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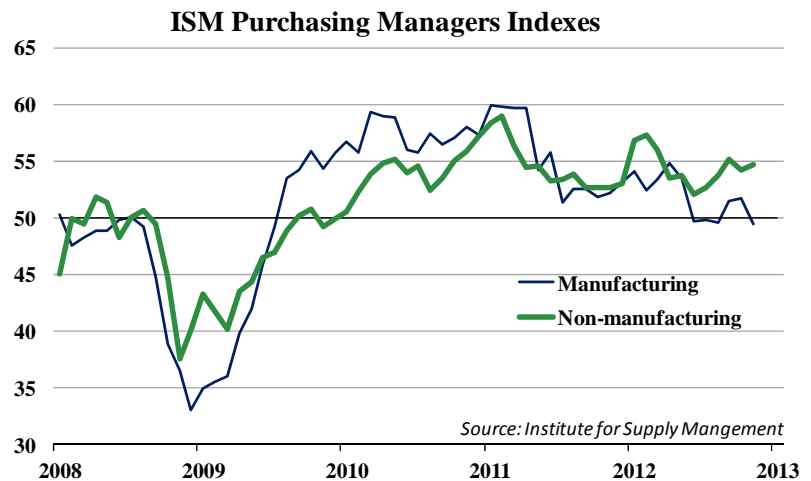
Business Rebound Likely As Consumers Lift Sales

A dichotomy between consumers and businesses has begun to emerge in the US economy (also reflected globally). Whereas businesses led the way out of the 2007-2009 recession and are now enjoying record profits, consumers languished amid high unemployment and meager income gains. Now, with housing bottoming and unemployment falling, the consumer outlook has decidedly started to improve, as we detailed last week. Meanwhile, business sentiment and investment have been falling amid uncertainty surrounding the fiscal cliff. We believe this can be clearly seen in the Institute for Supply Management's (ISM) manufacturing and non-manufacturing (i.e., services) purchasing managers' indices.

Manufacturing activity generally tracks business sentiment, while services activity — 80% of the US GDP — is more reflective of consumer spending, which accounts for 70% of GDP. November's manufacturing PMI (thin blue line) fell below 50, suggesting a slight contraction in business activity for about 20% of the US economy. Although this partially reflects East Coast disruptions from Hurricane Sandy at the end of October, according to ISM: "Comments from the panel this month generally indicate that the second half of the year continues to show a slowdown in demand; respondents also express concern over how and when the fiscal cliff issue will be resolved."

The good news is that the fiscal cliff is likely to be resolved soon (or at least postponed for another year) and our expectation is that it will be done without too much economic drag because it is in neither party's interests to cause a recession. With new orders and investment delayed for the last half of the year, we anticipate a rebound next year to match the uptick in consumer demand.

