"Great Expectations Could Disappoint Wall Street"
Market Commentary – March 2004

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Gross Domestic Product (GDP), a measure of the output of the U.S. economy, was revised up from 4.0% to an annualized 4.1% for the fourth quarter of 2003. Recent data confirm solid economic growth.

- The Midwest regional manufacturing index of the National Association of Purchasing Management – Chicago hit 63.6 in February, indicating strength in the manufacturing sector. This was the fourth consecutive reading over 60, which has not occurred since 1994-95.
- Durables, which measure big-ticket orders to U.S. factories, rose 2.0% in January, not including transportation. Capital good orders, a component of Durables and an excellent indicator for business investment, rose 3.6%.
- The four-week average for initial claims for jobless benefits is 354,750. Readings below the key 400,000 level suggest that the economy is creating jobs.
- Unemployment fell from 5.7% in December to 5.6% in January, the lowest level in two years.
- The Core Consumer Price Index (CPI), a measure of inflation which factors out the volatile food and energy sectors, rose 0.2% in January. Since last year, Core CPI has risen only 1.1%, a 38-year low.

While absolute levels for economic news have been favorable, high expectations leave room for disappointment on Wall Street. Imagine the emotional build-up leading to Christmas morning. If you are expecting the best gift ever, you will likely be disappointed with the gift you unwrap, even if it is the best gift you have ever received. On the other hand, if you are told in advance that the gift is nothing extraordinary, you will be thrilled when you unwrap a fantastic gift. In the U.S. economy, expectations for inflation are dangerously low. The consensus forecast of Fed governors and regional bank presidents predicts inflation between 1% and 1.25% in 2004. With this range being in-line with multi-decade lows, it is more likely that expectations have erred on the side of being too low. Any news of unexpected inflation would likely result in rising interest rates, which would in turn create downward pressure for stocks and bonds.

Technical factors of the market are mildly bearish (more supply than demand), while fundamentals are fairly priced – therefore, we are mildly bearish on the market. This is the second consecutive month that we have maintained a mildly negative view of the market. Fundamentally, stocks are priced at the high end of fair valuation. Technically, market index declines in February were generally on higher volume than subsequent rallies. As well, market breadth has continued to deteriorate with the number of stocks declining being greater than the number of stocks rising. We continue to expect that a catalyst for an intermediate-term correction could be a failure of the economy to meet lofty expectations. Until we see a positive change in the market's character, such as a high volume rally or an improvement in market breadth, we will maintain our mildly bearish position.

We are selectively buying undervalued stocks on market weakness, but we are protecting adequate cash liquidity in our portfolios given our mildly bearish view. Banyan Asset Management's proprietary sector analysis is favoring defensive sectors, such as utilities, consumer staples, healthcare, and financials. When we do find stocks that have attractive fundamental and technical factors, in whichever industry, we add them to portfolios as long as those portfolios still have adequate cash liquidity after the purchase. This cash liquidity will be used to buy more stocks at lower prices should the market decline. In the meantime, dividends and covered call premiums are generating growth for our portfolios while the market consolidates.