

The Avatar Advisor

MEETING THE INVESTMENT CHALLENGE SINCE 1970

OUR RESEARCH:

Last month we suggested that investors had arrived at a point which seemed to imply some doubts about the future, following an extremely sharp rally over the prior nine months. That hesitation recently started to be reflected more directly in the markets. We have been suggesting that markets naturally have periods of counter-trend movement. But while markets do not, in fact, move in a straight line, we have noted an unusual degree of concern regarding two important elements in the outlook. First, will the economy clearly enter into a self-sustaining recovery after all the extra governmental stimulus has been spent? And, relatedly, will the Federal Reserve therefore start a program of being less accomodative? From the vantage point of our research, the overall uptrend still seems dominant. But there are very many examples in history of markets taking a pause or even a good correction as they contemplate issues like these two.

Our **Practical Value model**, while registering a neutral reading, is not as bullish as it had been just a few months ago. Insiders have hesitated once more in their pace of acquiring their own company's stock. Many surveys of investors attitudes show low levels of bearishness and that is a concern. On the other hand, the number of bulls is not as high as might be expected after a 70% rally since last March. Still, there are a couple of other nagging factors, especially the jump in call option buying relative to put option buying. That ratio suggests that a fair amount of good news has already been discounted.

EQUITY UPDATE:

After a very nice upward move in December, markets were decidedly less buoyant in January. What appeared to be an early "January Effect" fizzled mid-month and melted away in the last two weeks. The S&P 500 Index and the Dow Jones Industrial Average were both down more than 3% for the month, while the NASDAQ was down more than 5%. As a result, all three indices now find themselves back at levels of two months ago. While economic data continues to show, on balance, signs of improvement, investors have focused their attention recently on news from Washington and elsewhere in the world. Much of this discussion centers

Our **Economic Liquidity model** stabilized in the neutral zone after a few months of deterioration. The primary positive element has been the firmer level of the dollar. In addition, the Fed has announced a continuation of its ultra-low short-term interest rate policy. However, the Fed has also made clear that it will gradually wind down its special programs that offered targeted support to certain lending markets. It will be an important test for monetary policy to see how these baby steps toward a policy "exit" are received by investors.

Our **Momentum model** no longer is as bullish as it had been. The model is not bearish but important supports have weakened. The number of stocks reaching new highs has stalled. There has been a smaller number of individual groups that participated on days when the market was rising. In addition, trading volume has expanded on days when prices moved lower. A number of important foreign markets have begun moving sideways.

Our **Bond model** moved still lower in the neutral zone. Again, the Treasury market is the reason for the poorer model readings. While inflation expectations remain subdued, a number of leading indicators are suggesting that a cyclical rise in inflation pressures could well be on its way. Fortunately, the actual level of inflation is likely to remain in a low regime, even if the rate creeps a bit higher. Credit instruments still look okay to us at this time, but without the promise of the same kinds of returns that were earned a year ago.

on the deficit, the budget, healthcare, job creation, and regulation of the financial industry.

Out of the gate, so to speak, "value" companies have outperformed "growth" companies, particularly in the large capitalization names. Last year, you may recall, growth names far outperformed value names in this space. Should the economic expansion continue, we would expect to see a shift back to growth at some point. In any recovery, there is a natural shift from "bouncing losers" to high-quality growth stories at that certain point where the turn-around is generally accepted as real.

The S&P Volatility Index (VIX) has swung from 17.5 to almost 27.5 over the last month, only to end the month at a point near the middle of those two numbers. While markets have experienced three months of generally declining volatility, this recent spike has been material. The lows of last month brought this index to levels not seen since before the Lehman collapse, but this recent spike serves as a reminder that volatility is by no means dead.

2008 was a year in which it was very helpful to avoid equities generally, but in particular, the financial stocks. 2009, optimistically referred to as a “recover year”, held good things for cyclical stocks in general, but in particular, the technology names. So far in 2010, neither of these patterns is holding true. Technology stocks have been poor performers, despite good earnings reports, and financial stocks have been mediocre performers for several obvious reasons. First, with rates effectively at zero, banks can borrow cheaply and lend at large spreads to those borrowing costs, enabling them to report very good operating results. Unfortunately, their role in the meltdown of 2008 has placed them squarely in the cross-hairs of the politicians. The pluses, as it were, seem to pretty much balance out the minuses. Our SectorStrength model has been negative on this group for what seems like forever (actually since early in 2007), and it is apparent to us that the major structural changes that have, and will occur for this group, will render the members of the sector relatively uninteresting well into the future. There will undoubtedly be exceptions to this statement, and we will continue to take advantage of these opportunities through the purchase of sub-sector ETFs. One such example is our purchase of the KBW Insurance ETF (KIE), which has handily outperformed the sector during the recovery of the last year.

