"Asset Allocation Shifting To Stocks"

Market Commentary – July 2003

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At the end of June, the Federal Reserve cut the fed funds interest rate by 25 basis points to 1.0%, the lowest level since 1958. The Fed cited that another rate cut was needed to insure a recovery in the sluggish U.S. economy. They changed their "balance of risks" assessment from "weighted toward weakness" to a "roughly equal" balance between a strong recovery and continued economic weakness. Going into the Fed meeting, the treasury market was debating whether the rate cut would be 25 or 50 basis points. Upon hearing the news of the 25 basis point cut coupled with the change in the balance of risks assessment, the treasury market sold off aggressively in terms of price and rose in terms of yield. The market seems to think that the Fed is done cutting rates. Some economists believe that rates will not start to trend back up for another 6 to 12 months.

The housing market continues to be red hot. New-home sales jumped 12.5% to a record annual rate of 1.157 million units in May. Existing-home sales rose 1.2% to 5.92 million units. Bankrate.com reports its national 30-year fixed mortgage rate index at 5.31%. Ironically, following the Fed rate cut, mortgage rates jumped up. It seems that mortgage lenders were expecting the Fed to cut rates by 50 basis points and had to adjust expectations when the actual 25 basis point cut was released. If mortgage rates have indeed bottomed out, it will be interesting to see whether the housing market boom continues in the months ahead.

Banyan Asset Management's sector analysis suggests that a main driving force behind the stock market's rise over the past few months is asset allocation. All ten sectors have participated in the rally: energy, industrials, materials, utilities, consumer staples, consumer discretionary, financials, health care, information technology, and telecommunication services. A possible explanation for the lack of favoritism among sectors is that investors are choosing to buy stocks in general. This makes sense in the context of low expected returns from treasuries and corporate bonds. Imagine, for an example, a pension fund that needs to achieve a 9% annual return. With yields from the treasury and corporate bond markets so low, such a fund must invest in real estate or stocks to get higher returns. Due to the illiquidity of non-REIT real estate investments, pension funds are left with stocks as the most viable alternative. Based on the high volume in the market indexes, it is clear that institutions have been buying – the elephant has been getting back into the bathtub.

Market technicals are bullish (more demand than supply), while fundamentals are fairly priced – therefore, we are mildly bullish on the market. The major indexes pushed through their near-term resistance levels, and we are now seeing a test of old resistance as support. So far, the mild pullback in the indexes over the past week has occurred on light volume. The bullish technical pattern will remain in tact as long as volume on down days remains light. We are curious to see whether the bid underlying the stock market disappears as money managers who missed most of the 2003 rally no longer feel the pressure of "window dressing" once second quarter statements are finalized on June 30.

In our portfolios, we are buying stocks on low-volume declines and selling covered calls on rallies. We raised cash in the past couple weeks as we were called out of some June covered call positions. On days where the market pulls back on light volume, we are slowly adding stocks back to our portfolios. There is no way to know how far the market could correct, so we believe that adding stocks incrementally will help us minimize the effects of poor timing. As we said last month, should the market decline on high volume, we will put our buying on hold for the time being.