NOW'S A GOOD TIME TO GET SOME GOOD ADVICE

ROLLER COASTER RIDE

March to June was a brutal quarter. The DJIA closed down 6.4%, including a June decline that was the worst since the Great Depression. We delivered excellent results by emphasizing cash, employing hedging techniques, holding winners and avoiding big losers. The roller coaster ride that began last summer continues: from mid-March until mid-May, the DJIA surged 11.7%, only to turn right around and plunge **17.5%** by mid-July! Our allocations to cash, inverse mutual funds and/or exchange traded funds offered effective protection on the downside. We added value on the upside by avoiding losers like financial services (-15.6% for the quarter) and emphasizing winners like natural resources (+24.5% for the quarter).[1]

In mid-July, the US Treasury and Federal Reserve's proposed rescue of Fannie Mae and Freddie Mac generally calmed markets. Prices once again advanced, only to come under renewed pressure in August, as Fannie and Freddie went back on deathwatch. The market is betting that Fannie and Freddie shareholders will be thrown to the wolves, while the agencies' creditors will be bailed out by the government. If it isn't Fannie or Freddie or the price of a barrel of oil, it will be something else in this highly reactive environment. We expect tradable rallies in the coming months but this is still a bear market. We do look forward to the end of this current bear, but until then, we remain cautious. We expect the July lows to be tested in the fall of 2008. This bottom has the potential for setting up a new bull market and ending the current roller coaster ride. When the market begins a

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sustained advance, Avalon portfolios should be in an excellent position to benefit from this patient and vigilant strategy. Until then, we continue to follow the strategic and tactical guidelines outlined in our February piece **Changing Shades of Gray**, which is available on our website at www.avaloncapital.com.

Commodity Prices Retreat

In July, we took profits in natural resources; accounts are currently positioned neutral to slightly overweight. So…Oil is down; natural gas is down. Platinum, gold, corn, wheat - all down. What happened to the age of scarcity argument? After all, global demand for fuel, metals and foodstuffs are still rising, as China and the developing countries boost consumption. But speculative investors pushed commodities up, over the short term, far more than justified by long-term consumption trends. In recent weeks, signs of falling consumption in the United States and slowing global economies prompted speculators to bail. The markets got ahead of themselves and have simply corrected the excess above trend line. The secular argument for the Age of Scarcity, as outlined in our May piece Eye of the Storm, still holds. Oil and other commodities will probably trade in a broad range for the next twelve to eighteen months before beginning an assault on their recent July highs.

Current Economy

United States Economy

If, as California goes, so goes the nation, then the nation is not doing well. A recent Field Poll finds that 63% of Californians say they are worse off financially than they were a year ago. This is the highest percentage of unhappy Californians since the poll started in 1961. Even during the financial turmoil of the 70's, only 43% of Californians reported themselves worse off. It is not hard to see why 86% of Californians feel the state is in "bad" economic times.[2] The median price of existing single-family houses in California collapsed 40.3% from a year ago, the biggest decline since the Realtors began tracking home prices.[3] The state unemployment rate hit 7.3% in July; the highest rate since July 1996. Unemployment combined with the rate of inflation is economist Stephen Levy's Misery Index. The Index topped 12% in July, the highest level in 15 years.[4] So far, other than easing commodity prices, that may reduce inflationary pressures, there is no significant recovery in sight. Like California, the U.S. economy may experience very slow growth for some time; expect 1.4% GDP growth in 2008 and -0.2% in 2009.[5] Given this slow growth outlook and recent Fed comments that they expect "further deteriorating financial conditions," we do not expect the Fed to raise rates for a very long time.

