"Buying The Dips"

Market Commentary – December 2005

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Growth of Gross Domestic Product (GDP), a measure of the output of the U.S. economy, was revised up from 3.8% to 4.3% for the third quarter of 2005. This was the strongest quarterly gain in GDP since the first quarter of 2004. Consumer spending, which accounts for about two-thirds of GDP, was up 4.2% in the third quarter (versus a 3.4% increase in the second quarter). Confirming this strength, the Conference Board's consumer confidence index rose to 98.9 in November from 85.2 in October (the biggest increase since April 2003). Overall, the economy is growing at a healthy clip, driven by consumer spending.

Inflation remains a concern as the spike in oil and natural gas prices works its way through the economy. The consumer price index, which measures inflation in goods and services sold to consumers, is up 4.3% year over year. The producer price index, which measures inflation in goods and services sold to other businesses, is up 5.9% year over year. If corporations believe they can raise prices without losing market share, they will likely pass their high costs on to consumers.

The Federal Reserve is expected to raise their benchmark Fed Funds rate another 0.25% to 4.25% at their meeting on December 13. As expected, the Fed increased the Fed Funds rate by 0.25% to 4.0% at their meeting on November 1. Futures markets predict that the Fed Funds rate will be 4.75% by April. While the market has priced in a 25 basis point increase at the FOMC meeting on January 31, there is only a 56 percent chance of a final 25 basis point increase on March 28. The end of the interest rate tightening cycle finally seems to be approaching. Should inflation become even more of a concern, however, the Fed would probably raise the Fed Funds rate beyond 4.75%.

Technical factors of the market are bullish (more demand than supply), while fundamentals are fairly priced – therefore, we are mildly bullish on the market. After running up in October, long-term interest rates pulled back a bit in November. Given that the Fed is still raising short-term interest rates, however, long-term rates will likely continue to rise. It seems inevitable that the 10-year U.S. Treasury Note will break above 4.5%, and perhaps approach 5% or higher in the coming months. Such a move would pressure stock valuations. Technically, the S&P 500 index broke through resistance at 1245 on reasonably high volume. A pullback to test old resistance as new support would be healthy.

At Banyan Asset Management, our proprietary indicators lead us to "buy the dips". Our sector analysis reversed course in November and has been strengthening. Industries in a strong downtrend fell from 11.5% at the end of October to 1.4% at the end of November, while industries in a strong uptrend rose from 1.9% to 18.2% over the same period. Our market breadth indicator, which had been negative since August 15, turned positive on November 8. It continues to stay firmly in positive territory.

The end of the year presents an interesting opportunity for investors to buy high quality stocks temporarily "on sale". December is usually characterized by "tax-loss selling", where investors realize gains and losses on stocks before the end of the year for income tax purposes. As the month progresses, selling pressure alleviates and the market indexes typically rise in what is dubbed a "Santa Claus" rally. When others are selling, we are more apt to buy stocks that we calculate to be at least 10 percent undervalued and that have favorable technical chart patterns.

Still, these seasonal factors do not trump the higher priorities of asset allocation and diversification. Asset allocation means guarding a prudent amount of cash in the portfolio. Diversification is achieved by owning stocks that span various sectors and industries. As Nelson Kjos wrote in one of his stock market sketches in The Money Manager and The Poet, "the key to successful investing" is to "utilize investment dollars and take reasonable risks through asset allocation".