"Green Light: Buy Signal Observed"

Market Commentary – April 2003

By Frank C. Fontana, CFA
President, Banyan Asset Management, Inc.
Written March 31, 2003 – www.banyan-asset.com

We got the buy signal we were looking for in the middle of March: a high volume rally in the market indexes. On Thursday, March 13, the stock market indexes rallied more than 3% on the best volume of 2003. Ironically, the market strengthened before the war with Iraq started. While the high volume rally did not tell us with certainty that the market would continue going up, it did tell us that the probability of the market rising was greater than the probability of the market declining. Risk-reward was favorable enough to put some of our idle cash to work and selectively leg into some new positions.

Geopolitical uncertainty is still the dominating force on Wall Street, with the main event being the war with Iraq. As expected, the U.S. went to war without U.N. approval. The purpose of the war is to remove Saddam Hussein's regime from power and to rid Iraq of weapons of mass destruction. The market continued its pre-war rally as the first bullets were fired, with the highest market levels reached during the "Shock and Awe" bombing of Baghdad. Typical of a situation fraught with uncertainty, rumors circulated on Wall Street that Saddam Hussein was injured or even dead. Traders anticipated that the regime was quickly losing control of Iraq. Unfortunately, news came out the following week indicating that Iraqi troops were resisting more than expected and that the Republican Guard is poised to put up a fierce battle to protect Baghdad. The reality of U.S. troops killed and captured as POW's also dampened the hopes of Americans that this would be a "clean" war. Of course, there is no such thing as a "clean" war. This is an example of the struggle between perception and reality on Wall Street.

The financial markets are still trying to forecast the end of the war. While the war is not expected to take many months, it is clearly lasting more than several days. Curiously, the market will likely see the end of the war before the actual news comes out. When such clarity is gained, the market will probably make its next leg up on high volume.

Headlines will eventually move from war to the economy, which continues to be mixed at best. The price of oil has dropped from nearly $40 per barrel to less than $30 per barrel. Correspondingly, the price of gasoline has recently eased. High fuel prices act like an extra tax weighing down the economy. Industrial output was up a mild 1.7%, year over year. Retail sales tumbled 1.6% in February compared with January, with weather and war worries cited as the cause. Finally, unemployment edged up one-tenth percentage point to 5.8% in February. We will get more insight into the first quarter as companies start to announce their earnings in April.

Debates continue regarding the use of monetary and fiscal policy. Low inflation is allowing the Federal Reserve to keep interest rates low while the economy recovers. As for the future of interest rates, minutes from the Federal Reserve's January 28-29 meeting express "difficulty disentangling the effects of current geopolitical tensions from the underlying momentum of the economy." In terms of fiscal policy, the Senate is trying to cut President Bush's $726 billion tax cut plan by more than half in order to help pay for the war. This move jeopardizes President Bush's plan to eliminate the taxation of dividends.

Fundamentally, the market is fairly priced; technically, it is improving. While it is possible that the market could rally to an overvalued level, current fundamentals will make it difficult for the market to rally to new highs anytime soon. Technically, the declines in February and early March were on light volume. The sharp rally in mid-March, which was the strongest week since 1982, occurred on high volume. While short covering helped contribute to this volume, money from the sidelines was being put to work. The decline at the end of March has occurred on light volume. This suggests that the developing bullish pattern is still in tact. A high volume decline in the market indexes would cause us to turn more cautious.

We are selectively legging into long positions, buying stocks that we calculate to be undervalued fundamentally with bullish technical charts. We also sold covered calls following the mid-March rally to capture excellent call premiums and to help make volatility work in our favor. Unless the market indexes exhibit high volume declines and undergo a negative change of character, we will continue to buy the low volume dips. As our portfolios appreciate, we will use market confirmation to justify investing even more cash.