"Ubiquitous Information"

Market Commentary – October 2010

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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. increased at an annual rate of 1.7% in the second quarter of 2010. This is slightly higher than the second estimate of 1.6% announced last month. On September 20, 2010, the National Bureau of Economic Research (NBER) officially declared that the recession, which began in December 2007, ended in June 2009. Lasting 18 months, this recession was the longest of any since World War II (the 1973-75 and 1981-82 recessions both lasted 16 months). By calling an end to the recession, the NBER means that an economic trough occurred in June 2009 and a recovery began. It does not mean, however, that the economy is back to normal. According to the NBER, "the trough marks the end of the declining phase and the start of the rising phase of the business cycle". The NBER made it clear that "any future downturn of the economy would be a new recession and not a continuation of the recession that began in December 2007". It is typical for the NBER to make economic calls many months after the fact (15 months after the fact in this case).

On September 21, the Federal Open Market Committee (FOMC) announced its decision to keep the benchmark Fed Funds rate at a record low target range of 0% to 0.25% "for an extended period". They are also going to continue reinvesting principal payments from its securities holdings. The Fed acknowledged that "the pace of recovery in output and employment has slowed in recent months". They added that "household spending is increasing gradually, but remains constrained by high unemployment, modest income growth, lower housing wealth, and tight credit". After commenting that inflation is lower than they would like, the Fed "is prepared to provide additional accommodation if needed to support the economic recovery and to return inflation, over time, to levels consistent with its mandate". Reading in between the lines, the Fed is more concerned with deflation than inflation. The next FOMC decision on interest rates will be announced on November 3.

At Banyan Asset Management, we have a hypothesis that ubiquitous information is magnifying the effects of human behavior in the realm of risk-based decision making. People are bombarded with information, much of which they do not know how to process. The large supply of news has encouraged a degree of sensationalism in order to attract followers. This feeds emotions which hinder an investor's ability to make solid decisions. Plus, with the Internet, there is an easy mechanism for someone to impulsively act on these emotions by hitting the buy or sell button. Prudent investors who squelch such emotions have a competitive advantage these days.

Technical factors of the market are bullish (more demand than supply), while fundamentals are attractively priced – therefore, we are bullish on the market. The Standard & Poor's forecast for S&P 500 operating earnings per share (EPS) over the next 12 months is $87.58, which implies a price-to-earnings (P/E) ratio of 13.1 with the S&P 500 at 1143. The earnings yield (E/P) is 7.66%, representing attractive value with the 10-year U.S. Treasury note at 2.53%. Despite a strong rally in stock prices in September, there is still plenty of upside potential before equity valuations become rich.

The trading range between 1025 and 1125 that has characterized S&P 500 price action during much of this year should reward investors with a significant floor for stock prices. Old resistance levels tend to become new areas of support. Now that the S&P 500 has broken above major resistance at 1125, it can look ahead to resistance at 1170 and 1210. Another bullish factor is that the 50 day moving average (1105) is close to crossing above the 200 day moving average (1118). In the short run, stock prices seem overextended and need to consolidate, but they should soon be ready to push higher. We believe this is still a cyclical bull market within a secular bear market. Investors should consider replacing stocks that have rocketed higher to near fair value with other stocks that are still cheap.