"Resilient"

Market Commentary – May 2011

By Frank C. Fontana, CFA
President, Banyan Asset Management, Inc.
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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 1.8% in the first quarter of 2011. This is lower than the fourth quarter's reading of 3.1%, indicating that economic growth decelerated in early 2011. The Federal Reserve recently lowered its projection for 2011 GDP growth from 3.4%-3.9% to 3.1%-3.3%. Consumer spending, which accounts for approximately 70% of GDP, grew at an acceptable 2.7% rate in the first quarter. The unemployment rate inched lower to 8.8% in March, but it remains well above the Fed's long term forecast of 5.0%-6.0%. Overall, the Federal Open Market Committee (FOMC) stated on April 27 that "the economic recovery is proceeding at a moderate pace and overall conditions in the labor market are improving gradually."

The Federal Reserve has signaled the end of an easing in monetary policy, but a tightening is still not yet on the horizon. The Federal Reserve announced that it will complete its $600 billion purchase of longer-term U.S. Treasuries in June, as originally planned. While new Treasury purchases will end, the Fed does plan to continue to reinvest principal payments as existing holdings mature. In terms of interest rates, the FOMC decided to keep its benchmark Fed Funds rate at a record low target range of 0% to 0.25% "for an extended period". In a first-ever Federal Reserve press conference held on April 27, Fed Chairman Ben Bernanke said "there would be a couple of meetings probably before action". The futures market does not expect drastic changes anytime soon, as market participants are pricing in only a 0.5% Fed Funds rate by June 2012. When the Fed does eventually tighten monetary policy, it will likely be a combination of raising short-term interest rates and trimming the Fed's bloated balance sheet (which expanded from about $900 billion in 2008 before Lehman Brothers failed to $2.7 trillion today).

On April 18, Standard & Poor's kept the credit rating for U.S. government Treasury securities at a pristine AAA level, but warned investors by lowering its outlook from "stable" to "negative". If S&P ends up downgrading the U.S. credit rating from AAA, the next highest credit rating is AA+. A credit rating downgrade would lead to higher interest rates for U.S. Treasury securities. Since Treasuries are a benchmark for various borrowing rates, those rates would rise, too. S&P cited a "material risk" that budget challenges would not be resolved by government leaders. It would be wise for politicians to heed this shot across the bow and get the country's fiscal house in order before a crisis erupts. According to *Barron's*, last year in a report called "Federal Debt and the Risk of a Fiscal Crisis", the bipartisan Congressional Budget Office warned that "a growing level of federal debt would…increase the probability of a sudden fiscal crisis, during which investors would lose confidence in the government's ability to manage its budget…." The U.S. would then "lose its ability to borrow at affordable rates".

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 $100.10, which implies a price-to-earnings (P/E) ratio of 13.6 with the S&P 500 at 1364. The earnings yield (E/P) is currently 7.34%, which represents attractive value relative to the 10-year U.S. Treasury note yield of 3.30%. Earnings estimates have been marching higher in recent weeks and stock prices have followed.

The cyclical bull is still in control of stock prices. The resilience of the stock market has been phenomenal. Bad news is being ignored. Earnings are growing. Stock prices, in general, are rising. Still, it is prudent for investors to be vigilant for possible signs of fatigue. Volume, which technicians commonly utilize to gauge conviction in a market move, has been light since September 2010. There is plenty of resistance overhead at 1375 and 1410. (There is also plenty of support below at 1345, 1305, and 1255.) Some stock prices are getting ahead of reality. Indeed, we took the opportunity to sell a few stocks in April. We would rather rotate into other stocks that represent better values.