Economic Update

Broadleaf Partners, LLC

The Year in Review

December 21, 2010

At the end of every year, I like to take a look back at the year that was and share some thoughts on what worked, what didn't, and how we see the future. While there are still a handful of trading days left this year - we all know how quickly things can change - this year has indeed been a pleasant and welcome surprise. Through yesterday, the S&P 500 has gained 14%.

As we began 2010, we believed that most of the stock market's cyclical gains were behind us. In contrast to 2009 when the market did exceedingly well in the face of a lackluster economy, for 2010, we believed that the economy would do very well in the face of more measured gains by the stock market.

In general, while there were more fits and starts for the economy through the year than we care to remember, I would say that we got the economy part right, but were pleasantly surprised by just how strong the stock market finished. Anytime we get double digit returns, we should consider ourselves blessed. (Frankly, even in negative environments we should consider ourselves blessed, and perhaps doubly so, but that is a sermon for another day.)

Perhaps our best call in 2010 was the notion that the long reign of bonds at the top of the investor food chain was nearing its end and that equities, particularly those that paid competitive yields, could begin to attract the attention of income investors no longer satisfied with paltry fixed income yields and perhaps soon to be made skittish by the prospects of falling bond prices, once viewed as safe.

Many income producing equities did in fact put up nice returns throughout the year, something we suspect will continue, particularly as the pain of declining bond prices becomes more acute. Ever since the second round of quantitative easing (QE2) was unleashed, interest rates have spiked to the upside, exactly the opposite of what most had expected would be the case, especially since the Fed would be buying bonds in a big way.

For 2011, we believe this trend of bond outflows and equity inflows will likely continue, overwhelming any concerns about valuations or fundamentals. In the short run, I've come to realize that fund flows, or investor desires for specific favored asset classes over others – tends to exacerbate price movements in both directions, often for much longer than most expect. For anyone that doubts this tendency, just take a look at tech stocks ten years ago, housing and banking stocks five years ago, private equity and commodities three years ago, and bonds, particularly the government variety today.

While I will get to the reasons for our positive stock market bias in a moment, I would also like to be candid in mentioning what didn't go so well for us. At the beginning of the year, while we believed that most of the market's cyclical gains were behind us, we were also more optimistic about an improving employment outlook than proved justified. We still believe that employment trends will improve, but perhaps in a more gradual fashion than has historically been the case following recessions.

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Fortunately, several factors play into our positive thesis for equities and employment in 2011. First and foremost, is a more politically friendly environment for business. Given the historic changing of the guard in Washington D.C., it appears as though President Obama may be willing to take a more centrist approach as Clinton ultimately did following his first two, difficult years in office.

One of the biggest strengths of the economy in the past year has been the level of corporate profits and cash balances, but most executives have remained cautious with their actual spending given recent memories, the prevailing anti-business sentiment, and tax and regulatory policy uncertainty. The good news is that these headwinds may now prove to be tailwinds, turning the ability to invest into a desire to follow through. Weekly unemployment claims have improved to new, lower levels consistent with decent although not spectacular payroll gains since the August time frame, gains which we suspect will continue given the improving political outlook.

As we mentioned in a blog entry earlier this month titled Trump Cards: Contagion or The Economy, leading economic indicators remain strong, indicating a positive outlook for the manufacturing sector. At some point in 2011 or early 2012, we suspect that the economy will move from a recovery phase to an outright expansion, meaning that profits will at some point eclipse the highs achieved prior to the most recent recession.

Finally, as mentioned earlier, one of the best reasons to be positive on stocks may very well be the state of the bond market. Rising interest rates may actually be a positive to the extent that it signals an improvement in the economy, which we suspect is the case today. Bernanke, like him or not, appears willing and ready to do whatever it takes to keep the economy and specifically the stock market moving in a positive direction. If that means higher rates even as they buy bonds through QE2, so be it.

While I may be giving the Fed far too much credit, higher interest rates may also improve net interest margins for the banking system, providing an incentive rather than a disincentive to bank lending. It also improves the income earned on float balances, currently running at pretty much zero today. At the very least, higher rates may help banks heal their balance sheets, improving the supply of money offered in the form of new loans.

Higher interest rates, of course, also means tougher times for bond investors as bond prices decline. While the back up in yields may not matter much for investors intent on holding until maturity, I would suspect that a large percentage of recent bond buyers has been investing on the basis of total return and the allure of rising prices than simply their yields, even if unknowingly so.

Sixty Minutes did an excellent piece on the fragile set of affairs for local and state governments this weekend. The recession that clocked the private sector for most of the last two years went virtually unnoticed by the public sector in recent years, whose time for pain may now just be around the corner. (See The Terminator Nails It)

Prime among the sacred cows in the sector is the public pension system, whose benefits are no longer in keeping with new economic realities. Early retirement, double dipping, and pension benefits themselves must all be reformed. Things have been so good, that many in the sector simply and quite innocently don't realize how good they've had it. The situation reminds me a great deal of the college age student who has all the benefits and privileges of adulthood, but none of the rent. It isn't their fault, but it is time to move on.

As a board member of my alma mater's public business school, I've seen firsthand some of the problems coming down the budgetary pike, problems that many people are largely unaware of save perhaps Cisco, which recently pointed to the sector as a significant problem area. While we will prevail against such challenges – we always do – I can't deny that I left the most recent board meeting wondering how a hedge fund would position themselves to benefit from the potential calamity.

If some municipal debt offerings do fail as Meredith Whitney suggests (note I consider Meredith Whitney a perma-bear, but tend to agree with her on this issue), the outflow from bonds may become even more acute, potentially turning the slow trickle into stocks today into a veritable gusher of sorts as the year progresses.

Corporate America has been under the gun for nearly three long years now and while it doesn't help that the public sector may now find itself under pressure, it also can't hurt. The sooner the patient gets help, the better.

In summary, I see great things for the stock market in 2011. While an improving economy will help, a shakeout in bonds may be just what the doctor ordered to get investors truly interested in stocks again.

Kindest Regards,

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