GODSEY & GIBB
WEALTH MANAGEMENT

INVESTMENT WATCH

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Liquidity Trumps Fundamentals as Central Bank Easing Drives Risk Assets Higher, Increasing the Chance of a Pullback; Oil Rises on Mid-East Tensions; European Recession, China Slowdown, U.S. Election Uncertainty and Fiscal Drag Loom

The post-Great Recession bull market turned three-years old in March, as central bank liquidity drove stocks to near four-year highs in an aggressive year-to-date rally dominated by lower quality issues. Stocks rose in the best first quarter increase since 1998, and volatility declined significantly due to the lack of major positive or negative macro-related events. However, in our analysis, due to a potential lack of positive follow-through, the rapid market gains increased the chance of pullback driven by disappointing economic and earnings data in the spring.

Moreover, uncertainty related to the elections in November including the fiscal drag expected from spending cuts, and the implications of rising taxes, could lead to increased financial market volatility. The election will heighten partisanship, increase the risk of brinkmanship, and leave important policy decisions regarding spending cuts and tax increases that total over $500 billion, or 3.5% of GDP, to a lame duck session of Congress. Without legislative action the 2003 tax cuts will expire at the end of the year, and the administration now supports a dividend rate of 39.6%, plus the 3.8% investment tax that kicks in on investment income next year as part of the health care law, for a total of 43.4%, or close to triple the current 15% level. The price of gasoline is up 20% since the start of the year to $3.93/gallon nationally. The risks of higher gas prices are far reaching in the economy, with grocers, restaurants and retailers, among others, starting to see an impact on their businesses, increasing concern.

Globally, crude oil prices rose in the first quarter on political tensions and economic sanctions regarding Iran, putting a strain on companies' profit margins as their input costs increased and giving consumers less disposable income to fund discretionary purchases. Crude oil rose to as high as $111/barrel in February before easing off and the past year has seen the highest sustained period of elevated oil prices since 2008. Consumer expenditures on energy per unit of GDP are approximately seven percent today. According to the ISI Group, this figure approached eight to nine percent twice in the last four decades and in both cases a meaningful decline in demand followed. A persistent rise in oil prices could derail global economic growth, as for every 10% increase in the price GDP typically drops 0.4% over the following year.

In the U.S., labor markets are improving. Nonfarm payrolls increased by 227,000 in February and averaged 245,000 per month over the last three months. Improvements in the labor market are offsetting rising gasoline prices in the near term. Although the gains in employment have been encouraging, gains in wages have been modest as pay gains have not kept pace with inflation. While weekly unemployment claims have fallen to the lowest level since February 2008, the four-week moving average for unemployment insurance has steadied near 365,000.

Moreover, unemployment persists at 8.2% even after the most robust period of growth since 2006. Further labor market improvement may require more robust economic growth; but with a slowing global growth outlook due to recession in Europe and a looming slowdown in China, continued gains may be more modest. To this point, Federal Reserve (Fed) Chairman Ben Bernanke recently concluded, "we cannot yet be sure that the recent pace of improvement in the labor market will be sustained."

The U.S. housing market is also recovering from extremely depressed levels, and contributing to growth, boosted by better employment data, greater affordability, historically-low interest rates and pent-up demand. The National Association of Home Builders Housing Market Index held steady at the highest level since June 2007 in March. Housing starts are also improving. Builders broke ground on new homes at a 698,000 annual pace in February, boosted by gains in multi-family home construction including townhomes and apartment buildings. In a positive sign for future construction, building permits rose to an annual rate of 717,000, the most since October 2008. Lastly, based on data from the National Association of Realtors, January and February marked the best start to a year for existing home sales in five years.

Given the data confirming the U.S. economy is perking up, along with rising inflation expectations driven mainly by higher oil prices, bond prices fell with yields rising to the highest levels since October, with the benchmark 10-year note touching a five-month high of 2.40% in March. Bonds typically sell off during periods of stronger economic growth. While the recent rise can be viewed as somewhat of a normalization for bond yields, which recently touched historical lows, if rates were to continue to rise the Fed could potentially enter into another round of "quantitative easing" by purchasing bonds to force rates lower. The central bank purchased $2.3 trillion of securities in two rounds of bond buying from December 2008 to June 2011 as part of its unconventional stimulus programs to cap interest rates and boost demand.

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In March, the Fed announced no change in its zero-interest-rate-policy "at least through late 2014". The target funds rate has stayed at zero to 0.25% since December 2008. The Federal Open Markets Committee (FOMC) did slightly upgrade its growth outlook to "moderate economic growth" compared to "modest" growth in its last statement. The FOMC left all options on the table, including the possibility of a new round of quantitative easing, pending future economic data, when its current program, the so-called "Operation Twist" ends in June.

