“Testing Support”

Market Commentary – January 2006

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Written December 31, 2005 – www.banyan-asset.com

Growth of Gross Domestic Product (GDP), a measure of the output of the U.S. economy, was revised down from 4.3% to 4.1% for the third quarter of 2005. Productivity, a major factor in determining long-term economic growth, grew a revised 4.7% in the third quarter, the highest increase in two years. From 2000 to 2004, productivity growth averaged 3.4% versus 2.1% over the last 45 years. High productivity in recent years has supported economic growth while keeping a lid on inflation.

The housing market shows signs of softening. In November, new home sales posted their worst drop in 11 years. The supply of new homes for sale climbed to 4.9 months, the highest since 1996. Moreover, new housing starts rose 5.3% in November, as builders bet on future buyers for their homes. This bet may prove dicey as mortgage applications fell 6.8% to the lowest level since May 2002; plus, there is a push by U.S. regulators to curb risky interest-only loans. The median new-home price was $225,200, barely higher than a year earlier. A slow housing market could weigh on the U.S. economy in 2006.

The Federal Reserve is expected to raise their benchmark Fed Funds rate another 0.25% to 4.50% at their meeting on January 31. As for the meeting on March 28, the first to be led by incoming Fed Chairman Ben Bernanke, futures markets are uncertain whether the Fed has one more 25 basis point hike left. The future of interest rates will consider expected inflation. In November, producer prices were up 4.4% and consumer prices were up 3.5%, year-over-year. Still, the Fed maintains that long-term inflation expectations are “contained”. Judging by the inverted yield curve, the bond market apparently agrees.

In December, the yield curve “inverted”, meaning that short-term interest rates are higher than long-term interest rates. (Our September 2005 Market Commentary explains the yield curve.) As of 12/31/05, annualized Treasury yields were 4.08% for three months, 4.36% for six months, 4.40% for two years, 4.35% for five years, 4.38% for ten years, and 4.53% for 30 years. Note that the 2-year Treasury note yields more than the 5-year and 10-year Treasury notes. This inversion event will become more significant if the inversion remains for several months and/or becomes more pronounced. The yield curve has inverted before each of the past four U.S. recessions, but not every occurrence of an inverted yield curve has been followed by a recession. For now, we must cautiously observe how this story unfolds.

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 18.3. This is only slightly off of the 3/19/05 market high reading of 18.9 and is well above the 10/9/02 most recent market low reading of 14.1. Fundamentally, the market continues to trade at the high end of fair valuation.

At Banyan Asset Management, our proprietary indicators are mixed. Our sector analysis continued to slowly gain strength throughout December. More than 51% of the 209 industries spanning the entire stock market are in either medium or strong uptrends. In contrast, our market breadth indicator turned negative on December 29; it had been positive since November 8. Technically, the S&P 500 (currently at 1248) is testing 1240 as support following the November breakout. The next major support areas are 1200 and 1170. Given that the test is occurring on low volume, we view the recent consolidation as being healthy. A bearish change of events would be a break of support on high volume.

Overall, we maintain that a balanced approach will yield favorable risk-reward characteristics in this current market. Several opportunities have emerged to buy high-quality, undervalued stocks with favorable technical chart patterns. While we certainly expect to add some of these stocks to our portfolios over the coming weeks, we still plan to guard a prudent level of cash liquidity. This cyclical bull market is aging, and we must protect investment dollars as best as possible from downside risk.