"Capitulation"
Market Commentary – October 2008

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Written September 30, 2008 – www.banyan-asset.com

The final reading of Gross Domestic Product (GDP) shows that the value of goods and services produced in the U.S. grew 2.8% in the second quarter. On its own, this GDP figure indicates a modestly growing economy. Of course, the second quarter ended June 30, so effects of the recent financial market volatility will not show up in GDP until the third quarter, which ended today. The National Bureau of Economic Research (NBER) defines a recession as "a significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in real GDP, real income, employment, industrial production, and wholesale-retail sales". The NBER tends to work on delay, however. For example, it declared on November 26, 2001, roughly eight months after the fact, that the U.S. economy entered a recession in March 2001.

At Banyan Asset Management, our hypothesis is that the turmoil occurring in the U.S. economy has its roots going back to the 1990s. Technology brought tremendous gains in productivity in the 1990s, which led to a boom in the stock prices of growing technology companies. This bubble burst in mid-2000 while the benchmark Fed Funds rate was 6.5%. Because of the recession in 2001 and the September 11, 2001 terrorist attacks, the Fed had to lower the Fed Funds rate drastically to boost the economy, finally settling at 1.0% by June 2003. Money became cheap to borrow, and people flocked to real estate. As real estate prices inflated to bubble proportions, interest-only mortgages became popular. Banks wanted to profit from the boom and issued mortgages to risky borrowers without doing their homework. Some of these loans were sold to investors via mortgage-backed securities, and the rest remained on bank balance sheets. As risky borrowers stopped making mortgage payments, these loans have turned toxic. No one knows what they are worth, and this has generated an enormous credit crunch and lack of confidence.

The media is hyping the $700 billion government bailout, which should help, but it will not magically make the economy's problems go away. Wall Street and Main Street are dealing with a crisis in confidence. To help restore confidence, the government should raise FDIC limits on bank deposits and provide similar guarantees for money market deposits (taxable and municipal). The government also needs to provide liquidity to the commercial paper market, enabling companies to meet their short-term obligations. This would help stop the run on banks and the flight to U.S. Treasuries. To deal with the toxic loans on the banks' balance sheets, banks could sell troubled loans to a government entity for a fraction of their worth, say 50 cents on the dollar. This enables banks to quickly come clean and the government could then have the patience and deep pockets to wait out the situation. It is unlikely that every troubled loan will default. Taxpayers may actually make money on the deal. There are other tools in the toolbox, as well, such as lowering the Fed Funds rate (which futures markets are now predicting), bringing back short-selling with the uptick rule, and eliminating mark-to-market accounting.

Technical factors of the market are bearish (more supply than demand), while fundamentals are attractively priced – therefore, we are mildly bearish on the market. With the S&P 500 at 1166 and earnings at $51.83, the price-to-earnings (P/E) ratio is 22.5. This may seem high, but we believe that earnings are temporarily low. Using S&P 500 earnings from one year ago, the P/E ratio drops to 13.7.

The panic in stock prices in recent days is providing a fantastic opportunity to "buy low", but human nature makes it difficult for many people to commit capital on these favorable terms. Some market analysts talk about "capitulation" ending bear markets. Capitulation simply means "throwing the baby out with the bath water", where people become so scared of stocks that they are overcome with fear and sell into the hysteria. Sellers are flushed out of the system, allowing stocks to then move higher. By keeping ample cash ready to deploy, we are positioned to buy stocks from these sellers. Indeed, we still expect to accumulate stocks incrementally in this environment while they are on sale. Balancing cash and stocks should allow for a degree of objectivity in the investment decision process.