"Tired"

Market Commentary – June 2015

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Written May 31, 2015 – www.banyan-asset.com

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. decreased at an annual rate of 0.7% in the first quarter of 2015. This is lower than the advance estimate of +0.2% growth and much lower than +2.2% in 2014 Q4. Two categories seem to explain most of the change between the advance and second estimates: inventories (+0.33 percentage point in second estimate vs. +0.74 percentage point in advance estimate) and net exports (-1.90 percentage points vs. -1.25% percentage points). It is not necessarily a bad thing that companies are cooling it with building inventory, and the net export reading is a direct function of the strong U.S. dollar (thanks to the Federal Reserve's monetary policy relative to those of central banks around the world). The Fed itself views the Q1 GDP reading as being affected by "transitory" factors. Excuses aside, at some point we must recognize a negative value for what it is.

Financial markets are watching the Federal Reserve closely for signs that interest rates are heading higher. Fed funds futures are projecting a slow increase, pricing in a federal funds rate target of 0.5% by April 2016 and 1.0% by December 2016. The next Federal Open Market Committee announcement on monetary policy is scheduled for June 17. Interestingly, Federal Reserve Chair Janet Yellen said on May 6 that "equity market valuations at this point generally are quite high" and warned of "potential dangers". This brings back memories of former Fed Chair Alan Greenspan, when, in late 1996, he famously described stock prices as exhibiting "irrational exuberance". It should be noted that stock prices continued to rise until early 2000. We are interpreting Yellen's comments that the Fed is concerned about the side effects of central bank policies, which include asset prices that move ahead of reality.

We are humbled that a major investor apparently shares our concern about the bond market bubble: Warren Buffett. During an interview on CNBC on May 4, Buffett warned that buyers of bonds at these paltry yields will get hurt when interest rates rise. He said, "If I had an easy way, and a non-risk way, of shorting a whole lot of 20- or 30-year bonds, I'd do it. But that's not my game, and it can't be done in the kind of quantity that would make sense for us. But I think that bonds are very overvalued, I'll put it that way." Remember that in the bond world, yields and prices move in opposite directions. Rock-bottom bond yields these days correspond to sky-high bond prices.

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 $124.92, which implies a price-to-earnings (P/E) ratio of 16.9 with the S&P 500 at 2,107. The earnings yield (E/P) of 5.93% represents attractive value relative to the 10-year U.S. Treasury note yield of 2.10%. Our assessment of fundamentals as being attractively priced is a function of current low interest rates. Yellen's assessment of high valuations is likely from the perspective of more normalized interest rates.

Just when the stock market looks like it is going to cave in, buyers crawl out of the woodwork to prop prices back up again. Despite volatility on a day-to-day basis, stock prices overall are simply treading water. The S&P 500 did close at an all-time high of 2,130 on May 21, but the push higher did not result in a "breakout" (a significant jump up after breaking through resistance). We take this as a clue stock investors are tired, which in turn gives us caution.

Generally speaking, we are being protective of our cash positions, but we are not running to the hills and selling aggressively. There are certainly some companies that look attractive (cheap valuations, strong balance sheets, high dividend yields, and low betas). However, market risk has us concerned. We have been diligent over the past year in selling stock positions with valuations that have become too rich. Our balanced position should keep us nimble.