"The Test"

Market Commentary – March 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 6.2% in the fourth quarter. The preliminary reading is even worse than last month's advance reading of a 3.8% decline. The U.S. is in the largest contraction since 1982, when GDP fell 6.4%. Moreover, this time the economic decline is worldwide, with GDP down 12% in Japan, down 5.9% in Europe, and down 5.9% in the U.K. A risk of globalization is the apparent increased correlation between economies, thus resulting in less benefit from global diversification. In a negative feedback loop, consumers are cutting spending, and companies in turn are slashing jobs and production. While it is unclear when this recession will end, growth will eventually win.

Using a poker analogy to describe the U.S. government fiscal and monetary response, famed investor Warren Buffett described the Treasury and Federal Reserve as "all in". Fed Chairman Ben Bernanke commented that "to break (the) adverse feedback loop, it is essential that we continue to complement fiscal stimulus with strong government action to stabilize financial institutions and financial markets". In addition to the Treasury's $700 billion Troubled Asset Relief Program (TARP), the Treasury and the Federal Reserve are planning a $1 trillion program to energize the asset-backed securities market for consumer and business loans. As well, up to $1 trillion would be used for a public-private investment partnership to buy distressed assets from bank balance sheets. President Obama recently signed into law a $787 billion stimulus plan, the largest spending bill in U.S. history. The plan includes $280 billion in tax cuts and $507 billion in spending. The Obama administration estimates the 2009 budget deficit at $1.75 trillion, and hopes to cut it to $533 billion by 2013. There is a high probability that tax rates for many Americans, especially the wealthiest ones, will be heading higher.

Carnage from this bear market has been spread across all market capitalizations, hitting value a bit more than growth. The following analysis shows the percent declines from the market peak, which were reached between July and October of 2007. The declines are presented in the format of (overall index, value component of index, growth component of index): S&P 500 Large Cap (-53.0%, -59.5%, -46.6%), S&P 400 Mid Cap (-51.5%, -54.7%, -49.5%), S&P 600 Small Cap (-53.7%, -56.2%, -52.7%).

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. Debt magnifies both profits and losses. The business world is becoming more deleveraged as debt is evaporating from corporate and personal balance sheets. When the economic pendulum eventually swings back toward growth, earnings will likely not be as high as they were in the leveraged world. They should still be robust, however, and they should be higher than current levels. In the short-run, earnings estimates seem to be on the decline. In the long-run, however, tremendous value has been created by this bear market.

Bulls and bears are in a massive tug-o-war, as the major market indexes are testing the closing lows from November 2008. The S&P 500 is currently at 735, slightly below the November closing low of 752. A slight breach of support is acceptable to technicians, but a close much below 735 would suggest yet another leg down. Volume on recent down days for the S&P 500 has been high, a sign that investors are capitulating again (i.e. throwing in the towel). Surprisingly, a sharp rally could ignite at any time.

As the market tests its November lows, investors' emotions are also being tested. To profit in the stock market, investors want to buy low and sell high. This formula makes sense, but it is easier to say than to implement. Logically, there is a "50% off" sale in the stock market right now. Psychologically, investors are afraid they are buying damaged goods. Banyan Asset Management, Inc. believes that the opportunities resulting from this bear market occur only once every few decades and, in general, we are incremental buyers at these prices.