Economic Update

Broadleaf Partners, LLC

A Reader Asks…

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In response to yesterday's Broadleaf Blog entry, Milk and Cookies, a reader asks...

"Where do you look to buy if a recession is on the horizon? How do you protect yourself in a recession and still make some money versus hiding out in a money market fund?"

Here were our thoughts, which he felt were worth sharing.

It is very difficult to protect oneself from a recession. Last year, we made adjustments, thinking one would come and it didn't come. While we recovered some, we left a couple of percent upside on the table.

Basically, we aren't selling anything right now because we still believe a soft landing is more likely than a recession. But if our normal selling process leads to some extra cash on hand, we'll be a bit more patient about redeploying the proceeds. And here I'm saying 5-10% cash, not 30-50% or more.

Typically, defensive names do better but often still decline. You can buy things like consumer staples stocks as we did last year. We made good money on these but lagged for a bit as the recession we anticipated didn't come to fruition. This is the danger in buying these types of names now, which have done VERY well.

On average, stock indices fall 20% in a recession, lasting an average of eight months. A proper asset allocation can help cushion the blow, and is usually the best approach. The problem is that many investors are likely overweight what has worked well in the past few years, the value style. And unfortunately, the value style, at least presently composed, is more sensitive to the economic cycle. Some hedge funds also hold out the promise of doing well in differing market environments due to their ability to go short, but so far, I'm not convinced that the long-term returns are worth the significantly higher fees and the lack of transparency.

Technically speaking, a recession is two consecutive quarters of negative growth. The problem is that you never truly know you were in one until after the fact. And as one wag once commented, the markets have accurately predicted ten of the last three recessions, indicating there are many false positives. We're probably at about 1% GDP growth in the economy right now. Looking at the S&P, near-term downside would be about 1407, where it went in both August and November. We're at 1456 now, which would suggest about another 4-5% is possible. The recent high in the S&P 500 was 1566 many months go. A recessionary, 20% correction from there would be 1266 or about another 13%.

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I suspect that 2008 will be a very slow growth year, with the direction of the markets totally determined by Fed policy and their ability to stay ahead of the curve rather than behind it. If inflation comes back down as I suspect it will, the Fed will likely be much more aggressive. We also have an election in 2008 and everyone will be talking about change, change, change. Change always breeds short-term uncertainty, which won't help matters.

But again, barring a recession, this environment suggests a great opportunity for those companies that are capable of growing in spite of it all. As growth becomes scarcer, the premium paid for those that can grow tends to rise. This is the basis for our positive outlook for growth investors in the coming year.

Happy Holidays from Broadleaf.

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