"Fed To Begin Hiking Interest Rates?"
Market Commentary – June 2004

By Frank C. Fontana, CFA
President, Banyan Asset Management, Inc.
Written May 31, 2004 – www.banyan-asset.com

The U.S. reportedly has "credible intelligence from multiple sources" that Al-Qaeda is almost ready to "hit the U.S. hard". The form of threat is unclear, but it could be linked to an event such as a convention. Still, the terror alert remains yellow. To quote from our March 2003 Market Commentary: "The war on terrorism now constantly weighs on the minds of investors. We are adjusting. In time, people will come to accept this new reality and will become increasingly desensitized to it."

Gross Domestic Product (GDP), a measure of the output of the U.S. economy, was revised up from 4.2% to 4.4% in the first quarter of 2004. Strong economic data continue to be reported:

- Corporate profits climbed 31.6% from 2003's war-depressed levels.
- The Chicago purchasers' index jumped 4.1 points in May to 68, the highest since January 1988. Readings over 50 signal growth.
- April hiring was strong, with 288,000 new jobs added. So far, 867,000 jobs have been added to the U.S. economy in 2004. In turn, the unemployment rate fell to 5.6%. Even manufacturers have hired for the past three months, following 42 straight months of factory job losses.
- Productivity, a measure of worker output per hour, rose at a 3.5% annual rate and was up 5.4% from a year ago. The difference between non-farm business output of 4.9% and productivity growth of 3.5% in the first quarter suggests that employers needed to hire more employees to get the desired increase in output (as opposed to relying on increased productivity).

While politicians and the media have focused on the high absolute price of oil, the story is not as exciting on an inflation-adjusted basis. Oil set a 21-year high of $41.85 on May 17. Recently, the average gallon of unleaded gas rose to a new closing high of $2.06 a gallon. This year, gas has risen nearly 60 cents a gallon. This is not desirable for economic growth, but the situation is not nearly as bad on an inflation-adjusted basis. Gasoline peaked at an inflation-adjusted $2.99 a gallon in March 1981. Moreover, back in 1980, oil consumption was 8% of GDP, compared with 2.7% of GDP now. The high price of oil does weigh on the economy, but its relative effects have been sensationalized.

The Federal Reserve kept their benchmark Fed Funds rate at a 46-year low of 1.0% at their meeting on May 4, but they will likely hike it 0.25% (25 basis points) at their meeting on June 30. Inflationary pressures are accelerating. The Producer Price Index (PPI) has risen 3.7% over the past year and at an annualized 5.3% pace during the last three months. The Core Consumer Price Index (CPI) has risen 1.8% since last year and at an annualized 3.3% pace during the last three months (the fastest in eight years). Commodity prices, as measured by the Reuters/CRB Futures index, have risen 46% since November 2001. Due to the political pressures of an election year, we anticipate that the Fed will raise rates slowly at first and then accelerate the tightening into 2005.

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. Fundamentally, stocks are on the high end of fair valuation. Technically, the rally over the past week has been on lighter volume than previous declines. While Banyan Asset Management's proprietary market breadth indicator has improved in recent trading sessions, it is still negative.

We continue to defensively manage our cash positions in client portfolios. There are numerous potential sources for surprise in June (such as, but not limited to, second quarter earnings warning preannouncements, changes in interest rates, terrorism, the transfer of power in Iraq, and developments in the U.S. presidential race). As well, there is more than an average amount of liquidity on the sidelines, waiting to enter the market. Should some of these surprises cause a high volume rally or a more significant improvement in market breadth, we will shift from defense to offense.