"The Wall Of Worry"
Market Commentary – October 2005

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If financial markets like to "climb the wall of worry", as one market saying goes, there is certainly plenty to worry about in the U.S. economy:

- Consumer spending may finally be in trouble, squeezed by rising gasoline and natural gas prices due to Hurricanes Katrina and Rita. The Conference Board's consumer-confidence index fell to 86.6 in September, down sharply from 105.5 in August. This is the largest decline since 1990. Likewise, the University of Michigan consumer sentiment index dropped to 76.9 in September from 89.1 in August. While a drop in consumer confidence does not always translate into a decline in consumer spending, it is clear that consumers are more apprehensive about the U.S. economy.
- Homeowners have been using their homes as ATM machines to fuel their spending habits, but a rise in mortgage rates could trigger a spending pullback. As of August 2005, the median home price was up 15.8% over last year. Alan Greenspan, Chairman of the Federal Reserve, supervised research that shows households borrowed nearly $600 billion against the value of their homes to supplement their spending, equivalent to 7% of personal disposable income (compared with 3% in 2000 and 1% in 1994). Greenspan believes this increase is attributable to the decline in mortgage interest rates. Should mortgage rates rise, consumer spending could slow (with a longer term benefit of raising U.S. saving and narrowing the trade deficit).
- The Federal Reserve is expected to raise their benchmark Fed Funds rate another 0.25% to 4.00% at their meeting on November 1. Moreover, Fed Funds rate futures predict an additional 0.25% increase to 4.25% at the meeting on December 13. At some point, rate hikes cool the economy.
- As a nation, the U.S. spends more than it earns. Only 20 years ago, the U.S. was a creditor nation. Now it is a debtor nation, relying on the savings of foreigners to keep U.S. interest rates low (which fuels business and consumer spending). If other countries do not grow faster, the U.S. economy may slow due to interest rate increases, stock or bond market declines, an end to the housing boom, and/or tax increases. When will the current situation correct itself?
- The Pension Benefit Guarantee Corporation (PBGC), the government agency that insures private pensions, had a $23 billion deficit before the bankruptcies of Delta and Northwest Airlines. Data indicate that 31% of public pensions are underfunded by a total of $53 billion. Tax payers could be asked to bail out the PBGC.

Technical factors of the market are bearish (more supply than demand), while fundamentals are fairly priced – therefore, we are mildly bearish on the market. Stocks continue to trade at fair valuations given low long-term interest rates. As we have pointed out before, however, a spike in long-term interest rates would hurt the valuation of stocks. Technically, our proprietary oscillators at Banyan Asset Management continue to suggest underlying technical weakness. Our sector analysis is in a holding pattern with a bias toward weakness. Our market breadth analysis went negative on August 15 and has remained firmly in negative territory ever since.

Armed with cash on the sideline, we stand ready to incrementally buy undervalued stocks when opportunities present themselves. While market risk is currently unfavorable, a decline in the stock market could give us the chance to buy excellent stocks temporarily "on sale". We also need to be prepared for a rally inspired by "the wall of worry". In terms of security risk, there are several companies we have identified and researched that have attractive fundamental and technical factors. These will be our first candidates to buy. To quote Nelson Kjos, author of The Poet of Wall Street, "be financially conservative, but know when to be aggressive."