"Digesting 2013"

Market Commentary – April 2014

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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 2.6% in the fourth quarter of 2013. This is lower than the advance estimate of 3.2% and higher than the second estimate of 2.4%. In March, the Federal Open Market Committee (FOMC) revised its GDP projections. It now projects 2014 GDP at 2.8%-3.0%, 2015 GDP at 3.0%-3.2%, 2016 GDP at 2.5%-3.0%, and "longer run" GDP at 2.2%-2.3%. Compared with their December forecasts, the lower end of the forecast ranges were maintained, while the upper end of the ranges was reduced by 0.1% or 0.2%. The Fed envisions a U.S. economy that is growing in a slow, but steady fashion. While the level of GDP growth may not be that impressive, perhaps financial markets will be rewarded with lower variance in economic growth.

In her first post-FOMC press conference on March 19, Chair Janet Yellen revealed a juicy hint when interest rates may start to rise. Earlier that day the FOMC cut its $65 billion monthly bond-buying program by another $10 billion to $55 billion. Following the first $10 billion cut in December and the second $10 billion cut in January, this move was somewhat expected by financial markets. The more newsworthy event was at the press conference following the FOMC monetary policy announcement. When asked about how long of a gap we should expect between completion of the bond-buying program and the initial hiking of interest rates, Yellen said, "something on the order of around six months or that type of thing." Whether this nugget was strategically or accidentally revealed is irrelevant; the genie is out of the bottle. At this pace, it looks like interest rates may rise in early to mid-2015. In the meantime, it is important to remember that the Fed is still easing monetary policy by continuing to buy large amounts of Treasury and mortgage-backed securities each month.

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 $120.11, which implies a price-to-earnings (P/E) ratio of 15.5 with the S&P 500 at 1858. The earnings yield (E/P) of 6.47% represents attractive value relative to the 10-year U.S. Treasury note yield of 2.71%. There has been stabilization in expected earnings and stock prices in recent weeks.

Following a roughly 30% gain in the S&P 500 during 2013, 2014 has been relatively boring (so far). The S&P 500 is up 1.0% this year, including dividends. Annualizing this pace, the market is on target to earn a total return of 4%. At Banyan Asset Management, we find this market action encouraging. Big gains from 2013 need to be digested by market participants as a whole. This can be done with scary corrections that shake out the weak players, or with a market that grinds sideways for a period of time (also known as a "trading range"). The trading range outcome is relatively benign, but it can be frustrating for bullish investors who were spoiled by a previously skyrocketing market. The S&P 500 spent the month of March oscillating between 1840 and 1880. A move north of 1880 would resume the uptrend. Looking below, there should be plenty of support around 1750 due to the 200-day moving average and the February low.

There was an interesting change of character in the market during March. Some of the high flying stocks, especially as represented by the Nasdaq Composite Index, have pulled back sharply. Meanwhile, money has rotated into the more defensive stocks, which is what we tend to emphasize in our portfolios. It remains to be seen how long the hot stocks will stay cool, but it is more important to be consistent than focused on the flavor of the day. In a world that bombards us with risk, we need to always be alert to the potential dangers that may lurk around the corner. At the same time, we cannot be paralyzed by the presence of risk, and instead, we must embrace it. Investors, after all, get paid to take risk.