

# RIVERPOINT

CAPITAL MANAGEMENT

INVESTMENT ADVISORS

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## STOCKS SIDE-STEP MULTIPLE SPEEDBUMPS ON WAY TO STRONG FIRST QUARTER

It is amazing to watch the strength of the stock market recently, so quickly after the awful events in Japan and the turmoil in the Middle East; it says a lot about the resiliency of this market. We view this continued recovery as a positive sign regarding the psychology of investors and the improved condition of company fundamentals.

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*The S&P 500 Index had its  
best first quarter since  
1998!*

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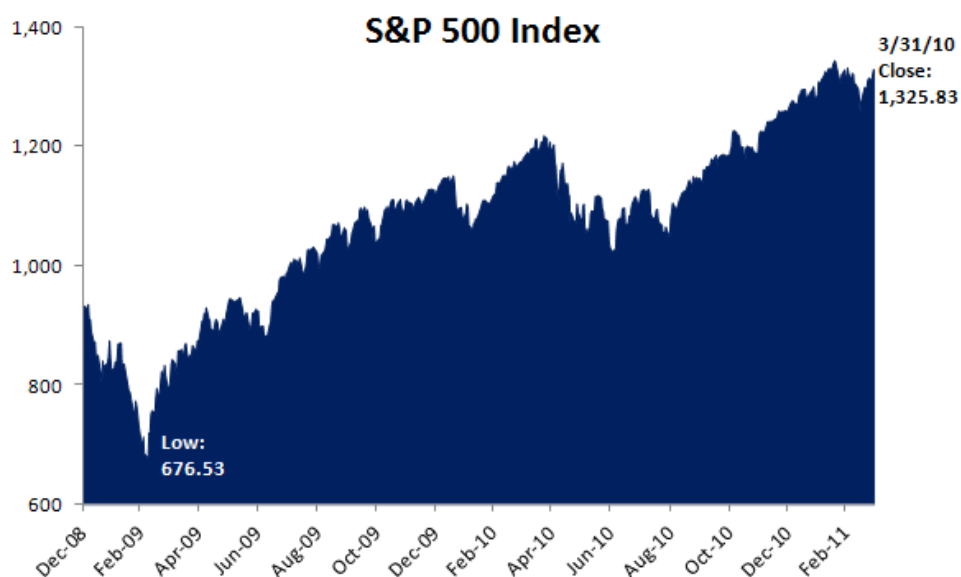
We just capped off a very volatile quarter, but it turned out quite well. The S&P 500 had its best first quarter since 1998, rising nearly 6%. Citing a specific reason for market performance is always an inexact science, but in this case it seems that stocks performed well due to two primary reasons: increasing confidence in the global economic recovery and remorseful investors buying stocks, feeling as though they “missed out” on the rally of the past two years.

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### The RiverPoint Team

Valerie Newell, CPA  
Leon Loewenstine, CPA  
Victor Lassandro  
Pamela Schmitt, CFA  
Ryan Brown  
Casey Jones, CFA  
Kirk Koppenhoefer, CFA

