NOW'S A
GOOD TIME
TO GET SOME
GOOD ADVICE

Nice quarter

July 25, 2003

At the end of March, we counseled our clients to ignore the negative headlines and ride out the storm of uncertainty. We did and it paid off.

Amid the fear and trepidation of the first quarter, we urged our clients to maintain perspective, and we affirmed that it was time to stay fully invested, not to liquidate. Cash was attractive for emotional security, but it was not the asset of choice.

We were right. The rally in the second quarter was extremely positive and broad-based, with only the U.S. Treasury bond market under-performing.

Past investment recommendations that may have been profitable do not necessarily mean that future recommendations will also be profitable. Investing in the markets always bears a risk of loss, especially during uncertain economic conditions.

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Asset Class and Benchmark Returns: March 31, 2003 – June 30, 2003

Real Estate	U.S. Stocks	Natural Resources	International Stocks	Bonds
NAREIT 13.1	S&P 500 15.3	Thomson Energy Fds 11.2	E.A.F.E. Index (US$) 16.4	Lehman Intl. Govt. 2.0
	NASDAQ 21.0			Lehman HY Corp. 9.6
	Dow Jones Industrial 13.0			

*The above returns include income.

*Figures represent unmanaged index returns, which include the reinvestment of dividends and other income, but do not include the deduction of management and other fees. The returns do not represent the performance of Avalon Capital Management; actual client returns may have been significantly different.

EFFECTIVE ASSET ALLOCATION

We underweighted cash, treasuries, and REITS. Cash and money market funds were the poorest performers along with treasuries. Emphasizing corporate bonds over treasuries was a good decision, as high yield bonds returned 7% to 8% better than treasuries. This is a substantial difference and boosted the returns for the bond portion of your portfolio. REITS performed better than we expected, but still returned slightly less than the major averages.

Overweighting U.S. and International Equities paid off handsomely during this quarter. In the U.S., we emphasized biotechnology, telecommunications, and technology; all were return leaders in the U. S. market. Holding positions in the Far East and Emerging markets beat the return of an indexed international portfolio. While returns for resource-based assets were double digit, they trailed the returns of the broader averages.

Are we making any changes to the allocation?

We are currently making little change other than raising some cash to capture some of the strong gains from the powerful rally since March. We expect the market to be flat to down through the third quarter as other market participants do the same, but we do not expect to aggressively raise cash at this time. Any cash we do raise will be "parked" and ready for opportunities after the pause.

What comes after the pause? Driven by liquidity, with geopolitical uncertainties diminishing, the fundamental ingredients for a sustainable global economic recovery, beginning in the second half of the year, are falling into place. According to the U.S. Department of Commerce, U.S. expenditures for Information Processing Equipment (which account for over 50% of total capital expenditures) have been up for the six straight quarters ending in June. Actual expenditures could soon exceed the previous high, which occurred at the top of the boom in 2000. This supports our view that little change is needed in our overweighting of technology in the domestic equity portfolio.

In the international area, our focus will be on Japan. Both the Japanese economy and the equity markets seem to be acting better than they have for almost fourteen years. Many international portfolios are significantly under exposed to Japan. If the rally gains steam, portfolio managers may be forced into the market, providing further fuel for a rally.

While we do expect a pause in global equity markets in the third quarter, our view is that last October was the start of a new cyclical bull market that could last through the first half of 2004. Let's review:

4-Year Cycle Projection Revisited

In our March piece "Maintaining Perspective" we noted that six months out from the S&P 500 October 2002 low, the market lagged the average gain over the last forty years from a 4-year cycle bottom by 9.9%. (You can review this article on our web site at www.avaloncapital.com.) Although three months late, probably due to the war, by the end of June the market had remedied this and had advanced 26.6% (price only), exceeding the six months' average gain of 23.4%.

One year out from the 4-year cycle October bottom, our historical analysis shows that, on average, the market advances 32.8%. From current levels the S&P 500 would need to advance only 4.7% by October 2003 to achieve that historical return. As a result, we expect the market correction into October of this year to be relatively mild. Two years out from the same October 2002 bottom, historically the market would advance 82% (price only). From current levels the S&P 500 would need to advance 43.5% by October 2004 to achieve this average 82% return.

LOOKING WAY OUT

Federal Government Policy Changes

Two major policy shifts may have emerged in the second quarter. The U.S. Federal Reserve declared war on deflation and the new tax bill declared war on federal government surpluses.

