“Be Conservative”

Market Commentary – April 2005

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There are hints that manufacturers are starting to pass their price increases on to consumers. The core producer price index (PPI), a measure of the cost of goods used by manufacturers, has surged 2.8% between February 2004 and February 2005, the biggest jump since late 1995. The core consumer price index (CPI), a measure of inflation in consumer goods, has jumped 2.4% in the past year, the fastest pace since August 2002. Because it can squeeze companies’ profit margins and increase interest rates, inflation is generally viewed as a negative for the stock market.

As expected, the Federal Reserve raised their benchmark Fed Funds rate another 0.25% to 2.75% at their meeting on March 22. This was the seventh 0.25% tightening move since June 2004. In their prepared statement, the Fed communicated plans for future “measured” rate hikes, especially with evidence of inflation heating up. Futures markets have priced in 0.25% hikes at the next several Fed meetings, with a possible 0.50% hike at either the May 3 or June 30 meeting. At Banyan Asset Management, we maintain that as interest rates continue to rise over the coming months, favorable yields will make short-maturity bonds attractive to buy.

Corporate earnings growth is slowing, while the quality of earnings will likely deteriorate. Earnings for the S&P 500 companies grew 20% year-over-year in the fourth quarter of 2004. This brisk pace is not sustainable. The long-term historical average of earnings growth is 7.6%. Earnings in the first quarter of 2005 are expected to grow only 7.2% over last year. After years of cost-cutting, revenue growth will have to carry more weight in growing earnings. If revenue growth falls short, companies may be tempted to back out “special charges” from earnings to make their income statements look better than they really are. As investors, we need to monitor earnings quality as true growth becomes more difficult to achieve.

Technical factors of the market are bearish (more supply than demand), while fundamentals are fairly priced – therefore, we are mildly bearish on the market. Concerns about stock valuations underlie the stock market’s recent weakness. The yield on the 10-year U.S. Treasury note has risen above 4.5%. Any future increases in long-term interest rates, which we expect, will cause the fair valuations of stocks to fall.

Technically, market declines in March have been on slightly higher volume than the rallies. The Dow Jones Industrials Average and the S&P 500 (large-cap) are testing support at their January lows, which also marked their lows for 2005. Meanwhile, the S&P 400 (mid-cap) and S&P 600 (small-cap) indexes are about 4% above their low points for 2005. Overall, the stock market is in a long-term and intermediate-term uptrend and a short-term downtrend.

Our proprietary market breadth indicator went negative on March 21 and has been gaining momentum in negative territory. The explosive market rally on March 30 was likely a “dead-cat bounce” ignited by short covering. It will take a more sustained improvement in market breadth to reverse our indicator. Our proprietary sector analysis shows that 74.2% of the 209 industries spanning the entire stock market are in either “strong” or “medium” uptrends. The Energy sector seems ripe for a pullback, while the defensive sectors (Utilities and Consumer Staples) appear more stable.

We locked in some profits into strength in February and early March and have raised some cash. When we find stocks that are undervalued with bullish technical chart patterns, we will add them to our portfolios. We are currently protective, however, of our buying power. If the market rallies into early April on light volume, we will lock in a few more profits and sell some covered calls with expiration dates spanning the entire summer. It is important to be conservative in this low-return market environment.