



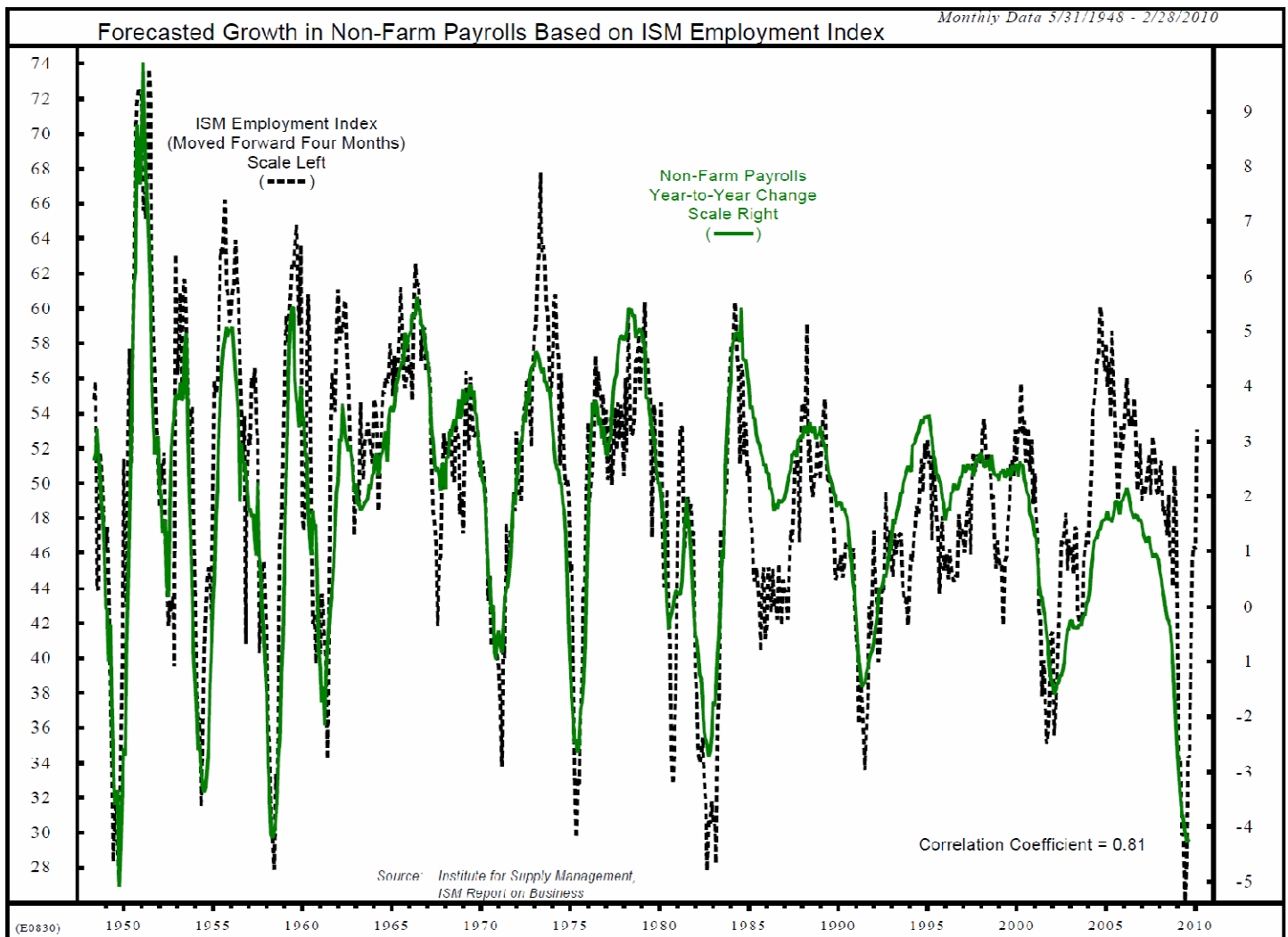
Ten Conditions for a Sustainable Recovery, Revisited

The 6/22/09 edition of *The Weekly View* set forth ten conditions that we believed were necessary for economic recovery to be sustained. Since then, all conditions have made progress with most of the conditions being met. Here is our list with updated commentary:

