"Balance Sheet Recessions"

Market Commentary – January 2011

By Frank C. Fontana, CFA
President, Banyan Asset Management, Inc.
Written December 31, 2010 – www.banyan-asset.com

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 2.6% in the third quarter of 2010. This is higher than the second estimate of 2.5% announced in November. GDP is calculated as the sum of consumer spending (70.3% of GDP in 2010 Q3), business investment (12.9%), government spending (20.5%), and net exports (-3.7%; negative because imports were greater than exports). Consumer spending, which clearly makes up the bulk of GDP, faces headwinds created by high levels of personal debt, declining home values, and slow wage growth. While GDP is growing, it is not expanding at a fast enough clip to reduce the unemployment rate from 9.8%. It will not help matters if cash-strapped state and local governments are forced to cut back spending and shed jobs in 2011.

On December 14, the Federal Open Market Committee (FOMC) announced its decision to keep the benchmark Fed Funds rate at a record low target range of 0% to 0.25% "for an extended period". They are also going to continue reinvesting principal payments from its securities holdings and will keep buying about $75 billion in Treasuries per month ($600 billion total) through June 2011. The Federal Reserve has a "dual mandate": maximize employment and maintain price stability. The FOMC noted that "the economic recovery is continuing, though at a rate that has been insufficient to bring down unemployment". As for price stability, inflation is too low. Therefore, the Fed is stimulating economic growth. The next FOMC decision on interest rates will be announced on January 26.

In a "balance sheet recession", debt minimization is a top priority until balance sheets are deleveraged and companies and households feel comfortable borrowing money again. Economist Richard Koo reported this concept at the CFA Institute Annual Conference held in Boston in May 2010. After the collapse of a debt-financed bubble (such as U.S. real estate), many balance sheets (including those of companies and households) are underwater. The amount owed is greater than the depressed market value of the assets that were financed at higher prices. Capital is applied toward paying down debt in an effort to deleverage balance sheets. Even though money is available to borrow at low interest rates, companies and households do not want to borrow it. Low demand for borrowed money helps interest rates stay low. Once balance sheets are deleveraged, society needs to regain its appetite for borrowed money. If not, interest rates will continue to stay low, like they have done in Japan. Robust economic growth begins once balance sheets are healthy and money is willingly borrowed. In the meantime, government borrowing and spending help maintain economic output. This was the situation faced by Japan for many years, and which the U.S. currently faces.

Technical factors of the market are mildly 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 $91.42, which implies a price-to-earnings (P/E) ratio of 13.8 with the S&P 500 at 1258. Over the past month, rising stock prices have lowered the earnings yield (E/P) from 7.71% to 7.27%. At the same time, falling bond prices have pushed the 10-year U.S. Treasury note yield higher from 2.81% to 3.31%. While the gap between the earnings and Treasury yields has narrowed, there is still potential upside for stock prices.

Overextended in the short run, stocks seem due for a mild pullback. The S&P 500 rose 6.5% in December – an impressive move. Our market breadth indicator is still positive, but it is in an area where historically it has reversed. Support should be found near the November high at 1225 and the 50 day moving average at 1215. It is prudent to avoid stocks that have raced ahead of reality and buy stocks on market weakness that trade at attractive valuations. Our hypothesis continues to be that the stock market is experiencing a cyclical (short-term) bull market within a secular (long-term) bear market. Deleveraging takes times.