"Central Bank Magic"
Market Commentary – December 2014

By Frank C. Fontana, CFA
President, Banyan Asset Management, Inc.
Written November 30, 2014 – www.banyan-asset.com

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 3.9% in the third quarter of 2014. The components of GDP reveal that this revision was a surprisingly strong improvement over the advance estimate of 3.5%. The following compares Q3 GDP components in the second estimate with the advance estimate: consumer spending +1.51 percentage points (vs. +1.22), investment +0.85 percentage point (vs. +0.17), net exports +0.78 percentage point (vs. +1.32), and government spending +0.76 percentage point (vs. +0.83). The most impressive revision was with investment, which was driven by businesses truly investing and not just creating inventory. Consumer spending was more robust than initially expected, which is favorable. It is not alarming to see net exports lower than expected (they tend to be volatile anyhow). Contributions from net exports will likely be challenged in future quarters as long as the U.S. dollar remains so strong. Finally, less-than-expected government spending from a fiscally-strapped government is a relief. Overall, the Q3 GDP reading was fairly solid. Other parts of the world, especially Europe and Japan, are jealous.

Stock markets worldwide have been rallying on the easy money policies of global central banks. We already know how the Bank of Japan jolted global markets on October 31 with a surprise, unprecedented asset purchase stimulus. Major stock markets rallied worldwide. About a week ago, the People's Bank of China announced a surprise interest rate cut in an attempt to juice the Chinese economy. Stock prices soared on the news. Later that day, European Central Bank (ECB) President Mario Draghi expressed the need to raise inflation in the eurozone "without delay". Markets interpreted this as a sign that the ECB will buy more eurozone bonds. Meanwhile, any news of the U.S. Federal Open Market Committee potentially delaying a raise in its federal funds rate is met with enthusiasm from stock market bulls. Investors around the world are addicted to low interest rates.

As global central banks distort asset prices with their macroeconomic experiment of easy money, investors should brace themselves for unintended consequences. Our biggest area of concern is the massive bubble in the sovereign debt market. The prices of many assets classes are pegged off of sovereign debt, so they are at risk, too. The following scenario expresses our concern. When the bubble in sovereign debt eventually bursts, long-term bonds would get crushed in price and yields would skyrocket. Money would rush to cash and gold, keeping short-term rates relatively low and thus steepening the yield curve. The stock market would fall sharply, making stocks a great buy. Ultimately, this may usher in a new golden age of investing, where equities are cheap and interest rates are more normal. However, we would have some pain to endure before we get there.

Technical factors of the market are bearish (more supply than demand), while fundamentals are attractively priced – therefore, we are mildly bearish on the market. The Standard & Poor's forecast for S&P 500 operating earnings per share (EPS) over the next 12 months is $129.21, which implies a price-to-earnings (P/E) ratio of 16.0 with the S&P 500 at 2068. The earnings yield (E/P) of 6.25% represents attractive value relative to the 10-year U.S. Treasury note yield of 2.19%. Low interest rates are making stock valuations more attractive than they would be in a more normal rate environment.

The divergence between small and large cap stocks is still present, with Nasdaq stocks leading the S&P 500 higher. As we analyzed in our October 2014 market commentary, this divergence hints that the stock market is not as healthy as one may think with the S&P 500 incrementally pushing to new highs on a regular basis. A correction from the amazing rally since mid-October is due. With the central banks' influence, it is unlikely that such a correction would develop into something nastier at this time. We are quietly locking in some gains on fairly valued stocks, while plugging our nose and buying some of the out-of-favor stocks. The tide has not been raising all boats, which we view as an opportunity.