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Will $50 Oil, Election Uncertainty and Geopolitical Tensions Derail the Global Economy?

October 20, 2004

$50 Oil

The stock market has gone nowhere in 2004 despite good economic growth and strong profits. The electorate is polarized, terrorism concerns abound and Iraq remains a front-page story. The high price of oil, which recently surpassed $55 per barrel, is the latest in the growing list of investor concerns. With respect to the price of oil, Federal Reserve Chairman Alan Greenspan answers this way; "so far this year the rise in the value of imported oil has cost Gross Domestic Product (GDP) about 3/4 percent in growth". He stated that while oil prices have taken a "noticeable" toll on the U.S. economy they are not likely to inflict the same level of pain as in the 1970's. He also expects that over the long haul, technological advances and market forces would likely ensure the world had enough crude as it makes an eventual transition to other energy sources.[1] Adjusted for inflation, oil would have to reach $80 per barrel to match the price shocks of the 1970's. So today's oil prices won't do the damage done in the 1970's, but the rate of change in prices, up a whopping 71% in the last 12 months alone, is of considerable concern to investors.

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In our February "2004 Q&A" piece, which can be viewed at our web www.avaloncapital.com, one of our concerns was that oil could move well above $40 per barrel in 2004. Greenspan attributes the run-up in oil prices to a combination of factors: strong global demand, precautionary stock building amid supply worries and a revival in market speculation.[1] We look for a partial unwinding of these factors over the next six to twelve months allowing the price to retreat back below $40. A decline of this magnitude would be seen as a "tax cut" for the world and U.S. economies and should act as a catalyst for continued worldwide growth, thereby boosting investor confidence. A necessary condition for strong stocks that has been conspicuously absent in 2004, despite a healthy global economy and strong profits.

Current Economy

United States Economy

The GDP gain in the second quarter of 3.3% was better than the 2.8% rate originally estimated.[2] A recent survey of 38 forecasters in the National Association of Business Economists (NABE) expects GDP to grow at 4.3% in 2004 and 3.7% in 2005, despite $55 oil.[3] The U.S. economy is awash in liquidity for both consumers and corporations. The net worth of American households has doubled in the past decade. America's corporations have a surfeit of cash for capital investment, dividend expansion, and paying down debt. The latest Fed data shows that the "quick ratio", the ratio of liquid assets to short-term liabilities, is at a 40-year high of 38.6%, up 12 percentage points in the last four years. 374 industrial companies in the S&P 500 are holding $556 billion in cash, more than double their liquid assets at the end of 1999.[4] Scared by the last bear market, and worried about the future, companies are now exercising fiscal restraint.

World Economy

Globally we think that real GDP could grow at 4.7% this year and 4.8% in 2005. There are at least three factors pushing global growth. First, technological innovation in the areas of communication technology, biotechnology, and materials and machine miniaturization (nano-technology) is positively impacting both productivity and living standards. Second is the expansion of international liquidity and global financial innovation to fund and fuel this technological explosion. The final factor is the economic development and globalization of emerging high-population players, notably China and India.[4]

Investment Outlook – United States

We have become nervous bulls toward U.S. equities. We expect an above trend-line GDP growth rate of 3.7% in 2005 (trend line is 3.1%).[4] Nevertheless, the growth rate will be decelerating from 2004, so the market may start anticipating a deceleration in 2006 and the potential for a recession. We also expect inflation and interest rates to be higher in 2005, which should eventually put downward pressure on the equity markets.

In our October 2002 piece, "Why a Rally Now", which can be viewed at our web site www.avaloncapital.com, we made the case that the stock market has made a major bottom every fourth year since 1962. Using October 2002 as the last bottom, the next projected major bottom would be the Fall of 2006. Time is running out on this bull market in terms of average duration, so we are becoming more vigilant and on the lookout for any signs that the next bear market is taking hold.

