“Stock Valuations And Rising Interest Rates”

Market Commentary – July 2004

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The Commerce Department revised Gross Domestic Product (GDP), a measure of the output of the U.S. economy, down from 4.4% to 3.9% for the first quarter of 2004. In spite of the downward revision, economic growth remains solid:

- The economy has been expanding for 10 straight quarters, growing faster in the past 12 months than any year in the 1990s.
- Manufacturing growth is strong, with industrial output rising 6.3% from a year ago, the largest annual gain since May 1998.
- The economy created 248,000 jobs in May and has created 1.4 million jobs since August 2003. Unemployment is stable at 5.6%.

The Federal Reserve raised their benchmark Fed Funds rate 0.25% from a 46-year low of 1.0% to 1.25% at their meeting on June 30. This rate hike officially begins a new upward cycle in the trend of interest rates. The Fed has indicated that future rate hikes will be “measured”, but they have also left open the door for raising rates at a faster clip should inflation get too hot. With inflation rising at a 3.3% annual rate over the past three months, real interest rates (interest rates adjusted for inflation) are negative when compared with the Fed Funds rate of 1.25%. For this reason, some economists believe that the Fed is far behind in their need to increase interest rates. The next Federal Reserve meeting is in August.

Corporate earnings have been strong, but comparisons will become increasingly difficult in the second half of 2004. Earnings for S&P 500 firms in the first quarter of 2004 were up 27.4% year-over-year, and they are expected to rise 20.3% in the second quarter versus last year. However, since earnings started improving in the third and fourth quarters of 2003, analysts are expecting “only” a 13.9% increase in the third quarter of 2004 and 15.4% in the fourth. Overall, corporate earnings continue to be robust.

Fundamental valuation models will calculate lower “intrinsic values” for stocks as interest rates rise. “Intrinsic value” is simply an estimate of the fair value of a stock. Higher interest rates cause the earnings and cash flow generated by a company to become worth relatively less. Moreover, these models are very sensitive to changes in interest rates. For example, we estimate that General Electric, which is trading around $32.50 at the time of this writing, is worth $32.50 with interest rates where they are at. If we assume interest rates rise 1%, fair valuation is reduced to $27; if interest rates increase 2%, fair valuation is cut to $23. As interest rates rise, we expect lower fair valuations for stocks.

Technical factors of the market are mildly bullish (more demand than supply), while fundamentals are fairly priced – therefore, we are mildly bullish on the market. Fundamentally, stocks continue to trade at the high end of fair valuation. Technically, volume in June has generally been light, which suggests that the market lacks conviction. However, Banyan Asset Management’s proprietary market breadth indicator turned positive in early June and has maintained its favorable levels.

We have been selectively buying stocks in portfolios with ample cash, while protecting cash positions in portfolios that are more fully invested. While the market on the whole does not seem to be undervalued, there are several individual stocks that our proprietary research has identified as being undervalued with bullish technical factors. These stocks have been excellent additions to portfolios on market weakness. The covered call positions we wrote in March and April are expiring this summer. As the market has chopped back and forth, portfolios have benefited by the melting of time value on these option contracts. With an arsenal of liquidity and a large universe of stocks, we are patiently building our portfolios with the ebb and flow of the market.