



# Out of the Blocks

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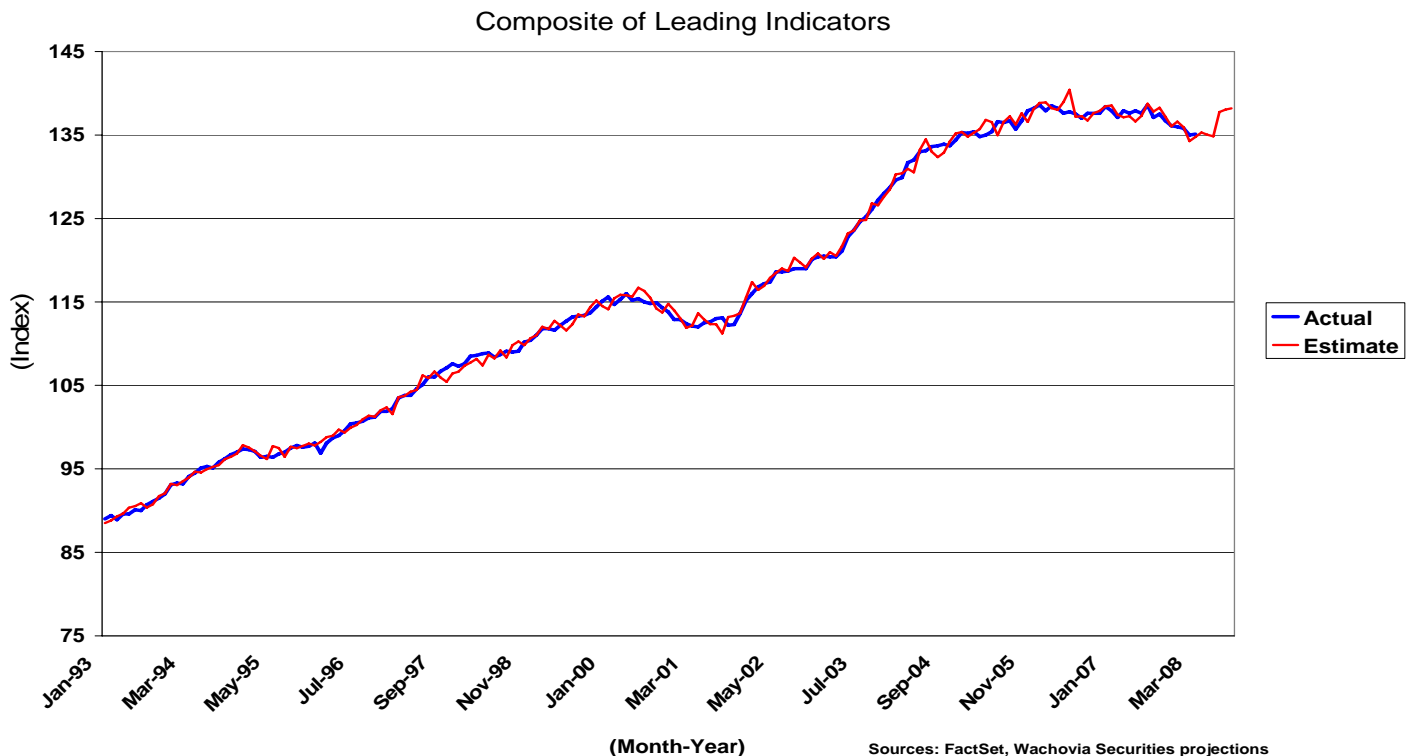
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## Equity Strategy Analysis Suggests Stabilization for Composite of Leading Indicators, Soon a Peak for Initial Unemployment Insurance Claims

In our work, a number of the leading indicators are showing signs of stabilization. Our forward-looking work on the Conference Board's Composite of 10 Leading Indicators suggests that the indicator may have stopped declining and is preparing to move sideways until mid-summer 2008 (Figure 1). If so, such analysis suggests that economic growth will likely remain tepid through the balance of the year. However, a pickup in our projection of the leading indicator (a lead of a lead) appears to signal that general domestic economic growth should lift early in calendar 2009. The Composite peaked in mid-summer 2007, which, at the time, was indicating a flat to softening economy for later last year and into 2008. Thus far, fourth 2007 and first quarter 2008 have each generated 0.6% GDP growth. Measurably better growth in early 2009 suggests, in our opinion, that the S&P Composite Index should move higher by the end of calendar 2008.

