"Competitive Advantage"

Market Commentary – March 2016

By Frank C. Fontana, CFA
President, Banyan Asset Management, Inc.
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The second 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 1.0% in the fourth quarter of 2015. This is slightly stronger than the 0.7% advance estimate. Minutes from the Federal Open Market Committee (FOMC) meeting at the end of January showed that the Fed struggled with uncertainty about the outlook for inflation and growth. Declining stock and oil prices, doubts about growth in China, declining inflation expectations, and other factors have caused some Fed officials to consider delaying future interest rate hikes. Futures project the federal funds rate increasing to 0.5% by October 2016. Interestingly, futures do not foresee 0.75% on the federal funds rate until April 2018. The next FOMC decision on monetary policy is scheduled for March 16.

While the U.S. Federal Reserve is looking to raise interest rates, other global central banks have been actively easing their respective monetary policies. In Japan and Europe, interest rates have actually turned negative. This means that instead of *receiving* interest, the investor/depositor has to *pay* interest to hold his/her cash. On the surface, this may seem unrealistic, but it shows that investors are more concerned with return *of* capital than return *on* capital. In his typical folksy style, Warren Buffett commented today, "We would be better off with a big mattress in Europe that we just stick all this stuff in, if I could just find a person I trusted to sleep on that mattress." Overall, central banks are engaging in an economic experiment, the outcome of which is unknown. Only time will reveal the ultimate success of these monetary decisions.

Technical factors of the market are 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 is $119.17, which implies a price-to-earnings (P/E) ratio of 16.2 with the S&P 500 at 1,932. The earnings yield (E/P) of 6.17% represents attractive value relative to the 10-year U.S. Treasury note yield of 1.74%. Earnings estimates have been coming down as the outlook for economic growth has become more tepid. At the same time, Treasury rates have fallen, too, as investors have bid up the prices of Treasuries in a "flight to safety". The bubble in the sovereign debt market is ballooning, which makes stocks relatively more attractive.

After testing the January 2016 low of 1,812 in February, the S&P 500 experienced a relief rally to around 1,950. This level corresponded to the 50-day moving average. While possible, it is unlikely that the S&P 500 will trade above the 200-day moving average, currently at 2,025, anytime soon. There is considerable resistance above. At the same time, an area of support has formed between 1,810 and 1,850 on the S&P 500. Another dip to that area could be met with a new round of buying, thus introducing a new trading range. It is also possible that the index could break to new lows, which could ultimately end around 1,500 on the S&P 500. This area corresponds to the index highs from the years 2000 and 2007, and it represents our worst-case scenario for this decline.

A refresher course on the importance of cash in a portfolio is in order, especially since it is rarely understood. At Banyan Asset Management, we view cash as a conservative way to short the market. For example, a portfolio that is 60% stocks and 40% cash has tremendous buying power to materially capitalize on lower stock prices. On the other hand, a portfolio that is 98% stocks and 2% cash will feel considerable pain in a stock market decline and low-priced stocks cannot meaningfully be added to the portfolio. Moreover, the investor in the fully-invested portfolio is more likely to succumb to fear, thus panicking and selling at the wrong time (i.e., the bottom). There are three strategic reasons for cash in a portfolio: 1) cash is not subject to stock market risk; 2) with cash, an investor has money ready to buy stocks when they are cheap; and 3) cash allows an investor to remain more logical when others are falling victim to their own psychology. Competitive advantage is critical…don't you agree?