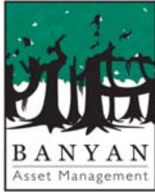

"Overbought"

Market Commentary – November 2006

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The Commerce Department's preliminary estimate of U.S. economic growth, as measured by Gross Domestic Product (GDP), expanded at a 1.6% annual rate in the third quarter. This was the slowest growth rate in three years and was below economists' consensus forecast of 2.1%. Consumer spending, which accounts for 70% of GDP, grew a healthy annualized 3.1%. On the other hand, the weak housing sector, as measured by residential investment, dragged third quarter GDP down by 1.1% in its worst decline since the first quarter of 1991. The median new-home price fell 9.7% year-over-year in September, the sharpest decline since 1970. With the University of Michigan consumer sentiment index hitting a 15-month high in October, consumers are pleased with low unemployment, growing wages, and the recent pullback in gasoline prices; still, they remain concerned about housing prices.

For the third consecutive meeting, the Federal Reserve decided to leave their benchmark Fed Funds rate unchanged at 5.25% on October 25. The Fed believes the slowing U.S. economy is due in part to the cooling of the housing market, and that economic growth should continue at a moderate pace. It also appears that the lagged effect of 17 consecutive quarter-point hikes by the Fed seems to be kicking in with the desired effect of slowing down economic growth and thus capping inflation. Futures markets are currently pricing in a 64% probability of a 25 basis point cut by May 2007. One of the factors driving the stock market rally in recent months is the belief that the Fed is done raising short-term interest rates.

Another important factor in the future direction of the stock market is the fate of long-term interest rates. The flat yield curve has been with us for quite a while, now. Annualized yields on Treasuries spanning from three months to 30 years have not changed much from last month. Demand for long-term U.S. Treasuries by China seems to be firm. Also supporting demand may be U.S. pension funds wishing to lock in a particular income stream for years to come. As for the cohort of retiring baby boomers, it makes sense that retirees are turning to the bond market for income, boosting demand for bonds, raising bond prices, and thus lowering bond yields. The stock market likes low long-term interest rates since they reduce borrowing costs and raise stock valuations.

Technical factors of the market are mildly bearish (more supply than demand), while fundamentals are fairly priced – therefore, we are mildly bearish on the market. Profits for the S&P 500 companies are on track to climb 17.4% in the third quarter year-over-year. This would be the best growth rate in earnings since the second quarter of 2004. Given the recent rally in stocks, however, valuations have become more expensive. The price-to-earnings (P/E) ratio on the Dow Jones Industrials Average is currently 23.5, up from 22.6 a month ago. A lower P/E ratio, perhaps below 16, would draw the attention of more value investors.

There comes a point when "too bullish" becomes a bit bearish – we are likely closer to that point than not. Such a market condition, called overbought, overextended, or exhausted, is often followed by "profit taking". At Banyan Asset Management, our proprietary sector analysis has steadily gained strength, with 20.1% of industries in a strong uptrend (up from 7.7% a month ago). Our market breadth indicator has stayed in positive territory, but it has leveled off while the stock market indexes kept rising. We interpret this as a mildly bearish leading indicator.

Overall, we expect some opportunities to buy stocks at somewhat lower prices in the coming weeks. Should this happen, the value of our defense will become more apparent. By maintaining a cash cushion, we have ammunition to capitalize on and profit from lower stock prices. On the other hand, if the market continues higher, our offense of high quality undervalued stocks should continue to generate solid returns. As well, we are producing some income from dividends and covered call premiums. Portfolio management is less about predicting the future and more about planning for it.