“Is Inflation Lurking Around The Corner?”
Market Commentary – January 2004

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The economy continues to thrive in the low interest rate, low inflation environment.

- The Institute for Supply Management (ISM) manufacturing index rose to 62.8, the highest level since December 1983. This is the fifth consecutive month above the key level of 50, which suggests growth in the manufacturing sector.
- Unemployment fell to 5.9% in November, dropping below 6% for the first time since March.
- Personal income grew at an annualized 4.1% during the last six months.
- Consumer sales online, which account for only 3% of total retail sales, were up 23% from last year for the period from November 1 to December 25.
- Core Consumer Price Index (CPI), a measure of inflation that excludes the volatile food and energy sectors, rose 1.1% over the past year, the smallest gain in 38 years. Total CPI rose 1.8% over the past year, the lowest since August 2002. While inflation remains low, the Federal Reserve can keep interest rates low.

The Federal Reserve left its benchmark Fed Funds rate at 1.0%, the same level since June and the lowest in four decades. In a policy statement released at its December meeting, the Fed now weighs the probability of disinflation as being roughly equal to the probability of a rise in inflation. They also indicated their intention to keep rates low for a “considerable period.” The definition of “considerable” is subjective, however. Before they begin raising interest rates, economists expect the Fed to withdraw its “considerable period” statement. We are looking for this to happen sometime in the summer of 2004.

Current low inflation data is conflicting with hints from the gold market that inflation is lurking around the corner. Gold has rallied from $260 per ounce in early 2001 to more than $410 per ounce today. While the weakening U.S. dollar is one factor in the gold’s recent strength, we believe the rise in the price of gold is predicting the return of inflation in the near future. Once inflation heats up, the Fed will be pressured to raise interest rates. Since this is a presidential election year, we expect the Fed to hold off on hiking interest rates until the second half of 2004.

Pension funding shortfalls are being erased by the bull market. Of the 320 firms in the S&P 500 with defined benefit plans, 284 (nearly 90%) were underfunded at the end of 2002. General Motors, which has the largest corporate pension plan in the U.S. with assets of nearly $61 billion, recently indicated that its unfunded pension liability of $19.3 billion at the end of 2002 should be nearly eliminated by the end of 2003. This favorable development has been caused by issuing new debt at cheap interest rates, contributing cash, and earning high returns on pension assets. Reduced pension expenses will increase earnings and free up cash for companies to plow back and grow operations.

Technical factors of the market are mildly bullish (more demand than supply), while fundamentals are fairly priced – therefore, we are mildly bullish on the market. The market has trended up since March 2003, while earnings estimates have risen. Therefore, we still estimate that the market is on the high end of being fairly priced. The market has risen considerably since March without a significant correction. We continue to watch out for signs of a negative reversal – a high volume sell-off and a subsequent rally on light volume. Banyan Asset Management’s proprietary sector analysis is indicating buying opportunities in the energy, industrial, utility, consumer staples, healthcare, and financial sectors.

For 2004, we are maintaining our strategy of buying undervalued stocks and selling covered calls into strength. Whether the market continues to grow, bounces sideways, or reverses, this strategy should prove beneficial. Strong fundamentals and dividends should help fuel the growth of our portfolios, while covered calls will partially hedge returns on the downside and instill an automatic discipline to buy low and sell high.