



Uneven Global Recovery Looks Good, Feels Bad as High U.S. Unemployment Lingers; Manufacturing Soars, Current and Expected Deficits Rise and Merger Activity Accelerates

In a continuation of the asymmetric global economic recovery and pre-recession trends, emerging Asia continued its rebound from the global financial crisis much faster than more mature economies. Asian economies are forecast to maintain a relative growth advantage, expanding at an expected 7% in both this year and next, compared to 3% for the U.S. and 1.2% for Western Europe. Since 1995, Asian economies have grown more than twice as fast as the U.S. and Europe.

Based on a purchasing power parity analysis, which includes relative price levels, Asia's share of the global economy has risen from 18% in 1980 to 27% in 1995 and 34% in 2009. With three of the world's biggest economies (China, Japan, and India) Asia's economies will probably exceed the combined sum of the U.S. and Europe within several years. And even with over three-fifths of the world's population living in Asia, the region's economies account for just over one-fifth of global private consumption, much less than the U.S. at 30%. Over the next 10 years, large Western multinational firms will likely generate close to half of their sales and profits in Asia, up from 20% to 25% today.

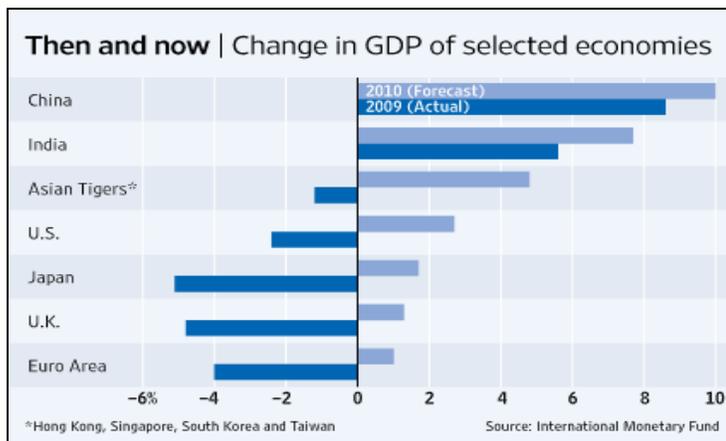
But given the impressive absolute and relative economic growth, along with rapid money growth and rising commodity prices, inflation at both the consumer and producer level is picking up in China and other Asian economies, forcing central banks to tap the brakes of economic growth. In January, the People's Bank of China began a tightening cycle by raising reserve requirements to slow loan growth and more tightening is expected. A tightening cycle is also underway in India. While these economies represent important investment opportunities, it is imperative to consider that equity markets rarely rally in tightening cycles as higher rates and tighter credit conditions make for a less favorable environment.

In the U.S., the manufacturing sector is leading the recovery, but high unemployment persists and with moderate expectations for inflation, the Federal Reserve (the Fed) is not expected to begin raising its benchmark fed funds rate until the second half of 2010.

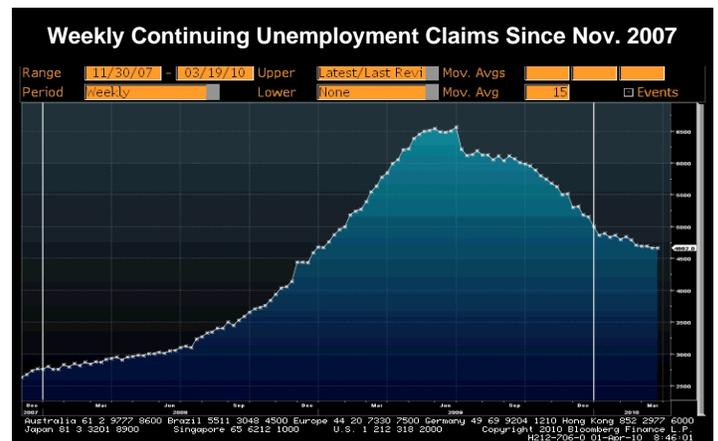
U.S. factories are boosting production to meet rising global demand and replenish depleted inventories. In March, manufacturing expanded for the eighth consecutive month and at the highest level since July 2004. However, the economy still requires job growth to drive a sustainable level of consumer spending. Consumer spending, which accounts for 70% of economic activity, is forecast to average 2% growth this year.

While our working assumption is that the unemployment rate peaked in October 2009 at 10.1%, the highest level since 1983, estimates for unemployment this year remain high at 9.6%. The unemployment rate held at 9.7% in March, despite the 162,000 gain in nonfarm payrolls. The economy needs to create at least 100,000 jobs per month in order to keep the unemployment rate flat due to population growth. Continuing jobless claims, which dropped considerably in the second half of 2009, have moved in a mostly sideways pattern year-to-date in 2010, as shown in the graph below.

