"Debt Is The Killer"

Market Commentary – March 2010

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Written February 28, 2010 – www.banyan-asset.com

The second 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 by 5.9% in the fourth quarter of 2009. This reflects an upward revision from the advance estimate of 5.7%. According to the Federal Open Market Committee (FOMC), "household spending is expanding at a moderate rate but remains constrained by a weak labor market, modest income growth, lower housing wealth, and tight credit". Further, it sees the pace of economic recovery as "likely to be moderate for a time". The FOMC expects resource slack to keep short-term and long-term inflation expectations stable. The bond market believes this, with the 30-year Treasury bond yielding only 4.53%.

Investors will need to watch closely how the Federal Reserve addresses monetary tightening as the economic recovery firms. The Fed surprised financial markets on February 18 when it raised the discount rate from 0.50% to 0.75%, citing "continued improvement in financial market conditions". Raising the discount rate (the rate banks pay on loans directly made by the Fed to banks) is not the same as raising the target Federal Funds rate (the rate banks charge each other, usually for overnight loans). Fed Chairman Ben Bernanke maintained that short-term interest rates are likely to remain near zero for at least several more months. Financial markets were relieved to hear Bernanke imply that the spiked punch bowl is not leaving the party. Still, analysts view this symbolic hike in the discount rate as a sample of what is to come. The next FOMC decision on interest rates is scheduled for March 16.

Fiscal policy made headlines in early February, as President Barack Obama's budget for fiscal 2011 projects a budget deficit of $1.6 trillion. The deficit is expected to trim back to $700 billion (4% of GDP) by 2013. Only about one third of the $787 billion Obama-administration economic stimulus program was delivered in Obama's first year. Infrastructure spending is set to ramp up for the program's second year, which will inject more cash into the private sector. Politicians know that such a deficit is alarming, but they are even more alarmed by the thought of curtailing spending and spinning the economy back into a deep recession under their leadership. Ben Bernanke warned Congress that federal budget deficits greater than "2.5 to 3 percent" of GDP could cause public debts to spiral out of control. For comparison purposes, the budget deficit in Greece is expected to be 12.7% of its GDP. While the U.S. situation is not ideal, Europe has its own troubles.

Technical factors of the market are mildly bullish (more demand than supply), while fundamentals are attractively priced – therefore, we are mildly bullish on the market. Standard & Poor's forecasts operating earnings per share (EPS) over the next 12 months for the S&P 500 to be $77.72, implying a price-to-earnings (P/E) ratio of 14.2 with the S&P 500 at 1104. The earnings yield (E/P) is 7.04%, which represents attractive value with the 10-year U.S. Treasury note at 3.60%.

The stock market has been consolidating in a trading range as it is building potential energy for its next major move. The S&P 500 hit a February low of 1044 before rallying back to 1104 by the end of the month. Our market breadth indicator turned positive on February 24. In terms of industries, 95.2% of them have a 50 day moving average above the 200 day moving average (our definition of an uptrend). As of January 9, 55.0% of industries were in a strong uptrend; now, 71.8% of them are in a medium uptrend. The short-term overbought situation has been alleviated.

Individual investors should focus on the strength of their personal balance sheets, which is something that governments cannot seem to do. Strong balance sheets lead to solid financial decisions. For example, it is tempting for investors to increase allocation to risky assets because money market funds are essentially paying no interest. The more prudent approach, however, is for the investor to understand the true purpose of liquidity. Investors with strong balance sheets survive recessions.