“Logic Trumps Emotion”

Market Commentary – September 2011

By Frank C. Fontana, CFA
President, Banyan Asset Management, Inc.
Written August 31, 2011 – www.banyan-asset.com

The second estimate of Gross Domestic Product (GDP) shows that the output of goods and services produced by labor and property located in the U.S. grew at an annual rate of 1.0% in the second quarter of 2011. This is lower than the advance estimate of 1.3%. In a sobering dose of reality, Federal Reserve Chairman Ben Bernanke recently admitted “the recovery from the crisis has been much less robust than we had hoped”. After noting a deterioration in the overall labor market and citing stubborn unemployment (9.1% in July), the Federal Open Market Committee (FOMC) pointed out in a statement issued on August 9 that “household spending has flattened out, investment in nonresidential structures is still weak, and the housing sector remains depressed”. According to *The Economist*, U.S. GDP growth is forecast at 2.3% in 2011 and 2.9% in 2012. While there is chatter about the possibility of the U.S. slipping back into recession, this has not yet made it into mainstream GDP forecasts.

While Bernanke maintains that the Fed still has “a range of tools that could be used”, it is unclear how effective monetary stimulus will be going forward. The Fed has already taken short-term interest rates close to 0% and bought more than $2 trillion in Treasury and mortgage bonds. They did, however, give clarity on interest rates by stating on August 9 that the Fed Funds rate would stay at “exceptionally low levels…at least through mid-2013”. This specific language replaces their previously ambiguous phrase “for an extended period”. It is possible that the Federal Reserve will purchase more bonds for a third round of quantitative easing, known as “QE3”. However, Bernanke was recently quoted as saying “most of the economic policies that support robust economic growth in the long run are outside the province of the central bank”. This was a shot at Congress to get its fiscal house in order. The next FOMC decision on monetary policy will be announced on September 21.

Investors reacted to the horrendous news flow in August by aggressively selling stocks; they panicked. The month of August started with politicians arguing over the $14.3 trillion debt ceiling, coming dangerously close to default before raising the debt ceiling at the midnight hour and thus kicking the can down the road. (The U.S. government is still spending more than it has coming in.) On August 5, Standard & Poor’s downgraded United States debt one notch from a pristine AAA to AA+. There were also persistent worries about a sovereign debt default by Greece rippling through the European and global financial markets. Add on an economy battling low economic growth, high unemployment, and the lingering effects of a burst housing bubble, and investors panicked.

Technical factors of the market are mildly bullish (more demand than supply), while fundamentals are attractively priced – therefore, we are mildly bullish on the market. The Standard & Poor’s forecast for S&P 500 operating earnings per share (EPS) over the next 12 months is $105.45, which implies a price-to-earnings (P/E) ratio of 11.6 with the S&P 500 at 1219. The earnings yield (E/P) is currently 8.65%, which represents attractive value relative to the 10-year U.S. Treasury note yield of 2.22%. Some analysts are worried that corporate earnings estimates are too high. Indeed, estimates have dropped slightly from $106.23 last month. However, valuations are so cheap given low interest rates that there could be a reasonable drop in earnings and stocks would still be cheap.

Investor panic caused the S&P 500 to slice through support levels before finally finding bottom near 1120 on a closing basis. Technicians note that when old support is broken, it becomes future resistance. There should be major resistance around 1260 (due to the March 2011 low, the June 2011 low, the 50 day moving average at 1258, and the 200 day moving average at 1284). Minor support exists at 1200, with major support at 1120. Banyan Asset Management is operating with a hypothesis that investor emotion trumped logic as waves of selling dropped stock prices quickly. Straight from our 2008 playbook, depending on the client, we incrementally bought into the decline. We cannot say whether “the bottom” is in place, but we do know that stocks are on sale. Still, we have some powder dry, just in case.