"Healthy Pullback"

Market Commentary – June 2011

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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 1.8% in the first quarter of 2011. This is unrevised from the advance estimate and is lower than the fourth quarter's reading of 3.1%. The U.S. recovery has exhibited weak economic growth, high unemployment (9.0% in April), and falling prices for homes.

Inflation is rumbling in the background. In April 2011, the Consumer Price Index rose 3.2% year-over-year (the highest since October 2008) and the Producer Price Index jumped 6.8% year-over-year (the highest since September 2008). The gasoline component of CPI is up a staggering 33.1% year-over-year. Companies are experiencing inflation in input prices. If this persists and companies have a hard time passing on these costs to consumers via higher prices, profit margins will get squeezed. On April 27, the Federal Open Market Committee (FOMC) acknowledged that "inflation has picked up in recent months", but noted that "longer-term inflation expectations have remained stable".

Eyes will be on the Federal Reserve in June as it completes its $600 billion purchase of longer-termed U.S. Treasuries, dubbed "QE2" for the second round of quantitative easing. The Fed is expected to stop new Treasury purchases, but continue to reinvest principal payments as existing holdings mature. The end of QE2 signals the end of an easing in monetary policy. This is the first step on the road to tightening monetary policy. The next scheduled FOMC decision on interest rates and quantitative easing will be announced on June 22.

While updating our universe of stocks last month, our research uncovered some intriguing companies that deserve more detailed analysis. Recently, *The Wall Street Journal* reported that companies in the Standard & Poor's 500 are holding a record pile of cash, totaling $960 billion. Indeed, our research identified many companies with strong balance sheets, robust free cash flow, and reasonable stock valuations. On the other hand, there are instances where investors are paying exorbitant premiums for growth. While growth is intoxicating to investors in a sluggish economy, it should not be purchased at a premium price. At Banyan Asset Management, we cannot justify the valuations at which these companies trade. Sometimes these stocks are hot performers, but our investment management style bypasses these high-fliers and instead focuses on stocks with a more favorable margin of safety.

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 $101.41, which implies a price-to-earnings (P/E) ratio of 13.3 with the S&P 500 at 1345. Earnings estimates are on the rise. The earnings yield (E/P) is currently 7.54%, which represents attractive value relative to the 10-year U.S. Treasury note yield of 3.05%. In our discounted free cash flow models, we lowered the risk-free rate from 4.5% to 4.0%, which boosts the intrinsic value calculation of stocks. We are cautiously watching long-term interest rates; should they spike, stocks would be less attractive.

Stock prices have risen sharply over the past 9 months. On August 31, 2010, the S&P 500 stood at 1049. It has risen 28% since then. The largest correction during that time was 6.4% in February and March of 2011. The most bullish thing that a stock can do is go up in price. However, volume has been light since September 2010, which indicates to technicians a lack of conviction in the market's move. Our market breadth indicator slipped into negative territory on May 24, showing that the number of stocks advancing is dwindling relative to the number of stocks declining. Strong support exists around 1250 due to the March low and the 200 day moving average. A mild pullback to this area would be healthy and would likely be met by buying.