"Headwinds"

Market Commentary – September 2013

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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 2.5% in the second quarter of 2013. This is higher than the advance estimate of 1.7%. GDP growth is the sum of consumer spending, investment, net exports, and government spending. In 2013 Q2, the consumer spending and investment categories led the charge. Of particular interest, investment contributed 1.48 percentage points of the 2.5% GDP reading, the category's highest contribution of points to GDP since 2012 Q1. Overall, though, investors should note that GDP growth is anemic compared with the long-term average growth rate of 3.3%.

It is still unclear when the Federal Reserve will start scaling back its $85 billion monthly bond purchase program, also known as "quantitative easing" (QE). According to minutes from the Federal Open Market Committee's (FOMC) July policy meeting, members of the FOMC are mixed regarding the proper direction for monetary policy. "A few members emphasized the importance of being patient and evaluating additional information on the economy before deciding on any changes to the pace of asset purchases. At the same time, a few others…suggested that it might soon be time to slow somewhat the pace of purchases." Financial markets are still addicted to monetary stimulus, generally rallying on news that it will continue. The next FOMC monetary policy announcement is scheduled for September 18.

There are several sources of uncertainty creating headwinds for the financial markets as "the wall of worry" builds. Investors have grown more cautious in recent weeks, especially as they ponder the outlook for monetary policy, naming the successor of Fed Chairman Ben Bernanke, pending fiscal policy debates in Washington, weak economic growth in Europe and emerging markets, and rising geopolitical tensions. At Banyan Asset Management, we view such caution as healthy and are encouraged that investors are becoming more grounded with expectations. The correction needs to run its course, but longer-term, this pullback in stock prices is favorable. Stock prices eventually climb the wall of worry.

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 $114.91, which implies a price-to-earnings (P/E) ratio of 14.2 with the S&P 500 at 1633. The earnings yield (E/P) of 7.04% represents attractive value relative to the 10-year U.S. Treasury note yield of 2.75%. P/E has contracted in recent weeks as stock prices have declined. Still, for the rally in stocks to resume, earnings growth really needs to be the driver. P/E expansion is not the most robust way to grow stock prices.

The pullback in August is a nice start, but a bit more fear should allow for some even sweeter buying opportunities. Major U.S. stock indexes have fallen in an orderly fashion from their highs hit in early August. Examples include the S&P 500 down 4.5%, Dow Jones Industrial Average down 5.4%, and S&P 400 (Mid Cap) down 5.9%. Looking at the S&P 500, major support should exist around 1570 (June low). The 200-day moving average (currently 1562 and rising) should boost this support. Our market breadth indicator turned negative on August 19 and has been trending lower.

So far, our general approach in 2013 has been to enjoy the ride higher, while locking in a few gains along the way. We were called out of some stocks this year, while others we simply decided to sell. Should stocks decline in price, we would look to incrementally buy high quality companies with solid balance sheets that we believe are trading at a discount to fair value. If the stock market sees a more severe downdraft in the weeks ahead, we plan to be more aggressive with our incremental purchases. Successful portfolio management is less about predicting and more about planning.