

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

November 2, 2009

CYCLICAL POSITIVES, SECULAR CONCERNS

Popular sentiment has shifted in the past six months – most pundits would agree that we are no longer staring into the abyss. At the same time, the situation is not all peaches and cream, either. In this issue of the RiverPoint Report, we will look at some of the near-term conditions that are being viewed positively (“cyclical positives”) and the bigger picture problems that are still left to be resolved following the events of the past year-and-a-half (“secular concerns”). The confluence of these somewhat contradictory conditions is the reason for our cautious outlook and conservative asset allocation stance.

CYCLICAL POSITIVES

- Third quarter earnings reports have largely exceeded expectations. Similar to the second quarter, cost cutting initiatives are an important driver behind this trend. However, revenue growth is starting to become evident in some sectors. In nearly every case, management teams are commenting that demand has at least hit bottom and should begin to pick up over the next quarter or two. Revenue growth is important because firms can only rely on cost cutting to drive earnings growth for so long. Quarter-over-quarter or year-over-year revenue growth is essential for the global economy to recover in earnest.
- The housing market is beginning to recover. The Standard & Poor’s / Case-Shiller Home Price Index has risen for three straight months, indicating that buyers are returning to the market. Mortgage rates remain low, making it possible for homeowners to refinance existing mortgages and making new home purchases more affordable. Though mortgage loan underwriting standards have become stricter, requiring that buyers contribute a larger down payment, a commitment to better underwriting practices could go a long way in preventing another financial crisis.
- Merger and acquisition activity has increased, a sign that corporate America is confident enough in the current economy to commit large sums of money to snap up assets on the cheap. Generally speaking, M&A activity heats up once business conditions have found a bottom and management teams feel good about their company prospects going forward. Anecdotally, this activity provides more evidence that the worst of the recession is behind us and that the economy should improve in the future.
- Investors appear to be regaining their appetite for riskier assets. In October, U.S. Treasury bond prices fell (and their yields rose) coincident with a rise in equity prices. This could be an indication that investors who were “hiding” in U.S. Treasuries are shifting funds to equities. If this trend continues, it would provide a continued boost to stock prices.

SECULAR CONCERNS

- While the general economy is showing signs of a nascent recovery, it hardly feels like the economy is humming along. The recession we experienced was very severe and it will take some time to get the economy back to a normal state. The question that haunts many business leaders and investors is, “Will the economy grow fast enough to really stimulate jobs growth?” Without jobs growth it will be tough for consumers to rebound. Since consumer spending accounts for over half of the United States’ GDP, it is necessary that consumers gain more confidence in their employment status so they can help re-start the American economy. It is important to remember that the unemployment rate usually peaks six to nine months after the trough in a recession. If this historical relationship holds, the unemployment rate could continue to rise for another couple of quarters.
- While the financial system is in much better shape than it was a year ago, the world’s banks are not yet totally in the clear. Losses on residential real estate holdings played a significant role in getting financial institutions into this predicament, and many fear that looming problems in the commercial real estate sector could lead to more trouble. Commercial real estate properties are getting hit on two fronts, the first of which is lower occupancy (and fewer rent checks for the property owner) due to the economic slowdown. The other side is that a deluge of commercial real estate loans are scheduled to come due in the next two-to-three years. In the halcyon days of the real estate boom, commercial property owners would have had no problem finding willing lenders, handsome property valuations and reasonable credit terms to renew their outstanding loans. Now, lenders are being more careful in extending credit and property values have fallen, leaving property owners struggling to find replacement loans. Banks have been going through a similar process on the residential side for over a year now and have written down loan portfolios accordingly. Our concern is that on the commercial side banks have been slow to recognize potential losses on their commercial real estate portfolios and that this swell of loans coming due could be enough to push banks right back to the edge.
- Following the unprecedented fiscal and monetary stimuli that have flooded the global financial system over the past year or so, the possibility of heightened inflation has crept into the minds of many. This, coupled with the decline of the dollar, has received a great deal of press in recent months. While we are confident in the ability of the Federal Reserve and U.S. Treasury Department to adjust policy in time to avoid extreme inflation, our opinion does not seem to be that of the majority. The concern is that if the Fed fails to reign in the “easy money” before the economy picks up, then inflation will take hold and we will find ourselves with a whole new set of problems. In this scenario, the Fed would presumably raise interest rates hard and fast in order to stop inflation. In turn, high interest rates could be enough to stymie an economic rebound and set the stage for another few years of sub-par growth. Given the slack that exists in the manufacturing sector, we believe that the economy will not experience a sudden spike in inflationary pressures, providing the powers that be enough opportunity to remove some of the liquidity in the system and prevent an inflationary spiral. Also, the Fed’s problem-solving creativity should not be underestimated. Chairman Bernanke and Company employed creative tools and novel solutions to successfully stave off an even more severe recession. Hopefully Mr. Bernanke will surprise us all with his exit strategies, as well.

At RiverPoint, we remain disciplined investors and have taken advantage of the significant recovery in the market since March to take some profits. We like energy stocks for the long term, but at \$80 / barrel, prices seem high relative to weak demand, leading us to take profits in some of our energy holdings. We have also realized profits in the retail and industrials sectors and international area in recent months. We will continue to capitalize on profit-taking opportunities until we see clear signs the economy is on stronger footing. Signs we are looking for include job growth, increased spending by consumers and businesses, banks lending more freely and a pickup in housing starts. Until these signs emerge, we remain cautious on the market at these levels.

REMINDER: 2009 YEAR-END TAX PLANNING

We carefully review all aspects of our clients' financial situations, and efficient tax planning is always a major consideration. Gifts to charities can be a great tool to lessen your tax liability, and gifts to individuals can be a good estate planning tool. If you have not already done so, please consider potential gifts as soon as possible. We would be happy to assist you with any issues regarding your portfolio and strategic gifting decisions.

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