Economic Update

Broadleaf Partners, LLC

Unemployment, The Consumer and the Faith of Ancients

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The market has pulled back in recent days, retesting previous lows. The primary reason for the decline may likely include the worsening outlook for the US auto industry and the delay in the Treasury department's program to guarantee money market deposits. Unemployment has now increased to 6.5% from a low of 4.8% back in February, with most economists calling for a peak rate in the mid-eight area. Foreign central bank rate cuts and government stimulus programs in recent days are an additional reminder of just how global this slowdown has become. But whatever the reason, retests are not uncommon and can often be expected within forty-five days of prior lows. Our best guess is that the markets have seen their lows, with possible downside to 820 or so on the S&P 500, where it based out following the tech bubble and recession earlier in the decade. Of course, we could easily be wrong in our prediction.

If we had to pick a swing factor in our forecast, it would likely be where unemployment levels eventually peak. While we have a bit higher than normal cash levels in our portfolio, our industry exposures could be characterized as less defensive in their orientation relative to our peers. As we've mentioned before, the greed for cash is running at all time highs. In fact, according to work from Francois Trahan at ISI Group, cash reserves adjusted for three month treasury bill rates are at forty-year highs. This suggests that investors are in no mood to take any risks with their money even as interest rates approach near zero levels.

Last June, we warned investors to be wary of a bubble in commodity stocks as oil prices approached $150 per barrel. While we argued that bubbles could stay in an upward trajectory for a period, we were also confident that this one would end badly and likely be pricked by a slowdown in global economies given the already existing weakness in our domestic economy and our skepticism regarding the theory of economic decoupling. In the short run, the demand for cash is likely being influenced to a considerable degree by legal issues, including margin calls and bank covenant violations, but fear is certainly playing its role as well. The premium on safety at all costs has been pushed to levels that look to us like $150 oil, unsustainable over the long run, but certainly capable of continuing in the shorter term.

Eventually, some good news will be reported and the price of alternative asset classes other than cash - like stocks - will rush upwards as fast as oil has plunged in the last few months. With more and more investors able to go short and long different asset classes, these huge swings may be a fact of investing life going forward. Volumes have been relatively weak in recent days, suggesting once again that investors are being influenced far more by the fear of loss than opportunity for gain.

Moving on, I would like to spend some time looking at unemployment trends. Historically, unemployment levels have been a lagging indicator for the economy and the stock market. In other words, unemployment lags inflection points in the overall economy rather than leading them, including the performance of the stock market.

According to a study by one of JP Morgan's retailing analysts yesterday, the unemployment rate has moved up an average of 2.5% during the past five recessions since the 1970's. The more similar periods to today may arguably be the outlier periods of 1974-75 and 1981-82 when unemployment levels increased nearly 4% to peak at 9 and 11% respectively. Of course, the most extreme outlier was the Great Depression, where unemployment skyrocketed to the mid twenties, but was exacerbated by very bad government policies, protectionism and a general inward looking attitude regarding world affairs. With unemployment having already increased 1.7% from its lows earlier in 2008, a really severe

recession would place peak levels this go around at roughly 8.8%, a tad higher than most economists are currently expecting.

JP Morgan's retailing analyst has studied these trends because he knows that his group of stocks typically starts to do better before evidence of an improving economy is apparent. (As we blogged yesterday, the official declaration of a peak in the economy rarely comes until we have come close to its trough!) According to JP Morgan's analysis, retailing stocks significantly outperform the overall stock market by a margin of nearly 50% beginning at roughly the halfway point in the increase towards peak unemployment. Barring a Great Depression, this data - along with our observations on the greed for cash - argue that now may be a better time to tilt the portfolio for an eventual recovery. The risk is not in our opinion that we will be wrong, but early.

Yesterday, Jeff and I drove to Cleveland to attend a meeting with the investor relations manager for Starwood Hotels. Starwood is well capitalized and gets roughly 75% of its revenues from hotel properties that it manages - rather than owns - worldwide. Several partners in the Middle East have also been buying premium properties from the company with their rich oil profits, signing management operating contracts with as much as forty year durations with guaranteed capital improvement commitments to these properties to boot. Starwood, as our readers know, made significant cuts to their earnings forecast during their call two or three weeks ago. While their consumer customers have been weak for over eighteen months, business travel came to a standstill during October. In spite of the negative news, the company will be paying a 5% dividend to shareholders of record at the end of December and the stock trades at just 10x reduced estimates.

Our view is that the consumer has been weak for quite sometime now and will likely lead us out of this mess in an eventual recovery. High energy prices took a big bite out of consumer budgets over the past year, but with prices now in rapid retreat should provide some eventual cushion in the face of higher unemployment levels. A close friend just told me this morning that the lower gas prices were saving them $300 in monthly commuting costs which is the typical lease payment on a lower end car.

In general, we do not subscribe to the view that the consumer is completely and utterly tapped out and addicted to home equity mortgage withdrawals as a source of personal consumption expenditures. We often view such claims with a suspicious eye, knowing that over the years, the consumer has proven much more resourceful and resilient than generally given credit for, particularly at times like now. According to an analysis of Fed data by Craig Johnson, President of Customer Growth Partners, just 1.5% of personal consumption expenditures were made using home equity loans in recent years. While talk of consumers using their homes as ATM's has been a focal point of the bears in this environment, the reality is that personal income growth has had the greater influence.

Of course, with unemployment levels rising and consumers now more cautious, personal income growth is moderating and personal consumption expenditures are suffering. At the same time, consumers are adapting as they always do, discovering new sources of savings in their budgets and value added for a given dollar of spend. The good news is that through this process, consumers are improving their balance sheets and providing incentives for companies to earn their business through their creative efforts. I suspect that many will emerge from the current mess intent on living within their means and in rarer instances even to their needs.

The writer of Hebrews defines faith as "being sure of what we hope for and certain of what we do not see." In the markets, we rarely have all the answers, but should still have faith that where personal liberties are guaranteed and wise choices are made, no hills will prove insurmountable to creative minds born of the Almighty.

Kindest Regards,

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