"Staying True To Our Process"

Market Commentary – April 2017

By Frank C. Fontana, CFA
President, Banyan Asset Management, Inc.
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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 2.1% in the fourth quarter of 2016. This is higher than the advance and second estimates of 1.9%, but lower than the Q3 reading of 3.5%. On March 15, the Federal Open Market Committee (FOMC) released its revised economic projections. It sees GDP growth of 2.1% in 2017, 2.1% in 2018, 1.9% in 2019, and 1.8% in the "longer run" (beyond 2019). Only the 2018 value was increased by 0.1% when compared with December's forecasts, while the other numbers remained the same. From 2017 through the longer run, the Fed expects unemployment to fluctuate between 4.5% and 4.8% and inflation to remain around 2.0%. At Banyan Asset Management, we are hopeful that the economic policies of the Trump administration will stimulate growth, but it does not seem that the Fed shares in that hope.

The FOMC nudged its benchmark federal funds rate up by 0.25% to a range of 0.75% to 1.0% in its announcement on March 15. Moreover, the FOMC forecasts its federal funds rate at 1.4% by the end of 2017, 2.1% in 2018, and 3.0% in 2019 and the longer run. This implies two more 0.25% rate hikes in 2017. Interestingly, the Fed has chosen to continue reinvesting proceeds from maturing Treasury securities, agency debt, and mortgage-backed securities. The original purchase of these securities was known as "quantitative easing", and the Fed has indicated it will keep its bloated balance sheet until normalization "is well under way" (per Fed Chair Janet Yellen). Overall, the Fed continues to refer to its monetary policy as accommodative, albeit less so. The next announcement on monetary policy is scheduled for May 3.

The annual update of our universe of stocks highlighted a lot of expensive stocks, which we are avoiding. We analyzed a total of 1,959 companies one at a time, with a cumulative market capitalization of $30.8 trillion. Our process allowed us to identify "our universe", which is comprised of stocks we believe have the best risk/reward prospects (based on a combination of low valuation, low beta, low debt to market cap, and, usually, high dividend yield). A total of 97 stocks made the cut and have the following market capitalization ranges: $28 million to $500 million (24 stocks), $500 million to $2 billion (14 stocks), $2 billion to $10 billion (28 stocks), $10 billion to $100 billion (24 stocks), and >$100 billion (7 stocks). Most of the opportunities are in the small and micro-cap space, while the larger companies have been heavily picked over. In the coming months, we will perform in-depth fundamental research on the companies in our universe with attractive technical chart patterns to determine which ones we should buy.

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 $129.74, which implies a price-to-earnings (P/E) ratio of 18.2 with the S&P 500 at 2,363. The earnings yield (E/P) of 5.49% represents attractive value relative to the 10-year U.S. Treasury note yield of 2.40%, but this spread continues to narrow. Interestingly, the 10-year Treasury yield has remained relatively flat during the Fed's latest increase of the federal funds rate.

The stock market has not been as strong in 2017 as one might initially think, with a small handful of large technology companies (e.g., Apple, Facebook, Amazon, etc.) driving certain indexes at the expense of the others. A brief analysis of the following market indexes (without dividends) tells the story: +11.8% Nasdaq 100, +9.8% Nasdaq Composite, +5.5% S&P 500 Large Cap, +4.6% Dow Jones Industrial, +4.8% S&P 400 Mid Cap Growth, +2.2% S&P 400 Mid Cap Value, +2.1% S&P 600 Small Cap Growth, -0.8% S&P 600 Small Cap Value. At Banyan Asset Management, after a very strong 2016, our strategy fell out of favor at the beginning of 2017 and has remained that way thus far. Still, we remain patient and true to our process, and we refuse to chase the current hot stocks (which were cold in 2016, by the way). Investors who do chase performance may ultimately wonder in hindsight why they bought high…again.