NOW'S A GOOD TIME TO GET SOME GOOD ADVICE

SUMMER MUSINGS

As summer comes to a close here is our latest thinking culled from lots of summer reading and a host of market indicators.

Since 2010 all asset classes have underperformed relative to the U.S stock market as the Federal Reserve inflated asset prices using a zero interest rate policy and their purchases of Treasury debt and mortgage bonds. Looking back it is clear that each time the Fed slowed the stimulus, ceased the stimulus or suggested there might be less stimulus, the U.S. stock market had a severe correction. This happened in April 2010, May 2011 and September2012. After each of these corrections, the Fed began another round of Quantitative Easing (QE) and the U.S. stock market rebounded to a new high. Most recently the Fed signaled that they wanted to reduce the stimulus by tapering (but not ceasing) their asset purchases over time. This time instead of an equity correction, the consequence was the biggest bond selloff since 1994. We expect, at some point, this tapering will weaken the U.S. stock market tape as well. Concerns about the ballooning balance sheet at the Fed make it unlikely the Fed will come to the market's rescue again, at least not with asset purchases. Recent Fed articles have proven that while debt purchases were successful in increasing asset prices, particularly houses and stocks, they **increased real GDP by only 0.04% for each QE.**[1]

AVALON CAPITAL MANAGEMENT

Asset Inflation – Economic Deflation

The underperformance of other asset classes to U.S. stocks began to shift in the third quarter. These other asset classes, namely international developed stocks and natural resources, have begun to outperform the U.S. stock market, in part because U.S. stocks are overpriced compared to their valuations. That said, many of these asset classes, on an absolute basis, are also overpriced (once again due to central bank excess liquidity); so while we are moving some money into these other asset classes, it is too early to be overly aggressive. Portfolios should seek below average risk. We do not think it is time to increase risk and reach for return but to reduce risk and wait for return. At a time when expected returns are low and risk is high, the best we can do is to be cautious over the coming months; capital preservation is our priority at this time.

WHAT DOES THIS MEAN FOR YOUR PORTFOLIO?

Overweight	Neutral	Underweight
· Cash	* Bonds	U.S. Stocks
· Gold		REITs
· Natural Resources		
· International Equities		

United States Stocks

The U.S. market has come a long way since 2009. This cyclical bull is 230 weeks long through the high of the week of August 2, 2013, making it the **third longest since 1932**! The price gains of stocks in the S&P 500 Index are outrunning profits by the fastest rate **since the final years of the 1990's technical bubble**. Margin debt is at the same levels as pre-crash in 2000 and pre-crash 2007.[2] We believe the June lows will be tested offering buying opportunities ahead. Many headwinds face the market: federal debt discussions in the Fall, a new Federal Reserve Chairman, the extent of Fed tapering, flat earnings, September's historically negative returns, geopolitical turmoil in the Middle East and potential currency collapses in many emerging markets. Positive factors are an accommodative Fed and an economy that is slowly growing.

The U.S. consumer seems to be running out of steam: interest rates have increased, new home sales are decreasing, retail sales are tepid, real wages are flat and most new employment is part-time. The spike in interest rates has caused sectors depending on the consumer to become relatively weak: retail, consumer discretionary, consumer staples, utilities and finance. Capital should be shifted to technology, industrials, biotech, health care and materials.

Fixed Income

Bond prices have plunged since May. **Treasuries are on course for their worst year since 1978; investment-grade corporate bonds since 1973 and municipals since 1994**. We think the selloff is overdone. Bullish bond sentiment is at the lowest in decades which presents an opportunity for a counter trend rally and a short-term opportunity. (This could also be helped by a flight to safety if the stock market continues to weaken.) We favor long-term treasuries and corporates. But it is a trade only – for long term investors, who do not want to trade the counter trend, the bond market has started a secular (multi-cycle) decline and only short maturities should be held.

International Equitities

The European stock markets have started to attract capital again as the Eurozone appears to be stabilizing. Given that Europe is at 40 year lows compared to the U.S. market, it is finally starting to outperform the U.S. market. China also seems to be stabilizing growth around 7.5% and Japan is pulling out all of the stops to grow again. The fly in the ointment is emerging markets and it is too early and dangerous to invest at this time. The consistent growth disappointments and deteriorating return on capital have been responsible for the exodus of capital from these markets. Emerging markets are paying the price for no structural reform, poor efficiency and lackluster productivity gains, all of which produce a lower growth rate. In addition to which emerging currencies are plunging. Led by the Indian rupee, which is down 30% since 2011, the currencies of Turkey, Chile, South Africa, Indonesia, Brazil, Thailand and Hungary have all weakened. Once again, much turns on what the Fed does; the 1994-95 Mexican crises, the 1997 Thai baht fallout and the crises in Brazil, Argentina and Turkey between 1998 and 2002 were all influenced by U.S monetary policy.[3] Will the currency turmoil cause contagion in the U.S. market? We doubt it, but it does bolster the case for exercising additional short-term caution for the U.S. market.

Natural Resources and Gold

Commodities and commodity stocks have started to outperform the U.S. market as the economies of China and Europe stabilize. With the Chinese economy now half the size of the U.S., a growth rate of 7.5% is equivalent to the U.S. growing at a rate of 4%. Energy stocks appear attractive again given their nice dividend yield and continued turmoil in the Middle East. We think gold has bottomed and should be accumulated. The rout in gold that wiped out $56 billion of value earlier this year is spurring consumer demand in China and India, the biggest buyers. Demand in China doubled from a year ago. Central banks continue to buy and users/producers have recently been massively increasing long exposure. Inflation usually lags monetary policy by two to four years so we do expect a significant rise in inflation in the future. Gold producers are now trading at the lowest price to book value of all industry groups.

Real Estate

REITs crashed some 19.2% over the last three months. They retreated with all interest sensitive stocks and we think it has been overdone. Their yields are up nicely from three months ago and they have a healthy discount from Net Asset Value. The supply of new construction (effectively new competition) has been below average across multiple property levels and is expected to remain at lower levels for the next few years. While we would not overweight REITs, we think they are due for a nice counter trend rally.

Summary

It is time to move money into other asset classes as they are beginning to outperform the U.S. market. However, this is not the time to be overly aggressive – portfolios should assume below average risk. You should overweight cash, gold, natural resources and international equities; underweight U.S. stocks, REITs and bonds.

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[1] www.frbsf.org
[2] www.ndr.com
[3] www.bcaresearch.com

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