NOW'S A GOOD TIME TO GET SOME GOOD ADVICE

On track

October 15, 2003

So far, 2003 has been very good to investors.

Asset Class and Benchmark Returns: December 31, 2002 – September 30, 2003

Real Estate	U.S. Stocks	Natural Resources	International Stocks	Bonds
NAREIT 24.7	S&P 500 14.7	Thomson Energy Fds 11.9	E.A.F.E. Index (US$) 17.3	Lehman Intl. Govt. 2.8
	NASDAQ 33.8			Lehman HY Corp. 21.2
	Dow Jones Industrial 13.2			

The above returns include income.

Note: 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 actual performance or the performance of Avalon Capital Management; actual Avalon client returns may have been significantly different during the period shown.

The Economy Is On Track

Six months ago, economists were fretting about deflation and/or a double-dip recession. Happily, as we projected, virtually all of the economic data is coming in positive instead.[1] U.S. economic growth is expected to exceed 7% in the third quarter following a 3.3% gain in the second quarter.[2] The fourth quarter forecast is about 4%.[3] Next year, we see overall growth around 4%.

AVALON CAPITAL MANAGEMENT

We anticipate that the 2004 economy will be characterized by minimal inflation, increased spending, low interest rates, and improving corporate profits. We believe that corporate profits are one critical key to good equity markets. Presently profits are recovering much faster than expected. For the past three quarters, profits have grown at an average rate of over 20%.[4] With accelerating economic growth, quarterly profits should continue to grow at close to 20% over the remainder of this year and into 2004.[5]

That this may be a "jobless recovery" is still a concern.[6] Sluggish job growth continues to make headlines and affect economic policies. For example, lack of job growth will be used as an excuse to promote protectionist measures and pressure the Chinese to revalue their currency.[7] "Labor cost arbitrage" or the transfer of jobs to lower paying countries such as China and India may make this recovery shorter than normal.[8] However, this also happened in the early 90's; eventually employment did rebound and the U.S. had a long expansion. September had a small increase of 56,000 non-farm jobs, breaking a seven-month downtrend, and perhaps signaling the beginning of an uptrend in payrolls.[9]

Global economic growth is also improving, 2003 is forecast at +3.3%, and more than 4% next year. Asia is currently expanding over 5%, including 8% gains in China and 7% in India. Even Japan is recovering and should show growth of more than 2%. Europe is growing more slowly, than its emerging counterparts, at 2%. Eastern Europe and Russia should show growth rates upwards of 5%.[10]

The Stock Market Is On Track

Year to date, this has been a good market for investors. At this writing, we are working through a period of "normal" seasonal weakness; and the market is holding a very tight trading range. There has been less downside here than we anticipated.

We are currently holding a small amount of cash in our client accounts that we expect to invest over the next few weeks. Our plan is to use various stocks and sectors that appear to be coming back into an attractive range in a rotational manner as our points of entry. Recent examples of good values are stocks in the following sectors: drugs, telecommunications and energy.

We believe that the period for possible seasonal weakness for this broad market should run from October into November. Beyond that we expect prices to go up into the first quarter of 2004.

Asset Allocation On Track

This year it was quite right to overweight equities. We continue to think it is the best place to be. Versus benchmarks we advise underweighting cash and bonds and remaining neutral toward real estate investment trusts. We continue to avoid treasuries and suggest using high-yield corporate bond mutual funds for bond market exposure.

Equities of all stripes, including U.S., International, and Natural Resources, are sound plays. In the U.S., we continue to emphasize high technology and biotechnology. Internationally, our exposure is in Japan, the Far East, China, and Emerging Markets. We think that these regions represent the most growth and the best relative valuations. The magnitude of the boom in world trade already exceeds that witnessed in 1999. The Baltic Freight Index has surged to its highest level since the 1980's and there are reports of capacity shortages in the world shipping industry. Trade always leads the world economy.[11]

Return to the 4-Year Cycle Projection

Clara's October 22, 2002 research piece "Why a rally now?" suggested that the rally from the October 9, 2002 low signaled the end of the bear market that began in March, 2000. (You can review the article on our web site at www.avaloncapital.com .) Historical analysis of the 4-year cycle in U.S. stocks since 1962 demonstrated that, on average, the S&P 500 index rallied over the next year 32.85% from the 4-year cycle low (price only). Now, 12 months later, the S&P500 has slightly exceeded the historical average advance from a 4-year cycle bottom, rising 34%.[12]

Now that this indicator has worked for the 11th time since 1962, what does it suggest about the next 12 months? Clara has updated the table to provide the next range from which we may base our expectations.