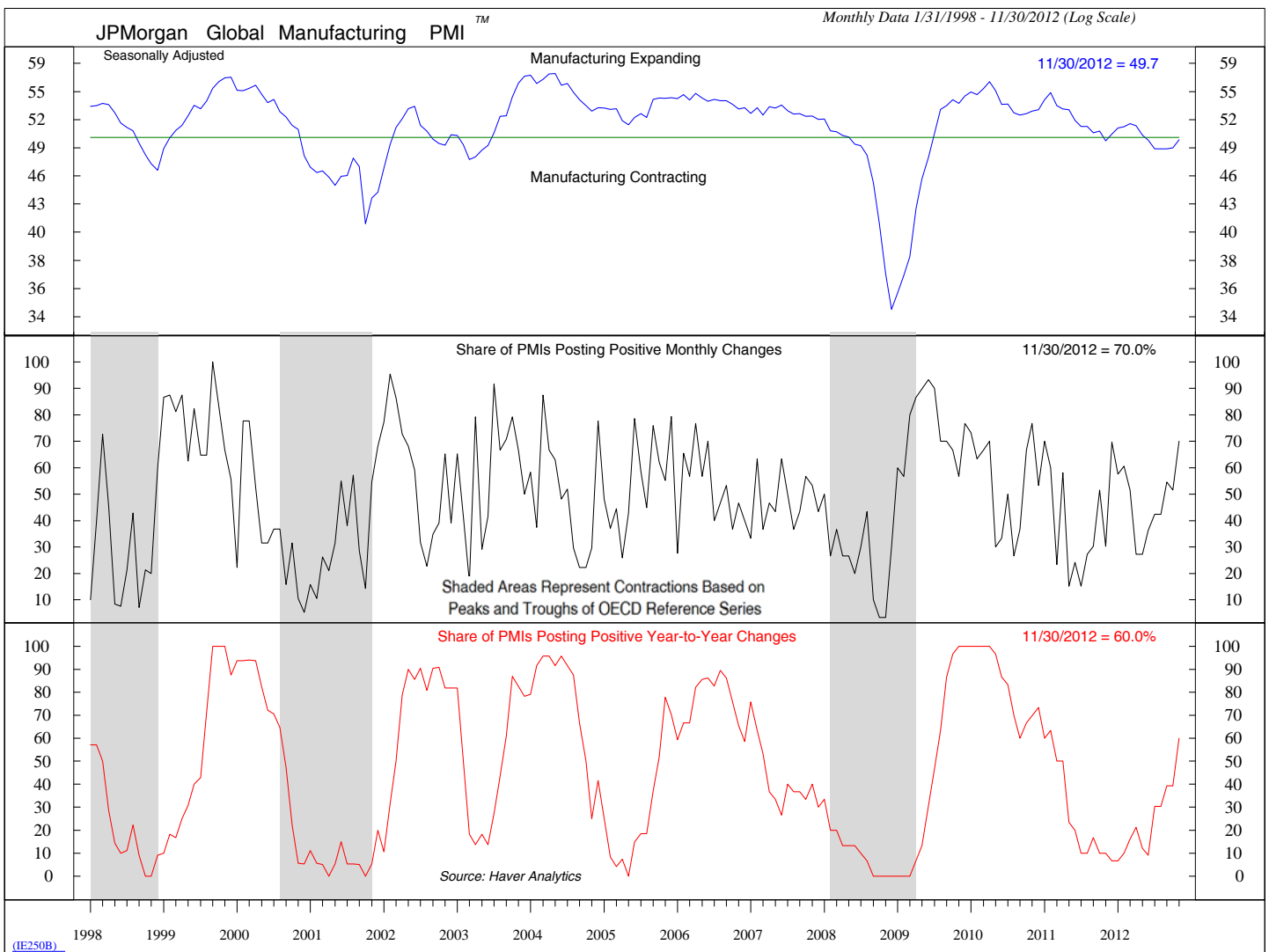
In contrast to the manufacturing PMI, the services PMI rose to almost 55 in November (thick green line), indicating further expansion in business activity for the bulk of the US economy. The employment report for November suggests steady albeit modest job gains and aggregate real income growth. In addition, Federal Reserve data released last week show ongoing household deleveraging, increasing home equity and higher net worth; stronger household balance sheets should translate into improvement in consumer confidence.



For corporations, which have undergone years of cost cutting and for which cash flow still exceeds capital expenditures, bottom-line margin improvement is unlikely to continue driving profits. However, “poor sales,” which is often listed by businesses as their biggest problem, may finally be turning the corner. Furthermore, as our Weekly Chart illustrates, improving demand appears to be occurring globally. Rising emerging market demand, progress in European financial conditions, and better prospects for reflation and reform in Japan, are starting to spur global manufacturing activity.

Although the global manufacturing PMI remains just under 50, like in the US, it improved in November as 70% of global PMI's posted positive changes (middle panel of chart below). Moreover 60% of global PMIs are now higher than a year ago after deteriorating for almost two years. We think this presents an opportunity internationally, where valuations remain attractive, and is also a positive for US exports. RiverFront has been increasing its international equity exposure over the past four months while decreasing exposure to US equities, which should help cushion our portfolios from any end-of-the-year volatility related to the fiscal cliff.

THE WEEKLY CHART: GLOBAL MANUFACTURING IMPROVING



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