"This Too Shall Pass"

Market Commentary – February 2009

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According to the advance reading, Gross Domestic Product (GDP), a measure of the value of goods and services produced in the U.S., fell 3.8% in the fourth quarter. This is the worst contraction since the first quarter of 1982, when GDP plummeted 6.4%. For comparison purposes, the largest post-World War II drop in GDP was 10.4% in 1958. Consumers are struggling. Consumer spending, which makes up 70% of GDP, slid 3.5%. The Conference Board's consumer sentiment index is at the lowest level since recordkeeping began in 1967. Moreover, the number of people collecting unemployment benefits as of mid-January hit the highest level since recordkeeping began, also in 1967. Unemployment was 7.2% in December, the most since January 1993. On the business side of the equation, conditions are not any better. Business investing plunged 19.1%, the worst since 1975. Factoring out a rise in inventories, which resulted from goods produced but not sold, GDP fell by 5.1% in the fourth quarter.

The federal government is desperately trying to stimulate the economy any way that it can. The House of Representatives passed (and the Senate is now debating) an $819 billion fiscal package of spending and tax rebates. This plan is in addition to the Treasury's $700 billion Troubled Asset Relief Program (TARP). Separately, the Federal Reserve has implemented heavily accommodative monetary policy, with the target Fed Funds rate in a range of 0% to 0.25%. Moreover, the Fed has expanded its balance sheet to buy mortgage-backed bonds and commercial paper to help unfreeze credit markets.

While these programs are designed to stimulate the economy, one has to wonder how the U.S. plans to pay for all of these bailouts. With 10-year and 30-year Treasuries yielding a paltry 2.84% and 3.60% respectively, the U.S. can finance the new debt cheaply. What happens, though, if the world assigns diminishing credibility to debt that is backed by "the full faith and credibility of the U.S. government"? What if the Federal Reserve's quantitative easing plan of buying long-term U.S. Treasuries does not offset the lack of demand for Treasuries from the rest of the world? The bubble in U.S. Treasuries would burst, and the U.S. would be plagued by record debt and high interest rates to boot.

Technical factors of the market are mildly bullish (more demand than supply), while fundamentals are attractively priced – therefore, we are mildly bullish on the market. Benjamin Graham and David Dodd, considered the fathers of value investing, postulated that earning power is the most important factor in determining an asset's intrinsic value. In the current market environment, earnings estimates are being revised lower as companies adjust their businesses for a deleveraged global economy. How low earnings ultimately go is unknown. An important question for investors to ask, however, is: What will be a "new" normal level of earnings in a world that relies less heavily on borrowed money? Banyan Asset Management, Inc. believes that tremendous value has been created by this bear market. While it will take time for this value to translate into profits, we believe that eventually it will do so.

The major market indexes have managed to remain above the closing lows from November 2008, thus defining a critical support level. The S&P 500 is currently at 825, well above the closing low of 752 reached on November 20, 2008. The market seems to be in a trading range, albeit a large one, fluctuating between 752 and 935. Being toward the lower end of the range make us more bullish. A break below support, however, would suggest even lower stock prices to follow. Lower stock prices generate more value, which in turn creates opportunities for investors with cash liquidity.

We are staying true to our strategy of incrementally buying stocks at these low prices. While recent economic news is not favorable, human nature penalizes investors by causing them to feel fear when opportunities to make money are the greatest. Economic cycles are a natural part of capitalism. They are normal and healthy. Just as the end of a boom cycle must come, so must the end of a bust cycle. In the meantime, it is prudent for investors to be patient. After all, this too shall pass.