"Strong Economy And Weak Stock Market"

Market Commentary – August 2004

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Gross Domestic Product (GDP), a measure of the output of the U.S. economy, grew 3.0% in the second quarter of 2004, down from the first quarter's upwardly revised growth rate of 4.5%.

- The Institute for Supply Management Purchasing Manager's Index, a leading indicator of economic activity, measured 61.1 in June, the 14th consecutive month above 50 (readings above 50 indicate economic growth).
- The Conference Board's consumer confidence index rose to 106.1 from 102.8 in June, the highest reading since June 2002.
- Unemployment was stable at 5.6% in June (unemployment peaked at 6.3% in June 2003).

While the economic recovery continues, there are mounting arguments for growth to slow:

- Inflation is creeping into the economy. The Consumer Price Index (CPI), a measure of inflation, rose 3.3% since June 2003, the biggest annual gain since May 2001. Core inflation, which factors out the volatile food and energy sectors, was 1.9%, the highest since January 2003.
- Interest rates are on the rise, which increases interest expense and pressures corporate earnings.
- Consumer spending is slowing, rising only 1% in the second quarter (weakest gain in three years).
- The U.S. presidential election between President Bush and John Kerry is close and uncertain.
- Geopolitical concerns, especially those associated with terrorism, lurk in the background.

Corporate earnings are expected to slow in the second half of 2004. As of July 23, with 177 of S&P 500 companies reporting second quarter earnings, 125 beat expectations, while 17 met and 35 missed. Earnings for S&P 500 firms in the second quarter are expected to be nearly 24% higher than a year earlier, the fourth straight quarter of 20% or greater year-over-year growth. Tougher comparisons to last year should limit earnings growth to 14.9% in the third quarter of 2004 and 15.4% in the fourth quarter.

The stock market is experiencing "price-to-earnings (P-E) compression" due to rising interest rates. Last week the P-E ratio for the S&P 500 hit 17.7, the lowest since 1996. In the late 1990s, the P-E ratio for the S&P 500 was more than 25. To put these values in perspective, the average P-E ratio for the S&P 500 going back to 1988 is 20, and going back to 1935 is 15.6. The market's P-E ratio appears to be reverting to its long-term mean as interest rates rise and lower fair valuations for stocks are expected.

Technical factors of the market are bearish (more supply than demand), while fundamentals are fairly priced – therefore, we are bearish on the market. Fundamentally, stocks are valued at the high end of fair valuation. Technically, while the major indexes are still in long-term uptrends (time horizon of more than a year), they are in intermediate-term downtrends (time horizon of several months). The S&P 500, Dow Jones Industrials Average, and Nasdaq Composite all broke below their 200-day moving averages on high volume in July. The stock market is in a precarious position heading into the seasonally weak months of August and September.

Banyan Asset Management's proprietary sector analysis and market breadth indicator suggest an emphasis on defense in our portfolios. Over the past three weeks, of the 209 industries spanning the entire stock market, the percentage of industries in a strong downtrend has jumped from 3.3% to 14.8%. Our proprietary breadth indicator quickly turned negative in early July and continues to break down.

In 2004, our approach to building client portfolios has proven profitable while the major market indexes have yielded negative returns year-to-date. We continue to follow our disciplined strategy of combining an offense of buying undervalued, technically strong individual stocks with a defense of selling covered calls and maintaining an adequate cash balance so that we may "buy low".