"Inflation Looms"

Market Commentary – April 2004

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Global tension is back in full force, causing Wall Street to pay attention to world events again:

- Terrorists bombed trains in Madrid, Spain, killing 190 people and injuring 1400.
- Palestinian terrorist group, Hamas, has vowed revenge attacks against the U.S. and Israel after Israel killed the group's founder in a rocket attack.
- Al-Qaida leaders pursued by Pakistan's army may have escaped attack using secret tunnels.

The Federal Reserve kept its benchmark Fed Funds rate at a 45-year low of 1.0% and said that it "can be patient" on raising interest rates anytime soon. While the U.S. economy is growing at a solid pace, it is not creating many new jobs. Productivity, which rose 5.4% versus a year earlier, has let firms do more with fewer workers. As well, the "offshoring" of jobs to other countries has curtailed U.S. jobs. Wall Street is looking to new jobs data as an indicator of the future of interest rates. Lack of job growth would suggest that economic growth may not be sustainable, and that interest rates may remain low. On the other hand, strong job growth would suggest that inflation could spark, creating the need to raise interest rates and cool off the economy.

Traditional measures are showing that inflation is tame, but there are other early signs of inflation in the U.S. economy. Core inflation, which excludes food and energy, was only 1.2% in February, just above January's 38-year low of 1.1%. Still, there are other early signs that inflation is on the horizon:

- Producer prices are rising faster than consumer prices, and that gap hit a 28-year high in December. January's Producer Price Index (PPI) rose 3.3% year over year. While those costs have not yet passed to consumers, they eventually will.
- Commodity prices are soaring. Since November 2001, the Reuters-CRB index, a measure of commodity prices, has risen more than 50%. David Littman, chief economist with Comerica bank, agrees that the "run-up in commodity prices is a sign inflation is on the way."
- Gasoline prices are averaging $1.70 a gallon nationwide and more than $2 a gallon in California. Even with oil at the high price of $36 per barrel, oil cartel OPEC announced their plan to cut oil production by 1 million barrels per day.

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. This is the third consecutive month that we have maintained a mildly negative view of the market. Fundamentally, stocks are still priced at the high end of fair valuation. Technically, market index declines in March were generally on higher volume than subsequent rallies. Banyan Asset Management's proprietary market breadth indicator is at its worst level in a year, suggesting weakness underlying market activity. Catalysts for continuation of the intermediate-term correction could include a global event such as terrorism, or economic news that fails to meet high expectations.

We continue to selectively buy undervalued stocks on market weakness, while protecting ample cash liquidity in our portfolios given our mildly bearish view. Rather than "time" the bottom of this intermediate-term market decline, it is more prudent to gradually put excess cash to work. When we find stocks that have attractive fundamental and technical factors, we buy them in portfolios that have plenty of cash remaining after the purchase. When we see a positive change in the market's character, such as a high volume rally or an improvement in market breadth, we will shift our focus from defense to offense.