1. **Savings rates at 8% or higher:** Household savings rates turned negative during the housing-boom euphoria because homes were considered an ever-appreciating asset (a savings substitute). Although the savings rate rebounded to almost 6% in May, it has retreated to 3% currently as the economy and housing markets have stabilized. The trend, however, is still rising in our view with the long-term solvency of social security (and health care), along with job security, still in question. Moreover, when the Federal Reserve eventually normalizes interest rate policy, we think households will have greater incentive to save.
2. **Home prices within 10-15% of a bottom:** We think home prices nationally are bottoming, based on fundamental measures (relative to income and rents) as well as historical trends. While there is still risk of an overshoot, especially given mounting bankruptcies and foreclosures, with fiscal and monetary policy so stimulative we think there is a decent chance that recent stabilization in home prices can be maintained, especially at the low end and with low mortgage rates (see next).
3. **Mortgage rates below 6.5%:** Thanks in part to aggressive quantitative easing by the Fed, mortgage rates have remained close to 5%, supporting additional purchase and refinancing activity through the summer and fall. Housing support should continue at least through next spring with the extension of the new home buyer tax credit, the Fed's continuing purchases of mortgage backed securities and still quiescent inflation keeping 10-year Treasury yields low. Thus, we think mortgage rates will likely remain below 6.5% through the first half of 2010. Furthermore, when mortgage rates eventually do approach 6.5%, it will likely be in the context of an employment recovery, so rising household income should be able to absorb higher mortgage payments.
4. **Unemployment rate below 11%:** Currently at 10.2%, the unemployment rate is approaching the upper end of the Fed's (revised) 2009 and 2010 projected range of 10.5% (8.5% is the lower end of the range). With unemployment expected to remain stubbornly high through next year, and given the sensitivity of defaults to unemployment, the economy (and banking system) cannot be expected to make a full recovery until unemployment peaks and begins to trend lower. To put the challenge of lowering the unemployment rate in perspective, the economy must consistently add around 170,000 jobs a month just to keep the unemployment rate from rising. In October, 190,000 jobs were lost.
5. **Weekly initial jobless claims falling below 500,000:** A good real-time indicator of economic activity given its close inverse relationship with real GDP, initial jobless claims are currently 523,750 (four-week average) down from the early April peak of 658,750. This suggests to us that recovery is taking hold. However, further declines to 500,000 and below are necessary before the positive feedback loop from increasing employment will start to help consumption, in our view (400,000 has historically been consistent with about 1% year-over-year real economic growth).
6. **Purchasing Managers Indexes (PMIs) above 50:** The PMIs have provided early indications of recovery, with the manufacturing PMI crossing into expansion territory in August and the services PMI following in September. Incidentally, and not surprisingly, the employment components of the PMIs provide a good leading indication of employment (see Weekly Chart) and imply positive year-over-year growth in the next four months.
7. **Inflation expectations under 3%:** We think the Fed's goal of economic revival will be harder to achieve if inflation expectations rise above 3%. Currently, ten-year inflation expectations are 2.1%, with 10-year real Treasury yields at 1.4% and nominal yields at 3.5%. Extraordinarily loose monetary conditions – near-zero short-term rates along with credit and quantitative easing policies – were intended to offset depression-style debt deflation. Concerns now are whether Fed accommodation may overstay its welcome, potentially leading to higher sustained inflation. To maintain its credibility, we believe the Fed would be unable to remain accommodative should inflation expectations rise above 3%.
8. **Credit spreads stabilizing or narrowing:** For us, narrowing credit spreads have been the hallmark of lessening financial market distress and healing. Although still high relative to the 2005-2007 credit boom, spreads returned to 'pre-Lehman' levels in September and have since leveled off, which we view as consistent with an economy emerging from recession. With the cost of systemic risk now mostly transferred to government and taxpayers, we think further credit spread narrowing will only result from improving household and business conditions. Conversely, widening credit spreads from here would strongly suggest deteriorating economic fundamentals.

9. **Positive productivity:** Rising productivity – making and doing things better and more efficiently, utilizing less time and resources – is the key to long-run prosperity. Without it, an economy is destined to grow no faster than its population. Higher productivity requires investment (by business *and* government) with no certain outcomes. Fortunately, while productivity growth was decelerating entering into the recession, over the last two quarters productivity growth has accelerated strongly, rising 6.9% in the second quarter and 9.5% in the third. High levels of productivity growth have been evident in higher profits that, if maintained, are likely to lead to greater hiring and investment. In addition, it makes the Fed’s job of reflating the economy – to facilitate the deleveraging process – much easier and less likely to result in damaging inflation (#7) and destabilizing higher interest rates (#3).
10. **Lower leverage:** As more household income is devoted to paying down debt, savings rates naturally increase and equity ratios rise. Households have begun to make progress as debt service as a percentage of disposable personal income fell to 13% in the second quarter from 14% at its 2007 peak. However, we expect several more years of deleveraging (and higher savings rates) for the debt service ratio to trough. We think this entails more defaults, but also requires ongoing restructuring, asset sales and income generation; a slow process, but one which will ultimately leave US consumers stronger, healthier and better able to support sustainable economic growth.

The Weekly Chart: Bleak jobs picture should start to improve



Past performance is no guarantee of future results

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