Broadleaf Partners, LLC

Broadleaf's 2015 Investment Playbook December 22, 2014

It's been a good year.

The U.S. stock market has done well, gas prices are down at the pump, and the job market continues to improve.

CEO confidence has returned, with merger and acquisition related activity finally joining stock buybacks and dividend increases as worthy uses of shareholder capital.

The local builder is putting the finishing touches on a new housing development next door.

Are things perfect? Far from it. But we stand by our opening comment.

It's been a good year.

And we may need to get used to it.

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Before we discuss our Investment Playbook for 2015, a review of last year's calls is in order. Published in January, our 2014 Investment Playbook highlighted the following four bullet points that would help guide our investment decisions.

1. *2014 could look a lot like 1994, with early weakness eventually giving way to a multi-year period of economic and stock market strength.*
2. *Developed markets should outperform developing markets.*
3. *Following initial weakness, our stock market should find firmer ground as domestic earnings gains persist and three secular tailwinds find greater footing.*
4. *In spite of fears of a significant back up in domestic interest rates, a low inflation environment and troubles in emerging markets could keep domestic rates low, providing a further boost to our economy even as Fed intervention starts to recede.*

In general, our 2014 Investment Playbook served us well, perhaps unusually so. Typically, we would expect to get a few things right and few things wrong, but this year, it seems like most were within the proverbial ballpark.

In many ways, we hate that fact because as reversion to the mean, baseball type of guys, we could be in for a slump, perhaps an ugly one. Time will tell, but in the meantime, we'll keep swinging.

So then, let's review.

*1. 2014 could look a lot like 1994, with early weakness eventually giving way to a multi-year period of economic and stock market strength.*

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Our first point was generally accurate, with the market having gained 12% as we approach the final week of the year. While the Fed did not raise interest rates - as we expected to be the case - concerns over the tapering of bond purchases were unsettling for a period, contributing to early year volatility.

*As we look to the coming year, we believe the Fed will start to raise interest rates, but will only do so to the extent employment and inflation trends are on the right trajectory*. The markets are learning that the Yellen Fed will likely err on the side of dovishness in the face of doubt, which could mitigate the stock market volatility often experienced at the start of prior rate hike cycles. We maintain last year's view that the *rate hike process could mark the beginning of a several year bullish trend, similar to what we experienced in the second half of the 1990's.*

*2. Developed markets should outperform developing markets.*

Our second point proved accurate as well, with developed markets, particularly the United States, far outperforming most developing markets. We continue to believe a more bearish bias to the international markets makes sense, particularly in China, where investors are just beginning to realize the extent of the overbuilding. *The unwinding of the China "investment" bubble is contributing to the decline in commodity prices today, a trend which we expect could continue for another ten or more years as the excesses are digested and their efforts to strengthen their consumer base begins. While we believe things could get very ugly for China, at their best, perhaps things will go nowhere.*

As a single party political system, China may be more successful at sweeping their economic issues under the rug longer than other two party systems, but this may also prolong denial and the political energy necessary to effect positive change. *While there may be short term trading opportunities in energy and commodity related stocks, we suspect a sustained period of underperformance is likely.*

*3. Following initial weakness, our stock market should find firmer ground as domestic earnings gains persist and three secular tailwinds find greater footing.*

On the third point, the three secular tailwinds to which we referred included the domestic energy renaissance, slowing emerging market growth, and tech developments associated with the "sharing economy". As mentioned earlier, the stock market did find firmer ground as the year progressed, with earnings gains persisting and perhaps even accelerating into year end, partly because of last year's chilling winter.

Each quarter, we track the year over year revenue and earnings results of about one-hundred companies we follow and the thirty we currently own. With our last company reporting earnings last Thursday evening – Nike - the cumulative fourth quarter totals are in. The average portfolio holding grew revenues and earnings 25% and 43% respectively year over year in the fourth quarter, while the average company we track grew revenues and earnings 14% and 41% respectively. While it could be debated as to whether or not the three secular tailwinds contributed to this year's earnings gains, it seems clearer that they will going forward.

As for 2015? The rapid decline in energy prices over the last few months may be a boon to overall economic growth in the United States, acting like Reagan's tax cuts as we mentioned last year. While some areas of our economy will be hurt by lower energy prices, the overall economy should experience a net benefit. Money and profits will be freed up to spend elsewhere by consumers and businesses alike.

