Broadleaf Partners, LLC

What We're Thinking August 5, 2024

It's quite amazing how fast things can change in just a few short weeks. Nearly in correction territory, and certainly so if today's declines hold, it can be said that though earnings have remained solid, the prices of stocks have not. I've been through a number of periods like this. While different, they also often rhyme, but are never much fun. It could be said that it comes with the territory. Join me now, as I review the last few weeks, what we know to be true, and what we're currently thinking.

The markets reached all-time highs on July 10th, , less than one month ago. The next day, the CPI was released, with continued progress in the right direction. This ushered in, in a violent fashion, a historic rally in small cap stocks at the expense of large caps which have been strong not only this year, but on a relative basis for nearly a decade. An asset allocation trade was on, in the hope that lower rates might finally accompany the improved CPI report, ushering in a more favorable environment for smaller companies that theoretically might depend more on debt and less earnings strength than their cash rich, large cap growth peers.

In spite of our significant year to date outperformance, we were admittedly surprised by the sudden and significant shift in preferences and decided to take a closer look at history to ascertain similar periods. An initial look seemed to suggest only a handful of similar periods over the last three years, all of which occurred around or near less than ideal environments - the tech bubble, the housing crisis, and the outbreak of Covid. Unsettling, to be sure, but, when we drilled down further, they also seemed to coincide closer to the market bottoming process for these periods than a market top, particularly during the housing crisis. In essence, the market shift and message of just a few weeks short ago might be interpreted as one of a hoped for soft-landing and a healthy broadening of the market, or a market nearing the end of a crisis. Given the results at the end of the second quarter, only the former seemed plausible. Money might rotate, with thought, but would ultimately end up in the areas of greatest earnings power.

An attempted presidential assassination, a withdrawal from the campaign, and heightened geopolitical risks centered in Israel, while unnerving, weren't immediately observable in the markets, even if it felt as though they could be making a contribution. This general outlook lasted until late last week and, in particular, on Friday, when a weaker than expected employment report sent the markets in an entirely different direction and interpretation. No longer was the market going to broaden, but now it was getting ready for a hard landing; a recession might be at hand.

The ISM Purchasing Managers Index was released earlier in the week, showing the manufacturing sector was contracting, but given the rolling nature of sector driven recessions of

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the post Covid era, that reading was generally ignored. The real culprit for Friday's decline may have been over concerns with the quality of Friday's employment report. While we gained over 100,000 new jobs, this was lower than expected, and a measure, based on the Sahim rule, might indicate the economy was already in a recession. Just as sudden as was the move to small caps a few weeks ago, was the sudden distaste for all equities, small or large, and a preference for government bonds, long forlorn as an effective hedge. In spite of Professor Sahm's statement that the indicator might not be accurate this go around and Fed chairman Powell's caution against the recession interpretation, the markets just didn't care.

Now, as luck would have it, I was trying to relax on vacation with my family in the Outer Banks last week. While the characterization is probably unfair, it seems like this happens more often than I'd like. But at least I now have a bigger staff, including my son and our summer intern, to do the heavy lifting. A couple rounds of golf and few beach beers helped keep my mind on vacation things, but since one of my jobs is to worry for my clients so they don't have to, it was less than ideal. That happens at times, and is why, I suspect, they call any career "work" at times. Eager to catch up with where the rubber meets the road in the markets, I had my youngest son Johnny and my wife Lisa do the bulk of the driving on the ten hour ride back home, so I could catch up on some of the earnings calls and notes from my son Pete and our summer intern Quin.

So what did I learn from last week's earnings and this season's earnings so far? Aside from two company specific blow ups which were unforeseeable and happen from time to time, the reported results have actually been quite good. Some companies in the consumer space have talked about weakening demand and trade down behavior from lower end consumers, but they've similarly been saying this for several quarters now. Amazon comes to mind here. Mastercard, on the other hand, has seen consumer spending as resilient, both domestically and now internationally. Meta continues to see robust advertising demand, which is usually one of the first things to be cut during recessions.

The potential unwinding of the artificial intelligence "trade" has also been on the market's mind, with some declaring a bubble close to popping. While we may be naïve to trust company management's that are investing in the space, we also tend to know, having read so many calls over the years, who calls it as it is rather than with an always on optimism. Microsoft, ServiceNow, Amazon and Meta, on this front, remain exceedingly bullish when it comes to AI. Each continues to forecast increased capital spending on AI in the coming year, with a complete remake of the modern data center likely at hand, followed by the eventual upgrades of existing infrastructures. If things do slow, they can pullback given the design process. Each of these companies also pushed back on the notion that these investments weren't generating a return, citing specific examples of where Ai was benefitting both the front and back office across a variety of industries, with both large and small language models. Nothing was said, at least at this time, which could be construed as a long term change in the outlook for this new technology.

Bill Gates and others have commented in the past that technology shifts like the PC, the internet, and now perhaps AI can be overhyped in the short run, but are often underhyped in the long run. Who could have imagined the birth of companies like Meta and Google following the rollout of the internet and now, artificial intelligence? The bubble concern, to be sure, is worth monitoring, but the valuations of a few weeks ago and now that many stocks have come in today, are nowhere near the levels they were during the dotcom bubble. Managing risks is top of mind, but the rewards in our mind remain compelling. Even if Nvidia delays its next generation of GPU's due to technical issues, the spending isn't a matter of IF in our book, but only a matter of WHEN.

Another piece of news perhaps moving the markets this morning is Warren Buffet's disclosure that he sold half of his holdings in Apple Computer over the last quarter. We took a look at his holdings of Apple a quarter or two ago when we learned that it was nearly 50% of his public equity exposure and calculated that that might mean it was perhaps 20% of the overall assets on Berkshire's balance sheet. Warren may indeed be raising cash to have a war chest of cash available to go shopping in an imminent recession, but it could be equally true that he felt it was time to pare back this quite concentrated position.

In conclusion, we think it is premature to declaring a recession. We still believe a soft landing is possible, and would argue over the longer run, that a broadening of the market rather than a narrow one, can also be a healthier one. The earnings reports we have read so far don't suggest a crisis is imminent in the economy, nor does it seem like AI is in a near term bubble. Our sell discipline will, of course, get us to adjust course when needed, but these recent moves seem premature.

A client recently told me he could handle one more recession. Sometimes I feel the same, as though I'm getting too old for it. At the same time, I've got wisdom and experience worth sharing, and so I will keep on keeping on. Corrections happen, and so do recessions, but we've always come back, and the future has been better than the past, indeed.

Kindest Regards,

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