"Reflection Point"

Market Commentary – April 2012

By Frank C. Fontana, CFA
President, Banyan Asset Management, Inc.
Written March 31, 2012 – www.banyan-asset.com

The third 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 3.0% in the fourth quarter of 2011. For 2012, the Federal Reserve projects GDP growth between 2.2% and 2.7%. A poll by *The Economist* estimates 2012 GDP growth at 2.1%. Either way, the expansion is viewed as mild. Moreover, the Fed sees 2013 GDP between 2.8% and 3.2%, 2014 GDP between 3.3% and 4.0%, and in the longer run between 2.3% and 2.6%. Expectations have adjusted for a low-growth domestic economy. With the bar having been lowered, there is a possibility for positive surprises in the future.

The Federal Open Market Committee (FOMC) announced in a press release after its meeting on March 13 that it "expects to maintain a highly accommodative stance for monetary policy". Their press release notes that "the Committee expects moderate economic growth over coming quarters and consequently anticipates that the unemployment rate will decline gradually". It also stated that "strains in global financial markets have eased, though they continue to pose significant downside risks to the economic outlook". Fed chairman Ben Bernanke is concerned about deep-rooted problems in the labor market. At a conference held on March 26, he said "we cannot yet be sure that the recent pace of improvement in the labor market will be sustained". He also referred to the recent improvement in the labor market as "something of a puzzle". Major stock market indexes rallied more than 1% on his comments, as this implies low interest rates may truly be here for a while.

The financial markets seem to be at a reflection point which will determine whether our current bull market rally is cyclical (short-term) or secular (long-term). On the surface, it seems reasonable that stock market participants would celebrate the prospect of low interest rates through late 2014, as the FOMC has indicated. With interest rates low, investment dollars are lured from cash, which pays next to nothing, into riskier asset classes, such as equities and high-yield "junk" bonds. Upon further reflection, though, one must realize that monetary policy is accommodative to address problems. The moment of truth will be when the Fed restricts monetary policy. Does the economy struggle again and possibly slip back into recession? Will there be enough momentum for the economy to carry forward without having the wind at its back? The answer will be revealed in the coming months. Meantime, our hypothesis at Banyan Asset Management is that this is a cyclical bull market within a secular bear market.

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 $104.94, which implies a price-to-earnings (P/E) ratio of 13.4 with the S&P 500 at 1408. The earnings yield (E/P) is 7.45%, which represents attractive value relative to the 10-year U.S. Treasury note yield of 2.22%. The gap between the earnings yield and the 10-year Treasury yield has narrowed, but stocks are still the better value.

While investors should be grateful for the fantastic rise in stock prices in recent months, it is unrealistic to expect this pace to continue. The S&P 500 has rallied 31% from the bottom in October. There is plenty of technical support for stock prices, and a moderate pullback to 1350 or 1330 would be healthy. Overhead, the next resistance areas are at 1425 and 1515. Market breadth is diverging, which indicates that fewer stocks are leading the march higher.

Our portfolios are positioned defensively in anticipation of a mild pullback in the stock market. Our investment style tends to avoid the "high-flying" stocks which have become popular in recent months. We prefer to stick with companies that are stodgier but more stable. Investors with risky stocks in a strong bull market can fall victim to their own emotions, as they gain a false sense that their investing style is invincible. They will learn. To quote the late Nelson Kjos, "investing is speculating enough".