"Rising Interest Rates Cause Concern For Stocks"
Market Commentary – February 2004

By Frank C. Fontana, CFA
President, Banyan Asset Management, Inc.
Written January 31, 2004 – www.banyan-asset.com

Gross Domestic Product (GDP), a measure of the output of the U.S. economy, grew at an annualized 4.0% in the fourth quarter. This pace is more sustainable than the third quarter's 8.2%, which was the highest since 1984. For all of 2003, GDP grew at 3.1% versus 2.2% in 2002 and 0.5% in 2001. Economic data suggest that this growth is solid, but cooling off.

- Fourth-quarter 2003 earnings for S&P 500 companies are expected to rise 22.2% from last year.
- The Conference Board's Consumer Confidence Index measured 96.8 in January, the highest level since July 2002. Consumers are more optimistic about the present and the next six months.
- Housing starts rose 8.1% in 2003, the best since 1978 and the third consecutive annual increase.
- Unemployment fell to 5.7% in December from 5.9% in November.
- Consumer spending grew 2.6%, less than expected and less than the third quarter's 6.9%, which was the best in 17 years.
- Durable goods spending rose 0.9% in the fourth quarter versus 28% in the third quarter.
- Nondurable spending rose 4.4% in the fourth quarter versus 7.3% in the third quarter.
- The National Association of Purchasing Management's regional factory activity index hit 65.9, the highest level since July 1994 and above the level of 50 suggesting continued expansion.
- Fiscal stimulus of $40 billion from bigger tax refunds and lower tax payments will benefit the economy starting this spring.

The Federal Reserve left its benchmark Fed Funds rate at 1.0%, the same level since June and the lowest in 45 years, but subtly hinted at future interest rate hikes. At its December meeting, the Fed said that it would not raise interest rates "for a considerable period". In the policy statement from the January meeting, however, the Fed now says that it "can be patient" in tightening interest rates. Both stocks and bonds reacted negatively to the possibility of higher interest rates. At Banyan Asset Management, Inc., we maintain that interest rates will rise toward the end of 2004 and into 2005. Given the political pressures of a presidential election year, the Fed will likely wait as close to November as possible to begin the hikes.

Speculative stocks and high-yield junk bonds may not perform as well in 2004 since the risk of bankruptcy has already plunged. Research from Citigroup indicates that the corporate default rate, which has typically oscillated between 0.1% and 1.5% since 1970, spiked as high as 5.0% in early 2002. The default rate now sits at 1.6%. The prices of speculative stocks skyrocketed in 2003 as it became evident that many would not go bankrupt. It is important to keep in mind, however, that the corporate default rate cannot go below 0%. We believe that the good news is mostly priced into speculative stocks and their relative price performance will likely cool off this year.

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 mildly negative position on the market should not be interpreted as a call to sell all stocks and run for cover. The S&P 500 has risen for ten months without more than a 6% correction. A catalyst for an intermediate-term correction could be a failure of the economy to meet lofty expectations. While absolute levels for economic news have been favorable, high expectations leave room for disappointment. Market breadth has started to deteriorate and recent index declines have been on higher volume. Light volume rallies over the next two weeks would confirm the slight negative change in character.

We continue to buy undervalued stocks on market weakness and sell covered calls into strength. Strong fundamentals and dividends should support portfolio performance, while covered calls partially hedge returns on the downside and instill an automatic discipline to buy low and sell high.