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CAPITAL MANAGEMENT
INVESTMENT ADVISORS

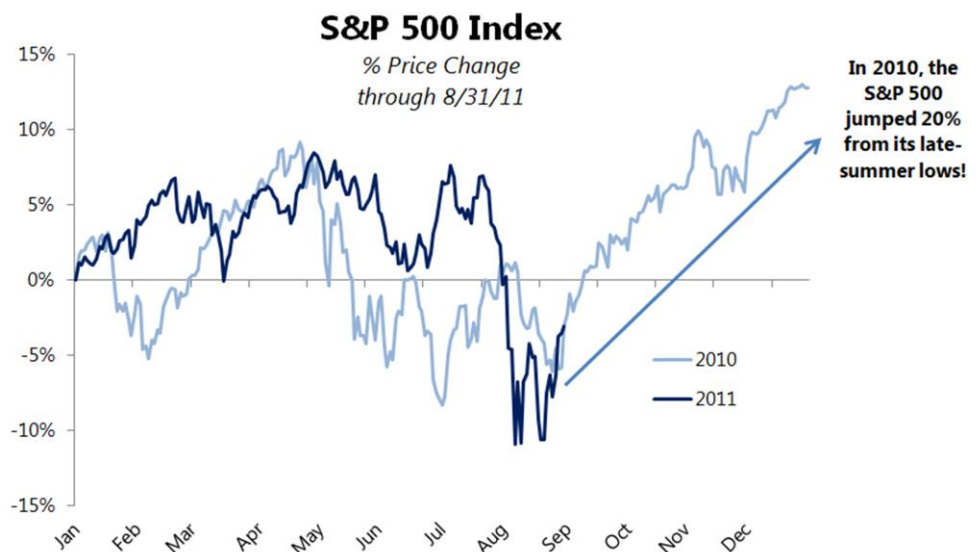
DESPITE RISKS, STOCKS COULD STILL FINISH 2011 WITH A FLOURISH

Will stocks end 2011 like they did in 2010?

August has been a tumultuous month for the stock market. Early in the month, the market traded almost exclusively on rumors and fears of troubled banks, while the next couple of weeks saw disappointing macroeconomic data take center stage as the financial press obsessed over the probability of a recession. Despite these concerns, stocks finished the month well, gaining ground in seven of the final eight trading days.

As Yogi Berra famously said, "It's like déjà vu all over again."

The S&P 500's path in 2011 looks strikingly similar to that of 2010.



The key question at this point is, of course, "will 2011 end up like 2010?" It is true that there are some weighty issues that could keep stocks in a swoon for some time: concerns over the Euro Zone,

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worries about the strength of the US economic recovery, and the performance of the Budget Super-Committee could all contribute to continuing market volatility. Moreover, the scope for aggressive policy response is more limited than a year ago. Due to these concerns, we are maintaining our conservative stance regarding our clients' asset allocations. However, we present the following as an explanation of how stock prices could run up before year-end. Since the following arguments are within the realm of possibility, we are selectively taking advantage of opportunities in the equity markets without altering our overall asset allocation.

The two biggest concerns are the problems in Europe and whether the US is dipping back into recession.

The two biggest concerns that need to be addressed are the problems in Europe, as well as the fears that the US is on the verge of entering another recession. The problems in Europe are well known: countries borrowed too much, exacerbating the '08-09 recession for the smaller countries that now are unable to meet their funding needs through debt markets. These troubles have led to rather harsh budget cutbacks in order to right-size expenditures, as well as increasing borrowing costs that raise concerns over the future of the monetary union. The onus is now on the EU's largest economies – France and Germany – to keep the union afloat; at this point, both countries are doing their best to delay the inevitable. In turn, the health of European bank balance sheets has been called into question causing “illiquidity” rumors to start up. These banking system fears and budget-related economic slowdown concerns have cast a pall over the markets.

