NOW'S A
GOOD TIME
TO GET SOME
GOOD ADVICE

ASSET INFLATION– ECONOMIC DEFLATION

On a relative basis, the first quarter was hard on global balanced managers as all assets underperformed the "safe haven" U.S. stock market. Investment grade bonds were off for the quarter as 20 year Treasuries sank 3.0%. Global balanced funds were up 4.1% for the quarter. Most of our portfolios did less well because of our position in Apple (which offset our otherwise positive technology performance) and our tarnished gold position.

World assets continue to decline in price except in the Japanese and U.S. stock markets. In the U.S., the only sectors continuing to hit new highs (and propelling the indices to new highs) are

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defensive: REITs, consumer discretionary and staples, retail, utilities, health and biotech. When the leadership gets this narrow on a worldwide basis, the next significant move is usually to the downside. Given the vicious price declines in commodities this year, we think global growth, (despite monetary reflation), will continue to slow down and we are concerned about deflation near term. Portfolios are currently positioned defensively but we may raise more cash or buy puts and ETF hedges if things get worse.

Asset Inflation – Economic Deflation

Global monetary expansion has been unprecedented. $10.6 trillion has been added to central banks' balance sheets, up from $5.4 trillion in 2007[1]. This is an experiment by central bankers with potential unintended consequences. From a cyclical perspective, monetary expansion has yet to yield much traction in the real economy, so we should expect central bankers to keep pumping money into the system. Recently, for example, the Bank of Japan announced that they intend to DOUBLE their money supply over the next TWO YEARS!

One objective of central bank monetary expansion is asset inflation which results in bank and individual balance sheet repairs. Here central banks have been far more successful; helping their banking friends relative to savers, and financial assets have seen a huge valuation increase since the 2009 low. The S&P 500, junk bonds, and gold have doubled from their lows. Collectables, such as art and antique cars are hitting new highs. Home prices have begun to recover and in some high-end areas are above 2006 levels. Local real estate prices in the San Francisco Bay Area suggest the euphoria of 2006-2007 is back in town.

On the other hand, commodities, which are usually sensitive to economic conditions, have seen substantial price declines in the last six months, suggesting demand for industrial commodities is waning and perhaps warning of economic deflation over the near term. The Dow Jones Commodity Index is down 15% from last fall and down 28% from its high two years ago. What concerns us most is the continuing weakness in global economic growth despite an unprecedented level of monetary stimulus. What happens if they stop the money machine? If and when they do there will likely be many unintended consequences but there are some consequences we can expect: the likelihood of higher price inflation; a series of mini bubbles; lots more volatility in asset prices and probably a low growth world for years to come. Jeremy Grantham of GMO, whose firm has done an excellent job at forecasting GDP and asset returns over long periods of time, is projecting the US to grow at 1.5% per year over the next 10 years. Grantham sees negative real returns for a conventional 60% equity, 40% bond portfolio over this period.[2] Near term capital preservation should be a top priority for all investors.

Current Economy

United States Economy

Measures of US economic activity continue to weaken. In addition to poor employment numbers, retail sales fell in March by the greatest margin in nine months as wholesale prices fell more than expected. NAHB's Housing Market Index declined for a 3rd straight month. We believe investors were lulled into complacency about the economy by the positive numbers early in the year. The dire economic warnings issued by the White House before the "sequester" – social security checks would be delayed, airport security checks would be clogged and other federal facilities closed – seem overblown. But there is a lag in the implementation of the cuts and many of the effects are local, decentralized and not recognized as part of the fallout. Many people whose jobs are affected are being "furloughed" rather than fired. Furlough means working shorter weeks and taking pay cuts. Furloughs do not show up in the unemployment statistics. Keep in mind that the sequestration is just starting; we are expecting growth of around 1% for 2013 as government cutbacks, higher taxes, and rising healthcare costs impact domestic consumer and business spending, and a slumping global economy continues to depress merchandise exports.