Federal Reserve Policy Shift

Liquidity! Liquidity! Liquidity! The U.S. Federal Reserve and all other major central bankers have said that they will provide easy money indefinitely to assure worldwide economic growth. Federal Reserve Governor Ben Bernanke said that the Fed is willing to push the federal funds rate to zero, and leave rates low for a considerable amount of time to ensure the economy escapes the grip of destabilizing deflation. This follows Fed Chairman Greenspan's assurance that the Fed was prepared to keep rates low "for as long as it takes" to get the economy growing at a stronger pace.

Less than four weeks ago. the Fed lowered rates by another .25%. Since then, 30-year Treasury bond yields have shot up by more than 1%; inversely, the value of a 30-year treasury bond has dropped 11%. Investors seeking a "safe" haven in these bonds have been sorely disappointed.

What is going on? Why would interest rates rise when the Fed is lowering the controlled Federal Funds Rate – and the headlines are screaming concerns about deflation, unemployment and lack of economic growth?

The current Fed may be reinstating a policy put in place in 1945. After WWII, there was fear that the U.S. would be in for another set of the depression years. So the 1945 Fed adopted a policy that focused on growing the economy and keeping people employed. Deflation was the threat, not inflation. This policy reigned for more than 30 years.

By the mid-70's, inflation had emerged as the greater threat. Expectations for higher and higher inflation rates became embedded in the economic structure. The bond market was officially declared dead. *Bondholders had lost money for 35 years.* The 1945 Fed policy gave way to a radical new framework. Paul Volker and the Fed of the late 70's took on the task of eliminating inflation and the boom/bust cycles that had prevailed for the prior 20 years. Volker changed policy dramatically. Inflation was now the enemy. It no longer mattered how many people were without work, and however many recessions it took, the Fed was doing battle. Runaway inflation was the biggest threat to our way of life. Bond buyers enjoyed excellent returns from 1981 until now. The focus on inflation worked so well that we are potentially faced with a deflationary scenario similar to what Japan may be finally exiting. What to do?

Alan Greenspan, twenty-two years later, may be changing Volker's policy and readopting the 1945 policy. Deflation is now the enemy. The Fed may continue to open the money spigot until it is no longer a threat. Historically, when a new policy is put in place it stays in place for a long, long time. *This is what recently spooked the bond market. This new policy is bad for bondholders over the long-term because it spells reflation, not deflation.*

Almost all central bankers around the world are pursuing the same easy money policies. Even Europe is starting to crack under the strain of no growth, rising unemployment, and deflationary pressures. Chirac of France and Schroeder of Germany are pushing the central bank to loosen monetary policy much more than "officially" allowed.

Federal Deficits

The new tax bill will be good for individuals and the economy in the near-term. It may be the death knell for budget surpluses for many years to come. The White House's original forecast in February was for a $304 billion deficit for fiscal 2003. It is now $455 billion and rising.

This is 57% more than the record deficit of $290 billion recorded in 1992. This will be the largest on-budget deficit as a percentage of GDP since 1983 and the second largest since 1946. It is not hard to come up with a scenario where the 2004 deficit will be closer to $600 billion than the $475 billion the administration is currently projecting. To pay for this deficit, the government will sell more bonds, thereby swelling supply and eventually driving down bond prices. *This is more bad news for bondholders.*

The U.S. is not alone. The worldwide slump has wreaked havoc with government budgets around the globe. Jacques Chirac used Bastille Day to "kick down the walls" of the Stability and Growth Pact. Arguing for Europewide steps to boost economic growth, Chirac called for a relaxation of the rules restricting government budget deficits to 3 percent of GDP across the EU.

If we are correct that a sea change may be underway in these government policies, there are profound implications for investment strategy going forward. Currently there is no evidence that inflation is a problem. It is still too early, but the policy the Fed may be moving to implement could eventually lead to an environment of increasing inflation and interest rates. In such an environment, bonds should be avoided. Natural Resource and Gold Stocks should do well. Real estate, international stocks (because of a weak dollar), and high technology stocks (because they can increase productivity and hold down costs) should also outperform most equities.

Our analysis is based upon our best professional judgment; of course, "the markets' past performance cannot predict the future." However, our analysis does suggest that whatever surprises lie directly ahead could be positive ones. This would be a welcome change from the past three years.

Enjoy the remaining summer! We will look forward to seeing you sometime this fall.

Dave Rahn, Clara Basile, and Bill Oberman

Source: Avalon Capital Management proprietary research

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