NOW'S A
GOOD TIME
TO GET SOME
GOOD ADVICE

SOME FLURRIES OF GOOD NEWS

Investors began 2009 licking their wounds from the worst year on Wall Street since the great Depression. A year-end rally, based on "hope" for market stability and a new administration, ended abruptly in early January. Worldwide economic deterioration, confusion and uncertainty about government bail-out and stimulus programs, resulted in a stunning, broad-based decline into early March. Fearing (among others), the bankruptcy of General Motors and the nationalization of major U. S. banks, including Citicorp, Bank of America and Wells Fargo, the market hit prices last seen in 1996. On Monday, March 9, 2009, the Dow Jones Industrial Average was down 25.4% YTD, the Russell 2000 had fallen 31.2% and the Dow Jones Transportation Index declined 39.3%.[1] **Global stocks, from their all-time highs reached in 2007 and 2008, were down between 55% and 85%.**

Then, on Tuesday, March 10th, **came some flurries of good news**. Not great news, but news that wasn't as bad as everyone expected. Suddenly investors had hope that the world was not about to end. The head of Citicorp said the bank had managed **to turn a profit** in the first two months of the year, and **would not need additional government support**. Similar statements that day followed from Bank of America, Wells Fargo Bank and JPMorgan Chase. Ex-autos, retail sales for February were announced; surprisingly, they were **up** 0.7%, and January's retail sales were revised **up** to 1.6%. On Thursday, the FASB (Financial Accounting Standards

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Board) announced that they might ease financial reporting rules on "mark-to market" accounting. The old rules forced companies to reduce financial assets on their balance sheets as if they had to sell them the next day, even if they wanted to hold on to them until maturity. The rule change could materially increase a bank's bottom line, capital ratio and balance sheet stability. Also, General Motors announced that it would not need a $2 billion government loan for March. That same day, General Electric (whose stock hit $5.73 on March 4th, **down 90.5%** from its high) shot up 36% for the week, after its credit rating was cut less than expected. For the week ended March 13th, the S&P 500 rose 10.7% and the Dow finished up 9.1%.[2] This could be the beginning of the first sustainable rally since the bear market began in October 2007, exceeding last Fall's short-term bounce when markets were up 20% to 30% from the November low. It is too early to call the end of the current long-term bear market, but this bear market rally could travel longer and higher than any rally over the last 18 months.

Portfolio Management in an Uncertain Environment

2009 will require more of the tactics we employed in 2007 and 2008. For each client our strategic focus begins with an appropriate long term "benchmark portfolio" that is then adjusted for the risk/return potential of the market. This adjusted portfolio allows us to capture the upside when times are good and lets us protect portfolios when things get rough. Within the portfolio, we overweight those asset classes and sub-sectors that we believe will outperform the strategic benchmark portfolio and underweight those areas that we believe will underperform the benchmark portfolio. Additional measures that we may take to reduce risk and increase return are:

1. Raising and/or keeping cash for intermediate (four to six months) periods of time - we could hold 25% to 80% in cash and bonds.
2. Buying inverse mutual funds and ETFs (Exchange Traded Funds). These funds go up in value when the market declines.
3. Buying S&P 500 put options as a hedge against long positions.
4. Avoiding the troubled areas - in 2007 and 2008, these were financials, real estate and consumer durables.
5. Overweighting the secular leadership areas - in 2007 and 2008, these were natural resources, industrials and international.
6. Overweighting recession resistant stocks like consumer staples, drugs and biotech.
7. Taking advantage of shorter-term trading opportunities.

Losing money is never fun. Sometimes losing less is as good as it gets. For clients who have been with us for years, we successfully preserved many of the gains from the last bull market, while relevant benchmarks now show negative returns for the last ten years. For more recent clients, your portfolios did far better than your benchmark and the market. We achieved this by holding large cash positions, minimizing exposure to financial and retailing companies and by generating gains from shorting that either hedged your long positions and/or the market. The strategy was not perfect, but it was in keeping with our goal of participating on the upside and cushioning on the downside.

