"Building For A Breakout"

Market Commentary – March 2006

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Gross Domestic Product (GDP), a measure of the output of the U.S. economy, was revised up from 1.1% to 1.6% in the fourth quarter of 2005. While this growth is weak, Federal Reserve Chairman Ben Bernanke maintains that "the economic expansion remains on track". The Federal Reserve has forecasted the following for 2006:

- GDP of 3.5% (2005 actual 3.1% vs. 2005 Fed forecast 3.75%-4.0%).
- Inflation of 2.0% (2005 actual 1.9% vs. 2005 Fed forecast 1.5%-1.75%).
- Unemployment rate between 4.75% and 5.0% (2005 actual 5.0% vs. 2005 Fed forecast 5.25%).

The Federal Reserve is expected to raise their benchmark Fed Funds rate another 0.25% to 4.75% at their meeting on March 28. Moreover, futures markets predict that the Fed Funds rate will be 5.0% by July. In his February testimony to the House Committee on Financial Services on Capitol Hill, Bernanke indicated that future rate hikes will be data driven and "may be necessary" to help battle inflation. Right now, the financial markets see the rate hikes ending by mid-2006.

The yield curve is slightly inverted as long-term interest rates seem immune to higher short-term interest rates. As of 2/28/06, annualized Treasury yields were 4.62% for three months, 4.74% for six months, 4.68% for two years, 4.59% for five years, 4.54% for ten years, and 4.50% for 30 years. Note that yields progressively decline from the 6-month Treasury bill to the 30-year Treasury bond. Investors are willing to accept a lower interest rate to lock in that rate for longer periods of time.

While past yield curve inversions have almost always foreshadowed an economic slowdown, Chairman Bernanke disagrees with applying this observation to today's situation. He argues that long-term yields are low due to lower and more stable inflation around the world and higher demand from foreign investors, U.S. pensions, and insurance companies for safe, long-term U.S. assets. He also points out that inversions ahead of past recessions came at times when overall interest rates were much higher than they are today. At Banyan Asset Management, we view the developing story surrounding the yield curve as an important source of market risk.

Technical factors of the market are mildly bullish (slightly more demand than supply), while fundamentals are fairly priced – therefore, we are mildly bullish on the market. Value Line cites the median price-to-earnings (P/E) ratio on all stocks with earnings as 19.3. This is much greater than the 10/9/02 most recent market low reading of 14.1. A high P/E ratio indicates an expensive market; fundamentally, stocks are richly priced.

At Banyan Asset Management, our proprietary indicators recouped some strength and are hanging on to modestly positive levels. Our sector analysis indicates more than 69% of the 209 industries spanning the entire stock market are in either medium or strong uptrends. Long term, this will be difficult for the market to sustain. Our market breadth indicator briefly dipped into negative territory from February 14 to 16, but it has been pushing slowly higher into positive territory since then. Volume was weak for most of February, until the higher volume pullback on February 28. Based on our indicators, the market may take a breather for a week or two, but then reposition itself for a breakout to the upside.

Investors should find that a balance of risk and reward yields favorable results for their portfolios. Recent market strength has given us an opportunity to sell covered calls with expirations extending into the summer. If the underlying stocks rise and our positions are called away, we will realize capital gains. If the stocks stay flat or decline, our portfolios will capture the call premiums as income. While there are selective opportunities to buy undervalued stocks with favorable technical chart patterns, we are preserving a prudent level of cash to potentially profit from future volatility.