"When The Fed Is Done"

Market Commentary – August 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, grew only 2.5% in the second quarter of 2006, down from a brisk 5.6% in the first quarter. Economic growth has cooled quickly. The Federal Reserve has lowered its forecast of 2006 GDP growth from 3.5% to a range of 3.25% to 3.5%. Moreover, they expect 2007 GDP growth to be between 3% and 3.25%. Weighing on overall economic growth are smaller increases in spending by consumers, businesses, and the government.

The stock market interpreted the news of slowing economic growth in an interesting fashion – it went up. While there are many factors overhanging the financial markets these days, such as military battles between Israel and Hezbollah guerillas in Lebanon, high oil prices, and second quarter corporate earnings, the direction of interest rates is critical. Curiously, the most positive days in the stock market recently have been reactions to unfavorable economic news. The Fed has indicated that slowing economic growth should help cool inflation, thus reducing the need to fight inflation by raising interest rates. The stock market wants the Fed to leave interest rates alone.

Futures markets indicate only a 24% 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 contracts for September, October, and November suggest that the Fed Funds rate will likely stay at 5.25% in the coming months. This is a distinct change of character from last month, when the futures markets were simply pricing in a pause at the August meeting, with more hikes to follow later in the year. The market is now saying that the Fed is done with its two year tightening cycle.

Technical factors of the market are mildly bearish (more supply than demand), while fundamentals are fairly priced – therefore, we are mildly bearish on the market. Value continues to be created as the price-to-earnings (P/E) ratio has compressed further, but stocks are still pricey. Value Line cites the median P/E ratio on all stocks with earnings as 17.4. While this is lower than 19.6 at the market's high on 5/5/06, it is also much higher than 14.1 at the market's low on 10/9/02.

Our proprietary indicators at Banyan Asset Management show a modestly weak market. Our sector analysis has tilted negative, with 56% of the 209 industries spanning the entire stock market in some form of downtrend (weak, medium, or strong). Our market breadth indicator has been hovering around the same slightly negative levels since mid-May. Ironically, despite the stock market's rally in the second half of July, breadth has failed to confirm the strength. Volume on the major market indexes tells a similar story, with volume on market rises not being high enough to suggest a bullish market. The average volume on up-days indicates a lack of conviction in the market's direction.

We are maintaining a balanced approach to positioning our portfolios in the current market. Our primary concern is that the stock market has built up its hopes that the interest rate story will have a happy ending soon. While news of the Fed keeping rates the same on August 8 would be a short-term positive, in the longer-run, the market will have to assess the effects of a slowing economy with simultaneous inflation. If the Fed does choose to raise interest rates on August 8, the stock market would be very disappointed and sell off. Adding in the geopolitical uncertainty in the world, we conclude that we should be careful to not exhaust our cash reserves at this time. The scenario is building for an abundance of opportunities this fall as the seasonally weak months of September and October approach.