"Caution In An Eerie Month"

Market Commentary – October 2003

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Fluctuations in the U.S. dollar and oil prices are causing short-term volatility in the financial markets. In recent weeks the U.S. dollar has weakened versus the euro and yen. A weak dollar helps make U.S.-produced goods more competitive and could help boost earnings. On the other hand, foreign and multi-national firms find their products more expensive. On the oil front, OPEC lowered their production quota to limit supply and raise prices in advance of anticipated Iraqi output. While Wall Street reacts to these issues in the short-term, in the long run these fluctuations should even themselves out for a well-diversified portfolio.

Productivity growth is greater than output growth, which may be why the economy is growing without job creation. Productivity rose 6.8%, compared with Gross Domestic Product (GDP) growth of 3.1%, in the second quarter. The productivity gain is the biggest since the first quarter of 2002 (a year only matched in productivity growth by 1950). On the employment side, the four-week moving average of new jobless claims is 407,000 (above 400,000 suggests that the economy is not creating jobs). It seems that employers have boosted output by raising productivity while cutting jobs.

Inflation in August hit a 37-year low of 1.3%, helping the Federal Reserve to keep its benchmark Fed Funds interest rate at 1.0%. The Fed sees rates low for a "considerable amount of time." The 5, 10, and 30-year treasuries have retraced approximately 40% of the mid-June to mid-August spike in interest rates. As interest rates fall, bond prices rise. In our opinion, this dip in rates is providing an excellent opportunity to lock in profits and exit bond funds. Individual bonds, which are discrete in nature, still deserve a healthy allocation in a diversified portfolio.

Growth in corporate sales is not keeping up with earnings growth, but sales for small cap companies are faring better than large caps. Third-quarter profit for the S&P 500 is projected up 14.8%, with estimates increasing for the seasonally weak third quarter. Revenue by sector is expected to rise 4% for materials, 5% for consumer staples, and only 2% for consumer cyclicals. The small cap S&P 600, which has been outperforming the large cap S&P 500, had 12.6% revenue growth in the second quarter, better than the S&P 500's 7.4%.

"Analysts' 600 least recommended stocks have outperformed the 600 most recommended in the last four years", according to Investor's Business Daily. Banyan Asset Management, Inc. performs its own proprietary fundamental and technical research. The objectivity resulting from our independence is one of our competitive advantages. Our goal is to make our clients money by building well-diversified portfolios of fundamentally strong companies of all market capitalizations, with an emphasis on value.

Market technicals are mildly bearish (more supply than demand), while fundamentals are fairly priced – therefore, we are mildly bearish on the market. The fundamentals will not likely support higher stock prices, meaning the market is riding more on momentum (especially the frothy Nasdaq). At the end of September, the market indexes saw declines on higher volume. While there is no reason to expect a long-term retreat in equity prices, an intermediate-term dip is certainly reasonable.

We are exercising caution when initiating new equity positions and are selling covered calls on low volume rallies. Given mutual fund tax-loss selling and general seasonal weakness in October, we believe it is prudent to be cautious about buying stocks. With our large universe of stocks, we patiently wait for opportunities to buy defensive names, especially in the consumer staples, utilities, energy and healthcare sectors. We are holding on to some cash in our portfolios so that we may buy at lower prices in the event of a drop in the market.