On the other hand there are some powerful arguments for another market advance before the next bear begins. First, the stock market is entering its seasonal sweet spot: the fourth quarter of the year. Stocks have historically performed better in the fourth quarter than in any other period of the year. Since 1896, the Dow has risen an average of 2.5% in the fourth quarter, significantly better than any other quarter.[5] Of course, past performance is no guarantee of future results.

Second, there is an analog to today's market in the early 1970's that may hold some clues to what could follow in the coming months. Veteran market analyst John Mendelson of Schwab Soundview Capital notes that the trading pattern since March 2003 replicates the market movements of 1970-73 when the S&P 500 Index bottomed in May 1970 and rallied 52% until the end of April 1971 – an eleven-month advance. That rally was followed by a seven-month consolidation. In the current market, the S&P 500 bottomed on March 14, 2003 and rallied 47% to a high in late January 2004 – a ten-month move. Since January, the S&P500 has been consolidating for nine months. The point of the comparison is that the consolidation of 1971 was followed by an almost vertical rally of five months and a further upward move of nine months, the whole advance taking the market up 33%.[6] Although there is no guarantee, there is a historical precedent in which, like today, the "other" factors limiting the market's advance like war, high oil prices and a post-boom environment, eventually resulted in a surge upward after a year-long consolidation.

Finally there is plenty of liquidity to fuel an advance. Cash has been piling up on the sidelines over the last nine months as investors sit on the fence, watching and waiting. Cash stands at an all time high of about $5 trillion. The broadest measure of U.S. stocks, the Wilshire 5000, is currently valued at just under $13 trillion. Thus cash represents 40% of the value of common stocks.[7]

We believe the market will rally into the first quarter, however given the maturity of the cyclical advance that began in 2002, we will carefully monitor events and raise cash if we think it is prudent.

Asset Allocation

U.S. Stock and Bonds

Our asset allocation continues to favor equities over bonds. We did take some profits in our bond portfolios from purchases we made during the second quarter. We expect interest rates to be higher as investor concerns abate and stocks rally. For fixed-income focused portfolios, we are sticking to corporate bonds or bond funds with maturities less than ten years.

Since we are "nervous" bulls we are holding cash for additional equity purchases. Even though tech stocks have been one of the worst performers in 2004, we think that they may be one of the leaders in the next advance as the cycle crests.

International

We continue to overweight the international area favoring Japan, the Far East and Emerging markets. Emerging market equities are attractively valued compared to most developed markets. Interest rates have come down sharply but there has been no corresponding multiple expansion in emerging market stocks. The present forward P/E for emerging markets is 40% lower than the S&P500 and earnings are growing faster than in the U.S.[8] A bull market in emerging market equities may well turn out to be a secular story that could last for years to come.

Natural Resources and Energy

It is time to do some profit taking in this area due to the significant price rise and our expectation that oil could retreat over the next few months. Still, we want to remain in an overweight position. There is a secular story here that suggests that Energy (and other natural resources) is the leadership for the next several years, even if the next several months produce a consolidation in prices.

Real Estate

REITS have been stellar performers again in 2004. Their double-digit gains have made them the second best performing asset class after resource stocks. We still advocate an underweight position. Most REITS are not bargains at current prices, selling above their underlying values. Interest rates are likely to rise over the next year dampening investor enthusiasm for real estate and putting pressure on REIT prices.

Summary

The world economy continues to grow despite $55 oil. If the oil price stabilizes or retreats, the environment for economic growth should look even better. Inflation and interest rates remain low by historical standards. While we are expecting equity markets to advance through the first quarter, the cyclical rally has reached a late stage and will warrant some major portfolio shifts over the next 6-9 months.

Dave Bill Clara

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

Other than the footnotes below, the research underlying this piece represents Avalon Capital Management's proprietary research activities.

Footnotes

1 Reuters.com
2 AP.org
3 NABE.com
4 Cass Research Associates, Inc.
5 WSJ.com
6 Schwab.com
7 Davis Skaggs Market Review Sept/Oct 2004
8 BCAresearch.com

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avaloncapital.com
(650) 306-1500