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# 2005 Q&A

January 14, 2005

*As at the beginning of 2004, Dave, Clara and Bill gathered to recapitulate the year passed and sketch some scenarios about the future. The highlights of that discussion, presented in a Q&A format, follow.*

**Q:** Last year Avalon had some concerns but felt the economy and financial markets would do pretty well in 2004. You thought that the price of oil could exceed \$40 per barrel, the U.S. dollar would continue to decline and election uncertainty would cause some market volatility. However, you said that these concerns should be more than offset by strong economic momentum, rising corporate profits and an accommodative Federal Reserve. How did it all turn out?

**A:** Pretty much as we laid it out. All of our concerns hit the headlines in 2004: oil hit \$55.00, the dollar continued to slide and election uncertainties abounded. Among others, these factors slowed the economy in the second quarter and stopped the equity markets from advancing during the year until just before the election. The economy strengthened in the second half and real GDP (Gross Domestic Product) should end the year up 4.5% in 2004.<sup>1</sup> Financial markets did well last year. All of our asset classes achieved positive returns for the year, with most of the returns occurring in the fourth quarter.

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**Q:** How positive were the asset class returns and how well did you do in emphasizing the better performers?

**A:** Here are the relevant benchmark returns:<sup>2</sup>

Cash (Treasury Bills)	1.2
Bonds (Lehman Intermediate Government)	2.3
Dow Jones Industrial Average	5.3
S&P 500 Index	10.9
E.A.F.E. Index in U.S. \$	18.2
Thomson Energy Funds	27.4
NAREIT (Real Estate Investment Trusts)	31.5

Note: Figures represent unmanaged index returns, which include the reinvestment of dividends and other income, but do not include the deduction of management and other fees. The returns do not represent the actual performance or the performance of Avalon Capital Management; actual client returns may have been significantly different during the period shown.

Our best overall calls were over weighting equities versus bonds. We under weighted cash, bonds and REITS. With the exception of REITS, where our call was dead wrong, we emphasized equities in the United States, internationally and in the natural resource area. We also expected long bond yields to rise during the year, but they finished about where they started in 2004. Still we did take advantage of a couple of fixed income price swings, thereby enhancing our returns.

**Q:** What are your concerns and general outlook for 2005?

**A:** Our main concern is that the Federal Reserve will continue to raise rates, perhaps tighten too much, and choke off the current recovery. The Fed minutes from December 14, 2004 concluded that interest rates are still too low to keep inflation stable. Moreover, the Fed indicated that they are increasingly more concerned about rising rates of inflation than the strength of the economic recovery. "A weaker dollar, higher energy prices, diminishing competition in some industries and a possible slowdown in worker output per hour were among the forces that may drive prices higher," the minutes said. Most members felt that the economic expansion was firmly entrenched, resilient and showing few imbalances.<sup>3</sup> Recently, St. Louis Fed President William Poole said that "we will eventually remove the measured pace language that has signaled gradual quarter-point rate hikes". Other Fed comments have also signaled a more hawkish tone.<sup>4</sup>

Our second concern is that economic growth may slow in 2005. Rising interest rates, no new tax cuts and the lagging effects of higher energy bills will combine to slow growth this year. The economy is forecast to grow 3.0% to 3.5% in 2005,<sup>5</sup> but at a decelerating rate during the year. While still a good growth rate, it could raise concerns about a weakening trend that may extend into 2006.

Our third concern is that corporate profit growth is also slowing down. Profits were up around 20% in 2004. Forecasters expect earnings growth for 2005 to range from 5% to 8%. Corporate profit margins will certainly be squeezed from increasing costs, including energy and labor. In 2004 U.S. corporate profits represented 7.6% of nominal GDP, the highest percentage since the end of World War II. As the economy slows it is unlikely profits as a percentage of GDP are going higher; therefore, it seems reasonable to expect them to grow in line with nominal GDP, which may be around 6%.<sup>6</sup>

**Q:** Since the Fed seems to be a key driver, how high do you think short-term rates could go this year?

**A:** Good question. There are a couple of approaches to answer this question.

Pimco Advisors well-respected bond manager Bill Gross observes that real short rates (current interest rates minus the inflation rate) drive the Fed's decisions. When the Fed is concerned about inflation, they raise the Federal

funds rate to achieve a real short rate of 0.5% to 1.0% (or more).<sup>7</sup> We think that the core CPI (Consumer Price Index) rate could rise to 3.1% this year.<sup>8</sup> If so, then the Fed Funds rate, which is currently 2.25%, is headed to between 3.6% and 4.1% by year-end. Where the Fed stops depends on the future of U.S. inflation, in this analysis.

