From right to left:

Rod Smyth
CHIEF INVESTMENT STRATEGIST

Bill Ryder, CFA, CMT
DIRECTOR OF QUANTITATIVE STRATEGY

Ken Liu
GLOBAL MACRO STRATEGIST

Fading Wall of Worry Lifts Stocks to New Highs

April's manufacturing and services purchasing manager indexes (PMIs) indicate ongoing GDP growth of around 3%. US growth is currently in line with the "Optimistic Scenario" outlined in RiverFront's *2013 Outlook*. As Chief Investment Officer Michael Jones said in the *Strategic View* on 4/23/13, "As a result, we think the S&P 500 is likely to finish the year well above 1600 and could approach our fair value level of about 1700."

PMIs also suggest continued employment gains around 200,000 a month. Indeed, April's job report of 165,000, coupled with an additional 114,000 from upward revisions for the prior two months, brings three-month average job gains to 212,000, enough to keep up with population growth and perhaps gradually lower the unemployment rate further from 7.5%. Low unit labor costs of just 0.6% year over year for the first quarter of 2013 (see Weekly Chart) should allow US corporations to maintain profit margins, and with 12-month forward earnings estimates for the S&P 500 showing around 5% growth, we expect hiring to remain steady.

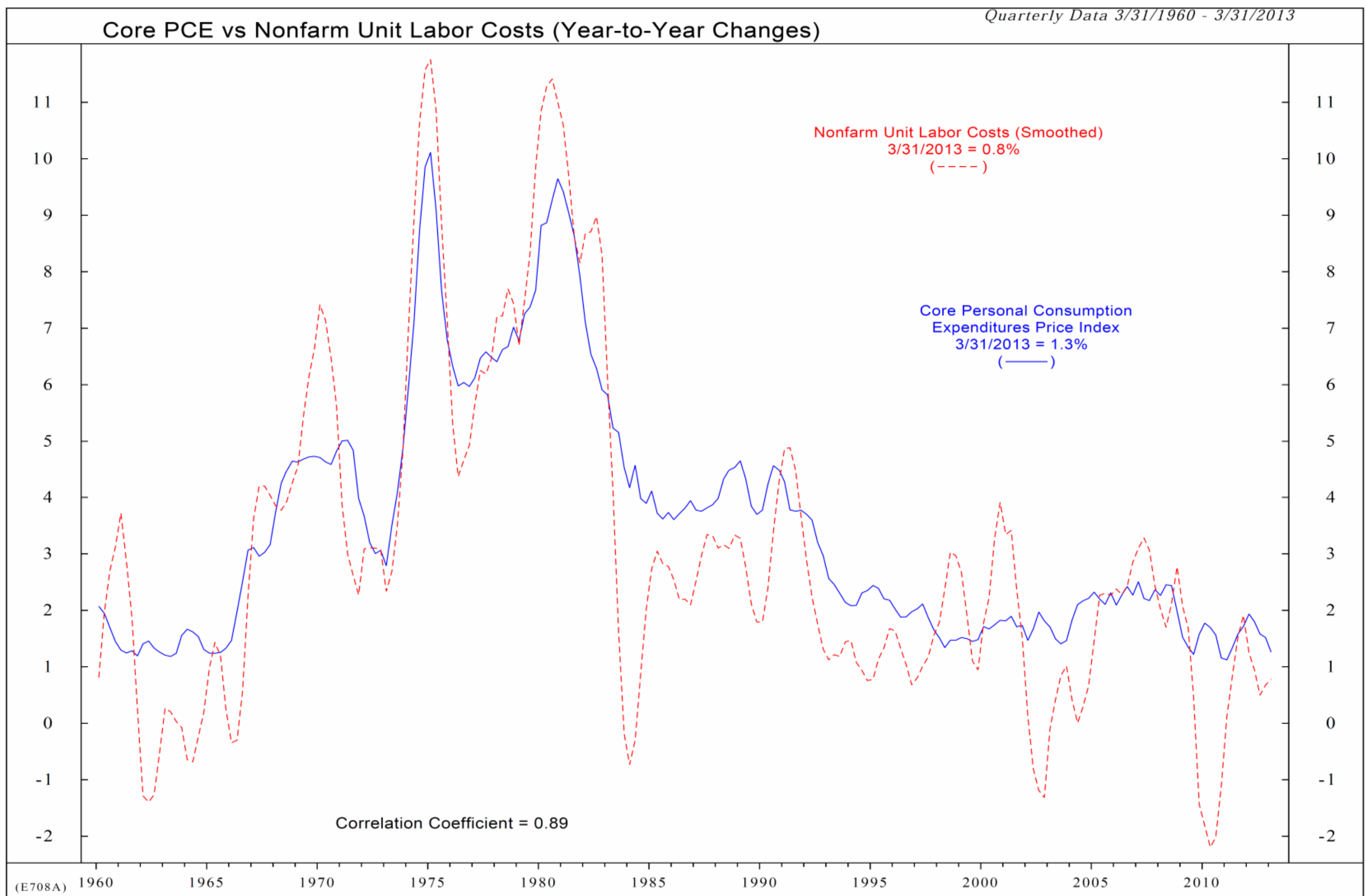
As the S&P 500 moves to new highs, we note a change in the character of the rally over the past two weeks: more volatile cyclical stocks are starting to outperform lower-volatility defensive stocks, which had led the market since last February. We think this reflects fading sequester fears, housing optimism, a declining budget deficit and fewer inflation worries as commodity prices fall. Furthermore, although recessionary conditions persist in Europe, financial distress is easing as sovereign bond yields continue to fall and governments ease up on austerity, laying the groundwork for eventual growth. In Japan, growth has even started to pick up, despite still being mired in deflation. Furthermore, a major policy goal – rising prices – is starting to appear achievable, as reflected by five-year inflation expectations embedded in the Japanese bond market rising to 2%. This points to the increasing credibility of the Bank of Japan and the efficacy of Prime Minister Shinzo Abe's policies, in our view.

