“Incrementally”

Market Commentary – November 2005

By Frank C. Fontana, CFA
President, Banyan Asset Management, Inc.
Written October 31, 2005 – www.banyan-asset.com

Advance estimates of Gross Domestic Product (GDP), a measure of the output of the U.S. economy, indicate growth of 3.8% for the third quarter of 2005. This measure is ahead of the second quarter’s final reading of 3.3%. While this level of growth seems healthy, there are reasons to be cautious:

- Inflation, as measured by the Consumer Price Index (CPI), shot up 1.2% in September, the highest increase since 1980. Core CPI, which factors out the volatile food and energy sectors, rose just 0.1%. Some argue that it is not realistic to factor out food and energy. After all, people buy food and energy to enjoy a comfortable standard of living. Including food and energy, consumer prices are up 4.7% over last year, a 14-year high. It is only a matter of time before companies pass their higher energy costs on to consumers by raising the prices of their goods.
- Trading near an 18-year high of $472 per ounce, gold is hinting that inflation is a problem.
- Unemployment increased to 5.1% in September from a four-year low of 4.9% in August due to Hurricanes Katrina and Rita.

The Federal Reserve is expected to raise their benchmark Fed Funds rate another 0.25% to 4.0% at their meeting on November 1. There is still no indication that the Fed is nearing the end of this tightening cycle. Benjamin Bernanke, who was recently nominated by President Bush to replace Alan Greenspan upon his retirement at the end of January 2006, was quick to announce that his “first priority will be to maintain continuity with the policies and policy strategies established during the Greenspan years.” One change that Bernanke might make in Fed policy, however, is to set a specific and public target for inflation. It would be interesting to see what effect this would have on Wall Street.

High earnings expectations for future quarters may be setting up Wall Street for disappointment. With 164 of S&P 500 companies reporting third quarter earnings, 112 companies have beaten consensus estimates, 26 have matched, and 26 have missed. Earnings in 2005 Q3 are on track to rise 15.8% over last year, the ninth consecutive quarter of double digit growth. Moreover, analysts expect earnings growth of 16.4% in 2005 Q4, 13.7% in 2006 Q1, and 12.4% in 2006 Q2. While these expected earnings are impressive, Wall Street tends to celebrate the philosophy of “under-promise and over-deliver”. Failure to meet high expectations could trigger further downside in the equity markets.

Technical factors of the market are bearish (more supply than demand), while fundamentals are fairly priced – therefore, we are mildly bearish on the market. Long-term interest rates have been on the rise. As of today, the 10-year U.S. Treasury Note is yielding 4.55%, up from 4.0% at the beginning of September. Higher long-term interest rates lower the fair valuation of stocks, calculated based on discounted free cash flow to equity (the fundamental analysis model used at Banyan Asset Management). Technically, our sector analysis has been weakening, with 11.5% of industries in a strong downtrend. Moreover, our market breadth indicator has been negative since August 15. While it has bounced from its lowest level on October 18, it is still in negative territory.

As expected, market weakness in September and October has yielded some excellent opportunities to buy undervalued stocks. Despite our cautious outlook on market risk, our research has uncovered some high quality stocks that we estimate to be undervalued with favorable technical factors. The key principle right now is to do things incrementally. Those who try to implement “all or nothing” strategies could suffer significantly if they are positioned incorrectly. It is prudent to maintain a more balanced approach of investing in a diversified portfolio, coupled with a healthy portion of cash liquidity.