The Bank Credit Analyst takes a different approach. They observe that when the Fed funds rate rests below two-year Treasury yields, the Fed is in a tightening mood. The central bank will only stop raising rates when two-year T-note yields drop below the Fed funds rate. Judging by this rule, the Fed is unlikely to pause anytime soon.<sup>9</sup> Current two-year T-notes are yielding 3.2% and rising. This approach puts the Federal funds rate in the 3.5% to 4.0% range by year end.

Either way, the Fed will only find the equilibrium rate of interest, the rate that allows growth with little inflation rate-of-change, by observing financial market moves. The ever present risk is the Fed over-tightening until interest rates reach a “choking point” when equity prices weaken significantly. An inexact science, a rising interest rate environment eventually produces an equity bear market.<sup>10</sup> No one knows how close current interest rates are to that “choking point”; therein lies the danger.

**Q: Given your concerns, what is your investment strategy going forward?**

**A:** All asset classes have been up for two years in a row. Currently there are no undervalued asset classes. Now the downside risk to your portfolio looms larger than the diminishing upside potential. Thus our strategy will be quite different from that of the past two years.

This year we expect to over weight cash and short-term bonds and under weight all other asset classes. Since we have made a secular case (a trend lasting more than one economic cycle) for natural resources and international stocks we will tend to stay around our benchmark to slightly over weight for those areas.

Short-term bonds are defined as maturities of less than five years, on average. We will trade out of most of our high yield corporate positions, higher quality corporate issues, and move back into treasuries over time.

Though the current economy is doing fine, we are concerned about U.S. equities. There are few attractive sectors left in the market, leaving little upside potential. Investors have become complacent. Mutual fund cash positions as a percentage of assets are at exceptionally low levels. The net-long exposure of hedge funds has risen to levels corresponding to other market peaks. A recent poll of stock-market advisors showed 62% bulls and 21% bears, the highest bullish number seen since 1987.<sup>11</sup> Since 1932, using the four year presidential cycle (2005 being year one), the first two years of those political cycles have produced down markets 67% of the time in real terms.<sup>12</sup> The median duration of a bull market since the start of the 20th century has been about 27 months.<sup>13</sup> This current bull is at 27 months and counting. Finally, the January barometer is also troubling. Since 1897, if the Dow loses value in the first five sessions of the year, then 50% of the time it falls for the entire year. 2005 opened down four of the first five days. Although past results cannot predict future results, for all of the above reasons we are under weighting U.S. equities.

Though we are reducing exposure to benchmark weightings in the international area, we still like Japan, the Far East and Emerging Markets. The secular story for natural resources is still compelling and warrants a benchmark weighting. Although under weighting REITS, we will emphasize the residential and office sectors.

**Q: This is quite an asset allocation change for you from the last two years. Are there any implications from a portfolio management perspective?**

**A:** We think the main one is over weighting cash and then using it only if attractive opportunities arise. For example, the market may give up enough ground in the first half of this year to justify some additional investment. The second is to pay attention to entry points in our secular themes of international and natural resource stocks. Since we believe these areas will produce the big winners for this decade we want to be sure

and use price weakness as a buying opportunity. The third is more psychological - to work at being comfortable with a large cash position, using patience to wait for the right time to buy.

**Q:** I think that covers it for now. You will let us know if you are making any big changes.

**A:** As always.

Past performance is no guarantee of future results. A risk of loss is involved with investing in financial markets. Other than the footnotes below, the research underlying this piece represents Avalon Capital Management's proprietary research activities.

Footnotes:

- 1,8 Cass Research Associates, Inc.
- 2 The Lehman Intermediate Government Index is a total return index consisting of investment grade corporate debt issuers as well as U.S. government securities. The debt issuers all maintain maturities within a range of one to ten years. Thomson Financial is a well known tracker of mutual fund information and NAREIT is the National Association of Real Estate Investment Trusts Index.
- 3 FederalReserve.com
- 4 Investors.com
- 5 NABE.com
- 6 Barrons.com
- 7 PimcoAdvisors.com
- 9,10 BCA.com
- 11,12 Barrons.com
- 13,14 WSJ.com

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