NOW'S A GOOD TIME TO GET SOME GOOD ADVICE

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Tough Environment

In our April "Mid-Cycle Blues" piece, which can be viewed on our web site www.avaloncapital.com, we maintained that investors may be caught in a mid-cycle transition where everyone feels that economic and earnings growth will probably slow down but are hopeful for a "soft" landing (no recession) instead of a "hard" landing (a severe recession). The resultant tug of war between the two perceptions creates very volatile markets and markets which can reverse direction quickly. And so it was in May! Toward the end of April, U.S. equities were down 6% to 14% for the year, depending on the index cited.[1] Yesterday the S&P 500 Index hit a new four year high! What happened? In April, investors were focused on a slowing economy, Fed tightening and a rapidly increasing inflation rate: expecting the "hard landing" scenario not the "soft landing" scenario. As June closed out it appeared that the economy was doing fine, inflation was heading down and that the Fed could be close to ending its rate increases, pointing to a "soft" landing. The message for investors: markets could continue to be very volatile and investors should be very nimble in this tricky environment. In a relatively low investment return world, tactical asset allocation changes may be one of the prudent strategies an investor can employ to manage volatility and achieve investment returns above the "averages".

AVALON CAPITAL MANAGEMENT

Current Economy

United States Economy

The U.S. economy is proving very resilient. In April we thought the economy was slowing while the inflation rate was increasing. We expected growth to slow to between 3.0% and 3.5% in 2005. Recent data, however, indicates that growth may be closer to 3.5%. Job growth picked up in June, when the U.S. unemployment rate fell to its lowest level since September 2001.[2] This is more evidence that the economy and labor markets have settled into a fairly steady expansion phase. The 56 economists who participate in the Wall Street Journal's economic survey forecast GDP (Gross Domestic Product) to expand at a rate just shy of 3.5% for the remainder of the year.[3] Also, inflation seems less threatening. Inflation rose rapidly from February through April (hitting an annualized rate of 7.2% in March) as energy prices soared. But in May the CPI (Consumer Price Index) made a sharp reversal and edged down by 0.1 percent, and rose only 0.1% in June.[4] Economists also believe that the recent jump in oil to $60 per barrel will not be enough to change the overall benign inflation picture.[5] Jobs growth and inflation numbers support the view that the Federal Reserve could soon change position and stop increasing interest rates.

World Economy

Global GDP is slowing to around a 3% growth rate in 2005 down from 3.8% in 2004. Asian vigor is being offset by European malaise. China's economy is barreling ahead, based on strong gains in consumer spending, housing, investment and exports. Employment and personal income are growing in Japan for the first time in years. On the other hand, Europe has replaced Japan as the world's sick economic area. Economic growth in much of continental Europe, particularly Euro economies, remains sub par around 1.4% in 2005.[6] This slower growth outlook has central bankers reassessing their inflation risks. The Swedish central bank recently cut rates and the Bank of England may be the next in line. Even the European Central Bank has begun to soften its rhetoric. The dollar should continue to strengthen against the Euro to around $1.15 (from the current level of $1.21) given potentially lower interest rates in Europe versus higher rates in the U.S. The Euro is also wounded by the recent French and Dutch rejection of the European Union constitution.

Investment Outlook - United States Equities

In April we were cautious about the outlook for U.S. equities but expected that an intermediate rally lasting several months could happen at any time. With better economic news, particularly on the inflation front, investor confidence began strengthening and investors began buying anticipating that the Fed could stop raising rates, by the end of the year, if not sooner. The recent tragic London terror attacks suggest improving investor confidence. Barron's argues that markets are bouncing back more quickly after these events. After 9/11, the S&P 500 fell 12%, recovering two months later. In 2004, after Madrid, the S&P 500 fell 7% and recovered a month later. The London bombings saw a 4% drop; one day later the losses had been covered.[7] This may suggest that the global economy is in reasonably good shape and that confidence is high that monetary and other authorities probably would move to promote growth if economies deteriorate. We are once again cautious bulls and began overweighting equities in May and June.

Asset Allocation

U.S. Stock and Bonds

Our overall asset allocation currently favors equities over cash and bonds. Profits could come in stronger than the reduced expectations from earlier in the year and relative valuation favors stocks over bonds. The earnings yield for stocks (the reciprocal of the P/E ratio) relative to the 10-year treasury yield has reached its most attractive level since the end of the 1974 recession.[8] We are overweighting biotech and high technology, particularly semiconductors. According to Ned Davis Research these sectors have done relatively well after the end of the Fed tightening cycle (defined as the final rate hike after a series of hikes).[9] We are emphasizing treasuries, corporates or bond funds with maturities less than five years for fixed income holdings. We do not want to take the risk of longer maturities because if the economy remains resilient or improves then long rates may rise from current levels.

International

We are overweighting the international markets favoring the Far East and Emerging Markets. Equities in these markets are available at lower P/E's than U.S. stocks while their earnings are growing faster. For example, in the Matthews Pacific Tiger fund, estimated EPS growth for Fiscal Year 2006 is 14%, the estimated P/E is 11.3X.[10]

Natural Resources and Energy

Even though we think that the price of oil could drop below $50 over the next six months, given our bullish secular outlook for oil and other commodities, we will stay at benchmark or benchmark plus weightings.

Real Estate

We increased our real estate holdings in the 2nd quarter, favoring apartment REITS. Real estate continues to prosper in the current low interest rate environment. Historical experience suggests that REIT prices will hold firm as long as interest rates stay low. However, since REIT returns have been so good for the last five years we are nervous bulls, ready to cash out.

Summary

Investors have been heartened by recent economic data, particularly the waning of inflation. This environment could prove profitable to holders of equities. On the other hand, huge fiscal and trade deficits as well as potential political tensions between the U.S. and China, make us nervous bulls. A change in strategy could come at any time.

Dave

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The opinions expressed are those of Avalon Capital Management as of July 15, 2005, and are subject to change. There is no guarantee that the forecasts made will come to pass. This material does not constitute investment advice and is not intended as an endorsement of any specific investment. Investment involves risk. Past performance is no guarantee of future results. Investing in foreign markets involves currency and political risks. Other than the footnotes below, the research underlying this piece represents Avalon Capital Management's proprietary research activities.

Footnotes
1. Barrons.com
2. Dol.gov
3. WSJ.com
4. Dol.gov
5. AP.org
6. Jpmorganmarket.com
7. Barrons.com
8. BCAresearch.com
9. Schwab.com
10. Matthewsfunds.com

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