China remains a worry; with housing price appreciation reaccelerating (and credit booming), policy is likely to remain restrictive rather than stimulative. However, amid an overall slowdown in growth, the needed transition from investment- and export-led growth to consumption- and service-oriented growth appears to be taking place. As the *Wall Street Journal* recently reported, Asia's middle class "is expected to grow by an average of more than 100 million people each year... By 2020, more than half of the world's middle class is expected to reside in Asia, compared with one-fourth in 2009." For example in China: "Sales of clothing and apparel are projected to exceed 800 billion yuan, or about $130 billion, by 2015, nearly doubling from 460 billion yuan in 2011, according to Boston Consulting Group." China's services sector appears poised to finally overtake its industrial sector, which are each about 45% of the economy (with the agricultural sector the remainder). As *The Economist* recently noted, "China's collars are turning white."

Geopolitics is always hard to handicap, but with oil down 13% from last year's peak, a *Wall Street Journal* article caught our attention. It reported that "military forces from the

semiautonomous Kurdish region expanded southward into the Iraqi region of Kirkuk, which has been roiled by sectarian fighting." Furthermore, Kurdistan's relationship with Turkey has recently warmed, and the completion of a pipeline to Turkey from the oil rich Kurdish territory is expected this September.* This is a reminder that a major issue regarding Iraq remains unresolved, namely Kurdistan's geographic control of significant oil reserves and its desire for independence. Talks between the parties have been fractious — the Kurdistan Regional Government just ended its parliamentary boycott and has returned to talks in Baghdad. We do not currently believe this situation is sufficient to cause oil prices to spike but, along with escalation in Syria, it is one of several reasons that reinforce the value to the US of continuing to develop North American reserves of oil and natural gas. (**The Economist*: "Proven reserves are now put at 45 billion barrels, a third or less of Iraq's total, but still nearly double America's. Kurdish production capacity is rising fast. It should reach 1 million barrels a day by 2015 and possibly 2 million by 2020, says an executive at Genel, a British-Turkish firm that is Kurdistan's biggest operator.")

THE WEEKLY CHART: SUBDUED LABOR COSTS LOWERING INFLATION



© Copyright 2013 Ned Davis Research, Inc. Further distribution prohibited without prior permission. All Rights Reserved.
See NDR Disclaimer at www.ndr.com/copyright.html. For data vendor disclaimers refer to www.ndr.com/vendorinfo/.

Unit labor costs (dashed red line), which subtracts productivity from employee compensation to get a picture of actual production costs, are up only 0.8% from a year ago, smoothed over four quarters (0.6% unsmoothed). As can be seen, there is a high correlation (0.89) with changes in the core-PCE price index (solid blue line), the Federal Reserve's preferred inflation measure. With unit labor costs 'pulling' inflation lower for now, we are not currently worried about excess money creation by the Fed or that quantitative easing is likely to end any time soon. What's more, low unit labor costs are also associated with high profit margins, another reason to be overweight stocks, in our view.

Past performance is no guarantee of future results. Information provided in this report is for educational and illustrative purposes only and should not be construed as individualized investment advice. The investment or strategy discussed may not be suitable for all investors. Technical analysis is based on the study of historical price movements and past trend patterns. There are also no assurances that movements or trends can or will be duplicated in the future. Standard & Poor's (S&P) 500 Index measures the performance of 500 large cap stocks, which together represent about 75% of the total US equities market. It is not possible to invest directly in an index.