"Buying On Weakness"

Market Commentary – November 2009

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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. grew by 3.5% in the third quarter of 2009. This is the first expansion of the economy since the second quarter of 2008. However, economists are concerned that this growth was induced by government stimulus and will thus be fleeting. Third quarter GDP benefitted from "cash for clunkers" and a first-time homebuyer's credit designed to spur sales of autos and houses. Such programs tend to boost sales today at the expense of sales tomorrow, so third quarter GDP likely overstated the strength underlying the economy. Unemployment is 9.8%, a 26-year high. Still, it seems that the economy is out of the recession. The National Bureau of Economic Research (NBER) will officially let us know that the recession is over many months after the fact.

The Federal Open Market Committee (FOMC) is expected to announce on November 4 its decision to keep its benchmark Fed Funds rate at a record low target range of 0% to 0.25%. Futures markets are pricing in a Fed Funds rate of 0.5% by July 2010, 1.0% by November 2010, and only 2.0% by August 2011. Market participants believe the Fed's statement that rates will stay in this low range "for an extended period". However, as the Fed and Congress gradually tighten monetary and fiscal policies, the economy will battle headwinds. There is a serious risk that the economy could slip into recession again. Should this happen, our expectation is that the recession would be mild. The likely scenario is a prolonged period of stagnant growth. It will take time for the economy to digest the excess debt that plagues it today. Moreover, the government will need to deleverage and balance its budget without the private sector leveraging itself again.

Our working hypothesis continues to be that the stock market is experiencing a cyclical bull market within a secular bear market. The cyclical bull market began in March 2009. Assuming that the 10-year U.S. Treasury note stays below 4%, valuations suggest that there is more upside ahead with this cyclical bull market with a reasonable margin of safety on the downside. However, as stocks become more richly priced and the economy slowly works its way through the shockwaves of the collapsed real estate bubble, stock prices may get stuck in a range. This would be an excellent environment for buying stocks at support levels, collecting dividends, and selling covered calls near resistance levels.

Technical factors of the market are bearish (more supply than demand), while fundamentals are attractively priced – therefore, we are mildly bearish on the market. With 37% of the S&P 500 reporting, third quarter earnings have faired well so far. Moreover, the story is not just about cost-cutting; there is some revenue growth. More than 71% of the companies reporting beat analysts' consensus operating earnings estimates, and 43% announced higher earnings than a year ago. Revenue growth has been reasonable with nearly 64% of companies beating estimates and almost 27% having higher revenue than last year. Analysts' earnings estimates for the next year are on the rise, although the range of forecasts is widening as analysts disagree on the details. Standard & Poor's expects operating earnings per share (EPS) to be $70.64 for the S&P 500 over the next 12 months (versus a forecast of $64.21 last month). The forecast implies a price-to-earnings (P/E) ratio of 14.7 with the S&P 500 at 1036.

At Banyan Asset Management, our breadth indicator slipped into negative territory, suggesting there may be some short-term selling pressure in the stock market. We interpret this as an opportunity to put more cash to work in this cyclical bull market. Having been called out of a few stocks in September and October, our portfolios have some extra buying power. It is important to not chase the low quality "high fliers" that have soared to expensive prices in the cyclical bull market. Instead, our preference is to put cash to work incrementally by buying high quality stocks that are still on sale. In the meantime, premiums on November and December calls continue to melt in our favor, and our portfolios are quietly collecting healthy dividends.