Economic Update

Broadleaf Partners, LLC

Engines & Brakes

November 13, 2007

Earnings season is almost officially over, which is good news to our ears as it has been a tough one for stocks. Since peaking at the end of October, the S&P 500 and Russell 1000 Growth Indices have declined 7% while the NASDAQ Composite has fallen a more aggressive 10%. Why might this be the case? Slowing reported earnings growth.

At the beginning of the fourth quarter, a bottoms-up compilation of earnings estimates for companies in the S&P 500 implied year over year earnings growth expectations of 4% for the third quarter. By the end of last week, however, actual reported results showed something different, with earnings actually DOWN 2.4% for the third quarter. (ISI Group Research)

The greatest degree of deceleration came from the materials and energy sectors. This deceleration is entirely consistent with the tone of third quarter earnings calls from companies in these two sectors, but flies directly in the face of the parabolic rise in many commodity prices in recent days, including oil. While the falling dollar may have something to do with rising commodity prices, there is likely a speculative influence at work as well.

We can still trace the weakness in our economy back to the housing industry, which started to show problems over two years ago. The weakness resurfaced in the form of sub prime loan problems last spring and very recently in the significant write downs of several bank asset portfolios. The source of this weakness isn't new, it's just now apparent on both sides of the balance sheet, something we pointed to in our November 5th blog entry titled La La Land.

While we are believers in the rise of industrializing nations, we also think the theme may be a bit crowded in the short run and due for a pullback. The U.S. may no longer be the engine that drives the world economy, but its brakes are likely still large enough to slow it. At the margin, we'd be a bit more cautious on emerging markets and its related beneficiaries, including materials and energy. These areas have been stellar performers for over five years and many investors may be unknowingly overexposed.

On the other hand, a sell-off in many leading technology companies last week, courtesy of Cisco's earnings call, may provide some interesting opportunities within the sector. On its call, Cisco simply stated that a dramatic decline in the domestic financial services sector, autos and to a lesser extent retailing was *more than offset* by the strength of business from the rest of the world. This commentary is consistent with what we already know to be true and therefore isn't a surprise. Until this year, technology stocks had broadly underperformed the markets since their crash in 2001 and most investors are likely still underexposed.

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So, what has changed? Other than stock prices, our forecast remains the same. The domestic economy is slowing. In a slowing economy, growth is harder to come by, enabling the valuations of those who can grow to expand. And, in spite of the high profile spike in commodities and oil, we think the risks of runaway inflation are minimal. Housing prices are a mess and wages are relatively contained. All of these factors should give the Fed the wiggle room it seeks to continue its easing policy.

Kindest Regards,

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