The Fed released results from its stress tests on U.S. financial institutions in March, which said 15 of 19 banks would be able to maintain capital levels above a regulatory minimum in an "extremely adverse" economic scenario, while continuing to pay dividends and repurchase stock. Even so, in addition to known headwinds such as oil price shock, fallout from the sovereign debt crisis in Europe and a so-called "hard landing" in China, the increasing regulatory burden (Basel III, the Dodd-Frank Act including the Volcker Rule) which requires higher levels of countercyclical capital buffers to mitigate systematic risks and billions in new costs for compliance, will likely keep bank lending to the actual economy at modest levels for the foreseeable future.

In Europe, 25 countries, including 17 using the common currency agreed to a new fiscal contract with strict new rules on deficits and debt, and sanctions on member states that fail to meet targets. Additionally in the first quarter, the European Central Bank (ECB) enacted its second round of modifications to its long-term refinancing operating (LTROs). The LTRO program allowed the ECB to extend three-year loans at a 1% rate to European banks using acceptable collateral, providing a key source of liquidity and keeping yields on sovereign bonds lower as these instruments serve as acceptable collateral. The LTRO program has significantly lowered the risk of a systematically important bank failure or liquidity crisis in the near-term.

Greece and its fiscal and financial regulators put the finishing touches on the largest sovereign debt restructuring in history which included the write-down of more than 50% of that country's outstanding debt, allowing it to avoid a disorderly default and to receive a $172 billion rescue in its second bailout. To surpass the 90% participation rate, Greece had to use Collective Action Clauses, triggering credit default swaps, which are used to insure against a default, setting a dangerous precedent for Portugal, Spain and Italy. Moreover, Greece is required to implement tough austerity measures and could be forced to take another round of aid by 2015, or default again, or possibly eventually leave the Euro-zone, if it fails to follow through.

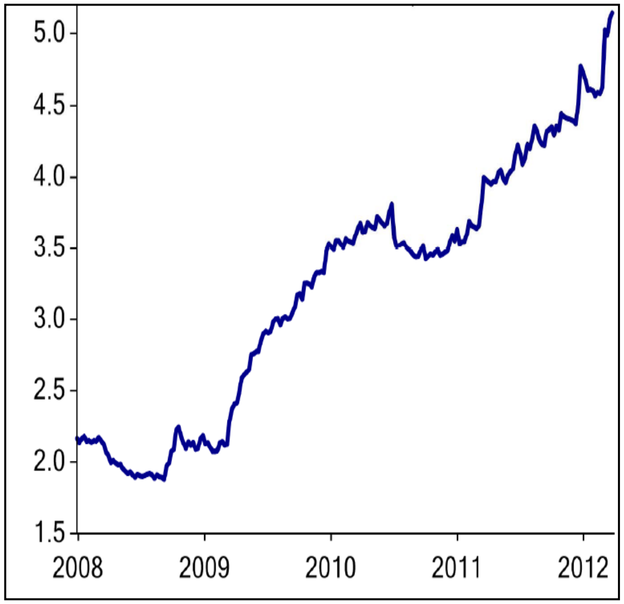
The bigger question remains whether the European authorities can prevent the Greek situation from spreading to the larger European economies. Portugal, Spain, and Italy have sizeable debt burdens and an adequate firewall is needed. Economic recession in southern Europe is underway as of the fourth quarter and a severe or protracted downturn could slow growth not just in Europe but also in the U.S. and other economies globally.

China now expects its GDP growth rate to slow to 7.5%, the lowest in eight years, which would hurt U.S. exports, while potentially reducing global commodity prices. Chinese export growth has slowed this year due to weaker demand out of Europe. In the first two months of the year, China's factory output rose the least since 2009 and retail sales increased less than economist predicted. China is expected to ease monetary policy this year in an attempt to stimulate growth. More broadly, China's growth engines are shifting from exports and infrastructure to consumption, which will lead to a decline in demand for commodities. China's property market has been weakening for months and with less contribution from the industrial and investment sectors, we will be closely monitoring China's attempts to engineer a modest slowdown, or so-called "soft landing."

Despite the strong year-to-date rally in risk assets, the market remains technically weak and maintains technical attributes consistent with an intermediate-term top – as the popular averages made multi-year highs, weekly new highs have dropped sharply, and trading volume has been weak as many investors are wary about adding new money. Turning to fundamentals, growth in emerging markets may be challenged as developed economies slow. Consensus earnings expectations are falling and market strategists are as conservative as they have been since 2006. Given these risks, and with the ECB policy actions coming to an end the Federal Reserve's Operation Twist set to conclude in June we remain cautious and comfortable playing it safe.

In an environment with short-term interest rates near zero, and a 10-year U.S. Treasury yield near 2.0%, we believe large-cap dividend-focused stocks that have durable growth characteristics and reasonable valuations continue to look most attractive. Many corporations have significant cash balances and strong free cash flow to support and grow current dividends, buyback shares, and invest appropriately in their businesses. These stocks have also tended to be less volatile, providing an additional benefit in an uncertain macroeconomic environment.

Developed Economies Balance Sheet Expansion (Fed, ECB, BoJ, and BoE - March 23: $5.14 Trillion)



Source: ISI Group, Inc.