"Relief Rally"

Market Commentary – July 2006

By Frank C. Fontana, CFA
President, Banyan Asset Management, Inc.
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Gross Domestic Product (GDP), a measure of the output of the U.S. economy, was revised up again to 5.6% in the first quarter of 2006. For all of 2006, the Federal Reserve expects GDP to be 3.5%. At its meeting on June 29, the Federal Open Market Committee noted that "economic growth is moderating". There are several red flags for consumers which could contribute to slower economic growth: gas prices near $3 per gallon, personal savings at record lows, and a cooler housing market.

Still, inflationary pressures are elevated and are reason for concern. In May, overall inflation was 4.2% and core inflation, which factors out the volatile food and energy sectors, was 2.4%. The Fed prefers core inflation to stay between 1% and 2%. Producer prices in May rose 4.5% over last year and core producer prices increased 1.5%. Of course, high energy prices are fueling inflation. Also contributing, however, is low unemployment (4.6% in May, the lowest since July 2001). Companies are having a difficult time finding skilled workers, so they generate inflation by raising wages.

Futures markets are pricing in a 46% probability that the Federal Reserve will raise their benchmark Fed Funds rate another 0.25% to 5.50% at their meeting on August 8. Moreover, futures predict a 66% chance that the Fed Funds rate will be 5.50% by September and an 82% probability that it will be 5.50% by October. Following their seventeenth consecutive 25 basis point rate hike to 5.25% on June 29, the Fed left the door open for further interest rate tightening or a pause. The stock market celebrated the possibility of interest rates staying put with a relief rally.

Technical factors of the market are mildly bullish (more demand than supply), while fundamentals are fairly priced – therefore, we are mildly bullish on the market. S&P 500 companies reported an 11.2% gain in second-quarter profits versus a year earlier, the twelfth consecutive quarter of double-digit growth. Cash at these firms equal 7.4% of market value, the most since 1988. With this cash, companies are choosing to buy back stock. S&P 500 buybacks are up 22.1% from a year earlier to $100.2 billion. While balance sheets, income statements, and cash flow statements are healthy, however, stock valuations are only reasonable at best.

At Banyan Asset Management, our proprietary indicators are improving…slightly. Our sector analysis indicates that about 48% of the 209 industries spanning the entire stock market are in either medium or strong uptrends. This is down from 68% a month ago. Our market breadth indicator continues to tread in negative territory, but it has been moderating in recent days with improved breadth. Still, it will take several days of extremely strong breadth for this indicator to turn positive. For now, we interpret any stock market strength as more of a relief rally than a genuine reversal to the upside. The next test will come with second quarter earnings in July and August.

Our value approach to buying stocks, coupled with our balanced asset allocation between stocks and cash, made recent market volatility a bit less bumpy. June turned out to be a month of little activity for us in the stock market – our portfolios were already positioned. We did take the opportunity to do extensive equity research, both on our existing holdings and on new stocks. In July, we expect to tweak our holdings while maintaining a prudent level of cash should market weakness resume later in July or in August. What is certain is that as the summer months pass, our covered call positions will continue to expire and our portfolios will enjoy solid dividends.