The two other secular tailwinds - slowing emerging market growth and technological innovation (i.e. the "sharing economy") – should continue to keep inflation pressures restrained, helping stock market multiples as much or more than earnings growth in the total return equation. *In short, with these secular tailwinds more clearly in the picture today than they were one year ago, worries over peak multiples and earnings may be put to rest for another year.*

*4. In spite of fears of a significant back up in domestic interest rates, a low inflation environment and troubles in emerging markets could keep domestic rates low, providing a further boost to our economy even as Fed intervention starts to recede*

Our final bullet point – perhaps our most gutsy call – also proved accurate. In last year's playbook, we stated that "*worldwide economies will no longer be as synchronized as they have been in recent years and the Fed's outlook that interest rates will remain lower for longer may come to pass not because of their words or direct actions in the financial markets, but because of a strengthening dollar and improvements at home relative to other areas of the world. Interest rates will likely rise to be sure as the domestic economy improves, but weakness elsewhere may keep them lower than it otherwise might have been, an additional positive for the consumer*."

In spite of continued fears that rising interest rates would usher in the long awaited bond market rout, such fears failed to materialize in 2014, once again. Interest rates did just the opposite as geopolitical concerns and emerging market weakness kept our domestic yields low and the dollar strong.

Will this trend continue in 2015? We're not as sure. While we don't believe interest rates will move substantially higher from here, it's difficult envisioning them substantially lower from current levels, especially if the Fed starts to raise rates at the short end of the curve. *Relative to bonds, common stocks should once again offer far greater value to investors in 2015, on both a risk and return basis.*

Knowing that it will be hard to repeat the success of last year's forecast, our 2015 Investment Playbook can be summarized as follows:

1. *While the Fed will likely increase interest rates in 2015, the economy should be strong enough to absorb it.*
2. *Energy prices, like interest rates last year, may stay lower for longer, a net benefit for US consumers in an improving job market.*
3. *A continued bid for the US dollar in a weaker global environment will tend to favor developed over developing markets once again, but also domestic operations over multinational ones because of these currency effects.*
4. *Inflation should remain subdued thanks to trends in commodity prices, emerging market economies and the productivity of assets associated with the "sharing" economy. Non-inflationary driven growth tends to be a favorite type of growth for the stock market. Stocks should once again outperform bonds.*
5. *What could go wrong? Financial contagion related to the rapid decline in energy prices and weak overseas economies could affect the U.S. economy. Just as our domestic housing problems affected other areas of the world during the Great Recession, we can't rule out the potential for overseas problems to similarly affect us via financial contagion. While we believe our exposures are adequately contained and reserved against, it is a risk worth monitoring.*

If these predictions appear to be similar to those from our 2014 Investment Playbook, they are. A good Investment Playbook should highlight themes capable of lasting longer than most would expect; the real secret is knowing when to cut the cord. If we're correct about our predictions, funds should continue to flow to the US markets, but at some point, perhaps far into the future, these fund flows will become as excessive as those that have chased China and the emerging markets over the past fifteen years. A strong investment discipline like the one we use will be crucial in managing upside risks.

*Just For Fun.*

Usually, we stick to bigger picture themes in the Investment Playbook we share with the public at large, but for kicks, here are a few morsels from the sector and stock specific levels we've been chewing on for the past few weeks. This doesn't mean we have or will take action on these ideas in our portfolios, but they are certainly open to further discussion and research. We'd love your feedback.

- Heightened geopolitical concerns (Russia, Ukraine, ISIL) coupled with weak overseas economies may lead to increased defense budgets worldwide. While the aerospace sector has already made a big move in the past year and a half *in spite of domestic budget cuts*, perhaps this fact, in and of itself, says something.

- Following the overwhelming success of Gilead's Solvaldi cure for Hepatitis C in 2014, other groundbreaking biotech discoveries could be in the offing. Are we riding a wave to future gains or setting ourselves up for another epic disappointment for the sector?

- For the first time in history, television viewership may reach an inflection point and start to decline. This doesn't mean television "content" will disappear, only that it will increasingly be consumed elsewhere. Advertising budgets will follow the eyeballs as the democratization of broadcasting in social media and software apps takes share.

- Investor enthusiasm for Facebook reaches Apple like proportions in the stock market. Google experiences an eighteen month period like Apple had in 2012-2013. Faced with huge cash balances that are deemed excessive and core advertising markets that are maturing in the face of new digital alternatives and a limited advertising pie, the company is pressured to consider a dividend and stock buybacks rather than investing solely in long term moonshots like self-driving cars and Google Glass. Perhaps an Icahn dinner with Brin and Page lies in the not too distant future?

Wishing you a blessed Holiday Season and a Prosperous New Year,

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