The Fed has been active in withdrawing its liquidity measures and it raised the discount rate charged to banks for direct loans to 0.75% from 0.50% in February. We believe the Fed will begin raising its policy fed funds rate when it believes the recovery is sustainable. Historically, the Fed has waited for unemployment to fall for 12 months before raising rates, however the Fed could signal a policy change earlier by dropping the 'extend period' language.



Sources: The IMF and The Economist



Sources: Dept. of Labor and Bloomberg

Anxiety about government legislation and regulation, including the administration's health care overhaul, and the apparent inability to deal with record high structural budget deficits are further clouding the economic outlook and financial market environment. The recently-passed health-care bill could dramatically alter the costs associated with employing workers. The large current and project budget deficits could pressure the dollar, potentially increasing inflation and incent foreigners to invest elsewhere.

In March, Standard & Poor's warned that unless the U.S. adopts a credible medium-term plan to rein in fiscal spending, it could potentially undermine the dollar's status as the global reserve currency which would "weigh on the triple A rating on the U.S." Fed Chairman Bernanke testified in February, "It is very, very important for Congress and the administration to come to some kind of program, some kind of plan that will credibly show how the U.S. government is going to bring itself back to a sustainable position." The funding requirements of entitlement programs, such as Medicare, Medicaid, and Social Security, will be critical to future deficits. The administration's newly appointed deficit commission will have the tough task of trying to reduce the deficit without massive tax hikes; however tax and entitlement reform may only occur in response to a crisis.

With overcapacity in labor and other resource markets, deflationary pressure will likely persist outside the volatile food and energy sectors in the near-term. However, rising commodity prices continue to create some inflation risks. Overall inflation expectations have decreased year-to-date based on the difference in yields for Treasury inflation protected securities and nominal Treasury notes. Core inflation, measured by the personal consumption expenditures (PCE) core index, was up 1.3% in February and the Fed projects the PCE core index to be 1.4% to 1.7% in 2010. While the Fed currently holds record excess reserves of over \$1 trillion, slow money supply growth due to tight credit should limit the risk of near-term inflation in the U.S.

Even with modest levels of economic growth and above-average levels of unemployment, corporate profits continue to rebound. According to Thomson Reuters, 72% of companies in the S&P 500 Index beat earnings expectations for the fourth quarter of 2009. Moreover, share buybacks, dividend increases and merger activity have intensified in recent periods, helping to promote a shareholder friendly environment.

Through the first quarter, the Godsey & Gibb Associates Approved List of companies has generated 20 dividend increases in 2010. Merger and acquisition activity of late for deals greater than \$1 billion in enterprise value have totaled over \$218 billion for Approved List companies, including Pfizer's \$68 billion mega-merger with Wyeth announced last January which recently closed (shown in the table below). Moreover, the deal flow has been broad-based, involving companies in six of the 10 major industry groups. Many smaller deals of under \$1 billion in enterprise value have also been announced from across multiple industry sectors.

From an overall equity strategy perspective, with market upside potentially limited due to the possibility of future Fed tightening, we continue to believe a focus on high-quality, growth companies with sustainable earnings and above-average dividend growth will serve investors well in a modest economic recovery. These companies have strong balance sheets, with ample cash levels and significant free cash flow generation in order to continue to repurchase shares, increase dividends, or make value-added acquisitions. Many large multinationals also have non-U.S. segments, which provide exposure to the fast growing emerging markets. We remain very selective in both Financials, given the trends for reregulation out of Washington, and in the Consumer Discretionary sector, given the high levels of both consumer debt and unemployment. We maintain overweight positions in the Consumer Staples, Healthcare and Technology sectors.

Recent Merger & Acquisition Activity for Godsey & Gibb's Approved List of Companies

Buyer	Target Company Acquired	Industry Sector	Transaction Enterprise Value (in billions)
Pfizer Inc.	Wyeth	Healthcare	\$68.0
Exxon Mobil Corp.	XTO Energy, Inc.	Energy	\$41.0
Novartis	Alcon – from Nestle	Healthcare	\$28.1
Pepsico, Inc.	Pepsi Bottling & PepsiAmericas	Consumer Staples	\$19.8
Kraft Foods, Inc.	Cadbury, plc	Consumer Staples	\$18.9
Schlumberger Limited	Smith International, Inc	Energy	\$12.8
Oracle Corp.	Sun Microsystems, Inc.	Technology	\$5.6
Teva Pharmaceutical Ltd.	Ratiopharm GmbH	Healthcare	\$5.0
Express Scripts, Inc.	NextRx, LLC – from Wellpoint	Healthcare	\$4.7
First Energy Corp.	Allegheny Energy, Inc.	Utilities	\$4.7
Cisco Systems, Inc.	Tandburg	Technology	\$3.0
Hewlett-Packard Co.	3Com Corp.	Technology	\$2.7
United Technologies	GE Security	Industrials	\$1.8
Walgreen Co.	Duane Reade	Consumer Staples	\$1.1
Schlumberger Limited	The Geoservices Group	Energy	\$1.1
TOTAL			\$218.1

Source: Godsey & Gibb Associates

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