"Wall Street Roller Coaster"

Market Commentary – December 2011

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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. grew at an annual rate of 2.0% in the third quarter of 2011. This is lower than the advance estimate of 2.5%, but still higher than 0.4% in 2011 Q1 and 1.3% in 2011 Q2. Earlier in November, the Federal Reserve lowered its projection of 2012 real GDP growth from a range of 3.3%-3.7% to 2.5%-2.9%. Unemployment remains stubbornly high, ticking down 0.1 percentage point from September to 9.0% in October. The Fed expects unemployment to be between 8.5% and 8.7% in 2012. Economic growth is not strong enough to further dent the unemployment rate. It is important for investors to remember, however, that the economy is growing…albeit slowly.

The Federal Reserve is still trying to spark economic growth with accommodative monetary policy. A statement released on November 2 by the Federal Open Market Committee (FOMC) confirms its view that "there are significant downside risks to the economic outlook, including strains in global financial markets". As a result, the FOMC maintained that its benchmark Fed Funds rate will remain in a range of 0% to 0.25% through mid-2013. They are also continuing with "Operation Twist", which was announced in September. The next FOMC decision on monetary policy is scheduled for December 13.

In a surprise move earlier today, major central banks across the globe coordinated action to provide liquidity to the global markets, and the stock market reacted with a powerful rally. In recent months, investors concerned about European governments burdened with unsustainable levels of debt have been aggressively selling the sovereign bonds of Greece, Italy, Spain, and Portugal, causing the yields on these bonds to skyrocket. European banks, which are major holders of these sovereign bonds, would suffer in the event of default. Due to this risky exposure, European banks have struggled to sell *their* debt to investors, which typically include U.S. money market funds. After the 2008 credit crunch, money market funds are more cautious this time around. Absent the flow of dollars from U.S. money market funds, European banks have been paying large premiums to access dollars through the swap market. The coordinated action today, which involved the Federal Reserve, the European Central Bank, the Bank of England, the Bank of Canada, the Bank of Japan, and the Swiss National Bank, lowers the cost of liquidity swaps by 50 basis points, thus giving banks cheaper access to dollars. The result is more liquidity for European banks. Of course, this does not resolve the debt crisis of European governments, but it does ease the risk of a credit crunch. The odds of a worst-case financial meltdown are reduced.

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 $103.94, which implies a price-to-earnings (P/E) ratio of 12.0 with the S&P 500 at 1247. The earnings yield (E/P) is 8.34%, which represents attractive value relative to the 10-year U.S. Treasury note yield of 2.07%.

Despite volatile market conditions, stock prices have been range-bound since August. The S&P 500 found support in the middle of the 1120-1220 range observed in August and September, bottoming at 1158 on November 25. While support is strong in the mid-1100s, there is also significant resistance in the upper-1200s. Key resistance levels include the 200 day moving average at 1265 and the October high around 1290. Above that, the next resistance level is around 1350. Our market breadth indicator corrected from a level interpreted as "too positive to be sustainable"; it is now in a better position to rally.

In a stock market fueled by emotion, a critical challenge for investors is to squelch emotion as much as possible and remain logical. This is a key source of competitive advantage. At Banyan Asset Management, we strive to make logical investment decisions based on a combination of fundamental and technical analysis, rather than sensationalized news (negative or positive).