Godsey & Gibb Associates
Investment Watch
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Global Economies, U.S. Leading Indicators Rebound, But Is the Recovery Sustainable? Revenue Growth, Job Creation Will Be Keys To Upturn's Eventual Strength, Duration

Global economic growth rebounded in the third quarter from the depths of the Great Recession, led by emerging economies in Asia, Latin America and Eastern Europe. Financial markets reacted positively, sending stocks to new highs for the year and gold to over $1,000 an ounce. The yield for the 10-Year U.S. Treasury bond fell to a 5-month low of 3.3% at quarter-end, as healthy demand for the safest assets persisted from the Federal Reserve, foreign investors and U.S. financial institutions.

Asia's emerging economies are clearly leading the global economic recovery with expected growth of at least 5% in 2009, compared to negative 3.5% for developed, G7 nations. Aggressive fiscal and monetary stimulus across the Asian region, moderate levels of public debt, and lower use of leverage by households have combined to drive sharp increases in industrial production, bank lending, and overall spending. Emerging economies also remain large consumers of industrial metals such as steel, copper, and aluminum due to urbanization and industrialization.

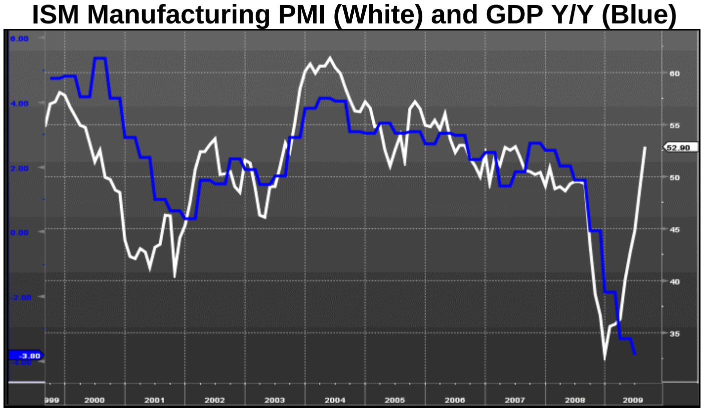
Economic conditions stabilized in the more developed countries, including the U.S., in the third quarter. The Federal Reserve began to formulate exit strategies from the numerous interventions initiated over the course of the last cycle. After 21 months of declines, the longest downtrend since the mid 1970s, leading economic indicators in the U.S. rose for the fifth straight month in August, suggesting the recession has ended. Leading indicators include such metrics as stock prices, jobless claims, building permits, consumer expectations, and the slope of the yield curve. As such, growth domestic product (GDP) is expected to rebound in the third and fourth quarters, and into 2010.

Positive GDP could help lead to top line revenue growth for corporations, an element of the recovery that has been missing as of yet. While aggressive cost cutting, declining labor costs, improving operating margins, and strengthening productivity have supported profit levels and led to increasing analysts' estimates, we believe a key element of the economic recovery will be the return of revenue growth. A return of private demand from both consumers and businesses will be necessary, in our view, for a meaningful return to revenue growth for corporations.

Improving stock market returns and housing sector gains led to a 3.9% increase in U.S. household net worth to $53.1 trillion in the second quarter, marking the first increase in nearly two years. Housing prices, like stocks, are indicating the early signs of a recovery. After peaking in June of 2006, the S&P Case-Shiller house price index fell for 33 straight months before showing gains in May, June and July of 2009. Improved affordability and historically low mortgage rates appear to be boosting housing demand.

Corporate mergers and acquisitions (M&A) activity is also recovering. After dipping to the lowest levels since 2003 earlier this year, a number of multi-billion dollar transactions were announced in the third quarter, signaling a potential turn in the cycle. Catalysts for continued strength in M&A include high cash levels, stockpiled by corporations as a safety net in the downturn, the attractive valuations of target companies, and the quest for global growth in both revenue and earnings from exposure to international markets.

