"Taxmageddon"

Market Commentary – December 2012

By Frank C. Fontana, CFA
President, Banyan Asset Management, Inc.
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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 2.7% in the third quarter of 2012. This is higher than the advance estimate of 2.0%. GDP growth in Q3 was primarily driven by the temporary factors of businesses accumulating inventory and federal government spending. It is ideal for GDP to grow due to more sustainable reasons. While Europe's recession and China's slowing growth are weighing on the economy, the U.S. fiscal cliff is grabbing the headlines.

It is important for investors to understand the potential implications of the fiscal cliff, also dubbed by the media as "taxmageddon". Unless politicians can strike an agreement beforehand, a series of tax hikes (around $500 billion) and spending cuts (more than $100 billion) are scheduled to occur on January 1, 2013. Higher taxes on dividends and capital gains would have a direct effect on investors. However, the biggest risk to investors is whether the fiscal headwinds would cause the U.S. economy to sink into recession. The non-partisan Congressional Budget Office projects that if policy makers do not act in time to avert the fiscal cliff, GDP will contract by 0.5% in 2013. If current tax policy is extended, GDP is forecast to grow by an anemic 1.7%.

The Federal Reserve is doing what it can to boost the economy in the form of accommodative monetary policy. Between QE3, Operation Twist, and committing to a Fed Funds rate at an ultra-low range of 0% to 0.25% through mid-2015, the Fed currently has several remedies in place. Unfortunately, monetary policy can only help so much. The U.S. is facing problems that are fiscal in nature.

Technical factors of the market are 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 $109.13, which implies a price-to-earnings (P/E) ratio of 13.0 with the S&P 500 at 1416. The earnings yield (E/P) of 7.71% represents attractive value relative to the 10-year U.S. Treasury note yield of 1.61%. Analyst estimates continue to trend lower, reflecting gloomier outlooks. Still, it is important to acknowledge that financial markets are about expectations, and significant market moves (in either direction) are generated when reality deviates from the consensus view.

Fear and greed are in a tug-of-war, which has been reflected in recent stock price movement. Following the election results on the evening of November 6, the stock market sold off for 7 days. After piercing the 200-day moving average for a few days, support held firm around 1350 and the S&P 500 bounced back. Resistance is hovering above from the 50-day moving average at 1422 and old horizontal support near 1425. Above that, the 1465 level proved formidable in September. Market breadth has been on the mend, with our indicator popping into positive territory on November 30.

While it is tempting for drivers to look through the crystal-clear rearview mirror instead of the cloudy windshield, those who do so will likely hit something right in front of them. All of us are dealing with the same financial markets. How do we create an edge? When emotion is running high, it pays to be more logical than others. Stocks are not at bubble valuations. Dividends are solid and increasing. Corporate balance sheets are robust. Investors who maintain a balance of stocks and cash have already positioned themselves for various scenarios. If politicians cannot agree on fiscal policy, the fiscal cliff hits, and investors panic, the "2008 playbook" comes into focus: incrementally buy stocks at wonderful bargain prices. If there is agreement in Washington D.C., stock prices could quickly jump higher. Investors who are 100% invested in stocks or cash, or who are leveraged, have made their situation fragile. Successful investing is more about planning for the future than predicting it.