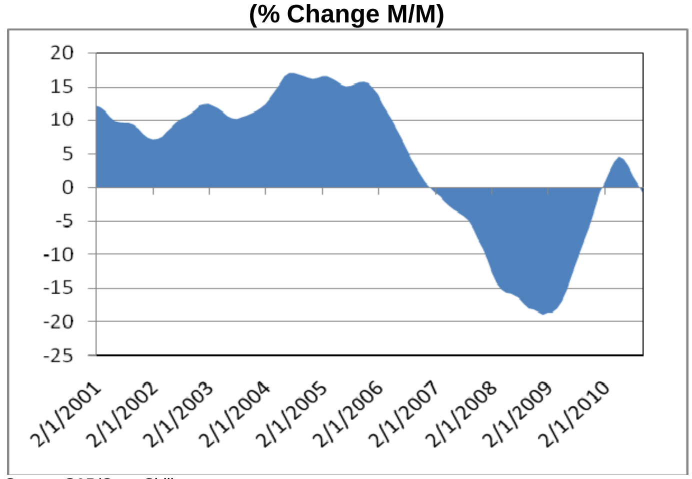
Despite persistently high unemployment and the weak housing market, with the backdrop of an economy that is gaining strength, moderate inflation and accommodative monetary policy, we continue to favor equities over bonds and cash. We are maintaining a focus on quality and stability, while shifting to a more cyclical stance with the addition of several new companies in the Technology, Financial Services and Industrials sectors. We believe our disciplined investment strategy, which focuses on higher-quality, financially strong companies, with consistent track records of earnings and dividend growth, is well-suited for this environment. The businesses that we invest in maintain sustainable competitive advantages, exposure to the higher growth markets overseas, and significant cash generation for value creating acquisitions, capital investments in new products and technology, and the potential to return cash to shareholders through dividends and share repurchases.

U.S. Unemployment Rate (1980 – 2010)
(Total, Seasonally Adjusted)



Source: U.S. Bureau of Labor Statistics

S&P/Case-Shiller 20-City Home Price Index
(% Change M/M)



Source: S&P/Case-Shiller