"Protecting Portfolios With Cash"

Market Commentary – September 2004

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The Federal Reserve raised their benchmark Fed Funds rate 0.25% to 1.5% at their meeting on August 10, indicating expectations of solid economic growth and modest inflation. They explained that the spike in energy prices likely helped slow GDP growth from 4.5% in the first quarter of 2004 to 3% in the second quarter. After bottoming at a 46-year low of 1.0%, a Fed Funds rate of 1.5% is still relatively low. To put this in perspective, the last interest rate cycle peaked at 6.5% in May 2000. Before that, the last time the Fed Funds rate was higher than 6.5% was back in 1991. The next Federal Reserve interest rate decision is on September 21.

While the spike in the price of oil and political instability in Iraq are important factors in the future of interest rates, the key factor may be U.S. job growth. The unemployment rate fell to 5.5% in July, the lowest level since October 2001. However, the non-farm payrolls report showed that the U.S. economy created only 32,000 jobs in July, far below forecasts of 243,000. This is the fourth straight month of decelerating job growth. On weak job growth news, the Treasury markets have been rallying in price and selling off in yield in anticipation that the Fed will not have to raise rates as aggressively as previously thought. With strong job growth in March and April, yields on the 10-year Treasury note jumped from 3.7% on March 17 to 4.8% on May 13. Now the 10-year Treasury note yields only 4.1%. Further weakness in job growth would likely allow the Fed to be more patient in hiking rates.

The Volatility Index ("VIX"), a measure of option volatility and a contrary sentiment indicator, suggests that investors are complacent in their view of market risk (which can be interpreted as bearish for the stock market). A high VIX implies that investors have a high degree of fear, while a low VIX suggests a low level of fear. Typically markets bottom when fear is high and they peak when fear is low. Going back to 1997, the VIX oscillated between 20 and 30, with spikes at market bottoms reaching as high as 40 or 50. In contrast, the VIX has spent most of the past year hovering between 14 and 20, closing at 15.3 on August 31. While a low VIX does not guarantee a market decline, it does hint that investors may have let down their guard.

Technical factors of the market are bearish (more supply than demand), while fundamentals are fairly priced – therefore, we are mildly bearish on the market. Fundamentally, stocks are valued at the high end of fair valuation. Technically, volume was anemic in August, indicating a lack of conviction. The major market indexes (S&P 500, DJIA, and Nasdaq) continue their intermediate-term downtrends, staying below their 200-day moving averages since breaking them on high volume in July. There is a lot of resistance overhead, reinforced by the range-bound market thus far in 2004.

Banyan Asset Management's proprietary sector analysis recommends continued defense, while our market breadth indicator has improved. Over the past seven weeks, of the 209 industries spanning the entire stock market, the percentage of industries in a strong downtrend has jumped from 3.3% to 19.1%. Our proprietary breadth indicator turned positive about one week ago. We observe this with caution, however, since the improved breadth was not accompanied by higher volume.

We are sticking with our disciplined approach to investing as the market enters the historically weak month of September. Although we are buying certain individual stocks that have excellent technical chart patterns and are fundamentally undervalued, overall we are protecting our cash positions. By holding on to adequate cash, we are able to buy at lower prices in the event of further market weakness. Our patience has been, and will likely continue to be, rewarded with favorable risk-adjusted portfolio returns.