

The markets are off to a rip-roaring start this year -- in the wrong direction. We are hearing all sorts of sensationalized firsts, including the fact that we just endured the worst first few days of January on record. While this is a painful fact, it is also one that is perhaps more sensationalized than most. If January wasn't the month of new beginnings and New Year's resolutions, we don't think it would be getting all the press. If this were happening in the month of February, for instance, would it get this kind of attention?

In our book, nothing is really new, in spite of the very real year to date pain. The same risks continue to keep anxiety levels on high alert and a poor technical backdrop for nearly every market index only exacerbates such fears. The Fed has finally removed the economy's training wheels and in an [earnings void](#) with no corporate insights yet at hand, we're prone to swings in action as fickle as the direction of the wind.

In this update, we'd like to discuss three things. First, what are the risks in the economy? Second, what do these risks mean for how we invest? And third, what does it mean for you as an investor?

The major risks in the market remain largely the same. China and the energy markets are in a world of hurt. As a single party, Communist government, no one truly believes the data coming out of China, nor should they. We aren't bashing on China here, only stating a reality of human nature. Imagine, for instance, what truth and power would look like in the United States if we only had the Democratic or Republican parties and CNN or Fox News. Competition in business and among political parties keeps everyone a little more honest and excellent than they might otherwise be. We can capture some glimpses of truth in China, but perhaps only from what U.S. companies are willing to disclose about their business there and what the commodity markets may be signaling in terms of changing demand.

The situation in China reminds us of one part Russia and one part Japan. Like Mother Russia during the Cold War, budget problems can be swept under the rug for years if not decades in an environment of propaganda based news and reality. These problems are finally coming home to roost. Like Japan in the 1980's, however, China has just gone through a nearly twenty-year period of massive industrialization. At the end of such periods, overbuilding is almost always the norm.

The Japanese were free to invest the profits of their economic successes globally, but massively overpaid for things like Pebble Beach and Firestone Tire. It remains to be seen whether or not China will even relax its capital controls, but the outcome may be similar. Chinese citizens are eager to invest elsewhere given their domestic problems, which would naturally place downward pressure on the Yuan and upward pressure on the dollar.

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Of course, this situation in China also impacts the commodity markets, the second primary risk we see to the economy and the financial markets. A slowdown in industrial demand brings with it a reduced appetite for the commodities on which such projects are built at a time where global supplies are at all time highs. Currency differentials only make the issue more pronounced. As currencies like the Yuan depreciate, the dollar tends to increase in value, placing even more pressure on commodity prices like oil. Last year, energy companies had hedges in place, but this year, 2016, could be the year of bankruptcies.

So the risks remain China and the energy markets. What do these risks mean for how we invest?

We are firm believers in the catchphrase, “lower for longer”. We think that phrase fits for both commodity prices in the foreseeable future as well as domestic GDP growth. Periods of slow but stable growth have usually been among the most favorable for the financial markets, with the only caveat being that since we’re so close to zero growth, the fears of recession are everywhere magnified.

Lower commodity prices are indeed good for the consumer, but unlike the past, the consumer is behaving differently, spending some, but paying down debt rather than taking on more. Along with the global headwinds, this keeps growth less cyclical in nature, providing an excellent environment for those companies that can grow in spite of the economy. Innovation deserves a premium in a growth scarce environment.

Will energy be a buy? Yes, it will be someday, but history suggests not quite yet.

We’ve lived through the tech bubble and the housing bubble, and in recent weeks have put paper to pencil trying to determine when bubbles become buys. Tech, during its bubble, was nearly 34% of the S&P 500, meaning the sector had considerable sway for both the stock market and the overall economy. Fund flows into the sector had truly gone wild.

While the downturn started within the tech sector, the overall economy caught a cold one year after the dotcom implosion, succumbing to recessionary pressures. By our work, the tech sector fell 83% from peak to trough and experienced five new bottoms before finally reaching the lowest of them all twenty-nine months later. While the S&P 500 recovered to prior highs over a period of seven years, we know it took the tech heavy NASDAQ nearly fifteen years to do the same.

