NOW'S A
GOOD TIME
TO GET SOME
GOOD ADVICE

THE JAGGED PERCH

The decline in global equity markets from their April highs was swift, brutal and ugly. The S&P 500 was down almost 20% over this period (13.8% in the 3rd quarter). Other indices fared far worse; the Dow Transports gave up 29% and small cap stocks declined 30%. The hardest hit sectors were: metals and mining -46%, finance -34%, energy -31%, materials -31% and industrials -27%. U.S. stocks were a safe haven compared to international stocks: the benchmark EAFE Index (Europe, Australia and Far East) fell -32%, the Europe ETF (Exchange Traded Fund) -33%, the Latin America ETF -32%, the Emerging Markets ETF -32% and the Far East ETF (less Japan) -31%.[1]

The sell off reflected a dismal period marked by anxiety about the U.S. Debt ceiling, the European sovereign-debt crisis, a U.S. economy on the brink of a recession, and signs that China and the global economy are slowing down. The bad news, spiked with periodic flashes of optimism, led to one of the most volatile periods for stocks EVER. Swings in the S&P of 2% or more in a single day occurred on

AVALON
CAPITAL
MANAGEMENT

average five times a year from 1950 to 1999. 2011 has seen 24 such swings and the year is not over![2] It was an awful quarter for all assets except cash and treasuries. Avalon accounts suffered less because they were in a defensive posture. A defensive position is still warranted. A cyclic bear market began in May and should last until the fall of 2012. The U.S. market is at an important juncture: the S&P 500 at 1100 could hold at this level and with some unexpected good news rally back to 1250-1275 (+ 15%) or it could fall below 1100 on its way to 1000 (-9%).

History provides hope for the fourth quarter; Q3 2011 was the weakest third[3] quarter since 1928. Typically, after such a horrendous quarter, the following quarter shows positive results. In addition, there is a good chance for a significant fourth quarter rally because sentiment became so bearish during the last four months that any good news concerning the European Crisis, the global economy or China will be taken positively by the market. For example, global markets recently rallied 2-3% because the leaders of Germany and France announced that a "comprehensive package" of measures to shore up euro-zone banking and government bonds would be ready by the end of October.

Massive Uncertainty and Portfolio Management

For the foreseeable future, volatility and uncertainty are here to stay. We will continue with the tactics we employed since 2007 to reduce portfolio risk and volatility:

1. Raising and /or holding cash for intermediate (four to six months) periods of time. Portfolios could hold from 25% to 80% in cash and bonds.
2. Over weighting income producing equities.
3. Buying inverse mutual funds and ETFs. These vehicles go up in value when the market declines.
4. Buying S&P put options to protect long positions.
5. Under weighting troubled sectors: industrials, finance, materials, energy and metals and mining.
6. Over weighting classic defensive sectors: utilities, health and consumer staples. We also favor, as a defensive play, selective technology stocks where valuations are attractive, cash levels are high and business is less cyclical.

Current Economy

United States Economy

The U.S. economy grew a meager 0.9%[4] annualized rate in the first half of this year. The economy is on a jagged perch between slow growth and contraction. Economic data from this summer re-accelerated double dip fears. More recent data about improved manufacturing output and capital goods spending increases indicates that we are not in a recession yet. We expect second half GDP growth will stay positive around 1%. However, negative growth is not far from 1% growth; a slowing world economy could push the domestic economy back into a recession in the first half of 2012. For all of 2012, we expect U.S. growth to be slightly negative and that the economy will be fragile for some time to come.

Our long term scenario has a U.S. economy that is in for sub-par growth for the next five years and probably longer. Growth will likely be an uneven 2% per year. Goldman Sachs recently published a superb research piece ***"From the 'Great Recession' to the 'Great Stagnation'"***. Goldman defines stagnation as: a long-lasting period of sub-par GDP growth that is not interrupted by either sharp contractions or a return to mean growth. Their data covered dozens of countries from the late 1800s. They identified 93 episodes of stagnation, 24% of which lasted more than 10 years. 60% of the episodes have occurred since WWII. These periods of stagnation were characterized by: lower and less volatile economic growth (averaging 0.5% per year), low inflation, rising and sticky unemployment, stagnant home prices and reduced stock returns (averaging around 5%). Goldman assigns a 40% probability, based on historical data, that the U.S. has entered a period of stagnation.[5]

