Broadleaf Partners, LLC

Looking Back, Looking Forward

January 17, 2017

At the end of each year, we like to look back on the year that was and consider what we got right, what we got wrong, and what we might have learned in the process. We then turn our attention to the year to come hoping that by putting our thoughts in writing, we'll gain greater clarity on the factors that might drive our investment returns in the future.

We share these thoughts with you, our clients and friends, in the hope that you gain a better understanding of the influences that may drive our investment decisions in the coming year. As always, these decisions are fluid and may change with the circumstances, but are also made with a longer term perspective and intent to drive superior investment returns over time. We appreciate your continued confidence in our approach and interest in our work.

Thank you!

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Suffice it to say, 2016 was the year of surprises - economically, politically and financially speaking. Following a single rate hike by the Federal Reserve at the end 2015, global markets and economies came under significant dollar and oil induced weakness. Interest rates in some countries turned negative and the stock market experienced one of its worst starts to a year in history. Many investors, including ourselves, were concerned about the increased risks of a credit related recession tied to oil, muscle memory from having been through two significant market downturns over the last fifteen years.

The Federal Reserve, perhaps sensing the same risks at hand, abandoned the domestic intent to begin normalizing interest rates in the face of global risks that might possibly derail our own economy. Fortunately, or perhaps because of a reversal in their policy approach, the markets managed to recover most of its losses by the middle part of the year.

The decision to Brexit by Great Britain rocked the markets ever so briefly in late June, but then continued their forward progress up to our own election day and the surprising outcome of a Trump Presidency. But much like Brexit, the Trump win wasn't met with a market meltdown as many had feared, but by considerable gains amounting to nearly twelve percent for the S&P 500 by year end.

In last year's 2016 Investment Playbook, we had predicted that the market would finish 2016 on a surprisingly strong note, finally breaking the 2150 level for the S&P 500 that had proven so elusive for the prior eighteen months. Unfortunately, while we guessed the magnitude of such gains correctly, our estimate of the makeup of such returns, at least so far, was entirely misplaced.

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Rather than achieving record new levels on the back of an increasingly narrower market that might have benefitted our portfolio, the market's gains were instead achieved by far broader participation from the economy's more cyclical sectors frequently trafficked in by "value" investors. Instead of lagging the market's returns once again in 2016, the economy's cyclical sectors generated the largest gains for the year, with energy, financials, and material stocks leading the way and the more growth oriented, economically less sensitive sectors making little progress.

Key to the market's gains was a reversal in anticipatory indicators of an improving economy, reflecting a reflation trade and a rally in later stage cyclicals often associated with the later stages of an economic cycle. At least in our career, we have never quite witnessed such gains in the absence of fundamental growth drivers today. Certainly, oil prices have rebounded, but for the most part, the company fundamentals tied to the sector have not; they've simply not become worse. In a similar fashion, the Trump election has given new life to the financial sector, with many bank stocks moving to new all time highs in anticipation of higher interest rates and lower regulatory burdens ahead. Time will tell.

While we won't argue with the idea that the business environment might improve in the face of new government, we don't believe, with the market at all time highs, that this is the time to become complacent or chase the sectors that have moved the markets higher. Almost all President Elects enjoy a brief honeymoon period before the real work begins, and we suspect the 2017 story will be no different. In our experience, the government can make a difference in short term growth dynamics, but largely only at the expense of pulling future growth forward.

To recap, our first prediction from our 2016 Investment Playbook, "Lower for Longer", was at least in the short run incorrect. While interest rates and oil did plunge to new lows in early 2016, they bottomed and then ended the year at slightly higher levels than they started it. But while both rates and oil are higher than they were, it remains to be seen whether or not they are indeed "high" or that a "lower for longer" thesis is no longer the secular, longer term trend. Verdict: Wrong, but Stay Tuned.

Our second prediction that Fed induced jitters would continue to affect the market but that company fundamentals would start to matter more, was accurate in the first instance, but debatable from the second. Certainly, the stock market has rallied, but whether or not the fundamentals have truly improved compared to the beginning of last year could be debated given little movement in earnings and now elevated price earnings multiples. In our book, earnings for many areas of the market simply haven't gotten worse thanks to a rebound in oil prices which coupled with the change in administration, has led investors to bid up multiples in hopes that the earnings gains will follow. Verdict: Right on the Fed part, debatable on the second. Again, stay tuned.

Our final prediction, that the stock market would finish 2016 on a surprisingly strong note was indeed a good call, but unfortunately, as explained earlier, not accomplished in the manner we had anticipated. Verdict: Close, but no cigar.

