“Interest Rates On The Rise”
Market Commentary – August 2003

By Frank C. Fontana, CFA
President, Banyan Asset Management, Inc.
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The global news scene continues to play a reduced roll on movements in the financial markets. The market did pop up a bit on news of the death of Saddam Hussein’s sons Odai and Qusai, but the rally was not sustained. News of the capture or death of Saddam himself will likely create short-term positive sentiment in the market, but this, too, will probably not last. Portfolio managers are focusing more on the economy now.

The economy is showing modest improvement. Durable goods orders rose 2.1% in June from May, the first rise in three months. The Institute of Supply Management (ISM) Purchasing Managers’ Index was more neutral at 49.8 (a reading of 50 suggests that factory growth is flat). Unemployment in June stood at 6.4%, a nine-year high, but more recent data is more positive. New filings for jobless benefits last week hit a five-month low of 386,000, below the key 400,000 level, indicating that jobs are being added to the economy. Overall, the Fed believes that mild economic growth is in progress, calling for fourth-quarter GDP to be up 2.5% to 2.75% from a year earlier.

Interest rates have risen sharply over the past month, indicating that the treasury bubble may have finally burst. Ironically, ever since the Federal Reserve cut the fed funds interest rate in June, the market has voted otherwise – that rates are heading up from here. Given the inverse relation between bond prices and yields, bond prices have tanked and bond yields have skyrocketed over the past five weeks. The 10-year Treasury note yield hit a 45-year low of 3.07% on June 15, but now yields 4.33% (as of July 29). The market is demanding higher returns from fixed-income instruments, suggesting that an economic recovery is taking place.

Mortgage rates seem to have bottomed out, which may cool down the red hot housing sector. Bankrate.com reports that mortgage rates, which are closely tied to the 10-year Treasury note, rose for the fourth consecutive week in their national survey of large lenders. Their most recent survey puts the 30-year fixed-rate mortgage at 5.99%, up from 5.28% four weeks ago. The Mortgage Bankers Association of America said that mortgage loan applications for purchases and refinancings declined last week by 5.3%, although applications are still up over 56% compared to one year ago.

Market technicals are bullish (more demand than supply), while fundamentals are fairly price – therefore, we are mildly bullish on the market. The major indexes have consolidated gains since March by moving sideways. A couple pullbacks in July were on modestly higher volume, but not at a level to indicate a reversal. This pattern of price action is a healthy way for the market to build energy for the next leg up. There has been buying under this market at support levels. Technology has slightly outperformed, but all sectors have generally been moving in tandem. In terms of earnings, more companies are beating earnings estimates and fewer are missing. This is potentially misleading, however. CEOs have succeeded in lowering Wall Street’s earnings expectations over the past few years. Having underpromised, they are now positioned to overdeliver.

We continue to buy stocks on low-volume declines and sell covered calls on rallies. Our portfolios have performed well in the sideways market, thanks to our covered call positions. The August through October time frame tends to be rough for the market. We have protected our portfolios as best as possible by investing in companies with strong fundamentals and technicals, and by selling covered calls to generate income. We will put our buying on hold if the market declines on high volume. With regards to fixed-income, we are currently looking for exit points from our bond fund positions. With interest rates on the rise, we believe bond funds will likely lose money over the coming year. A short-term trading dip in interest rates will provide an opportunity for us to close these positions.