"Buying Low"

Market Commentary – November 2008

By Frank C. Fontana, CFA
President, Banyan Asset Management, Inc.
Written October 31, 2008 – www.banyan-asset.com

The advance reading of Gross Domestic Product (GDP), a measure of the value of goods and services produced in the U.S., declined by a seasonally adjusted 0.3% annual rate in the third quarter. This is the weakest GDP reading since the 1.4% decline in the third quarter of 2001. Consumer spending, which makes up 70% of GDP, dropped 3.1%, the worst since 1980. The Conference Board's Consumer Confidence Index hit 38, the lowest on record (going back to 1967). The debt-laden U.S. consumer is finally buckling. Economists forecast that fourth quarter GDP could decline by more than 3%, and contract even further in the first quarter of 2009. The National Bureau of Economic Research (NBER) has not officially declared a recession, but it is clear that the U.S. economy is currently in one.

While governments worldwide are doing all that they can to stop the financial meltdown, they cannot instantly alleviate the global hangover from the bursting of the real estate bubble. The U.S. federal government has been taking aggressive action to thaw the credit markets and get banks to lend:

- The Federal Reserve cut its benchmark Fed Funds rate by 50 basis points to 1.5% on October 8 in a globally coordinated surprise move by central banks. It then cut the rate by another 50 basis points to 1.0% at its regularly scheduled meeting on October 29. Futures markets forecast a Fed Funds rate of 0.64% in December, before rising to 1.10% by July 2009. The next scheduled interest rate decision is December 16.
- The Fed is buying high quality, 90-day short-term commercial paper from corporations to try to thaw the $1.5 trillion commercial paper market.
- As part of the $700 billion Troubled Asset Relief Program (TARP) bailout package, the U.S. Treasury announced plans to distribute $125 billion to nine major banks in exchange for ownership stakes. Curiously, instead of using the government help to loan out more money, "strong" banks are opting to use their new financial strength to acquire "weak" banks.
- The Federal Deposit Insurance Corporation (FDIC) will guarantee through June 2012 all senior unsecured bank debt issued now through June 2009. Year-to-date, 16 U.S. banks have failed.
- TARP may soon start buying distressed mortgage assets. The Treasury and FDIC are considering a program to offer $500 billion in guarantees for troubled mortgages. This may require lenders to restructure mortgages, lowering interest rates and requiring smaller principal amounts.

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 968.75 and using Standard & Poor's operating earnings forecast for the next 12 months of $83.57, the price-to-earnings (P/E) ratio for the S&P 500 is 11.6. Earnings estimates may prove too high, however; with more than half of the S&P 500 companies reporting, earnings are set to fall 24% versus a year ago. Looking back to 1937, the P/E for the S&P 500 has averaged 15.75. Despite the lack of clarity on future earnings, U.S. stocks are cheap. Ironically, we do not expect the election on November 4 to be a concern for the market.

On October 16, famed investor Warren Buffett wrote in *The New York Times* that he is buying U.S. stocks. According to Buffett, "A simple rule dictates my buying: Be fearful when others are greedy, and be greedy when others are fearful." There is plenty of fear in the financial markets these days. In order to buy, however, an investor must have had the discipline when times were better to keep ample cash on hand. This is exactly why we believe in maintaining a balance of stocks and cash. What the markets experienced in October was a textbook definition of "capitulation". Relentless selling drove the S&P 500 down 27.2% from September 30 to a closing low of 848.92 on October 27. Margin calls for hedge funds and mutual fund redemptions forced some money managers to sell at rock-bottom prices. Adding fuel to the fire, some individual investors let their emotions get the best of them and caused them to irrationally sell into the panic. According to our plan, depending on the client, we bought incrementally in October. As time passes and we identify more opportunities in the future, we plan to buy more stocks "on sale".