"Siren Song"
Market Commentary – May 2013

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Written April 30, 2013 – 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 2.5% in the first quarter of 2013. This is a significant recovery from the growth rate of 0.4% in the fourth quarter of 2012, proving that that reading was an anomaly (as the market expected). GDP growth is the sum of consumer spending, investment, net exports, and government spending. Digging into the components of 2013 Q1 GDP, the 2.5% reading is decent. Consumer spending, which historically makes up about 70% of GDP, contributed 2.24 percentage points to the 2.5% growth rate. Investment contributed 1.56 percentage points to GDP, but one could argue that two-thirds of this was due to inventories increasing (not sustainable or desirable). Net exports, which tend to be volatile around the zero level, penalized GDP by 0.50 of a percentage point. Finally, government spending subtracted 0.80 of a percentage point from GDP. In summary, GDP growth is riding on the coattails of the consumer, aided by some business spending. This is more favorable than GDP growth driven by government spending and exports.

A huge question for investors is addressing when the Fed plans to curtail the accommodative monetary policy that has juiced the stock market. Minutes from the Federal Open Market Committee (FOMC) meeting on March 19 and 20 indicate that the Fed plans to "continue purchasing mortgage-backed securities and longer-term Treasury securities at about the current pace at least through midyear." Beyond that, members of the FOMC have differing views on how the Fed should proceed. For now, though, they collectively agreed that "additional purchases would be necessary to achieve a substantial improvement in the outlook for the labor market." The next FOMC decision on monetary policy is scheduled for May 1.

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 $113.15, which implies a price-to-earnings (P/E) ratio of 14.1 with the S&P 500 at 1598. The earnings yield (E/P) of 7.08% represents attractive value relative to the 10-year U.S. Treasury note yield of 1.68%. Despite the overall attractiveness of stock prices, there are pockets in the stock market that appear to have overheated. Wall Street has a tendency to be overly-giddy about growth and to bid such stock prices unsustainably high (only to collapse in exhaustion). Curiously, we are observing rich valuations in some stocks that are boring and traditional. It would behoove investors to pay attention to valuations of individual stocks they are considering, as value generates a certain "margin of safety". Valuations matter.

The stock market is ripe for a correction. The S&P 500 is now up 18% from the low on November 15 without experiencing a significant correction. With the index closing April at an all-time high, there is no resistance overhead; not, at least, until buyers get tired. At Banyan Asset Management, something we loved about the stock market in 2012 was the "two steps forward, one step back" self-correcting mechanism in stock prices. That is now gone in 2013. Should there be a correction, we would expect plenty of support in the upper 1400s for the S&P 500. This would be a healthy scenario.

When considering the temptations of this stock market, investors may wish to recall the Sirens from Greek mythology. The Sirens were famous for luring sailors with their beautiful music, only to lead them to their unsuspecting death. Curious to hear this music for himself without perishing, Odysseus instructed his crew to put beeswax in their ears, tie him tightly to the boat's mast, and leave him tied no matter how much he begs for his release. Using this method, he was able to successfully hear the Siren song…and survive. It is tempting to buy stocks because they have gone up. As human beings, we tend to believe that the trend will continue. Maybe it will, maybe it won't. By staying objective when making decisions, investors can have the discipline to enjoy the market's sweet music.