A Perspective on Stock Values

One useful investor criteria is the Price/Earnings (P/E) ratio. Is the stock at a relatively low or high P/E compared to its historical range? With earnings being so volatile in the current environment, we thought it might prove useful to take a simple, common-sense approach to a sample of companies we expect to survive. (Some of these companies may be in portfolios. This analysis does not constitute a recommendation to buy them.) In this environment, it has been easy for investors to lose sight of the fact that many companies have real sales and real earnings despite the bear market. In many cases, the question of solvency in the banking system has dominated our perception about all companies. The accompanying table compares Blue Chip companies today after the current devastating bear market to where they were at the secular bull market peak in 2000.

A SAMPLING OF BLUE CHIP COMPANIES FOR 2000 AND 2008: SALES, EARNINGS AND PRICES

Company	2000 Sales($B)	2008 Sales($B)	% CHG	2000 EPS($)	2008 EPS($)	% CHG	2000 Price	3/2009 Price	% CHG
Cisco	$22B	$82B	+272	0.53	1.56	+194	$82	$16	-80
Intel	$33	$76	+130	1.64	0.99	- 40	$76	$13	-82
Microsoft	$23	$54	+135	0.86	1.87	+117	$54	$19	-64
Home Depot	$38	$70	+ 84	1.00	1.77	+ 77	$70	$23	-67
Oracle	$10	$47	+370	0.34	1.30	+282	$47	$17	-64
Walmart	$167	$378	+126	1.25	3.13	+150	$72	$62	-31
Pfizer	$29	$50	+ 72	1.02	2.42	+137	$50	$17	-66
TOTAL			**+198**			**+153**			**-76**

From 2000 to 2008, for these companies, **average sales are up 198% and EPS are up 153%, while stock prices are down 76%**. Granted, sales and earnings will probably be down this year for the group but not by 76%. In fact, for EPS to equate to the price declines since 2000, EPS would have to decline **89%,** which is not very likely to happen. Also, many of these companies have large cash positions on their balance sheets. Cisco has $29.5 billion in cash. If you are looking out three to five years, these stocks are all very good values. These rational facts can make an investor comfortable that they are buying these stocks at reasonable value, but they can't trump the fear that stock prices could go lower anyway. Investors must remain diligent and cautious, employing some of the techniques outlined above in "Portfolio Management in an Uncertain Environment".

Current Economy

Current times will probably come to be called "The Great Recession". It will be the worst recession since the depression, but will fall far short of a depression. Gross Domestic Product (GDP) fell 50% from 1929 to 1933 and the national unemployment rate rose from 3.2% in 1929 to 24.9% in 1933.[3] We expect 2009 GDP to decline 2.1% and be flat for next year, a far cry from a decline of 50%. Growth will not turn positive until the middle of 2010, with unemployment topping out over 10%.[4] The biggest combined global monetary and fiscal stimulus in history is well underway. Stimulus measures will take many months or even years to manifest their full effect. Government-induced stimulus is often messy, clumsy and slow-moving. Eventually, we will recover.

World Economy

The current global downturn in output, trade, capital investment, and liquidity is likely to last well into 2010. Gross World Product (GWP) could show a 1% decline in 2009, the worst performance since the 1930's. Growth in emerging and developing economies is expected to slow sharply, from 6.75% in 2008 to 3.25% in 2009,[5] but these economies are still growing and will come out of the slump much faster than developed countries, led by China, India and Brazil.

