"Time To Rest"

Market Commentary – April 2013

By Frank C. Fontana, CFA
President, Banyan Asset Management, Inc.
Written March 31, 2013 – 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. grew at an annual rate of 0.4% in the fourth quarter of 2012. This compares to the advance estimate of a contraction of 0.1% reported in January and growth of 0.1% reported in February. This pause in economic growth is expected to be temporary. As of March, the Federal Open Market Committee (FOMC) sees GDP expanding by 2.3%-2.8% in 2013, slightly more modest than the 2.3%-3.0% range for 2013 projected three months ago. Unemployment is expected to steadily trickle lower from 7.7% in February to 6.0%-6.5% during 2015. Inflation over the next three years is forecast to be tame (less than 2% per year).

The Fed has successfully used accommodative monetary policy to convince the financial markets that the future of the U.S. economy is bright. As long as unemployment remains greater than 6.5% and projected inflation in one to two years is expected to be less than 2.5%, the Fed has committed to keeping its benchmark Fed Funds rate in a range between 0% and 0.25%. However, the parameters that would end the quantitative easing program, where the Fed is buying $45 billion of long-term Treasury securities and $40 billion of mortgage-backed securities each month, are vague. The next FOMC decision on monetary policy is scheduled for May 1.

While the stock market rally in recent months has been enjoyable for investors, it would be prudent to recognize the key role monetary policy has played in the rally. By keeping interest rates ultra-low, investors have been forced to take on risk in order to earn better returns. This effect is favorable as long as investors recognize the risk they are taking. With bond prices sky-high and bond yields pushed down to historic lows, value is being found in the stock market. The true test of stock prices will come when the Fed starts giving signs of tightening monetary policy. If the economy has truly healed by then, stocks would likely hold their ground. However, if the economic malaise still lingers deep at a systemic level, stocks would probably experience a sharp correction. This issue is at the heart of the debate of whether stocks are currently in a secular bear or a secular bull market.

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 $111.14, which implies a price-to-earnings (P/E) ratio of 14.1 with the S&P 500 at 1569. While the earnings yield (E/P) of 7.08% represents attractive value relative to the 10-year U.S. Treasury note yield of 1.85%, stocks are not as cheap as they were five months ago.

While the stock market has marched virtually straight up from the November low, this pace of ascent is not sustainable. The S&P 500 is now up 16% from the low on November 15 without experiencing a significant correction. The all-time high for the S&P 500 had previously been 1565 on October 9, 2007. With the S&P 500 now at 1569, it is in the vicinity of the 2007 high. Technicians are excited to point out that above the 1565 level, there are no resistance levels overhead. Future resistance would be created whenever rallies in all-time-high turf peter out. There are plenty of support levels below: 1525 from the 50-day moving average and February consolidation, 1485 from the February low, and 1465 from resistance in September and October.

The perfect ending to this month's market commentary is the poem by Nelson Kjos titled "The Stock Market", as it appears in his book <u>The Money Manager and The Poet</u>. "It moves up and down and all around. You can be glad and then sad. Feel like a king, fly high on a wing. One should know best, when it is time to rest. Unfortunately, only a few appreciate this view."