"Bubbles, Bubbles Everywhere?"

Market Commentary – February 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 3.2% in the fourth quarter of 2013. As expected, the building of inventories, which contributed 1.67 percentage points to the Q3 reading of 4.1%, cooled off in Q4 (contributing a more reasonable 0.42 of a percentage point). Consumer spending picked up the slack with a robust 2.26 percentage points (the largest contribution of consumer spending to GDP over at least the past three years). Net exports came in high at 1.33 percentage points (not sustainable), but this was nearly offset by weaker government spending (-0.93 of a percentage point). The biggest unfavorable surprise was residential investment, which weighed on GDP by -0.32 of a percentage point (the only negative reading for residential investment over the past three years). Overall, GDP growth may be categorized as "slow and steady."

On January 29, the Federal Open Market Committee (FOMC) announced the continued tapering of its quantitative easing (QE) program. The FOMC cut its $75 billion monthly bond-buying program by another $10 billion to $65 billion. This follows the first $10 billion cut in December. Remember that the Fed is still buying a significant number of bonds each month; it is just that the rate of buying is slowing. Those familiar with calculus would say that the first derivative is positive, but the second derivative is negative. The Fed may be establishing a pace of $10 billion in cuts per FOMC meeting. If that is the case, the FOMC meeting in October may see the end of QE. The Fed insists that its federal funds rate will be in a range of 0% to 0.25% as long as unemployment is above 6.5% (6.7% in December 2013) and inflation in 1-2 years is expected to be less than 2.5%. It is noteworthy that Ben Bernanke's last day as Fed Chair is January 31, with Janet Yellen replacing him effective February 1.

Some investors are worried that the easy monetary policies of Ben Bernanke's 8-year term as Fed Chair have inflated bubbles. At Banyan Asset Management, we believe there is an element of truth to this, depending on where you look. When assessing a bubble, compare it to the technology stocks in the late 1990s and real estate in the mid-2000s. The stock market overall is not in a bubble, although there are some individual stocks that are (in the areas of Internet shopping, online movie downloads, 3-D printing, etc.). Real estate and commodity prices are not in bubbles, either. What is a bubble, however, is government debt. Central banks around the globe have been in a race to pump liquidity into their respective economies over the past several years. Japan is the most aggressive these days. Beware that prices of government bonds are too high and yields are artificially low. When the government debt bubble eventually bursts, stock prices will encounter headwinds. Higher yields on government debt will compete for dollars currently resting in stocks. Also, higher interest expense will weigh on corporate earnings. This event should not be feared, but rather understood for the opportunities created.

Technical factors of the market are bearish (more supply than demand), while fundamentals are attractively priced – therefore, we are mildly bearish on the market. The Standard & Poor's forecast for S&P 500 operating earnings per share (EPS) over the next 12 months is $120.83, which implies a price-to-earnings (P/E) ratio of 14.8 with the S&P 500 at 1783. The earnings yield (E/P) of 6.78% represents attractive value relative to the 10-year U.S. Treasury note yield of 2.67%. The January correction has made stocks more attractively priced, as earnings estimates have marched higher while stocks have pulled back in price.

So far, the January pullback in stock prices has looked like other pullbacks of 2013, but this one may have more teeth. Looking at the S&P 500, higher than average volume spikes on five of the down days in the second half of January suggests that more weakness may be ahead. Major support should exist around 1725 (September high), 1710 (July high), and 1706 (200-day moving average). Such a correction would be normal and orderly. We plan to be incremental buyers into further weakness.