“Resistance”
Market Commentary – June 2016

By Frank C. Fontana, CFA
President, Banyan Asset Management, Inc.
Written May 31, 2016 – 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 0.8% in the first quarter of 2016. This is higher than the advance estimate of 0.5%. The components of GDP growth did not change much between the advance and second estimates: consumer spending +1.29 percentage points, investment -0.45 percentage point, net exports -0.21 percentage point, and government spending +0.20 percentage point. (Note how the sum of these four numbers is 0.83, which was the GDP reading.) Lackluster growth has been the hallmark of the economic “recovery” since early 2009.

All eyes are on the Federal Open Market Committee (FOMC) as market participants weigh whether the FOMC will announce a hike in the federal funds rate on June 15. On May 27, Federal Reserve Chairwoman Janet Yellen said that a rate increase would be appropriate “probably in the coming months” if the economy and labor market continue to strengthen. She has clearly telegraphed that the pace of rate hikes should be slow. If interest rates are not raised on June 15, the next announcement on July 27 would have a higher probability of including such news. With 2016 being a major election year, the FOMC may hesitate to adjust interest rates as November approaches.

The annual update of our universe of stocks, which we view as a treasure hunt, has revealed some interesting opportunities and land mines. We analyzed a total of 1,893 companies (84 more companies than we reviewed in July 2015) with a cumulative market capitalization of $26.3 trillion. This time, we dug deeper into the microcap companies, with our smallest company having a market cap of only $80 million (much less than our typical minimum of $400 million). The biggest opportunities seem to be in these smallest companies, which have apparently been forgotten while capital has gravitated to the “exciting” big companies that dominate the headlines (such as Amazon and Facebook). One of the most surprising observations was how expensive utilities stocks have become. Utilities stocks have been a favorite of Banyan Asset Management for many years, but the high valuations are an indication that the bubble in the fixed income market is spreading as investors search for income. Overall, we are looking forward to doing in-depth analyses on the companies in our universe in the coming months.

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 $125.93, which implies a price-to-earnings (P/E) ratio of 16.7 with the S&P 500 at 2,097. The earnings yield (E/P) of 6.00% represents attractive value relative to the 10-year U.S. Treasury note yield of 1.83%. As we uncovered while updating our universe of stocks, valuations are a mixed bag. Overall, they are attractive because interest rates are so low. However, there are some extremely expensive stocks mixed with others that are being virtually ignored. It seems that investors are paying high premiums for growth – a risky practice.

With the S&P 500 on the doorstep of major resistance in the 2,100 area, investors are at a decision point. Rallies at this level have consistently failed over the past year-and-a-half, so our expectation is that this time will be similar. One factor in favor of the market heading higher is that investor sentiment is not bullish. The most recent American Association of Individual Investors (AAII) weekly survey on investor sentiment was 17.8% bullish, 52.9% neutral, and 29.4% bearish (compared with historical averages of 39% bullish, 31% neutral, and 30% bearish). AAII commented that this is only the sixth time in the survey’s history (since June 1987) where optimism was below 20% and neutral sentiment was above 50% in the same week. They also added that “on average, the S&P 500’s 26- and 52-week returns following those five corrections were 11.2% and 25.7%, respectively.” All of this being said, we were happily called out of a couple stocks on the third Friday of May. In addition to a fortified income stream, covered calls provide a disciplined way to sell high. When stocks get ahead of reality, it is better to sell.