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## Market Breaking Down... Vulnerabilities and Opportunities

Despite the market's strength since March 08, we have contended that the economy is not out of the woods yet and more time would be necessary to digest the real-estate bubble bursting. Last week's sell-off was, in our opinion, important confirmation that we are right to be cautious. Given our belief that we are still in a bear-market and the next period of economic expansion is not right around the corner here are our top-five areas of vulnerability and opportunity.

### Top-Five Opportunities:

- Consumer Staples:** Staple stocks have historically enjoyed low sensitivity to the economic sector, have yet to incorporate a fear premium in their valuations and seem to be in the cross-hairs of acquirers and activists.  
*Favorites: Vanguard Staples ETF (VDC-A-\$68.97), HJ Heinz (HNZ-N-\$46.55), JM Smucker (SJM-N-\$51.60)*
- Integrated Oil:** Oil prices are nearly double their levels of last summer yet surprisingly the prices of many of the majors are only now just testing the share prices they reached last summer. With over 72 billion barrels of oil equivalent, it is hard to believe that ExxonMobil (XOM-N-\$90.70) is not a significantly more valuable entity today than it was 12 months ago.
- Software:** The price of software has historically not been economically sensitive, and profit margins are relatively immune to rising costs of credit, energy, and other commodities. Software is essentially the Consumer Staple of the technology sector.  
*Favorites: iShares Goldman Software ETF (IGV-A-\$63.03), Citrix Systems (CTXS-O-\$33.72).*
- Defense:** Higher energy prices increases global tensions and instability creating a greater need for keeping the peace. The cycle for defense spending has also been relatively uncorrelated with the U.S. economy.  
*Favorites: iShares Aerospace Defense ETF (ITA-A-\$63.03), L3 Communication Holdings (LLL-N-\$106.35)*
- Utilities:** With the threat of Recession looming, interest rates should stay low keeping a floor on utility stocks since utility prices are largely a function of their dividend yields relative to Treasuries.  
*Favorites: Vanguard Utility ETF (VPU-A-\$84.76), Dominion (D-N-\$45.42), MDU Resources (MDU-N-\$31.52)*

### Top-Five Areas of Vulnerability:

- REITs:** Most companies with significant exposure to declining real-estate prices, credit losses and tighter lending standards have seen their shares plummet to late 2003 levels. However, the average REIT remains 60+% above 2003 levels. We think this is because income investors have historically focused more on dividend yields than fundamentals.
- Retail:** Tax rebates sound good and may win votes, but unless they are going to be given out monthly there will be little long-term effects. An empty tank cannot be primed.
- Hotels/Casinos:** Even if a consumer had the money to afford a vacation. It is becoming too expensive to get there. The share prices of airlines and restaurants have already fallen to levels not seen since 2003, however hotels and casinos remain well-above 03 levels. If they follow their airline and restaurant brethren, 25-50% additional downside may be ahead of them.
- Truckers:** Trucking stocks have outperformed the S&P by 20% ytd, yet their fortunes remain closely tied to the health of the retail sector. As goes retail, so too shall go the revenues for trucking companies. Combine that with the margin pinch from rising energy prices and one has the makings of a dangerous cocktail.
- Homebuilders:** The uptrend the builders have been forming since January has been broken. Many recent investors bought these stocks with the anticipation things couldn't get worse. With the uptrend having been violated, we think a number of recent investors will return to the sidelines and sell the stocks. The January 08 lows are still 15% away.

Doug Sandler, Chief Equity Officer • 804-549-4803 • [dsandler@riverfrontig.com](mailto:dsandler@riverfrontig.com) • [www.riverfrontig.com](http://www.riverfrontig.com)  
 Riverfront Investment Group, 9011 Arboretum Parkway, Suite 110, Richmond, VA 23236

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