

NOW'S A
GOOD TIME
TO GET SOME
GOOD ADVICE

THE SUN WILL SHINE AGAIN

People are not jumping out of windows on Wall Street, but investors are getting a bitter taste of what happened after the 1929 crash. It helps us now knowing what happened then. The Dow and S&P have erased more than a decade's worth of gains. Were the markets to finish at their yearly lows, it would be 1931 all over again. In this extraordinary bear market, ALL financial instruments have declined, except cash held in U.S. Treasuries and insured deposits. Morningstar tracks 11,585 U.S. and international equity mutual funds, ALL of them have negative returns.¹ Massive forced liquidations from hedge funds, mutual funds and margin calls have exacerbated the declines.

We started talking about a bear market more than 12 months ago. In anticipation of this, our portfolio allocation emphasized sectors where earnings would be cushioned in an economic slowdown; namely, consumer staples, healthcare, energy, cash equivalents and fixed income. We also hedged portfolios by buying puts and inverse index funds or by selling and going into cash. This strategy has performed much better than the overall market, where global stocks have declined anywhere from 50% to 85%. We were prepared for a major storm when we boarded up the windows. In hindsight, a full-scale evacuation was the only thing that worked perfectly.

Thanksgiving week may have been the turning point for the market. Catalyzed by critical government policy action, markets surged some 20% that week, the best short-term pop in 75 years. Another in a series of steps, the Federal government moved to stabilize Citigroup, guaranteeing close to \$300 billion in troubled assets and

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injecting about \$30 billion in capital. The Fed also pointed \$800 billion at mortgages, consumer credit and small business loans. President-elect Obama finished off the week by announcing a universally respected economic team and the prospect of a massive, new, fiscal stimulus program totaling more than 5% of GDP (Gross Domestic Product) over a two-year period. Spending will be focused on infrastructure, alternative energy and healthcare and is designed to create at least 2.5 million jobs by 2011.

Since then, the market has begun to shrug off bad news, for example: a horrendous November job loss of 533,000, the worst monthly decline in 34 years, suggesting improving market resiliency. Taken together, these changes could mean a “tradable rally” into early next year. Until the market begins a sustained advance, 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.

The Sun Will Shine Again

After all of this wrenching, we can be sure there will be a new bull market in our future. The sun will shine again. It is never too soon to be developing themes for the upcoming bull. We expect that the economic upturn will not be a “normal” business cycle recovery. Economic recoveries typically begin by easing monetary conditions which spurs consumers to increase spending. Because of the real estate bust, rising unemployment and the inability to get loans (banks are de-leveraging to improve their balance sheets), the consumer will not be the economic engine this time around. This time, as in the 30's, government spending on infrastructure will be a catalyst for growth. President-elect Obama's stimulus package is being replicated around the world. Central banks will help by keeping interest rates low until the recovery is assured. The recovery will be sub par; most likely a prolonged period of sub-trend domestic consumption growth, a rising propensity to save, low interest rates and disinflation. (Inflation may become a problem in three to five years but is not a problem now.) In this recovery, current bondholders will do very well as interest rates fall. The retail, financial and consumer discretionary sectors will rebound, but they will not be the leaders of the new bull. The sectors to overweight will be the old leaders: globally-gearred deep cyclicals in the resource and infrastructure areas, materials, industrials, information technology, biotechnology and healthcare. The developing world will recover much faster than developed economies. China, India and Brazil will lead the way. Emerging markets will be the best international investment because of superior growth, aided by a weak dollar that finally succumbs to the trillions of dollars the U.S. government is pumping into the economy.

Current Economy

U.S. Stocks and Bonds

The National Bureau of Economic Research officially declared that the current recession began last December.² The recession will be longer than the 1973-1975 recession, which lasted 17 months, the longest since the early 30's. One of the Fed's greatest fears when the credit markets first began to constrict was of an “adverse feedback loop.” In this situation, the tightening of credit conditions would depress investments and consumer spending, which, in turn, could further tighten credit. This “adverse feed back loop” continues to unfold today - both domestically and abroad. Countermeasure steps taken by Congress, the Fed, the Treasury and other governments throughout the world have been impressive and unprecedented. There is no question that governments will do whatever it takes to right the world economy. Fears of depression in the U. S. economy (and therefore in the world economy) have begun to crest. All the deflation-fighting initiatives, announced and prospective, will halt the downward spiral in the economy and eventually ignite confidence and a recovery. Nevertheless, these initiatives will take time. We are forecasting a 4.9% contraction in real GDP in the fourth quarter and **negative growth of 1.7%** in 2009. The recession may not end until late 2009 or early 2010.³

World Economy

Global growth prospects have deteriorated since September. Advanced economies are forecast to **contract .25%** on a full-year basis in 2009, the first such fall in the post-war period. In emerging economies, **growth** is expected to slow appreciably but still reach **5%**⁴. As in the United States, policy actions are being implemented to address the root causes of financial stress and to support demand, but it will take time to make changes, stabilize and recover. In spite of cooling momentum, emerging economies are still expected to provide a source of resilience, benefiting from strong productivity growth and improved monetary and fiscal policies. This time the crisis is focused on the United States, with its excessive debt and deteriorating demographic profile (aging population). Asia has very low debt, no systemic banking crises and demographics that support robust economic growth. 5% growth in this region may be the low point for this cycle.

