NOW'S A GOOD TIME TO GET SOME GOOD ADVICE

It's not always boom or doom

The economic story has been steadily improving over the last two years. The economy and profits were strong in 2003 and the markets reflected that. Yet in 2004, with an economy and profits that are even stronger, the investment markets have gone sideways. Is there a mounting wall of worry that could hinder further market gains or is this just a lull?

Current Economy

United States Economy

The U.S. economy could enjoy steady expansion for the rest of this year against a backdrop of mildly increasing inflation. According to a mid-year survey of 55 forecasters by the Wall Street Journal, the nation's gross domestic product (GDP) is projected to grow at an annual rate of 4.4% in both the second and third quarters, and 4.2% in the fourth quarter. They are anticipating growth of 3.7% in 2005, with a range of 2.9% to 5.3%.[1]

In the July 2004 Federal Reserve Board's Monetary Federal Policy Report to Congress, the Fed stated "that capital spending is continuing to increase briskly, bolstered by expectations of strong sales as well as by booming profits and supportive financial conditions. Moreover, inventories appear to be lean relative to sales, suggesting that stockbuilding may provide some impetus to production in the near term. The brightening outlook for economic activity abroad suggests that demand for U.S. exports should grow and provide a further lift to production."[2]

Chairman Greenspan in testimony to Congress on July 20th said, "There have been much clearer indications over recent months that conditions in the labor market are improving. Gains in private non-farm payroll employment have averaged about 200,000 per month over the last six months, up sharply from the pace of 60,000 per month registered over the fourth quarter of 2003."[2] Most economists are expecting monthly payroll increases to be in the 225,000 to 250,000 range for the rest of the year,[3] a nice moderate pace.

AVALON CAPITAL MANAGEMENT

Greenspan also stated "that improvements in labor market conditions will have important follow-on effects for household spending. Expanding employment should provide a lift to personal disposable income, adding to the support stemming from cuts in personal income taxes over the past year. The low interest rates of recent years have allowed many households to lower the burdens of their financial obligations. Although mortgage rates are up from recent lows, they remain quite attractive from a longer-run perspective and are providing solid support to home sales. Despite the softness of recent retail sales, the combination of higher current and anticipated future income, strengthened balance sheets, and still-low interest rates bodes well for consumer spending."[2] The Conference Board's Consumer Confidence Index rose sharply in June to levels last seen in June 2002. "Looking ahead, consumers expect the economy to grow at a healthy clip and continue to generate additional jobs," said Lynn Franco, Director of the Board's Consumer Research Center.[4]

Core consumer prices rose at the slowest pace of the year (0.1%) in June, raising confidence that the Fed will be able to raise interest rates gradually. That followed gains of 0.2% in May, 0.3% in April and 0.4% in March.[5] The Fed Report to the Congress released on July 20th stated the "the prospects seem favorable for inflation to remain contained in the period ahead."[2]

World Economy

The global economy is now in the most synchronized expansion since 1988-89, with almost 50% of the world growing at rates equal to or faster than the U.S. Worldwide economic growth should average in the 4% - 4.5% range for the next several years. This is the highest rate of expansion in Gross World Product (GWP) in 20 years and is being accompanied by a resurgence in industrial production, capital investment, and world trade. This is in conjunction with close to 40-year lows in inflation and interest rates.[6]

A note about China

What about the fear of China "overheating" and precipitating an economic hard landing? We conclude that such concerns are unjustified. Recent evidence shows that China's growth is cooling and that a soft landing is very likely, with growth easing to still-healthy levels. We expect growth to slow to a more sustainable 7% rate from 9-10% by 2005, probably followed by a decade of growth averaging 7% annually.[6] Inflation also appears to be under control. Non-food CPI has been essentially hovering close to zero. The only areas where price inflation is apparent are in the raw materials, food, and real estate sectors.[7]

Investment Outlook

United States Investment Outlook

If the economic outlook appears healthy why are the financial markets in such a muddle? Part of the reason may be that the strong gains of 2003 occurred in anticipation of the good data being reported in 2004. The markets often discount future news. If so, the market could be "resting" from those terrific gains as it looks out to 2005. While most of the prospects for 2005 are still positive, a number of factors have arisen or reasserted themselves over the last few months to build up a "wall of worry". These include (but certainly do not exhaust):

U.S. involvement in Iraq. It is too soon to know how the situation in Iraq will unfold in the coming months and the extent to which the new government can indeed control the country. This lack of resolution represents instability and on any given day, could spook the markets.

