# "Focus On Defense"
## Market Commentary – May 2004

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**Geopolitical uncertainty remains a wild card in the eyes of the financial markets.** With daily news reports of U.S. troops being killed, militia uprisings in Iraqi cities, and continued terror threats from Al-Qaeda, the market is frequently reminded of geopolitical risks. These risks are currently magnified by domestic politics associated with a presidential election year.

**Gross Domestic Product (GDP), a measure of the output of the U.S. economy, grew a robust 4.2% in the first quarter of 2004.** While this reading was less than economist expectations of 5.0%, the economy is clearly experiencing solid growth. The following economic data confirm this growth:

- Companies have beaten first quarter earnings estimates by an average of 8% so far (with 259 companies in the S&P 500 having reported earnings as of April 22). First Call predicts that first quarter profits will rise 26% from a year ago, following the fourth quarter's rise of 28.3% (the best since 1993). Revenue growth will likely top 10% for the second straight quarter.
- The U.S. job market is strengthening, with the economy adding a four-year high of 308,000 jobs in March.
- March retail sales rose 1.8% from February and 8.2% from last year, the best in four years.
- Big-ticket orders to U.S. factories rose 3.4% in March, evidence that business investment is healthy and the manufacturing rebound will likely be sustained.
- Consumer optimism rose in April, with the Conference Board's overall consumer confidence index rising 4.4 points to 92.0, the highest since January. There are two components of the overall index. The present situation component rose 6.2 points to 90.6, the best since August 2002, while the expectations component rose 3.2 points to 94.5. Consumers see both today and the outlook for the future as bright.

**Federal Reserve Chairman Alan Greenspan cautioned that interest rates will have to rise "at some point."** He added that with "solid economic growth", fear of too little inflation, or even deflation, is now history. The Core Consumer Price Index (CPI), a measure of inflation which factors out the volatile food and energy sectors, rose 0.4% in March and 1.6% from a year earlier. While this is still historically low, it is higher than the 38-year low of 1.1% in January. With inflation on the horizon, the market is demanding higher returns from fixed-income instruments. For example, the 10-year Treasury note yielded as low as 3.65% on March 17, but now yields 4.50% (as of April 30).

**Technical factors of the market are bearish (more supply than demand), while fundamentals are fairly priced – therefore, we are bearish on the market.** This is the fourth consecutive month of market deterioration. Fundamentally, stocks are on the high end of fair valuation. Technically, market index declines in April were on generally higher volume than subsequent rallies. Banyan Asset Management's proprietary market breadth indicator is still negative, suggesting weakness underlying market activity. U.S. stocks and bonds will likely face pressure as the financial markets adjust to the increasing probability of rising interest rates.

**With our focus continuing to be on defense, we are carefully managing cash positions in client portfolios.** The buying power of cash increases as stock prices decline. Therefore, holding onto cash is a conservative way to "short" the market, where shorting means profiting from market declines. Still, in the absence of a crystal ball, there is a threshold of cash that is considered "too much". In portfolios with excessive cash, we are purchasing some undervalued stocks with favorable technical factors. Our focus will shift from defense to offense when we see a positive change in the market's character, such as a high volume rally or an improvement in market breadth.