



## Broadleaf Partners, LLC

### We Hold These Truths to Be Self-Evident

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Over the last few days, CNBC has noted the strength in the markets, commenting that we've enjoyed a particularly long period of strong gains with nary a two percent, single-day correction. No, not one. Well, yesterday the S&P 500 closed down 3.5% with pundits also pointing out that this is the first time in three years that we've had five consecutive days of decline. So, there you have it. The statistics necessary to take us from glad to sad in a few short days, proving that emotions are fickle, that humans are always in search of a good story and that creative statisticians will never be in short supply.

There are many reasons as to why the markets may have declined so much yesterday, but I'm not sure any of them are more likely to be the reason than the fact that we haven't had a two percent single day correction in awhile. Here are some thoughts on a variety of other reasons suggested:

- **Worldwide Economies are Increasingly Interdependent.** China's market declined 9% yesterday and our markets followed suit. While it has often been the other way around, perhaps we should take heed. Political quick fixes to unfair trade balances and non-floating currencies may be expedient, but they may not be without their own domestic consequences.
- **Greenspan is a Smart Guy, but He's also Human (and an Economist).** Alan mentioned recently that it was possible that the current economic expansion is winding down creating the potential for the domestic economy to fall into a recession by the end of 2007. But he also mentioned a few weeks ago that the worst of the housing correction was likely behind us. He may simply be trying to tell us (and the Fed) that the economy is okay, but that it can still be broken if we try hard enough.
- **Durable Goods Data aren't always Durable.** Durable goods reports can be as volatile as the weather and monthly retail sales. While the reported number yesterday was still weak after adjusting for the lumpy aircraft order component, one month doesn't a trend make. The November and December numbers were actually quite good.

So, aside from these reasons, what do we know to be true? What do we hold to be self-evident?

- **Inflation is Moving in the Right Direction.** While inflation may still be higher than ideal levels at a third decimal point of precision, it is nevertheless headed in the right direction -- lower. Lower inflation is a positive for interest rates and ultimately earnings multiples and the stock market.

- **Earnings Season was Solid, but Slowing.** While earnings are slowing, they are still growing. Slowing earnings that don't forecast a recession are good for the markets as they help mitigate inflationary pressures, particularly in the more cyclical areas of the economy, especially energy, materials, and other commodities.
- **The Fed is on Hold.** The shift in Fed policy to neutral was a watershed event in the markets for anyone who has paid attention to three years of consistent increases. In spite of the strong stock market, the economy is fragile and it is therefore unlikely that the Fed will do anything rash by raising rates further. Yesterday's action may have actually increased the potential for a rate cut in 2007 -- this after talks of possibly needing an additional rate hike to slow an accelerating economy only a few short weeks ago. Fickle? Indeed.
- **Employment is Healthy.** Unemployment levels are at historical lows. As long as we stay gainfully employed, we'll continue to spend. Even those with adjustable rate mortgages should be okay in this scenario.

Yesterday's correction struck us as being of the orderly variety. Each index was down by almost an equivalent amount and each industry had similar declines. It was broad based and painful, but in an orderly sort of way. It was more like watching Johnny, my three-and-a-half-year-old son, make a systematic mess of the basement than watching a tornado whisk Johnny *and* the basement off to the Land of Oz.

Of course, only time will tell. While fickle may remain in fashion for a few more days or even weeks, we currently see no evidence to suggest that a significant change is underway.

Kindest Regards,

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