“Market Risk Creates Opportunity”

Market Commentary – September 2005

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Growth of Gross Domestic Product (GDP), a measure of the output of the U.S. economy, was revised down to 3.3% for the second quarter of 2005. While the economy is growing, the pace of growth has slowed slightly from the first quarter's GDP reading of 3.8%. Federal Reserve Chairman Alan Greenspan expressed concern about soaring home prices, the large budget deficit, and trade protectionism as threats to future U.S. economic growth. It is also likely that the high price of oil, natural gas, and gasoline will act as additional catalysts to slow economic expansion.

The Federal Reserve is expected to raise their benchmark Fed Funds rate another 0.25% to 3.75% at their meeting on September 20. After ten consecutive quarter point tightening moves since June 2004, there is still no indication that the Fed is nearing the end of this tightening cycle (the longest since Alan Greenspan became Fed chairman in 1987). Markets expect the Fed Funds rate to reach 4.25% to 4.5% by early 2006, but some economists are forecasting 5% sometime in 2006. The Fed has expressed concern about “elevated inflation pressures”. Unit labor costs are up 4.3% in the latest quarter versus a year ago, the highest annual rise since 2000. It is just a matter of time before companies pass these costs on to consumers, resulting in inflation.

If long-term interest rates continue to decline while the Fed raises short-term interest rates, the yield curve will eventually invert. The yield curve is a measure of interest rates spanning various time frames, from the One-Month Treasury Bill at the shortest maturity to the 30-Year Treasury Bond at the longest maturity. Typically, interest rates are higher for longer maturities, giving the yield curve its “normal” upward slope. When the yield curve inverts, however, investors earn a higher rate on short-maturity Treasuries. An inverted yield curve is often viewed as a predictor of recession in the coming quarters, but it does not guarantee a recession. In any case, the future of interest rates will likely be a critical factor in the future direction of the stock market.

Technical factors of the market are bearish (more supply than demand), while fundamentals are fairly priced – therefore, we are mildly bearish on the market. Stock valuations are fairly priced at current long-term interest rates, but they are overpriced if interest rates spike. Technically, our proprietary oscillators at Banyan Asset Management suggest underlying technical weakness. Our sector analysis shows that only 11.5% of the 209 industries spanning the entire stock market are in strong uptrends, compared with 27.3% as of July 30, 2005. Our breadth analysis went negative on August 15 and remains firmly in negative territory. While the market may experience a relief rally in the coming days, the underlying technical factors still suggest further market weakness.

During recent declines in the market indexes, we have been focused on what to buy, not what to sell. Having been active sellers of stock all summer, our portfolios have an appropriate amount of cash on the sidelines. This allows us to view any market weakness as an opportunity to buy low, not as a reason to be afraid. Our covered call positions and dividends continue to generate income for our portfolios while the market chops around. Should the market rise, our clients own high quality undervalued stocks.

There should be better opportunities to buy undervalued stocks in September and October. With the Fed raising interest rates, we are reminded of the common Wall Street saying, “Don't fight the Fed”. Adding the impact of high energy prices and the aftermath of Hurricane Katrina, market risk is currently unfavorable. At some point, however, the negatives turn into positives. The best investment opportunities often reveal themselves in the midst of adversity.