"Stocks On Sale"
Market Commentary – January 2009

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The final reading of Gross Domestic Product (GDP) shows that the value of goods and services produced in the U.S. declined by 0.5% in the third quarter. On December 1, 2008, the National Bureau of Economic Research (NBER) finally declared that the U.S. economy is officially in a recession, and it has been in one since December 2007. Already with an age of 12 months, the current recession is mature and one of the worst since the Great Depression. Looking at the previous ten recessions post-World War II, eight of them lasted 6 to 11 months. The recessions from November 1973 to March 1975 and from July 1981 to November 1982 were longer, each lasting 16 months. In comparison, the Great Depression, marked by the recession from August 1929 to March 1933, lasted 34 months (nearly 3 years).

Economic news headlines are not likely to get better any time soon. Numerous economic metrics are facing multi-decade lows. November housing starts tanked 18.9%, the lowest since records began in 1959. Thanks to the crash in commodity prices, consumer prices fell 1.7% in November, the most since records began in 1947. Holiday same-store sales are expected to fall 1.5%-2.0%, which would be the worst since 1970. Unemployment, currently 6.7%, is at a 15-year high. With fourth quarter earnings season about to begin, investors will actively seek any glimmers of hope in the horrible news.

The Federal Open Market Committee (FOMC) lowered its benchmark Fed Funds rate to a record-low range of 0% to 0.25% when it met on December 16. Moreover, the Fed announced that it expects interest rates to remain "exceptionally" low for some time. Now that interest rates are next to nothing, the Fed will rely on "quantitative easing", which involves increasing the supply of U.S. dollars. Indeed, the Fed's balance sheet has swelled from $1 trillion in September to more than $2.2 trillion in December. Announcements of the Fed's plan to buy agency debt and mortgage-backed securities have pushed interest rates lower, thus benefitting homeowners. One thing is certain: the Fed is committed to lifting the U.S. economy out of recession. The next scheduled FOMC meeting will be on January 27 and 28.

Technical factors of the market are bullish (more demand than supply), while fundamentals are attractively priced – therefore, we are bullish on the market. With the S&P 500 at 903.25 and using Standard & Poor's operating earnings forecast for the next 12 months of $70.22, the price-to-earnings (P/E) ratio for the S&P 500 is 12.9. The earnings yield (E/P) on the S&P 500 is 7.77%. Stocks are cheap when compared to the 10-year Treasury note yield of 2.25%. Treasury yields may be unsustainably low, however, as the flight to quality has created a bubble in Treasury prices.

While there is always risk that the market decline may resume, the bigger risk for investors is missing out on an explosive rally. At Banyan Asset Management, our proprietary market breadth turned decisively positive on December 10, as advancing stocks are now outweighing declining stocks. Telling a similar story, only 31.1% of the 209 industries spanning the entire stock market are in strong downtrends, compared with 95.2% of industries only 5 weeks ago. Many sellers capitulated and were flushed out of the market. As an investor, it does not pay to panic.

Throughout 2008, and especially in recent months, we have been incrementally buying stocks at seemingly bargain prices. As a result, cash positions in our portfolios are at the lower end of the range over the past year. Should the market experience the significant rally we are expecting, our plan is to sell covered calls maturing between one and six months in the future. This will generate cash flow and help our portfolios profit from volatility. The debate in the media about whether the market has bottomed is healthy. The skeptics are the ones who will feel pressure to put cash to work when the S&P is once again at higher levels, as they kick themselves for not buying when it was at 900. Imagine…how many investors and analysts would be surprised if the stock market actually has an outstanding 2009?