Broadleaf Partners, LLC

Recession Looming? **May 10, 2022**

Well, it's one of those periods again, where communicating more, rather than less, is probably the right decision, all things being equal. Unless you've been living under a rock – and good for you if you have! – you probably know that the markets have been pretty brutal of late, as fears over the effects of inflation, rising interest rates, and Fed policy moves have given rise to significant concerns regarding the likelihood of a recession.

We're not going to pretend we have any edge over whether or not a recession may be forthcoming in the next few quarters. But, an analyst we respect, Chris Verrone of Strategas Research Partners - pointed out this morning that the debate between recession or correction – may miss the point. Since 1950 – the average correction accompanied by a recession has been 27% for the S&P 500, while the average correction without one has been 23%. As of the writing of this update, the S&P 500 is down about 17% from its highs, with some indices and even the bond market, doing just as badly or worse.

Let's take a look at three things – what we've learned as earnings season is beginning to wind down, trends in interest rates influencing stock market valuations, and what both of us can be doing to best position ourselves for an always unknown future.

After reading through as many as sixty earnings calls – with a few more yet to come – what have the corporate tea leaves been saying? Generally, things have been modestly positive on the fundamental earnings front, even though stock prices haven't felt the same. There has been a lot of talk about inflation trending worse and supply constraints continuing to muddy the waters, making future sales gains more difficult than they might otherwise have been.

The pure pandemic beneficiary names – companies like Zoom, Peloton, and the ARK funds – have given back all of their pandemic stock market gains and then some. Generally speaking, these names have had their fifteen minutes of fame – and like my time as a tech fund manager after the dot com bubble – are now experiencing quite the comeuppance.

Excluding the energy complex, most companies are passing on some, but not all of their cost increases, moderately pressuring margins in a nevertheless positive overall environment. In other words, although earnings trends are still positive, year-over-year revenue gains are stronger than year-over-year bottom line gains. Guidance has generally reflected an uncertain tone thanks to supply constraints from the war in Ukraine and further COVID shutdowns leading to lower forecasted sales gains as mentioned earlier.

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9 Aurora Street, Suite 5
Hudson, Ohio 44236

Phone: 330-650-0921
www.broadleafpartners.com

At this point, most companies that have passed through higher costs to their customers by raising prices have not yet seen evidence of curtailed demand or trading down to "generics" behavior. This doesn't mean it won't happen, just that it generally hasn't happened yet. Setting aside the pandemic beneficiary crowd, I would say that the earnings season hasn't been fantastic, nor has it been disastrous.

Interest rates play an enormous role in determining the valuations investors are willing to pay for a dollar of given earnings today. This quarter, valuations have been under considerable pressure even as earnings have grown, as interest rates have risen on the long end of the curve to as high as 3.25% yesterday. Mortgage rates have nearly doubled off their lows in just a few short months. The valuation compression has been even more severe for those companies with fundamental questions or whose earnings prospects are far in the future.

While the Fed has raised rates only twice so far – 25 bps at the last meeting and 50 bps last week – Ed Yardeni's "bond market vigilantes" have moved interest rates far more aggressively, anticipating most of what the Fed may do over the next few quarters, even though the Fed has just begun its process. Of course, the totality of rate hikes ultimately depends on what happens with the direction of inflation from here – and whether or not the Fed will have to do even more than has currently been discounted. To that end, tomorrow morning's CPI report may offer the first clue as to whether or not things are getting better or worse with inflation. On that front, insights from company managements aren't quite there yet – most seemed to imply that things were getting worse, not better in this quarter's earnings calls. We suspect that over time, however, the inflation comps alone will start to get more difficult, bringing some natural relief, at the very least.

The ARK funds have followed the path of the NASDAQ after the tech bubble almost to a T. At that time, low quality, non-earning names took the hit first, then about a year later, those with earnings that were still valued too highly came under significant pressure. The high concentration of tech stocks in the S&P 500 and the subsequent job destruction was enough to pull the rest of the economy into a shallow recession, though not as prolonged for the sectors outside of tech.

We wouldn't be surprised if a similar path prevails today, with many companies that drove the markets in the past few years pulling back a bit and retrenching to new realities. Whether or not this reset is enough, along with Fed rate hikes, to slow inflation in the economy remains to be seen. For the most part, we think inflation has been far more supply driven than demand driven – and the Fed can't produce more oil, regardless of what they do with monetary policy. They can only shrink demand. Against worldwide economies that will eventually reopen, more supply will eventually be needed, providing the long term opportunity for investors in this new "growth" sector.

So, what can we do?

I hate to be so trite, but it is worth mentioning that recessions and corrections are a part of the capitalist lifestyle. We can't do much about them. Like going to the dentist –Sorry Dad!– recessions and visits to the dentist are a fact of life. We simply have to endure them and live for

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another day, maintaining a steady hand and a disciplined approach, even if the world about us feels like it is falling apart.

If we do have a recession sometime in the next twelve months, it doesn't *appear* as though an unknown asset bubble is about to pop. The obvious candidates feel like they've been deflating for quite some time. In addition, a strong, fully-employed consumer and solid corporate balance sheets might press one to believe a short and shallow recession might be at hand, if one is at all.

For our part, we continue to keep a more diversified approach to the portfolio than perhaps we've ever had in Broadleaf's entire seventeen-year history. We aren't giving up on unique growth innovators that are certain to eventually usher in long term wealth creation, but are also focusing on more mature companies associated with the Economic Cycle, those that may play a key role in remaking the United States and the rest of world as we hope it to be. A world that is "cleaner" environmentally, but also reduces the United States' dependence on others' supply chains, particularly more hostile nations in a world now trending towards "DE-globalization." We believe risk is about knowing where uncertainty is growing and planning for long term trends accordingly.

What can you do?

In all corrections and recessions, it is important to stay focused on the long term to the extent your finances enable you to do so, minimize any exposures to catastrophic or permanent loss, and dollar cost average down even in the tough times to accelerate your return to any drawdown breakeven.

This is the crux of the issue. Many feel like getting out of the market, but also know they will eventually want to get back in at some point, knowing this won't likely be the end of the world. It's akin to owning a house, but seeing the price of said home plunging every day, desire to sell it, hoping to buy it back at a lower price, even while still living in it. We want someone else to take the short term losses.

While this sounds ideal, we don't live in an ideal world. This isn't what being an equity owner entails. Long term investors - and elite athletes- build strength and excellence over time because they bear the pressure of weight moving against their muscles and with them over time. It's really as simple as that, but so hard for most to endure the discipline and the work involved.

For the true capitalist, there are no free lunches, and in this sense, we're all making history in the here and now. Going through periods like these is never easy, but they aren't as uncommon as we tend to make them out to be.

Be prudent, but also be smart, focused on the voyage ahead.

Kindest Regards,

Doug MacKay
CEO & CIO
dmackay@broadleafpartners.com

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