# "Ahead Of Reality"

## Market Commentary – April 2016

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*Written March 31, 2016 – 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 1.4% in the fourth quarter of 2015.** This is stronger than the 0.7% advance estimate and 1.0% second estimate. With its announcement on monetary policy on March 16, the Federal Open Market Committee (FOMC) updated its December 2015 economic forecasts. The FOMC now projects GDP growth of 2.2% in 2016, 2.1% in 2017, 2.0% in 2018, and 2.0% in the "longer run" (beyond 2018). December projections were 2.4%, 2.2%, 2.0%, and 2.0%, respectively. Unemployment is seen at between 4.5% and 4.8% and inflation is projected between 1.6% and 2.0% from 2016 through the longer run. The stagnant malaise is expected to continue for the foreseeable future. While it is unfair to call such economic growth "flat lining", it is safe to say that the economy could use a shock treatment to induce more meaningful growth. In the long run, companies cannot sustainably grow earnings faster than GDP, so low growth does weigh on stock prices.

**On March 16, the FOMC kept its benchmark federal funds rate steady between 0.25% and 0.50%, continuing its attempt to balance optimism for future growth with hesitation about risks to that growth.** The Fed cited in its written statement that the economy has been "expanding at a moderate pace", citing household spending and the housing sector as helping out. On the other hand, it said "business fixed investment and net exports have been soft". It also stated that "global economic and financial developments continue to pose risks". Fed Chair Janet Yellen told the Economic Club of New York on March 29 that the FOMC should "proceed cautiously" when considering future rate hikes. The next FOMC announcement on monetary policy is scheduled for April 27.

**While the long-term projections of interest rates are in question, stock investors are celebrating in the short run by hitting the buy button.** Their partying may be premature, however. The famous "dot plot", which illustrates the 17 FOMC participants' projections of the federal funds rate, suggests 1.02% by the end of 2016, 2.04% by the end of 2017, and 2.95% by the end of 2018. Interestingly, futures markets see a different story, forecasting 0.54% on the federal funds rate by the end of 2016, 0.72% by the end of 2017, and 0.98% by the end of 2018. This tells us that the Fed has a difficult job ahead with respect to managing market expectations. If the Fed raises interest rates as the dot plot suggests, investors will likely sell stocks aggressively.

**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 $123.37, which implies a price-to-earnings (P/E) ratio of 16.7 with the S&P 500 at 2,060. The earnings yield (E/P) of 5.99% represents attractive value relative to the 10-year U.S. Treasury note yield of 1.79%. Earnings estimates continue to come down. For example, the current estimate of $123.37 was $124.24 last month. We maintain that stocks are relatively more attractive because interest rates are so low.

**After the S&P 500 plummeted from December 29 to February 11, it has shown nearly a mirror image of strength through March 31.** The S&P 500 ultimately pushed north of its 200-day moving average, but there is significant resistance above (spanning up to 2,130). Significant support exists with the 50-day moving average near 1,950 and the January 29 closing high of 1,940. We would be more surprised to see continued strength than a pullback in the weeks ahead. Some stocks have gotten ahead of reality; perhaps we are toward the top of a trading range. In anticipation of a pullback, we have sold a few covered calls expiring in May in appropriate client portfolios. If stocks continue to rise, we will be forced to sell at prices we consider high. Forcing you to "sell high" is a subtle benefit of selling covered calls. We also plan to enjoy our healthy dividend yield, which is a solid 3.5% on average.