"Turning The Corner"

Market Commentary – July 2009

By Frank C. Fontana, CFA
President, Banyan Asset Management, Inc.
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The final reading of Gross Domestic Product (GDP) shows that the value of goods and services produced in the U.S. fell by 5.5% in the first quarter of 2009. The job market continues to be tough, but it is slowly improving. Unemployment in May was 9.4%, the highest since August 1983. However, nonfarm payroll employment fell by 345,000 in May, approximately half of the average monthly decline for the prior six months. Jobs are still being lost; they are just not being lost as fast as they were in early 2009. Generally, unemployment tends to get worse even as the economy starts to come out of recession.

The Federal Open Market Committee (FOMC) recently wrote that "the pace of economic contraction is slowing". Mathematicians would say that the "second derivative" has turned positive. In other words, the economy is still contracting (the first derivative is negative), but it is contracting at a slower rate (the second derivative is positive). This is an early sign of an economic recovery. Sure enough, the financial markets have latched on to this concept, bouncing significantly higher from the lows in March. The FOMC added that "policy actions to stabilize financial markets and institutions, fiscal and monetary stimulus, and market forces will contribute to a gradual resumption of sustainable economic growth in a context of price stability". The Fed believes that excess capacity will contain inflation.

The FOMC kept its benchmark Fed Funds rate at a target range of 0% to 0.25% on June 24, and it expects to leave the rate at these exceptionally low levels "for an extended period". Futures markets currently buy into this idea, with the expected Fed Funds rate at only 0.5% by February 2010, 1.0% by June 2010, and 2.0% by February 2011. The Federal Reserve is maintaining its commitment to buy up to $1.25 trillion of agency mortgage-backed securities and up to $200 billion of agency debt by the end of 2009. Moreover, they will buy up to $300 billion of Treasuries by fall 2009 in an attempt to keep Treasury interest rates low. Wall Street is diligently watching for signs how the Fed will reign in its accommodative policies. Timing is critical; taking away the punch bowl from the party too soon could throw the economy back into a recession, while taking away the punch bowl too late would fuel inflation. Fed Chairman Ben Bernanke will need to carefully walk this financial tightrope in the months ahead.

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. Interest rates are still relatively low, which causes our discounted free cash flow models to justify higher stock valuations. When valuing a stock in this environment, it is important to consider potential earnings in a more normal economy, not just in a depressed one. Technically, our market breadth indicator flipped positive on June 1, but it slipped negative again on June 22. Volume is tapering off following the heavier trading in March and April. This is equivalent to a driver taking his or her foot off of the accelerator. We interpret these technical factors to mean that the stock market could see some mild selling pressure in the near future, but we do not anticipate a major drop.

The sideways consolidation in May and June has been healthy for the stock market overall. While investors enjoyed a strong bounce from the early March lows, such a move is not sustainable. Likewise, the panic decline observed in January and February was not sustainable, either. Depending on the client and their unique risk profile, we expect to be an incremental buyer of stocks into further stock market weakness. Covered call positions written a couple of months ago are working out well. Our June calls expired worthless, just like our May calls, which is favorable for our portfolios. Other remaining calls will mature between July and September. If the market chooses to march higher, we would look to sell some more covered calls into strength. In the meantime, dividends continue to trickle in. Income, whether from covered calls or dividends, helps instill patience as the market consolidates.