Broadleaf Partners, LLC

Our 2022 Playbook
January 14, 2022

Each year, we look back at the prior year's Investment Playbook to assess what we got right, what we got wrong, and what we learned in the process. We then turn to the coming year, putting our dominant ideas in writing, with hopes of gaining greater clarity on the factors that might drive our investment returns going forward.

This piece isn't meant to be detailed or comprehensive. Our hope, rather, is that it may help you gain a better understanding of the primary influences that could drive our investment decisions in the coming year. How we react to changes and new information is a fluid exercise subject to our discretion, but always made with a longer term perspective in mind and the intent to drive superior returns over time.

Thank you for your continued confidence in our approach and interest in our work!

Looking Back

In our 2021 Investment Playbook we followed the pattern of several previous years where we provided general observations on the economy, the financial markets and politics in general.

While 2021 may have been "mildly" better than the year before, that claim largely depends on how one individually defines "being better." Thanks to on again and off again efforts to reopen the economy, solid earnings gains, and easy Fed policy, the investment returns of the market exceeded twenty percent. At the same time, market leadership remained difficult to discern, with the baton passing between growth and value stocks several times over the year.

Overall, I would say our primary views on the economy, the markets and politics for 2021 were solid, with the exception of our assessment that inflation would not be a pressing concern.

The Economy

Last year, we thought that the broader distribution of vaccines and a reopening of the economy would lead to above average GDP growth (i.e. more than 2-3%), partly as a function of easy year over year comps. We also felt the economy could exhibit greater cyclical effects associated with reopening and that while rates might rise on the longer end of the curve, the Fed would remain committed to short term rates near zero for several years.

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In general, these views came to fruition, with GDP growing at nearly 7% in real terms during the second quarter, but slowing to a little over 2.3% in the third. Unfortunately, the rate of inflation surprised almost everyone - hitting nearly 7% on an annualized basis in November. Recent indications from the Fed show that they are no longer in the strictly transitory inflation camp, admitting inflation may be more persistent. As a result, our view that the Fed would keep rates at zero for several more years now seems like wishful thinking.

The Markets

Last year, we indicated that we wouldn't be surprised if the market consolidated its strong gains, given the strength of the preceding two years. We thought the indices might tread water as underlying sector churn gained steam on a cyclical reopening of the economy.

The markets actually did quite well in 2021, and better than we would have expected, with a particularly strong showing for "value" stocks, which we hinted might be the case. Energy, financial and real estate picks were at the top of the leaderboard in 2021. Growth stocks also did well in absolute terms, only slightly underperforming the results of many previously forlorn "value" areas.

We cautioned investors to be careful of the potential for growing asset bubbles in some areas of the market given easy money policies and an environment that was starting to remind us more and more of the tech bubble twenty years ago. This warning proved to be warranted, as many non-earning, high flying, potential disrupters came under significant pressure in 2021, perhaps most notably reflected by the 25% decline in Cathie Wood's Ark Innovation Fund.

Politics

It remains to be seen whether or not the President can unite the country as we hoped might be possible last year. His hallmark Build Back Better program has been stalled in Congress, held up to a great extent by West Virginia Senator, Joe Manchin, who has likely been the most powerful politician in America over the past year.

Regardless of the continued polarization of politics made even worse by squabbles over vaccines and masks, our advice to check one's politics at the door when it comes to one's investment portfolio proved prescient once again.

Looking Forward – Our 2022 Playbook

As we turn to our Playbook for the coming year, we'll stick with the format we've been using and discuss our views on the economy, the markets, and politics for the year ahead.

The Economy

The economy should remain quite strong; we forecast GDP growth in the ballpark of 2-3%. We believe this figure will include an elevated inflation component, but that inflationary pressures should moderate as the year progresses. We believe some of the inflation spike will be transitory, particularly in goods where newfound pockets of oversupply could actually become deflationary,

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but also think that some inflation is likely to be persistent, particularly with respect to wages. We ultimately remain hopeful that inflation won't be problematic for the economy thanks to a continued emphasis by corporate America on productivity initiatives.