What about housing? The housing and financial sectors, epicenters of the Great Recession, were never quite the same weighting in the S&P 500 as tech was during its bubble, but nevertheless wasn’t quite small either. By our work, the financial and housing sectors were about 24% of the S&P 500 at their peak, strong enough to not only sway the stock market but also the economy.

Unlike the tech sector, however, the implosion in the financial and housing sectors was far more nefarious, as they threatened the credit markets and heightened risks of a run on the banks. According to our analysis, the financials and homebuilders fell 90% and 84%

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respectively from peak to trough. Homebuilders had three false bottoms before hitting their true bottom forty months later, while financials had seven false bottoms before finding firm ground twenty-two months later.

So what's this all mean for investing in energy and emerging markets like China today? It means we can wait. While no bubble is the same, we believe both qualify. We haven't rerun the numbers since the end of the year, but at that point in time, the energy sector ETF was just 39% off its highs reached just 17 months ago, with three bottoms in place and counting. The emerging markets ETF was likewise just 34% off its highs from 56 months ago, with two bottoms in place and China was down just 30% from its highs just six months ago. If history rhymes and energy and China have been in bubbles, we see no need to be in a rush to buy as the bottoms could be far from in.

All of which gets us to our next question. Is the implosion of the China and commodities bubble powerful enough to throw our economy into a recession? According to our work, energy at its peak was roughly 10% of the S&P 500, far less than the peak levels for both tech and finance during their respective bubbles. Even if we throw in the materials sector and a part of the multinational industrial sector exposed to the emerging markets and China, we doubt we'd reach peak levels of more than 15%.

Why do we care about recessions? Because while growth companies tend to perform well regardless of the economy, recessions do matter even for the stock prices of publicly traded innovators. Apple, in spite of growing its sales during the Great Recession, quickly caught up to the rest of the declining stock market, with shares falling more than fifty percent.

So the key question for us is whether or not the bubble in China and the energy related sectors are powerful enough to derail our economy and throw us into a recession as tech and banking did in the past. While mindful of energy related credit risks, we believe the answer is no, at least at this point in time. In addition to the fact that these sectors within the S&P 500 are smaller than the impact of tech and financials in their heyday, our fundamental checks into the domestic economy remain both positive and constructive.

Yesterday, I met with a real estate agent to sell my mother-in-law's condo. I asked her how business was, as I usually do with business people I meet. She said business was great and that she'd noticed a particular increase in calls since the beginning of the year. She had sold three condos in our complex in the past few months and business was getting better, not worse. We also know that employment trends have been improving and while volatile, consumer confidence levels remain both high and strong. Historically, declining commodity prices have been a positive for the consumer and while we haven't yet seen that impact in this cycle – perhaps because the consumer is smarter than the past – it can't be a bad thing, even if socked away as a savings net.

So what does this all mean for you as an investor? While we're betting on a no recession outcome and a lower for longer environment favorable to growth companies, what it means for you really depends on the risks you are willing to assume. Believe me -- I know -- the year to date downdraft in stocks has been unnerving; it's never fun. These periods help investors to not only understand their individual risk tolerances, but also their true time horizon. If you

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were sixty when we went through the Great Recession seven years ago but are now retired and living off an investment portfolio, your reality has changed and so should your portfolio. No one, including ourselves, will get the recession call right every time, even though we are paid to try. So point number one, know yourself and your circumstances.

On the other hand, if you do have a long term time horizon and can handle the volatility of the markets, history suggests that time is on your side, particularly as you go out five or more years. According to data provided by J.P. Morgan, the average intra-year decline in the market over the last thirty-five years has been 14.2%. While the decline has been front end loaded in 2016, we're squarely within this historical norm. This doesn't mean you should stick your head in the sand and ignore the changing circumstances, but it does mean you can stay involved in one way or another. So, point number two is having a sell discipline.

China and energy are the risks and lower for longer is the most likely domestic growth path. No recession is our call. And we'll sell when we need to, even when we don't necessarily want to. Discipline is key in times like these.

If we can help, please call.

Kindest Regards,

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