NOW'S A GOOD TIME TO GET SOME GOOD ADVICE

Higher Oil Prices

Volatile First Quarter

The Dow Jones Industrial Average was up 1.3% when Shanghai collapsed on February 27, 2007. As the Chinese government attempted to temper its ballooning economy by raising interest rates and shrinking the available lending capital, the Shanghai Composite Index responded by plummeting 9%. The Dow reacted by falling 546.02 points, off 4.3%, before recovering to close with a 3.3% loss on the day. (The Dow's decline was the worst since September 17, 2001, the first trading day after 9/11, when the blue chips closed down 7.1 %.) The Dow eventually bottomed on March 14th at 11,927, down 4.3% for the year, before recovering to close the quarter off .8%.[1]

In our February letter "Rare Air - Five Positive Years?" we forecast domestic stock market weakness into May. After the Shanghai sell off in early March, the Dow made a quick u-turn and started logging new highs thru late April. The rally was fueled with hopes for a Fed rate cut, stronger-than-expected corporate earnings reports, continued merger-and-acquisition activity and stable inflation data. The Dow Jones Industrial Average closed up 19 out of 21 days thru April 27th, for the second time in history (Charles Dow first published the DJIA in 1896).[2] This impressive string of positive trading results suggests a bullish stock market over the next several months. So far, energy stocks are the

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strongest performers in this recent rally. In "Rare Air" we encouraged investors to move to their maximum exposure in natural resources and energy stocks. Oil prices are headed higher over the next year. We also recommended large cap health care, biotechnology, high technology and consumer stocks, in addition to international investments. While a short 3% to 5% retrenchment could occur at anytime, investors should use any sharp weakness as an opportunity to get fully invested in areas displaying leadership. Given the breadth of stocks and sectors with considerable upside, overall "market" risk is minimized.

Current Economy

United States Economy

The U.S. economy has slowed over the last year. After a strong first quarter in 2006, real Gross Domestic Product (GDP) slowed to 2.2-2.5 % for the subsequent three quarters and 1.3% for the first quarter of 2007.[3] Is this a "midcycle pause" as occurred in 1986 and 1995? - or the early stages leading to a recession? We see more evidence of a pause than a recession. Consistent with past "midcycle pauses," the labor market remains robust, corporate profitability and equity prices are at high levels, and real interest rates are low by historical standards. While delinquency rates on subprime mortgages have increased sharply, those on prime mortgages and other forms of consumer credit and corporate debt, remain low. In April, the International Monetary Fund (IMF) forecast 2.2% growth in 2007, with domestic economic expansion gradually regaining momentum, to a 3% growth rate by mid-2008.[4]

World Economy

The IMF sees the world economy expanding at a 4.9% rate in the next two years. Experiencing the "strongest four-year period of global expansion since the early 1970's", Gross World Product (GWP) has increased at a 5% annual rate over the last four years.[5] The U.S. contributes 13% of this growth versus Asia's 55%. The once lagging Euro-zone saw accelerated growth of 3.6% in the fourth quarter of 2006 and is joining the party.[6] As always, a number of potentially negative factors could materially change this positive outlook: high energy prices, a record U.S. external deficit coupled with a weakening dollar, weakness in the housing sector, tax increases, trade protectionist measures and the ever present geopolitical uncertainties related to international terrorism. However, in the absence of an actual disruption in the supply of oil or an intensification of the deteriorating geopolitical situation, there is little economic evidence that would support a global slowdown in the next couple of years.

Investment Outlook - United States Equities

We believe it is time to "load the boat" in the Natural Resource and Energy Sector: here in the U.S. and overseas. Oil prices bottomed in late January and oil stocks bottomed in early March. In the current rally, energy stocks are the market leader and we expect them to continue to lead for the next twelve to eighteen months. Investors should maximize their exposure to this area. Information technology also is attractive with expected earnings growth of 14% in 2007.[7] We also recommend biotechnology, health care, telecommunications and selective consumer stocks. At current levels the S&P 500 Index is valued at 15X potential 2007 earnings,[8] a remarkably low multiple for the world's largest and most technologically advanced economy. Over the near-term, we could see a 3%-5% correction and investors should use this decline as an opportunity to get fully invested.

Asset Allocation

U.S. Stock and Bonds

We expect the Fed to do nothing in 2007. The economy should chug away at a moderate pace, with interest rates that remain flat or rise slightly over the next four to six months. We like cash and short-term bonds in the fixed income portfolio. We favor big-cap issues over small and mid-cap stocks and growth stocks over value stocks. Big cap stocks are the most effective participators in a booming global economy; 48% of S&P 500 revenue is derived from international buyers! Big multinational corporations also benefit from strong emerging-market economies and a weak dollar. Small cap stocks peaked relative to large caps a year ago, and appear to be losing their market leader status. Small caps face eroding profit margins since they are tied to slowing domestic growth. We recommend offsetting some of your long large cap positions using small cap inverse mutual funds or ETFs as protection against a near-term correction, or broader market risks.

International

International is where the growth action is; we continue to over weight this area. We have long favored the Far East, China and Japan, and now we are adding Europe into the mix. In 2006, the Euro economy regained momentum, led by exports and business investment. Real GDP grew 2.6%, the fastest rate in six years.[9] Europe's labor markets are finally benefiting from European Union (EU) reforms, including greater flexibility in hiring practices, reductions in pension and vacation costs, and the gradual removal of restrictions on labor migration within the EU.

Natural Resources and Energy

It is possible oil will hit $100 per barrel sometime in the next eighteen months. Charlie Maxwell, a well respected oil analyst, was interviewed last fall in Barron's. He delineated his case for higher oil prices over the next decade. We summarized his points from this article in our October piece "Follow The Leader?" which is available on our website at www.avaloncapital.com. We continue to expect this area to outperform.

Real Estate

Investors should be at their lowest weighting in real estate. We expect real estate to underperform other asset classes, including cash. Since this latest rally began, it has been one of the worst performers; as the Dow hits new highs, the Dow Jones Real Estate Index is 7.8% below its February highs.[10]

Summary

The U.S. stock market surprised us with its unexpected strength in April. It is time again to be fully invested in the Natural Gas and Energy area, both domestically and internationally, and to add to biotechnology, health care, high technology, telecommunications and consumer stocks. We continue to over weight international equities and under weight REITS. Overall market risks are minimal and the Dow and S&P 500 should not breach their lows of early March. Any market weakness is now a selective buying opportunity.

Dave

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2 Elliottwave.com
3 Commerce.gov
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6 Cass Research Associates
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