NOW'S A
GOOD TIME
TO GET SOME
GOOD ADVICE

Patience and Uncertainty

The second quarter of 2006 has been the toughest market since the beginning of the bull market in 2002. Most of the volatility was due to concerns about oil, inflation and interest rates, as we discussed in our May letter. Now, we need to address the fighting between Israel and Hezbollah as an additional concern.

Middle East Historical Perspective

We begin by looking at the current conflict in comparison with other regional confrontations in the last 40 years.

		Performance DJIA	
		After	
Event	Date	One Week	One Year
Six Day War	06.15.67	1.34	5.11
October War	10.06.73	0.76	- 39.81
Iran-Iraq War	09.17.80	1.71	- 9.97
Iraq invades Kuwait	08.02.90	-5.67	4.33
U.S. attacks Iraq	03.20.03	-0.43	24.56
Hezbollah attacks Israel	07.12.06	.10	n.a. [1]

One year after the event, the U.S. market behaved poorly in 1973 and 1980. Was the poor performance due to the outbreaks? While the conflicts did add to market volatility, the fact that the U.S. was already in a recession in both cases, was the greater reason for the negative performance. The market was up

AVALON
CAPITAL
MANAGEMENT

in the other three instances: 1967, 1990 and 2003, because U.S. economic fundamentals were strong. We are anticipating an economic slowdown over the next several quarters, but we are not projecting weak economic fundamentals or a recession. So one year from today we expect the market to be higher. There is no question that over short periods "war" news does cause increased uncertainty and greater market volatility. Right now, as portfolios are already defensively positioned, we don't believe it is necessary to take additional precautions. We are certainly monitoring all of these events, particularly oil supplies and the economy. We will take additional defensive action to cushion portfolios if necessary.

Israel - Hezbollah Fighting

While our analysis shows that past events in the Middle East have not had a lasting negative effect on investment returns, we don't believe these events can be ignored as background for investment decisions. This armed conflict may be the beginning of a confrontation that is a step-up from the global terrorism of the past few years and could extend beyond the borders of Lebanon. Even as Israel and Hezbollah attempt to settle scores, tension continues to build between the U.S. and Iran, and between the larger region's Shiites and Sunnis. Jordan's King Abdullah predicted the emergence of a "Shiite Crescent" stretching from Iran to Lebanon. Hezbollah's provocation needs to be seen in that light, as the "Party of God" (Hezbollah) is very much a party of Tehran. Since the early 1980's, Iran has armed and funded Hezbollah to the tune of some $100 million dollars a year.[2] Disarming Hezbollah will be no quick task for the Israelis and this "uncertainty" may be with us for some time to come.

Current Economy

United States Economy

In recent testimony before the U.S. Senate, Ben Bernanke, Chairman of the Federal Reserve, allowed that "economic growth has recently moderated from the 5.6% GDP (Gross Domestic Product) growth rate of the first quarter of 2006. This reflects the cooling of the housing market, the reduction of the slack in resource utilization, the rise in energy prices and the effects of increased interest rates."[3] Most forecasters expect a mid-cycle economic slowdown, with at least two or three quarters of growth nearer to 2% than 3%, beginning with the current quarter.[4] Bernanke also said that "the Federal Reserve projects the core CPI to be 2-1/4 percent to 2-1/2 percent this year and edge lower, to 2 percent to 2-1/4 percent next year".[5] Given his testimony and our outlook, we think the Fed may raise rates for the last time at their August meeting.

World Economy

Globally, output is quite strong but should gradually slow for the rest of the year as central bankers around the world increase short-term interest rates. For 2006, Gross World Product (GWP) should finish at a 5.0% growth rate versus 4.5% in 2005. It is significant that this economic expansion is the most broad-based in history, with virtually every region (save the Euro-Zone) forecast to grow over 3%.[6]

Investment Outlook - United States Equities

Investors turned away from risky (more volatile) assets in the second quarter as the S&P500 Index slid 1.5% while the NASDAQ gave up a whopping 7.2%. Generally, investments that did well in the first quarter gave up returns in the second quarter. Science and technology funds plunged 9.6%, health/

biotechnology funds fell 6.8% and telecommunication funds sank 5.7%. Large-cap growth funds dropped 5.0% versus small-cap growth's decline of 7.3%.[7] What we saw toward the end of the quarter was a flight to less volatile assets: cash, bonds and big cap stocks.

