Economic Update

Broadleaf Partners, LLC

Hold in May and Go Away
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There is a familiar adage on Wall Street which says simply, "Sell in May and go away." While it would be tempting to heed such advice given the fact that the Dow Jones Industrial Average has rallied on eighteen of the past twenty days, reaching a new all-time high along the way, very few investors are solely exposed to the narrow group of stocks that this index represents. Certainly, other indexes have done well, but few have been as straight up and to the right.

Having said this, it wouldn't surprise us if we saw the market backfill its recent gains. While we aren't saying that a correction will come, it is perhaps best to expect one from time to time.

Overall, earnings season has been quite strong for the markets with many companies beating reduced expectations by a healthy margin, particularly for large cap companies with significant overseas exposures. However, guidance as a whole has been relatively tepid and for the most part inline with existing expectations. As a result, many of the fastest growing companies have seen their stock prices correct this earnings season, as "simply in line" hasn't been good enough in the short term.

On the encouraging front, several stocks that had underperformed in recent months have enjoyed significant rallies following their earnings releases, which serves as an important lesson; all companies will experience pullbacks from time to time, but investors who can separate solid fundamental stories from the noise will often be rewarded for staying the course. Again, expectations are key.

The domestic economy has clearly slowed, which is consistent with our expectations. Recent GDP reports came in at less than 2% and the inflation data that the Fed continues to pay attention to the most, the personal consumption expenditures deflator, is moving in the right direction. The slower domestic economy is likely one reason that companies reduced expectations going into the quarter and largely kept them unchanged for the remainder of the year in spite of favorable current earnings reports. We believe that most companies are wise to consider the economy when they give forward looking guidance, particularly when the economy is softening and the penalty for missing expectations can be so high.

Our view remains the same. The domestic economy is experiencing a slowdown that is unique to us on a global basis as it stems from our housing and the related subprime lending issues. If it weren't for these two restraining effects, we suspect that we would continue to be growing at rates more comparable to the rest of the world. In a nutshell, China and India didn't have a housing bubble and as a result, things continue to hum along quite nicely for them.

While the markets will respond each and every quarter in an unpredictable fashion, we believe that the slower economic growth domestically will eventually reward those companies that can sustain above average earnings growth irrespective of the economy. This phenomenon should benefit classic growth stocks and in particular, those with innovative new products, as well as industrial cyclicals with significant exposure to overseas growth markets.

In summary, the earnings season is always capable of causing an upset stomach, no matter how good things look. In fact, history would suggest that if expectations are good going into a quarter, short term stock reactions can often be poor. However, high levels of liquidity, from both corporations and private equity funds, should provide a floor of support for the markets in the form of leveraged buyouts and aggressive stock buybacks. Technology and industrial names remain our favorite sectors at this time due to their cash rich balance sheets, high rates of innovation, and global exposures.

So, while we wouldn't sell in May, we wouldn't argue with going away – for a time at least. It wouldn't surprise us if the markets were a bit volatile in the next month or two, but we suspect that when all is said and done, the year end numbers will look great and be higher from here.

Kindest Regards,

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