"Stingy Dividends"
Market Commentary – August 2012

By Frank C. Fontana, CFA
President, Banyan Asset Management, Inc.
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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 1.5% in the second quarter of 2012. The U.S. Bureau of Economic Analysis revised GDP readings for the previous three years, including 2012 Q1 up from 1.9% to 2.0%. U.S. GDP grew 2.4% in 2010 and 1.8% in 2011. In a meeting with the Senate Banking Committee, Federal Reserve Chairman Ben Bernanke stated that "the U.S. economy has continued to recover, but economic activity appears to have decelerated somewhat during the first half of this year." Unemployment remains stubbornly high. With Europe in recession, growth in China slowing, and the U.S. facing a "fiscal cliff" at year-end (combination of tax hikes and spending cuts), there is plenty to worry about. These worries have created significant headwinds that curb growth. It is worth noting, however, that economists are still not generally forecasting a U.S. recession.

Market participants have been recently cheering the idea of more Fed monetary stimulus to help spur economic growth. The Federal Open Market Committee (FOMC) is scheduled to announce its latest monetary policy on the afternoon of August 1. The Fed has several options, including: initiate a new buying program of mortgage-backed or Treasury securities (i.e. "QE3"), announce its intention of keeping the Federal Funds rate in a range of 0% to 0.25% beyond late-2014, or use its discount window to provide cheap credit to banks that make new business or consumer loans. Rumors about Fed action have triggered stock market rallies in recent days. The trouble is that a major source of economic uncertainty involves fiscal policy; governments worldwide, including the U.S., are spending more than they are collecting via taxes. To instantly raise taxes or cut spending could throw an economy into a deep recession, so changes to fiscal policy should be gradual. Complicating the issue is the lack of willingness of elected politicians to "do the right thing", if they could even agree what that may be. The bottom line is that accommodative monetary policy can help buy time, but eventually fiscal policy must be fixed.

The dividend yield on the S&P 500, currently about 2.3%, could double if companies are simply willing to pay out more of their earnings. Banyan Asset Management's analysis of data provided to the public by Yale University Professor Robert Shiller indicates that the average dividend yield on the S&P 500 from 1871 to 2011 was 4.46%. Moreover, the average payout ratio during that time was 62%. According to Standard & Poor's, the payout ratio on the S&P 500 as of 3/31/12 was 30.8%. Assuming that companies once again prefer a 60% payout ratio, the dividend yield could rise to about 4.5%, in-line with the historical average. Companies make enough money to pay this level of dividend; they just have to be willing to pay it. The likelihood of dividend increases adds support to current stock prices.

Technical factors of the market are bullish (more demand than supply), while fundamentals are attractively priced – therefore, we are mildly bullish on the market. The Standard & Poor's forecast for S&P 500 operating earnings per share (EPS) over the next 12 months is $108.36, which implies a price-to-earnings (P/E) ratio of 12.7 with the S&P 500 at 1379. The earnings yield (E/P) of 7.86% represents attractive value relative to the 10-year U.S. Treasury note yield of 1.49%. Earnings are at historically high levels while major stock market indexes are not, which implies increased value in stocks.

The S&P 500 has exhibited a self-correcting "saw tooth" pattern with higher lows and higher highs over the past two months. The stock market has been taking two steps forward and one step back. Such a pattern is favorable since stock prices have not gotten ahead of reality. There should be plenty of support below: 50 day moving average at 1338, horizontal price support from July at 1330, 200 day moving average at 1320, and horizontal price support from June at 1310. Overhead, there should be stiff resistance around 1425. Should 1425 be broken, the next shot north is to 1500. The choppy pattern of advances and declines will likely continue, driven largely by news regarding corporate earnings, the Federal Reserve, European stability, and worldwide growth. The secular bear market remains in force.