# "Consolidating Recent Gains"

## Market Commentary – February 2012

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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 2.8% in the fourth quarter of 2011.** This is higher than 0.4% in 2011 Q1, 1.3% in 2011 Q2, and 1.8% in 2011 Q3. The Federal Reserve continues to reign in its GDP forecasts. It now sees 2012 GDP within a range of 2.2%-2.7%, which is down from their prior forecasts of 2.5-2.9% in November 2011 and 3.3%-3.7% in June 2011. This recovery is tepid. Unemployment, which came in at 8.5% in December 2011 after peaking at 10% in October 2009, is meandering lower, albeit at a stubbornly slow rate. It is difficult to create jobs when economic growth is lackluster.

**The Federal Open Market Committee (FOMC) announced after its meeting on January 25 that it "expects to maintain a highly accommodative stance for monetary policy".** While it cannot lower its benchmark Fed Funds rate from the rock-bottom range of 0% to 0.25%, the FOMC did extend the duration for these ultra-low rates from mid-2013 to late 2014. As well, Operation Twist remains in progress, which involves the extension of the average maturity of the Fed's securities holdings. At a news conference following the release of the FOMC statement, Fed Chairman Ben Bernanke noted "we continue to see head winds emanating from Europe, coming from the slowing global economy". He added, "I don't think we're ready to declare that we've entered a new, stronger phase at this point". The next FOMC decision on monetary policy is scheduled for March 13.

**On January 10, the Fed announced that the Reserve Banks gave the U.S. Treasury $76.9 billion, which was most of their $78.9 billion profit in 2011.** Interestingly, this profit was generated due to the Fed's securities portfolio, which includes U.S. Treasuries, federal agency debt, and securities by mortgage-finance firms Fannie Mae and Freddie Mac. It is well-known that the Fed inflated its portfolio from $875 billion before the financial crisis to $2.9 trillion currently. While this move boosted the Fed's risk profile, it also cranked up its potential for profit. The Fed, it turns out, is making money from the investment strategy of buying during a time of panic. Investors would be wise to take note.

**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 $105.78, which implies a price-to-earnings (P/E) ratio of 12.4 with the S&P 500 at 1312. The earnings yield (E/P) is 8.06%, which represents attractive value relative to the 10-year U.S. Treasury note yield of 1.80%. S&P expects earnings in 2012 to be 9.0% higher than in 2011. Companies are making money.

**At Banyan Asset Management, our technical analysis suggests a mild pullback is possible for the S&P 500.** Stocks have had a fantastic run over the past month, with the S&P 500 rising from 1205 on December 20 and to a peak of 1326 on January 25. This is a 10% jump. There is plenty of support below, especially around 1265. Technicians commonly note that old resistance becomes new support. Moreover, the 50 day moving average is at 1258 (and rising), while the 200 day moving average is at 1257. Our market breadth indicator is at a high level that is not sustainable. We do not expect the stock market to plummet, but a "breather" would be in order. Resistance overhead is at 1350.

**We prepared for a mild pullback by selling covered calls on several individual stock positions in January.** These call options expire between March and May of 2012. Should stock prices rest, our portfolios would generate healthy income from call premiums and dividends. Should stock prices rise, our portfolios would still generate healthy income from call premiums and dividends. Moreover, we would have the opportunity to sell a few stocks at even higher levels, which is favorable. A pullback in stock prices would offer a nice entry point for some incremental buying.