“Turbulence Ahead”
Market Commentary – March 2007

By Frank C. Fontana, CFA
President, Banyan Asset Management, Inc.
Written February 28, 2007 – www.banyan-asset.com

Growth in Gross Domestic Product (GDP), a measure of the output of the U.S. economy, was revised down from 3.5% to 2.2% for the fourth quarter of 2006. GDP growth measured 2.6% in the second quarter and 2.0% in the third quarter. With the 20-year average for GDP growth in the U.S. being 3.1%, economic growth has slowed to a below-average rate. This is likely attributable to the economy finally digesting the Federal Reserve’s increasing of its benchmark Fed Funds rate from 1.0% to 5.25% between June 2004 and June 2006.

On February 27, the Shanghai stock market plunged 9%, helping to trigger a steep sell-off in market indexes worldwide. U.S. market indexes fell roughly 3.5% in one day on heavy volume. Adding to the worry about global market weakness, former Federal Reserve Chairman Alan Greenspan mentioned that a U.S. recession is possible, although he did not say it is likely, and that the U.S. economy appears to be in the late stages of a cycle. Moreover, Freddie Mac, one of the biggest providers of funding for U.S. home mortgages, said that it will crack down on risky loans by no longer purchasing loans granted to subprime borrowers. Finally, there were some major sell orders that hit just before 3 p.m., causing the Dow Jones Industrials Average to plummet by 254 points in less than four minutes.

Earlier today, Federal Reserve Chairman Ben Bernanke gave the stock market a much needed dose of antacid as he comforted investors with soothing words. He said that there is no material change to the outlook for moderate growth in the U.S. economy, and there is a reasonable chance that the economy will strengthen. He added that he did not see any concerns about a liquidity crunch, and there is no indication that problems with subprime mortgages will spread beyond the risky firms who underwrote them. We must be cautious about Bernanke’s statements, however, because his job is to say those things. As of today, futures markets now estimate a 56% probability of a 0.25% rate cut by July.

Technical factors of the market are bearish (more supply than demand), while fundamentals are fairly priced – therefore, we are bearish on the market. The price-to-earnings (P/E) ratio for the S&P 500 is 17.1. This is down from 18.1 last month because the S&P 500 is lower in price and earnings estimates are a bit higher. Still, a P/E ratio of 17.1 is not cheap. The inverse of P/E, or E/P, is called the earnings yield. The earnings yield on the S&P 500 is 5.85% (1 divided by 17.1), while the yield on the 10-year Treasury note is 4.55%. The question that investors have to consider is whether it is worth the risk of owning the S&P 500 in order to earn an extra 1.30%. If the P/E ratio was lower than 17.1, the E/P would be higher than 5.85% and stocks would be more attractive.

Volume in the stock market finally spiked higher – as the market fell. This is a bearish development in terms of technical factors. We have been skeptical of the market rally over the past several months because volume did not move higher with price. The diverging trends of price and volume suggested that buying support was weaker than it appeared. A healthy correction would take the S&P 500 from 1406 to around 1325, which was a resistance level in May 2006.

Warren Buffett is a strong proponent of strategically holding cash in a portfolio. In an article on March 20, 2006, *Barron’s* called the balance sheet of Berkshire Hathaway, Warren Buffett’s company, “fortress-like” with “$40 billion in cash and $46 billion in stocks”. Later, Buffett is quoted as saying “he expects ‘no miracles’ from the equity portfolio, which is dominated by ‘strong, highly profitable businesses’ that are ‘not selling at anything like bargain prices’”. Finally, the last paragraph of the article hits the nail on the head: “In a financial meltdown, Buffett would be ready to deploy large amounts of capital on attractive terms. Wall Street now is penalizing Berkshire for Buffett’s conservatism, but that’s one of the company’s greatest assets.” In our client portfolios, our cash position is an important asset, especially when the market gets volatile. Its true value would become evident should stocks go “on sale”.