"The Red-Hot U.S. Economy"
Market Commentary – December 2003

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Gross Domestic Product (GDP), a measure of the output of the U.S. economy, was revised up to 8.2%, the fastest rise since 1984. The following data confirm the economy is recovering:

- After-tax corporate profits rose 10.6% in the third quarter, the highest since 1992.
- Consumers are feeling better about the economy. The Conference Board's consumer confidence index was 91.7 in November, the highest in 14 months. However, while the holiday shopping season is expected to be better than last year, sales might fall short of lofty expectations.
- Productivity rose at an 8.1% annual rate in the third quarter, the fastest rate since early 2002.
- Unemployment fell to 6.0% in October, the lowest level since April. In addition, weekly jobless claims fell to 351,000 in the week of November 22, the lowest level since January 2001. Still, productivity and the migration of jobs to China and India will likely pressure unemployment.
- The Purchasing Managers' Index, an important manufacturing indicator, rose unexpectedly to 64.1, the highest since February 1995.

Declining foreign interest in U.S. assets helped the U.S. Dollar index sink to its lowest level since 1996, amid fears that protectionism could undermine the U.S. economic recovery. On a net basis, foreigners sold $6.3 billion in U.S. stocks in September, compared with purchasing $11.6 billion of U.S. stocks in August. They also only bought $5.6 billion of fixed income securities in September, versus $25.2 billion in August. Federal Reserve Chairman Alan Greenspan expressed concern about U.S. tariffs and quotas on foreign goods and the possibility of trade wars with the European Union, China, and Japan. Perhaps these protectionist moves by President Bush are politically driven to gain support in industrial states ahead of the 2004 election.

Individual investors are cautious, but not shaken, about the recent mutual fund scandals alleging improper trades and overcharging certain customers. Some of the fund families being questioned include: Janus, Strong, Nations Bank, Bank of America, Putnam, Prudential, Alliance, and Alger. In spite of the scandal news, Investment Company Institute calculated that investors put a net $17.3 billion into equity mutual funds in September versus $23.4 billion in August. An average of $5.4 billion per week has been going into stock funds the past four weeks, the highest rate of inflow since May 2001. Money does not seem to be leaving the stock market because of the scandals.

Market technicals are mildly bullish (more demand than supply), while fundamentals are fairly priced – therefore, we are mildly bullish on the market. The market continues to push the upper limits of being fairly priced. If the market does trek into overvalued territory, we will keep our eyes glued to our charts for signs of a key reversal. A negative reversal would be indicated by a high volume sell-off and a subsequent rally on light volume.

Investors may choose to lock in gains this month, offsetting losses from the three-year bear market. With traditional tax-loss selling, investors who have realized gains in their portfolios tend to sell their losing stocks, realize their losses, and use those losses to offset realized gains from other stocks. This year, we may see investors take profits, and use those realized gains to offset realized losses accumulated over the past three years. If this happens, stocks that have performed well may see selling pressure.

Our strategy of buying undervalued stocks and selling covered calls into strength has proven profitable in 2003. Banyan Asset Management's proprietary sector analysis is indicating buying opportunities in the industrial, utility, consumer staples, healthcare, financial, and energy sectors. We still maintain that it is prudent to be defensive at this stage in the market rally. Strong fundamentals and dividends should help fuel the growth of our portfolios, while covered calls will partially hedge returns on the downside.