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Double-Dip?

The second quarter delivered a poignant reminder that this is not a "buy and hold" environment. It fact, it was a terrible quarter for investors. Markets plummeted on the back of the sovereign debt crisis in Europe, fanning concerns about a double-dip recession in Europe and the U.S. Only cash, government bonds and gold recorded positive returns. U.S. stocks fell 11.5%, while international equities sank 13.7%. In the U.S., none of the ten economic sectors were positive for the quarter. The biggest loser was materials at minus 15.7%, versus the "best" performer: utilities, down 4.8%.[1] Avalon portfolios did much better than the major averages because we anticipated the decline and took defensive action.

Going forward, the big question investors are asking is whether this is merely a mid-course slowdown, where the economy continues to expand, but at a reduced pace, or will the slow-down degenerate into a double-dip recession? A mid-cycle slowdown commonly sees stocks weaken, bonds rally, and commodity prices fall - just what happened in the second quarter. However, in the early stages of deceleration, benign slowdown or double-dip recession are virtually indistinguishable from one another. In spite of all the negative forces: individual debt, sovereign debt, China slowing, tax increases, unemployment etc., we believe the U.S. and global economies will escape double-dip recessions. There have been only two double-dips in postwar history: one in the early 1970s and one in the early 1980s. In both cases, substantial, additional, negative shocks brought about the second leg of the contraction. In the early 1970s, the oil shock combined with a sharp jump in interest rates aborted the recovery process. In the early 1980s, Paul Volker's double-digit interest rate increases triggered the second leg contraction. Thus, in the absence of a major negative shock, the natural tendency for the economy is to recover by climbing (sometimes jerkily) out of the earlier recession. The second reason we are cautiously optimistic is that corporate profit growth is very strong and businesses have balance sheets that are healthy. Spending by businesses on equipment and software increased at a

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blistering 21.9% pace in the second quarter, the most in 13 years.[2] Corporations should continue to spend in these areas for increased productivity. Finally, interest rates around the world are very low and governments wish to accommodate, fiscally and monetarily.

Since early July, markets have rebounded as concerns over sovereign debt and a double-dip recession have abated. (These concerns have not gone away; they are on the back burner for now.) We remain in a secular bear market. Over the last 110 years, the U.S. equity market has experienced three secular bear markets: the 1930s, the 1970s and from 2000 to the present. For the rest of the year, we expect markets to be range bound, bouncing from 1000 to 1200 and back again in the S&P 500 (currently at 1106). We will trade this range in order to preserve capital and generate positive returns.

Portfolio Management in an Uncertain Environment

The market, over the next couple of years, will continue to be extraordinarily volatile and uncertain. (It will require us to use more of the tactics we employed in 2007, 2008 and early 2009.) For each client our strategic focus begins with an appropriate long term "benchmark portfolio", which is then adjusted for the risk/return potential of the market. For example, in a portfolio with a mandate of 60% equities, 40% bonds, we might target 40% equity, 40% bonds and 20% cash, if we thought the overall equity outlook was sub par. This "adjusted for the outlook" portfolio allows us to capture the upside when times are good and lets us protect portfolios when things get rough. In 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. In addition we take measures to reduce risk and increase return such as:

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 put options as a hedge against long positions.
4. Avoiding the troubled areas. For example, in the first two quarters, we avoided materials, down 19.9%, and Europe, down 22%, while the S&P was down only 6.7% over the same time period.
5. Overweighting the secular leadership areas: emerging markets, natural resources, industrials and gold.
6. Overweighting bonds and income producing equities.

Current Economy

United States Economy

The recovery lost momentum in the second quarter as growth slowed to 2.4%, its most sluggish showing in nearly a year and too weak to drive down unemployment. Consumers spent less and companies slowed their restocking of shelves. We expect the economy will continue to decelerate through the rest of 2010, growing in the 1% to 2% range. While we do not see a double-dip recession, we do think the economy will muddle along in 2011. The government will take both fiscal and monetary action if growth comes to a complete standstill. With recent data sluggish and the outlook "unusually uncertain," as Fed chairman Bernanke told Congress recently, the central bank signaled that it is ready to do more to boost the economy, if necessary. On a positive note, we believe that inflation will drop to near zero and hold at this level for the next few years, one result of anemic economic activity. Zero inflation means nominal returns and real returns (after inflation) will be the same and a seemingly low return of 3-5% becomes attractive when none of the return is lost to inflation.

