“Modest Improvement”
Market Commentary – September 2006

By Frank C. Fontana, CFA
President, Banyan Asset Management, Inc.
Written August 31, 2006 – www.banyan-asset.com

The Commerce Department now calculates that the U.S. economy, as measured by Gross Domestic Product (GDP), grew 2.9% in the second quarter of 2006. This is higher than the government's original second quarter estimate of 2.5%, but down from 5.6% growth in the first quarter. As the economy slows, economists are torn whether the U.S. economy will experience a "hard" or "soft" landing. A hard landing means a recession, where the economy actually contracts. A soft landing implies that economic growth is still positive, but that the growth rate is slower than in past quarters.

The sluggish housing market is contributing to the decelerating growth of the U.S. economy. Housing sales in July were down 11.2% versus a year earlier. Inventories of unsold homes rose to a 7.3-month supply, the largest level since 1993. Housing prices in every region other than the south have slid from 0.3% to 2.1% over the past year (compared to housing prices jumping 15.7% between July 2004 and July 2005). With an estimated $1 trillion in adjustable mortgages ready to reset soon, many homeowners will be zapped with higher payments. This does not bode well for housing prices in the short-run.

As expected, the Federal Reserve decided to leave their benchmark Fed Funds rate at 5.25% at their meeting on August 8. Minutes released from the meeting indicate that the decision to pause the rate hikes was a "close call". The Fed remains concerned about inflation. July consumer prices rose 4.1% and producer (wholesale) prices rose 4.2% year-over-year, both hot clips. Concerning the Fed a bit more, however, is the potential double whammy of tightening rates too much at the same time the housing market slows. Futures markets confirm that the Fed is done raising rates. Curiously, they forecast a 100% probability of a 25 basis point *reduction* in the Fed Funds rate by July 2007.

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. Profits for the S&P 500 companies are expected to rise 14.7% in the third quarter year-over-year, the 13th consecutive double-digit gain. Despite the strong earnings, however, stock valuations are fair at best as the price-to-earnings (P/E) ratio continues to compress from the inflated levels of the late 1990s.

Companies, especially the larger ones, are flush with cash and are buying back their stock at record rates. A record $116 billion was spent by S&P 500 companies in the second quarter to buy back their own shares, a 40% rise over 2005 Q2 and 175% greater than 2004 Q2. Share buybacks are favorable for stockholders since there are fewer shares outstanding for a company's given level of earnings. Therefore, earnings per share increases and the stock price likely moves higher. As an alternative to investing in their own stock, perhaps companies may be more apt to invest their cash in the stock of other companies. We could see a wave of mergers and acquisitions in the near future.

Our proprietary indicators at Banyan Asset Management show a modest improvement in the technical factors of the market. Our sector analysis shows that 7.2% of the 209 industries spanning the entire stock market are in a strong downtrend, down from a high of 14.8% on August 12. This suggests that the worst-performing industries are starting to form bases, an important part of the bottoming process. Our market breadth indicator finally turned positive on August 21 in its most impressive showing since April. The biggest technical concern has been the light volume on the rally in stocks over the past two weeks.

We are incrementally buying stocks without exhausting our cash cushion. September and October are historically volatile months, particularly to the downside. By maintaining a balance of stocks and cash, our clients can profit from market upside while also keeping the ability to buy stocks at lower prices should the market fall. After all, how can an investor buy stocks without any cash?