ISM Manufacturing PMI (White) and GDP Y/Y (Blue)



Sources: ISM, BEA and Bloomberg

U.S. Household Net Worth (Nominal, in $Billions)

Sources: Federal Reserve and Bloomberg

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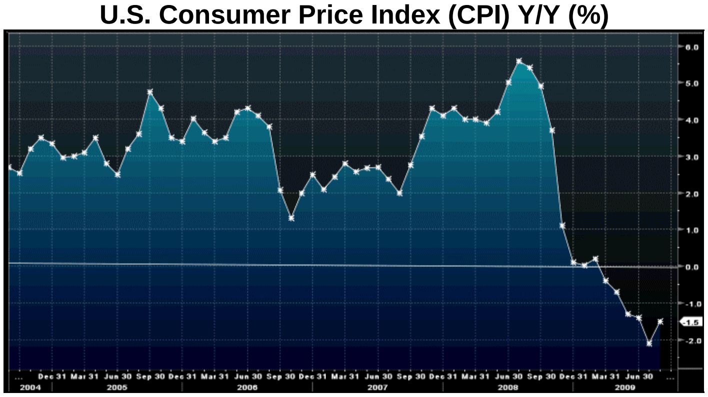
Employment, which is still in decline, will need to improve before a recovery in consumer spending can take hold. In August, 27 states reported increases in month-over-month unemployment rates, and over the last year the jobless rate increased in all 50 states. But even with a modest upturn in overall economic activity, the unemployment rate is expected to stay near 9.5% to 10.0% for an extended period of time. Moreover, persistently high unemployment, combined with ongoing balance sheet repair by individuals, should lead to a continued rise in the personal savings rate and restrain future consumer spending.

The consumer price index (CPI) may have found a floor, as commodity inflation is likely to move higher in the near term. Broad inflation in consumer goods such as housing and wages will likely remain subdued however, due to historically low capacity utilization, 70.5% in September, and high unemployment, 9.8% in September. The market appears comfortable that the Federal Reserve will keep interest rates low for some time. However, as the economic outlook improves, the Fed's balance sheet will need to contract to maintain price stability. While we anticipate the Federal Reserve will maintain its historically low rate bias for longer than in past cycles, to insure an upturn take holds, Fed officials have indicated that the bank will tighten monetary policy once the economy improves.

The U.S. dollar fell to new lows for the year in the third quarter as government debt rose to the highest percentage of GDP since the 1950s and Federal Reserve policy easing flooded the financial system with greenbacks. A growing number of emerging economies have called for a substitute as a global reserve currency. While the U.S. dollar still accounts for 65% of world currency reserves, according to the IMF, it is losing market share for new reserves. The dollar's 7-month decline has increased concerns regarding government budget, and current-account deficits, and the potential for higher inflation. However a weaker dollar does provide benefits by making U.S. goods and services, and U.S. equities, more affordable to foreign consumers and investors, respectively.

U.S. Consumer Price Index (CPI) Y/Y (%)



Sources: Bureau of Labor Statistics and Bloomberg

Economic forecasts anticipate that the shape of the economic recovery could resemble a wide range of letters including "V", "U", "W", and "L", and even the Nike® "Swoosh" symbol. Given the risks, the economic recovery will likely take longer and be more muted than in past cycles. With consumer balance sheet repair still underway, evidenced by the record $113 billion decline in consumer credit over the last 12 months, a jobless recovery unfolding, and an expanding role of government relative to the private sector, we believe economic growth will remain subpar relative to past recoveries. Despite the early positive signs from the inventory cycle, the positively shaped yield curve, and rising earnings estimates, we believe that the low level of available credit from banks, along with the high level of liabilities relative to disposable incomes for households, will keep consumer spending, the engine of U.S. economic growth, restrained.

While we think the relative growth advantage of emerging economies over slower growth, more highly levered developed markets will continue, we believe one area of opportunity that has been overlooked in advanced economies is "quality." The sharp rally in the equity markets from the March lows has been led by the most speculative, highest risk (beta), lowest quality, securities with the highest short interest, including the Financial and Consumer Discretionary sectors. We believe that multiple factors including relatively low price-to-earning multiples, attractive growth outlooks, high levels of cash flow and strong financial positions could drive relative outperformance by large cap, high-quality stocks. "Blue chip" names also offer greater downside protection if the market should temporarily weaken. Given our outlook, we continue to position portfolios with a "barbell" approach, for both secular and cyclical growth opportunities on the one end (e.g. commodities, emerging markets, and technology), along with exposure to more defensive, conservative growth investment opportunities (e.g. healthcare and consumer staples).

U.S. Dollar Index (Spot) Year to Date in 2009

Source: Bloomberg