NOW'S A GOOD TIME TO GET SOME GOOD ADVICE

SAME TIME LAST YEAR

We begin with a quick review of last year. In 2011, it was a seesaw between reflation to stimulate jobs and housing, and austerity, to scale back and reduce growing government debt. When the central banks of the world opted to print money and stimulate economies, the riskier assets benefited. We would call these "risk-on" assets. When debt reduction via austerity measures was the chosen path and central bank stimulus was withheld, then deflationary assets did better. We would call these "risk-off" assets. In the first half of 2011, reflation ruled and the best returns were found in risk-on investments: international, technology, consumer discretionary, industrial, materials and commodity stocks. In the second half of last year austerity was king and risk-off assets: cash, bonds, healthcare, utilities, consumer staples and high yield big cap stocks, did the best.

AVALON CAPITAL MANAGEMENT

2012 is shaping up to look a lot like 2011. Central banks started printing money last fall and into the first part of this year. The US central bank (Federal Reserve) rolled out "Operation Twist" (exchanging long term US debt for short term US debt) and announced its intention to keep rates at historical lows through 2014. The European Central Bank (ECB), through its LTRO (Long Term Refinancing Operation), lent 1.3 trillion euros to its member banks, swapping their short term debt for 3 year loans from the ECB (in Europe this is referred to as "cash for trash"). With all the stimulus, risk-on assets have done better so far this year. Meanwhile, as 2012 unfolds, none of the problems that still haunt the markets have been solved. In addition to which the US can add that the Bush tax cuts are set to expire at year end, as are the Obama payroll tax cuts and extended unemployment benefits, further burdening the US economy.

So near term, we would recommend only a modest overweight position in US stocks and high quality corporate bonds. In our longer view, given the fragility of the economic, financial and socio-political environment, we will not hesitate to move back to a neutral or underweight (risk-off) stance.

Deleveraging: Where are we now?

The economic meltdown of 2008 was a devastating reminder of the danger of too much mismanaged debt. Europe's sovereign debt crisis has compounded the economic trouble, even as it further proves the point. A recent McKinsey Global Institute research report suggests that the reduction of public sector debt - or deleveraging - has barely begun. In fact, since 2008, the debt ratio has GROWN in the world's 10 largest economies; this is especially true in France, Japan and Spain. A heavy debt burden erodes economic growth.

There is some hopeful news for private sector debt in the US. US household debt has fallen $600 billion (4%) since the end of 2008.[1] If history serves, US households may be halfway through the deleveraging process. At this rate it would take another 2 to 4 years to finish the job.

The primary cause of public sector deficits after a banking crisis is twin fold: declining tax revenues are coupled with an increase in government expenditures, in the form of stimulus and automatic stabilizer payments like unemployment benefits. Significant public sector deleveraging typically occurs when GDP growth rebounds, later in the cycle. Hence, we do not expect federal debt to decline in a meaningful way for another 2 to 4 years. The debt burden will keep US GDP low, but if there is slow growth without inflation, US investors can be rewarded. Goldman Sachs recently said "given current valuations, we think it is time to say the 'long good bye' to bonds, and embrace the 'long good buy' for equities, as they expect them to embark on an upward trend over the next few years."[2] Longer term, as the debt is worked off and interest rates stay low, a slow growth environment could produce positive returns.

Current Economy

United States Economy

The US economy continues to show improvement, with private - sector payroll growth, increasing retail sales and an upward revision to income gains. The quickening pace of job creation could also reflect a pickup in capital spending. Some of the improving numbers are due to an unusually warm winter, which has probably stolen some activity from the second quarter. The International Monetary Fund (IMF) is projecting 1.6% growth for the US for 2012 - we think it could be closer to 2%. To put this in perspective, over the last ten years, the economy has grown at an average rate of 1.7% per year.[3]

World Economy

The IMF lowered its 2012 global growth to 3.3% from its prior forecast of 3.9%. (The world grew at 3.8% in 2011.) They also warned that the European debt crisis threatened to derail the world economy. They project the euro area to **shrink** 0.5% to 1.0%, developed countries to grow at 1.2% and developing economies at 5.4%. China's estimated expansion was cut to 8.2% from 9.0%.[4]

Currently the markets are taking one of many breathers from the European debt crisis. Greece defaulted on 100 billion euros even as it agreed to add an additional 30 billion euros in debt. The Greek debt holders, who have already taken a 50% haircut, now hold new debt, trading at a 70% discount in the market![5] Goldman Sachs estimates that Greece will need at least another 20 billion euros in the next six months.[6] The next Greek tragedy may be Spain. Spanish authorities have chosen to defy European leaders by setting their budget deficit at 5% of GDP in 2012, 30% higher than the target all countries agreed to in Brussels earlier this year. With high unemployment and devastating austerity measures, Spain could be the country to take Greece's spot on the front pages this summer.

