"Incremental And Balanced"

Market Commentary – August 2013

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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 1.7% in the second quarter of 2013. The first quarter GDP number was revised down from 1.8% to 1.1%. With the release of 2013 Q2 GDP, the U.S. Bureau of Economic Analysis revised GDP readings from 1929 to present. From 1929 to 2012 (long-term), the average annual growth rate of real GDP was 3.3%. From 2002 to 2012, GDP grew only 1.8% per year. From 2007 Q4 to 2009 Q2, which includes "The Great Recession", GDP shrank by 2.9% per year. From 2009 Q2 to 2013 Q1, GDP grew by 2.2% per year. Recent economic growth remains anemic as compared to historical readings. The "boom" period that typically follows a recession has not exceeded the long-term average annual growth rate of 3.3%.

In its monetary policy announcement released earlier today, the Federal Open Market Committee (FOMC) slightly downgraded its view of the economy with its select choice of words. In past months, the Fed has referred to economic growth as "moderate". In the today's announcement, it used the term "modest" to describe the first six months of 2013. The FOMC maintained its commitment to buy $85 billion in mortgage-backed securities and longer-term Treasury securities. The financial markets remain addicted to monetary stimulus. On July 10, Fed Chairman Ben Bernanke commented after the market closed that monetary policy will be "highly accommodative" for the foreseeable future. The next day, the S&P 500 rallied 1.36%.

Two important words for investors to remember are "incremental" and "balanced". Incremental financial decisions are equivalent to a driver gently pressing on the accelerator or brake pedal in a car. Investors who make "all or nothing" decisions in the financial markets put themselves in a tough position. This leads to another key word: balanced. At Banyan Asset Management, we prefer to keep a balance of stocks and cash. The subtle benefit of cash in a portfolio is that the investor can *incrementally* buy when others are panicking and selling aggressively. It gives you the courage to hit the buy button when it is scary to do so.

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 $115.51, which implies a price-to-earnings (P/E) ratio of 14.6 with the S&P 500 at 1686. The earnings yield (E/P) of 6.85% represents attractive value relative to the 10-year U.S. Treasury note yield of 2.59%. The yield gap between the Treasury market and stock market continues to narrow. The rise in stock prices is outpacing the rise in earnings, causing P/E to expand. A more robust situation is when earnings drive stock prices.

The stock market stubbornly continued its trek higher in July, ignoring calls for a deeper correction than was presented in June. The S&P 500 is encountering resistance in the 1690 area. Looking at support areas below, the 50-day moving average is currently 1646, the June low was about 1575, and the 200-day moving average is 1534.

The strength in stocks has been nothing short of remarkable, but a historical look at 1987 may help ground the euphoria. On 12/31/86, the S&P 500 was 242 (yes, the same S&P 500 that is now 1686). By 8/25/87, the S&P 500 had rallied 39% to 337. After peeling back 7%, the index crashed from 315 on 10/13/87 to an intraday low of 216 on 10/20/87 (an additional 31% correction in just 5 market days). The S&P 500 closed at 247 on 12/31/87. If you observed the stock market at the beginning of 1987 and ignored the news for 12 months, you would think 1987 was a sleepy year: up only 2% plus dividends. The market crash alleviated the bullish froth. While we are not predicting a repeat of 1987 today, understanding *incremental* and *balanced* helps plan for such a possible scenario.