NOW'S A
GOOD TIME
TO GET SOME
GOOD ADVICE

Transition

Improvement in a host of indicators suggests the early stages of an economic upturn. A "pedal to the metal and hold it down" monetary and fiscal response from all governments has catalyzed an extraordinary about-face in the global stock markets over the last nine months. Recently, however, the world-wide rally has stalled and appears to be at a juncture. The global markets are shifting away from being driven by global policy action, liquidity and relief that the world is not sinking into a depression toward being driven by growth in corporate earnings and real advances in the economy. It should come as no surprise that the latter phase will be a tougher environment for stocks as profits are likely to disappoint.

As the rally matures, the next phase will be less euphoric, broad based and certain. So far, the global stock markets have retraced 50% to 60% of the bear market decline. This behavior is typical in secular (more than one cycle) bears over the past eighty years. It is at this juncture that every market has had at least one 10% or larger correction before a final rally into the cycle peak. As a modern-day example, Japan is currently the best model of a secular bear. From its high in 1990, it has had six cyclical bear market rallies over the last 18 years, but it remains 75% below the 1990 peak. These "relief" rallies appreciated 50% to 60% and lasted for only 15 months, on average.[1] If our market follows suit the rally that started in March could be over by late spring of 2010.

This is the 10th year of the U.S. secular bear - (a buy and hold strategy has been bad advice over this period.) The Dow Jones Industrial Average is about where it was 10 years ago. We advised clients when the DOW passed through 10,000 in 1999 that there would be many repeat trips coming in the next 10 to 20 years. The investment markets will likely remain very unstable for at least a few more years. Our primary goal remains preserving your capital and diligently cashing in on the market rebounds as warranted.

AVALON
CAPITAL
MANAGEMENT

Portfolio Management

Our secular themes remain unchanged. We believe that wealth is being distributed from Europe and the U.S. to the Far East, India, China, Australia and Latin America. Major art auctions are now held in Hong Kong, Singapore and Shanghai, not London or New York. Investment banking centers are shifting from London and New York as well. We all know that labor and manufacturing have moved outside our borders but now growing numbers of U.S. and other foreign firms are shifting key operations to China - including R&D centers, regional offices and other corporate entities. These companies want to take full advantage of the world's largest and fastest growing consumer market. This growing consumer base will continue to put pressure on resources such as oil, copper, coal and other commodities, including agricultural commodities and products.

So how have we positioned ourselves in the last year and where are we currently? After protecting portfolios with cash, put options and inverse ETFs (Exchange Traded Funds) in January and February, we reversed our hedges and put the money back to work in March and April, focusing on our investment themes: emerging markets, commodities, energy, deep cyclicals, basic materials, industrials, technology, health care and biotech. We underplayed fundamentally vulnerable sectors such as finance, banks, REIT's, retail and consumer cyclical. We also stayed away from small capitalization stocks. We invested in corporate bonds with the expectation that as the Federal Reserve liquefied the financial system, interest rates would come down and bond prices would increase in value. Although we became more cautious and raised some cash over the last few months, our risk adjusted returns for the year remain excellent.

So if the market is transitioning how are we shifting our strategy? Over the short term (3 to 6 months) the U.S. dollar looks as if it's bottoming and we expect it to surprise everyone on the upside. As most of our thematic positions benefit from dollar weakness we are reducing our exposure. Portfolios will be allocated more defensively using high dividend issuers: utilities, telecommunications, consumer staples, pharmaceuticals, health care and integrated oils. We continue to underweight retail, finance, REITs and consumer cyclicals. We are sticking to Big Caps over Small Caps and favor short and intermediate corporate bonds over treasuries. If the overall market becomes more vulnerable, we will reestablish the bear market defensive hedges of cash, put options and inverse ETFs.

Current Economy

United States Economy

Robust economic recovery in 2010 is certainly on most investors' wish list. Recovery would end their two year long financial nightmare and buttress a rebounding stock market. Unfortunately, bad assets on personal and institutional balance sheets are the equivalent of a ball and chain strapped to the economic leg. This bad debt overhang is the main reason bank lending continues to free fall. Small businesses, which account for half of all jobs in this country, are taking the brunt of the credit contraction. Unemployment will remain high through 2010, which limits the ability of consumers to bolster the economic recovery. Goldman Sachs is forecasting a sluggish recovery in 2010 of about 2% GDP (Gross Domestic Product) and no Fed hikes until 2012. Inflation will remain under control in 2010 because of excess capacity in labor and plant and equipment.[2]

World Economy

The world economy is in better shape than the U.S., primarily because of the growth in countries such as China and Brazil. The speed and underlying strength of the recoveries varies from region to region, reflecting different policy stances, underlying growth potential and the general health of the financial system. China stands out in the recovery process. Economic boom-times have returned; car sales are up 98% since last year, exceeding U.S. car sales, and some real estate prices are reported to be up 60% over a year ago in the major cities. The International Monetary Fund is forecasting that advanced economies will grow 1.25% in 2010, while emerging economies will grow 5%. Overall global growth will be about 3%. This gradual pace of recovery points to a prolonged period of subdued inflation and vulnerability to mild deflation.[3]

Asset Allocation

U.S. Stocks and Bonds

Investors should reduce their exposure to investments that have benefited from dollar weakness such as commodities and basic materials. Those proceeds should be added to defensive, high quality, dividend paying issues including telecommunications, utilities, pharmaceuticals, consumer staples and integrated oils. We are underweighting retail, finance, and consumer cyclicals.

