NOW'S A
GOOD TIME
TO GET SOME
GOOD ADVICE

SUSTAINABILITY

Stocks rose briskly in the fourth quarter and continued to do so in the first quarter of 2011. Although the market ended up nicely for the year, there were huge shifts in “risk off” (out of the market) and “risk on” (in the market) trades during 2010. For example, between April and June the S&P 500 *declined 17%*! The same groups that did well in 2010 continued to so in 2011, namely: industrials, energy, materials and information technology.

Economic growth in the United States has continued to improve in recent weeks. Business confidence measures have moved to multi-year highs, sales levels are rising, profits are improving and business investment remains robust. The economy is clearly transitioning from a recovery phase to a self-sustaining phase. The difference between the two is that the former is dependent on monetary and fiscal stimulus while the latter is based on improvements in demand from the consumer sector as well as on corporate top-line growth and upward trends in capital investment.

It is important to remember, however, that significant long-term issues remain and though economic growth is sustainable, it will probably be at lower than historical growth rates of 3.5%. Longer term we remain concerned about several unresolved problems: Chinese and emerging markets increasing inflation pressures and responding monetary tightening, Europe's sovereign debt, federal and municipal debt, continued housing weakness and chronically high unemployment. In addition, we now have the economic and financial risks stemming from North African and Middle Eastern turmoil. We may not be able to see the political future for this region but it seems clear that global inflation will be higher and growth slower than would have been the case before the increasing tensions.

The potential for rising geopolitical tensions and inflation could cause a general flight out of risk assets and the “risk off” trade may be back on. The financial markets are vulnerable to a correction of some magnitude. The S&P 500 is up almost 100% since the March 2009 bottom. This has happened only twice in U.S. history, 1934 and 1937. In each instance, the market had a subsequent, meaningful correction. We do not think this is the time to be fully invested in equities. Expectations for a “normal” correction of 5% to 10%, or one that approaches 20%, means equity exposure should be reduced and we have adjusted portfolios accordingly.

AVALON
CAPITAL
MANAGEMENT

Inflation Is Back!!

Unfortunately, while sustainable growth is finally getting some traction, global inflation is starting to rear its ugly head. For the last three months, U.S. inflation on an annualized basis is running over 3%.[1] While disturbing, this is nothing compared to what is happening overseas, particularly in the big emerging markets of China, Brazil, India and Indonesia, as well as smaller economies such as Thailand, Malaysia, Vietnam, Venezuela and Argentina. China and Brazil are experiencing rates around 5%, while India's is 8.3% and Vietnam's a whopping 12.3%. Latin America is back in the inflation headlines with Argentina at 26.6% and Venezuela at 27.2%. The United Kingdom's inflation rate is approaching 5% and the Euro-zone area's 2.4% rate skidded past their 2% target ceiling. Eastern Europe is running at a 6.6% annual rate and Russia is at 8.1%.[2] Central banks in most of these countries have started to tighten monetary policy and raise interest rates to slow their economies down. So far they are behind the curve. The higher emerging country inflation goes, the greater the chance of its leaking into the inflation rates of the United Sates and Europe, via higher traded goods prices and exchange rate moves to the downside. It is entirely possible that the U.S. could find itself back in stagflation (sluggish growth and rising prices). There is no indication from the Fed that inflation is a concern for them. They are focused on getting the unemployment rate down come hell or high water. Indeed, some members of the Fed have stated that they should be targeting inflation as high as 4%![3] The implications for U.S. investors: wage costs will begin rising; companies will begin raising their prices; interest rates will go up; and, eventually, stock prices will be negatively impacted.

Current Economy

United States Economy

The economy grew more slowly in the fourth quarter than initially estimated because government spending shrank more sharply and consumer spending was less robust. GDP (Gross Domestic Product) grew at an annualized rate of 2.8%, revised down from the 3.2% estimate.[4] Against the backdrop of surging oil prices, impending government budget cuts and a weak housing market, the outlook for growth has been diminished. GDP growth should be 3.0% to 3.5% for the first half of 2011 and back under 3% by the second half.

