Economic Update

Broadleaf Partners, LLC

Easy Money

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I've taken great interest in the masculine characters of several Clint Eastwood films recently, including *Unforgiven's* William Munny and *Gran Torino's* Walt Kowalski. This past weekend, I was also introduced to Robert Redford's *Jeremiah Johnson,* a movie by the same name. These films elevate the state of manliness – even with its flaws - to a level worthy of respect rather than scorn as is often the case in today's culture. Courage is displayed in a noble light, but is neither easy nor free.

Throughout much of January, I heard the phrase "easy money" to describe the gains of 2009. With the "easy gains" now behind us, the implication is that further progress for the markets will be more difficult. While I agree with the idea that future gains may be measured, I disagree with the notion that the gains of the last ten months were somehow "easy". Employers, employees and investors alike have suffered greatly over the last eighteen months and in some cases, the pain remains severe.

In spite of January's market decline, we believe the economic recovery remains intact. Jason Trennert of Strategas Research Partners points out that of the 45% of S&P 500 companies that have reported earnings results, 78% have beaten bottom line estimates, while a whopping 70% beat top line revenue estimates. This latter figure is a tremendous improvement from year ago levels when only 30% of companies exceeded their goals. Revenue growth is important as it is a useful indicator of a healthy recovery and future employment gains.

ISI Group takes the argument a little further, suggesting that at current rates of improvement, S&P 500 profits could be back to the peak levels achieved in 2006 by the second quarter of this year. It is worth noting that the last time profit levels were that high, the S&P 500, in spite of 2009's gains, was nearly thirty percent higher than it is today. The rate of decline in unemployment claims has also been surprising, exceeding the average declines of the prior two slow/jobless recoveries in 1991 and 2002 by almost three fold.

On an individual stock basis, the prices of a few companies are already back to or near their former all time highs. In general terms, these companies seem to be from one of two camps, each on opposite sides of the capitalist spectrum. On the one side are companies that have been the beneficiaries of rare levels of sustained innovation and new highs in profits (Apple Computer) and on the other are those that have been beneficiaries of "too big to fail" government policy (A few banks). It will be interesting to see in the months and quarters ahead if the "too big to fail" premium reflects hoped for market share gains at the expense of the weak or out of business or simply the government's implicit guarantee of equity shares.

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As we look forward, we see a recovery based on the strength of corporate profits and business spending rather than the consumer as has often been the case in recent history. For all the bashing of the U.S. that goes on these days, our companies are able to change directions relatively quickly on a global scale, as market pressures dictate.

Today, U.S. companies are generating significant cash flow and like it or not, have leverage over the labor force. With aging corporate infrastructures, we would look to the capex cycle and improved exports to take the traditional place of the consumer in recent recoveries and eventually, as stimulus is curtailed, government spending as well.

The economy, as the recent GDP report suggests, may be stronger than most expect, but this won't necessarily translate into another outsized year of stock market gains. Earnings will play a more dominant role in valuations as reality catches up with already expected improvements. This is likely one reason that the response of recent stock prices to earnings reports has been underwhelming.

We are firmly in the camp that the recovery is intact, but fully expect some backing and filling along the way. As the year progresses, it may behoove investors to look at companies with stable growth prospects that are less dependent on the economic cycle for outperformance in addition to those cyclical companies that have not yet fully participated in the expectation of recovery.

Gains won't be easy, but in spite of the rhetoric, they rarely are. Buying stocks last March wasn't a very "easy" thing to do for anyone being honest with themselves. Only in hindsight do the rewards of success appear "easy". Unfortunately, such views are most often shared by Monday morning quarterbacks and perhaps politicians lacking a majority.

William Munny, Walt Kowalski and Jeremiah Johnson would not approve.

Kindest Regards,

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