Economic Update

Broadleaf Partners, LLC

Go Granola
Buy Organic, Sell the Rest
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It's been awhile since we wrote our last topical update, but much of what we spoke about during mid-May appears to be bearing fruit. (See, A Narrower Market) The current market correction, we believe, reflects the beginning stages of a melt down in private equity, top-ticked by the IPO of the Blackstone Group a few short weeks ago and now stimulated by a repricing of risk in the credit markets, which has fueled the feeding frenzy.

Having witnessed and participated in the rise of several investment bubbles and their ultimate demise over the course of the last two decades, we are, perhaps, in the fortunate position of being able to see how they rhyme.

In the late 90's and early part of this decade, the rise of the Internet gave birth to New Economy talk, with the bubble reaching its zenith at NASDAQ 5000. As a young technology fund manager, I found my face on the cover of Barron's in September of 2001 for having avoided the dot.com bust in favor of large and profitable technology infrastructure plays. CNBC's Jim Cramer wrote an article in the Street.com about the fund, giving us kudos for similar reasons. Fund flows ticked up at a torrential pace at that time, amounting to tens of millions per day on several occasions. While somewhat apprehensive, I had no sense for the carnage that lay ahead.

While the good times were great, they didn't make up for the pain that would ultimately come. Individual investors were, of course, burned by the meltdown, and perhaps because of this began throwing their excess savings into their homes rather than the stock market. (Ironically, during the late 90's when tech stocks were on a tear, many folks were bemoaning the fact that their homes were lousy long term investments, barely keeping up with the rate of inflation.)

Over a few short years, housing stocks and everything related became the next market darlings. I was at an industry conference a few years ago when John Neff -- retired, 80 year old manager of Vanguard's celebrated Windsor fund -- commented that his style of investment management -- making extreme industry bets – wouldn't make it in today's world. At that time, John was just managing his personal assets and those of a few friends. His favorite industry group was the homebuilders, sporting low PE's of only 8x. Mr. Neff noted that he had 40% of his assets in the group at the time.

This past June, a few years later, Mr. Neff spoke to another industry group and while I wasn't in attendance, someone that was told me that homebuilders were still among his favorite groups. While I don't know for sure, it wouldn't surprise me if Mr. Neff had

maintained his concentrated position in the group, now mired in a recession and more than 50% off its highs.

While earnings growth within the economy has been solid, I suspect some gains in the stock market have been largely generated by the financial engineering efforts of many hedge funds and private equity players. Many institutional investors have been scrambling to up their allocations to so called "alternative" investments offered by these players, but these investments may pale in comparison to the amount of debt these funds are able to raise alongside it.

In recent days, renewed subprime lending concerns and a possible credit crunch in the institutional debt market have caused a sell-off in the broader stock market, overwhelming the positives of a strong corporate earnings season. When the bears are out in full force, nothing is ever good enough. Our past experience suggests that a recovery is highly probable for the stock market at large. The market for stocks is after all, an incredible self-healing machine. Often when one hot area dies down, new leadership groups emerge to take their place.

Who will benefit? Who will lead? I suspect the areas that are achieving their growth objectives the old fashioned way -- through organic, internally driven efforts, spurred on by innovation and the industrialization of the rest of the world. While these very same areas aren't immune to the current downside we're experiencing, we suspect they will emerge as leaders in the year ahead.

Kindest Regards,

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