"Doom And Gloom"

Market Commentary – July 2010

By Frank C. Fontana, CFA
President, Banyan Asset Management, Inc.
Written June 30, 2010 – www.banyan-asset.com

The third estimate of Gross Domestic Product (GDP) shows that the output of goods and services produced by labor and property located in the U.S. increased at an annual rate of 2.7% in the first quarter of 2010. The third estimate was revised slightly lower from the second estimate of 3.0%. While economists view a double-dip recession as unlikely, they do see the possibility of slower economic growth in the second half of 2010. Slower than expected growth in China, fiscal stimulus wearing off, a gloomy U.S. consumer, and fear of financial contagion from Europe have investors on edge. The 9.7% unemployment rate only tells part of the employment story, as those without jobs have been without work for nearly six months (twice the previous post-World War II peak of 12.3 weeks recorded in 1982-1983). With regulatory, tax, and economic uncertainty, businesses are hesitant to hire.

On June 23, the Federal Open Market Committee (FOMC) announced its decision to keep the benchmark Fed Funds rate at a record low target range of 0% to 0.25% "for an extended period". The FOMC reported that "the economic recovery is proceeding", which was a downgrade from their April 28 statement which said "economic activity has continued to strengthen". They added that "household spending is increasing but remains constrained by high unemployment, modest income growth, lower housing wealth, and tight credit." With concerns over economic troubles abroad making the situation in the U.S. worse, the Federal Reserve is having a difficult time deciding when to stop spiking the punch bowl with ultra-low interest rates. The Fed is walking a financial tightrope: tighter monetary policy would hurt economic growth, but inflation is a potential long-term effect of accommodative monetary policy. The next scheduled FOMC decision on interest rates is August 10.

Investors have flocked to the relative safety of U.S. Treasuries, boosting their prices and causing yields to tank. The 10-year U.S. Treasury note yields 2.95%, the lowest level since April 2009. Inflation is currently low (2.0% over the past year as measured by the Consumer Price Index), but investors are so afraid that they are willing to accept only 2.95% per year for ten years. If inflation is sparked in the years ahead, investors in these Treasuries will find that they did not avoid risk.

Technical factors of the market are mildly 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 $84.26, which implies a price-to-earnings (P/E) ratio of 12.2 with the S&P 500 at 1030. The earnings yield (E/P) is 8.18%, representing attractive value with the 10-year U.S. Treasury note at 2.95%. Having recently updated our intrinsic value calculations on all of the stocks owned in our portfolios, there is a common theme across all sectors that stocks are significantly undervalued. It may take time for market participants on a whole to recognize this, but this decline in stock prices is presenting an outstanding opportunity to accumulate high quality companies on the cheap.

While stocks prices continued lower in June and momentum is still to the downside, a positive divergence has developed. Our market breadth indicator bottomed on June 2 and turned slightly positive between June 23 and June 29. While it slipped back into negative territory on June 30, market breadth is not hitting new lows as stock prices are pushing to lower lows. This is a positive divergence and signals a favorable change of character in the background.

Volatility is back. It is amazing how two months ago stock prices were marching higher, oblivious to risk. It is equally amazing how quickly fear has spread, causing investors to react with their emotions. To profit from volatility, we sold covered calls on several stocks in appropriate portfolios. These calls will mature between July and October. We also added new positions to our portfolios, sticking with high quality companies that are generating excellent free cash flow. We are buying stocks into this decline.