

## Traders Notes for April 23rd 2008

Prepared by;

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### Early Earnings Season Reactions... Some Surprises, Some Not

Q1 Earnings Season is still in the early innings and many companies have yet to report. However, we think a few conclusions can be drawn, thus far:

#### In-Line with our Expectations:

- **Banks:** Going into EPS season we expected bad news and most reports lived up to those expectations. In the reports we saw little evidence that all the bad news is behind the banks and do not believe a bottom has been made.
- **Airlines/Truckers:** We believe both groups are caught in the middle between deteriorating demand from consumers and escalating costs (energy). Thus far any bear market bounce either group had been experiencing has quickly been derailed and the downtrend has resumed.
- **Managed Care:** A few of the managed care companies pre-announced earlier in the quarter citing higher cost pressures that they couldn't pass along. A few of the stocks bounced since their big declines in early March as bottom-fishers came in claiming the pressures were 'one-time' in nature. We believed this was not the case and the poor operating environment was here to stay. Yesterday, an industry bellwether guided forward estimates lower and concurred that the weaknesses they were experiencing was more than just a temporary 'bump'.
- **Exchanges:** We have noticed weakening relative strength for the major stock, bond, future and commodity exchange companies. After being one of the hottest sectors of 2006 and 2007, we worried that expectations were too high and that the group couldn't avoid the weakness that was being experienced throughout the rest of the capital markets arena. Yesterday, one of the leading exchanges fell short of analyst's estimates and the shares were driven down nearly 8%.
- **Machinery/Metals/Energy:** Going into the quarter, many of these companies had seen their valuation multiples compress as investors were unwilling to pay full price for their historically cyclical earnings. This would have been the appropriate response had we believed the commodity bull market was nearing its end and a pullback was just around the corner. However, we disputed that viewpoint and argued that as long as commodity prices were stable or moving higher significant upside still existed. Thus far, most of the metals, energy and machinery companies that have reported have met or exceeded expectations and their share prices have begun a new leg higher.

#### Surprises:

- **Technology:** We worried after Q4 earnings season that the technology group couldn't avoid the negative implications of a U.S. economic recession, particularly with two of their biggest customers, banks and retailers, suffering the most. To date, we have been positively surprised by the earnings reports of many technology companies. They have displayed less cyclicalities than we would have expected and the stocks responded favorably.

We need to keep an eye on this group in coming quarters for more evidence that they can ‘buck’ the economic trends.

- **REITs:** We have predicted imminent disaster for the real estate investment trust companies (REITs) for the last several months. Surprisingly, disaster has not come and REITs have been one of the top-performing sub-sectors of the financial group year-to-date. While we have been wrong, we are ‘sticking to our guns’. The bounce in REITs, in our opinion, is not attributable to anything fundamental, but rather the plummeting 10-year Treasury rate. Between January 1, 2008 and March 14, 2008 the rate on the 10-year Treasury fell around 50bps. To investors seeking income, REITs became attractive replacements to Treasuries, and rallied strongly outperforming the equally weighted S&P 500 by over 1000bps.

Since mid-March, the yield on the 10-year Note has reversed course and rose by nearly 40bps and is now getting closer to the levels it touched at the beginning of the year. Surprisingly, REITs have not given back their big gains and we believe are vulnerable to a major re-valuation. Additionally, we believe REITs are likely to be hurt by the repercussions of the credit crunch (tighter lending, higher interest rates, tenant bankruptcies, etc.) in the long-term, and many of these fundamental problems will take time to surface. We would continue to recommend avoiding the REIT space.

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