"Balanced"
Market Commentary – October 2006

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In its final revision, the Commerce Department calculated that the U.S. economy, as measured by Gross Domestic Product (GDP), grew 2.6% in the second quarter of 2006. This is higher than the initial estimate of 2.5% and lower than the revised estimate of 2.9%. An economic slowdown is under way, led by tighter monetary policy (higher short-term interest rates) and a cooling housing market. So far, evidence is leaning toward a "soft" landing, where economic growth slows but remains positive.

For the second consecutive meeting, the Federal Reserve decided to leave their benchmark Fed Funds rate at 5.25% on September 20. While the Fed said that the future of interest rate hikes will be data dependent, the futures market is voting that the Fed is done raising rates for this cycle and the next move will be a rate cut. Specifically, Fed Funds futures are pricing in an 86% probability of a 25 basis point cut by May 2007. The stock market is hopeful that the Fed has raised rates enough to cool inflation while not slowing the economy so much that a recession is created.

The yield curve continues to be flat as inflation fears ease and the economy slows. As of 9/29/06, annualized Treasury yields were 4.89% for three months, 5.02% for six months, 4.91% for one year, 4.71% for two years, 4.59% for five years, 4.64% for ten years, and 4.77% for thirty years. Long-term interest rates have actually declined over the past two months. This has been a bullish catalyst for stocks, since lower long-term interest rates reduce borrowing costs and lead to higher stock valuations.

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 14.2% in the third quarter year-over-year, the 13^{th} consecutive double-digit gain. Still, stock valuations are on the pricey side. The price-to-earnings (P/E) ratio on the Dow Jones Industrials Average is currently 22.6, in the middle of its five year range of 16.9 to 29.7. A high P/E ratio indicates an expensive market; even the five year low reading of 16.9 is high on a historical basis.

Our proprietary technical indicators at Banyan Asset Management have maintained their favorable levels throughout September. Our sector analysis shows only 1.4% of the 209 industries spanning the entire stock market in a strong downtrend, down from a high of 14.8% on August 12. Our market breadth indicator has stayed at modestly positive levels since turning positive on August 21. Short interest increased from mid-August to mid-September, which could add fuel to the stock market's upside potential when traders eventually buy back stock to cover their short positions. Moreover, demand from stock buybacks, mergers, and private equity buyouts will likely be favorable for stocks.

Tempering our bullishness a bit are excessive optimism, seasonal factors, and low volume on the market indexes. The stock market has certainly celebrated in recent weeks the falling price of oil. We should remember how easy it would be, however, for an exogenous event to reverse this. Also, stocks have enjoyed cheaper long-term interest rates. Just how low will long-term interest rates go? If they continue much lower, perhaps they will foreshadow a recession, which would be bearish for the stock market. Seasonal factors keep us on guard, as October often sees high volatility to the downside. Finally, the stock market rally over the past two months has occurred on light volume, with the exception of the days when the S&P 500 broke through resistance from the May 2006 high.

It is important to maintain a balanced portfolio in the current market. Our offense consists of owning high quality undervalued stocks. Our defense consists of a cash cushion, the true value of which would become apparent should the market decline. While maintaining a prudent amount of cash to balance risk and reward, we anticipate incrementally adding more undervalued stocks to our portfolios on short-term weakness and the selling covered calls into strength.