"Is A Breakout Coming?"

Market Commentary – March 2005

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Gross Domestic Product (GDP), a measure of the output of the U.S. economy, was revised up from 3.1% to 3.8% in the fourth quarter. With the exception of the spike to 8.2% in the third quarter of 2003, GDP has grown at a steady annualized 3% to 4% each quarter for nearly two years. While consumer spending has kept the economy growing, business spending is now picking up. Consumer spending increased at a 4.2% annual rate and business investment rose at a 14% annual rate in the fourth quarter. The Federal Reserve has forecasted the following for 2005:

- GDP between 3.75% and 4.0% (actually measured 3.7% for 2004).
- Inflation between 1.5% and 1.75% (actually measured 1.6% for 2004).
- Unemployment rate of 5.25% (actually measured 5.4% for 2004).

Inflation is hitting manufacturers, but they have not passed price increases on to consumers…yet. The core producer price index (PPI), a measure of the cost of goods used by manufacturers, spiked a surprising 0.8% in January, the largest increase since late 1998. In contrast, the core consumer price index (CPI), a measure of inflation in consumer goods, rose only 0.2% in January. Companies have seen their profit margins squeezed since they have not been able to offset increased input costs by raising the prices of their products. Once companies feel comfortable that they can increase prices without sacrificing market share, they will likely do so.

As expected, the Federal Reserve raised their benchmark Fed Funds rate another 0.25% to 2.50% at their meeting on February 2. Futures markets have priced in 0.25% hikes at the Fed's meetings in March and May, and they forecast a 0.25% hike at the June meeting as "likely". This would put the Fed Funds rate at 3.25%. As investors, our money market funds will continue to yield higher returns as 2005 progresses. There should be excellent opportunities to buy short-maturity bonds by the middle of 2005.

Technical factors of the market are bullish (more demand than supply), while fundamentals are fairly priced – therefore, we are mildly bullish on the market. There certainly are stocks that are undervalued, but the market as a whole is pushing the upper reaches of fair valuation. Long-term interest rates have stayed low, with the 10-year U.S. Treasury still yielding only 4.3% in spite of the increase in the short-term Fed Funds rate. When long-term interest rates eventually rise, as we expect them to do, stocks at current valuations will become less attractive to own.

Technically, market rallies in February have been on slightly lower volume than the declines in January. Still, the Dow Jones Industrials Average and the S&P 500 (large-cap) have managed to push up to resistance levels once again. It is not unusual to see lower volume before a breakout to new highs. Meanwhile, the S&P 400 (mid-cap) and S&P 600 (small-cap) indexes are close to all-time highs. Small and mid-sized companies have been leading the stock market for the past several years.

Our proprietary market breadth indicator went positive on February 8 and has been leveling off in positive territory. Our proprietary sector analysis shows that 82.3% of the 209 industries spanning the entire stock market are in either "strong" or "medium" uptrends. Overall, the market seems poised to continue the February rally, but we are mindful that valuations are stretched.

We continue to buy undervalued stocks on short-term weakness and lock in some profits when prices move up "too fast". In February, we sold our first stocks of the year to lock in some gains as their prices rallied much faster than expected. We also sold several covered call positions to make volatility work for our clients. In addition, we bought a few undervalued stocks with bullish technical chart patterns. Of course, the reason we could buy is because we maintain a healthy, but not excessive, cash balance. We are not too anxious to exhaust our buying power, just in case the market weakens again.