Economic Update

Broadleaf Partners, LLC

CNBC Appearance: The Commodities Debate

June 3, 2008

A blog entry we posted last week caught the eyes of CNBC's producers and they asked us to appear in a debate regarding the direction of commodity prices this morning, June 3rd. If you missed the interview, you should be able to view it here.

In preparing for such appearances, I always like to organize my thoughts ahead of time in writing. Sometimes these ideas are fleshed out in an interview, but sometimes they are not.

These are the thoughts I had ahead of this morning's debate on the commodities complex. Keep in mind, they are notes and I apologize to any English teachers out there.

Setting the stage. We are a long only manager. We have benefited from the commodity complex on the long side through materials, energy, and industrial holdings as well as exposure to international sales through domestic large cap growth exposures. We do not sell short. You could say that we have no axe to grind. We also have a longer term time horizon. We don't need to be right about things tomorrow and in fact, as an investors, are more concerned about understanding what is true. Many commodities have already declined significantly, save for oil and to a lesser extent, gold. We are probably more bearish about energy than other commodities, but history has shown they will all likely move together, just as profitable tech eventually followed fantasy tech.

Round 1: Know Yourself. To know the answer to the dangers and opportunities involved, investors first need to know what their personal upsides and downsides are in the event of catastrophe. If a crash occurs, does it mean you'll be falling off a stepstool or the top of ten story building? What is the cost of a bad outcome for you personally? While we are underweight energy after a nice, long run, we have also tried to better understand what other areas in the portfolio may have benefited from the strong energy complex.

Round 2: Look at the recent past. The bull market in commodities has largely coincided with the rapid industrialization of emerging market nations like China and India. Is it possible that these countries can still experience economic cycles within a long term positive trend? Absolutely!!! Strong fundamentals don't make one immune to cycles. If these countries do experience the downside of an economic cycle, what will be the impact on commodities? Is it reasonable to expect a like effect on the downside?

Round 3: Consider the Present. If you were a citizen of China, listening to China CNBC, what would you be thinking of your markets if leading economic indicators were starting to decline, inflation was running in the double digits in your country and other emerging economies, and monetary policy had been tight for some time now? Also, your stock market has declined 40-50% year to date. If your markets are more

capitalistic than they used to be but still largely controlled by the government, what would that mean in terms of transparency and flexibility? Is fiscal policy more likely or less likely to be stimulative after the Olympics? Will the rising cost of oil subsidies eventually cause you to cry uncle and if so, what will happen to market forces? I would argue that China is about to turn down but that the long term trend will remain.

Round 4: What are the clues? Valuations, fundamentals, and management team optimism have rarely been good indicators of bubbles. Tech valuations were high but housing and banking valuations were low. Things turn fast, really fast. I remember Mozillo on CNBC shortly before the mortgage bust, ditto for many tech and housing execs. Hard to see before the fact, easy to see after the fact. Instead, look at Fund Flows Gone Wild. (I should trademark that!) Where is the action? Where do college kids want to work these days? What are the coveted internships? What is the largest sector in the S&P 500? What stocks dominate the IBD 100? How long has this been the case?

Round 5: Understanding Human Nature. I'm a Christian. I'm also an investor. The bible is a great book, even if you're not a believer. It tells a lot about human nature and experience and how we as humans also make the same mistakes over and over again. There is nothing new under the sun, indeed. Speculative building of mansions in Greenwich, CT two years ago for hedge funds and private equity guys. Dot Com overnight millionaires. Forbes 400 type lists dominated by those outside of the U.S. today. But who dominated such lists prior to the tech bust? India high rise home, 60 stories for a family of four. Dubai. It's different this time. No, not really. Same story, different time. Human nature. As discussed in the blog entry, unscrupulous activities invariably occur during bubbles but can only be seen after the fact.

Round 6: Make the Best of It; How to Play Some Offense. How do you benefit from a cyclical retrenchment in a very long term secular bull market for China? If commodities crack, who benefits? In addition to possibly trimming your MEI exposures (congrats on your profits), you could also start buying consumer discretionary names or in general, the U.S. stock market, which should move counter to the commodities complex. I would also argue that in an environment of no recession, no recovery, investors will want to focus on innovation. Technology has and will always continue to be one of the United States greatest natural resources because we have a political system that remains the most option to free and open thought, bar none.

Rounds 7-10. Pigs get fat, hogs get slaughtered.

Kindest Regards,

Doug

Doug MacKay
President & CIO
dmackay@broadleafpartners.com
Office: 330-650-0921

Jeff

Jeff Travis
COO & Director of Research
jtravis@broadleafpartners.com
Office: 330-650-0921