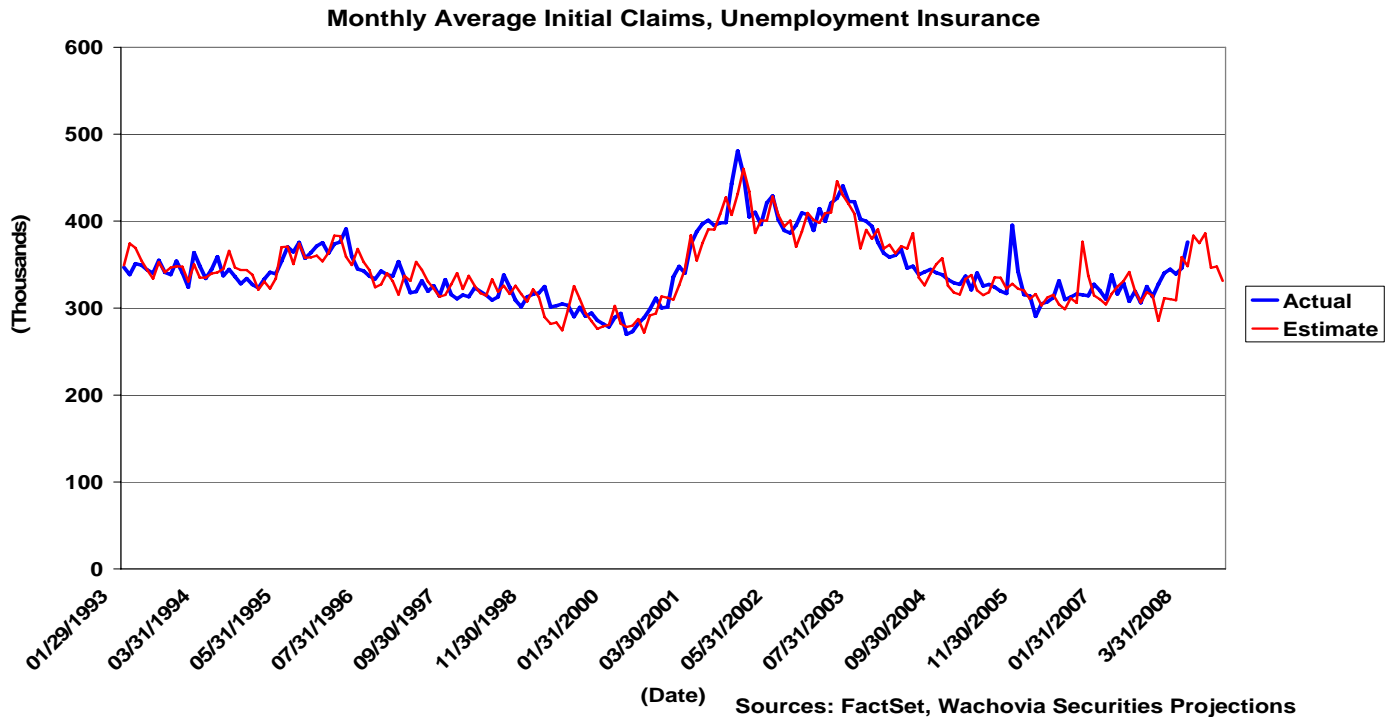


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Please see Page 4 of this report for important definitions and disclosure information.

Supporting our view discussed above for the economy and stocks is our projective work on a labor-related leading indicator. Thus far, monthly average initial claims for unemployment insurance have moved higher and alongside our forward-looking projection for the last five or six months. However, our work indicates that initial unemployment claims are likely to peak over the next few months. Thereafter, we foresee a decline in initial unemployment insurance claims to levels below the current level by later this year (Figure #2). If we are on track, we believe the indication is once again that we should anticipate better economic growth by later this year or during the first quarter of 2009. Both of these forward-looking analyses of leading indicators provide some evidence, in our opinion, that the current economic slowdown is likely to be of average magnitude, and that it is also roughly half over.



