

NOW'S A
GOOD TIME
TO GET SOME
GOOD ADVICE

EYE OF THE STORM

The first quarter of 2008 was the toughest period for investors since the third quarter of 2002. It was hard to find a safe haven as global equity markets lost \$6.5 trillion in market value, a drop of 10.8%.¹ Our overweight cash position and allocations to inverse mutual funds and/or Exchange Traded Funds provided beneficial portfolio protection during this brutal time. We greatly improved results by emphasizing relative winners like: natural resources and bonds and vigorously avoiding losers like: financial services, consumer discretionary and consumer cyclical. Although a difficult quarter, it would have been much worse if the Fed had not engineered JP Morgan Chase's buyout of Bear Stearns on March 17th. This bailout and the largest liquidity infusion since the Great Depression seem to be restoring confidence. In turn, Avalon portfolios have been benefiting since we increased stock allocations and reduced cash near the intermediate low in March. We do not think the bear market is over, but tradable rallies should continue over the next several months. We expect to take advantage of these as they occur. We continue to follow the strategic and tactical guidelines outlined in our February piece, **"Changing Shades of Gray."**

Inflation - Not Going Away Anytime Soon

In May 2006, we warned that inflation was not going away in our piece **"Oil, Inflation and Interest Rates."** This view has not changed except we now believe that inflation will accelerate over the foreseeable future. The global economy looks to be entering a new era - an **Age of Scarcity**, a title recently penned by international economist Roger Cass of Cass Research Associates. He contends that credit, energy, food,

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water, cheap labor, all critical and abundant ingredients in the great globalization of the past fifteen years, are now scarce. This will impose unprecedented constraints on global growth and accelerate the rise in world prices. The Global CPI (Consumer Price Index) doubled from 2.2% in mid-2007 to 4.9% in the first quarter of this year. Cass is projecting 5.5% and 6.5% increases in this global price index in 2009-10.² Recent announcements from countries around the world support his projections. China is experiencing price increases of 8.5%, while India reports 7.0%. The IMF (International Monetary Fund) predicts the Arab Gulf States and the Middle East and North Africa region will have inflation rates above 10% this year. Eastern Europe will hit 11.5%, while many areas of Southeast Asia are encountering 7% to 10% price increases.³ Cass expects core inflation in the United States to be 3.4% in 2008 and 3.8% in 2009. Historically, once an expectation of rising inflation becomes embedded in an economy, it becomes very difficult to reverse the trend. Testifying before Congress, Paul Volcker, the former Fed chairman, warned of “a resemblance between the inflation outlook today and in the early 1970’s, when the economy tended towards rising prices, as well as big increases in energy and agricultural prices.” He said that “the response from the Fed at the time had not been “forceful enough in terms of tightening monetary policy.”⁴ Is the current Fed making the same mistake? We will be approaching our investment decisions with a rising inflation environment in mind.

Current Economy

United States Economy

Since the economy did not plunge into a recession as investors expected prior to the Fed's rescue, they are feeling better about the outlook and beginning to think that the worst is behind them. Unfortunately, we think we are in the **Eye of the Storm**, that region of mostly calm weather found at the center of cyclones. Surrounded by the eyewall are a ring of towering thunderstorms where the most severe weather of a cyclone occurs. As the eyewall approaches, investor's pessimism will reappear. History shows that the unwinding of bubbles is long and painful. Deleveraging usually takes several years. It could be five years before the private credit-to-GDP (Gross Domestic Product) ratio (credit divided by GDP) reverts to its long-term trend. Homeownership and the mortgage debt associated with it, is just one manifestation of the credit problem. While homeownership has fallen from the peak of 69.2% in 1Q05, at 67.6%, it is still well above the long-term average of 64% of 1965 to 1995.⁵ With tight lending standards and foreclosures, we expect the homeownership rate will continue to decline for another two or three years. As the U.S. faces a long period of debt retrenchment, the economy may experience very slow growth for some time. Combined with high inflation, we could be back to a period similar to the “stagflation” of the 70's. Expect GDP growth around 1.5% in 2008 and 0.5% in 2009.⁶

