"Heavily Medicated"

Market Commentary – March 2012

By Frank C. Fontana, CFA
President, Banyan Asset Management, Inc.
Written February 29, 2012 – 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 at an annual rate of 3.0% in the fourth quarter of 2011. This is higher than the advance estimate of 2.8. While the U.S. economy is growing in real terms (i.e. after inflation), the expansion is mild. This is surprising given the huge amount of monetary stimulus in the economy. During his biannual "Humphrey-Hawkins" testimony to Congress, Federal Reserve Chairman Ben Bernanke called the recovery "uneven and modest".

Unemployment has been ticking lower in recent months, causing the Fed to reconsider introducing additional monetary stimulus to the economy. The unemployment rate was 8.3% in January 2012, down from 9.1% in August 2011. On January 27, the Federal Open Market Committee (FOMC) projected the unemployment rate for 2012 to be in a range of 8.2% to 8.5%. Therefore, unemployment is already toward the low end of this projected range. Bernanke told Congress on February 29 that "continued improvement (in unemployment) is likely to require stronger growth in final demand and production". Indeed, economists commonly believe that stronger economic growth is needed to boost employment. It remains to be seen how sustainable the recent drop in unemployment really is.

Using a metaphor that equates the U.S. economy to a sick patient in the hospital, the patient is starting to feel better, but this feeling may be artificially induced by medication. The "medication" includes major accommodative monetary policy tools in place by the Fed, such as keeping the benchmark Fed Funds rate in a range of 0% to 0.25%, committing to maintain these rock-bottom levels through late 2014, and extending the average maturity of the Fed's portfolio holdings using "Operation Twist". Market participants are enjoying this medicated environment, as stock prices have jumped in response to the stimulus. One has to wonder, though, how robust this rally would be if economic data were so strong that it was clear the Fed could back off of its aggressively accommodative policy.

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 $105.00, which implies a price-to-earnings (P/E) ratio of 13.0 with the S&P 500 at 1366. The earnings yield (E/P) is 7.69%, which represents attractive value relative to the 10-year U.S. Treasury note yield of 1.98%. It is difficult to argue that stock valuations have inflated to bubble levels. As long as earnings estimates for 2012 stay firm, there is still more potential upside for stock prices.

Technical indicators are suggesting that this current rally needs to catch its breath. Having bottomed at 1075 in October, the S&P 500 has had a remarkable leap up to 1366. This is a 27% rally. While this has certainly been enjoyable for investors, such a pace is not likely sustainable. Decent support exists around 1300, with strong support occurring around the 200 day moving average at 1258. Looking above, resistance exists near 1425. Our market breadth indicator peaked on January 26, has pulled back, and is about turn negative. The number of stocks leading the market's overall charge higher is diminishing, suggesting a certain degree of exhaustion.

At Banyan Asset Management, we continue to view covered calls as a helpful strategy in anticipation of a mild pullback. The idea behind covered calls is to earn some income from call premiums and dividends to partially hedge some downside risk. Of course, if stocks prices drop, our portfolios would go down in value overall. The income generated would simply help soften the impact of a mild pullback. We have been patient with our buying in recent weeks, preferring to commit capital on slightly more favorable terms. Our hypothesis continues to be that stocks are in a cyclical (short-term) bull market, within the context of a secular (long-term) bear market.