R I V E R P O I N T R E P O R T

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CONCERNS OVER EUROPE CONTINUE TO WEIGH ON INVESTORS

Since our last *RiverPoint Report*, markets have become increasingly concerned about the situation in the Euro Zone. On May 9, European Union members, the International Monetary Fund and the European Central Bank announced a package totaling nearly $1 trillion to support troubled countries; this bit of good news sparked a one-day relief rally on May 10. Since that day, there has been little from Europe to cheer about.

While the sizable aid package has alleviated some concerns about government bond defaults, the issue of banks not lending to each other has taken its place as the top concern in the market. During the worst of the U.S. credit crisis, anxiety peaked when banks stopped lending money to each other out of fear that the loans couldn't be repaid. Inter-bank lending costs skyrocketed more than four-fold beginning in mid-2008, essentially stopping the flow of funds between institutions. Eventually, these costs fell dramatically throughout 2009 as the American credit crisis dissipated. Fears over the future of the European Union and its members have caused these inter-bank lending costs to rise again, roughly doubling in a matter of weeks. Though still only a fraction of the levels reached during late-2008, any whiff of hesitancy among banks to lend to each other has brought back painful memories for investors. As a result, "risky assets" such as stocks and commodities have been selling off as spooked investors flee to the safety of less-risky investments like U.S. Treasury bonds. To wit, the yield on the 10-year U.S. Treasury bond is now 3.29%, down from 3.54% on May 10 (bond yields decline as their prices increase).

This "flight to safety" has been a drag on equity markets around the world. Economic globalization has blurred the divisions between country and regional economies; thirty years ago, a sovereign debt problem in Greece wouldn't have been a major concern in the United States. Now, with the world resembling one giant economy rather than an amalgamation of individual economies, a problem in one part of the world is viewed as a potential issue for everyone. This increased globalization has also led to international financial markets being intertwined more than ever before. Again, thirty years ago would American stocks have rallied over 3% if China announced that it wasn't giving up on its European holdings (as was the case on May 26)? This is the framework in which we must operate today – one where global macroeconomic news and geopolitical risks are of greater importance than in years past.

Despite the uncertainty regarding the situation in Europe and its ultimate impact on the global economy, domestic equities look more attractive than they have in quite a long time. The American economy is continuing to show signs of strength, evidenced by strong corporate earnings for the first quarter and continued improvement in many economic indicators. Inflation fears have subsided, meaning that the Federal Reserve is likely to keep interest rates low for the foreseeable future. A continuation of easy monetary policy and low interest rates are conducive to economic growth, which bodes well for companies in the U.S. In addition to having a nice economic breeze in their sails, domestic stocks are attractively valued. At current prices, the S&P 500 is trading at 13 times estimated earnings. Excluding '07-'09 Bear market, the last time the S&P 500 was priced this attractively on an estimated-earnings basis was in the early 1990's, just before the great bull market of the late 1990's. Also supporting the relative attractiveness of stocks versus bonds is the relationship between the yield on the 10-year Treasury bond and the market's "earnings yield" (the earnings per share for the S&P 500, divided by the price of the S&P 500). The earnings yield for the S&P 500 is at its highest premium relative to yield on the 10-year Treasury since before the long-term bull market that began in the early 1980's.

The result of all of this is that the market is providing us with the opportunity to pick up shares of leading companies at bargain-basement valuations. The following table highlights some of the bargains that can be found among companies that are industry leaders with proven histories of consistent earnings growth and still have solid growth prospects into the future:

Company Name	Current Price	Current Dividend Yield	Price-to-Estimated 2011 Earnings	Discount to Average 5 Yr P/E	Positve EPS Years in Last 10	Estimated Long-Term Future EPS Growth
Abbott Laboratories	$47.17	3.7%	10.1	44%	10	11%
TJX Companies	$44.50	1.3%	12.0	26%	9	12%
CVS / Caremark	$33.77	1.0%	10.9	41%	9	14%
Fiserv	$46.45	0.0%	10.5	39%	10	12%
General Dynamics	$66.38	2.5%	9.4	37%	8	8%
Hewlett-Packard	$45.72	0.7%	9.2	38%	8	13%
Johnson & Johnson	$59.66	3.6%	11.4	29%	10	7%
Occidental Petroleum	$78.18	1.9%	10.2	10%	7	11%
Symantec	$14.14	0.0%	9.2	42%	8	10%
Teva Pharmaceuticals	$54.30	1.3%	10.6	43%	10	14%

The group above represents a broad array of stocks across several sectors – Health Care, Consumer Discretionary, Energy, Consumer Staples, Technology and Industrials. The aforementioned stocks provide a good illustration of the opportunities we look to exploit in our client portfolios. For example, look at the data for Health Care giant Abbott Laboratories (ABT). The company has a long history of great management and innovative product offerings, which has allowed the company to grow into a global leader in the health care industry. Typically, industry leaders that deliver consistent earnings growth (10 consecutive years) with solid balance sheets and good growth prospects (11% annualized EPS growth for the next 5 years) would fetch a P/E multiple somewhere in the low-teens (13 or 14). Even if the P/E multiple stays low, if you add a 3.7% dividend to the expected earnings growth the stock could earn 13%-14% per year over the next few years. On top of the earnings growth and dividends, if the market rebounds and ABT realizes a P/E ratio anywhere close to its five year average (ABT currently trades at a 44% discount to its 5-year average P/E), it's entirely possible that the stock could return more than 15% per year for the next three-to-five years.

Another way to look at a company like this is to compare the yield on the stock to the yield on that company's bonds. Normally a stock's dividend yield would be less than its bond yield because the stock holders benefit from both the dividend payment and any growth in profits. Bond holders, on the other hand, enjoy more safety but see their total return primarily limited to just the regular coupon payments made by the company. However, investors are so fearful and stocks are so cheap that ABT's stock is actually yielding more (3.7%) than the company's bond maturing in 2016 (3.2%)! From a common sense perspective, would you rather own a bond where you know that you will get 3.2% per year for the next six years, or would you rather own that same company's stock that is yielding more (3.7%) and is expected to grow earnings in the future at a much faster rate (+11%) than the broader economy?

Due to fear and uncertainty continuing to swirl around Europe and worries of a new credit crisis as a result, we remain cautious in our client portfolios. Overall, stocks will continue to trade based on the headlines coming out of Europe until there is some sort of resolution to the recent problems. Until we become more comfortable with the situation across the Atlantic, equity exposure in our individual client accounts will remain at the low end of their allocation ranges. Although our asset allocation is conservative, we remain committed to a core portfolio of high-quality stocks like those mentioned above. While remaining cautious, we are not going to simply stuff our client's money under the proverbial mattress – we will continue to look for opportunities to purchase shares of industry-leading companies at depressed valuations in order to better protect our client assets as well as position them to prosper in the future. As always, if you have any questions, please feel free to contact a RiverPoint investment professional.

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