"Buy The Rumor, Sell The News"

Market Commentary – May 2006

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Gross Domestic Product (GDP), a measure of the output of the U.S. economy, rose a solid 4.8% in the first quarter of 2006. Business spending jumped 14.3% and consumer spending increased a respectable 5.5%. Also, durable-goods surged 6.1% in March, and consumer confidence hit a four-year high in April. Inflation is up only 2% from a year earlier, but that statistic ignores food and energy (where inflation has arguably been more than 2%). Housing is a wild-card, with both new and existing homes not selling as briskly. Moreover, mortgage applications are 23% below last year's levels. Overall, the U.S. economy continues to chug ahead.

The Federal Reserve is expected to raise their benchmark Fed Funds rate another 0.25% to 5.00% at their meeting on May 10. In the minutes from their March meeting, some Fed governors "expressed concerns about the dangers of tightening (interest rates) too much." Recently, Fed chief Ben Bernanke publicly announced his expectation for economic growth to cool and inflation to be contained. He added that "at some point in the future the committee may decide to take no action at one or more meetings in the interest of allowing more time to receive information relevant to the outlook." These clues indicate that the Fed is nearly done raising rates. The futures market confirms this, pricing in a 25 basis point hike on May 10, with another hike possible toward the end of summer.

There is a curious phenomenon in the financial markets represented by the saying, "buy the rumor and sell the news". It is not uncommon for the stock market to move in anticipation of a news event. When that news event happens as expected, however, the market often suddenly changes course and heads in the opposite direction. Most on Wall Street would agree that it would be favorable news should the Fed announce that they are done raising interest rates for now. The market would likely experience a brief rally, but it could then suddenly reverse to the downside. The stock market is ripe for a correction. Since the cyclical bull market began in March 2003, corrections have not exceeded about 8%. While this trend could continue for some time to come, it is possible that news of the Fed being done raising rates could trigger a "sell the news" event and create the next stock market correction.

Technical factors of the market are mildly bearish (slightly more supply than demand), while fundamentals are fairly priced – therefore, we are mildly bearish on the market. Fundamentally, valuation of the stock market in general does not represent a bargain. Moreover, we are concerned with the effect of a higher 10-year Treasury note on our calculations of intrinsic value (explained in our market commentary last month).

At Banyan Asset Management, our proprietary indicators show a divergence to the market's upward direction in recent months. Our sector analysis indicates that about 72% of the 209 industries spanning the entire stock market are in either medium or strong uptrends. Looking more closely, the number of industries in strong uptrends has dropped from 26.3% to 21.5%. Our market breadth indicator fell into negative territory on April 17 and has been hovering there ever since. Volume on the market indexes has been higher than average in recent days without the indexes gaining much ground, which can be a leading sign of weakness to come.

While it is certainly desirable to enjoy the stock market creeping higher, it is important to remember that risk is the other half of the law of "risk and reward". With a cautious eye on risk, we are maintaining our balanced approach to investing. Our conservatism is reflected in our desire to buy stocks that we calculate to be undervalued relative to their intrinsic values. Our focus on companies that generate ample free cash flow often leads us to stocks that pay healthy dividends. Covered calls provide another way to create income in our portfolios. Finally, the cash that we hold in our portfolios is the ultimate asset, allowing us to "buy low" should the stock market become choppy.