"Bipolar Mr. Market"
Market Commentary – January 2012

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The third 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 third quarter of 2011. This is lower than the second estimate of 2.0%, but still higher than 0.4% in 2011 Q1 and 1.3% in 2011 Q2. According to the U.S. Bureau of Economic Analysis (BEA), the following percentages of GDP were attributable to consumer spending, government spending, gross investment, and net exports, respectively, in 2011 Q3: 71.1%, 20.1%, 12.6%, and -3.7%. Interestingly, historical data from the BEA shows that back in 1982 Q1, percentages for the same four categories were as follows: 63.3%, 20.7%, 16.5%, and -0.5%. Consumer spending has been a stable, consistent driver of GDP for many years. With foreclosures weighing on home prices and a lackluster job market (8.6% unemployment in November), a spark in the U.S. consumer is needed to ignite economic growth.

According to their statement released on December 13, the Federal Open Market Committee (FOMC) hopes to stimulate economic growth with monetary policy. The FOMC maintained that its benchmark Fed Funds rate will remain in a range of 0% to 0.25% through mid-2013. Moreover, they continued to extend the average maturity of their securities holdings (also known as "Operation Twist"). The next FOMC decision on monetary policy is scheduled for January 25.

"Mr. Market", the fictional character created by legendary value investor Benjamin Graham to describe market movements, is showing his bipolar tendencies regarding news out of Europe. Fear and greed cause Mr. Market to drive valuations to extremes, which are not justified logically. Mr. Market represents the cumulative psychological thoughts of market participants, who individually tend to be emotional. Over the past several months, Mr. Market has been extremely sensitive to news out of Europe. We have observed strings of days where the stock market is down significantly on fears that the European debt crisis is spiraling out of control. Skyrocketing yields on government debt in Greece, Italy, Spain, and Portugal suggest that levels of debt are not sustainable, leading to the panic selling of stocks. Then, out of the blue, we get surprise favorable news and the market reverses course. Ubiquitous information seems to magnify the bipolar trait of Mr. Market, which provides opportunity for investors who do their own analysis and remain logical.

Technical factors of the market are bullish (more demand than supply), while fundamentals are attractively priced – therefore, we are bullish on the market. The Standard & Poor's forecast for S&P 500 operating earnings per share (EPS) over the next 12 months is $102.81, which implies a price-to-earnings (P/E) ratio of 12.2 with the S&P 500 at 1258. The earnings yield (E/P) is 8.18%, which represents attractive value relative to the 10-year U.S. Treasury note yield of 1.87%. A 40-year chart that recently appeared in *Barron's* shows the spread between the earnings yield and 10-year Treasury as the largest since 1974 (the low of a major bear market). This is bullish for stocks.

At Banyan Asset Management, our technical analysis suggests a possible breakout to the upside for the S&P 500. The index is in an "ascending triangle", defined by a series of higher lows in October, November, and December met with firm resistance around 1265. The 200 day moving average is now 1259, contributing to resistance. Adding to the bullish pressure, the 50 day moving average is at 1237 and ascending. Market breadth (which compares advancing stocks to declining stocks) is accelerating, which also hints at a breakout to the upside. The next area of resistance is around 1350.

This bullish call should not be interpreted by investors as a green light to ignore their risk profile. It is important to maintain defense. Our hypothesis continues to be that stocks are in a secular bear market, likely to continue for several more years. As the debt bubble is digested over time, those who planted investment seeds when others were afraid may be pleased with what the seeds have grown into.