"Backing And Filling"
Market Commentary – September 2010

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. increased at an annual rate of 1.6% in the second quarter of 2010. This was lower than the advance estimate of 2.4% announced last month. The unemployment rate is staying stubbornly high, measuring 9.5% in July. Federal Reserve Chairman Ben Bernanke recently admitted that "the pace of recovery in output and employment has slowed somewhat in recent months". He also stated that the economy will "continue to expand in the second half of this year, albeit at a relatively modest pace" and that "the preconditions for a pickup in growth in 2011 appear to remain in place". According to *The Economist*, 2010 GDP is projected to be 3.0% and 2011 GDP is forecast at 2.8%. These estimates are more pessimistic than those issued by the Fed and the White House.

In a move hinted by Ben Bernanke in July, the Federal Open Market Committee (FOMC) announced on August 10 the Federal Reserve's plan to reinvest principal proceeds from maturing agency debt, agency mortgage-backed securities, and Treasury securities into longer-term Treasury securities. Plunging mortgage rates have led millions of homeowners to refinance their mortgages, causing a wave of early loan repayments. As a result, the Fed's portfolio would have contracted by roughly $400 billion by the end of 2011, essentially tightening monetary policy. Reinvesting principal into Treasuries will help the Fed maintain the current level of monetary stimulus. The FOMC also announced its decision to keep the benchmark Fed Funds rate at a record low target range of 0% to 0.25% "for an extended period". Bernanke recently stated that "central bankers alone cannot solve the world's economic problems", implying that fiscal policy also plays a crucial role. He told Congress that additional fiscal stimulus must be accompanied by a credible plan to reduce deficits and stabilize the ratio of debt to GDP. The next FOMC decision on interest rates is scheduled for September 21.

Treasury rates are plunging to record low levels as scared investors seem more concerned with return *of* capital than return *on* capital. Strong demand by investors bids the price of a bond higher, causing the yield on that bond to fall. Demand for U.S. Treasury securities has been so high that yields have plummeted to the following levels: 0.13% annualized for 3 months; 0.47% per year for 2 years; 1.33% per year for 5 years; 2.47% per year for 10 years; and 3.52% per year for 30 years. Investors willing to accept these paltry returns believe that the U.S. government will pay them interest and return their original capital. Should investors ever question whether payment of interest or principal is in jeopardy (due to loose fiscal policy), Treasury prices would tank, Treasury yields would soar, and investors would learn about the significant interest rate risk accompanying their Treasury investments.

Technical factors of the market are mildly 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 $87.80, which implies a price-to-earnings (P/E) ratio of 11.9 with the S&P 500 at 1049. The earnings yield (E/P) is 8.37%, representing attractive value with the 10-year U.S. Treasury note at 2.47%. Generally speaking, stocks are cheap. Moreover, corporate balance sheets are strong, flush with record amounts of cash.

Technicians are watching how well support for the S&P 500 will hold near 1025, an area representing the July low. Below 1025, the next major support area is around 940. Looking higher, major resistance is at 1125. The "backing and filling" action of the stock market in recent months is healthy, especially given the high degree of fear currently in the market. A recent article in *The Wall Street Journal* questioned the relevance of the P/E ratio and value investing in general. We view that article as an example of capitulation. The author expressed frustration with the lack of an immediate translation of solid corporate earnings into higher stock prices. Such expectations are not realistic. It can take time for a stock's alpha (potential risk-adjusted return) to be realized. Investing requires patience.