Economic Update

Broadleaf Partners, LLC

Caribbean Blue
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I just returned from a family vacation last week where I took this picture and had a fantastic time. It was a strikingly beautiful and temperate place, with some of the most exotic sands I've ever witnessed. I even lost weight during the week, something that hasn't happened since backpacking at Philmont Scout Ranch twenty-eight years ago. As a budding entrepreneur, I will also admit that vacations have been few and far between, making each one more enjoyable and cherished than the last.

Before proceeding with this update, I'd encourage you to guess where we went, with the added hint that reality may not always be as it seems. On that note, we are in the thick of earnings season and in spite of record earnings and generally optimistic management teams, stock prices are performing poorly. For investors, the logical question is why?

In our opinion, there is no doubt that economic growth is slowing after a significant reacceleration off the Great Recession lows experienced sixteen months ago. The only question in our minds at this point, is how much it slows. After peaking in the four percent vicinity, most economists now expect GDP growth to slow to something in the 2% range, with those we respect the most seeing less than 2% as likely.

It is important, of course, to recognize that all economic recoveries experience a point at which the initial acceleration in growth off depressed lows begins to slow. It is nearly always the case that when this deceleration occurs, folks in our industry begin to wonder if growth will merely slow to a "soft landing" outcome or if we will crash land in a much too soon "double dip" recession .

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In attempting to understand the apparent divergence between stock prices and earnings news today, it may help to remember that the markets tend to act in anticipation of future events rather than those that are being reported today. As we've mentioned in the past, leading indicators of economic activity like the ISM index are one of the few data points we follow that may legitimately provide clues on the performance of the economy six to twelve months out and thus, the stock market today.

During the second quarter, leading economic indicators, including the ISM index, hit new highs. As Francois Trahan from Wolfe Trahan points out, it is logical that the earnings results being reported today are strong since LEI's hit new highs during the very same period. It is also not too surprising that many management teams remain bullish and optimistic given such circumstances.

Unfortunately, there is yet another divergence occurring between what companies are saying and what they are actually doing. In spite of record cash flows, few companies are "bucking" up to their bullish outlooks by putting new money to work. Leading economic indicators, in spite of hitting new highs in the second quarter, also peaked in May and now appear to be declining. While a theme of earnings beats and slight revenues misses may hint at this change, it is likely that actual earnings results won't reflect it for another quarter or two.

So far this year, we've been correct in our view that the bulk of the market's cyclical gains are behind us and that a more defensive posture makes sense. Now that we've arrived at this reality, the next question becomes "soft landing" or "double dip?" For those focused on point C five years from point A today, the answer may matter little, but for those concerned about any point B along the way, it very well may.

In 1994, I experienced what turned out to be my first "soft landing" as an investor. Following the Persian Gulf War recession, the economy recovered and during this time, several new companies and industries, including Cisco Systems, came into their own. During 1993, the Fed began to raise interest rates in a tightening campaign designed to keep inflation associated with improving growth prospects at bay. As a result, the stock market began to struggle. (Note that interest rate policy is a leading indicator.)

Many companies at the time, including such beloved stocks as Parametric Technology and Cisco Systems, experienced price declines of more than 50% as the question of soft landing or recession was debated. While Cisco was an innovator whose fundamentals, like Apple most recently, had defied previous economic cycles, it was also experiencing its first product transition as the market shifted from an exclusive focus on routers to switching as well.

While it is never easy to discern the eventual outcome of a soft landing or double dip debate, two factors still lead me to give the edge to a "soft landing,". First of all, the Fed has not yet raised rates as they had been doing in 1994, likely given their dual mandate and the stubbornly high unemployment rate. In addition, foreign countries like China, who have already been raising rates, may now be taking their foot off the monetary brakes as their own inflation concerns subside.

Another perhaps more proprietary factor that might be considered is the relative performance characteristics of the three baskets of stocks we own, including those primarily influenced by the economic cycle, the credit cycle, and the innovation cycle. So far, classic cyclical stocks are discounting at least a slowdown in near term economic growth prospects, with most down 15-30% from their recent highs. However, it is interesting to note that the basket of innovation oriented companies we own and watch closely – companies similar to Cisco in the nineties and Apple today - remain near their all time highs.

A key sign as to whether or not the economy "soft lands" or ultimately "double dips" may lie in the relative performance of this group of stocks. While stock prices and earnings results of serial innovators may be resilient in the face of soft landings (absent product transitions as was the case for Cisco in 1994), these stocks usually get clobbered during recessions and double dips even in the face of their own improving fundamentals. (Apple nearly two years ago.) For now, the strong performance of this group of stocks may suggest that a soft landing may still be the most probable outcome.

We continue to believe a more defensive posture for the portfolio makes sense at this stage of the game and will be monitoring both Fed policy and the performance of our basket of innovators as clues on the eventual outcome of the raging debate over soft landings and double dips.

For investors with a longer term time frame, the outcome of the debate may matter little. In spite of an initial fifty percent decline going into the Great Recession, Apple's stock recovered all of its initial losses and now trades another fifty percent higher. To this end, successful investing may be far more about understanding your own personal time horizon, tolerance for volatility, and optimal asset allocation, than the buy or sell decision on any single security.

For those who made it this far or will simply admit to skipping the boring stuff in between, our family vacationed in Glen Arbor, Michigan last week, a small town located in the northwest corner of the state, sandwiched between Lake Michigan to the west and Little and Big Glen Lakes to the South and East.

While the water was Caribbean Blue and the sands of Sleeping Bear Dunes seemed other-worldly at times, the reality was Michigan just four hundred miles away.

Like the behavior of the stock market in the face of strong earnings reports, reality may not always be as it seems.

Kindest Regards,

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