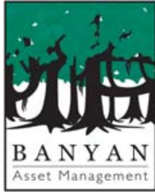

"Santa Claus To Visit Wall Street"

Market Commentary – December 2008

By Frank C. Fontana, CFA
President, Banyan Asset Management, Inc.
Written November 30, 2008 – www.banyan-asset.com

The preliminary reading of Gross Domestic Product (GDP) shows that the value of goods and services produced in the U.S. declined by 0.5% in the third quarter. Despite the clear slowdown in economic activity since the fourth quarter of 2007, the National Bureau of Economic Research (NBER) has still not officially declared a recession. The consensus among economists is that the U.S. economy is currently in one of the worst recessions since World War II. Unemployment hit 6.5% in October, the highest since March 1994. At the end of October, 3.84 million people were collecting unemployment insurance benefits, a 25-year high. Until consumers feel more comfortable about their job security, consumer spending, which makes up 70% of GDP, will likely remain under pressure.

The vacuum of leadership in Washington D.C. between the lame-duck Bush administration and the incoming Obama administration has fueled volatility in the financial markets. The stock market does not like uncertainty, especially regarding the federal government's changing approach toward easing the financial crisis. For example, the $700 billion Troubled Asset Relief Program (TARP) passed by Congress in October was initially intended to purchase troubled loans from banks, allowing banks to keep their good loans and thus get a fresh start. By November, TARP morphed into a capital injection program, with the government buying shares in banks. With the automotive industry on thin ice, other industries, and even municipal governments, are lining up to get some money from TARP. The federal government could regain some credibility on Wall Street by doing what they say they are going to do.

As the private sector deleverages (shrinks its debt), the federal government is leveraging its balance sheet (taking on debt) in an effort to encourage economic growth.

- The Federal Reserve is expected to lower the target Fed Funds rate another 50 basis points to 0.50% on December 16. It will likely also lower the discount window, which lowers the interest rates that banks pay to borrow from the Fed.
- The Treasury, Federal Deposit Insurance Corporation (FDIC), and Fed agreed to absorb much of the potential losses in Citigroup's $306 billion portfolio of mortgage-related assets.
- The Fed agreed to provide up to $800 billion to reduce mortgage rates and improve liquidity for the asset-backed securities market (auto, credit card, student, and small business loans).
- There is talk of another $500 billion stimulus package (in addition to the Treasury's $700 billion TARP), as President-elect Obama is looking to create 2.5 million jobs by spending on roads, bridges, schools, and clean-energy programs.
- The Fed has been buying high quality, short-term commercial paper from corporations.
- Through the Temporary Liquidity Guarantee program, the FDIC will guarantee through June 2012 all senior unsecured bank debt issued now through June 2009.

Technical factors of the market are bullish (more demand than supply), while fundamentals are attractively priced – therefore, we are bullish on the market. With the S&P 500 at 896.24 and using Standard & Poor's operating earnings forecast for the next 12 months of $77.69, the price-to-earnings (P/E) ratio for the S&P 500 is 11.5. The earnings yield (E/P) on the S&P 500 is 8.70%. Compared to the 10-year Treasury note yield of 2.92%, stocks are cheap. Technically, stocks have been trading sideways for the past six weeks. A positive divergence has developed in Banyan Asset Management's proprietary market breadth indicator, which suggests that sellers are being flushed out of stocks. Once December's traditional tax loss selling has eased, the market should be free to march higher in a Santa Claus rally.

Despite the bullish call for stocks, it is important to maintain a balanced approach toward portfolio management. Exogenous events, such as a terrorist attack in the U.S., are always possible. A balance of stocks and cash is an effective source of defense for a portfolio…just in case.