Economic Update

Broadleaf Partners, LLC

Buy the Bleeding: Time to Revisit Energy & Industrials?

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Yesterday's announcement of the takeover of Fannie and Freddie provided a brief respite for the markets, with the financial sector surging and taking the S&P 500 up a couple of percent. Today, the action is a tad different, with all areas of the market down with the exception of slight gains in consumer staples and discretionary stocks.

Readers know that we have been bearish on commodities for a number of months but as we wrote a few weeks ago, it is more difficult to be convinced that oil is going lower now that it is at $105 rather than $145. While we did trim many of our energy related names, the swift correction in a number of machinery and other "energy" industrial names is frankly a tad confounding.

Many of these stocks have corrected as much as 50% in a two week time period in spite of reporting record earnings, revenues and in many cases bookings. What has happened to the stocks, therefore, has little to do with earnings and everything to do with earnings multiples. Of course, earnings multiples do contract when companies hit the peak of their cycles, but with the data at hand presently, we don't believe this is likely the situation. The slowdown in many emerging markets and around the world has been evident for many months now, but has only seemed to be recognized by the markets in the last few weeks.

The declines in some of these stocks are getting to the point where I think they are far better buys than sales. While we do see a global slowdown at hand, the United States economy appears to be a tad better off after several quarters of Fed stimulus. International economies, including Europe, are hopefully getting the message that the greater risk is growth rather than inflation, providing some room for future monetary easing. Just as emerging markets are not immune to economic cycles, let us not similarly forget that they too have monetary and fiscal policy tools at their disposal.

As we wrote in our prior economic update, Uncertainty and the Birth of Black Swans, we do expect and are presently experiencing a global slowdown, but are not yet convinced that we're about to enter a global scale recession or even worse, depression. Many cyclical stocks, however, are taking the path of prior industry bubbles where the stocks go lower, lower, and lower with few stops in between.

Was energy a bubble or did prices just get overextended? This is the million dollar question and based on the action of the stocks recently, it appears the market is going with the former. We tend to believe they just were

overextended, but time will certainly tell us if something worse is at hand. We'll know for sure if we start seeing huge inventory builds in strange and unseen places, as we did in housing and technology goods. It is hard to know for sure how many buildings China has built over the last few years that are truly occupied versus those that were pure speculation, but if the evidence of a bubble were to rear its head somewhere, perhaps this would be a place to consider looking.

At this time, our best guess is that the straight down move in machinery and engineering and construction names is a mid cycle pause rather than the end of the current cycle. Perhaps one negative of having experienced so many asset bubbles in recent history is that anyone and everyone has become accustomed to thinking that there are no in betweens. We're in a shoot first, ask questions later investment world.

With oil at $105 today, it is lower than the average of $115 so far this year but also higher than the $75 average of last year. In other words, the prices are cheaper than they were, but also still above the levels where new exploration efforts are likely to take place and be productive.

It's always hardest to buy what isn't working. For months now, we've encouraged folks to buy consumer discretionary names and while we thought the financials appeared attractive, we couldn't pull the trigger. Now that both of these areas have become shorter term market darlings, it could be time to switch gears to the latest ugly ducklings which may quite frankly be the energy and industrial names. While the macro environment for these names is indeed uncertain, the same could have easily been said of financials and consumer discretionary names a short few months ago.

Buying stocks when they are bleeding is always the toughest thing to do, but at least in the recent past, it has been a far healthier undertaking for one's portfolio than buying the pictures of perfect health. You might check out tech as well.

Kindest Regards,

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