"Short Covering"
Market Commentary – December 2006

By Frank C. Fontana, CFA
President, Banyan Asset Management, Inc.
Written November 30, 2006 – www.banyan-asset.com

Revising its initial estimate, the Commerce Department now reports that the U.S. economy, as measured by Gross Domestic Product (GDP), grew 2.2% in the third quarter. Federal Reserve chairman Ben Bernanke said that "over the next year or so, the economy appears likely to expand at a moderate rate, close to or modestly below the economy's long-run sustainable pace." Echoing Ben Bernanke, the White House expects 2007 GDP growth to be around 2.9%.

The weak housing market continues to weigh on the U.S. economy. Unit sales of existing homes rose 0.5% in October, the first increase in sales since February. The median price for existing homes, however, slipped 3.5%. New housing starts in October were down 27.4% versus last year, to the lowest level since July 2000. Building permits are at the lowest level in nearly 9 years. Chairman Bernanke expects housing's slump to continue in 2007.

Fed Funds futures are pricing in a 28% probability of a 0.25% cut in the Fed Funds rate to 5.0% by March 2007. This is how the market is expecting the Fed to respond to the slowing U.S. economy. Publicly, however, the Fed is still hawkish on inflation. The Fed typically combats high inflation by raising interest rates. Ben Bernanke said "the risks to the forecast (of inflation) seem primarily to the upside". He added that "a failure of inflation to moderate as expected would be especially troublesome". It seems that the Fed Funds futures market is reading between the lines to reach its conclusion.

The falling U.S. dollar and low bond yields are hinting at the risk of a recession down the road. Given that one can usually argue both pros and cons for currency fluctuations, a severe negative consequence of the falling U.S. dollar is potentially brewing. As the U.S. dollar drops in value, the price of imports would spike, leading to inflation. This would force the Fed to hike interest rates. With GDP already slowing, the U.S. economy could then enter a recession. The bond market is concerned about recession, with the yield on the 30-Year Treasury bond at only 4.56%. In the short run, lower U.S. interest rates and a weaker economy could drag down the U.S. dollar even more as economic growth improves in Europe and Japan.

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. In November 2005, the S&P 500 was trading at 1268 and had a price-to-earnings (P/E) ratio of 19.0. A year later, the S&P 500 is around 1400 and has a P/E ratio of 17.8. Interestingly, despite the increase in the S&P 500 index over the past year, earnings have grown even more. This has generated value in the form of lower P/E ratios. Still, it would be prudent to note that a P/E ratio of 17.8 is not cheap.

"Short covering" has fueled the market higher over the past month. Traders short stocks in hopes of profiting from declining prices. If traders with short positions are wrong and stock prices move higher, they have to buy to "cover" and close their short positions to minimize their loss. Short interest measures shares that have been shorted and represents future buying demand. On the New York Stock Exchange, short interest fell 1.0% from mid-October to mid-November, while short interest fell 1.8% on the American Stock Exchange. Disappointed that the markets did not get crushed in September and October, traders apparently threw in the towel and bought back some of the stocks they borrowed. This buying helped push the stock market higher than it would normally have been inclined to rise.

At Banyan Asset Management, Inc., we seem to be in a waiting period regarding our portfolios. In November, we sold numerous covered calls expiring between January and May to generate income for our portfolios. With many stock prices so high, however, there were limited buying opportunities. When the market eventually pulls back, we plan to put some of our cash to work.