Economic Update

Broadleaf Partners, LLC

American Creativity

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It was a rip roaring January for the stock market. While the pace cooled a bit towards the end of the month, the surge made it among the best Januarys in post war history and *the* best January since 1997. After surging nearly 12% in the fourth quarter, last month brought additional gains of nearly 4.5% by the S&P 500.

To be sure, last year's *full year* performance was anything but impressive, more closely resembling a stock market struggling with recession. Parts of the gains of the last few months have simply represented a recovery of the value lost over a summer marked by political discord and European chaos. At the end of the day, what last year taught may be the simple lesson that what goes down, can also go back up.

In terms of the future, we remain bullish on the stock market. In an environment of low or non-existent bond yields, stocks may not only represent a compelling alternative source of income, but likely have a far better risk reward profile when it comes to upside return potential. After more than a decade of being the cellar dweller of annual asset class returns, domestic common stocks may finally be due for some positive mean reversion.

In declaring ourselves bulls, this doesn't mean we believe we're headed back to an era of multi-year, double digit returns – though that could happen – but that given a choice among alternatives, stocks should prove to be the best game in town.

With regards to the economy, we still expect slow growth for as far as the eyes can see, interrupted from time to time by the ebbs and flows of more frequent yet subdued economic cycles. Long term investors should remain focused on innovation plays that can grow regardless of the economy, while introducing greater cyclicality to the portfolio as the circumstances warrant.

A few months ago, leading economic indicators began to improve, suggesting that the market and economy might have some cyclical upside. In addition to the outperformance of dividend yielding stocks, this proved to be the case as the cyclical areas of the market outperformed defensives into year end, a trend that continued in January.

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The market has also had a pronounced January effect, with some of the worst performing sectors and stocks of 2011 sporting the best gains. Theoretically, stocks that have been poor performers during the year come under tax related selling pressure in December, but rebound – sometimes abnormally so – as the selling pressure dissipates in January. (Before getting carried away by the idea that January's gains may be ushering in a new era of sector leadership, investors may wish to contemplate the January effect and the likelihood that New Year's attitudes reflect greater hope for change.)

There is no doubt that the recent upswing in the market feels far better economically speaking than it did during the doldrums of summer. Real economic indicators support this notion as well. New unemployment claims have declined, leading economic indicators have improved, China appears to be engineering a soft landing, and for the most part, worldwide monetary policy is accommodative. Consumer confidence in December also approached post-recession highs.

It should come as little surprise that corporate earnings are at near record levels. Save banking, most business owners only enjoy one safety net – their own pocketbook. The incentive for profits and fear of loss are powerful forces that shape the mindset of business owners. From this vantage point, it may be easier to understand why corporate balance sheets are far healthier than most governments around the world.

In all respects, if there were a time in the last three years that the recovery felt self-sustaining – now would be that time. And yet, in spite of that feeling, the most perplexing news of the last few months was the Federal Reserve last week, which hinted that additional easing may be in the offing in the form of QE3.

The Fed has a dual mandate – to ensure full employment and price stability. With employment trends finally improving and inflationary pressures from last year's QE2 waning, we would have thought QE3 was off the table. What could the Fed see that we are missing? It's possible, that the Fed remains concerned about deflation, the environment that has plagued Japan for two decades.

In the past, economic recoveries have usually been far more robust than what we've experienced in the last three years and are usually driven by a rapid recovery in the economy's most cyclical areas, primarily housing and autos. But since the sources of the most recent bubble and ensuing recession were housing and the banking sector which financed it, the recovery in these sectors has been far from status quo. While possibly stabilizing, housing prices have fallen precipitously in the past year.

In December, Ben Bernanke and the Federal Reserve published an unusual white paper which highlighted the importance of the housing sector to the economy at large. While small in terms of its overall size, the housing sector has an outsized impact on the overall economy through its multiplier effect on job creation, lending, and homebuilding suppliers. Small business formation has likely also suffered with housing, as entrepreneurs haven't been able to access equity in their homes, an important historical source of start-up capital and thus job creation.

The timing of Bernanke's paper, the statement that QE3 would target purchases of mortgage securities, and President Obama's call for mortgage refinance reform, all suggest that until the housing sector improves, the Fed may remain cautious about the state of the economy, employment and price stability. The Fed may be declaring an all in attempt to jumpstart the housing market.

Recent data suggests that the housing sector – in terms of the fundamentals (starts, permits, prices) - may have found a floor, but if the homebuilder exchange traded fund (XHB) is any guide, the sector remains far from robust. At both this time last year and the year before, homebuilding stocks had similar rallies, only to fall back significantly once a full-fledged recovery failed to materialize. Falling prices have hurt appraisal values, making it difficult for even qualified mortgagors to refinance their loans. Sadly, a full-fledged recovery in the housing market may simply take a lot more time.

The Fed's views notwithstanding, the prospect for a self-sustaining recovery feels better than it has at almost any time in the past three years. As long as leading indicators continue to improve, the stock market should enjoy some cyclical tailwinds, but without the participation of the housing and banking sectors, long term economic growth will likely remain slow for as far as the eyes can see.

Facebook officially registered for its initial public offering last night, and while I am still working my way through the prospectus, the growth they've achieved demonstrates the power of creativity and innovation to overcome even the worst that the economy has to offer.

Animal spirits are rare these days, but that doesn't mean they are extinct. Mark Zuckerberg managed to bootstrap the financing of Facebook in its early days, without access to a home equity loan. Though borrowing from friends and acquaintances has brought its own host of legal issues, at the end of the day, Mark Zuckerberg figured out how to make it work.

Somewhere in America, the seeds of the next Facebook are being sewn. To the American entrepreneur, greater problems demand better solutions, providing fertile ground for American creativity, invention and innovation to thrive. In honor of Facebook, a big thumbs up to all who try.

Kindest Regards,

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