"Hurricane Shutters Are On"

Market Commentary – August 2014

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Written July 31, 2014 – www.banyan-asset.com

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 4.0% in the second quarter of 2014. The U.S. Bureau of Economic Analysis revised its GDP calculations for the past 15 years, concluding that 2014 Q1 GDP declined by -2.1% instead of the third estimate of -2.9%. While economists commonly view the Q1 GDP headline of -2.1% as temporary, the Q2 GDP headline should be viewed similarly, although in the opposite direction. Investment boomeranged from -1.13 percentage points in Q1 to +2.57 percentage points in Q2. Neither reading is sustainable. Digging into the Q2 investment figure, inventories, which are notoriously volatile, accounted for 1.66 percentage points of the 2.57 percentage point reading. We prefer to think of Q1 and Q2 combined, which comes back to the theme of tepid growth (but growth, nonetheless).

The Federal Open Market Committee (FOMC) has finally revealed a potential end date for its monthly bond-buying program, known as "quantitative easing" or "QE". Minutes from the FOMC's June 18-19 meeting, released on July 9, state: "If the economy progresses about as the Committee expects, warranting reductions in the pace of purchases at each upcoming meeting, this final reduction would occur following the October meeting." The most recent FOMC decision on monetary policy, announced on July 30, saw the Fed cut its $35 billion QE program by another $10 billion to $25 billion (following $10 billion cuts in December, January, March, April, and June). As of 7/23/2014, the Fed's balance sheet stood at a staggering $4.4 trillion, up from about $900 billion in August 2008.

Once QE has ended, focus will shift to the inevitable rise in interest rates. The federal funds rate has been stuck at the lowest range of 0% to 0.25% since December 2008. During her testimony to Congress on July 15, Federal Reserve Chair Janet Yellen said, "If the labor market continues to improve more quickly than anticipated by the [Fed], then increases in the federal funds rate target likely would occur sooner and be more rapid than currently envisioned." At the same time, she emphasized that "a high degree of monetary policy accommodation remains appropriate." As of June, FOMC participants on average see the federal funds rate at 1.20% by the end of 2015 and at 2.53% by the end of 2016. The next FOMC announcement on monetary policy is scheduled for September 17.

Technical factors of the market are bearish (more supply than demand), while fundamentals are attractively priced – therefore, we are bearish on the market. The Standard & Poor's forecast for S&P 500 operating earnings per share (EPS) over the next 12 months is $128.53, which implies a price-to-earnings (P/E) ratio of 15.0 with the S&P 500 at 1931. The earnings yield (E/P) of 6.66% represents attractive value relative to the 10-year U.S. Treasury note yield of 2.56%. In her testimony to Congress on July 15, Yellen made comments, unusual for a Fed Chair, about equity valuations: "Valuation metrics in some sectors do appear substantially stretched – particularly those for smaller firms in the social media and biotechnology industries." At Banyan Asset Management, we agree. Yellen is observing the selective bubble valuations that we have written about in prior market commentaries.

A correction appears to be in progress…finally. Major support levels for the S&P 500 include 1880 (resistance level from March to May 2014) and 1857 (200-day moving average). However, it is possible that stocks could be setting up for something worse in the coming months. Remember that the end result will ultimately be healthy for the long-term direction of stock prices. A frothy excitement has overcome investors over the past year. Beware of emotion trumping logic in the realm of investing. Investors have become complacent, seemingly forgetting that stocks also move down in price. In Southwest Florida, when a hurricane's "cone of uncertainty" (i.e. projected path) covers our area, we put on our hurricane shutters. In our portfolios, we put on the hurricane shutters in recent months by selling certain stocks to raise cash. Ironically, we welcome the potential of lower prices so that we can buy stocks on sale.