“Unintended Consequences”
Market Commentary – June 2009

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The preliminary reading of Gross Domestic Product (GDP) shows that the value of goods and services produced in the U.S. fell by 5.7% in the first quarter of 2009. On a positive note, U.S. corporate profits rose by $42.6 billion to $1.307 trillion in the first quarter, the first increase after six consecutive quarterly declines. Consumers are feeling a bit more chipper. The University of Michigan Consumer Sentiment Index hit 68.7 in May, the highest since September 2008. Consumer spending accounts for approximately 70% of GDP.

The U.S. Treasury market is already highlighting some of the unintended consequences of the government’s aggressive stimulus program. In December 2008, the 30-year Treasury bond yielded only 2.55%. As of Friday, it had jumped up to 4.34%. As bond yields move up, bond prices move down. U.S. Treasuries are being sold despite the Federal Reserve’s commitment to buy up to $300 billion in Treasuries in an attempt to prop up prices and keep interest rates low. The benign interpretation of such selling implies that investors who were scared of any investment not government backed have reversed course, sold their Treasuries, and have bought riskier investments again. The malignant interpretation, however, is that investors now fear that the U.S. has mortgaged its future to such an extent that the world will assign higher risk to the theoretically “risk free” U.S. Treasuries. If this turns out to be the bursting of the U.S. Treasury bubble, the U.S. government will face a difficult challenge of fighting inflation and higher interest rates without throwing the U.S. economy back into a severe recession. Higher yields on Treasuries create higher interest costs while the U.S. deficit is expected to hit $1.845 trillion this year. They could also push up other interest rates, hurt the real estate market again, and slow the economy.

At Banyan Asset Management, Inc., our working hypothesis is that the stock market will experience a cyclical bull market within a secular bear market. Cyclical trends usually have a duration lasting from several months to a few years. Secular trends last much longer, on the order of 10 to 20 years. In recognition of the government’s expansive stimulus, the stock market bottomed in early March and has not looked back. It seems that the stock market has entered a cyclical bull. The secular bear market, however, began in September 2000 for the S&P 500 when it peaked at 1530. We acknowledged this secular bear in our January 2005 Market Commentary. More than four years later, the secular bear still growls. For the secular bear to come to an end, the government will need to deleverage and balance its budget without the private sector leveraging itself again. In other words, the economy will have finally digested the excess debt that plagues it today.

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. When we updated our universe of stocks in mid-April, we identified about 250 companies with strong balance sheets and solid cash flow. With interest rates still relatively low, our discounted free cash flow models generally show that the stocks we are valuing are trading below their intrinsic value. On the technical side, our market breadth indicator slipped into negative ground on May 27, the first negative reading since March 24. Volume is tapering off as this rally of nearly three months gets winded.

Having sold some covered calls between late March and early May, we plan to “buy the dip” should the market pull back. If the market does not pull back, we will enjoy the ride up and sell more covered calls into strength. So far, our use of covered calls has proven profitable. Our May calls expired worthless, which is favorable for our portfolios. Other covered calls are laddered to mature between June and September. In addition to juicy call premiums, our portfolios also collect healthy dividends. The income component helps sweeten the overall total return.