Asset Allocation

U.S. Stocks and Bonds

The U.S. stock market is still in a bear market. At the lows of November, there was so much damage in so short a period that it defies hyperbole. The S&P 500 was farther below its all-time high than at any time since 1949. It has not been that far below its 200-day moving average since 1932. The current bear was down almost exactly as much as the 1929-'32 and 1937-'38 bear markets.⁵ While history offers no sure trading edge, it does suggest that being aggressively bearish from these levels requires a belief that the economic implications of the present crisis are comparable with the Depression. For the present, we could be enjoying a nice bear market rally until early next year. First, the tone of the market has improved markedly over the last couple of weeks. The abject pessimism in November has subsided and following weeks of extremely high volatility the market is **looking and feeling more normal**. Second, valuations are cheap. Using normalized earnings, book value, cash flow and market value versus GDP, stocks are very cheap (though not as cheap as they were in the 1930s). The S&P dividend yield exceeds the yield on the 10 and 30-year Treasury bonds for the **first time in 50 years**. Thirdly, the market has been devastated and is deeply oversold. History suggests that even in enduring, secular bear markets there are not just 20% bounces but also one 30-50% rally. We should be due. Since everything came down together during the crash, most everything should participate in the current rally, although we favor our secular themes in infrastructure, materials, industrials, information technology, biotechnology and healthcare.

Truth told, the crash in the bond market was worse than the crash in the equity market. After all, bonds are supposed to be conservative investments and therefore safer than stocks. Bond prices declined (except Treasuries) 15% to 35% very quickly, suffering the worst price debacle on record. They are starting to stabilize as the forced selling for liquidity has diminished. Being overweight bonds works because the Fed will continue to push rates lower and keep them low until they are convinced we are out of the woods. We are buying high quality cash instruments, short and intermediate-term bonds and short and intermediate-term bond funds. Even Treasuries make sense at current yields because the Fed will push rates even lower by buying Treasuries in order to get mortgage rates to come down. Analysts expect the Fed would like to see mortgage rates around 4.5%. Recently the Treasury 10-year note yield fell below 3% for the first time in its 46-year history.⁶ The yield could fall below 2% over the coming year.

International

International equity markets were creamed this year. Most markets were down 50% to 85% at their lows. Emerging markets did the worst. Governments and central bankers around the world are taking similar steps to the U.S. in attempting to ameliorate the economic crisis. While developed economies are in a similar position to ours, emerging economies are in good shape to weather and to benefit from the storm. Their markets have probably overshot on the downside relative to their underlying growth rates. The developing world will come out of this slump much faster than the developed countries, with China, India and Brazil leading the way.

China, for example, is a high-savings nation, has no foreign debt and is in the midst of a long industrialization and urbanization process with a huge need for infrastructure building. We favor the emerging markets for this asset class.

Natural Resources and Energy

Crude futures topped \$147 in July and recently hit a low of \$38, a **75% decline in four months**. Other commodity prices experienced a similar fate. Speculation, hedging contracts and margin borrowing fueled this summer's spike in all commodities. Now similar forces have been pushing prices down to levels industry experts consider equally unsustainable. Selling pressure in commodities appears to be abating and prices are attempting to stabilize. Natural resources and energy will eventually benefit from the huge infrastructure stimulus that is being planned around the world. The International Energy Agency recently reported that output from the world's oilfields is declining faster than previously thought. Without additional investment over current levels to raise production, the natural annual rate of output decline is 9.1%.⁷ The findings suggest the world will struggle to produce enough oil to make up for steep declines from existing fields, such as in the North Sea, Russia and Alaska. Production declines could worsen as prices fall and investment decisions are delayed. All portfolios should continue to have positions in natural resources and energy.

Real Estate

REITs (Real Estate Investment Trusts) have been in a bear market since February, 2007. At their recent lows, REITs have declined more than 75% from their highs. At current levels, REITs are becoming increasingly attractive. They sell at a 16% discount from Net Asset Value, boast an average yield of 7.5% and are expected to generate dividend growth of 2% to 3% in 2009.⁸ Nevertheless, we recommend an underweight position until the new bull emerges.

Summary

The upcoming economic upturn will not be a "normal" business cycle recovery. We may see a prolonged period of sub-trend growth, a rising propensity to save, low interest rates and disinflation. It is too early to be fully invested. Bonds and cash are our only overweighed asset classes. Until the new bull begins, we will add selective positions in asset classes at intermediate bottoms and reduce them at intermediate tops or use puts and inverse index funds to change the investment mix.



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1 Barrons.com

2 Nber.org

3 Cass Research Associates

4 Imf.org

5 Barrons.com

6 Cnnmoney.com

7 Iea.org

8 Cohenandsteers.com

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