Consistent with higher growth and inflation, we believe that the Fed will raise rates several times this year, but as has been the case with more recent tightening campaigns, it wouldn't surprise us if it isn't as prolonged or as severe as perhaps currently feared. Hopefully, the outcome is the best of both worlds – the end of the deflationary spiral of the last ten years, but also the quelling of 1970's style inflationary concerns. Long term interest rates are likely to increase, but we wouldn't be surprised if they struggle to break higher than 2.5% given growth dynamics and continued global uncertainties driving continued flight to safety demand for treasuries.

<u>The Markets</u>

We've long held to a proprietary investment approach which postulates that three cycles determine overall value creation in the stock market. These three cycles include: *The Economic Cycle, the Innovation Cycle and the Credit Cycle.*

Historically speaking, *the Economic Cycle* – the economy's natural movement from recession to recovery to expansion - has tended to have the greatest impact on market returns in any given year. Given the recent strength of the economy, we continue to see cyclical gains ahead and more elevated inflationary pressures than previously perceived, particularly with respect to wages. We continue to believe the Economic Cycle will have more influence on the markets than it has in the last ten years, given greater volatility along a whole host of variables including GDP, inflation and interest rates. Continued ESG mandates will likely contribute to this phenomenon.

Longer term, meaning more than a year out, we believe *the Innovation Cycle* will continue to be the dominant generator of alpha for investment portfolios. The pandemic has accelerated efforts in corporate America to achieve greater productivity gains, but at the same time, easy money policy in recent quarters has helped to finance a flurry of newly disruptive companies, many of which may not survive. If this is the case, the profit margins and sales growth of existing profitable innovators may be slower than it might have otherwise been, at least until any "excess" supply is liquidated.

With respect to *the Credit Cycle*, there is no doubt that the Fed seems to be far more hawkish than it was even one month ago. Not only will rate hikes be in the cards, but some recent proceedings suggest the Fed may not only taper, but also start to sell their excess treasury holdings. On this front, we're not sure – we believe the economy is strong, but there remain enough concerns that the Fed may not be able to be as forceful as currently anticipated.

In the end, we're hopeful that the Fed can engineer a soft landing, taming increasing inflation expectations with a shift in monetary policy. But we also know that the process is delicate, akin to threading a needle. In the last four economic cycles, the Fed is two for four in engineering soft landings. The other two rate hike campaigns pricked asset bubbles in the housing and tech sectors, which ushered in economic recessions in both instances.

Based on an analysis of prior rate hike cycles not ending in recessions, market corrections can be expected, but are often not durable enough in nature to be noticed for more than a few months and sometimes just weeks. While we tend to focus on the worst of the worst, more often than not market corrections are much tamer than anticipated. As always, the key to success is having a longer term investment horizon, recession or not.

We continue to favor companies associated with the Innovation Cycle longer term, the Economic Cycle in the intermediate term, and would continue to exercise caution in managing risks associated with companies born during the most recent Credit Cycle, particularly those with no earnings. A few disrupters may ultimately succeed and perhaps wildly so, but if history is a guide, many more will fail.

Politics

The nation remains highly polarized.

As we stated in our most recent quarterly update, one way we might as a nation temper these views could be by recognizing the beneficial role and value that those with differing functions and points of view have on the whole, and how our unique contributions –even in "backward looking" industries like fossil fuels -- can help us get to the future we envision. If our economy is able to collaborate successfully, perhaps value and growth stocks can both do well in 2022 once again.

An analysis of the history of midterm elections could suggest a rockier year ahead as 2022 is a midterm election year. Given the strong returns of the last few years, we wouldn't be surprised by such an outcome, but remain hopeful that barring a recession, we'll still end the year in the positive column.

We'll close our 2022 Playbook as we have always done, by reminding investors that our business is never easy, but it's always an intellectual challenge worth pursuing.

May God bless you abundantly in the coming year, even if it comes in ways you don't expect!

Kindest Regards,

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