“Skeptical”

Market Commentary – February 2007

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The Commerce Department issued its preliminary report that the U.S. economy, as measured by Gross Domestic Product (GDP), expanded by a healthy 3.5% in the fourth quarter. To put this in perspective, the 20-year average for GDP growth in the U.S. is 3.1%. With GDP growth in the second and third quarters at 2.6% and 2.0% respectively, some economists claim that the “soft landing” for the U.S. economy has already happened. Consumer spending, which makes up more than two-thirds of the U.S. economy, has clearly more than compensated for the struggling housing market and higher short-term interest rates from the Federal Reserve’s rate hike campaign that ended last year. Overall, it seems that the economy is characterized by solid growth, low unemployment, and modest inflation that is stable.

Earlier today, the Federal Reserve chose to leave their benchmark Fed Funds rate unchanged at 5.25% for the fifth consecutive meeting. In their post-meeting statement, the Fed said that “recent indicators have suggested somewhat firmer economic growth and some tentative signs of stabilization…in the housing market”. Moreover, “inflation pressures seem likely to moderate”. The Fed understands the need to under-promise and over-deliver by reiterating that economic growth is likely to “moderate” into 2007. Following the GDP report, futures markets changed their forecast from the Fed lowering rates by July to possibly raising rates. The stock market cheered this news.

The yield curve is still curiously flat as investors are satisfied with earning nearly the same annualized interest rate for various time periods. As of 1/31/07, annualized Treasury yields were 5.12% for three months, 5.16% for six months, 5.09% for one year, 4.94% for two years, 4.82% for five years, 4.83% for ten years, and 4.93% for thirty years. At Banyan Asset Management, Inc., we maintain that the low ten year and thirty year Treasury yields are critical to high stock market valuations. Not only would higher long-term interest rates raise borrowing costs and thus lower net income, but they would also cause discounted cash flow models to estimate lower fair values for stocks. While long-term interest rates have stayed low for a while now, they should be monitored closely for future increases.

Technical factors of the market are mildly bearish (more supply than demand), while fundamentals are fairly priced – therefore, we are mildly bearish on the market. With 39% having already reported fourth quarter earnings, S&P 500 companies are on track to post 9.9% profit growth over last year. Should this number end up greater than 10%, it would mark the fourteenth consecutive quarter of double-digit profit growth. The price-to-earnings (P/E) ratio for the S&P 500 is 18.1. This may be justified if earnings growth continues to be strong, but valuations could take a hit if earnings stumble.

While the stock market indexes have generally marched higher since bottoming in July, volume has noticeably not kept pace. Market technicians, those who study charts of the past in order to forecast the future, usually prefer to see volume move higher with price. The diverging trends of price and volume suggest that buying support behind the rally since July is not as strong as one might initially believe. We interpret this as a cautionary flag and are skeptical of the stock market’s recent strength.

Our stocks have continued to enjoy upside, but we are also closely guarding our cash positions. Our recent research has uncovered several interesting stocks for possible investment. While security risk for these equities looks favorable, market risk makes us cautious. A portfolio that does not have any stocks is not able to benefit from rising stock prices. At the same time, by keeping a prudent amount of cash on hand, a portfolio can weather stormy seas and capitalize on lower prices when stocks are truly cheap. It is important to maintain a balance between stocks and cash in this environment.