



“War With Iraq Imminent”

Market Commentary – February 2003

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

The situation with Iraq continues to intensify. President Bush is trying to build international support for a U.S.-led military effort, but he has also made it clear that the U.S. is prepared to go it alone. With reports from UN weapons inspectors indicating a lack of cooperation on behalf of Iraq, it seems that the more appropriate question regarding war with Iraq is “when”, not “if”.

The economy continues to show mixed signals. Gross Domestic Product (GDP), a measure of the economy’s output, rose at an annual rate of 0.7% in the fourth quarter of 2002. For all of 2002, GDP grew 2.4%. Economic growth is having trouble building momentum from quarter-to-quarter. While growth has clearly slowed again, however, the economy has yet to slip back into recession. The Chicago Purchasing Managers’ Index (PMI) was announced at 56, versus expectations of 53. Any number greater than 50 indicates that the manufacturing sector is expanding. Also, business investment in software and computers rose at a 5% annual pace, its third straight quarterly expansion. On the negative side, unemployment stayed at an 8-year high of 6.0% in December. The Conference Board’s Consumer Confidence Index fell to 79.0, its lowest level since late 1993. The current expectations portion of the index rose to 75.4 from 69.6 a month earlier. The expectations component, looking six months out, fell to 81.4 from 88.1. This suggests that consumers are jittery about the prospects of the future.

Corporate earnings season is now half over and it appears that S&P 500 companies may have experienced double-digit growth last quarter. So far, sales are up 5.3% and profits are up 12.2% for the quarter. The bad news is that companies are also cutting first and second quarter earnings guidance. Other companies, such as McDonald’s and Coca-Cola are no longer giving quarterly earnings guidance. Of 209 firms in the S&P 500 providing earnings forecasts for the first quarter of 2003, 28% said profit would beat estimates, while 53% said they’ll miss estimates. First-quarter earnings growth estimates for the S&P 500 are forecast at 10%, while second-quarter estimates are 9.4%.

The Federal Reserve announced this week that they kept the fed funds rate at its 40-year low of 1.25%. The Fed believes that the 12 rate cuts made since the start of 2001 will be enough to revive the economy. In terms of fiscal policy, additional tax cuts being proposed by President Bush should also help.

The Dow Jones Industrials Average is fairly priced at its current level. Still, there are opportunities to buy individual stocks that are undervalued. Technically, the market indexes are in a position to test the October lows. Such a test is critical to how the indexes will perform this year. If the October lows fail, then technical sell signals would be given, yielding a high probability that the market would trend even lower from that point. In the meantime, the market has been falling on light volume, suggesting that the decline is being caused more by an absence of buyers than by an abundance of sellers.

Last month, we indicated that our portfolios are in balanced positions. We are still long some fundamentally and technically strong stocks, and we have used covered calls on some these positions to profit from the market’s volatility. We continue to maintain a balance of stocks and cash in advance of the war with Iraq. Our belief is that this pre-war market decline will yield opportunities to buy fundamentally and technically strong stocks. A buy signal we are looking for is a solid rise in the market indexes on very high volume. While we wait patiently for such a signal, we are quietly collecting dividends and option premiums from covered calls.