"An Important Reversal…"
Market Commentary – June 2006

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Gross Domestic Product (GDP), a measure of the output of the U.S. economy, was revised up to 5.3% in the first quarter of 2006. Many economists view the solid growth in the first quarter as a one-time recovery event related to the unusually slow fourth quarter due to the major hurricanes last year. Recent economic data have been mixed:

- After-tax corporate profits in the first quarter were up 24.8% from a year earlier, the largest annual increase since 2002.
- Unemployment is only 4.7%, the lowest in five years.
- High employment is starting to generate wage inflation, with average hourly earnings up 3.8% over last year, the sharpest increase since 2001.
- Inventory of single-family homes is up 40.5% from last year, the largest increase since 1982 when the National Association of Realtors began collecting the data.

Inflation is becoming more of a concern to the financial markets. The consumer price index, which measures inflation in goods and services sold to consumers, is up 3.5% year over year. The producer price index, which measures inflation in goods and services sold to other businesses, is up 4.0% year over year. With high energy and raw materials costs and average hourly earnings on the rise, companies are now starting to pass along their higher costs to consumers at the risk of losing market share.

Futures markets are pricing in a 58% probability that the Federal Reserve raises their benchmark Fed Funds rate another 0.25% to 5.25% at their meeting on June 29. Moreover, futures predict a 98% chance that the Fed Funds rate will be 5.25% by September. In other words, if the 25 basis point rate hike does not occur at the Fed meeting in June, it will likely occur at the Fed meeting in August or September instead. The Fed's policy statement released on May 10 noted that "some further policy firming may yet be needed to address inflation risks", but that "the extent and timing of any such firming will depend importantly on the evolution of the economic outlook as implied by incoming information". For the first time in this rising interest rate cycle, it is unclear whether the Fed should be more concerned with battling inflation or slowing economic growth.

Technical factors of the market are bearish (more supply than demand), while fundamentals are fairly priced – therefore, we are bearish on the market. Since the end of 2003, S&P 500 earnings per share are up 48% compared with the S&P 500 index being up about 13%. Value has been created as the price-to-earnings (P/E) ratio has compressed. Still, with Value Line citing the median P/E ratio on all stocks with earnings as 18.7, stocks are not cheap.

At Banyan Asset Management, our proprietary indicators are solidly negative. Our sector analysis indicates that the number of industries in strong uptrends has dropped from 21.5% to 2.4%. Our market breadth indicator is firmly in negative territory, evidence of the large number of declining stocks relative to advancing stocks in recent weeks. Volume during the May decline in the market indexes has been higher than average, suggesting institutional selling behind the recent weakness.

The stock market may be in the midst of an important reversal to the downside. On May 29, *Barron's* noted that "the S&P 500 has gone 810 trading days without a 10% correction – well above the average 222 days between such pullbacks (in another 20 days this could become the second-largest such streak since 1965)." In the meantime, we have added a couple of new companies to our portfolios that we calculate to be undervalued. We have also locked in a few profits and sold some covered calls expiring between June and September. As the market pulls back, we expect to incrementally put our cash reserves to work.