"Fork In The Road"
Market Commentary – April 2011

By Frank C. Fontana, CFA
President, Banyan Asset Management, Inc.
Written March 31, 2011 – www.banyan-asset.com

The third 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 3.1% in the fourth quarter of 2010. This is lower than the advance estimate of 3.2% and higher than the second estimate of 2.8%. According to a poll conducted by *The Economist*, U.S. GDP is projected to be 3.3% in 2011 and 3.2% in 2012. The Federal Open Market Committee (FOMC) announced in its statement on March 15 that "the economic recovery is on a firmer footing, and overall conditions in the labor market appear to be improving gradually". Indeed, the unemployment rate fell to 8.9% in February, which is the lowest level since April 2009. Unemployment peaked at 10.1% in October 2009 and was only 4.9% in April 2008. More jobs would likely be created if the economic recovery could gain more steam.

Monetary policy continues to medicate the economy with rock-bottom interest rates and the Federal Reserve's purchase of U.S. Treasuries. On March 15, the FOMC decided to keep its benchmark Fed Funds rate at a record low target range of 0% to 0.25% "for an extended period". The FOMC maintains that "longer-term inflation expectations have remained stable, and measures of underlying inflation have been subdued", despite also pointing out that "commodity prices have risen significantly since the summer, and concerns about global supplies of crude oil have contributed to a sharp run-up in oil prices in recent weeks". The next Fed decision on interest rates will be on April 27.

***CFA Magazine* recently featured an interview with demographic expert Richard Hokenson, who believes that world population could begin to shrink, which he says is causing a lack of inflation and a global "race to zero interest rates".** Hokenson states that if "you have an age structure where people don't borrow money (aging populations), it doesn't matter what the price of money is". In other words, the stimulative effect of low interest rates is minimized if people are not willing to borrow. Hokenson maintains that inflation is caused by money demand (a demographic issue), not money supply (controlled by central banks). "Since the population of the world is aging, reflation becomes less and less likely", according to Hokenson. In terms of economic growth, he states that "labor force growth is slowing…worldwide", and "that will continue to pull down nominal GDP and nominal interest rates".

Technical factors of the market are mildly 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 $96.23, which implies a price-to-earnings (P/E) ratio of 13.8 with the S&P 500 at 1326. The earnings yield (E/P) is currently 7.26%, which represents attractive value relative to the 10-year U.S. Treasury note yield of 3.45%. Earnings estimates and stock prices have stagnated over the past month.

As suggested in the March market commentary, a news catalyst did indeed trigger a sell-off in global stock markets (although we could have never predicted the exact event: the earthquake and tsunami in Japan on March 11). The stock market swooned on word of the tragic news. The S&P 500 bounced intraday at 1249 a few days later and has pushed higher ever since. While we were expecting investors to put cash to work and support stock prices, this bounce happened more quickly than we expected. Investors are encountering a fork in the road with respect to stock prices. On one hand, volume has been light on the recent rally in stock prices, indicating a lack of conviction behind the price action. Resistance overhead is around 1345 and 1375. On the other hand, equity valuations are not at bubble levels (despite what some of the doomsday pundits have been saying lately). Ample support exists below at the 50 day moving average at 1308, the March low at 1249, and the November high at 1225. Our April covered calls have been quietly melting. Depending on the portfolio, this may be an opportunity to lock in a couple of gains and sell some more covered calls with expirations maturing over the summer.