"Profit Taking"

Market Commentary – January 2007

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In its final revision, the Commerce Department reports that the U.S. economy, as measured by Gross Domestic Product (GDP), grew 2.0% in the third quarter. While the economy is still expanding, growth is significantly slower than the first quarter GDP growth rate of 5.6%. The weak housing sector is a main culprit. As well, the economy has been digesting higher interest rates associated with the Federal Reserve's tighter monetary policy. At the same time, corporate earnings have been strong and unemployment is only 4.5%. Inflation has been elevated in recent months, but it is not at unreasonable levels. Some are beginning to dub this a "Goldilocks economy", where economic growth is not so hot that inflation flares, and it is not so cold that the economy sinks into recession.

The financial markets expect the Federal Reserve to begin lowering interest rates sometime during the summer of 2007. Fed Funds futures estimate an 80% probability of a 0.25% cut in the Fed Funds rate to 5.0% by September 2007. The stock market would welcome lower interest rates, as long as there is not much reason to fear a recession. Currently, the Fed sees simultaneous, offsetting risks of inflation and an economic slowdown.

Merger & Acquisition (M&A) activity was red hot in 2006, creating a floor and generating upward momentum in stock prices. The final tally of M&A activity in 2006 is expected to total about $1.4 trillion. Many of these acquisitions are being driven by private equity, likely with a high degree of leverage. The number and size of the private equity deals are impressive, with the biggest acquisition being $21.3 billion. It seems that companies of virtually any size are fair game these days. This momentum is expected to continue into 2007.

Technical factors of the market are bearish (more supply than demand), while fundamentals are fairly priced – therefore, we are bearish on the market. The price-to-earnings (P/E) ratio for the S&P 500 is 18.0. While it would be inappropriate to use the word "bubble" to describe such a valuation, it is also not considered cheap. Our proprietary sector analysis shows the number of industries in a strong uptrend has declined from 31.6% when it peaked on November 25 to 17.6% currently. Moreover, our market breadth indicator is one bad day from turning negative. At Banyan Asset Management, Inc., we interpret both of these indicators as suggesting a correction in the stock market.

Having enjoyed a strong 2006 and sitting on significant unrealized capital gains for the first time in years, portfolio managers will likely "take profits" in January. Profit taking consists of selling stocks in order to realize capital gains. Considering the uncertainties with forecasts for the New Year, portfolio managers will want to lock in some gains before they erode due to the next market decline. As selling becomes more active, the stock market overall turns lower and the next correction is created. Magnifying this effect would probably be a news event of some sort. A possible catalyst for a stock market pullback could be the reaction to a Christmas season that, while strong, was not as strong as expected.

At Banyan Asset Management, Inc., research of our updated universe of stocks has highlighted some interesting opportunities in the financial and health care sectors. The stocks that we have identified have favorable technical chart patterns and are undervalued fundamentally, according to our calculations. It is important to note, however, that finding such stocks has become increasingly difficult given the market's rally over the past several months. This is an additional bit of evidence that the market is ripe for a correction. Should the market correct, many of our portfolios have covered calls to partially hedge downside risk. As well, our significant cash positions allow us to buy when stocks are on sale. Overall, a balanced approach should yield attractive risk and reward characteristics for investors.