World Economy

The IMF (International Monetary Fund) says that the global expansion of the last five years is losing ground fast, projecting world growth at 3.7% for 2008 and 2009. For the same time period, the Euro-zone will slow to 1.5% and 1.2%, and Latin America to 4.4% and 3.6%. The IMF also cut growth in Asia to 6.2% for 2008 saying that Asia “has not delinked” from the US and that “the US slowdown could have a larger impact” than recent US downturns; particularly on China, given the increased economic integration between the two countries. Although the Chinese economy expanded at its fastest pace in thirteen years in 2007, there are tough times ahead: earthquakes, power disruptions, falling exports, food and water shortages, a plunging stock market and rising consumer prices. From 11.9% in 2007, growth should slow to 9.0% in 2008 and be under 8% by 2009.⁷

Asset Allocation

U.S. Stocks and Bonds

We believe that the U.S. Stock Market is still a bear market. The current rally is a bear market rally, not the start of a new bull market. A fruitful rally thus far, it may continue for another month or two. Right now, it is very important to be positioned properly with strategies to raise cash when the time is right. The sectors that have provided good relative returns continue to do so; overweighting industrial and transportation, biotech and high technology should produce positive returns; while avoiding financial services, consumer cyclical, consumer discretionary and utilities should protect portfolios.

We are buying high quality cash instruments, short-term bonds and short-term high yield bond funds in fixed income portfolios. We also like long-term municipal bonds, where nominal yields now exceed those of treasury bonds. Treasuries are overpriced and offer little value relative to inflation rates. While a worst-case economic scenario could push short-term treasury yields to lower levels, much of this appears to be fully discounted.

International

In our October 2007 piece **“Bubble or Bust”**, we warned that the next bubble to burst would be the Chinese stock market. From its peak in October 2007 to its low in April, The Shanghai Composite Index plummeted over 50%. We would avoid this market except for special situations. On the other hand, funds should be committed to Japan, which is up a surprisingly 20.1% since March. It is one of the cheapest markets in the world on a PE basis. Energy and commodity based countries such as Australia, Canada and Brazil should also be considered given our **Age of Scarcity** theme. Overall, we recommend a neutral to overweight position in international stocks, emphasizing the Far East and emerging markets. We advocate the same strategy as in the U.S. market; buy the intermediate bottoms and sell the intermediate tops until there are indications of a new bull market.

Natural Resources and Energy

Oil is approaching \$135 per barrel. While the price of oil is extended on a short-term basis we do not think it is time to give up on the energy bull. Oil is a finite resource; it drives the global transport system; and if emerging economies consumed oil as Europeans do, world consumption would jump by **150 per cent!** All of this supports the rising price. Expanding supply by an annual amount of about 1.4 million barrels a day needed to meet demand looks increasingly unlikely. Over the next seven years the additional needed supply is equal to Saudi Arabia's current output!⁸ Prices of energy commodities and stocks should continue to benefit from the growing imbalance between demand and supply. We have emphasized oil in our discussion, but the same factors affect other energy sources; natural gas, coal and green alternatives such as solar and wind. Agricultural related issues also are promising given **“Scarcity”** concerns in the coming years. Natural resources and energy continue to be our favorite sector.

Real Estate

REITs (Real Estate Investment Trusts) are clawing their way back after being clobbered in the credit crunch last year. The average REIT, which was down over 40% from peak to trough, is up nearly 5.6% this year through May 12th. First-quarter earnings for about half of REIT stocks were above expectations. We recommend a neutral position in this area.

Summary

The world economy is slowing down and could show sub par growth over the next couple of years. While all markets around the world are currently experiencing what we believe to be bear market rallies, portfolio management should be biased toward preserving capital. Cash should be raised at the next intermediate top. We recommend being overweight energy and natural resources, neutral to overweight in international markets and a neutral weight in real estate.

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