"Bracing For A Breakout"

Market Commentary – May 2008

By Frank C. Fontana, CFA
President, Banyan Asset Management, Inc.
Written April 30, 2008 – www.banyan-asset.com

According to the advance reading of Gross Domestic Product (GDP), a measure of the value of goods and services produced in the U.S., the U.S. economy grew 0.6% in the first quarter. Factoring in growth of only 0.6% in the fourth quarter of 2007, the U.S. economy has experienced the weakest two consecutive quarters since the recession of 2001. In his testimony to Congress' Joint Economic Committee in early April, Federal Reserve chairman Ben Bernanke noted that the U.S. economy could fall into recession. He stated that "real gross domestic product will not grow much, if at all, over the first half of 2008 and could even contract slightly". He expects economic growth to improve in the second half of 2008, as benefits kick in from the Fed's aggressive interest rate cuts and the government's $168 billion fiscal stimulus plan.

The Federal Open Market Committee (FOMC) lowered the benchmark Fed Funds rate by 25 basis points to 2.0% at its meeting on April 30. In a statement released by the Fed, they indicated that "financial markets remain under considerable stress, and tight credit conditions and the deepening housing contraction are likely to weigh on economic growth over the next few quarters." They added that "the substantial easing of monetary policy to date…should help to promote moderate growth over time and to mitigate risks to economic activity". Futures markets are forecasting that the Fed is not only done lowering interest rates for now, but that they will begin hiking rates again in 2009. The next decision on the Fed Funds rate will be announced on June 25.

While corporate earnings will likely come in lower than last year, the main culprit is the financial sector. With 52% of the S&P 500 companies reporting, earnings are on pace to fall 14.1% year-over-year. Earnings of financial companies are expected to plummet by 70% in the first quarter. Without the financials, S&P 500 earnings would actually rise by 8.6%. The consumer discretionary sector is also weak, with earnings set to drop by 13%. On the other hand, the energy sector should see earnings jump by 29%. Consumer staples and technology earnings are also strong, expected to grow by 11% and 9%, respectively. Other sectors should see earnings growth in the low to mid single-digit range.

Technical factors of the market are bullish (more demand than supply), while fundamentals are fairly priced – therefore, we are bullish on the market. The price-to-earnings (P/E) ratio of the S&P 500 is 20.9. Last month, the P/E measured 18.4. The rising P/E is a function of higher stock prices and lower earnings being announced. Weighing on earnings, financial companies have suffered large write-downs in recent months on expected loan defaults. As the economic cycle improves, however, these write-downs may prove too pessimistic and be reversed back into earnings in future quarters.

The S&P 500, battling with major resistance around the 1400 level, appears poised for a breakout. In August and November of 2007, the S&P 500 bottomed out near 1400, creating strong support. When support failed in January 2008, the floor under stock prices near 1400 became a new ceiling (technicians note that failed support levels become future resistance). Indeed, the S&P 500 has struggled with this 1400 level for nearly four months. In the meantime, though, stock prices have consolidated as the downtrend of lower lows gave way to sideways price action. Slowly, market breadth has crept back up into positive territory, indicating an improving health underlying the stock market.

At Banyan Asset Management, Inc., we have been incrementally buying stocks, putting some of our cash liquidity to work in equities we calculate to be "on sale". Investors get paid to take risk. Those who wait until the coast is clear may find themselves buying at the high price. In an attempt to capitalize on recent fear, we have bought stocks believed to be temporarily on sale. At the same time, we must recognize that until the market proves otherwise, it is in a primary bear market. Therefore, it is prudent to not exhaust our buying power. Maintaining balance keeps a portfolio in a position of strength.