"Forming A Base"

Market Commentary – April 2008

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Written March 31, 2008 – www.banyan-asset.com

The final reading of Gross Domestic Product (GDP), a measure of the value of goods and services produced in the U.S., shows that the U.S. economy grew 0.6% in the fourth quarter. While the economy officially stayed out of recession in 2007, GDP growth has decelerated quickly from 4.9% in the third quarter. Falling home prices, a credit crunch, and a weakening job market may lead a slowdown in consumer spending. Consumer spending accounts for roughly 70% of U.S. GDP. Treasury Secretary Henry Paulson recently admitted that the economy has "turned down sharply", although he has avoided using the word recession. Similarly, the Federal Reserve noted that "downside risks to growth remain".

The Federal Open Market Committee (FOMC) cut the benchmark Fed Funds rate by 75 basis points to 2.25% at its meeting on March 18. This rate has been slashed by 3% since September 2007. In addition to lowering interest rates, the Fed has introduced auctions to provide banks with hundreds of billions of dollars in cash, and they have also started accepting banks' illiquid mortgage backed securities in exchange for liquid Treasuries. Plus, investment banks can now get loans from the Fed for the first time in decades. Futures markets estimate a 32% probability that the FOMC will reduce the Fed Funds rate by another 25 basis points on April 30.

Backed by the Federal Reserve, J.P. Morgan is bailing out Bear Stearns, the fifth-largest U.S. investment bank. Customers of Bear Stearns became concerned that the company's balance sheet was no longer healthy, tainted by toxic subprime mortgage losses. As a result, they began to pull accounts in a mass exodus, amounting to a run on the bank. Perception of a problem, true or not, can create a problem in banking, thus leading to a self-fulfilling prophecy. In an attempt to prevent a global financial crisis, J.P. Morgan vowed to back up Bear Stearns and buy the firm, albeit at a rock bottom price. Then, to "bolster market liquidity and promote orderly market functioning", the Federal Reserve agreed to back J.P. Morgan with a $30 billion credit line. While Bear Stearns shareholders have seen their stock plummet from more than $170 per share in January 2007 to the deal price of around $10 per share, the stock market overall has reacted favorably since the deal was announced.

Technical factors of the market are mildly bullish (more demand than supply), while fundamentals are fairly priced – therefore, we are mildly bullish on the market. With earnings depressed, especially in the financial sector, the price-to-earnings (P/E) ratio of the S&P 500 is currently 18.4. Stock valuations are not cheap, but they are also not at bubble levels. First quarter earnings will start being reported in April. The direction of the stock market will likely be driven by how reported earnings compare with first quarter expectations. Also important will be corporate earnings outlooks for the second quarter. By May and June, Americans should have received their tax rebate checks as part of the government's $168 billion stimulus package. The lagged effect of the Fed's first interest rate cuts from back in September should also kick in by then, too. These factors should help improve second quarter earnings expectations.

While the S&P 500 is still struggling to form a higher high, it succeeded in not forming a lower low. Support from the January intraday lows around 1270 held firm in March. Technicians refer to this market behavior as consolidation. Market breadth is negative on an absolute basis, but it appears to be consolidating, as well. While it is unclear whether stock prices have seen "the bottom", the underlying health of stock prices is improving (despite woeful economic news).

Recent events on Wall Street highlight the effects of leverage (debt) relative to the boom and bust economic cycle. Debt magnifies profits and losses. Those who maintain strong balance sheets are able to profit from opportunities temporarily created by others who were not as careful in their assessment of risk. This holds true for corporations, as well as for individual investors.