World Economy

A *bit of good news!* In the last month, the dollar has gained over 7%. The bad news -- it has appreciated because the rest of the world's economies are starting to slow faster than the U.S. economy. This may not bode well for international equity investors. The United Kingdom, Germany, France and the broader euro zone, joined Japan to move half way into a recession - technically defined as two successive quarters of growth contraction - after their GDP's fell in the second quarter. In emerging markets, inflation is increasingly a problem. While most of these economies are still growing, a rapid rise in commodity prices has quickly fostered wage-push inflation. The requisite fiscal and monetary tightening necessary to bring inflation under control will likely stymie economic growth - particularly in Asia (including China), where slowing export growth is already an economic drag. Vietnam is a current example; inflation rose to **27 percent** last month. Food prices were **74%** above those a year ago. Vietnam is suffering its *first serious downturn* since it moved from a command economy to an open market economy nearly **twenty** years ago.[6]

Asset Allocation

U.S. Stocks and Bonds

The U.S. Stock Market is still a bear market. The current rally is a bear market rally, not the start of a new bull market. Our overall strategy remains defensive, with long positions in a few carefully chosen sectors where we think the trends remain positive: biotech, healthcare, consumer staples and some technology. Financials and consumer discretionary stocks are still minimally represented in the portfolio. There have been attempts at stabilizing the severe downtrends in these two lagging sectors. Despite increasingly decent valuations, it is too early to overweight them in portfolios.

We continue to buy high quality cash instruments, short-term bonds and short-term bond funds for fixed income participation. Treasuries remain overpriced. While a worst-case economic scenario could push short-term treasury yields to lower levels, much of this appears to be fully discounted. We expect the Fed to leave short rates alone until next year.

International

We have consistently advised overweighting the international area since we turned bullish in the fall of 2002. Our main argument was that over the coming bull cycle, international equities offered opportunities in faster growing economies and that dollar weakness, over time, would be beneficial to U.S. based investors. Now we see mounting signs of slowing around the world which could lead to a stronger dollar. A weak global economic outlook, combined with a strong dollar, has caused international equities to underperform U.S. equities for the first time in six years. Since the middle of April, U.S. stocks have outperformed Europe by 12% and have outperformed emerging markets by 10%.[7] While we think the secular outlook for international investing remains attractive, these markets (in U.S. dollar terms) could continue to lag the U.S. market for some time. We recommend a slightly underweight to neutral holding in this area, emphasizing the Far East and emerging markets. We will employ the same strategy as in the U.S. market: buying the intermediate bottoms, and selling the intermediate tops, until our indicators tell us we have begun a new international bull market.

Natural Resources and Energy

In July, we reduced our exposure to natural resources and energy to a neutral or slightly overweight position. *Bubble, Bubble - Oil in trouble.* What a difference four weeks can make! Oil crashed from $147 per barrel to $111, down 24%, while natural gas plummeted from $13.70 per MCF to $7.70, a 43% decline. Similar declines were seen in other commodities. In concert, energy and commodity stocks declined 25% to 50% over the same time period. Is this the end of the energy and commodity secular boom? Absolutely not, it is just a correction in the secular trend that started in 1999 and should continue until 2015 plus or minus a couple of years. All portfolios should continue to have positions in this area while prices consolidate in a trading range that may last up to eighteen months. Similar to our overall strategy, we will add to positions on intermediate lows and lighten up at intermediate tops until the bull market in this area resumes.

Real Estate

REITs (Real Estate Investment Trusts) are attempting to find a bottom, as are other real estate related and financial services equities. Since they are so closely tied to the ongoing mortgage and credit crisis, they have had a hard time gaining traction even though their fundamentals are sound. On average, REITs in the FTSE NAREIT Index, are selling at an 11.7% discount to Net Asset Value with a dividend yield of 5.3%. Cohen & Steers (a mutual fund company specializing in REITs) expects REITs to generate earnings growth of 4%--6% this year and next.[8]
We recommend an underweight allocation until financial stocks have stabilized.

Summary

Over the next couple of years, world economies will likely produce sub par growth. Investors should be biased toward preserving capital. It is too early to be fully invested. Underweight the U.S. market; add selective positions at intermediate bottoms and reduce them at intermediate tops. Natural resource and energy stocks are experiencing a correction in their ongoing secular bull market; stay neutral or slightly overweight in this area. We recommend being underweight or neutral for international markets and underweight in real estate.

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