"Opportunities Brewing"

Market Commentary – July 2007

By Frank C. Fontana, CFA
President, Banyan Asset Management, Inc.
Written June 30, 2007 – www.banyan-asset.com

Growth of the U.S. economy, as measured by Gross Domestic Product (GDP), was revised up from 0.6% to 0.7% in the first quarter of 2007. This is still the weakest reading in four years. Most economists forecast GDP to grow between 2.5% and 3.0% in the second half of 2007. Housing continues to be a drag on the U.S. economy. Inventory of unsold homes hit 8.9 months' worth of supply given current sales rates, the highest level since 1992. The median existing-home price fell 2.1% in May, the tenth straight monthly decline. Facing headwinds of rising interest rates, foreclosures, and tighter lending standards, the housing sector does not appear to have bottomed yet.

The Federal Reserve held its benchmark Fed Funds rate steady at 5.25% for the eighth consecutive meeting, expecting moderate economic growth while core inflation cools. According to the Fed, "economic growth appears to have been moderate during the first half of this year." Looking forward, the economy "seems likely to continue to expand at a moderate pace". Wall Street expects the Fed to stay at rest for the remainder of 2007. Futures markets continue to assess only a 22% probability that the Fed will cut the Fed Funds rate by 0.25% by December.

Inflation is still on the Fed's radar screen, as they cite the "predominant policy concern remains the risk that inflation will fail to moderate as expected". Core inflation, which factors out the volatile food and energy sectors, seems contained for now. The core PCE deflator, the Fed's preferred metric of inflation, rose 1.9% for May, within the desired range of 1% to 2%. Core inflation is deceiving, however, because the consumption of food and energy is a normal part of the American lifestyle. The consumer price index, which includes food and energy prices, is 2.7% higher than a year earlier. Meanwhile, producer prices are up 4.1% year over year. Rising wholesale prices could force companies to pass higher prices on to consumers.

Technical factors of the market are mildly bearish (more supply than demand), while fundamentals are fairly priced – therefore, we are mildly bearish on the market. The price-to-earnings (P/E) ratio for the S&P 500 is 18.0, giving an earnings yield (E/P) of 5.55%. The yield on the 10-year Treasury note jumped as high as 5.31% in mid-June, before settling at the end of the month at 5.03%. As the 10-year Treasury spiked in yield, stocks did indeed stumble. Cheap money has fueled the private-equity buyout boom, which has put a floor under stock prices. Should long-term interest rates go up much higher, that floor could prove to not be so closely below.

At this point, we view market weakness as an opportunity to incrementally put cash to work. Our proprietary market breadth indicator, which had been clinging on to positive territory since March, finally turned negative on June 28. The indicator is not collapsing, though; rather, it is meandering in negative turf. As a result, we interpret it as a sign of a mild correction, and thus a potential buying opportunity. Looking at the S&P 500, if support at 1490 fails, there should be adequate support at 1450 from the February high and 1430 near the 200 day moving average. Such a pullback would be normal and healthy.

We are continuing our balanced approach toward stock market risk. The near collapse of two Bear Stearns hedge funds with big positions in sub-prime mortgages is an excellent reminder of the importance of balance. Even the smartest minds on Wall Street will be wrong. The probability of a full-blown collapse, however, is greater when an investor ignores asset allocation and diversification. By keeping a balance of stocks and cash in our portfolios, we are positioned for a variety of potential scenarios that may come our way.