"One Lump Or Two?"

Market Commentary – April 2006

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Gross Domestic Product (GDP), a measure of the output of the U.S. economy, was revised up from 1.6% to 1.7% in the fourth quarter of 2005. The Federal Reserve believes that the low growth was due to temporary and special factors. Economists tend to agree; the consensus forecast for first quarter GDP is 4.5%, slowing to about 3% later in 2006. Unemployment is at 4.8%, just above a four year low. Moreover, corporate profits gained 16.4% in 2005. On the downside, consumer spending grew only 0.9% in the fourth quarter, the slowest in 10 years. Also, capital spending by businesses may face some pressure as higher interest rates increase borrowing costs.

The Federal Reserve is expected to raise their benchmark Fed Funds rate another 0.25% to 5.00% at their meeting on May 10. Beyond that, futures markets are pricing in a 40% probability of an additional 25 basis point rate hike at the meeting on June 29. After their fifteenth consecutive 0.25% increase on March 28, the Fed reiterated their commitment to fighting inflation. While they see only "modest" evidence that high energy prices and commodity prices are trickling down to consumers, they noted that "further policy firming may be needed" to ensure that growth and inflation remain "roughly in balance". If the Fed stops raising rates soon, the stock market could rally. If the Fed tightens too much, however, the economy could sink into recession.

The yield curve has shifted higher, but is still as flat as a pancake. As of 3/31/06, annualized Treasury yields were 4.61% for three months, 4.81% for six months, 4.82% for two years, 4.81% for five years, 4.85% for ten years, and 4.89% for 30 years. Compared to last month, the long end of the yield curve (Treasuries with longer maturity dates) has pushed higher in yield. The increase is only commensurate with the higher Fed Funds rate, however. Investors are still willing to accept a low interest rate to lock in that rate for longer periods of time.

Fundamentally, stock valuations are starting to feel pressure from higher long-term interest rates. Fundamental valuation models calculate lower "intrinsic values", or fair value estimates, for stocks as the 10-year Treasury note rises in yield. In March, we began to use 5.0% as the risk-free interest rate in our valuation models in an attempt to mirror the 10-year Treasury note. We had used 4.5% in our models since mid-2002. To illustrate the sensitivity of our valuation models to changes in interest rates, consider one stock that is currently trading near $29. Using 4.5% as our risk-free rate, we estimate fair value to be $35. Increasing the risk-free rate to 5.0%, fair value drops to $32 (5.5% = $29 fair value and 6.0% = $27 fair value). As interest rates rise, we expect lower fair valuations for stocks.

Technical factors of the market are mildly bullish (slightly more demand than supply), while fundamentals are fairly priced – therefore, we are mildly bullish on the market. Fundamentally, the stock market is not cheap. Value Line cites the median price-to-earnings (P/E) ratio on all stocks with earnings as 19.1, much greater than the 10/9/02 most recent market low reading of 14.1. A high P/E ratio indicates an expensive market, especially as interest rates rise. Our proprietary indicators continue to hang on to modestly positive levels. Our sector analysis shows that about 69% of the 209 industries spanning the entire stock market are in either medium or strong uptrends. Our market breadth indicator has been hovering in slightly positive ground for about six weeks. Price-volume patterns in the major market indexes are reasonably healthy, with volume somewhat heavier on up days than on down days.

Overall, we are sticking to our balanced approach as the financial markets sort out whether there will be one more Fed rate hike or two. Our value approach, cash liquidity, dividends and use of covered option writing offer our clients some degree of protection should the market weaken.