"A Jekyll And Hyde Market"
Market Commentary – September 2007

By Frank C. Fontana, CFA
President, Banyan Asset Management, Inc.
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Growth of U.S. Gross Domestic Product (GDP), a measure of the output of the U.S. economy, was revised up to 4.0% for the second quarter of 2007. While economic growth has improved from the first quarter, there are significant headwinds now, especially due to the weak housing market. In the coming months, the interest rates on billions of dollars in adjustable rate mortgages will reset. Unless homeowners are able to refinance at more favorable rates, many will find themselves suddenly unable to afford their monthly mortgage payments.

In recent years, mortgage lenders were able to issue risky loans, and then unload that risk by selling these loans as mortgage-backed securities. Individual mortgages were pooled together, segmented into tranches of varying risk, and then sold to investors as mortgage-backed securities with seemingly low risk and high returns. As mortgage defaults have spiked, however, investor demand for these securities and other mortgage lender debt has evaporated. Without financing, lenders do not have cash to loan to any borrowers, even those with excellent credit. This lack of liquidity is putting even more pressure on real estate prices, which could in turn create further mortgage defaults.

The credit crunch stemming from subprime mortgages has the attention of the Federal Reserve. In the first half of August, the stock market dropped and investors flocked to the safety of U.S. Treasuries out of fear. The contagion was spreading irrationally across asset classes and across the world. On August 17, the Federal Reserve cut the "discount rate" by half a percentage point to 5.75%. The discount rate is the rate at which the Fed lends money to major banks. This is different from the Fed Funds rate, which directly affects banks' lending to businesses and consumers. The Fed has also injected cash and cut some lending fees to help get money into the financial markets. So far, these moves have helped the frozen credit markets thaw a bit. Stocks, in turn, have rallied since the discount rate was cut.

Futures markets are assessing a 100% probability that the Federal Reserve will cut its benchmark Fed Funds rate by 0.25% to 5.0% when it meets on September 18. While the Fed will not bail out those who are suffering from risky investments turned sour, Fed Chairman Ben Bernanke said that the Fed "will act as needed to limit the adverse effects on the broader economy that may arise from the disruptions in the financial markets". Additional rate reductions are expected in 2007. By December, futures markets are pricing in a 100% probability of a second 0.25% cut and a 56% chance of a third 0.25% cut. Looking ahead to March 2008, the Fed Funds rate is expected to be 4.47%, 0.78% below the current level of 5.25%.

Technical factors of the market are mildly bullish (more demand than supply), while fundamentals are fairly priced – therefore, we are mildly bullish on the market. The price-to-earnings (P/E) ratio for the S&P 500 is 17.3, giving an earnings yield (E/P) of 5.78%. Compared to the 4.54% yield on the 10-year Treasury note, stocks are now offering somewhat attractive valuations (although the stock market should not be considered "cheap").

Stock prices have been exhibiting extreme volatility from day to day in a seemingly bi-polar way (e.g. down 2% one day and up 2% the next). Market participants, especially those who are highly leveraged, rush for the exit one day and crowd the entrance the next as the news of the day triggers emotional decision-making. Our proprietary market breadth indicator, which turned negative on July 27, is within two days of turning positive again. The S&P 500 bounced intraday at 1370 and has not closed below 1400 since March 2007. Still, we should be mindful that trading volume during the recent rally has been light. The lack of volume and extreme volatility suggest that investors are not yet convinced that the financial markets are out of the woods. We are continuously on the hunt for investment opportunities with favorable risk-reward characteristics. Patience is crucial.