Economic Update

Broadleaf Partners, LLC

Broken Records
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With each of the past few updates we've published this year, we've had an increasing sense of Déjà Vu. Since February, the markets have been hitting new recovery highs, succumbing to market pressure, then reversing course and moving on to higher highs. The pattern is beginning to feel a lot like a broken record.

Currently, we've been experiencing a renewed downtrend, with the market off 6% from its April highs. While these moves are normal following a 30% plus advance in just eight months, I don't deny they can become disorienting. The truth, however, is the uninterrupted steady gains we experienced from August through late February may be far more unusual for the markets than the back and forth gyrations of the past three months.

The standing joke - which actually may not be one at all - is that both the stock market and economists have accurately predicted ten of the last three recessions. Inevitably, someone will make an accurate market call - as Nouriel Roubini and Meredith Whitney did in 2007 - and then get a lot of press until their powers of prophecy wear thin.

While few rarely track it, heeding the advice of these latter two individuals over the past three years would have kept you largely bearish, an expensive proposition in a recovering stock market. Over the long term, stocks have tended to increase in value – through wars, famines, market crashes, BP Oil spills, European contagion and recessions – making two time winners in market timing circles very rare breeds, indeed.

Harold Camping, an elderly "Christian" man recently predicted that the end of the world would arrive on May 21st at 6pm and the news went viral, spreading worldwide. But as we all now know, May 21st came and went just like every other day, including one in 1994, when a younger Harold made a similar prediction. While the end of the world will come someday, I doubt any of us will accurately predict it and even if someone does luck out and get it right, let's face it, it's a guarantee they won't get it right a second time!

Granted, calling an economic recession and a market cycle is not exactly the same as predicting the end of the world, but we are still struck by how few get it right a second time. I suspect that there are such things as Perma Bears *and* Perma Bulls, but at least with the latter, history appears to be on their side. Unfortunately, most investors rarely realize the stock market's long term returns, usually because they end up buying high and selling low far too often than they'd care to admit. The tendency is so extreme that Morningstar now publishes investor realized returns alongside reported returns for most mutual funds.

Long ago, Warren Buffett labeled some of his stock positions as permanent holdings. While he hasn't been perfect year in and year out – no one is – he certainly has been a far more lasting figure in investing circles than most. I would attribute some of his success to a disciplined value based investing approach, but also believe his optimistic outlook has helped. Indeed his purchase of Burlington Northern a couple of years ago – not just some stock but the whole company – was based on his firm belief in the outlook of our country's economy and the central role the rails may play in enabling that growth.

Switching gears, I'd like to review some of the things we've pointed out in our two most recent Economic Updates. In those, we said that it would be within the realm of reason for leading economic indicators (LEI's) to weaken given the unrest in Africa, the disaster in Japan, and more recently, unprecedented North American weather. My son's baseball team – and I know I'm not the only baseball parent out there – only played 10 of their scheduled 25 games this season, all because of rainouts and an inability to reschedule. Executives at the Scott's Miracle Gro Company have said that this has been the worst spring that they've seen in the thirty plus years they've been at the company.

One type of LEI we pay particularly close attention to are the regional and national purchasing manager surveys (PMI's) which are released on a monthly basis as an indicator of manufacturing activity in the economy. We tend to focus particular attention to these indicators as they seem to correlate well with near term, forward stock market returns. Last week's releases confirmed our suspicion; while remaining in expansion territory, these leading indicators clearly declined. Last week's employment releases were also far from desirable.

As has been the case for us the past two months, investors might be well served by entertaining a discussion of the causation and duration of an anticipated decline in LEI's rather than automatically considering every change as an actionable trade worthy of investment attention. In other words, is the anticipated or current decline a bump in the road caused by temporary but logical events or of the more sinister type that could lead to a recession?

While no two cycles are exactly the same, we continue to believe that the anticipated and now confirmed declines in LEI's will prove to be short lived, as was the case in 2010. Following a downturn in leading indicators last summer that accompanied unrest in Greece, European contagion and the BP oil spill, the same indicators eventually turned up, leading to the 30% plus surge in the stock market we've experienced over the last eight months. While inflation has picked up, it isn't the massive problem domestically that it is overseas, suggesting that this go around of lower LEI's may likely prove temporary as well.

According to Strategas Research Partners, the average bull market since 1928 has lasted 57 months and generated investor gains of 164%. If the current downturn is truly more than a bump in the road and we are headed back into a recession, then this would prove to be one of the shortest and smallest recoveries on record at 27 months and a 97% gain.

To be sure, the world isn't perfect right now. Unemployment remains high, the

housing market shows no signs of a bottom, the U.S. government is overextended, and social unrest is increasing around the world. At the same time, I am reminded that big declines often come not when most folks expect it, but when things seem so right with the world.

With perhaps the exception of the Facebook and LinkedIn crowds, the market environment hardly appears ideal, which leads me to believe that the current decline may prove to be temporary and yet another false positive for 2011.

As always, time will tell.

Kindest Regards,

Doug

Doug MacKay
CEO & CIO
dmackay@broadleafpartners.com

Bill

Bill Hoover
President
bhoover@broadleafpartners.com