“Is The Bottom Near?”

Market Commentary – October 2002

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Tensions with Iraq continue to develop as President Bush talks tough about Saddam Hussein. If the U.S. goes to war, it will likely be a strong negative for the stock market…at first. Somewhere in the heart of battle, though, I expect the stock market to curiously go up, as Wall Street senses the end of the conflict.

The economy continues to struggle. The Conference Board’s Consumer Confidence Index, declined in September for the fourth straight month. Interestingly, the Present Situation Index declined, indicating consumers’ negativity about the short-term, while the Expectations Index rose, suggesting that people do see light at the end of the tunnel. With business spending weak, consumer confidence is paramount to economic strength.

The stock market tends to form major bottoms in the September/October time frame. There is a saying on Wall Street: “Sell in May and go away.” Historical studies of the U.S. stock market indicate that most portfolio returns are earned between November 1st of a given year and April 30th of the following year. The studies suggest a possible strategy of selling stocks on April 30th, sitting in cash from May 1st to October 31st, and then buying stocks again on November 1st. While Banyan Asset Management does not adhere to this saying as a rule, we are mindful of the seasonal pattern. One possible explanation for the seasonality involves October 31st as the end of the fiscal year for many mutual funds. Mutual funds tend to do their “tax-loss selling” in September and October. Stocks that were beaten up earlier in the year see heavy selling pressure again, and stocks that proved to be winners are also sold to match gains to the losses realized. As a result, there tends to be selling pressure across the board.

Something else to consider for this year will be third quarter mutual fund statements that investors will receive in the first couple weeks of October. Our sector analysis indicates that third quarter weakness was in virtually every sector, and that the market has not favored any particular market capitalization. Nothing was spared. Investors may find their account balances so sickening that they may capitulate and pull the plug on their mutual funds. If they do, the market will plummet.

Our working hypothesis is that we may see a bottom of sorts for the stock market in October. It is looking increasingly likely that the bottom may be preceded by a steep decline on high volume. Fundamentally, we calculate a fair value for the Dow Jones Industrials Average at approximately 8700. Around 8000, the Dow is slightly undervalued, but we believe it could get significantly cheaper before buyers are lured back into stocks. Technically, the S&P 500 is still coming to terms with the bearish head-and-shoulders pattern it completed in July. This pattern suggests that we are in a secular bear market, which is a longer-term bear than its cyclical counterpart.

In conclusion, we are going into October heavily weighted with cash and an occasional short position. If we get a steep sell-off, we will be tempted to buy a few quality companies that are “on sale”. The only way we can do this with confidence, however, is to cut our loss if our purchase proves to be premature. A conservative approach toward risk in this choppy market should help us maintain stability.