"Will Santa Claus Visit Wall Street?"

Market Commentary – December 2004

By Frank C. Fontana, CFA
President, Banyan Asset Management, Inc.
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Overall, the U.S. economy continues to show solid, but moderate, growth amid concerns of high energy prices, a lack of any new tax stimulus, and a slow-down in mortgage refinancing.

- The Conference Board's consumer confidence index fell to 90.5 in November from 92.9 in October. Uncertainty with gasoline and heating oil costs are weighing on consumer confidence.
- U.S. productivity rose 3.1% year-over-year in the third quarter, below the second quarter's 4.9%.
- Unemployment edged up to 5.5% in October from 5.4% in September, but that is still down from a high of 6.3% in June 2003.
- The four-week moving average for new jobless benefits fell to 332,000 in the week ended November 20, the lowest level since November 2000.

The flight of foreign capital from U.S. Treasuries could cause interest rates to spike, thus cooling off the U.S. economy. The U.S. "current account", a measure of the balance between imports and exports in the U.S., is in deficit because the U.S. imports more goods and services than it exports. In the second quarter of 2004, the U.S. current account deficit hit a record $664.8 billion annual rate. Since foreigners receive dollars in exchange for goods sold in the U.S., they may invest those dollars in U.S. assets such as stocks and bonds. (One economist estimates that foreigners own 50% of U.S. Treasuries.) With interest rates relatively low and the dollar weakening, U.S. investments are less attractive for foreigners. As a result, they sell U.S. Treasuries, causing interest rates to spike. Federal Reserve Chairman Alan Greenspan suggested that the U.S. can lessen its dependence on foreign capital if Washington reduces the federal budget deficit.

The Federal Reserve is expected to raise their benchmark Fed Funds rate another 0.25% to 2.25% at their meeting on December 14. When the Fed hiked rates 0.25% to 2.0% on November 10, they indicated their intention to continue tightening rates at a "measured" pace. Signs of inflation in the past few weeks confirm this intention. In October, the Consumer Price Index (CPI), a measure of inflation in goods and services purchased by consumers, rose 0.6%. Producer prices surged 1.7% in October (4.4% year-over-year), the largest gain since January 1990. The inflation data and the rise in the price of gold, oil, and other commodities suggest that inflation is lurking. The Fed is expected to hike rates well into the first quarter of 2005.

Technical factors of the market are bullish (more demand than supply), while fundamentals are fairly priced – therefore, we are mildly bullish on the market. Fundamentally, stocks are at the high end of fair valuation. Technically, the market had a strong rally on high volume in November. While our proprietary market breadth indicator suggests that the market is short-term overbought, it has stayed intermediate-term bullish. Our proprietary sector analysis has been bullish since the end of October.

While December is usually characterized by tax-loss selling, it also typically hosts a "Santa Claus" rally. Tax-loss selling occurs when investors sell their losing stocks to offset gains from winners. With the flat market of 2004, we expect the effect of tax-loss selling to be less pronounced. A "Santa Claus" rally usually prevails the last week or two of December, evidenced by rising market indexes. Moreover, the stock market is in a seasonally favorable time of year (between November and April).

We continue to incrementally focus on offense in our portfolios, while guarding a prudent level of cash. On low volume market declines, we are buying undervalued stocks with bullish technical chart patterns. While we are net buyers of stock, we do not feel the urge to exhaust our cash. Our cash positions help reduce the effects of market volatility on our portfolios.