"A Tale Of Two Markets"

Market Commentary – November 2007

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Gross Domestic Product (GDP), a measure of the value of goods and services produced in the U.S., grew 3.9% in the third quarter of 2007. This compares with 3.8% growth in the second quarter of 2007 and 0.6% growth in the first quarter. Declining residential investment caused GDP to contract by 1%, but this was more than offset by strength in consumer spending (adding 2.1% to GDP growth) and surging exports (adding another 1%). As of now, the depressed housing market has not yet spilled over to the rest of the economy. Still, most economists expect the housing bust, the credit crunch, and high oil prices to weigh heavily on economic growth into 2008. One recent survey indicated that economists estimate a 34% probability of a U.S. recession in the next 12 months.

Earlier today, the Federal Reserve cut its benchmark Fed Funds rate by 0.25% to 4.50% in a move to boost economic growth. While this rate cut was expected, the Fed hinted that future rate reductions are not as likely since it views the risks of weaker economic growth and higher inflation as "roughly in balance". The Fed is walking a tightrope and must proceed carefully. On one hand, it is concerned about the deflation of house prices sinking the economy into recession. On the other hand, it is cautious about inflation, as evidenced by increases in energy and commodity prices, potentially magnified by the weakening dollar. Futures markets are now pricing in a 28% probability of a 0.25% reduction in the Fed Funds rate by December, and a 96% probability of it happening by April. The next scheduled interest rate decision by the Federal Open Market Committee is December 11.

Third quarter earnings are showing that this is a tale of two markets, especially in terms of earnings growth by sector. Overall, third quarter earnings are poised for the worst performance since early 2002. With 56% of the S&P 500 reporting, average profits are on pace to decline by 1%. Ironically, median profits have grown by 11.5%. The reason why the average and median earnings growth rates are so different is because the 21% of the S&P 500 companies which have missed estimates came up quite a bit short. Looking deeper, earnings for financial and consumer discretionary companies are down 16% and 15% respectfully, year-over-year. In sharp contrast, technology earnings are up 15% and health care earnings are up 14%. Profits for industrial companies are up 10%, and those for consumer staples firms are up 9%. So far, the gloom is contained to two of the ten sectors spanning the market.

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. The price-to-earnings (P/E) ratio for the S&P 500 is 17.8, giving an earnings yield (E/P) of 5.60%. Compared to the 4.48% yield on the 10-year Treasury note, stocks are reasonably priced at current interest rates. Our proprietary market breadth indicator turned negative on October 23, but only slightly so. It has already consolidated and is in position to move higher with only modestly positive breadth in the coming days. Volume has continued to be light compared with the sell-off in August.

Another way that this is a tale of two markets is evidenced by the outperformance of the growth style over the value style in recent months. Among the best performing stocks recently have been those which show exceedingly high earnings growth. To buyers of these stocks, valuations do not seem to be of concern. The simple presence (and sometimes perception) of earnings growth is enough reason to buy. While growth is the hot style of the moment, it would be prudent for investors to consider valuation before buying. Earnings growth is attractive for equity investors, but only when such growth may be bought "on sale". Eventually, the euphoria of growth investing wanes (usually with a nasty ending for those investors when dreams of growth turn out to be fantasy). In our view at Banyan Asset Management, Inc., value investors win in the long run.