"Marching Ahead"

Market Commentary – August 2009

By Frank C. Fontana, CFA
President, Banyan Asset Management, Inc.
Written July 31, 2009 – www.banyan-asset.com

The advance estimate of Gross Domestic Product (GDP) shows that the value of goods and services produced in the U.S. fell by 1.0% in the second quarter of 2009. GDP has fallen by 3.9% since it peaked in the second quarter of 2008, thus making this the worst recession since World War II (quarterly records began in 1947). However, following contractions of 5.4% in the fourth quarter and 6.4% in the first quarter, the economy is rebounding. According to the Federal Reserve's Beige Book, a survey of regional economic conditions, "the pace of decline has moderated since the last report (in June) or that activity has begun to stabilize, albeit at a low level". Several economists are forecasting positive GDP growth in the third quarter. Even if the recession has already ended, which it may have, the National Bureau of Economic Research (NBER) will not officially announce this until months after the fact. The Fed forecasts GDP to grow by 2.1% to 3.3% in 2010.

With the economy on the mend, Wall Street is watching for signs how the Federal Reserve will restrict its accommodative policies and shrink its bloated $2 trillion balance sheet. In recent months the Federal Open Market Committee (FOMC) has repeatedly stated that it will keep its benchmark Fed Funds rate at an exceptionally low target range of 0% to 0.25% "for an extended period". A key indicator to watch will be inflation. The Fed believes that excess capacity will contain inflation. The Consumer Price Index (CPI) rose in the second quarter at a seasonally adjusted annualized rate of 3.3%, up from 2.2% in the first quarter. Should inflation spike higher in the months ahead, the Fed will be pressured to raise interest rates. The next FOMC decision on interest rates will be announced on August 12.

Correlations approach one in a bear market, but markets are beginning again to diverge. The following analysis shows market index increases in 2009 year-to-date, presented in a format of (overall index, value component of index, growth component of index): S&P 500 Large Cap (+9.3%, +4.7%, +13.7%), S&P 400 Mid Cap (+16.7%, +12.3%, +21.2%), S&P 600 Small Cap (+10.1%, +7.5%, +12.7%). Moreover, the Dow Jones Industrials Average is up +4.5%, the Russell 2000 is up +11.5%, and the NASDAQ Composite is up +25.5%. Growth stocks are clearly outpacing value stocks, with mid cap and technology stocks leading the way. Investors should be cautious on chasing such performance, especially with red-hot technology stocks. A diversified, multi-cap portfolio of value stocks is more prudent.

Technical factors of the market are bullish (more demand than supply), while fundamentals are attractively priced – therefore, we are bullish on the market. As of July 23, 2009 with 197 of the S&P 500 companies having reported second quarter earnings, actual operating earnings per share (EPS) are 29.6% below second quarter of 2008 results. While 60.9% of companies have beat analysts' consensus estimates, only 35.5% of companies have reported higher earnings than a year earlier. Trailing 12-month operating EPS is $40.20, while Standard & Poor's forecasts operating EPS for the next 12 months to be $65.38. Earnings are improving. Moreover, the 10-year U.S. Treasury Note yield is a low 3.5%, which causes our discounted free cash flow models to compute high intrinsic valuations for stocks.

The S&P 500 pulled back 4.4% in the first 10 days of July, before shooting up 12.3% from the July lows. Our market breadth indicator turned positive on July 20 and has been racing higher. The S&P 500 broke through resistance at 945, defined by the May and June highs. Sitting at 987, the S&P 500 should have plenty of support at 945 (old resistance becomes future support), at 920 from the early May and late June highs, and with the 50 day moving average at 927 and the 200 day moving average at 871. Resistance above is at 1000 and 1090.

We are sticking with our strategy of a diversified portfolio of dividend-paying value stocks with a sprinkling of covered calls. This approach, while not exciting, helps us to stay more even-keeled when other investors become emotional. Emotions cloud an investor's ability to make solid decisions.