"Low Inflation = Bullish Stock Market"

Market Commentary – November 2003

By Frank C. Fontana, CFA
President, Banyan Asset Management, Inc.
Written October 31, 2003 – www.banyan-asset.com

Data suggest that the U.S. economy continues to strengthen. Third-quarter Gross Domestic Product (GDP) grew an annualized 7.2%, the fastest rate since 1984. Earlier this year, second-quarter GDP came in at 3.3%. Inventories shrank by 0.4% in August, the steepest drop in two years, as producers were caught by surprise that third quarter demand picked up. Third-quarter retail sales grew at an annualized 9.9%, boding well for the coming holiday season. Consumer spending, which accounts for 70% of the $10 trillion U.S. economy, rose 6.6%, the largest gain in more than five years. The employment picture is stabilizing, with unemployment at 6.1%. Job growth may be seen in the recent hiring of temporary workers. According to *Investor's Business Daily*, "firms have cut 115,000 positions from their payrolls since May, but over the same span they have added 146,500 temporary workers."

Inflation has crept down to 1.2%, the lowest level since 1966, helping the Federal Reserve to keep its benchmark Fed Funds interest rate at 1.0%. The Fed continues to believe that "policy accommodation can be maintained for a considerable period." In other words, interest rates are likely to remain unchanged until sometime in 2004. The Fed also indicated that "an unwelcome fall in inflation" outweighs the risks of higher inflation, yet it sees consumer spending and labor markets strengthening. And Wall Street was definitely pleased.

Earnings growth continues to be strong, but this will not be sustainable if sales growth lags. With 322 of the S&P 500 companies having reported third-quarter earnings already, 210 companies (65%) exceeded analyst consensus earnings, while 72 companies (22%) met expectations and 40 companies (13%) missed. Historically, 58% of companies beat analyst consensus earnings while 20% miss. The outlook for fourth-quarter earnings is bullish, with earnings expected to rise 22.1%. While the bottom-line seems to be performing well, much of the earnings growth has been caused by cost cutting and low interest rates. It also helps that companies and analysts have been conservative with guidance in the post-bubble economy.

Market technicals are mildly bullish (more demand than supply), while fundamentals are fairly priced – therefore, we are mildly bullish on the market. As a whole, the market is on the high end of being fairly priced. Fundamentals are only half of the equation, however. As long as demand is greater than supply, equity prices will rise. The major stock market indexes countered the high volume declines at the end of September by rising on equally high volume in October. Our proprietary market breadth indicator confirms the bullish improvement in technicals.

Banyan Asset Management's proprietary sector analysis is indicating buying opportunities in the utility, consumer staples, healthcare, financial, and energy sectors. While we are not averse to owning certain industrial, consumer discretionary, and telecommunication services stocks, it is prudent to be more defensive given the market's valuation. *Barron's* stated that from May to July alone, Nasdaq margin grew from $7.3 billion to $26 billion, while NYSE margin rose only 1.4%. Speculation is alive and well in the technology space. Such speculation is not appropriate for our client portfolios. To quote from Nelson Kjos' book, <u>The Poet of Wall Street</u>, "investing is speculating enough".

We are initiating new equity positions in undervalued stocks and selling covered calls into strength. The companies we own generate positive free cash flow, which is either paid to shareholders in the form of a dividend or is plowed back into the firm to grow operations. Our portfolios are also positioned with covered calls expiring incrementally over the coming months, ensuring consistent cash liquidity. Our strategy should continue to yield satisfactory upside potential while partially hedging returns from sideways and downward movements in the market.