Economic Update

Broadleaf Partners, LLC

A January Dud, Bad Banks and Earnings Insights

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The markets have continued to sell off, heading towards but not yet hitting levels last seen in November. After a nice bounce off the November lows, January turned into a dud, the biggest one for the S&P 500 in over one hundred years. If you are superstitious, you have probably heard the notion that as January goes, so goes the year. While this has generally been the case, it may be more comforting to recognize that what has generally been the case has not been too common at least during the past year or so.

While it was a tough January, the markets provided some insight last week into what might outperform as the credit crisis subsides and the markets return to more normal conditions. Last week, news of a potential bad bank structure surfaced, whereby banks would sell poorly performing loans for cents on the dollar to a government sponsored trust, similar to a strategy which ultimately proved successful in the savings and loan crisis during the early 80's. When we first heard of the idea, we were encouraged, believing that by quarantining the bad from the good, the system as a whole might stay healthier.

There has been considerable debate over the merits of such a strategy over the last few days, but we keep coming back to it, believing that it could be viable if for no other reason than it appears to have worked in the past. Pricing the bad loans appropriately, to both the buyer and seller, seems to be at the heart of whether or not the idea gains additional traction.

Regardless of the near term outcome, we could not help noticing that the markets really responded nicely to the idea, suggesting that it may provide hope in an environment devoid of it. Early cyclical stocks, including consumer discretionary and financials, responded very nicely to the prospect while defensive oriented investments lagged considerably. If there was anything interesting about last week's market action, it was the fact that investors may have been encouraged to bid up risk a bit while talking down the desire for safety. This mindset will be a necessary ingredient to getting anyone in the mood to hire again, so when you have a spike like last week, it may be worth understanding the reasons behind it. With companies like Proctor and Gamble now hitting new 52 week lows, we may be reaching the point of maximum pessimism, where even the most defensive of sectors succumbs to a degree of cyclicality.

We are roughly halfway through the earnings season and so far, the action has been as expected. Except in the most unusual of circumstances, earnings estimates have been brought down. The reaction of specific stock prices to earnings results has been mixed, which is at least encouraging from the perspective that some differentiation may be occurring at the margin and that

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investors are starting to look beyond trough earnings scenarios and look to what might be considered normalized earnings power over a fuller market cycle.

One thing is clear, however, and that is almost every company is focused on controlling the factors that they can influence and that is at least for today, the cost front. Frankly, I would be more worried if companies were sticking their heads in the sand, but they are not. Most are cutting variable costs wherever possible and also targeting additional cuts if certain cash flow targets fail to materialize. This is a rational response to the current crisis, but also one which reinforces the amplitude of the down cycle.

We continue to be of the view that it makes the most sense to be a buyer of stocks at current levels, especially as we have retraced the gains off the November lows. While the prospect of recovery feels far fetched, the stocks that are likely to outperform the most from current levels are also those that are more cyclical and despised than defensive and adored. Similarly, in the choice between stocks and bonds, it is worth noting that bonds are more expensive today than stocks were in 2000. In 2000, you would have been best served buying bonds rather than stocks, but for the decade ahead, the opposite could prove true.

In spite of a January dud, there are no major changes to our game plan. We have seen this territory before and while we do not enjoy it, we will stay focused on an eventual recovery while remaining mindful of new data and events.

Kindest Regards,

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