"Black Swans"
Market Commentary – July 2016

By Frank C. Fontana, CFA
President, Banyan Asset Management, Inc.
Written June 30, 2016 – 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 1.1% in the first quarter of 2016. This is higher than the advance estimate of 0.5% and the second estimate of 0.8%. With its announcement on monetary policy on June 15, the Federal Open Market Committee (FOMC) revised its March 2016 economic forecasts. The FOMC now projects GDP growth of 2.0% in 2016, 2017, 2018, and in the "longer run" (beyond 2018). March projections were 2.2%, 2.1%, 2.0%, and 2.0%, respectively. Unemployment is seen between 4.6% and 4.8% and inflation is projected between 1.4% and 2.0% from 2016 through the longer run. The future of the U.S. economy is becoming clearer given that the variance of economic forecasts is narrowing. Unfortunately, that clarity is revealing that sluggish economic growth will likely plague us for quite a while.

With the surprise shock on June 24 of the United Kingdom voting to leave the European Union (dubbed "Brexit" by the media), the prospects of an interest rate hike in the U.S. have evaporated. On June 15, which seems like eons ago given the amazing news flow over the past week, the FOMC left its benchmark federal funds rate alone, citing a mixed bag of economic data. Favorable developments include the declining unemployment rate, growth in household spending, and improvement in the housing sector. On the other hand, "job gains have diminished" and "business fixed investment has been soft". As news of the Brexit situation unfolded, financial markets worldwide immediately went into a tailspin. In response, global central banks pledged to do their best to ensure liquidity and smooth-functioning markets. Futures markets now predict the federal funds rate to be 0.5% in February 2018, and a 94% probability of 0.75% by June 2019. The next FOMC monetary policy decision is scheduled for July 27.

With the Brexit news in recent headlines, it is important to remember how building a margin of safety into a portfolio helps cushion the blow from "black swan events". Black swan events are rare, hard-to-predict situations that come as a surprise and have a major effect. The reality is that we live in a world filled with many possible black swan events. Brexit is only one example; terrorism is another (think about September 11, 2001, which is not to discount the numerous horrific events in recent headlines). Rather than try to predict these events, it is more realistic to build a portfolio that attempts to absorb the shock as best as possible. At Banyan Asset Management, our primary tool is to balance exposure to stocks with cash. Additional tools include emphasizing cheap valuations relative to earnings and free cash flow, low betas, and strong balance sheets. Robust dividends and covered calls, for appropriate clients, help generate a healthy income stream.

Technical factors of the market are 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 $125.59, which implies a price-to-earnings (P/E) ratio of 16.7 with the S&P 500 at 2,099. The earnings yield (E/P) of 5.98% represents attractive value relative to the 10-year U.S. Treasury note yield of 1.49%. The sovereign debt bubble continues to inflate as investors flock to the "safety" of Treasuries – beware.

While the reason for the decline at resistance was a surprise, sure enough, the S&P 500 failed again at major resistance in the 2,100 area. In a roller coaster whipsaw, the S&P 500 travelled from 2,113 the day before the Brexit vote, to 1,992 intraday two days later, and back to 2,099 today. We have our eye on a trading range for the S&P 500 between the low 1,800 area and around 2,100. The market is at the high end of that range. The sharp rebound off of the Brexit lows feels like portfolio window dressing in time for the end of the second quarter. Portfolio management is a continuous process, not a discrete event, and it is easy for stocks to peel back 15% or even 30% or more if something nastier awaits. The effects of the Brexit black swan are not over, and another black swan is around the corner.