Broadleaf Partners, LLC

Nothing Changed

November 14, 2012

Many events have transpired since our mid-September update, but not much has really changed. Economic growth should remain slow for as far as the eyes can see, as each region of the world struggles with its own version of the New Normal. Capitalistic animal spirits have gone the way of the modern American male and while not completely extinct, he's decidedly more metrosexual. Flannel has ceded ground to the skinny jean and ambition has given way to contentment. Save for the halls of America's top military brass, unbridled passion is simply no longer.

After four long years, Europe's fiscal issues remain entrenched and China, while avoiding a hard landing, is bouncing along a bottom at a rate of growth far below its historical norms. Our domestic recovery, in spite of modest improvements, remains substandard and our political system very much divided. The Fiscal Cliff looms as the most forecasted disaster in recent history, but in a bit of irony, also represents real progress towards deficit reduction when politicians fail to do their job.

Bob Woodward's book, The Price of Politics, offers insight into the failed budget negotiations of the past two years. While both parties talked a good game regarding the risks of the growing deficit, neither party cared enough to get a deal done. In the ideal world in which no one truly lives, Democrats would attempt to plug the hole entirely with tax increases, while Republicans would do so with cuts to entitlement programs.

Perhaps in search of an elusive mandate, America's politicians punted the deficit question to voters last week, who returned no such verdict. In spite of the subsequent hot air, the narrow margins of victory didn't suggest voters were mandating anything other than that politicians get their act together and reach some sort of compromise.

In spite of the New Normal, slow growth for as far as the eyes can see doesn't have to be an exercise in unbridled pessimism. Recent data clearly suggests that the economy isn't as bad as it feels. Corporate profits are twenty percent higher than they were at the 2007 peak and profit margins are at levels not seen in the last fifty years. For the first time in four years, consumer debt levels increased on a quarter over quarter basis rather than remaining in deleveraging mode.

The actual results for the ISM Index of Leading Indicators for manufacturers and service based companies was better than the estimates of all eighty economists in the survey, a pattern which also proved true for consumer confidence and homebuilding activity. With the latter increasing at the rate it has been, it would be unusual and perhaps even unprecedented for the economy to enter a near term recession.

Last week I was asked to speak on the markets and economy to a group of leading homebuilders at the Mandalay Bay Hotel in Las Vegas, Nevada. While listening to other

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speaker presentations at the conference, I gained a clearer understanding of the paralyzing impacts that Dodd-Frank might have on both business risk taking efforts and new small business formation, activities which would normally be a source of new jobs for the economy.

One speaker spent an hour discussing the new mortgage closing forms proposed by the Consumer Finance Protection Bureau, culled from an extraordinarily cumbersome 1000 page FAQ on the subject. The questions far outnumbered the answers to the many valid issues raised by the homebuilders, but one thing was clear; in the rush to find understanding and guidance on the new laws, most would be very risk averse in their initial interpretation of the new laws.

A friend at the conference also mentioned that he would never have been able to start the title agency he had launched and sold in recent years given the high cost of state mandated audits. To the extent new business formation in an industry is thwarted by higher startup costs – real or perceived - competition declines, giving an advantage to big companies over small ones, and unintentionally promoting the Big in Too Big to Fail. In an effort to help consumers, such regulations often have unintended consequences born of increased uncertainty, which in the end, will likely do very little to prevent the flavors of abuse that will contribute to America's next asset bubble.

In spite of the complex maze of new regulations the industry is facing, visiting with these executives confirmed our view that the industry is finally recovering after many years in the doldrums. Low interest rates, lean supplies of new homes, and new household formation trends are all contributing to the recovery. Home prices are also starting to improve in some areas of the country, which may help explain record consumer confidence levels in spite of slow employment growth.

While new home construction only affects .5% of the U.S. population, rising home prices affect nearly 100% of us. I for one, was pleasantly surprised by the appraisal that came in for my home, which means that I will finally be able to refinance my mortgage at nearly 3% less than the annual interest rate I have been paying. The savings, afforded by improved housing values, represents real cash flow savings to my bottom line, and an opportunity to invest, save or spend elsewhere.

In closing, our message remains the same. The economy will continue to grow at a slow pace for the foreseeable future. Europe, the deficit, the Fiscal Cliff, and the recent hurricane will all act to restrain growth. While corporate profit levels are high and homebuilding is on the mend, trying to figure out what new regulations will mean to industry represent another restraint. Record cash levels on corporate balance sheets are no doubt reflective of the new reality, where it may pay to keep an extra life buoy or two on hand.

Like it or not, this is our new reality. While it may not be the ideal environment, it also isn't the end of the world. In spite of the new regulations, homebuilders are selling new homes to parents who are still having new children. The act of procreation, I'm reminded, remains nature's single greatest act of optimism. Capitalism's job ultimately is not to question the environment that exists, but to dynamically adjust to the circumstances and meet the needs of consumers in the most efficient manner possible.

In an environment of slower growth, anxiety levels will, no doubt, remain elevated as we are everywhere and anywhere that much closer to negative real rates of growth with almost every bump in the road. At the same time, innovation remains an important tailwind for United States business, particularly on the energy front, where cheap sources of natural gas have America projected to be the world's largest energy exporter by 2016.

Whenever pessimism reigns and future jams appear insurmountable, I'm reminded that just four years ago, the entire political campaign centered on our dangerous dependence on foreign oil. What we cannot fathom doesn't mean it can't happen. Like the Reagan tax cuts, low cost, domestic energy sources could be the elixir that not only gets the economy growing again, but also, in turn helps us to ultimately reduce the deficit.

Drill baby, Drill!

Kindest Regards,

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