"Slow And Steady Wins The Race"
Market Commentary – June 2005

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Written May 31, 2005 – www.banyan-asset.com

Growth of Gross Domestic Product (GDP), a measure of the output of the U.S. economy, was revised up from 3.1% to 3.5% for the first quarter of 2005. This is the seventh consecutive quarter that growth exceeded 3%, the best streak since 1983 to 1986.

- National employment is strong, with the economy creating 274,000 jobs in April.
- Unemployment measured 5.2% in April, matching the lowest level since late 2001.
- The core consumer price index (CPI), a measure of inflation in consumer goods, was flat in April and up 2.2% over the previous year. In February, consumer prices were up 2.4% over the previous year, so inflation has cooled slightly.

Still, there are some dark clouds on the economic horizon:

- The University of Michigan consumer sentiment index for May hit a two-year low of 86.9, indicating that consumers are less optimistic about the economy.
- Personal savings hit a three-year low in April, falling 0.4%. While consumer spending helps the economy today, some question how sustainable spending can be without disciplined saving.
- There is a nationwide debate over the presence of a housing bubble. Some people have relied on appreciating home prices to do their saving for them. When they tap into their equity for cash, they are essentially treating their homes as ATMs at the bank. This behavior is not sustainable.

The Federal Reserve is expected to raise their benchmark Fed Funds rate another 0.25% to 3.25% at their meeting on June 30. This would be the ninth consecutive 0.25% tightening move since June 2004. As they hiked the Fed Funds rate 0.25% at their meeting on May 3, the Fed announced in their released statement that inflation is "well-contained" and that they plan to maintain their policy of "measured" future interest rate hikes. Additional increases in short-term interest rates will depend on inflation and economic growth. If inflation heats up, the Fed will become more aggressive in raising rates. If economic growth slows, then the Fed will likely leave interest rates alone.

Technical factors of the market are bearish (more supply than demand), while fundamentals are fairly priced – therefore, we are mildly bearish on the market. Despite weakness in 2005, the stock market as a whole continues to trade toward the high end of fair valuation. Equity valuation models rely heavily on long-term interest rates. Curiously, long-term interest rates have fallen over the past year while short-term rates have steadily risen. The 10-year U.S. Treasury note currently yields only 4.0%. While lower long-term interest rates have helped support stock prices, a spike in long-term interest rates would pressure stocks.

Technically, volume will be the key to determining the sustainability of the current market rally. High volume tends to give more credibility to movement in price, both on the upside and downside. In May, volume for the major indexes was less than the 50 day moving average. This indicates a lack of conviction in the market's recent advance. Confirming this observation, our proprietary sector analysis shows that only 34% of the 209 industries spanning the entire stock market are in either "strong" or "medium" uptrends. In contrast, our proprietary market breadth indicator went positive on May 16 and is holding firm in positive territory.

Our investment strategy is based on the principle that "slow and steady wins the race". While the market chops back and forth, our portfolios are profiting from three sources: dividends, melting covered call premiums, and capital gains realized on market strength. Our defense, which consists of an appropriate amount of cash, allows us to "buy low" when stocks are temporarily down in price. We continue to maintain our conservative approach in this low-return market environment.