"Let The Taper Begin"

Market Commentary – January 2014

By Frank C. Fontana, CFA
President, Banyan Asset Management, Inc.
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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 4.1% in the third quarter of 2013. This compares to the advance estimate of 2.8% and the second estimate of 3.6%, which was released on December 5. It is fascinating to note how volatile the results are, represented by the huge swing from 2.8% to 4.1% based on "more complete source data". Remember that GDP readings are merely estimates. Digging into the 4.1% result, Q3 was not as strong as it may seem. The building of inventories, which is notoriously volatile and not sustainable, contributed 1.67 percentage points. Perhaps businesses are making products in anticipation of stronger sales. However, it is likely that this component of GDP will cool off rapidly in Q4 and beyond. More desirable sources of GDP growth include consumer spending and fixed investment.

On December 18, the Federal Open Market Committee (FOMC) announced the long-awaited tapering of its quantitative easing (QE) program. The FOMC reduced its $85 billion monthly bond-buying program by $10 billion to $75 billion. Assuming that future economic data is favorable, they expect further reductions in QE. Ironically, the stock market soared on news of the "feared" taper. Stock investors like that the uncertainty of the taper is out of the way. Moreover, the Fed is still likely going to continue QE for several more months; only the pace of bond purchases has been reduced. Plus, the FOMC kept its federal funds rate at a rock-bottom range of 0% to 0.25%. They anticipate keeping rates low until unemployment is well-below 6.5% (as long as inflation is below 2%). Unemployment was 7.0% as of November. The Fed sees unemployment at 6.3%-6.6% in 2014 and 5.8%-6.1% in 2015, so rate hikes may not be in store until 2015. Investors cheered the easy monetary policy by buying stocks.

Technical factors of the market are bullish (more demand than supply), while fundamentals are fairly 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 $117.52, which implies a price-to-earnings (P/E) ratio of 15.7 with the S&P 500 at 1848. The earnings yield (E/P) of 6.36% represents fair value relative to the 10-year U.S. Treasury note yield of 3.03%. Stocks have become less attractive as prices have soared faster than earnings and long-term Treasury yields have risen. In our discounted free cash flow to equity models, which we use to estimate the intrinsic value of a stock, we have been using 4.0% for the 10-year Treasury yield since May 2010. Our stock fair values are conservatively calculated.

Investors are less sensitive to risk as they pour money into stocks. In December, the S&P 500 barely pulled back to its 50-day moving average before rocketing higher. There is no resistance above since the index is at an all-time high. Support levels on the S&P 500 should exist around 1790 (50-day moving average), 1725 (September high), and 1680 (200-day moving average). At some point, this market needs to cool down. It seems reasonable that stock prices in 2014 will be choppier than 2013. Remember that the higher stock prices get relative to earnings, the riskier they become.

The steady trek of stock prices higher is looking eerily similar to 1987. A severe correction, perhaps on the order of 20%, would be a fantastic buying opportunity and may ironically represent the death of the secular bear market that extends back to 2000. Absent a crystal ball, it is difficult to anticipate if and when such a move may occur. Rather than predict such an event, we prefer to plan for the possibility. Our primary line of defense is our cash position, which includes cash sitting in a portfolio and/or future contributions into an investment account. More subtle forms of protection involve lining portfolios with low-beta stocks trading at attractive valuations, with healthy balance sheets and solid dividends. Such stocks are not as exciting to own, but with investing, sometimes boring is better.