NOW'S A GOOD TIME TO GET SOME GOOD ADVICE

Buckle Up

Buckle Up for a Bumpy Ride

The first seven trading days in January the Dow was up 2.9% (the index was flat for all of 2005) and the NASDAQ was up 3.8%. Over the next seven days the Dow was down 3.1% and the NASDAQ fell 4.0%. U. S. stocks suffered their biggest one day loss since March 2003 on Friday, January 20, 2006. The Dow Jones Industrial Average was down 213.32 points or almost 2%; The NASDAQ fell 54.11 points or 2.35%.[1] We expect 2006 to be a very volatile year for equity markets. Investors should buckle up for a bumpy ride by making sure they are comfortable with their equity allocation if they plan to ride out the bumps in the road to come.

Greenspan Out, Bernanke In

Ben Bernanke is now Chairman of the Federal Reserve. He arrives with plenty of storm clouds on the horizon: an inflated housing market, geopolitical pressures in places like Iraq, Iran, Nigeria and Venezuela that could cause oil prices to spike, a ballooning federal deficit and record U.S. trade imbalances. Bernanke has declared that his first priority is to maintain the continuity of Greenspan's policies. Kevin Hassett, director of economic policy at the American Enterprise Institute believes

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"Bernanke is going to arrive without Greenspan's reputation and therefore be very tough at the beginning - give tough speeches, increase interest rates and show he's a credible central banker".[2] If Hassett is correct, the Fed Funds rate would be increased from the current 4.5% to 5% or more. On the other hand rates have been rising since the summer of 2004. It takes 12 to 18 months after a rate increase for it to become effective; to affect the housing market, mortgage equitization, and corporate investment cycles. Bernanke knows about this lag effect as do the other Fed members but they may be willing to risk an interest rate overshoot and a yield curve inversion (short rates higher than long rates) in order to ensure benign inflation and enough economic slack for a stable economy.

Current Economy

United States Economy

The U.S. economy continues to slow. GDP fell from 4.2% in 2004 to an estimated 3.5% in 2005.[3] The consensus estimate for GDP growth in 2006 is around 3%.[4] Macroeconomic Advisors is forecasting first quarter growth around 4.5%, due to ramped-up spending in the Gulf region. Then the economy will resume its deceleration through the rest of the year as increased interest rates begin to bite.[5]

Consumer spending rose 1.1% in the fourth quarter, the smallest gain since the second quarter of 2001.[6] This suggests that the consumer may be finally running out of steam. This is important because consumer spending and residential investment account for 75% of GDP, so any retrenchment in these areas will slow overall growth. The surge in housing prices over the past three years accounted for 40% of the expansion in household spending via home equity cash-outs. The National Association of Realtors reported that sales of previously owned houses dropped by 5.7% in December compared to November. It marked the third consecutive monthly decline, something that has not occurred in more than three years. Inventories of new homes stand at the highest level in nine years.[7] David Rosenberg, an economist at Merrill Lynch, thinks that stagnant home prices could shave a full percentage point off consumer spending growth in the current year. A significant decline in housing prices could shave off as much as two or three percentage points.[8]

World Economy

The world economy could actually do better in 2006 than 2005 thanks to the long-awaited revival of growth in Japan and Europe joining the robust growth of the Far East, China, and Emerging Countries. For 2006, Japanese GDP should grow about 3% and Europe about 2%. The Far East may show 6.5% growth, China around 9.5% and Emerging Countries near 8%.[9]

Investment Outlook - United States Equities

We expect 2006 will be a tough investment environment for U.S. equities. Uncertainty surrounding the Fed's rate hikes, potential problems in the Middle East, elevated energy prices and potential earnings disappointments cause us to underweight the U.S. Market. In our October 2002 piece: Why a Rally Now? (You can review this on our web site www.avaloncapital.com) we argued that the stock market bottoms roughly every 4 years. The S&P 500 is now in the fourth year since the last market major low in October 2002. We expect the next major low this fall, which may be the launching pad for a new bull market cycle phase. The next six months are likely to be quite challenging. Even as we remain defensive we look forward to a brighter investment environment to follow. Why? Much of the Fed tightening will be behind us, while any economic slowdown would allow for Fed easing supporting better earnings in 2007. A substantial sell off would create a “cheap” market, setting up another bull that could last several years, near-term concerns notwithstanding. A material correction would create an opportunity to put cash to work.

Asset Allocation

U.S. Stock and Bonds

Our near-term asset allocation favors selective equity themes, cash and short-term bonds. This approach worked well last year versus lackluster performance in the major indices. Given 2005's flat market, over weighted sectors and under weighted sectors made a big difference in a portfolio’s performance. For example, energy and materials were up 33.8% and 20.7%; consumer discretionary and telecom services were down 4.8% and 5.4%.[10] We are sticking to big cap issues: consumer staples, high technology, biotech and health care, particularly pharmaceuticals which have lagged for the last four years. We continue to recommend treasuries, corporate bonds or bond funds with maturities less than five years for fixed income portfolios.

International

We recommend over weighting international stocks, particularly the Far East, Japan and Emerging Markets. Though the Japanese market has advanced over 50% since its low in May 2005, we believe that it has only just begun a secular advance that will last many years. With all of the post-bubble excesses of bank debt, production capacity, employment, and real estate now eliminated, the restructured Japanese economy and stock market are set for sustainable growth over the next decade. With inflation rates turning positive and incomes, property prices, and the stock market rising, consumer spending is again driving economic growth. With the structural transformation of the economy now underway, Japan has for the first time since WWII become a true two-party democracy, which is increasing the pressures for meaningful economic reform.

Natural Resources and Energy

Oil is back to just under $70. Investors should over weight energy and natural resource stocks. Barring short-term setbacks, we will probably over weight energy and natural resources during the next five to ten years.

Real Estate

If the Fed is serious about continuing to raise interest rates, REIT's could be vulnerable to a significant price correction and relative underperformance. Consequently, we strongly recommend that investors under weight REIT's relative to their benchmark.

Summary

Uncertainty in the economy and financial markets has increased as we enter the fourth year of the current bull market cycle. At this stage the market is vulnerable to unexpected bad news as a lot of the good news is already embedded in current prices. Right now the downside risk is greater than the upside potential. We will over weight international, natural resource and energy stocks because they stand to do relatively well versus overall equities. We remain defensive by emphasizing cash and short-term bonds, and under weighting consumer and finance stocks.

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1 Yahoo.com
2 Aei.org
3 Commerce.gov
4 Aspenpublishers.com
5 Macroadvisors.com
6 Commerce.gov
7 Realtors.com
8 Barrons.com
9 Cass Research Associates and BCAresearch.com
10 Schwab.com

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