World Economy

The world economy also continues to slow down. Last fall investors hoped that China was going to turn things around; start to grow again and help stabilize global growth. Data had started to improve, but recent, slower China growth may signal that economic miracles in China are coming to an end. A cleanup is now under way, after an economic party of epic proportions that lifted incomes but left behind debt, corruption and a mess of the environment. After three decades of annual economic growth averaging 10%, it looks like the new range is 6-7%. While we would love to have that rate of growth in the US, it is slow for the world's second largest economy and has a dramatic impact on demand for industrial commodities and on world growth in general. A sustained shift to lower-growth would impact everything from iron-ore demand in Australia to the fortunes of companies like General Motors, who counts heavily on Chine to drive profits. It also increases challenges for policy makers contending with Europe's debt turmoil and Japan's monetary easing. All world economies are slowing, Europe is already in a recession, and we expect global growth to be around 2% in 2013.

Asset Allocation

United States Bonds and Stocks

Bonds were flat to down in the first quarter. We believe it is time to put money back in this area. As the economy slows and equity volatility increases, bonds will do well and we recommend an overweight position. We like Treasuries and favor mortgages, municipals and investment grade corporate bonds with intermediate maturities.

The US market was the safe haven for money worldwide in the first quarter and major indices hit new highs. While cyclically sensitive sectors such as industrials, technology, materials and mining did little during the quarter, money piled into defensive sectors: utilities, health care, biotech, finance and consumer staples. Indices are hitting new highs, as if uncoupled from economic and earnings fundamentals. The Federal Reserve's sea of liquidity is buoying the markets; but for how long? The fundamentals of the 30 Dow Industrial stocks, for example, are tepid, at best. Revenue growth for the most recent quarter was up 1.7%; earnings grew at 1%. The situation isn't much better looking at the broader S&P 500. For Q1 this year, analysts are looking at a revenue increase of 1% and earnings increase of 4%[3]. A market that is propelled by a few sectors is vulnerable to unexpected bad news. Our portfolios are underweight and favor defensive sectors.

International Stocks

Last fall we thought it was time to overweight international stocks since they had underperformed US markets by 30% over the prior two years. They had also underperformed the US market over the last ten years. For a while, we were right. Europe, China and the Far East came back strongly in the 4th quarter and then they hit a brick wall. World economic fundamentals started to deteriorate again and so did foreign markets. Other than Japan (where monetary expansion has just accelerated), and a few European stock markets, most international markets are now down for the year. Emerging markets are down 7.8% and China is down 12%. The big cap EAFE (European, Australia and Far East) Index (which has a hefty weighting in Japan) is up 5.5%, significantly trailing the US. We recommend a neutral position for international stocks.

Natural Resources and Energy

We are neutral natural resources and energy. All commodities and commodity related stocks have crashed this year. Many commodities are hitting new 2 year lows which may signal stagnant world growth. The SPDR Metals and Mining ETF is down 20.8% YTD.

Gold collapsed some $200 in two days. It broke a key support area which set off a wave of margin calls and stop loss sell orders. Selling picked up following an announcement that the financially stressed nation of Cyprus would sell gold (and would other European nations be forced to do the same?), a recommendation by Goldman Sachs to short the metal and signs that Federal Reserve members were considering easing up on their support for financial markets, which would raise interest rates. Over the near term gold should embark on a partial recovery, then settle back, and go lower temporarily. We would add to positions under $1300, but recognize that it will take many months of base building to repair the recent damage. We have long stated that the most important reason for holding gold is for insurance purposes against a devaluing dollar.

The ongoing trend toward monetary expansion and eroding central bank independence will continue to keep gold attractive for investors seeking a proven hedge against inflation.

Real Estate

We remain underweight in REITs. While the Fed's open ended commitment to purchase mortgage-related securities and keep short rates low for another 3 years is beneficial to real estate, we think valuations are still too high. They have been performing well recently, as they are perceived as a defensive sector in the market.

Summary

The world's economies continue to slow despite the unprecedented liquidity provided by the world's central bankers. Currently, the only markets doing well are Japan and the US. Such narrow leadership eventually falls away as the winners are finally sold off. Our portfolios are currently defensive; we are overweight cash and bonds, neutral international stocks and natural resources and energy, and underweight REITs and the US market. In the US we favor defensive sectors such as health care, biotech, utilities and consumer discretionary and staples. We favor big cap over small cap.

Dave

Clara

Bill

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

[1] Roger Cass Research and Associates
[2] www.GMO.com
[3] www.wsj.com

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avaloncapital.com
(650) 306-1500