"On Thin Ice"
Market Commentary – January 2008

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Written December 31, 2007 – www.banyan-asset.com

In the final calculation made by the U.S. Bureau of Economic Analysis, Gross Domestic Product (GDP), a measure of the value of goods and services produced in the U.S., grew 4.9% in the third quarter of 2007. The Federal Reserve predicts that 2008 GDP will grow between 1.8% and 2.5%. Former Fed Chairman Alan Greenspan, who now works in the private sector, estimates a 50% chance that the U.S. will enter a recession (classically defined as two consecutive quarters of contracting GDP).

Not all recent economic news has been unfavorable. Industrial companies are benefiting from the weak U.S. dollar and booming exports. Moreover, unemployment at 4.7% is historically low. As long as people stay employed and do not fear losing their jobs, they spend. Consumer spending accounts for roughly 70% of U.S. GDP.

Still, the housing market in the U.S. continues to weigh on the U.S. economy, with the threat of spreading globally. Robert Shiller, the well-known Yale University Professor of Economics, believes that declining U.S. house prices could force the economy into recession. According to Shiller, "this is a classic bubble scenario. A few years ago house prices got very high, pushed up because of investor expectations. Americans have fueled the myth that prices would never fall, that values could only go up. People believed the story." He added that American real estate values have already lost around $1 trillion, which could increase to $3 trillion over the next few years.

To soften the economic slowdown, the Federal Reserve cut its benchmark Fed Funds rate by 0.25% to 4.25% on December 11. According to the Fed, "economic growth is slowing, reflecting the intensification of the housing correction and some softening in business and consumer spending." If inflation rises any further, however, the Fed may be more reluctant to boost economic growth by lowering interest rates. While there is clearly deflation in housing prices, consumer prices globally are significantly higher than a year earlier (U.S. +4.3%, China +6.9%, and Europe +3.1%). Futures markets are pricing in a 36% probability that the Federal Open Market Committee will cut the Fed Funds rate by 0.25% to 4.00% when it meets on January 30.

Technical factors of the market are mildly bearish (more supply than demand), while fundamentals are fairly priced – therefore, we are mildly bearish on the market. The price-to-earnings (P/E) ratio for the S&P 500 is 18.6, giving an earnings yield (E/P) of 5.36%. Compared to the 4.04% yield on the 10-year Treasury note, stocks are reasonably priced relative to current interest rates. Fourth quarter earnings are due to be reported in January and February. Expectations for the financial and consumer discretionary sectors are dismal, while those for the materials and technology sectors are optimistic.

At Banyan Asset Management, Inc., our proprietary market breadth indicator is flat and skating on thin ice. There is weakness underlying the stock market right now. Fewer stocks are leading the way higher. While the market cap weighted S&P 500 index (large cap stocks) rose by +3.5% in 2007 (not including dividends), the equally-weighted version of the S&P 500 ended 2007 where it began. Growth stocks have outperformed value stocks over the past year. Within the S&P 500, growth stocks gained +7.7%, while value stocks fell -0.4%. The same relationship held true for the S&P 400 (mid cap stocks) and S&P 600 (small cap stocks). In fact, S&P 600 value stocks were down -6.9% in 2007.

While earnings growth is desirable, investors should not overpay for that growth. There are some attractive buying opportunities in stocks which are being irrationally sold out of fear. Stocks do not go on sale when the recent news is favorable. Still, it is important to consider market risk, in addition to security risk, when putting capital to work. The emotional decision making of market participants creates opportunity for profits, especially for investors with buying power (i.e. significant cash on the sidelines).