Economic Update

Broadleaf Partners, LLC

Let Yourself Feel Good Again
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The stock market has continued to perform exceedingly well so far in 2011 and is now up roughly 7% year to date. While an oil spill or European contagion type event could always disrupt the progression, the stock market, S&P 500 profit levels, and leading economic indicators are all pointing to a similar conclusion. The economy is likely to graduate from its recovery phase to an outright expansion sometime this year. It's time to start letting yourself feel good again.

I would like to address two topics in this Economic Update. While I will be the first to admit that neither will be as easy to read as our comments on Steve Jobs may have been last month, I hope they are still investment opinions worth sharing. The first topic concerns the issue of rising inflation expectations and how investors might choose to think about it. The perspective just might surprise you. The second issue relates to what investors might want to emphasize in their portfolios if we are indeed on the eve of an economic expansion.

There is no doubt that inflation expectations have been heating up, as most commodities have reached new all time highs. Farmers in China have been stockpiling cotton, gas prices at the pump have pushed over $3 per gallon, and coffee prices are at fourteen year highs. With the exception of natural gas which is suffering from new sources of recoverable supply brought about by newer horizontal drilling techniques, everything, particularly food prices, appears to be on the rise. At the same time, unemployment levels, though improving, are still high, and wage pressures remain subdued.

There is significant gnashing of teeth over whether or not the Federal Reserve is ushering in a major policy error by remaining too stimulative for too long. In many ways, I share some of the concerns but at least for now, *acting on those fears* could prove costly. So far there are no indications that higher producer prices brought about by rising commodities are being passed along to consumers in the form of higher consumer price index readings (CPI.) Ironically, that might actually be just what we need, a subject I will get to in a moment.

Earlier this week, I had the opportunity to enjoy breakfast with Roberto Perli, ISI's Washington analyst and veteran Fed watcher. While the rise in commodity prices doesn't have me concerned about overall inflation levels given their relatively small contribution to the overall cost of goods for most Americans, I also know that roughly thirty percent of the consumer price index is the overall cost of housing, a factor which, because of the way it is calculated, might be poised to increase.

The Fed measures housing inflation indirectly, through what is known as owner implied rent. Basically, they survey homeowners and ask them the monthly rental income they could expect to receive for their home. This methodology introduces some real time pricing dynamics to the housing market since for most folks the reality is that once you get your mortgage, your housing costs remains fixed.

Another way to look at housing costs in this light is by analyzing the trend in apartment rents. For the most part, the apartment REITs we follow expect rents to firm in 2011 as unemployment trends improve and then increase. If this proves a reasonable assertion, then owner implied rents, the measure used in the CPI to incorporate housing prices, should begin to improve. In essence, an important deflationary element in the CPI is removed and replaced by an inflating one.

When I asked Roberto about this likelihood and what the Fed's reaction to it might be, his response - to be frank - surprised me. "If that happens", he said, "the Fed succeeds." In other words, higher inflation isn't a policy error in the Fed's eyes but in fact, a policy goal.

I think most people of my investing generation shudder when they think that the Fed is actually trying to promote higher inflation. For most of the past thirty years, maintaining price stability has meant fighting price inflation rather than promoting it. For an interesting and easy read on economics and Fed policy, pick up a copy Greg Ip's recent book titled, The Little Book of Economics.

In this book, it becomes apparent that in the choice between deflation and inflation, the Fed would far prefer inflation simply because it is easier to combat once it gets going. If we compare the deflationary period of the Great Depression to the high inflation period of the 1970's and had to choose one policy error over the other, most would choose the 70's variety in spite of disco.

A former intern stumbled onto an observation in a research meeting this morning by noting that historically speaking employment gains haven't become mainstream until the rate of increase in the consumer price index (CPI) exceeds the rate of increase in the producer price index (PPI). While the PPI has spiked because of higher commodity prices, we're not quite there yet for the CPI. To some extent this makes sense; revenues pay for wages, not profits, which is precisely how General Motors can have so many employees in spite of its relatively paltry profits. Once again, "Don't Fight the Fed" appears to be a wise investment strategy.

Moving to the second subject, if we are really moving from an economic recovery where revenue and profit levels are below their previous highs to an outright expansion where they are exceeded, what should be the significance of this transition for investors? Should they even care?

We spend a lot of time thinking about three cycles of influence on investment value, factors which we recently incorporated into our new Institutional Investment Brochure. To keep it simple, we believe three cycles play a crucial role in determining the valuation investors place on stocks at any given time. These include the Economic Cycle, the Innovation Cycle, and the Credit Cycle. If you'd like to learn more, please refer to the brochure. Essentially, it is our belief that certain sectors or areas of the economy tend to do better or produce more "alpha" during different economic climates. The transition from an economic recovery to an economic expansion might just signal one such change and opportunity.

Recently, we took a second look at some research from Nicholas Bohnsack at Strategas Research Partners. His research looked at the three prior recovery/expansion cycles in the economy (1983, 1994 and 2003) to get a sense of any patterns of stock market returns during the six month period prior to an economic expansion or, to put it another way, the last six months of a recovery.

In analyzing the sector data, it appeared to us that for the expansion phases of the economy (and this recession looked most like the one experienced in the 80's as it was accompanied by a credit crisis), the leading stocks were those that ultimately led the next wave of innovation in the coming decade. In other words, the big run of pharma and packaged goods in the 80's, computers and networking in the 90's, and housing and commodities in the 2000's, could be seen in the budding relative outperformance of those sectors during the economy's early expansion months. Similarly, the areas that tended to do the best during the last months of the recovery were commodity oriented sectors, while the worst were the traditional defensive investments.

While no periods of time are always the same, I find it instructive to point out that the pattern of investment performance seen recently is very similar to what would be consistent with the final stages of an economic recovery and the early stages of an expansion. In recent months, commodities have been soaring while those most exposed to them through input costs have been lagging. The market hasn't been enamored by the P&G's of the world recently and the stocks, though not declining much, if at all, just haven't kept pace.

If we are indeed moving into an expansion phase, then it may make sense for investors to begin positioning themselves in the next wave of innovation plays, names which might be identifiable from their budding relative outperformance characteristics today. Keeping in mind that the duration of any expansion may likely be shorter than those experienced during the last thirty years, if I had to guess the next hot innovation theme for the 2010's, it might be anything cloud computing oriented or global and emerging markets related, including, perhaps the rise of the Chinese and Indian middle class consumer.

While technology remains a large preference for our firm because of the inherent level of innovation and creative destruction it unleashes (witness the closing of Borders and Blockbuster locations at the hands of Amazon and Netflix recently), we also believe that the industrial sector and many later stage cyclical plays could also have some innovation tailwinds at their back not because they have shaken their traditional cyclical clothes, but because they are now entertaining entirely new geographic product markets with longer term secular appeal. Trains, planes and automobiles may be mature markets domestically, but for many emerging market economies they are relatively untapped.

In this sense, the coming decade could be a surprisingly good one for the beaten and bruised, rust belt economy. Yes, it could even be our time...Ohio time.

But the first step to feeling good again is putting your guard down just a tad and allowing yourself the luxury.

Go ahead, try it. You just might like it.

Kindest Regards,

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