In summary, 2016 was indeed a year of many surprises. As discussed in our Fourth Quarter Performance Review, we finished the year essentially flat from a performance perspective in a market that was up twelve percent, the widest margin of underperformance in our eleven year history. We don't take pride in these results, but they are what they are, and we ALWAYS report them, regardless of the outcome. At Broadleaf, you have our commitment that we will always put forth our best efforts and never report "fake news."

But what now? What do we see for 2017? Some might call us stubborn, but essentially, we don't believe that a single calendar year can validate or refute the longer term call. The calendar year is useful for measuring time and the progress of individual quarterly earnings, but not always the best measure of long term trends. The problem with being a publicly held company is that you have to report quarterly results, which can also lead to a short term mindset. Were the earnings results of our holdings uninspiring as our flat results suggest? Hardly. *The average company in our portfolio posted revenue growth of 10% and earnings growth of 24% for the full year, while many of the market's cyclical sectors which drove the index to new highs continued to decline or at best, found a near term bottom.*

All things being equal, we like where we sit. Barring extreme levels of valuation, stock prices tend to, over the years, follow the earnings gains. While a cyclically induced earnings recovery is one way to anticipate gains, this approach also requires not only ultimate achievement of earnings gains, but then sustainability to maintain those gains. Simply put, we didn't and do not believe that the economy has the power to induce the types of cyclical gains seen in economic cycles of recent memory.

So what does our Playbook for 2017 look like? We will divide it into three avenues of thought, economically, financially and politically.

Economically. Economically speaking, we continue to believe 2017 will be a year of slow GDP growth. Last year's gains in oil prices from the lows, higher interest rates now and in the future, and fuller employment, will likely restrain GDP and profit growth rather than stimulate it as perhaps was the anticipated case for 2016. In addition, a stronger dollar associated with divergent monetary policies around the globe will likely be a headwind for foreign profits of our multinational corporations. Even though the labor market shows signs of being tighter, we are strong believers in the idea that many resources are far more plentiful than generally perceived. Whether it is new drilling techniques in the energy patch or new sharing efficiencies achieved by advances in the technology sector, asset utilization levels perhaps aren't near the capacity limits that historically might have been assumed. Entire industries, from the media to shopping malls are being remade.

Financially. Financially speaking, we once again believe that 2017 could be a good year for investors, but like 2016, highly dependent on being in the right areas. We don't think the gains will be as strong as last year's were, but do believe something in the neighborhood of 5% is likely for the market as a whole. Unlike last year, however, we suspect that many of the sectors that drove this year's gains will either give some of those gains up or consolidate and not participate to the same extent largely as a reflection of a return to lower for longer thinking. The cyclically hoped for recovery may show some progress, but we are doubtful that the experience will be as robust as many cyclical sectors are currently discounting. Fiscal policy in the form of tax cuts or infrastructure spending may help in 2018 and beyond, but are unlikely to have an impact in 2017. In addition, a decision to cut taxes at this stage of the economic cycle would be unusual to say the least, and might cause the Fed to raise rates faster than it otherwise might given the tighter labor market. Again, we don't believe the overarching narrative for a lower for longer environment has changed in spite of cyclically induced enthusiasm to the contrary.

Politically. I really wish I could say that 2017 will offer a return to normalcy from a political point of view, but I highly suspect that this, too, will prove to be wishful thinking. In Brexit is Beautiful, a 2016 Economic Update, we commented how political changes can often move in waves across the globe. Brexit was the start of something big and the election of Trump may only mark the beginning of more surprises to come. In the rush to globalize, perhaps we've been too quick to write off alternative points of view or ways of getting things done. Trump's tweets may be alarming to many, but we suspect over time, will be understood as just a new way to get old things done – or not. ☺ Everything from a geopolitical standpoint will be up for review, once again reinforcing our belief that lower for longer and a risk constrained world will be with us for awhile. While some might suggest that the Republican Party has been given a mandate and thus an allowance to do things the Democrats couldn't have dreamed under President Obama, it is also true that what it means to be Republican or Democrat is up for debate and in the process of changing before our very eyes.

While this year wasn't the best of all years for the Broadleaf Growth Equity Portfolio, being flat also isn't the worst thing that could have occurred. Over time stock prices tend to follow earnings and on this basis, we think 2017 will be a strong one for our growth oriented names. In a choice between cyclical forces of economic recovery and longer term, powerful trends in innovation, we're going with the latter as a more sustainable approach.

In a lower for longer world, many variables in the markets won't necessarily behave as they have in the past thirty or forty years, as this recent past has been anything but normal when it comes to key variables like the behavior of interest rates which rose to the high teens and then came back down again. As one investment wag we highly respect puts it, investors may no longer find it productive to invest in value and vacation in growth, but the other way around.

This business is never easy, but it's always an intellectual challenge worth pursuing. May God bless you abundantly in the coming year, even if it comes in ways you don't expect.

Kindest Regards,

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