"The Correction"

Market Commentary – June 2013

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Written May 31, 2013 – 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 2.4% in the first quarter of 2013. This is a slight drop from the advance estimate of 2.5% and robustly ahead of 0.4% in the fourth quarter of 2012. The unemployment rate trickled down to 7.5% in April, which is the lowest reading since December 2008. While still relatively high, unemployment has steadily trended lower since it peaked at 10.0% in October 2009. The Federal Reserve is targeting unemployment at or below 6.5%. Inflation remains tame, as the Consumer Price Index rose only 1.1% for the 12-month period ending April 2013. The Fed remains committed to an inflation rate at or below 2%.

Financial market participants are trying to anticipate the end of "quantitative easing" (QE), the name given to the Federal Reserve's program of buying Treasury and mortgage-backed securities. QE has helped to fuel a rally in the stock market, which has undoubtedly generated a wealth effect that is buoying economic demand. The timing of the end of QE is a major debate these days, and the Federal Reserve's conflicting signals have left the financial markets guessing. In his recent testimony to Congress, Fed Chairman Ben Bernanke said that "a premature tightening of monetary policy could lead interest rates to rise temporarily but would also carry a substantial risk of slowing or ending the economic recovery and causing inflation to fall further." However, he also added that QE may be reduced at one of its "next few meetings." Minutes from the April 30-May 1 meeting of the Federal Open Market Committee (FOMC) revealed that some FOMC officials were prepared to curtail QE at the June meeting, while the group as a whole seemed more cautious. A change in Fed policy may cause headwinds for the stock market. The next FOMC decision on monetary policy is scheduled for June 19.

Bullishness is too rampant and a healthy correction needs to take place soon…or else. It is common belief that pictures of bears appearing in the media occur near market bottoms, while pictures of bulls signal market tops. These clues indicate complacency with market participants. In the May 11-17 edition of *The Economist* magazine, the cover showed a snorting bull breaking through a wall under the headline "Wall Street Is Back." The article is actually about investment banking instead of the roaring stock market, but robust investment banking is indeed linked to the stock market. The cover of the May 13 edition of *Barron's* states "Dow 15,000: This Bull Has Room To Run", as the supporting article gloats "we were right!" regarding the rally. Bold predictions of Dow 17,000 by year-end are given. Such a rally may or may not happen, but these predictions are an eerie sign of emotions running strong in the bullish camp. A correction now would help to ground investors with a sense of reality. Delaying such a correction could trigger something more severe down the road. Eventually the tide will go out.

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 $112.47, which implies a price-to-earnings (P/E) ratio of 14.5 with the S&P 500 at 1631. The earnings yield (E/P) of 6.90% represents attractive value relative to the 10-year U.S. Treasury note yield of 2.16%. It is important to note that the earnings multiple on stocks has expanded, showing that stocks are not as cheap as they were several months ago. Also, interest rates have spiked over the past month. It is unclear whether this is due to the economy improving in health or the bond market bubble bursting.

Given the high-volume trading on down days over the past two weeks, it appears that "the correction" has begun. Previous corrections of the S&P 500 since November have only led to the 50-day moving average (currently 1600). A pullback to the 200-day moving average (currently 1490) would inject a bit of fear needed for stocks to ironically propel higher. Corrections are painful and not much fun, but they should not be feared. Instead, investors should fear bullishness that is out of control.