"Musical Chairs"

Market Commentary – July 2014

By Frank C. Fontana, CFA
President, Banyan Asset Management, Inc.
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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. declined at an annual rate of 2.9% in the first quarter of 2014. News keeps getting worse for Q1, as the advance estimate of GDP showed growth of 0.1% and the second estimate was a decline of 1.0%. The two biggest drags on Q1 GDP were inventory depletion (-1.70 GDP percentage points) and declining exports (-1.25 GDP percentage points). Both of these are temporary effects, so the economy is not likely on the verge of recession. Still, the Federal Open Market Committee (FOMC) did lower its forecast for 2014 GDP from 2.8%-3.0% as of March to 2.1%-2.3% as of June. Interestingly, the FOMC also sees this same lower range for GDP in the "longer run" (beyond 2016). Corporations cannot grow their sales in perpetuity in excess of GDP – otherwise, a high growth company would take over the economy. Slow economic growth implies a limit on the sales growth of corporations, which in turn limits the upside potential of stock prices.

On June 18, the FOMC cut its $45 billion monthly bond-buying program by another $10 billion to $35 billion. This follows $10 billion reductions in December, January, March, and April. While the federal funds rate is still at a rock-bottom range of 0% to 0.25%, FOMC participants on average see that rate at 1.20% by the end of 2015 and at 2.53% by the end of 2016. Compared to its forecast in September 2013 of 1.55% by the end of 2015 and 2.41% by the end of 2016, the Fed is consistent in its communication with investors that higher interest rates are coming. The next FOMC announcement on monetary policy is scheduled for July 30.

Having updated our universe of stocks, we are now refreshing our research on each individual stock owned in client portfolios. We utilize a discounted free cash flow to equity model to calculate the intrinsic value of a stock. The "discount rate" is critical to this model: the higher the discount rate, the less valuable the future earnings, which results in a lower intrinsic value for a given stock. We use the capital asset pricing model (also known as "CAPM") to compute our discount rate for each stock's model. CAPM is a function of the risk-free rate, the equity risk premium, and the beta of an individual stock. Our calculation of the equity risk premium has risen from 4.92% in February 2013 to 5.35% today. Therefore, the discount rate for a stock with a beta of 1.0 has jumped from 8.92% to 9.35%. This may not sound like much, but it does make a stock worth less. For one stock we recently analyzed, changing the discount rate from 8.92% to 9.35% resulted in an 8% decline in intrinsic value. We are now deciding whether to sell that stock or, at a minimum, sell covered calls against it. We must stay true to our process.

Technical factors of the market are bullish (more demand than supply), while fundamentals are attractively priced – therefore, we are mildly bullish on the market. The Standard & Poor's forecast for S&P 500 operating earnings per share (EPS) over the next 12 months is $124.33, which implies a price-to-earnings (P/E) ratio of 15.8 with the S&P 500 at 1960. The earnings yield (E/P) of 6.34% represents attractive value relative to the 10-year U.S. Treasury note yield of 2.52%. Low interest rates are making stocks more attractive than they would otherwise be.

While an uptrend in stock prices is as bullish as it gets, we cannot help but get more skeptical of the sustainability of this uptrend. The S&P 500 pushed to yet another all-time high in June as volatility, measured by the VIX, hit the lowest level since early 2007. Technicians view low volatility as a sign that investors have become complacent. There is no law that says volatility must spike higher within a certain time frame. However, it would be prudent for investors to remember that stocks can rapidly decline in price. On the downside, a logical area of support for the S&P 500 is around 1880, followed by the 200-day moving average at 1826. In recent weeks, we have favored the sell button in certain client portfolios. The spirit of incrementally raising cash is to "sell high". Remembering the childhood game of musical chairs, we do not want to be the one without a chair when the music stops.