“Gravitation Of Money”
Market Commentary – December 2015

By Frank C. Fontana, CFA
President, Banyan Asset Management, Inc.
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The second 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 2.1% in the third quarter of 2015. This is higher than the advance estimate of 1.5%. The big revision centered on inventories, which is a component of investment spending. In the advance estimate, inventory changes reduced GDP by 1.44 percentage points, but they only cut GDP by 0.59 percentage point in the second estimate. This is a significant change, providing an appropriate opportunity to reflect on the fact that these “calculations” are estimates. Economic data is not as precise as we would like to believe.

Minutes from the Federal Open Market Committee (FOMC) meeting on October 28 indicate that December 16 could be the day of the first hike in the benchmark federal funds rate. According to the minutes, “most (FOMC) participants anticipated that, based on their assessment of the current economic situation and their outlook for economic activity, the labor market, and inflation, (conditions for beginning policy normalization) could well be met by the time of the next meeting.” The next FOMC announcement regarding monetary policy is scheduled for December 16. As we pointed out last month, the Fed is influenced by stability, or lack of, in the financial markets. It is also worth remembering that just as important as the timing of the first hike is the pace of future interest rate hikes. All indications are that the Fed will go gingerly on this front, in comparison with the steady hikes from 1.0% to 5.25% between 2004 and 2006 under Fed Chairman Alan Greenspan.

The gravitation of money toward expensive growth stocks will likely have an unpleasant ending, although it is impossible to time when this will happen. Interestingly, Goldman Sachs recently published a list of 35 stocks they feel will outperform in 2016. Out of curiosity, we whipped up a spreadsheet to analyze the valuation of these stocks. The mean price-to-earnings (P/E) ratio is a nosebleed 25.3. While the mean P/E is skewed by one stock with a P/E of 119, the median P/E is still a sky-high 21.4. The average dividend is a paltry 1.3%. Without getting into the specific companies, the list includes many of the same unoriginal growth names that have been popular in 2015. It should come as no surprise that Warren Buffett’s Berkshire Hathaway has positions in only three of the 35 companies loved by Goldman Sachs. These three companies include two banks (one of which we own, as well) and one telecommunications company; all three are attractively priced. Ironically, Berkshire Hathaway has a position in Goldman Sachs itself. An advantage of Banyan Asset Management being independent of the big Wall Street firms is that we can steer clear of stocks that violate our investment principles.

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 $126.55, which implies a price-to-earnings (P/E) ratio of 16.4 with the S&P 500 at 2,080. The earnings yield (E/P) of 6.08% represents attractive value relative to the 10-year U.S. Treasury note yield of 2.22%. Valuation of the S&P 500 overall is misleading, as it blends stocks with cheap valuations and others priced to perfection.

Following the late summer swoon, the S&P 500 has resumed the trading range that has characterized most of 2015. Support exists at 2,020 (November low), 2,000 (old resistance in September), and 1,870 (lows of late summer). Overhead, there is tremendous resistance at 2,130. It seems that news of global central banks being accommodative causes stocks to bounce at support, while concern over the U.S. raising interest rates in a world plagued by tepid growth seemingly causes stocks to retreat. With stocks near the high end of the range, a modest pullback is in order. Value stocks may suffer even more from year-end tax loss selling. Similar to Warren Buffett, we are not going to let the short-term allure of growth investing cause us to deviate from the long-term success of value investing. When money eventually gravitates back to value stocks, our portfolios will enjoy the reversal.