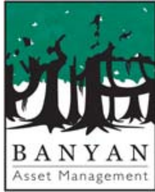

"Potential Energy Building"

Market Commentary – June 2008

By Frank C. Fontana, CFA
President, Banyan Asset Management, Inc.
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According to the preliminary reading of Gross Domestic Product (GDP), a measure of the value of goods and services produced in the U.S., the U.S. economy grew 0.9% in the first quarter. In May, the Federal Reserve cut its forecast for 2008 GDP growth from a range of 1.3%-2.0% to 0.3%-1.2%. There are several factors weighing on the U.S. economy:

- Inflation is a concern. The Consumer Price Index, a measure of inflation in consumer products and services, is up 3.9% from a year earlier. Even more worrisome, the Producer Price Index, a measure of inflation in wholesale products, is up 6.5% from a year earlier. The fear is that businesses will pass on rising costs to consumers via higher prices. The Fed forecasts inflation in 2008 will be between 3.1% and 3.4%.
- The Case-Shiller national index of single-family home prices fell a record 14.1% year-over-year in the first quarter of 2008. Housing is a major deflationary force in the economy right now.
- The Conference Board's Consumer Confidence Index plunged to 57.2 in May, its lowest level since October 1992. The expectations component, which measures confidence in the future, is at the worst level since December 1973. The perception of consumers can create economic reality.

The Federal Reserve may find itself in a pickle as it tries to keep workers employed while containing inflation. Lower interest rates are designed to spur economic growth and thus help keep people working, but those same lower interest rates can also ignite inflation. According to minutes of the Federal Open Market Committee's meeting on April 30, "although downside risks to growth remained, (FOMC) members were also concerned about the upside risks to the inflation outlook". GDP growth staying positive in the first quarter strengthens the argument that the Fed is done cutting interest rates. Indeed, the benchmark Fed Funds rate, currently at 2.0%, is forecast by futures markets to be higher in the months ahead. Futures anticipate this rate to be 2.34% by January 2009, 2.73% by April 2009, and 3.27% by August 2009. The Fed will announce its next interest rate decision on June 25.

The Federal Deposit Insurance Corporation (FDIC) is warning that U.S. bank failures could spike. So far in 2008, three U.S. banks have failed. This compares with three banks failing in 2007 and none in 2005 and 2006. The FDIC indicated that the number of "problem" banks rose in the first quarter from 76 to 90 (out of 8,494 institutions). For comparison purposes, the historical low number of "problem" banks was 47 in the third quarter of 2006. During the savings and loan crisis of the 1980s and 1990s, approximately one in ten banks were in the "problem" category.

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 price-to-earnings (P/E) ratio of the S&P 500 is 22.5. The higher P/E ratio is due to higher stock prices, skewed by earnings that have been weighed down by the large write-downs of financial companies. At some point, these write-downs will stop and possibly even be reversed into future earnings.

Potential energy is building as the S&P 500 trades below the 200 day moving average and above the 50 day moving average. With a compressed coiled spring, potential energy is converted into kinetic energy (movement) when the compression is relieved. In the stock market, the recent trading range can turn into a breakout with the addition of a catalyst. Given the recent news flow, an unexpected breakdown in the price of oil could provide such a lift. At Banyan Asset Management, our proprietary market breadth indicator has stayed modestly positive since April 29, hinting at a degree of health underlying market action. We have added some attractively priced stocks to our portfolios in recent months, and we have also been sellers of covered calls to generate cash flow. Importantly, we have cash liquidity to capitalize on lower prices should the stock market pull back.