"Patience"
Market Commentary – August 2005

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Written July 31, 2005 – www.banyan-asset.com

Growth of Gross Domestic Product (GDP), a measure of the output of the U.S. economy, was 3.4% in the second quarter of 2005. When Alan Greenspan, Chairman of the Federal Reserve, testified before the House Financial Services Committee in July, he said that "our baseline outlook for the U.S. economy is one of sustained economic growth and contained inflation pressures." The Fed forecasts GDP growth of 3.5% in 2005 and 3.25%-3.5% in 2006. Moreover, they anticipate that inflation will be in the range of 1.75% to 2.0% in 2005 and 2006.

Long-term interest rates have a catalyst in place to head higher now that China has stopped pegging the value of their currency, the yuan, exclusively to the dollar. On July 22, China announced that they will now tie the yuan to a basket of currencies. This move will likely reduce China's strong demand for U.S. Treasuries, and could in turn raise long-term interest rates in the U.S. It could also raise the prices of Chinese exports to the U.S, helping to fuel U.S. inflation. The effects of the revaluation will become clearer over the coming months.

Short-term interest rates are still on the rise, with futures markets forecasting that the Federal Reserve will hike their benchmark Fed Funds rate another 0.25% to 3.50% at their meeting on August 9. After nine consecutive quarter point tightening moves since June 2004, there is no indication from Alan Greenspan that the Fed is nearing the end of this tightening cycle. Some economists believe the Fed Funds rate will be in the 4% to 5% range before short-term rates stop going up.

Technical factors of the market are bearish (more supply than demand), while fundamentals are fairly priced – therefore, we are mildly bearish on the market. Stock valuations continue to trade toward the high end of fair valuation. Plus, they are susceptible to downside pressure should long-term interest rates rise. Technically, our proprietary sector analysis has slowly strengthened. After swooning at the beginning of July, our market breadth indicator firmed in positive territory, but has leveled off. The overall fundamental and technical patterns suggest that the market may weaken soon.

Volume has crept up in the most recent days as a sign of capitulation among short sellers. For traders who short the market (i.e. try to profit from the market declining), it is scary to see the market take out resistance levels. This causes short sellers to buy stock to "cover" their short positions and cut their losses. The short-interest ratio (total short sales divided by the average daily volume over the period covered) fell from 6.2 days in mid-June to 5.8 days in mid-July. When a market breaks out to new highs, this should be accompanied by very high volume. This has not been the case for the major market indexes and causes us to be concerned about the recent rally.

A balanced approach of offense and defense has allowed our portfolios to enjoy upside gains, while providing a level of downside protection. Without clairvoyance, which no one possesses, we have found it prudent to lock in a few profits for our clients as the summer has progressed. This has primarily occurred as covered call positions have been exercised and underlying stock has been called away (a systematic way of buying low and selling high). Going into August, we will likely lock in additional gains and sell some more covered calls expiring in September, October, and November. If the market goes sideways or declines over the next couple of months, our portfolios will profit from dividends and melting covered call premiums. If the market rises instead, we will realize more gains. Opportunities to buy undervalued stocks will probably be more plentiful this fall. Armed with a defense of cash, we are ready to buy when the right situations present themselves. Until then, we remain patient.