Economic Update

Broadleaf Partners, LLC

Look Forward and Smile

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Earnings season is winding down and now that Cisco's results are out of the way, only a few major companies have yet to report. As is always the case, I've read through a boatload of earnings results and conference call transcripts and will pass along my generalizations shortly. But before I go there, I thought I'd discuss the recent economic data, which continues to paint a picture of an economy on the mend, a recession nearer its end, and a recovery that may be far more and powerfully V shaped than most expect.

The most important leading indicator we follow is the ISM Manufacturing Survey, which continued to increase last week and is now very close to levels associated with an expansion in the manufacturing sector. New unemployment claims continue to move in the right direction as well, and although it tends to be a lagging rather than leading indicator, it can't hurt to have it moving in a more bullish fashion. And finally, housing related data, be it starts, inventories or pricing, have all been interpreted in a more positive light in recent days.

The stock market itself has also tended to be a decent leading economic indicator. With the S&P 500 now up fifty percent from its lows, it is clearly signaling a shift in attitudes over economic prospects. As this index has climbed to the 1000 mark, a distinguishing feature of recent pullbacks has been the fact that they have attracted new buyers. Again, this suggests it isn't just purchasing managers (the ISM Survey) that are becoming more confident about the future, but investors as well. They aren't panicked by the dips but are starting to view them as buying opportunities.

Now, let's move back to where the rubber meets the road, or where the reality of recent–company earnings and management commentaries can be measured against the pulse of the macroeconomic data. As I read through the earnings reports, the one key factor that sticks out the most is the strong cash flow - often record cash flow - that many companies are generating in spite of the very difficult top line environment. Many companies have responded to the eighteen month downturn by cutting costs wherever possible and it shows up visibly in the earnings data.

In addition to cutting costs, cash flow has surpassed reported net income levels as many companies have reduced inventories and other working capital to bare bones levels. While no one wants to hear it, in past recessions, the more severe the downturn has been, the more powerful the upturns have been. Bears are decrying a jobless recovery with very little demand growth. While this may prove accurate for a time, it doesn't take much of an increase in demand to spark a powerful improvement in manufacturing and production when inventory levels are so low. I suspect bearish phrases like "jobless recovery" or "below trend growth going forward" have been common coming out of most recessions, particularly those as severe as the one we've just experienced. Let's grant ourselves some leeway.

Aside from the numbers, what have management teams been saying? For the most part and across most industries, they are saying what we've all hearing in the media. Results appear to be stabilizing at lower levels, with some faint signs of improvement in some areas. The stock market could be represented as the collective picture of our very human attitudes towards the

9 Aurora Street, Suite 5
Hudson, Ohio 44236
Phone: 330-650-0921
www.broadleafpartners.com

future. Historically, a turn in the markets has preceded the end of recessions by about six months. With the lows put in during March, six months would place the third quarter earnings season as a likely time for management teams to start using the word "improving" more often than merely "stabilizing". Stay tuned this fall.

Another clear element of the economic recovery has been the role that foreign countries have played. Asia and China in particular are already back to production and market levels seen when Lehman went under about one year ago. For all the talk about a dying U.S. consumer (I'm not so dire), the Chinese consumer is picking up a lot of the slack. In its earnings call, Goodyear mentioned that sales to the region had grown every year for the past few and that tire production that was once being exported from China to countries like ours was now staying there and being consumed internally. China, as many know, recently surpassed Japan as the number two auto market in the world, behind only the United States. Its importance cannot be denied.

Speaking of Goodyear, they noted a statistic in their call that I found interesting. Domestic miles driven increased for the second consecutive month in May after a record sixteen months of decline. Like other macroeconomic statistics, year over year figures like miles driven are still down, but are moving in the right direction on a month to month basis. And how about this for a surprising statistic. The scant .008% fewer miles driven year over year equates to a total reduction of ten BILLION miles. I guess this might fit with the notion that when inventories are low, a slight uptick in demand can make a world of a difference, powerful enough to produce the V shaped recovery we all (although some secretly) desire.

I asked myself two questions of every company I reviewed this earnings season. One, is this company positioned to take advantage of faster growing, international economies? And two, what kinds of secular growth dynamics - independent of geography - does this company have going for it? In general, these questions have driven me to two areas of the market - industries with international, cyclical based characteristics and those with overwhelming and powerful levels of innovation-driven demand. For this second type of company, it is worth noting that recessions often play a key role in transitioning change within working cultures, particularly those that can drive worker productivity. Why? I suppose it's because when times are fat and happy, incentives are few, but when they are lean and mean, hunger takes over.

So, what does the future look like? If the past two years have taught us anything, it's to expect surprises, especially the big ones. And since the notion of a big, fat V shaped recovery seems laughable to most, we'll run with it.

Don't be left out of this recovery. While we're already 50% off the market's bottom, we're still 36% from its peak. If we can lend a thought or hand, please give us a call.

Kindest Regards,

Doug

Doug MacKay
CEO & CIO
dmackay@broadleafpartners.com
Office: 330-650-0921

Bill

Bill Hoover
President
bhoover@broadleafpartners.com
Office: 330-650-0921