Asset Allocation

U.S. Stocks and Bonds

The U.S. stock market is still a bear. Within the bear, a rally of unknown magnitude and duration looks to be developing. We expect it could surprise investors by exceeding any rally we have had in the last 18 months. General Electric's credit rating downgrade, when the stock soared, is evidence that most bad news is already in the price. Even as the market averages dropped below their November lows on March 9th, individual new lows were a third of the number last November; this suggests that most individual stocks are doing better than the market indices indicate. Also, any time the market has declined by more than 50%, there has always been an ensuing rally of 30% to 50%, even during the Depression years. The best performers for the week of March 9th were Financials, Industrials, Base Materials, Technology and Health.[6] We like all of these areas but are wary of the financials as long-term investments. Much of their move was related to short covering. We do not expect financials to be the market leaders when a sustained uptrend comes. They will likely act like the technology bubble stocks of 2000-2002. The tech-driven NASDAQ fell 80% top to bottom, (a record recently surpassed on the downside by financial stocks). By the September 2003 high tech had risen 70% in a year, while the S&P was up half that: 35%. From that point, however, tech stocks stagnated for the duration of the bull market, a full four years. The leaders of the prior bull market are usually not the leaders of the new bull.

In our last letter, we recommended overweighting corporate bonds or bond funds. We reasoned that the Fed had begun targeting borrowing rates for the private sector and would expand the TALF (Term Asset Backed Loan Facility) program to meet its goals. Thus we felt that corporate bond yields would fall because of a weak economy, and/or the Fed would force the outcome by buying these securities. We believe that our overweight position will make money on a 9-12 month time horizon. Valuation is excellent, and a lot of bad news has already been discounted. We are also overweight mortgage-backed securities, which now have Fed backing and municipal bonds, which offer pre-tax yields that surpass those on treasury securities.

International

Stock markets in the Far East, China and Latin America are improving relative to the U.S. market. Canada and Australia also look interesting as commodity markets begin to stabilize. We recommend avoiding Europe. We remain bullish on China's long-term growth and investment outlook. China has a lot of good economics: huge reserves, the size of its internal market and the potential for expanding its capital market. Additionally, the bulk of government spending goes for infrastructure, particularly for reconstruction after the earthquake and to extend China's railway network.

Natural Resources and Energy

After massive price drops alongside stocks over the past several months, crude oil has jumped 16% in the past three weeks. Crude oil and copper, which has also risen 17% in the same three weeks, tend to be economic barometers. If the cost of industrial metals and crude are rising, it suggests traders see demand trickling back. Much of this increased demand results from China's stimulus for infrastructure spending. Also, courtesy of aggressive plant and mine closures, the global supply backdrop for a number of commodity groups has improved. These closures have eased bottlenecks for production inputs so production costs (labor and energy) have fallen, supporting profit margins. Inventories have also stopped swelling in a number of commodity industries. For example, inventories at aluminum and nonferrous metals smelters are now contracting at rates last seen in the early 2000 economic downturn. Materials and energy stock valuations have improved considerably and with the stabilization of commodity and energy prices, we believe all portfolios should be exposed to this area.

Real Estate

REITs (Real Estate Investment Trusts) rebounded sharply along with the financials. At their recent lows, REITs **declined 77.8%** from their highs. At current levels, they have discounted a 45% decline in private real estate values from their peak. Cash flows will decline about 7% in 2009, driven by demand contracting, not oversupply. The average REIT is selling at a 26% discount to its Net Asset Value and yields more than 7%, assuming dividend cuts in 2009.[7] Valuations are attractive, but we see REITs the same way we see financials, a broken former leader that should remain underweight until stability in the underlying real estate emerges.

Summary

The coming economic upturn likely won't occur until the middle of 2010. After which we expect a prolonged period of sub-trend growth. Even as we forecast an above average "trading" rally over the near term, it is too early to be fully invested. Cash and bonds remain our only overweight asset classes. Until there is a new bull, 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 protect portfolios.

Dave

Dave Rahn

Clara

Clara Basile

Bill

Bill Oberman

1 Schwab.marketedge.com
2 Schwab.marketedge.com
3 Ft.com
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5 Imf.org
6 Barrons.com
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