Economic Update

Broadleaf Partners, LLC

Oil, Earnings and When To Sell

July 31st, 2008

Since we wrote our last economic update, Ugly Days, Springboards and Silver Linings, the S&P 500 bottomed at about 1211 and rebounded approximately 6% off its lows. Over the same period of time, the price of Nymex Crude peaked at roughly $145 per barrel, falling roughly 14% to $125 per barrel today. Clearly the price of oil is a short term factor for the markets, a correlation we continue to see going forward.

As we have said before, we believe that oil will continue to work its way lower over time, based on a slowdown in emerging market economies and the destruction of demand we're seeing here in the states as people move to smaller cars and industries more aggressively look at sources of alternative energy. Keep in mind that oil could decline to $90 without breaking its positive longer term trend, suggesting that while the long term outlook can remain solid, the recent year to date gains have likely been more speculative in nature.

The financial services sector has also enjoyed a strong recovery, with some bank stocks doubling off their lows. The government's decision to disallow short selling in the shares of nineteen financial companies coincided with both the rally in financial stocks as well as the crack in energy shares. This regulatory action, though very controversial, may very likely have been a catalyst that put the popularity of the short financials/long energy trade on hold.

While we added a financial services company to our portfolio in recent weeks, we remain underweight at the margin and continue to view the banks with suspicion, believing it will be quite some time before the fundamentals improve. Until then, we believe the current move is likely based more on technicals and as a result, may prove tenuous at best. While the prohibition on the short selling of this group of financial shares was extended to August 12th, it will then expire and will not be renewed according to announcements today. Investors who have done well with this trade may want to mark their calendars and review their positions shortly ahead of this expiration.

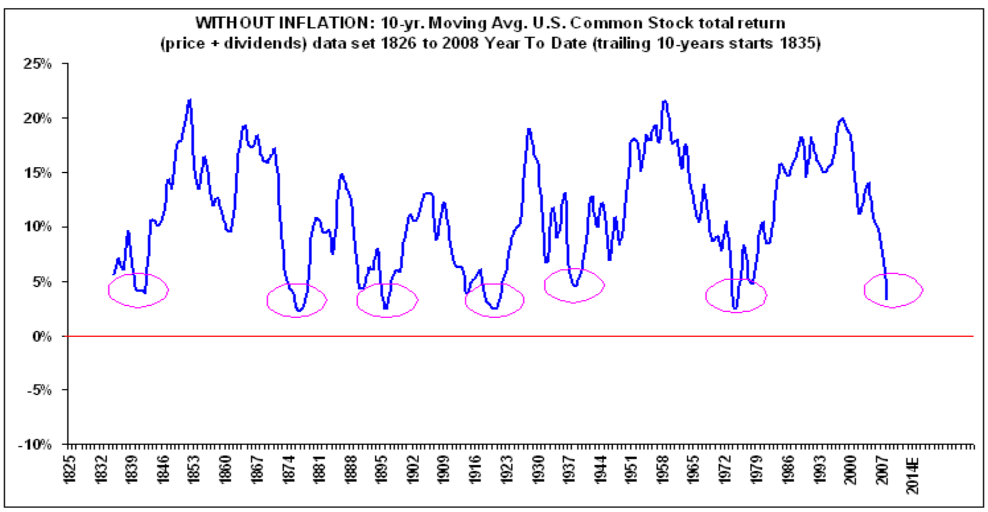
Earnings season has also kicked into high gear since our last update and generally speaking, if you have reported earnings, your stock has been hard hit regardless of the news. Approximately 65% of the S&P 500 companies have reported earnings and has been the case with prior quarters, the financial sector has been the key swing factor. Including financials, reported earnings are down 17.9% year over year but excluding financials, earnings are up an average of 7.7% year over year.

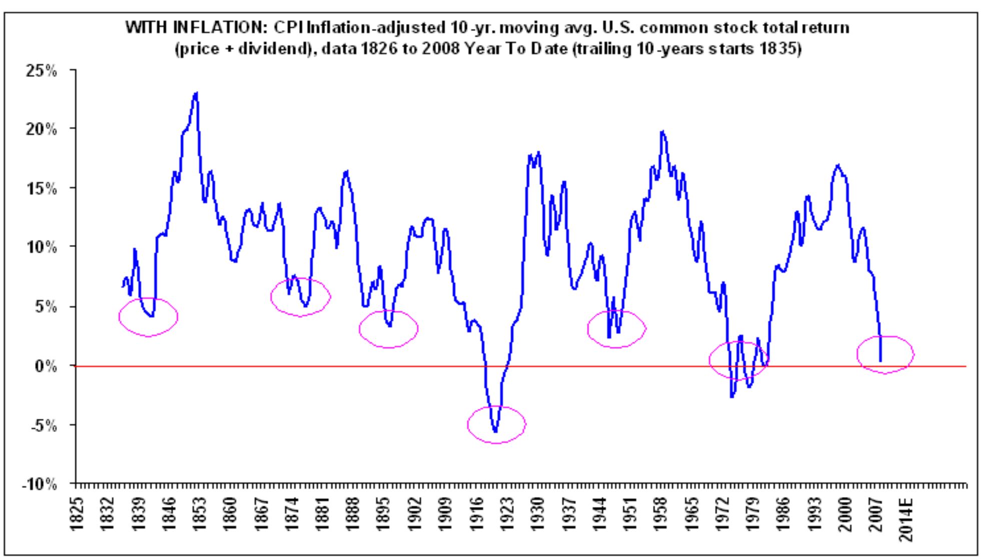
The point here may be that while the financial services sector has experienced an 85% decline in year over year earnings so far this quarter, the disease still does not appear to be infecting the rest of the economy to a similar extent.

When stock prices decline, as they have done this earnings season, the urge to sell increases considerably. While these urges are largely based on emotion, they are undeniably strong. We believe now is not the time to sell and would propose two pieces of evidence to suggest why we might be right. The first line of evidence has to do with a top down look at prior market cycles while the second has to do with a review of stock sales that we have personally made in the past and an accompanying analysis of when we were correct to sell and when we were not.

Following up on our prior economic update, the S&P 500 has done very little over the last ten years whether you include or exclude the impact of inflation. These periods -- though not unheard of -- are unusual.

The charts below, courtesy of Barry Bannister at Stifel Nicholas, show rolling ten year periods of stock market returns going back to the early 1800's. While the last ten years have been discouraging for investors, the charts would suggest that similar levels in the past have coincided with an improving future. In other words, selling now might be a mistake, especially if your time horizon is truly longer term. These charts seem to support the notion that from the stock market's perspective, it may indeed be the "darkest before the dawn".





On a final note, even if you are not convinced that the biggest reason your stocks are down is due to the bear market, then perhaps it would be beneficial to review the lessons we have learned about selling individual stocks in the past.

Each year, we look back at the stocks we have sold in our portfolio with the hope that we can uncover any systematic or repeated mistakes and thereby improve our decisions for the future. After separating our successful sales (the stock goes down further) from our unsuccessful sales (the stock moves higher), a key differentiator has been the impact of competitive dynamics on the company under question.

Our conclusion in the matter is this. Before you act on an urge to sell, first be aware of the overall market environment and where you might be in a stock market or economic cycle. And secondly, if you still feel like selling, try to determine to the best of your ability whether or not the company you own faces a considerably different competitive environment.

Unfortunately, the answers are not always obvious. When the stock market environment is difficult, as it is now, a company's problems - including perceptions about future competition - tend to be magnified often beyond what may realistically be justified.

Successful investing is never easy, but there is hope. Limit your mistakes, but never waste one without learning something in the process.

Kindest Regards,

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