With 0.1% Treasury bill yields, investors have flocked to bonds and bond funds. The Federal Reserve didn't just slash short-term interest rates to help banks; it did so to make sitting in cash painful enough to force investors back into riskier assets such as equities and bonds. However, we think the easy money has been made in bonds and investors should review their holdings carefully both for credit worthiness and maturity (no long maturity bonds!). Investors should become more cautious by sticking to high quality short and intermediate corporate bonds or bond funds. We would avoid treasuries and individual municipal bonds at this time.
Will sovereign (government) debt be the new subprime? Is the next bubble government debt? Sovereign debt is widely presumed to be ultra safe; so safe that the yield is known as the "risk-free rate". Recently, however, government debt has soared to levels not seen during peacetime for centuries, or ever, as with the US and UK. Fiscal deficits are swelling across the western world. Downgrades have been issued for Greece and are pending for Portugal, Spain, Ireland, Italy and Mexico. The Baltic states of Latvia and Lithuania have been warned by the ECB (European Bank) of being "sucked into a second debt-fueled economic crisis". The same goes for Romania and Hungry. Moody's Rating Service says that UK and US debt are vulnerable to being cut to a double-A rating. This is not to say outright default looms large; indeed, defaults seem highly unlikely. However it is easy to imagine that some countries will end up eroding the value of their bonds by debasing their currencies in the coming years, printing money and potentially stoking inflation. If you are so inclined, an abstract by Reinhart and Rogoff "This Time is Different: A Panoramic View of Eight Centuries of Financial Crisis", is an excellent piece on the history of government debt defaults. (It can be found at www.economics.harvard.edu.) The important point they make is that major default episodes are typically spaced some years (or decades) apart, creating the illusion that "this time is different" (i.e., there is no chance of governments defaulting on their loans) among policymakers and investors. Caveat emptor!

International Stocks

We still favor the Far East, China, India, Latin America and the commodity rich counties of Canada and Australia. For U.S. investors, the weak dollar this year has added to returns. If the dollar does strengthen over the next three to six months, returns would be diminished accordingly. At this time it is hard to come up with a case for a significant decline in emerging markets given their robust growth. On the other hand, they have been the best performing markets in the world and from current levels a further significant gain in prices would occur only if mania-type forces erupt globally. While this cannot be ruled out, the odds at this stage call for a range-bound market. It is time to pare back positions if you are heavy in this area.

Natural Resources and Energy

As we pare back positions in some commodities, we think it is time to add back to energy. Crude oil and energy stocks have been flat since June and look ready for another run, even if the dollar appreciates. The excellent secular outlook for energy says it is time to overweight this area again. We favor oil and exploration companies and integrated oils.

We still like gold for secular reasons but have pared our position given the recent run-up and potential for dollar appreciation. Our central theme remains; we believe the dollar and other currencies over time will lose value as their governments continue to put the printing presses on overtime. The U.S. greenback is losing the trust of those who hold it. Zhou Xeachuan, China's central bank governor, calls for replacing the dollar as the dominant world currency and creating "an international reserve currency that is disconnected from individual nations".[5] However this may take a long time – and in the meantime what is a body to do? We say, ***buy gold as it corrects***. China, India, Russia and other nations have made major gold purchases in recent months. If central banks have transitioned from net sellers of gold to net buyers, then there are significant implications for gold's supply/demand equation. Furthermore, the symbolic implications of central banks buying gold (indicating a lack of confidence in the U.S. dollar) will eventually underpin healthy retail investment demand as well. All investors should own some gold.

Real Estate

Real estate is not out of the woods yet. A huge amount of debt has to be rolled over on office buildings in the next couple of years and banks have been holding off on foreclosures for fear of hurting their balance sheets. Eventually this will come home to roost and the foreclosures will eventually happen. Real estate is in a secular bear market and should be underweighted in portfolios.

Summary

We expect a sluggish economy in 2010, growing at about 2%. Emerging economies should see 5% growth. The dollar should be strong in the first half of next year, which would hurt the returns for our secular leaders. Holdings should be transitioned from international equities, commodities and commodity stocks to Big Cap utilities, telecommunications, consumer staples, pharmaceuticals and integrated oils. We are negative on financials, real estate, retail, and consumer cyclicals. We prefer short and intermediate term corporate bonds over treasuries.

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1 www.notleygroup.com
2 Goldman Sachs US Economics
3 www.imf.org
4 www.barrons.com
5 www.cfr.org

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