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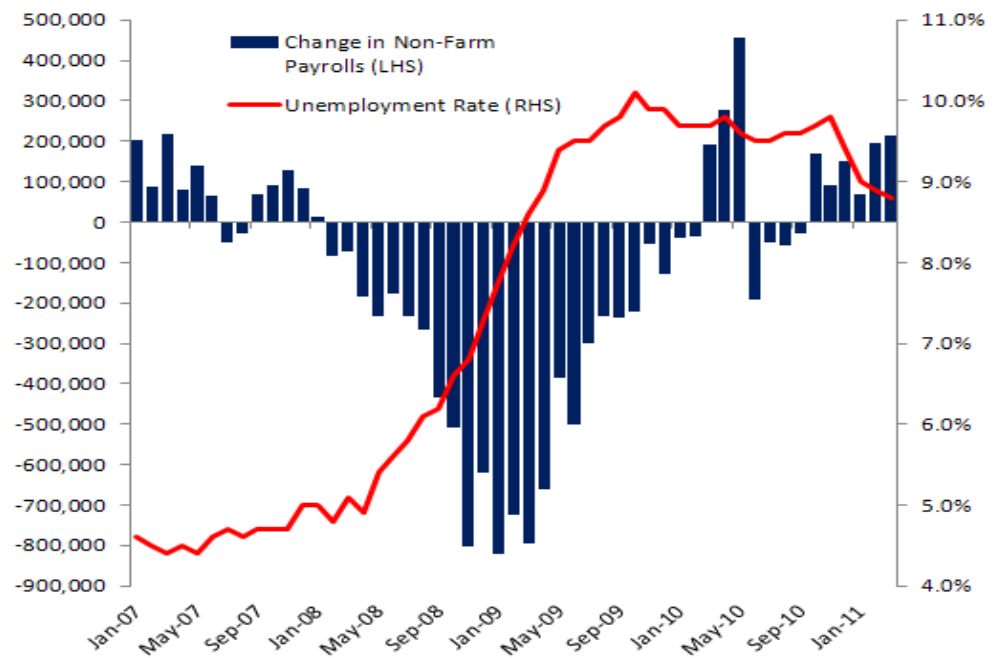
Profit reports from the fourth quarter of 2010 painted a pretty rosy picture of the general business environment. Costs were primarily kept under control, demand was coming back in the business-to-business sector, and pricing power was decent. Financial firms are still healing from the financial crisis of 2007-2008, but their balance sheets are in better shape as they took fewer losses on existing loans than in previous quarters. The consumer continued to spend, and companies are beginning to pick up the pace of their spending. This translates to strong results for Consumer, Technology, and some Industrial companies. Emerging economies continued to grow, supporting the prices of Basic Materials stocks. Consumer Staples stocks have been able to keep food inflation under wraps up until this point, though the prospect of falling margins have impacted stock prices in recent weeks. For the moment, the impact of the Japanese earthquake and tsunami seems to be contained, and it appears that the tragedy will have little effect on the global economy (even after a couple of large aftershocks in recent days).

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*Macroeconomic data confirms that the US economic recovery continues apace.*

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Macroeconomic data has corroborated the view that the economic rebound is ongoing. US Manufacturing has been registering its strongest levels in years, as both domestic and international demand have increased new orders for durable goods. The US employment picture is clearly improving, as 200,000 new jobs have been created in each of the past two months. The chart below depicts the improvements in the employment picture. The unemployment rate (the red line, right-hand scale) has dipped below 9% for the first time since early 2009. The economy has added jobs (blue bars, left-hand scale) for six consecutive months – the first such streak since early 2007.



