



“Effect Of Political Uncertainty On Wall Street” Market Commentary – October 2004

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The Commerce Department revised Gross Domestic Product (GDP), a measure of the output of the U.S. economy, up from 2.8% to 3.3% for the second quarter of 2004. With the long-term growth rate of the U.S. economy averaging 3.5% since 1930, today’s economy continues on its path of steady growth:

- The core Consumer Price Index (CPI), which factors out the volatile food and energy sectors, rose 0.1% for a third consecutive month. Over the past six months, inflation has grown by 2.2%.
- The unemployment rate dipped to 5.4% in August, the lowest since October 2001.
- Crude oil is pushing a record price of \$50 per barrel. Further price increases will likely weigh on economic growth.

The Federal Reserve raised their benchmark Fed Funds rate 0.25% to 1.75% at their meeting on September 21, maintaining their expectations of solid economic growth and modest inflation. The Fed explained that the economy has gained traction and the labor market has improved modestly. It signaled an intention to continue raising interest rates, perhaps at their next meeting on November 10.

Futures contracts predict that President Bush has a 64% chance of winning the Presidential election. Other contracts also forecast that the Republican Party has a 91% chance of retaining control of the House of Representatives and an 80% chance of retaining control of the Senate. Futures contracts associated with a variety of world events actively trade on a web site called www.tradesports.com. When an event does not happen, the contract closes at 0. When an event does happen, the contract closes at 100. While the outcome of an event is uncertain, the contract trades between 0 and 100, where the bid estimates the probability that an event will occur. Markets have a fascinating way of quantifying expectations for the future. Based on current market data, there is a good chance that the November elections will be favorable for the Republican Party across the board.

As expected, corporate earnings are exhibiting positive growth, although slower than the first half of 2004. First Call forecasts third-quarter earnings growth of 17%, the lowest in five quarters. As of September 17, 115 S&P 500 firms had lowered earnings guidance while 59 had raised it. This negative-to-positive preannouncement ratio of 1.95 is the highest since the second quarter of 2003. Growth is expected to continue to slow. Fourth quarter earnings are expected to grow 15.5% and first quarter of 2005 earnings should grow 7.5%. While it is clear that earnings growth is slowing, it is still positive.

Technical factors of the market are bearish (more supply than demand), while fundamentals are fairly priced – therefore, we are mildly bearish on the market. Fundamentally, stocks continue to be valued at the high end of fair valuation. Technically, the major market indexes have maintained their intermediate-term downtrends. Volume on down days in recent weeks has tended to be higher than on up days. A break below support of 1,060 on the S&P 500 and 9,800 on the DJIA would likely result in a steep, high-volume sell-off. The low volatility index (VIX) gives further reason for concern, as investors are generally complacent with a low level of fear.

At Banyan Asset Management, Inc., we are focusing on defense as the market creeps into the typically volatile month of October. Our portfolio management process is based on a combination of offense and defense. Our offense consists of our portfolio of stocks and bonds that we have purchased, while our defense is our cash liquidity. When fundamental and technical factors of the market exhibit appropriate risk-reward characteristics, we shift our focus from defense to offense. This leads us to put more cash to work and buy more positions for our portfolios. With current market conditions, however, we are emphasizing bigger cash positions than normal with the possibility of buying stocks at lower prices. To quote Nelson Kjos, author of *The Poet of Wall Street*, “be financially conservative, but know when to be aggressive.”