"Transitory High Prices"

Market Commentary – May 2015

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 0.2% in the first quarter of 2015. This is a significant drop from 2.2% in 2014 Q4 and re-emphasizes the choppiness that has plagued this economic recovery since 2009. Looking into the components of Q1 GDP, consumer spending contributed +1.31 percentage points to GDP (mediocre). Investment added only +0.34 percentage point to GDP, which includes +0.74 percentage point from inventory building. If you subtract inventory building from the overall investment figure, the drop of -0.40 percentage point is the worst reading since 2009 Q2. Businesses are cutting back on investment and accumulating inventory…not what we want to see if we are rooting for strong economic growth. Net exports subtracted -1.25 percentage points from GDP, an expected consequence of the strong dollar. Government spending weighed on GDP by -0.15 percentage point (not a concern). Overall, the GDP report is alarming as consumers and businesses are reigning in spending.

The Federal Reserve believes the slowdown in economic growth during the winter months reflects, in part, "transitory" factors. This is a fancy way to "blame it on the snow". By communicating that economic growth is likely to rebound, a hike in interest rates is still on the table. It is important to remember that the Fed's accommodative monetary policy consists of low interest rates and quantitative easing. While the Fed is no longer adding to its massive $4.5 trillion balance sheet, they are reinvesting principal payments from their maturing bond holdings. This has resulted in the Fed's balance sheet plateauing near its current level since the end of October 2014 when it "ended" QE. When it eventually decides to unwind its balance sheet, the Fed will stop the reinvestment of principal payments from maturing bond holdings. This will likely result in lower bond prices and higher yields. We anticipate dealing with this hangover for many, many years. The next Federal Open Market Committee decision on monetary policy is scheduled for June 17.

Technical factors of the market are bearish (more supply than demand), while fundamentals are attractively priced – therefore, we are bearish on the market. The Standard & Poor's forecast for S&P 500 operating earnings per share (EPS) over the next 12 months is $121.27, which implies a price-to-earnings (P/E) ratio of 17.2 with the S&P 500 at 2,086. The earnings yield (E/P) of 5.81% represents attractive value relative to the 10-year U.S. Treasury note yield of 2.05%. If the 10-year Treasury was yielding something on the order of 4% (which we are using in our valuation models, by the way), current stock prices would not be nearly as compelling. The attractiveness of stocks' earnings power is directly related to interest rates.

Stocks have been treading water in recent months as investors engage in a massive tug of war. The S&P 500 met resistance near 2,115 in February, and this level was tested again last week. Assuming that a breakout above 2,115 is not in the cards, the S&P 500 should find a degree of support near 2,040 from the March low and 2,026 from the 200-day moving average. Should those areas of support fail, the shift in momentum could drive the S&P 500 down to 1,850 (the October 2014 low). Longer-term, it would not be surprising to see the S&P 500 around 1,500. This was an area of major resistance in the years 2000 and 2007. When the index broke out above this area in 2013, it did not look back. A successful test of old resistance as future support would be a very bullish sign for stocks (at that level) and would be proof that the secular bear market is dead.

While the U.S. stock market is not in a bubble, one has formed in China's stock market. The Shanghai Composite, having sat around 2,050 in July 2014, rallied to 3,250 by March 2015. Over the past six weeks, it has skyrocketed to 4,442. With China's economic growth slowing, their central bank is pumping up stocks. Watch the Chinese stock market for a sign of what happens when a bubble bursts.