"Strong Balance Sheets"

Market Commentary – May 2010

By Frank C. Fontana, CFA
President, Banyan Asset Management, Inc.
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The advance estimate of Gross Domestic Product (GDP) indicates that the output of goods and services produced by labor and property located in the U.S. increased at an annual rate of 3.2% in the first quarter of 2010. This is the third consecutive quarter of economic growth. Consumer spending, which accounts for nearly 70% of GDP, rose at a solid 3.6% pace. Economists are concerned that economic growth will slow in the second half of 2010 as fiscal and monetary policy are gradually tightened. With unemployment at 9.7%, near a 26-year high, businesses are not hiring enough people to lower the unemployment rate. Overall, while acknowledging that "most indicators have turned up", the National Bureau of Economic Research (NBER) has not officially declared the end of the recession that began in December 2007.

On April 28, 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". While interest rate decisions make headlines for the Federal Reserve, another important area to watch is the reduction of the Fed's portfolio of more than $1 trillion in mortgage-backed securities. The Fed wants to go back to holding only government bonds on its balance sheet, but it must be careful in doing so. If the Fed dumps too many mortgage-backed securities on the market too quickly, mortgage rates could skyrocket and the feeble housing market recovery would stumble. On the other hand, maintaining stimulus when the market no longer requires it could fuel inflation. For now, the Fed has stopped buying mortgage bonds and is keeping silent on its plans to liquidate its huge portfolio.

As we are researching stocks in each industry to update our universe of stocks, which is our primary source of investment ideas for individual stock portfolios, we are observing some favorable patterns. In general, corporations are in healthy shape. Income statements have turned profitable, and these profits are backed by positive cash flow from operating activities. Also, balance sheets are strengthening. Companies that were frugal during the economic downturn are now finding that cash is accumulating. They have a choice of what to do with this cash: keep it for a rainy day, pay down debt, pay dividends, buy back stock, or fund an acquisition. The first four options are favorable for stockholders, while the fifth option depends on the details of a particular acquisition. The allocation of this cash should help stock prices in the coming months.

Technical factors of the market are mildly bearish (more supply than demand), while fundamentals are attractively priced – therefore, we are mildly bearish on the market. The Standard & Poor's forecast for S&P 500 operating earnings per share (EPS) over the next 12 months has jumped up to $83.97, which implies a price-to-earnings (P/E) ratio of 14.1 with the S&P 500 at 1187. The earnings yield (E/P) is 7.07%, representing attractive value with the 10-year U.S. Treasury note at 3.66%. With 172 of the S&P 500 companies reporting 2010 first quarter results, 83% of companies beat earnings expectations (compared with an average of 61%). Most impressively, these strong earnings are being generated by revenue growth rather than cost-cutting alone. Strong same-store sales gains with retailers confirm that consumers are spending money despite the bleak employment outlook.

The short-term overbought situation for stock prices has only been made worse in recent weeks, thus causing us to expect a mild correction soon. As stock prices made a new high in April, market breadth failed to do so. Market technicians often look for such divergences to anticipate reversals. Stock market volume on recent down days has been high, suggesting that stocks are being distributed rather than accumulated. In the medium-term, stock prices in general are attractive and we therefore still believe that there is more upside potential for this cyclical bull market. In the long-term, the stock market will need to deal with high unemployment, fiscally-challenged state and federal governments (in the U.S. and abroad), and possible inflation; hence our hypothesis that the secular bear market is still in effect.