"The Downside Of Leverage"
Market Commentary – August 2007

By Frank C. Fontana, CFA
President, Banyan Asset Management, Inc.
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Gross Domestic Product (GDP), a measure of the output of the U.S. economy, grew 3.4% in the second quarter of 2007. As expected, the economy rebounded from revised GDP growth of 0.6% in the first quarter. Government spending and exports boosted GDP. On the other hand, consumer spending, which accounts for roughly 70% of GDP, grew only 1.3% in the second quarter. With the weak housing market, tight credit, and high oil prices, economists are now concerned about economic growth in the second half of the year. Trimming estimates given in February, the Federal Reserve now forecasts real GDP growth for 2007 in the range of 2.25% to 2.5%.

U.S. financial markets are anticipating that the Federal Reserve will cut its benchmark Fed Funds rate before the end of 2007. Specifically, futures markets are pricing in a 74% probability of a 0.25% cut in the Fed Funds rate by December. Looking out to July 2008, the Fed Funds rate is expected to be 4.75%, 50 basis points lower than the current level of 5.25%. Federal Reserve chairman Ben Bernanke predicts "moderate" economic growth in the second half with "a bit" of strengthening next year.

Tightening credit markets are cutting off the supply of easy money that helped propel stocks higher. Now that lending institutions are facing tough times with spiking subprime mortgage defaults, lenders are scrutinizing borrowers more closely. Investors are demanding more return for their risk; therefore, borrowing money has become more expensive. Private equity firms, which have relied heavily on borrowing money to buy other companies, may now have trouble borrowing cash. Plus, when firms invest too much borrowed money, one mistake can prove catastrophic. A slowdown in leveraged buyouts (LBOs) is likely going forward, with any mergers being smaller.

The takeover premium in stock prices seems to be deflating as liquidity dries up. Earlier this year, speculation of more leveraged buyouts inflated stock prices. With liquidity drying up, however, future buyouts seem less likely. In turn, stock prices have fallen. From the highest close in mid-July through 7/31, all of the major U.S. stock market indexes are significantly lower: Dow Jones Industrials Average -5.6%, Nasdaq -6.4%, Large Cap S&P 500 -5.1%, Mid Cap S&P 400 -7.5%, Small Cap S&P 600 -7.9%, and Russell 2000 -9.3%. Smaller companies are being hit harder than larger ones, but the selling is broad.

Technical factors of the market are bearish (more supply than demand), while fundamentals are fairly priced – therefore, we are bearish on the market. The price-to-earnings (P/E) ratio for the S&P 500 is 17.5, giving an earnings yield (E/P) of 5.71%. As stock prices have fallen in recent days, demand for the safety of U.S. Treasuries has pushed the yield on the 10-year note down to 4.77%. Growth in corporate earnings has slowed. With 25% of the S&P 500 reporting as of July 23, second quarter profits are now on track to rise 5.2%. For comparison purposes, a Thompson analyst estimates the long-term average earnings growth rate to be about 7.5%.

Trading volume has been heavy on the recent stock sell-off, indicating that there is some force behind the selling. Institutional investors, including hedge funds, mutual funds, and pension plans, who enjoyed the perks of being more fully invested in a rising tide, are now rushing for the same exit. With the S&P 500 currently at 1455, there is significant support around 1450. If that fails, the next major area of support is between 1375 and 1400. Our proprietary market breadth indicator has fallen sharply into negative territory, increasing the likelihood that support at 1450 will not hold.

The sharp pullback in stocks gives us reason to temporarily pause and observe market activity. We do not plan to exhaust our cash liquidity at this time, although we may incrementally buy some attractive stocks which we calculate to be undervalued. A balance of stocks and cash should help us weather stock market turbulence.