# "A Bull Within A Bear"

## Market Commentary – January 2005

By Frank C. Fontana, CFA
President, Banyan Asset Management, Inc.
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**The U.S. economy is growing at a steady pace, as third quarter Gross Domestic Product (GDP) was revised up from 3.7% to 3.9%.** Still, individual economic factors have been mixed. For example,

- The Conference Board's consumer confidence index measured 102.3 in December, up from 90.5 in November. Consumer confidence was likely boosted by the end of the elections, falling oil prices, and a strengthening job market.
- November new home sales fell 12% from October, with the median sales price down 8.2% from October. The supply of unsold homes grew to 4.5 months, the highest since February 2003, while new home inventory is at a 25-year high. A slowdown in the U.S. housing market could cool the wealth effect that seems evident in the spending habits of U.S. consumers.

**As expected, the Federal Reserve raised their benchmark Fed Funds rate another 0.25% to 2.25% at their meeting on December 14.** This is the fifth interest rate hike since June 2004. According to the Fed, "output appears to be growing at a moderate pace despite the earlier rise in energy prices, and labor market conditions continue to improve gradually." They expect to continue raising interest rates at a "moderate pace". As of December 15, Fed fund futures traders estimated a 96% chance of another 25 basis point rate hike at the Fed's February meeting and a 78% chance of another at their March meeting.

**Corporate earnings are growing at a slower rate.** Before the third quarter of 2004, earnings for the S&P 500 companies grew for four straight quarters at more than 20% year-over-year. Earnings in the third quarter of 2004 grew 16.8% year-over-year. Analysts are now forecasting fourth-quarter earnings to rise 14.8% versus last year. Furthermore, analysts expect 7.8% and 8.1% profit growth in the first two quarters of 2005. While it is clear that earnings growth is slowing, it is still positive.

**Technical factors of the market are bullish (more demand than supply), while fundamentals are fairly priced – therefore, we are mildly bullish on the market.** Fundamentally, the average stock is not cheap when valued using discounted free cash flow analysis. As interest rates rise, stocks will become even more richly priced. Technically, stocks rallied on high volume in December to close near 52-week highs. Indeed, Santa Claus did visit Wall Street in December. Moreover, the stock market will likely benefit from the January Effect, where stocks typically get a push up from an inflow of fresh cash from investors. Our proprietary market breadth indicator and sector analysis are both still bullish, as they have been since the end of October.

**At Banyan Asset Management, Inc., our working hypothesis is that the stock market is experiencing a cyclical bull market within a secular bear market.** Cyclical trends usually have a duration lasting from several months to a few years. Secular trends last much longer, on the order of 10 to 20 years. The cyclical trend of the stock market has been up since it bottomed in March 2003. As long as the stock market rises less than the growth of earnings, valuations become more attractive. However, with earnings growth expected to slow in 2005, valuations may become even more of a concern. Add in the negative effect that rising interest rates have on stock valuations, and there is a reasonable probability that the stock market can trade sideways for an extended period of time (similar to the 1970s). Active management, which we do for our clients, is an excellent way to make money in such an environment.

**We continue to focus on offense in our portfolios, but we are still keeping a prudent level of cash on hand.** Consistent with our investment philosophy, we are buying undervalued stocks with bullish technical chart patterns on low volume market declines. In the meantime, our cash positions will help buffer our portfolios from volatility should the market unexpectedly break to the downside.