"Muddling Along"
Market Commentary – May 2012

By Frank C. Fontana, CFA
President, Banyan Asset Management, Inc.
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The advance 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 2.2% in the first quarter of 2012. This reading is lower than 3.0% for 2011 Q4. Consumer spending growth accounted for 2.0 percentage points of the 2.2% GDP metric, while higher domestic investment offset lower government spending and net exports had a neutral effect. On a favorable note, the Federal Reserve bumped up its forecast for 2012 GDP from 2.2%-2.7% to 2.4%-2.9%. However, they simultaneously lowered their estimates for 2013 GDP from 2.8%-3.2% to 2.7%-3.1% and 2014 GDP from 3.3%-4.0% to 3.1%-3.6%. According to data from the U.S. Bureau of Economic Analysis, the last time real GDP growth was above 4% was in 2006 Q1. From 1997 to 2000, GDP grew annually by 4.5%, 4.4%, 4.8%, and 4.1%. Those were the days.

According to their statement released on April 25, the Federal Open Market Committee (FOMC) will continue to stimulate economic growth with accommodative monetary policy. The FOMC maintained that its benchmark Fed Funds rate will remain in a range of 0% to 0.25% through late 2014. Moreover, Operation Twist, which involves the extension of the average maturity of the Fed's securities holdings, is still in progress (though it is scheduled to end in June). In a press conference following the release of the FOMC statement, Fed Chairman Ben Bernanke said that the Fed remains "entirely prepared to take additional balance sheet actions if necessary". This is code for a third round of quantitative easing, dubbed "QE3". The stock market rallies whenever there is a hint that the Fed is considering QE3. The true test will be the strength of stock prices without all of this help from the Fed.

Having updated our universe of stocks in April, we observed numerous opportunities and potential land mines in the stock market. There are many companies with solid balance sheets, robust earnings, and reasonable stock valuations. These stocks deserve more detailed analysis. However, there is also a group of companies, especially in the technology sector, with nosebleed valuations. The difference between 2012 and 1999 is that these companies are profitable. Still, the valuation attached to these stocks is mindboggling. Just as the Sirens famously lured unsuspecting sailors to their demise with the sound of sweet music, investors are captivated by and paying exorbitant premiums for growth. The concept of "margin of safety" is timeless, and it would behoove investors to include it in their investing discipline.

Technical factors of the market are bullish (more demand than supply), while fundamentals are attractively priced – therefore, we are mildly bullish on the market. The Standard & Poor's forecast for S&P 500 operating earnings per share (EPS) over the next 12 months is $109.09, which implies a price-to-earnings (P/E) ratio of 12.8 with the S&P 500 at 1398. The earnings yield (E/P) is 7.80%, which represents attractive value relative to the 10-year U.S. Treasury note yield of 1.92%. Expected earnings are on the rise, which bodes well for the direction of stock prices.

The mild, but healthy, correction in April helped to recharge the market's battery. Resistance held firm at 1420, while support was found at 1360. It remains to be seen whether a deeper correction is necessary. In 2005 and 2006, the market used mild corrections as a foundation to meander higher. This may be the case again. Our market breadth indicator bottomed and has turned up. A breakout above 1420 would suggest a possible run to 1515. Below 1360, there is plenty of support.

We look forward to buying incrementally on favorable terms. In March and April, we had an opportunity to sell a few stocks, into strength, that are no longer in our universe of stocks. Having updated our universe, we are now performing detailed research on many companies – those we currently own and also new ones. Throughout this process, we are staying true to our investment style.