Terrorism around the world. This overhangs financial markets in a way that is hard to quantify. Liken it to living in earthquake country. You know it will happen someday, but life must go on. A particular concern remains the threat of a terrorist disruption of world oil supplies. In the absence of a "Saudi surprise" however, financial markets have priced in this concern.

Rising inflation and interest rates. What worries markets are unexpectedly large increases in prices. This concern ebbs and flows depending on recent news. We expect inflation to be in the 2.5% range this year versus 2.2% last year. In 2005 inflation could reach 3.4%, a significant uptick, but still relatively low versus the 40-year average of 4.6%. We believe these inflation rates are already incorporated in financial asset prices.

This can also be said about the fear of a rise in short-term interest rates. The Fed has clearly stated that they will "raise rates' in a measured way. The markets are already expecting a Funds rate of 4% by year-end.[8] Asset prices have already discounted these rates.

Oil prices above $40. We raised this concern in our February 2004 Q&A piece (see www.avaloncapital.com). The markets have adjusted to this price area and our view is that oil prices may decline to the mid-30's per barrel by the end of the year as production increases and the "risk premium" declines. Problems in Iraq and the recent attack on foreign workers in Saudi Arabia have been cited as creating a "risk premium" in crude prices estimated by some observers of up to $10 per barrel.[9]

Divisive election campaign. This election has revealed intense polarity in the country and the political environment is unsettling. Our view is that significant political or legislative changes that could alter the economic environment will not occur in 2005, irrespective of who ends up in the White House.

So, where does that leave the market? Dull. It has not been this dull for more than 10 years; the range in the S&P 500 is the smallest for the first half of a year since 1993. In most cases, the anxieties that have plagued past dull markets have resolved themselves in a positive way. Since 1971 there have been 14 years (not including this one), where the volatility for the S&P 500 was under 15%. In 12 of those years, prices increased in the second half, for an average gain of 5.6%.[10]

Asset Allocation

U.S. Stock and Bonds

Our asset allocation favors equities over bonds. Just before the Fed raised rates, we did add to our bond positions. We bought corporate bonds or corporate or municipal bond funds (with a maturity of less than 10 years). While we think that rates may be higher a year from now, recent sharp increases created a good opportunity to lock in some yields at rates we thought were attractive over the near term. We are still holding cash for additional equity and bond purchases. For stocks we favor industrial, cyclical, health and tech issues. While tech stocks, in particular semiconductors, have been pressured in 2004 we look for another advance in these names before the cycle tops out.

International

We continue to overweight the international area, favoring Japan and the Far East. So far in 2004, Japan is the best performing market among the majors. Economic news continues to be good. The supposedly moribund Japanese economy has in fact been growing by an average of 3.6% over the eight quarters and 4.7% over the last year.[6] Over the last 15 years, among international markets, the main laggard had been Japan. We expect it to be one of the leaders over the coming ten years. After years of rating downgrades, S&P has been boosting credit ratings for many Japanese banks and financials.

Natural Resources and Energy

We have had a large over weight position in this year's best performing asset class. Even though we look for $35 oil by year-end, our long-term outlook remains quite positive for investing in this sector. The International Energy Agency forecasts that global oil demand will increase by 2.5% this year[6] and is projected to top 80 million barrels per day for the first time ever in 2004.[9]

Real Estate

We are still underweight REITS. Despite their outperformance in 2004, most REITS are not bargains at these prices, selling above their underlying values. Our research shows only 3 instances since the 70's when REIT prices were this stretched relative to their underlying trend. Each instance was followed by 3-5 years of below trend performance. However, there are REITS in the residential and office space sectors that are attractive and on a selective basis, we could add to these names.

Summary

The world economy is growing at a moderate pace. Inflation and interest rates remain low by historical standards. Stock and bond prices have been marking time this year as positive economic and financial conditions face off against "other" mounting concerns. While we are not expecting a robust advance, we expect portfolios to move higher in the second half of the year.

Dave Rahn **Bill Oberman** **Clara Basile**

Other than as footnoted below, the research underlying this article represents Avalon Capital Management's proprietary research activities.

Footnotes
1 WSJ.com
2 Federalreserve.gov
3 Reuters.com
4 Conference-board.org
5 Investors.com
6 Cass Research Associates
7 BCAresearch.com
8 Gs.com
9 International Energy Agency
10 Nytimes.com

AVALON
CAPITAL
MANAGEMENT

Investment management and counseling
for individuals and families

avaloncapital.com
(650) 306-1500