World Economy

The International Monetary Fund projects that activity for advanced economies will expand by 2.5% in 2011-12, down from 3.0% in 2010. They expect growth to slow for emerging and developing economies to 6.5% from 7.1% as these countries tighten fiscal and monetary policy to fight increasing inflation.[5] The world economy can withstand the surge in oil prices sparked by unrest in the Middle East and North Africa as long as *the increase proves short-lived.* Every $10 advance in oil prices reduces global growth by 0.5%.

Asset Allocation

U.S. Bonds and Stocks

Bond prices have been under pressure since last summer because of the growing economy and concerns about inflation. Long treasury bonds are down 19.3% and municipal bonds are down 10.7%. Near-term, we think this is excessive so intermediate treasury, corporate, municipal and BAB bonds, bond funds and ETFs are attractive at current prices. It will be at least a year before the Fed begins to raise short-term rates. The pro-growth policies that were implemented following the technology bust in 2000, namely, keeping short-term rates low for a long, long time, are essentially the same policies being pursued today, only "super-charged". We particularly like municipal bonds at this time. The credit risk in municipals has been overblown and represents a buying opportunity. Debt service for most municipalities is a small fraction of their overall budgets, which means they have little to gain by defaulting on their bonds. We prefer using bonds funds or ETFs because of their liquidity and advocate individual bonds only if the maturity is less than 10 years.

Since last summer the S&P 500 index has appreciated some 33%. The market is due for a breather and excessive, elevated earnings expectations and degrading valuations could be the ingredients for a topping process. Main problems that remain largely unresolved could cause a decline at any time: these include the euro zone debt crisis, spiraling U.S. government debt, global imbalances based largely on China's undervalued exchange rate, and rapidly rising food and energy prices. Even as we reduce overall exposure to the market, we continue to favor industrials, materials, energy and high technology. We prefer big cap stocks over mid and small cap stocks.

International Stocks

Emerging markets have underperformed U.S. equities by 10% since November while big cap international stocks have trailed by 5%. Many emerging economies are facing a genuine inflation flare, largely because the recession was shallow, on average, and economic slack was quickly absorbed by the recovery. Energy and food also make up a larger share of the consumers basket in the emerging economies. It is a different story in the developed world where most measures of economic slack remain. So far this year, big cap international stocks have matched the performance of the S&P 500. We think you should under weight the international area at this time and you should emphasize big cap international over emerging market equities.

Natural Resources and Energy

Here we go again! Brent crude oil hit $120.00 while West Texas topped $100.00. Pay attention to the Brent price as 70% of all oil globally trades at that price. The West Texas price is lower because of an inventory surplus in the United States; refineries in Texas and Louisiana are unable to get Canadian oil because of pipeline constraints. Overall, the commodity super-cycle is now back in full swing. In markets as diverse as copper, sugar, tin, cotton, gold, palladium wheat and pork bellies, prices have now exceeded the peaks set in the bull market of 2006-2008. Many commodities are at 30 and 40 year highs. This year promises to be a volatile one for commodities, with hard evidence that the financial crises only temporarily unseated the super-cycle of prices going up. We continue to over weight this area.

Real Estate

We continue to under weight this area. The Great Recession delivered a body blow to real estate investment trusts (REITs). Solvency quickly became a crucial concern following the debt-financed merger activity and capacity binge in the years leading up to the credit crisis. Since then, REITs have bounced back sharply following the March 2009 trough. What has not rebounded alongside REIT share prices, however, are cash flows. Cash flow growth so far has been negative and is likely to be slow to recover. Thus the risk in this market cycle is that the market has already discounted a typical recovery in operating income even though this may prove to be a much slower recovery than normal.

Summary

The Fed is determined to inflate its way out of the current economic malaise by driving investors away from short term assets like money market funds, CDs and treasury bills and toward riskier assets like long bonds and equities. Lower rates lead to a weaker dollar, so it makes sense for investors to favor investments that benefit from dollar weakness: materials, industrials, technology, commodities, energy, gold and international equities.

Dave Clara Bill

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1 www.commerce.gov
2 www.ft.com
3 www.wsj.com
4 www.commerce.gov
5 www.imf.org

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