

NOW'S A
GOOD TIME
TO GET SOME
GOOD ADVICE

Panic Attack

Good Second Quarter

Overall, the second quarter provided strong returns for most investors. Domestically, our recommendation to emphasize big cap issues in natural resource, high technology and telecommunication stocks proved rewarding. Natural Resource stocks were up 14.7%, while Telecommunication stocks returned 11.1% and Science and Technology stocks returned 9.0%. We also said to significantly underweight Financials, which were up only 1.9%. Our call to avoid real estate was spot-on as the NAREIT index was **down a whopping 9.1%**. The average U.S. Diversified Equity Fund was up 6.2% for the same period. We said to overweight the international area which beat U.S. indices, particularly the Far East, where the Pacific Ex-Japan Index advanced 16.1%.¹

1987 Experience Versus Today

Twenty years ago on October 19, 1987, the largest one day stock market crash in history took place. The Dow Jones Industrial Average lost 22.6% of its value, about **\$500 billion dollars!** Markets in every country around the world collapsed in tandem. 1987, into October, was the extension of an extremely powerful bull market that started in the summer of 1982 (similar to today's bull which started in '02). The 1987 bull market was fueled by a strong world economy, hostile takeovers, leveraged buyouts and a falling dollar. The world economy was robust; Japan was the engine. (Now China and the Far East are

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the engines of growth.) In leveraged buyouts, a company raises massive amounts of capital by selling junk bonds (high yield bonds) to the public. Twenty years later we have private equity funds doing exactly the same thing. Currently the U.S. credit market is expecting \$100 billion in new high yield debt and \$200 billion of leveraged loans during the rest of this year.² Prior to the 1987 crash, the U.S. dollar was declining. In an attempt to support the dollar, the Fed was ratcheting up interest rates. Currently the dollar has been declining since the summer of 2001, though no one seems concerned - official policy seems to be benign neglect and this worries us. It is also beginning to worry central banks, for example, China, which is beginning to allocate some of its reserves outside U.S. Treasuries. The U.S. Dollar Index, at 80.01, is not far from the low it set in 1992 at 78.19.³ This is the fifth time since 1990 that the dollar has approached this level. A breach of this level could force the Fed to raise rates in order to protect the dollar. Also, prior to the crash, the bond market suffered one of its worst declines in history. Today, responding to the subprime debacle, the high yield bond market's current yield has risen 1.7% in less than a month and bears watching. On the other hand, there are two important differences from 1987: a global growth rate much higher than 1987's and the institution of market circuit breakers. The employment of portfolio insurance and massive use of futures was a major reason for the one day meltdown in 1987. This has been mitigated by the institution of the circuit breakers.

Despite the recent panic attack on wall street, we want to emphasize that we do not see the beginning of a bear market similar to the early 2000's. We see a correction that may last until the fourth quarter, when the current bull market will resume. We have taken defensive actions in portfolios commensurate with our outlook and are primarily invested in those domestic areas we like, as well as energy and international stocks. We see China and the Far East as being in the same position as Japan in 1987. In 1987, Japan barely hiccupped and went on to new highs in 1988 and 1989.

Current Economy

United States Economy

In his semiannual report to Congress, Fed chairman Bernanke maintained the Fed's stance on monetary policy: no change in interest rates. He noted that the ongoing correction in housing prices as well as subprime lending concerns might prove "longer than anticipated, with possible spillovers onto consumer spending." Further he remains worried that high energy and other commodity prices might leak into increased inflation expectations and/or actual inflation. Citing a stronger-than-expected downturn in housing construction, Bernanke said the Fed forecasts U.S. economic growth to expand between 2.25 percent and 2.5 percent this year and 2.75 percent in 2008.⁴

World Economy

China's annual economic growth spurred to 11.9% in the second quarter, surpassing the 11.1% in the first quarter. This is an 11-year high and puts China in a position to overtake Germany as the world's third-biggest economy this year. China also announced that its foreign-exchange reserves rose to \$1.33 trillion at the end of June, up \$40 billion from the end of May.⁵ China recently formed a new State Investment Company, whose mandate is to diversify the country's holdings of foreign currency instruments, gradually shifting away from traditional low-risk U.S. government bonds into more aggressive investments. A country the size of China owning outright equity assets in other countries could become a concern for geopolitical, currency and financial reasons and is something new to be watching carefully. The IMF continues to see the world economy expanding at a 4.9% rate in the next two years.⁶ In the absence of an actual disruption in the supply of oil and/or an intensification of the deteriorating geopolitical situation, there is little evidence that would support a global economic slowdown in the next couple of years.

Investment Outlook - United States Equities

Domestic equity strength continued into July with the Dow Jones Industrial Average hitting a new intraday high of 14,121.04 on July 19, 2007. Technology stocks are enjoying one of their best years since they topped out in the spring of 2000. As of July 15, 2007, mutual funds that invest in tech stocks were up 15.7% for the year and in the last month were up 7.7%, beating every other category of domestic stock funds tracked by Morningstar. Real estate funds have been the investment sector to beat since the spring of 2000. Now they are trailing every other stock-fund sector for the past month, quarter and year to date. We think investors are making a seven year switch from real estate funds to technology funds and that the technology sector is back for real. However, the markets have made good returns through early July and now we think it is time to get underweight and defensive, either by raising cash or employing hedging strategies: inverse (move opposite the market) mutual funds, ETFs, or puts on the S&P 500 Index. We expect the market to be plagued through the fall with a triple whammy of high oil prices, housing and credit market woes and a mixed bag of earnings reports. We think the correction may be over by the end of this year.

Asset Allocation

U.S. Stock and Bonds

We think that the yields on high yield bonds are just beginning to go up relative to treasury yields and should be avoided except for very short-term maturities (less than 3 years). We recommend cash and short-term bonds in fixed income portfolios. We expect the Fed to do nothing in 2007 with regard to interest rate changes. U.S. stocks will have a tough time until possibly late fall as the market adjusts to the current housing and credit woes. Protect portfolios by sticking to big cap stocks in our favored areas of high technology, consumer, health care and telecommunications; or by using inverse mutual funds, ETFs or S&P 500 put options.

International

We like the International area. So far, most economic concerns are about the U.S. economy, not the rest of the world. Nevertheless, it is prudent to reduce exposure to foreign issues to slightly overweight because of U.S. market turmoil. We still favor the Far East, China and Japan.

Natural Resources and Energy

The International Energy Agency (IEA) recently warned that the world is facing an oil supply "crunch" within five years that will force up prices to record levels and increase the west's dependence on OPEC. In its starkest warning yet, on the world's fuel outlook, the IEA said "oil looks extremely tight in five year's time" and there are "prospects of even tighter natural gas markets at the turn of the decade." In addition to traditional energy stocks, we also recommend alternative energy stocks like solar. Despite our overall short-term, weak stock market outlook, we think investors should continue to overweight this area.

Real Estate

The Dow Jones Real Estate Index is currently some 25% below its February highs. It is too early to return to a neutral weighting in this area, let alone an overweight position. Avoid real estate altogether or significantly underweight it.

Summary

Equity markets worldwide did quite well in the second quarter and continued their advance into early July. We recommend that investors position their portfolios in a defensive manner by raising cash or using hedging techniques. The U.S. equity invested portion of the portfolio should be confined to big cap issues in high technology, consumer, health care and telecommunications. We recommend overweighting the energy and international asset classes.



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- 1 Lipper.com
- 2 Financialtimes.com
- 3 Yahoo.com
- 4 Federalreserve.gov
- 5 Matthewsunds.com
- 6 Imf.com
- 7 Iea.org

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