Economic Update

Broadleaf Partners, LLC

Cisco System's Second Quarter Earnings

What They Mean and Why You Should Care

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Last night, Cisco Systems reported stellar second quarter results. I want to get it out right away that we don't own the stock. We do, however, actively follow it, having done so religiously for the last fifteen years. Cisco's results are important – as are their calls – not just as an indicator of how the company is doing, but in our view, for providing insight into what may be happening in the economy at large and technology in general.

As one who frequently reads commentary from several influential economists and strategists on Wall Street, I have come to respect John Chambers not only as a strong CEO, but also as a decent – though perhaps accidental – economist on Main Street. Having customers in nearly every industry from around the globe can't hurt.

Reflecting on Cisco's last two earnings calls, I'm beginning to notice a few, emerging and perhaps polarizing trends which may prove lucrative for both the economy and investors this year.

A Strengthening Economy without Inflation

Last August, Chambers made a very unusual comment regarding the company's performance relative to GDP growth. For most of the last five years, Chambers has opened and closed each call stressing the point that their growth as a company would be largely dependent on the underlying GDP growth of the countries and economies they serve. However, during last quarter's call in August, he surprised us, by stating that this link might no longer hold true. In an unusual series of events, Cisco's results in the fourth quarter were beginning to accelerate, even as our domestic economy was starting to decelerate.

Now that a second quarter of similar results have passed, I believe that Chambers may be onto something not only specific to Cisco's strong product cycles, but perhaps the economy at large. The economy softened over the summer, but seems to have found stronger footing and may even now be accelerating once again, but this time without inflation. This morning, the government reported that productivity enjoyed a significant rebound to about 3% on an annualized basis while unit labor costs increased just 1.7%, well below the pace of a few quarters ago.

This quarter, Cisco also mentioned that international sales were quite strong, growing at very high double digit rates in many geographies and reaching over thirty percent of sales. While they've always discussed international results in the past, they haven't quite done it with such bullish undertones. We're not quite sure what to make of this, but stay tuned, as it could also suggest that further improvements are ahead.

Powerful, Emerging Technology Trends

It doesn't take a rocket scientist to realize that the internet is increasingly being influenced by all things "video." This quarter, Chambers commented that it could be the "killer app" among many positive trends they are experiencing.

As I read the Wall Street Journal online this morning, I was struck by how many of the articles were accompanied by video interviews providing additional education and insight into their subject matters. I even found myself instinctively skipping the reading altogether and could hear old teachers in the back of my head bemoaning the "lost art of reading". Nevertheless, I pressed on with this preference, perhaps an intuitive acknowledgement that video could offer a better experience with less effort.

Google's acquisition of YouTube, WalMart's announcement of a movie download service and Apple's push last night for entertainment studios to lighten up on digital rights management issues both point to the tremendous opportunities at stake here that may no longer be limited by money, demand, or the receding fears and memories associated with the last tech bust, but only by our creativity and a few bureaucratic details. The results at Scientific Atlanta, a set-top box maker acquired by Cisco last year, suggest that IP TV (internet television) is coming and perhaps sooner than most expect.

Cisco is an unusually large and successful company, with the unique ability to influence the performance of the entire technology food chain. The trends they are seeing will likely trickle down into many sub sectors including semiconductors, content delivery networks, and software as a service plays, perhaps with even more dramatic results for these companies' stocks than their own.

Changing Views on Stock Buy Backs

I have always applauded Cisco's religious fervor in buying back their stock. Until this year, it really hadn't paid much in the way of dividends, but over the last five years, with the stock up a lot, people have begun to notice that these buybacks have reduced their share count by some thirty percent. Cisco has bought back shares faithfully quarter in and quarter out, in spite of direct criticisms over stock options and the lack of a dividend payment. For many quarters, including this one, Cisco boldly spent every dollar they generated from operations on stock buybacks, and at times even more.

Again, I point out these financial decisions not only as evidence of Cisco's tremendous perseverance and belief in themselves, but also as Exhibit A that cash can be a good thing. (And as Art Laffer commented in a recent piece, a tax-preferred thing.) Throughout a difficult five year period, technology companies have maintained strong, debt-free balance sheets, while continuing to generate significant cash flows even as they saw their PE multiples fade and investor interest in their stocks wane.

Wall Street might begin to view these balance sheets in a positive light rather than a suspicious one, further bolstering the demand for tech shares, much in the way that the private equity phenomenon has supported the valuations of many non-tech industries more recently.

Concluding Comments

Cycles come and go in stocks. Yesterday, we read a fascinating article in Financial Advisor Magazine, which claimed that a majority of investment managers with superior ten year performance track records regularly experience three years of relative underperformance, sometimes consecutively, during their tenures. In this sense, Chambers – the accidental economist from Main Street –might share something in common with the better portfolio managers on Wall Street as well.

The favorable top-down macroeconomic backdrop – a Fed on hold and moderating inflation trends – have historically been linked to strong periods for the stock market and growth stocks in particular, as earnings multiples expand. The emergence of video as a potential "killer app" and a potential change in Wall Street attitudes towards stock buybacks and cash rich balance sheets are two fundamental bottoms up reasons to believe that technology might lead the way, as it has done in favorable periods for growth investors in the past.

Stay tuned!

Kindest Regards,

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