"Blame It On The Snow"
Market Commentary – May 2014

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The advance 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 0.1% in the first quarter of 2014. The severity of the drop from 2.6% in the fourth quarter of 2013 caught many economists by surprise, with a Wall Street Journal survey of economists projecting a 1.1% growth rate. At first glance, it is curious that the stock market would shrug off the low 0.1% reading. The components of the reading, however, reveal a bit more strength than the headline would suggest. GDP growth is the sum of consumer spending, investment, net exports, and government spending. In Q1, consumer spending accounted for 2.04 percentage points of GDP growth, investment -1.01 points, net exports -0.83 of a point, and government spending -0.09 of a point. Consumer spending, which historically makes up about 70% of GDP, drove the show in Q1 (healthy and normal). Investment was down, but shrinking inventories accounted for more than half of the decline (inventories are volatile and can easily bounce back). Exports dropped considerably, which is more reflective of tepid economies in Europe and Asia than weakness in the U.S. Overall, U.S. economic growth is slow, but it could have been worse.

Rather than blaming it on the rain, the Federal Open Market Committee (FOMC) blames the Q1 slowdown on the extreme cold and snow this winter. According to the FOMC press release on April 30, "information received since the FOMC met in March indicates that growth in economic activity has picked up recently, after having slowed sharply during the winter in part because of adverse weather conditions." The FOMC then proceeded with cutting its $55 billion monthly bond-buying program by another $10 billion to $45 billion. This follows $10 billion reductions in December, January, and March. It is important to remember that the Fed is still being accommodative; it is just being less so. As for interest rates, the FOMC left its federal funds rate at a rock-bottom range of 0% to 0.25%, and it expects to "maintain the current target range…for a considerable time after the asset purchase program ends." The next FOMC announcement on monetary policy is scheduled for June 18.

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 $124.52, which implies a price-to-earnings (P/E) ratio of 15.1 with the S&P 500 at 1884. The earnings yield (E/P) of 6.61% represents attractive value relative to the 10-year U.S. Treasury note yield of 2.65%. Earnings estimates are rising a bit faster than the stock market, which accounts for the P/E ratio dropping from 15.5 last month even though the stock market rose.

The S&P 500 and Dow Jones Industrial Average (DJIA) seem poised for a breakout to the upside, but the Nasdaq Composite Index is still struggling. The S&P 500 and DJIA are both in wedge formations, marked by higher lows and a horizontal ceiling of resistance above (1880 on the S&P and 16600 on the DJIA). The pummeling of high flying stocks with high sales growth and negligible earnings continued in April. A breakout above resistance would likely be followed by a pullback that tests old resistance as new support. Another possible scenario in the coming weeks is that the trading range continues. This would allow more digestion of the fantastic gains from 2013.

The major indexes have been led by some of the stodgier companies with cheaper valuations and higher dividends, but also lower sales growth. This has been a sweet spot for our investment style at Banyan Asset Management. Sales growth is important, but earnings matter. Consider a hypothetical company that sells $1 billion worth of goods. If it costs $1 billion to generate those sales, what is that company truly worth? It would be unfair to say that such a company is worthless, but it should be worth less than a sister company that generates a profit of $100 million from those same sales. Sustainable profit growth, driven by sales growth, adds a margin of safety to a successful investment strategy.