



Shifting Gears **December 16, 2009**

It has been quite a yawner for the markets since we published our last Economic Update, [Painting the House](#), in mid November. The S&P 500, our proxy for the stock market, has moved in an uncharacteristically narrow channel since then, with 1090 as the low and 1110 as the high, a whopping 1.8% in heart pounding variability.

In our view, this sideways move is a natural one, as the market digests its significant gains coming off the nearly fatal March lows and as the economy prepares to shift gears as it enters the 2010 straightaway. We believe there is a higher probability of above average gains for the coming year than most folks expect.

Why do we believe in an upside bias? Three reasons.

First, employment should not only stabilize in 2010, but should begin to increase, perhaps as early as next month. According to work done by ISI Group and thoughts echoed by former Fed Chairman Alan Greenspan this weekend, corporate managements likely cut employment too far as they prepared for Economic Armageddon over the past year. Historically speaking, a GDP decline of the recent magnitude would have resulted in a 3% cut in payrolls as opposed to the much more significant 6% decline that actually occurred.

Employment is, of course, a lagging indicator and as a result, improvements may not necessarily signal higher stock prices from here. Nevertheless, they should provide the basis for improved sentiment and clearly remove a key thesis for the market's bearishly inclined.

In addition to an improvement in employment, we also believe we are on the cusp of what will prove to be a significant increase in capital spending, particularly among cash rich, downsized and restructured corporations. As company executives become more comfortable with the sustainability of the recovery, they will likely move beyond simply replenishing inventories and hiring more folks and restart longer term investment projects that have been on hold.

As we've pointed out from recent earnings results, most companies have generated significant improvements in free cash flow as they've downsized, freed up working capital and curtailed longer term investments. But in addition to the improvement in internal cash flows, the credit markets have also thawed considerably, providing a refreshed source of external cash flow.

Recent mergers and acquisitions activity – Buffett's purchase of Burlington Northern and Exxon's purchase this week of XTO – are evidence of both improving corporate

sentiment and the ability of the capital markets to finance future strategies. Increased M&A activity is a noteworthy and bullish leading indicator.

Finally and perhaps most importantly, is the relationship between the depth of economic downturns and the strength of subsequent recoveries in the past. History suggests that deep downturns have almost always been accompanied by stronger than average recoveries. Again, according to work from ISI Group, the depth and duration of the recent recession would normally suggest a GDP rebound of eight percent. With many economists forecasting more tepid GDP growth of just four percent in the coming year, expectations appear conservative and the variation could prove to be on the upside.

While no downturn is ever fun, I find myself increasingly more comfortable with ***experiencing*** the reality of asset bubbles and economic recessions. Economic cycles are an inevitable trait of the capitalistic lifestyle. As long as humans are inclined to believe in money in an unhealthy fashion, we will not only succumb to the allure of greed, but also fall prey to fear. In harnessing the relative calm afforded by the reality of past experience, I'm hoping we can all improve our investment returns during future calamity.

Over ten years ago, I bought a new Dodge Viper. While I no longer own it, I loved nothing more than the rush I could get from shifting gears as I accelerated down a highway entrance ramp. On many occasions, I'd drive from my home to downtown Akron on State Route Eight, entering and exiting the freeway far more times than was truly necessary. While the car always got its share of admiring looks and could certainly have pushed the threshold of a prudent speed, it was the shifting of the low gears, the sound of the engine, and the feeling of torque that I will always remember the most.

As 2009 comes to a close and 2010 begins, I can't help but anticipate the excitement of shifting economic gears.

Kindest Regards,

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