"A Cautious Eye On Interest Rates"
Market Commentary – February 2006

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Gross Domestic Product (GDP), a measure of the output of the U.S. economy, grew only 1.1% in the fourth quarter of 2005. This ended a streak of ten consecutive quarters of growth of 3% or more. Consumer spending rose 1.1%, the lowest increase since the second quarter of 2001. Moreover, business investment in equipment and computers rose only 3.5%, causing concern that business spending may not make up for slower consumer spending. Many economists believe that the low GDP reading is an anomaly, skewed by one-time events and data that are likely to be revised. The Commerce Department will revise the fourth quarter GDP figure in February and again in March.

The Federal Reserve is expected to raise their benchmark Fed Funds rate another 0.25% to 4.75% at their meeting on March 28. In boosting the Fed Funds rate by 0.25% on January 31, the fourteenth consecutive 25 basis point hike, the Fed noted that "the expansion in economic activity appears solid" and that "some further policy firming may be needed". Inflation remains a concern to the Fed, as they pointed out that "elevated energy prices have the potential to add to inflation pressures." The next Federal Reserve meeting will be the first one led by Chairman Ben Bernanke. It makes sense that Bernanke will boost interest rates to signal to the market that he is vigilant about defending against excessive inflation. A rate hike in March may be the last one of this cycle.

The yield curve continues to be flat as long-term interest rates do not reflect the increase in short-term interest rates since June 2004. As of 1/31/06, annualized Treasury yields were 4.36% for three months, 4.42% for six months, 4.52% for two years, 4.45% for five years, 4.51% for ten years, and 4.67% for 30 years. While yields have slowly crept up in recent days due to weaker demand from banks, pension funds, and foreign central banks, they remain at unusually low levels. Typically, low long-term interest rates are favorable for stock valuations. There is, however, a potential lose-lose scenario brewing for the stock market. If long-term interest rates stay low, that could suggest that the U.S. economy will weaken as 2006 progresses. If long-term interest rates rise, stock valuations would come under pressure. We continue to observe the yield curve with caution and view it as an important source of market risk.

Technical factors of the market are mildly bearish (slightly more supply than demand), while fundamentals are fairly priced – therefore, we are mildly bearish on the market. Value Line cites the median price-to-earnings (P/E) ratio on all stocks with earnings as 18.8. This is close to the 3/19/05 market high reading of 18.9 and is well above the 10/9/02 most recent market low reading of 14.1. Fundamentally, the valuation of the overall stock market is not cheap. This will become even more of an issue should long-term interest rates rise.

At Banyan Asset Management, our proprietary indicators show signs of tiring. Our sector analysis indicates more than 67% of the 209 industries spanning the entire stock market are in either medium or strong uptrends. This is reaching a level that may be difficult for the market to sustain. Our market breadth indicator turned positive on January 12 and has been clinging on to positive territory ever since. Breadth should be stronger for a market getting ready to forge on to higher highs.

We maintain our view that a balanced approach toward risk and reward is favorable in this current market environment. Volatility has been unusually low since this cyclical bull market began in March 2003. During the cyclical bull market, corrections have been shallow, not exceeding 8%. The lack of volatility may have lulled investors into an illusion that the stock market is no longer risky. It would serve investors well to remember the bear market during 2002, when volatility to the downside was much higher. For example, between 3/19/02 and 7/24/02, the S&P 500 dropped 33.9%; between 8/22/02 and 10/10/02, it fell 20.4%. Our cash liquidity stands ready to go to work should such excellent buying opportunities present themselves.