“Fear Presents Opportunity”
Market Commentary – August 2011

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The advance 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 1.3% in the second quarter of 2011. Consumer spending, which accounts for roughly 70% of GDP, grew an anemic 0.1% in 2011 Q2. The unemployment rate rose 0.1% to 9.2% in June. As a rule of thumb, economic growth of at least 3% is needed to create jobs. Households are stretched with debt; *The Wall Street Journal* reported that household debt levels are 112% of annual income (much higher than the 1990s ratio of 84%). According to the University of Michigan consumer confidence survey, only 20% of households feel they will be better off financially in a year. Previous GDP calculations were revised, lowering the 2011 Q1 measurement from 1.9% to a paltry 0.4%, and revealing that the recession was more severe than originally thought. Some economists are concerned that the economy may dip back into recession.

Fiscal policy has ignited fear on Wall Street, Main Street, and across the globe as the United States faces a potential default on its debt. On August 2, the U.S. will “max its credit card”, having borrowed the limit of $14.3 trillion. If the debt ceiling is not raised by August 2, the U.S. will default on its debt. This would likely cascade throughout the financial markets as an economic tsunami. While politicians in Washington D.C. recognize the seriousness of a default, they are locked in a heated debate about the best way to proceed. With the government spending more money each year than it has coming in, it is only a matter of time before higher debt ceilings are reached, as well. Therefore, a source of debate is how to curb deficits going forward. While it is certainly possible that stubborn politicians fail to agree and drive the fiscal car over the cliff, Banyan Asset Management views this scenario as unlikely.

While a default is not likely, a downgrade of the U.S. credit rating is more realistic. The U.S. enjoys a pristine “AAA” credit rating from Standard & Poor’s, along with the equivalent highest ratings from the other major agencies. The possibility of a U.S. credit rating downgrade has been well-telegraphed to the financial markets. Some of this is baked into the financial picture, but it is unclear exactly how a downgrade will affect the economy in the U.S. and worldwide. S&P warned that a debt downgrade could cause interest rates to jump by 0.25%-0.50%. Higher borrowing costs would in turn weigh on economic growth. With or without a downgrade, a lack of clarity about the economic and political environment will likely make consumers and businesses more cautious about spending.

Technical factors of the market are mildly bullish (more demand than supply), while fundamentals are attractively 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 $106.23, which implies a price-to-earnings (P/E) ratio of 12.2 with the S&P 500 at 1292. The earnings yield (E/P) is currently 8.22%, which represents attractive value relative to the 10-year U.S. Treasury note yield of 2.81%. Corporate profits (and balance sheets) are robust. Value has been built into the stock market as stock prices have chopped sideways in recent months while earnings have continued to climb.

With all of the negative news lately, it might be surprising to step back and realize that the S&P 500 sits only 5% below its 2.5-year high. The index has essentially been range-bound since February. The 200 day moving average, which continues to gently rise, is providing support at 1285. Below this, support levels include 1260 (June 2011 low), 1250 (March 2011 low), and 1225 (November 2010 high).

Our balanced approach places our portfolios in a favorable position given this uncertain environment. Fear is high and earnings are strong; therefore, we would rather press down on the gas pedal than apply the brakes. Depending on the client, we have been an incremental buyer of stocks in recent weeks. We also sold a few covered calls when the market was approaching resistance. If the stock market drops from here, we would look to incrementally buy more shares at even lower prices.