

The last three months have been rewarding for stocks, but like baseball in the snow, something hasn't quite felt right. We've enjoyed some gains, but keeping pace with the rapidly rising indices has proven challenging. Historically, our long term results have almost entirely been a function of strong individual stock picks, but in recent months it has been more of a function of what we don't own – particularly our relative underexposure to the market's more defensive shares in health care and consumer staples.

In our experience, it has usually been a poor decision to buy defensive stocks like Procter & Gamble, Johnson & Johnson, and Pepsi after they've had a strong run, as has been the case in recent weeks. While high dividend paying stocks are attracting some demand given the low interest rate environment, we believe a greater portion of the rally may be based on the expectation of a looming recession or, at the very least, a fourth year in a row, summer stock market swoon. Recent earnings results in the past week from Procter & Gamble and Amgen suggest that the rally isn't related to new innovation or improving fundamental growth rates at these companies. In the absence of an economic collapse, the moves may prove unsustainable.

What happens if the economy, rather than deteriorating in the next six months, continues to make steady progress, neither falling off a cliff, nor working its way into a frenzied, upside breakout? What if, after years of pain, the improving housing market really is a sign that the economy is on the mend and while not gangbusters, is sustainable at an albeit slower than historical rate of growth? What if, after worrying about higher tax rates and cutbacks in federal spending, employment still manages to improve?

What if there is more to life than the next quarterly earnings report, the next marginal bracket in the tax code, or where we are in the bump of Laffer's curve? What if, in spite of the argument that we could be growing faster than we are, we still do grow? What if deflation rather than inflation really has been the greater risk and Bernanke deserves our praise? What if monetary experts discovered new policy tools that our kids will read in the economic textbooks of tomorrow? What if, in spite of all we think we've come to know, it remains true that we don't know everything and that the world may be far more resilient than we care or perhaps even choose to believe?

Our economic outlook remains as it was at the beginning of the year. The recovery in housing, corporate profits, and stock market levels suggest that the US economy is finally moving into expansion territory. We concede that an expansion of historical magnitude is unlikely as long as corporate boards are so laser focused on increasing dividends and buybacks at the expense of new growth initiatives. The downside of Fed policy may be that the stock market has to serve a more utilitarian purpose than it has in recent decades by providing an income stream to retirees where there are no alternatives.

It is no secret that our banking system, while healing, remains strained. With real interest rates below zero, further cost cuts need to occur to return banks to their historical levels of profitability. They are also still largely hesitant to lend. Who might pick up the slack? The non-financial sector, for one. The rest of corporate America is flush with cash and eventually the purse strings will come loose, just as private equity has done by sopping up the excess supply in the housing market and turning many into rentals.

What themes might attract new growth capital? Technology is one to be sure – social networking, the advent of anytime, anywhere video and changing advertising models are all growth areas. Breaking Bad, The Walking Dead, and the company of Madmen are no longer simply 9pm Thursday only affairs, but are available anytime on Netflix with the guidance of friends on Twitter and Facebook. New applications of social networking technology are yet to be discovered, as the recent capture of the Boston Bombers shows.

In the consumer discretionary sector, ecommerce continues to take share from the offline world through price and convenience and, after decades of industrialization, those living in the emerging markets will increasingly want to consume. While low cost energy supplies haven't changed the landscape of industrial America quite yet, it is an area worthy of investment, not only for the jobs it will create, but because its bridges won't be built to nowhere.

So, that's our bet. As has occurred in each of the last three years, the economy should continue to plug along, not as we might like it to be, but as we can reasonably expect. Growth scare or not, we suspect that the end of 2013 will show that continued progress lies ahead, but perhaps not exactly in the same pattern as it has thus far.

Kindest Regards,

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