World Economy

The world economy expanded at an annualized rate of 5% during the first quarter. According to the International Monetary Fund (IMF), macroeconomic developments during the spring confirmed expectations of a modest recovery in most advanced economies and strong growth in many emerging and developing countries. So far, the IMF sees little evidence of negative spillovers to real activity from the sovereign debt crises in Europe. They forecast that the Euro-zone will slowly stabilize and improve. In fact, things are finally going Europe's way. After months of crises and questions about the survivability of the Euro, a number of market indicators have turned positive. Riskier sovereign debt has rallied, credit-default insurance costs are at two-month lows and the Euro is flirting with an 11-week high versus the dollar. Borrowing costs of deeply indebted Euro members like Spain, Portugal, Ireland and Greece have fallen significantly relative to Germany and the Euro-zone economy has been stronger than economists expected. The IMF forecast for world growth in 2011 is 4.25%; suggesting no double-dip recession for the world economy.[3]

Asset Allocation

U.S. Bonds and Stocks

The Barclays Intermediate Government Bond had a total return of 3.2% in the second quarter, while all other assets except cash had a negative return. This flight to safety put 10 year Treasuries below a 3% yield; thus intermediate and long Treasuries should be avoided for the time being. On the other hand, with low inflation, investment grade and high yield corporate bonds are still attractive. We also like the new Build America Bonds (BAB), which are taxable municipal bonds that carry special tax credits and federal subsidies for either the bond issuer or the bondholder and currently yield 5.8%.

The equity market has been extremely volatile, rising strongly one day, only to plunge the next. However, the major short-term ambiguities that kept market participants in a selling mode during the spring months – slowing U.S. and Chinese growth, and European sovereign funding – have gone quiet for the time being. The second quarter correction priced equities attractively and we started putting money back to work in early July, with the expectation of an intermediate rally that may last through the end of August or early September. We like commodities, the agricultural area, industrials, technology, utilities and biotech. In this environment investors must adopt a highly-flexible approach rather than a buy-and-hold approach, which carries a lot more embedded risk than most people understand.

While the macro economic news has been on the gloomy side, corporate earnings have been on a tear. Final demand has been growing at an anemic 2% to 3% since the economy bottomed last summer, but S&P 500 operating earnings are up nearly 80%[4] over this period, due in part to high productivity growth. Slower economic growth is disappointing, but it does not follow that corporate earnings are set to plunge. In this cycle, companies have found ways to do more with less and are shrinking their businesses to a size that can prosper in a slow growth environment. If and when sales do improve, a surge in hiring is unlikely. The focus remains on keeping profits high, not rebuilding work forces decimated by the recession.

International Stocks

We like international stocks, especially Singapore, South Korea, India, China, Latin America and the commodity rich countries of Canada and Australia. We even like parts of Europe; export rich Germany, for example. China has been a market concern because policymakers there have been in a tightening mode. Currently, given better-than-expected inflation figures, the policy of tightening is probably coming to an end; which reduces the risk of a hard economic landing and is positive for the global outlook. We think India is an overlooked market. Indian stocks were the best performers among the 20 largest equity market's last quarter. The $1.2 trillion economy expanded at the third-fastest pace among the Group of 20 nations in the first quarter. According to Finance Minister Prenab Muklerjee, gross domestic product may grow at 8.75%, for the year started April 01, 2010.[5]

Natural Resources and Energy

With continuing global growth and a flat to weakening dollar, we look to overweight energy, natural resources, commodities and gold. China has surpassed the U.S. as the largest consumer of energy. This is a remarkable transformation; China's total energy consumption was just half the size of the U.S. 10 years ago.[6] China will be industrializing for a long time to come and oil consumption will rise accordingly. Both long term growth trends and cyclical swings in the Chinese economy will become the major drivers of global oil prices. Prices, this year, should slowly grind back toward $85-90 per barrel. On a longer time scale, world oil production will peak sometime between 2015 and 2020. Oil could cost $300 per barrel by 2020.

Real Estate

REITs have done better than we expected, driven by attractive yields and reports of month-to-month gains in commercial property prices. While a bottoming process in property prices have enabled them to roll over existing debt, cash flows will not grow this year. We continue to think that real estate will have a rough time in the current economic environment and investors should underweight this area.

Summary

The global economy continues to grow, although at a slower pace than the 5% growth of the first quarter. With this growth and a flat to weak dollar, we favor investments that benefit from dollar weakness: international equities, commodities, energy, technology, industrials and biotech. We continue to underweight real estate, financials, consumer discretionary, retail and consumer cyclicals. We recommend short and intermediate investment grade and high yield corporate bonds over intermediate and long treasuries.

Dave Clara Bill

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