

What a boring few weeks it has been. Following a post Brexit bounce that was surprising to many, August has largely been, well, August - about as exciting as dead summer lawns, and for the kids, the thought of going back to school.

But is this a calm before the storm? We don't think so.

The concerns that drove the markets down at the beginning of the year and caused us to be more concerned about the potential for a recession, appear to have abated as oil has bounced off its \$30 lows and the credit default swaps of European banks have stopped acting like our own did before the housing crisis.

The February swoon even spooked the Fed, causing them to reverse course on their decision to normalize interest rates in 2016. The Fed, perhaps for the first time, cited global instabilities as a reason to remain cautious with further domestic rate hikes. In our mind, further hikes in the face of weak global economies could have put upward pressure on the dollar and continued downward pressure on oil prices, exacerbating the concerns about debt levels at European banks tied to energy companies.

With oil prices back in the mid 40's and credit default swaps of European banks acting better, global growth concerns appear to be more contained. We're now at a time, once again, where all eyes are on what the Fed may or may not do in September and December. The obsession with the Fed is back, particularly with earnings season drawing to a close.

Over the past six months, we've made some changes to the portfolio, reducing the names whose growth is tied to a hoped for cyclical bounce in the economy and shifting it towards those companies that can grow independently of it. While 2015 was a year in which growth outperformed value in a growth starved world, 2016 has been a year in which value, or at least its more cyclical segments, has outperformed growth. This rally has been in anticipation of a cyclical upswing in earnings brought about by easy money around the globe, and in some places, even negative interest rates. We doubt the follow through.

The United States has perhaps seen the greatest improvement in growth since the Great Recession, but we're still averaging just 2-2.5% GDP growth in spite of the historically unprecedented amount of stimulus provided by our Fed over the last seven years. Inflation is still less than the hoped for 2% level, while unemployment rates, thankfully, are back to pre recession lows.

To us, the environment appears to have shifted gears in a once every few decades fashion, from one in which the economic cycles are long in duration and highly volatile, to one in which they are shorter, yet more stable.

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Two questions come to mind. One, why might this be the case? And two, is it necessarily a bad thing?

There is no doubt in our minds that the structural issues facing the global economy are both significant and well-advertised. Excess capacity appears to be abundant in most industries after years of torrid growth, particularly from emerging market economies like China. History suggests that periods following recessions that involve the credit and debt markets at their very center - environments like the Great Depression and Great Recession – are often accompanied by generational shifts in consumer spending behavior. Who doesn't remember the generational thrift of a grandparent who grew up in the 1930's?

Japan has been experiencing a slow to no growth, deflationary spiral for much of the past three decades, following its own industrialization period during the seventies and eighties in which it, too, overspent, overbuilt and overbought. While the Japanese stock market has enjoyed a few one hundred percent rallies in the past thirty years, such moves have been short-lived, with essentially flat markets over the last thirty years.

Productivity improvements have been absent in our own recovery and many are wondering why. We suspect it has been a lack of capex spending by companies and a preference for allocating capital to dividends and stock buybacks instead. In an era of low interest rates, return on investment assumptions on all projects shrink, and for many, it becomes an easier proposition to just pay dividends and buy back stock. It doesn't hurt as well, that investors around the globe are starved for yield.

Without gains in the productivity of America's workforce, it may be difficult to see a more significant improvement in GDP than the 2-3% we're seeing today, even though the labor market has improved. The polarized political environment has also prevented any form of fiscal stimulus – spending and tax related – that could be of some help in improving capital spending and thus potential worker productivity.

We're not quite sure how the sharing economy plays into the sluggish productivity stats from a traditional economics point of view, but there is no doubt in our mind that it is having an impact somehow. In a consumer and service driven economy where most of the benefits appear to accrue to the consumer rather than labor and business, it may be worth further study.

Sharing a car, a vacation home, or working from home a few days a week are ways technology can reduce the fixed costs in an individual's budget, perhaps a form of compensation we can't necessarily account for, but nevertheless has an effect on the aggregate economy. I regularly recognize the value of my short commute, which represents the opportunity for greater leisure time, a savings that might be shared, economically speaking, with an employer. More car, house and other fixed cost sharing by individuals also means, in the aggregate, less capex is spent on such things.

Will this change? Certainly to some extent. Eventually, sharing won't be so easy or desired, and people will want an asset of their own, even if it costs more and may be utilized less. All

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the same, the sharing economy is likely just starting, a generational zeitgeist of a consumer that has changed more permanently, just as the spending behaviors of those who went through the Great Depression. Young consumers have an aversion to taking on debt even at low rates of interest, and also seem to have a preference for experiences over things.

All of these factors lead us to one conclusion, the increased likelihood of a lower for longer environment – lower for longer economic growth, lower for longer interest rates, and lower for longer commodity prices. Economic cycles will likely be more frequent but also far less severe than those of the past thirty years. They may be driven more by short term inventory balances than longer term asset class bubbles.

Is this forecast a bad thing? We don't believe so. Contrary to how it might sound or come across to someone of the eighties generation, it actually has the potential to be a very positive outcome. Historically, periods of slow economic growth and low inflation have been solid environments for long term stock market returns. If consumers are more conservative in their spending and businesses more cautious with their capex plans, cycles and thus asset bubbles that eventually lead to severe recessions may be far less common and frequent. Slow and steady wins the marathon.

The Fed has talked more recently about a lower, market-neutral interest rate, the rate that is neither stimulative nor contractionary for the markets, one that keeps its dual mandate in check. Once again, this supports the view of lower for longer.

The good news is that over the long term, stock prices always tend to follow earnings, the mother's milk of the market as Larry Kudlow likes to say. Getting to the market-neutral rate is a destination I'm looking forward to, as it may represent a day when the Fed finally takes a backseat to earnings season and government influence to capitalist forces, rather than the other way around.

The overall growth rate in earnings may be lower than it has been in recent decades, but with fewer and shorter violent swings in the overall economic cycle, it may also prove to be more sustainable. There will also always be entirely new ways of doing things that come to market to solve real problems – these will be the new earnings streams.

So yes, lower for longer, but, hey, I'm short, so I'm comfortable with the concept. That's not a bad thing, it's just a real thing.

Or is it? ☺

Kindest Regards,

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