“Isn't It Ironic?”

Market Commentary – February 2016

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Written January 31, 2016 – www.banyan-asset.com

The advance 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 0.7% in the fourth quarter of 2015. This is a decline from the 2.0% growth seen in 2015 Q3. Looking into the components of the Q4 reading, the U.S. economy did indeed cool off. Consumption (historically about 70% of GDP) contributed 1.46 percentage points to GDP, which is down from 2.04 percentage points in 2015 Q3 and 2.42 percentage points in 2015 Q2. Investment weighed on GDP by -0.41 percentage point. Factoring out that inventories reduced investment by -0.45 percentage point, we are still left with an environment where fixed investment was flat. Net exports reduced GDP by -0.47 percentage point due to the strong dollar, but we do not get too worked up about that one. Finally, government spending contributed 0.12 percentage point to GDP (nothing noteworthy). Overall, the tepid economic growth can be described as one in which consumers are becoming more cautious and businesses have hit the brakes on investment spending in favor of a “wait-and-see” approach.

While the Federal Open Market Committee (FOMC) left its benchmark federal funds rate at 0.25% to 0.5% on January 27, they shocked market participants by leaving a March rate hike on the table. Recent global stock market volatility and the steep decline in the price of oil likely have Fed officials concerned. The FOMC press release stated they are “closely monitoring global economic and financial developments”, but they did not go so far as to hint that a March interest rate increase is no longer being considered. The U.S. stock market did not like this news. However, the Bank of Japan saved the day on Friday, January 29 with its decision to implement a negative interest rate (-0.1%) on current accounts that financial institutions hold at the central bank. In other words, the central bank will *collect* 0.1% for certain deposits instead of *paying* 0.1% (their prior policy). Global stock markets soared in response. It is interesting to note that the European Central Bank was the first major central bank to introduce negative interest rates in June 2014.

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 $122.99, which implies a price-to-earnings (P/E) ratio of 15.8 with the S&P 500 at 1,940. The earnings yield (E/P) of 6.34% represents attractive value relative to the 10-year U.S. Treasury note yield of 1.93%. While the dialogue surrounding the Fed has involved increasing short-term interest rates, market forces have ironically *lowered* the 10-year U.S. Treasury note yield due to concerns about the economy. Such a dynamic makes stocks relatively more attractive.

The S&P 500 broke out of its trading range to the downside, which may either invite an even lower trading range or a further decline. With the 1,870 area as support, the S&P 500 actually dipped as low as 1,812 intraday before consolidating for several days between 1,870 and 1,900. The strong rally on Friday was on excellent volume, which suggests more of a bounce ahead, possibly to around 2,000. However, much technical damage has been done to the stock market, and the path of least resistance for stocks remains down. The terrible January for stocks puts back in focus our worst-case downside target of 1,500 on the S&P 500, which corresponds to the index highs from the years 2000 and 2007.

As strange as it may sound, we are enjoying the market turmoil because lower stock prices creates opportunities to earn excellent returns with our cash. We are incrementally planting seeds by buying stocks that are on sale. The worse the sentiment about a sector or industry, the more comfortable we feel allocating some capital to it. It is also worth noting that January saw a few (but not all) of the 2015 market leaders finally come back to earth. Owning solid dividend paying stocks is coming back into favor. Isn't it ironic how when investors become afraid they run back to the good old “boring” stocks?