Economic Update

Broadleaf Partners, LLC

The Road to Recovery

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There has been a steady flow of "less bad" data since we wrote our last Economic Update in early April, but the basic question remains the same. Does the current rally foreshadow the end of a gut wrenching global recession and the dawning of a new bull market, or is it simply a head fake destined to end badly and a reminder that a Great Depression is only a heartbeat away?

While it is still too early to tell, we're biased towards optimism. A few months ago, we began positioning the portfolio for an eventual recovery when it clearly wasn't popular to do so. After a strong run, current valuations imply that a smaller margin of safety exists for stock market investors today, barring any fundamental improvement in the economy. Fortunately, on this front, there are several early signs of life worth heeding.

1.) The market has continued to move higher. If the current rally - up about 30% from the lows - proves to be a head fake, it would qualify as the fourth largest bear market rally since 1900. The other three larger bear market gains all came in the 1930's, lasted about 100 days and gained 35-60%. All the other more significant rallies represented the beginning of a new bull markets.

2.) Measured from the November lows, we're over 100 days into the current rally, coinciding with President Obama's election and a tad longer than his time in office. But in fairness, let's be careful about breaking out the partisan cheer. The markets hit new, lower lows in March, which coincided with the announcement of several overly ambitious White House initiatives. As these plans have been tempered, the markets have recovered, providing hope that President Obama may prove more Clinton than Carter.

3.) This has been the first earnings season since the third quarter of 2007 that S&P estimate revisions have been positive relative to where they were going into the quarter. While this measure is only slightly positive, it represents a noteworthy change in momentum. Just as initial negative revisions in the fourth quarter of 2007 preceded a brutal series of back to back quarterly declines for the market, perhaps there is a reason to believe that a positive inflection point might now signal better quarters ahead.

4.) On the economic front, first quarter GDP came in worse than expected yesterday morning, showing an economy that contracted another 6%. With all the "less bad" talk lately, many had hoped for a decline of only 4-5%. Nevertheless, the markets shrugged off these concerns and marched higher. Why? Inventory destocking contributed 3% of the decline and a surprising 3.9% reduction in government spending contributed more. Time will tell if the inventory reductions are sustainable, but prospects for continued declines in government spending seem laughable at best.

5.) So far, most areas of the market have generated positive returns, but the largest relative gains have been driven by consumer discretionary, technology, and financial shares. This pattern of performance is consistent with past economic recoveries. If this recent rally isn't a head fake, then we should eventually begin to see greater relative participation from other sectors of the economy, particularly later stage cyclicals. So far, the tone of earnings calls has been encouraging from the former sectors, but not yet the latter.

6.) An article in yesterday's Wall Street Journal discusses the demise of "buy and hold" investing and a preference among financial advisors for new products and approaches using tactical asset allocation, alternatives investments, and increased trading. New ideas and investment fads tend to reach their peak of popularity at the time of greatest media coverage and more often than not mark important turning points in the performance of various industry groups, stock market indices and investment styles. Contrarians take note!

7.) In my day to day conversations with investors, their biggest concern hasn't been whether or not the economy will recover, but what the unprecedented level of government spending may mean for inflation down the road. I find it difficult to envision overall price inflation rearing its head without first seeing a recovery in spending and employment. For all the buzz it engendered, the recent experience of skyrocketing commodity prices over the past two or three years failed to nurture the destructive form of inflation experienced in the 1970's. Some inflation might actually be a good thing as a sign of a healthier economy.

In closing, I have yet to meet anyone willing to declare that we are firmly on the road to recovery. Air Force One's surprise flyby over Manhattan serves as a powerful symbol of a rise in government influence not seen in America for decades. People remain suspicious and perhaps rightly so.

Some would argue that faith – a belief and hope in things unseen – is out of touch and perhaps even a sign of weakness in a modern day America, but I would beg to differ. Touch and see if you must, but remember that the blessings of simple faith can be far more rewarding.

All great stories of human tragedy, both real and fictional, follow a familiar pattern. Denial leads to pain, pain brings change, and change ultimately leads to new life. The fear of the past few months has demonstrably altered the behavior of corporate America and consumers alike. And in this sense, the road to recovery cannot be too far behind.

Bull markets, they say, always climb a wall of worry. I would be far more worried if there were nothing to worry about.

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