Source: Bloomberg

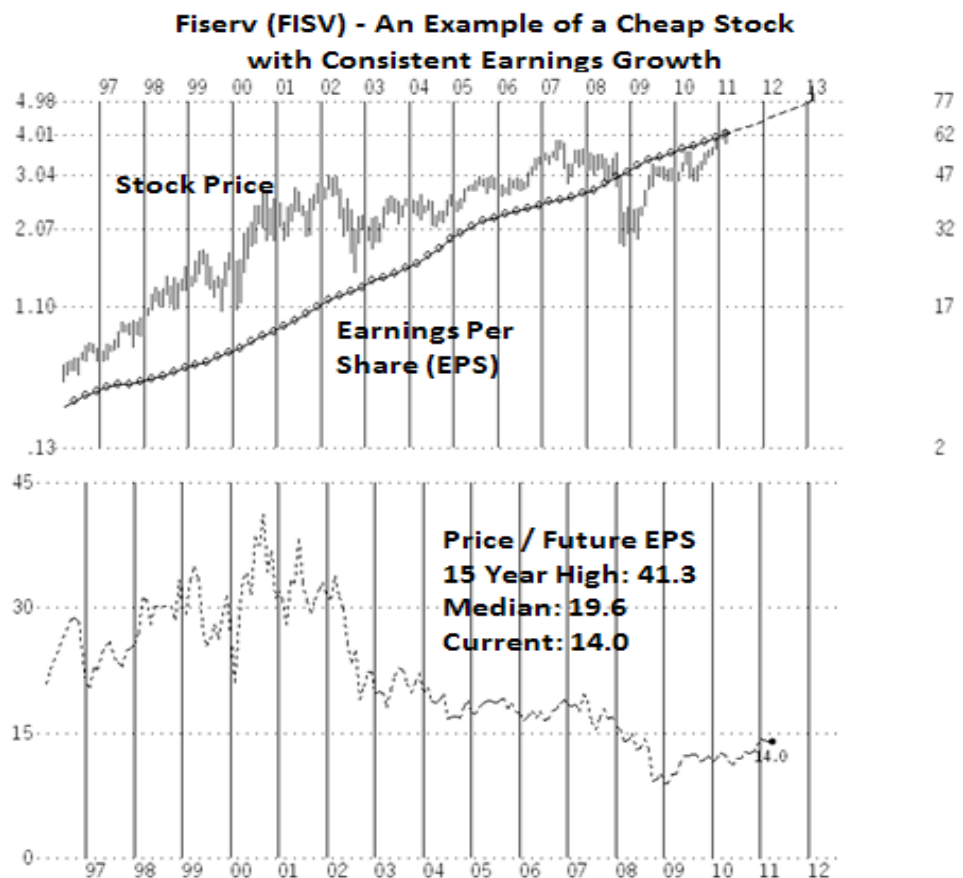
Inflation remains low for now, although increasing food and energy costs threaten to push up prices in the future. Food inflation isn't a huge negative factor in the US as food costs account for a small percentage of the average American budget. In emerging countries, however, food accounts for a much larger portion of the average budget. Any rise in food costs in these countries can significantly impact consumer spending and therefore impact economic growth. Energy price increases have a psychological impact on consumers, with rising oil prices flowing directly through to the pump. No one likes to spend \$4 per gallon on gas, and historically this level has generated a more discernable impact on consumer spending.

Interest rates, though rising, are still low, which is a good thing for many businesses. Borrowing costs are low, meaning that companies can access debt markets at reasonable prices in order to fund expansions (IBM and Cisco have both issued bonds paying less than 2%). Stock valuations remain at low levels (the S&P 500 is priced at 14 times estimated 2011 earnings), and this, combined with low rates and large corporate cash balances, means that the environment is ripe for mergers and acquisitions activity.

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*Cheap stocks + low interest rates + plenty of cash = M&A activity*

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Source: Thomson Baseline

Just recently, several big deals have been announced including AT&T offering to buy T-Mobile, Berkshire Hathaway buying Lubrizol, and the bidding war for NYSE Euronext. We like to see this activity because it is a sign that corporate executives are comfortable with future prospects and they see opportunities to expand their businesses at attractive prices.

Statements from the Federal Reserve have echoed the actions of corporations, as the nation's central bankers have become more positive about the economic environment. One thing we are carefully watching is if the Fed will continue its quantitative easing program (aka "QE2", whereby the central bank is buying Treasury bonds in order to keep interest rates low in an effort to keep the economy growing). What is going to happen once the program expires? Will rates pop up once the Fed stops its buying? Will rates remain low, signaling a stronger economy? Time will tell, but we expect that the expiration of "QE2" will likely be the impetus behind rising interest rates.

Of course, not everything is peaches and cream. While there is always something happening on the periphery to distract investors from the positives, there sure are a lot of potential pitfalls out there that could muck up the works. What impact Middle East turmoil will have on oil prices and the global economy, the potential for inflation, municipal finance issues here in the US and the ongoing financial woes of European countries all carry with them some risk of economic catastrophe. As things stand right now, we don't believe that any of the above will derail the global economic recovery. The economic impact of the Japanese tragedy seems to be controllable, and the recent UN actions in Libya seem to have cooled down that situation. Municipalities in the US are making tough budget decisions, which is a welcome – though very difficult – development. The European sovereign debt crisis has unfolded as expected, as Portugal recently became the third country (joining Ireland and Greece) to formally request aid from the International Monetary Fund. We are cautiously optimistic that the remaining European Union countries will not need financial support that exceeds the size of the current program.

At RiverPoint, we are comfortable with our current asset allocation in client accounts. The equity allocations are solidly within their target ranges, positioning the portfolios for continued economic growth. Where appropriate, our allocation to fixed income securities will provide a cushion of stability should the unexpected happen.