Asset Allocation

United States Bonds and Stocks

Long term treasury bonds are down 11.5% since their highs last October.[7] We think these yields will continue to move higher in the near term as bond investors exchange this safe haven for riskier assets and "Operation Twist" comes to an end at the end of June. Treasuries will begin to get really interesting if they fall another 3% to 5%. For the time being, they should be underweighted. Municipal bond yields are also starting to rise as more municipalities are heading for bankruptcy. High quality municipals, with maturities of less than five years, are still safe, as well as the Build America Bonds (BABs). We favor high yield and investment grade corporate bonds with less than five years maturities. International bonds face a tough headwind for US investors because of a strong US dollar.

US stocks have had an unexpectedly good year so far. The risk-on sectors, information technology, consumer discretionary, industrial, and biotech stocks, have been the leaders, joined for the first time by financials. Financials have given a long term buy signal and should be accumulated. Material and commodity stocks have lagged in this rally because of a slowing China. Last year, stocks topped in April as the good news began to fade. It will probably happen again this year but we will wait for market action to tell us to lighten up. Downside risks continue to include: the European debt crisis, a bigger than expected slowdown in China, escalating Middle East tensions, a potential surge in oil prices, the November elections and a slowdown in US economic activity.

International Stocks

International stocks have underperformed the US market for the last 2 years. Much of the underperformance can be attributed to capital shifting into the US market. The US market was a safe haven amidst the turmoil in Europe and a slowing China. Europe is in a recession and struggling with its debt problems. The latest Chinese economic data suggests that the two reserve requirement cuts have not boosted money supply or credit growth. Money and credit lead an economy by several months so the odds of a near term reacceleration in Chinese economic growth are low. In addition, Chinese industrial output between December 2011 and February 2012 registered its weakest rate of expansion in the last 10 years.[8] Finally, as Chinese imports decelerate further, countries that sell industrial metals and capital goods to China will feel the pinch. We are presently neutral on international stocks.

Natural Resources

We still favor our secular theme that says natural resources: energy, gold and commodities will continue to be one of the leading asset classes for the next 5 to 10 years. This area has underperformed the market this year, and we have been neutral, on fears about China's slowing growth. The IMF is projecting China's growth at 8.2% for 2012 - we think it will be 7.5% or lower. Recently, China raised fuel prices for the second time in six months in an attempt to dampen consumer demand. BHP Billiton, the world's largest mining company said it saw a "flattening" iron-ore demand from China - "The big infrastructure build has come to an end" said Ian Ashby, president of iron ore operations. Finally, China's vehicle sales may increase 5% this year, revised down from 8%.[9]

While metals and mining stocks are down for the year, oil, oil stocks and gold are up for the year. Demand for oil continues to grow and the global oil market is tight as long as the world stays out of recession. We also think oil is a good hedge against Middle East tensions and potential Israel-Iran conflict. While we are negative, for the time being, on metals and mining stocks, we are positive on oil and oil stocks, particularly the large integrated oil companies with a good dividend yield. Despite the volatile gold prices we have seen lately, gold will continue to remain a vital cornerstone in portfolios during these highly uncertain times. As economic growth stays weak and sovereign debt remains unsustainable, many countries are diversifying out of dollars and into gold as a more stable reserve holding.

Real Estate

Although we remain underweight in this asset class, we continue to favor companies with strong balance sheets and near-term growth outlooks. Over the last eighteen months, REITs overall have suffered a 12% contraction in cash flow.[10] Occupancy rates have moved modestly higher, but gains are mainly concentrated in apartment REITs. Meanwhile, there is considerable excess capacity in nonresidential REITs and the steady climb in delinquency rates across all categories - during an economic recovery, no less - reinforces that tenants are not in a position to accept higher rents.

Summary

While the domestic economy is firming, overall global growth continues to slow down. All equity markets have rallied on: US economic news being better than expected, massive liquidity generated by central banks and relief that the European Sovereign Debt Crisis has been put off until another day. We favor those areas that are participating in the current risk on trade: information technology, consumer discretionary, industrial, biotech stocks and for the first time, in five years, financials. We are underweight cash and REITs, neutral on international and natural resources and overweight US stocks and fixed income (except treasuries).

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1 www.mckinsey.com/Insights/MGI/Research
2 https://360.gs.com
3 www.imf.org
4 www.imf.org
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