"Continued Caution"
Market Commentary – May 2005

By Frank C. Fontana, CFA
President, Banyan Asset Management, Inc.
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Growth of Gross Domestic Product (GDP), a measure of the output of the U.S. economy, slowed to 3.1% in the first quarter of 2005. Investors are concerned that the U.S. economy has hit a "soft patch".

- Consumer spending, which makes up 70% of GDP, has slowed to a 3.5% annual growth rate in the first quarter of 2005 from 4.2% in the fourth quarter of 2004.
- The record U.S. trade deficit, in which U.S. imports exceeded exports by $61 billion in February, cut 1.5% from GDP.
- Durable goods orders fell 2.8% in March, the biggest drop since September 2002.
- The University of Michigan consumer sentiment index fell to 88.7 in April, an 18-month low.
- In the first quarter, earnings for S&P 500 companies are expected to grow by 8.3% over last year. However, if you take out energy companies, the growth rate is only 5.2%.

The Federal Reserve is expected to raise their benchmark Fed Funds rate another 0.25% to 3.0% at their meeting on May 3. This would be the eighth consecutive 0.25% tightening move since June 2004. Concerned about inflation heating up, the Fed has been raising short-term interest rates to cool off the economy and thus contain inflation. The core consumer price index (CPI), a measure of inflation in consumer goods, rose 0.4% in March, the largest increase since August 2002. While the economy seems to be slowing slightly, we have not yet seen the slowdown in inflation.

Ironically, long-term interest rates have fallen as short-term interest rates have risen. On June 1, 2004, the 10-year U.S. Treasury note was 4.7% and the 30-year U.S. Treasury bond was 5.4%. As of April 29, 2005, these rates were only 4.2% and 4.5%, respectively. Long-term rates should have risen as the Fed has been hiking short-term rates. This has not happened…yet.

We see the possible risk of a spike in long-term interest rates, which would be a short-term negative (and thus a buying opportunity) for the stock market. While some argue that long-term interest rates are low because bond traders believe inflation will remain contained, they may be artificially low because of foreign demand for U.S. Treasuries. Roughly half of the demand for U.S. Treasuries comes from foreign central banks. Foreigners will buy U.S. Treasuries as long as the U.S. is an attractive place to invest. Should something happen to change that view, however, foreigners would sell U.S. Treasuries, causing bond prices to plummet and yields to skyrocket. A catalyst for such an event could be a financial crisis, perhaps having to do with Fannie Mae/Freddie Mac or a downgrade of General Motors and Ford bonds to "junk status".

Technical factors of the market are bearish (more supply than demand), while fundamentals are fairly priced – therefore, we are mildly bearish on the market. In spite of the stock market's weakness in April, valuations are still not cheap. Plus, any future increases in long-term interest rates will cause the fair valuations of stocks to fall. Technically, market declines in April have been on slightly higher volume than the rallies.

Having locked in some gains earlier this year, we have extra cash in our portfolios to selectively put back into the market. If the April lows in the major indexes are violated on high volume, we would expect to see a fresh wave of selling and market declines to follow. The Fed meeting on May 3 is critical. News that the Fed is done (or nearly done) raising short-term rates could ignite a sharp rally. Without a crystal ball, we must deal in a world of probabilities. One of the best ways to deal with probabilities is to avoid "all or nothing" decisions in our portfolios and to focus on "incremental" changes. To quote Nelson Kjos from The Money Manager and The Poet, "Be financially conservative, but know when to be aggressive".