The weakness of small-cap stocks was a significant long-term trend change in the second quarter. Small-cap stocks outperformed large-cap stocks from 1999 through 2005. This is the longest run of out performance since the creation of the Russell indices in 1978. We think it is time for the big-caps to reassert themselves. As current valuations and earnings are less supportive for the small-cap sector, large caps could reign supreme for several years to come. The small-cap P/E (using the last 12 months from June 2006) is now double the large-cap P/E at 34X versus 17X. Small-cap earnings growth (last 12 months from June 2006) is inferior at 20% versus 38% for large caps. Last year the average small-cap stock had only an 8.3% return on equity versus 11.3% for the typical S&P 100 issue.[8] Buying big cap stocks brings twice the earnings growth at one-half the valuation of small cap issues. Big cap issues are attractive on their own; the S&P500's multiple is now where it stood four years ago, which turned out to be a great buying opportunity. The last time the P/E was any lower was in 1994, another very propitious time to buy big-cap stocks.[9]

4 Year Cycle Revisited

The bull market that began in October 2002 yielded, on average, double-digit returns over the next 3-1/2 years. Currently, as the market heads into another 4-year cycle low (this pattern is well-documented in our October 2002 piece, "Why a Rally Now" at www.avaloncapital.com), it's tempting to worry that it's 2000 all over again, just ahead of another grueling 2-year decline. This is not what we expect. In 2000 stocks were grossly overvalued (remember "irrational exuberance?"), the Fed was just beginning to raise rates and corporate balance sheets were weak. Today, stocks are fairly valued, or as with large caps, undervalued. The Fed is almost finished raising rates and corporate balance sheets are healthy. Technically, a better analog to the current market is July 2002-October 2002; stocks lost some ground, but mostly went up and down in very large swings and scared investors out of the market. During that period, values became compelling and ultimately produced strong returns for the subsequent 3-1/2 years. It's never a one-way street and our job is to use the current or future weakness so we can capitalize on the next up move by buying at attractive values. Investors must be patient through the near-term uncertainty in order to participate fully in the next bull market.

Asset Allocation

U.S. Stock and Bonds

Our near-term asset allocation favors cash, short-term bonds and specific equity themes. We recommend treasuries, corporate bonds or bond funds with maturities less than five years for fixed income portfolios. We are under weighting U.S. equities and favor big cap issues. We like health care, telecommunications, utilities and bank stocks.

International

Although we have rolled back from a heavy over weighting in international equities, we still recommend the area. We trimmed positions in emerging markets and await a better entry point to re-establish positions. We are maintaining our exposure to international bond mutual funds.

Natural Resources and Energy

We continue to over weight this area based on our positive secular outlook for energy and other commodities. Natural gas stocks look particularly attractive at this time.

Real Estate

REIT's continue to perform relatively better because of their defensive characteristics. Nevertheless, because of high valuations, we recommend under weighting this asset class.

Summary

The U.S. stock market should be setting up for an intermediate rally beginning in August. The rally could be muted by Middle East turmoil as well as a slowdown in the economy and lower earnings in the second half of 2006. We think that a better buying opportunity will occur in the fall or early 2007. We are emphasizing big cap stocks over small cap issues. We are under weighting REIT's and over weighting cash, bonds, natural resources and the international area.

Dave

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

The opinions expressed are those of Avalon Capital Management as of July 25, 2006 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. Data contained here is obtained from what are considered reliable resources; however, its accuracy, completeness or reliability cannot be guaranteed. Indexes are unmanaged, do not incur fees or expenses, and cannot be invested in directly. Investment strategies such as diversification do not assure a profit and do not protect against losses in a declining market. Other than the research noted by footnotes, the research underlying this piece represents Avalon Capital Management's proprietary research activities

1 WSJ.com
2 Mercurynews.com
3 Federalreserve.gov
4 BCAresearch.com
5 Federalreserve.com
6 Cass Research Associates
7 USAToday.com
8 Schwabinstitutional.com
9 Barrons.com

AVALON
CAPITAL
MANAGEMENT

Investment management and counseling
for individuals and families

avaloncapital.com
(650) 306-1500