NOW'S A GOOD TIME TO GET SOME GOOD ADVICE

Maintaining perspective

Economic and Investment Outlook

We revisited the Q&A piece that we sent you in January. Were we to write it again today, we would make very few changes and they would not significantly alter our conclusions.

Despite the day-to-day volatility in the equity markets, prices are at about the same level today as they were in January. War news has been the major driver of price changes for much of this year. For now, the intensive military part of the war seems to be culminating and mercifully the most feared scenarios have not unfolded. The lack of confidence that has held back both investment and economic activity may now begin to turn, allowing the positive changes that were just becoming evident in the final months of 2002 to hopefully reemerge.

While economic news has been weaker than we expected, we continue to view the slowdown as temporary. Should the weakness persist the Federal Reserve will likely take swift action to counteract the contraction. Additionally, central banks around the world are also poised to provide liquidity. According to the April 2003 Bank Credit Analyst, there is a "mountain" of cash sitting on the sidelines, representing nearly 50% of the value of the Wilshire 5000 index. That is an enormous amount of liquidity available for stocks and other assets that investors have perceived as "risky" in the post-bubble world. As confidence

(continued on next page)

returns, this $5 trillion, now yielding less that 1 percent, will almost certainly be invested in assets with greater potential for return. The underlying fundamentals of low inflation, low interest rates, high liquidity and plenty of capacity remain in place.

Near term, the biggest concern will be how first quarter earnings come through and how companies spin their forecasts of the 2nd quarter. So far, although the reported earnings are in line or slightly below recently reduced expectations, most stock prices have reacted positively to the announcements. In general, investors apparently are beginning to shift their focus away from the war and other global concerns to anticipating better results in the 3rd and 4th quarters.

4-year Cycle Scorecard

The running tally on the 4-year cycle bottom shows that, six months out from the S&P500 October 2002 low, the market has advanced 13.5% (price only). Historically, our research shows that this falls short of the average gain over the last forty years of 23.4% six months from a market low. The good news is that the market is improving in spite of unsettled economic and psychological times.

One year out from the same October low, our historical analysis shows that on average the market advanced 32.8%. From current levels the S&P500 would need to advance 16.9% by October 2003 to achieve a 32.8% return. Our market models have turned quite bullish; so, we are comfortable assigning a high probability to the October target being approached, although obviously no one can project what the market will do with any certainty. Historical market gains are not necessarily indicative of future gains. There is always a significant risk of loss when investing in the markets, especially during volatile economic times.

Asset Allocation

Our asset allocation has changed only slightly since January. We have been investing the cash we had previously recommended holding because of the war. In addition to under-weighting cash, we are also underweight-weighting treasuries and REITS versus your benchmarks.

In keeping with our projected recovery scenario, we still prefer corporate bonds to treasuries. Over the last six months, the continued narrowing of spreads, which remain very high by historical standards, continues to support our view that bond investors appear to believe balance sheets are improving and companies are getting healthier.

We are over-weighting U.S. and International Equities and holding a neutral allocation in the Resource area. Despite reasonable valuations for energy shares and with much of the war premium now coming out of oil and gold commodity prices, these energy shares may tread water for a while. From a macro economic perspective, the decline in oil prices should be a stimulative dividend for consumers, corporations, investors and the economy.

Internationally, we continue to emphasize the Far East and Emerging Markets. We are just beginning to add to Latin American holdings. Last year's currency weakness is becoming this year's improved competitiveness. This should help profits at a time when valuations are attractive.

AVALON
CAPITAL
MANAGEMENT

Clara Basile, Bill Oberman, Dave Rahn
Investment management and counseling
for individuals and families

(650) 306-1500