Economic Update

Broadleaf Partners, LLC

Caressing and Stressing, Shopping and Rebalancing

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The S&P 500 came within a point of caressing the November lows yesterday and is bouncing a tad today. I wouldn't say that anything new has surfaced over the last few months to suggest that further weakness is likely beyond these levels. Surely, whenever you see a retracement, it means that the bears are in control.

Many strategists are climbing over themselves to come up with new price targets for even lower levels on the S&P 500 by reducing their aggregate earnings estimates even further and then applying some expected multiple to those results. These analyses are always interesting, but given all the assumptions, should hardly be taken as gospel. Just as analysts jumped over themselves to raise index targets and aggregate earnings estimates on the upside, they are now doing the same thing but on the downside. Reality may likely reside somewhere in the middle.

Earnings results for the fourth quarter have been difficult, but nothing any more disastrous than the declines in most stocks would have already implied. I suspect that the retracing of the bear market bounce since January has largely been based on the skepticism with which the market has greeted many of Obama's stimulus programs or the vagueness of the Treasury Departments approach to the beleaguered banks.

Geithner and crew will be spending the next several weeks stress testing some of the nation's largest banks to see how solvent they would be in the event of a dramatically worse downturn in the economy. In many respects, these stress tests may be similar to the aforementioned aggregate earnings reduction exercises many strategists are undertaking. While these exercises have value in that they help all of us understand and better prepare for worst case scenarios, it is also important to realize that just because you take a look at them doesn't mean they will occur.

On a surprisingly positive note, several retailers over the last few days, including Nordstrom's and Macy's, have reported results that weren't nearly as bad as feared. Ee gads --- someone is still shopping. I only point this out because consumer discretionary stocks like these are also known as early cyclicals and typically respond first in an economic recovery. In addition to watching any progress in the banks, early clues as to an economic recovery might be expected from this group of stocks. Granted, they may represent the start of another bear market rally, but a rally it still would be.

We believe that now is an excellent time to begin committing new funds back into equities, but with the clear understanding that we may likely see several more bear market rallies and retracements throughout the year. Better economic fundamentals will likely be a 2010 event, which may be partially discounted later this year.

We have also received many questions from our readers wondering whether or not it makes sense to hold onto overweighted positions in corporate credits and other fixed income investments rather than rebalancing these funds back into "junior" equity

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positions. My general reaction to the question is that unless you believe many companies are going under, corporates and equities should respond similarly, just as they started to turn down together. In the absence of going under, "junior" may never come to pass and equities might see the "senior" returns.

Weeks like the last one certainly give anyone contemplating an equity rebalance a reason for pause, but the truth of the matter is that no one will time their move perfectly. When you manage huge pension or foundation assets, it is unlikely that you'll be able to make the move at the perfect time. As a result, an incremental approach is advised and with the S&P 500 nearly fifty percent off its highs and near support levels, now may be a good a time as any to begin the tiptoe process. (And if we can help you tiptoe, let us know!)

JP Morgan provided some analysis on the subject as well in this morning's research. In looking at credit spreads during the Great Depression, they noticed that equities did not start to perform better until spreads peaked and moved back below 300 basis points (BAA verses AAA yields). While history rarely repeats itself, it is nevertheless encouraging to know that spreads did peak last November and that they narrowed to 300 basis points on January 29th. Healed, no, but healing? It would seem so.

In other news, JP Morgan's stock is holding up today despite a decision to trim their dividend by 85% and Apple has finally firmed up details for distribution of their iPhone in China. At least for today, the bark of dividend cuts may be worse than their much feared bite. And, in spite of all the bad news, the world still has one new opportunity for American products -- selling iPhones to the Chinese.

Call me a lunatic, but I think there will be others. But if not, the iPhone is still pretty cool.

Kindest Regards,

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