“We are very far away from the situation we witnessed in 2008.” – German central bank official

The bull case, however, says that investors may be a little too sensitive at the moment. True, the EU has its problems that will take time to correct. The banking system, however, having just gone through the recent financial crisis, is in a much stronger financial position than it was just a few years ago. Also, bank exposure to troubled debt is much easier to calculate than exposures to esoteric derivative instruments. Recent comments by German central bank official Andreas Dombret echoed this sentiment: “We are very far away from the situation we witnessed in 2008. European banks... have considerably improved their capital base, making them less vulnerable to financial strains.” If the European banking system

avoids any trouble and is in better shape than feared, stocks would be set to jump.

Another major investor worry is that the American economy is entering the throes of another recession. Admittedly, recent macroeconomic data has been unexciting to say the least. Slowdowns in industrial activity and waning consumer confidence have driven most of these concerns. However, what if the slowdown is due to the uncertainty surrounding the budget deficit talks? What if businesses just hit the “pause” button while Washington bickered? Remember, President Obama and his staff were all over the news warning Congress of Armageddon if America defaulted on its debt.

The press harped on this idea for weeks on end. Eventually, consumers began to wonder “what if?” In a self-fulfilling cycle, these consumer doubts led to spending cutbacks, which led to poor economic data, which led to even more “Armageddon’s Coming!” headlines, which weakened confidence further. Is it possible that business just took a break while all of this was going on? It seemed clear that Washington would get it together before defaulting, but all of the media coverage created unfounded doubts. Knowing that August 2nd was the deadline, isn’t it conceivable that business owners delayed some activity until August 3rd, just in case Congress made the sky fall? The renewed concerns over Europe quickly followed, doubling down on consumer sentiment. What if the poor economic data points were a referendum on the current state of political leadership? If fears of a recession subside, the stock market could be in for a robust comeback.

Fear can, by itself, cause swift and dramatic declines in stock prices. However, fear cannot change the fact that underlying business fundamentals remain in good shape and stocks are cheap. As proof of this, more corporate insiders are spending large sums of money on their own stock. Insider sales have lost some of their validity as a predictor of stock performance, given that many executives sell their company’s shares on a pre-determined schedule or do so when monetizing stock options. Stock purchases, however, remain a decent indicator of underlying confidence in a company’s prospects (see table at left). At the same time, companies have been

Insider Buying

<i>Company</i>	<i>Stock Bought</i>
<i>JP Morgan</i>	<i>\$8.4 Million</i>
<i>Emerson Electric</i>	<i>\$2.2 Million</i>
<i>Merck</i>	<i>\$1.5 Million</i>

authorizing share buyback programs in an effort to capitalize on rock-bottom valuations. If the American and global economies were on the verge of material slowdowns, would those most exposed to businesses – the corporate insiders and companies themselves – be purchasing their own shares?

Another reason that stocks could rebound sharply from here is that, relative to bonds and other asset classes, stocks are flat-out cheap. We've talked about how price-to-earnings multiples are low (13 times expected earnings), which resonates with many. But consider this: right now, 332 stocks in the S&P 500 have a dividend yield greater than a 5-year US Treasury bond, and 218 stocks in the S&P yield more than 10-year US Treasuries! In other words, an investor can lock in a yield less than 2.25% for 10 years by holding a US Treasury bond until it matures, or buy shares of a company that pays out at least 2.25% per year. Remember that companies can grow and increase their dividends over time, whereas interest on US Treasury bonds is fixed and doesn't change. Which would you rather own?

Two-thirds of the S&P 500 stocks have dividend yields higher than yields on 5-year US Treasury bonds!

The above outlines the case for a strong market rebound through the end of 2011. At RiverPoint, we recognize that the stock market faces very real risks and, as such, remain conservative in our asset allocations. Our stock selection remains focused on companies with strong dividends and solid financials, taking advantage of opportunities to upgrade the quality of our client portfolios at attractive valuations. Along with the benefits of owning shares of higher quality companies, these opportunistic purchases provide exposure to a potential year-end market rebound without changing our generally conservative asset allocation. Our client's bond assets remain invested in high-quality corporate bonds, which continue to provide good value relative to US Treasuries with minimal incremental risk.