World Economy

The world economy is also slowing. Hope has faded for a quick and effective policy response from Europe to deal with its sovereign debt crisis. Europe will be in a recession by the end of the year as the credit crunch intensifies. Greece gloom has been in the headlines for the last eighteen months and could still be in the headlines a year from now; and if it isn't Greece, it will be Italy, or Spain, or Portugal or Ireland. China and emerging growth economies are also slowing because their exports are being hurt by the slowing to contracting economies in the U.S. and Europe. We expect world growth in 2012 to be between 3.0% and 3.5%, down from 4.7% in 2010.[6]

Asset Allocation

United States Bonds and Stocks

A 10-year treasury bond now yields 1.8%, as it became a safe haven for funds during the recent market turbulence. As a result, the risk/reward is not favorable for treasures. We favor corporate and municipal bonds with maturities of five years or less over treasuries. International bonds face a tough headwind for U.S. investors because of a rising U.S. dollar. Emerging market currencies have collapsed 11.3% against the dollar since the first of August.[7] This is quite a headwind against any international fixed income return.

The U.S. stock market bear cycle started in May. It will likely last until the fourth quarter of 2012, or the first quarter of 2013. We have reduced overall market exposure for defensive purposes.

Portfolios are invested in those sectors that have done well in previous bear markets: utilities, health care, consumer staples, selective high technology stocks and high-yield energy stocks. We have a preference for large capitalization companies over small-cap names and prefer stocks that pay dividends. We continue to underweight metals and mining, materials, finance, industrials and transportation.

International Stocks

International equities have also gotten smashed; most indices are down north of 30%. Many of these markets are even more volatile than the U.S. market due to the severe losses in banking shares and because they have more companies in the cyclical areas of mining and metals, materials and industrials and relatively few companies in utilities, health care and consumer staples. Capital is also fleeing their currencies for the safety of the dollar, which compounds the equity losses. Since April, the dollar has appreciated against other major currencies by 9.8% and 11.3% against emerging market currencies.[8] We think the dollar could remain strong for at least another year. A weak global economy and a strong dollar leaves us underweight in international equities.

Natural Resources and Energy

We still believe in our secular theme that commodities, natural resources and energy will be the leading sectors for the next five to ten years, However, in a cyclical bear market this is not the place to be. Commodities, commodity-related equities, oil and energy stock losses have exceeded 30% over the last five months. Money poured in during the bull phase from March, 2009 until early this year as global growth accelerated and the dollar weakened. Now, with a strong dollar and slowing global growth, the reverse is happening; money is pouring out. We have put this strategy to one side until it appears that global GDP is beginning to grow again. We took some profits in gold. While gold remains a secular leader, in the 2008 cyclical bear market, even gold declined as the need for liquidity increased..

Real Estate

Historically, in cyclical bear markets, real estate equities underperformed as vacancies rose and rents declined. We think this will be true this cycle as well but believe that REITs are better positioned for a downturn this time versus three years ago. The leverage profile has improved as REITs raised over $50 billion of equity in 2009/2010 and reduced debt on average to roughly 7X from 9X in 2008. Valuation is also better this time. REITs currently trade at 13.5X earnings per share versus 20X in 2007.[9] Although we remain underweight in this asset class, we continue to favor companies with strong balance sheets and near-term growth outlooks.

Summary

Domestic and global economies are slowing. Depending on how much they slow, the U.S. could be in a recession by the first half of next year. Amidst the slow growth and abundant fear, global equities have started a new cyclical bear market that could last until the fall of 2012. This is a time to be cautious, emphasizing those areas that do well in bear markets: utilities, health care, consumer staples, selected high technology companies and high yielding energy stocks. We are currently under weight international stocks, natural resource and energy stocks and REITs. We like short-term corporate and municipal bonds, bond funds and ETFs.

Dave Clara Bill

Dave Rahn **Clara Basile** **Bill Oberman**

[1] www.Bloomberg.com
[2] www.AP.org
[3] www.barrons.com
[4] www.commerce.gov
[5] www.gs.com
[6] www.gs.com and Cass Research Associates
[7] www.bloomberg.com
[8] www.bloomberg.com
[9] www.gs.com

AVALON
CAPITAL
MANAGEMENT

Investment management and counseling
for individuals and families

avaloncapital.com
(650) 306-1500