Historical Analysis of the 4-year cycle in U.S. stocks since 1962

Date of 4-year cycle bottom	S&P500 12 months later	S&P500 24 months later	Quality of Secular Trend
June 1962	+31%	+47%	Bull Market
October 1966	+21%	+29%	Bull Market
May 1970	+35%	+43%	Bear Market
December 1974	+37%	+57%	Bear Market
March 1978	+20%	+14%	Bear Market
August 1982	+44%	+26%	Bull Market
September 1986	+43%	+18%	Bull Market
October 1990	+34%	+38%	Bull Market
November 1994	+37%	+67%	Bull Market
October 1998	+26%	+55%	Bull Market
October 2002	+34%	????	Bear Market
Average	+33%	39%	

Source: Avalon Capital Management. Historical Data: Thompson Financial.
All changes price only.

Using the updated analysis, the estimates for the S&P500 24 months from the bottom of the 4-year cycle (based on low, average and high performance since 1962) range from a low on the index of 885 to a high of 1298. Historical experience suggests the index will trade to 1083.

From current levels, in price terms only, that translates into a "returns range" of -15% to +25% with +4% as the average expected return. The case for positive returns was much stronger a year ago, but on average, even after the healthy gains of the first 12 months, historically the S&P500 has continued to advance 2 years out.

While our analysis is based upon our best professional judgments, "the markets' past turnarounds and historical numbers cannot predict the future." Nevertheless, this analysis does suggest that the current cyclical bull market may have another leg or two to go before the onslaught of the next bear.

Technology – If it's on track, where is the track going?

Clearly, so much of the growth in the 1990's was built on the boom in technology. Likewise, much of the bear market that began in 2000 was due to the excess investment in technology and the poor or non-existent business models that accompanied the IPO frenzy of 1999 and 2000. Given the resurgence of technology stocks and their thematic emphasis in our portfolios, we must ask ourselves if this strength is fundamental and sustainable? If so, is this what is driving the recent gains? Or is this a new innovative phase that will lead to a new boom in the same way semiconductors, PCs, and the internet did in previous long cycles?

Over the past 12 months, the answer to these questions would not have greatly influenced how we invested. The question of how long these stocks would go up was irrelevant. Odds of a cyclical recovery were too high. Now, with many of the easy gains behind us, questioning the nature of the recovery becomes critical. If, in fact, this is a period of adjustment between long cycles whereby the innovation of the previous cycle works its way into the mainstream and incrementally improves, then valuations will become very important and must be closely monitored over the next few months. If, on the other hand, this is the next "new" thing, then a speculative fever will likely accompany any advance and prices will just keep going up, in another bubble building exercise. We think this latter scenario has a much lower probability.

At a recent Silicon Valley technology conference, it was clear that everyone believes innovation will continue "on the margin" and that the mass deployment of wireless through a convergence of mobile devices was upon us.[13] But is this "new" to the market? Are there undiscovered names or concepts that are likely to cause major dislocations within industries? Surely there are, but probably not immediately.

Now is more likely a time where the companies with real business models that survived the bust, go about the business of doing business. Now is when the R&D of many years ago makes its way into the mainstream. Biotechs are a case in point this year; a decade or more of R&D is coming to fruition and the stocks are being rewarded because the sales revenues are real.

Eventually something totally new and revolutionary will shake the reigns from the hands of the established leaders as the internet did in the 1990's, but this is not the probable course over the next couple years. It is more likely that this is the type of market where rewards come by evolution more than revolution as companies deepen and integrate the prior decade's many innovations. Within the portfolio, you have managed to participate through our investments in fast-growing themes like wireless, semiconductors, storage, and biotech. And while we do not think these trees will grow to the sky, this period of recovery will probably run into mid-2004, after which these ideas may become played out. Until then, with earnings just beginning to recover and investors just beginning to re-realize that tech is here to stay, more money is likely to find its way into these stocks.

We thank you for your continuing confidence in Avalon. This year has rewarded your patience. Enjoy!

Best Wishes,
Dave Rahn, Clara Basile, and Bill Oberman

Footnotes:
1 Reuters.com
2 Bureau of Economic Analysis
3-5, 10 Cass Research Associates
6-8, 11 BCA Research
9 BLS.gov
12 Thompson Financial
13 Churchill Club Technology Conference

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