**Specific Recommendations:**

We are currently recommending that clients carry an evenweight position in the Industrial sector. The shares of industrial companies, from an overall sector perspective, generally tend to outperform the market between the recession (so far we only have a slowdown) and three-quarters of the way through the ensuing expansion. Over the last 12 months, the Industrial sector index is up 1.6%, well ahead of the S&P 500's 5.5% decline. We believe prudent portfolio diversification requires exposure to the Industrials sector that is approximately in line with the S&P 500 (11.8%). The companies listed below are currently "Buy" rated by at least three correspondent research providers:

- Boeing Co. (BA-NYSE-\$85.40)
- Cummins Inc. (CMI-NYSE-\$66.90)
- Lockheed Martin Corp. (LMT-NYSE-\$107.00)

**Weekly Wrap and Look Ahead**

All three major indices finished higher in last week's trading. The S&P 500 gained 1.1% (Year-to-date down 3.7%), the Dow Industrials rose 1.3% (YTD down 1.6%) and the NASDAQ Composite gained 2.2% (YTD down 6.6%). Six of 10 S&P sectors outperformed the Index and eight of 10 finished higher on the week. The best performing sectors were Telecom Services (up 4.8%), Consumer Discretionary (up 2.5%) and Information Technology (up 2.4%). The worst performers were Materials (down 3.0%), Energy (down 1.8%) and Consumer Staples (up 0.6%).

Earnings season is beginning to wind down and the results continue to be in line with our expectations. Thus far, with nearly 80% of companies in the S&P 500 reporting, earnings are down 13.3% on a float adjusted market cap weighted basis. We have been looking for earnings to be down 13%-15% in the first quarter. For comparison purposes, note that on a purely market cap weighted basis (the S&P 500 Index is market cap weighted) earnings are actually up 2.3%. Of those companies reporting, approximately 63% have come in ahead of the average analyst estimate while 27% have fallen short of Street consensus.

Sector earnings performance, excluding financials, actually improved over the last week. Ex-financials, earnings are up more than 20%, typically an impressive performance under even the most optimistic economic scenarios. Financials continue to be the anchor dragging down overall earnings performance. Financial earnings are down 46% so far (less than we expected) with about 90% of companies in the sector reporting. Six of 10 S&P sectors are still posting double digit earnings gains with another two sectors up 8% or more. In addition to the Financials, the Consumer Discretionary sector is the only other segment posting year-over-year earnings declines (-7.1%).

As discussed in last week's commentary, we thought the stock market needed a big positive (unknown) surprise event to drive the major indices through all the upside resistance. We speculated the Fed standing pat on rates just might be the event that could trigger a further rally. However, in the end, the Fed cut the target rate 25 basis points to 2% as we (and the market) expected. In addition, the rather weak post meeting statement didn't state clearly (in Fed-speak) that the US Central Bank was finished cutting rates for the time being nor did it mention the lower dollar. As a result, in our opinion, it is likely the market pulls back somewhat in the near term.

In other important news last week, first quarter GDP (Gross Domestic Product) rose 0.6%, more than expected. Remember that just a few short weeks ago the consensus was calling for a decline. Our work suggested a flat to slightly negative quarter. So far, based on the data, we are not in a recession. Looking ahead, we still expect a small increase in GDP in the second quarter followed by more positive (but below trend) growth in the third and fourth quarters of this year. Employment data in April was much better than expected. Non-farm payrolls fell for the fourth consecutive month but the decline was well below the average economist estimate. Also, instead of increasing as most analysts expected, the unemployment rate fell to 5% (and was just hair away from falling to 4.9%). The labor market has been softening for some time but remains in better shape than most previous economic slowdowns (and certainly most recessions).

There is not much economic news on this week's calendar. The ISM (Institute for Supply Management) services survey will likely come in just below the 50 level, indicating a slight decline for the fourth consecutive month. Note that the ISM manufacturing survey came in better than expected last week. Wednesday's first quarter productivity and unit labor cost report will likely be the most important data of the week. We expect productivity growth to rise less than the fourth quarter's 1.9% while unit labor costs remain under control. We do not see a big rise in labor costs (and therefore inflation) from here. Remember that in the US, about 70% of input costs (on average) come from labor while around 10% come from commodities. To gauge inflation, we believe you should watch the cost of labor.

Industry groups of interest currently include Property & Casualty Insurance, Oil & Gas Refining & Marketing, Electric Utilities, Managed Health Care, Drug Retail and Food Retailers among others.

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**Cummins Inc. (CMI-NYSE-\$66.90)**

- No applicable disclosures

**Lockheed Martin Corp. (LMT-NYSE-\$107.00)**

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