At a barely positive return, the top performing group for the month of January was healthcare. Our SectorStrength model ranks this group near the top. We have been overweight the group, and recently increased our position not only in the Health Care Select SPDR (XLV), but also in the iShares Dow Jones Medical Equipment Index (IHI). This increased position was, in effect a swap from an overweight position in the technology sector, which has been falling in rank.

The next group was industrials. This group came in fourth for 2009, largely because of the under-performance of the biggest component of the index—GE. So far this year, GE is up more than 6%, which is much better than the major indices have done. While greatly reduced from the highs of 2007, earnings estimates have been moving up for this

bellwether company. We have invested in two subsector ETFs in this group: the SPDR S&P International Industrials Sector (IPN) and iShares Dow Jones U.S. Transportation Average Index (IYT).

The third group for the month of January was the consumer staples group, which ranks barely neutral in our work. Interestingly, this is one of the groups that grew earnings right through the heart of the recession. Unfortunately, these stocks hold little interest when there is current and future real growth to be had in other areas—really, it’s possible. Both CVS and Walgreen stocks are struggling despite continued consistent earnings growth over the last five years. There were few “bouncing losers” in this group last year, resulting in near bottom-of-the-pack performance last year, after top drawer performance in 2008. You can bet that if the market continues to struggle this group will hold up better than most.

The financials were in the fourth spot for January. We have already expressed our general displeasure with this group, and are currently underweight.

Asset Allocation Highlights		
Asset Class	Position	
Domestic Equities	Underweight	
International Equities	Neutral	
Bonds	Neutral	
Cash Equivalents	Overweight	
Domestic Sector Ranks		
Rank	Sector	S&P 500
1	Cons Discretionary	9.67%
2	Health Care	13.17%
3	Materials	3.41%
4	Energy	11.38%
5	Financials	14.71%
6	Cons Staples	11.65%
7	Information Tech	18.80%
8	Industrials	10.51%
9	Utilities	3.72%
10	Telecom Services	2.98%
		100.00%

Data as of 2/1/10

The consumer discretionary group was next. This sector has held up surprisingly well, considering the hits to employment the consumer has taken during the recession. Going forward, however, the employment numbers must improve for the consumer to keep spending. A turn in housing prices would also help. This group has earned the top slot in our SectorStrength model, and we are nervously watching for any changes.

Energy prices have been generally weak, as uncertainty about world economies have increased. Gold has also been weak, and investors have been making the “flight” trade to the U.S. dollar. All three of these events are in direct opposition to the pattern exhibited in the latter part of 2009.

Utilities, the seventh group for the month, rank very poorly in our work, and we are underweight. This group peaked in mid-December of last year, and has been steadily falling since then. Earnings for the group have generally been flat to weak over the last few years, and are expected to be the same for 2010.

Technology has slipped in our ranks, and has begun to under-perform the major indices. Despite a good quarter for

Microsoft—a company that has consistently grown its earnings through the recession—the stock sold off on the news. If there is to be continued improvement in the economy, this group is well positioned to take advantage of that. In the meantime, we seem to be in for some volatility for the top performing sector of 2009.

Materials and telecom round out the list for the month. The telecom group is our worst ranking group, but the materials group still ranks well. Should the downward pace of the market continue, the materials group will not avoid losses. We will watch with great interest the continued battle between the nascent economic recovery and the overarching global issues that could easily snuff it. Right now, our research models tell us we should be underweight our benchmarks.

As we ponder the data, and watch this market, we will approach the task of portfolio management as we always do: with a thoughtful implementation that is well-diversified and pays close attention to the risks we see in the marketplace.

FIXED INCOME UPDATE:

Throughout history, there are continuation years for the economy and there are transition ones. 2010 gives every indication of being one of the most important transition years in a long time. These periods seem to be those which finally begin to resolve the outstanding issues. And in the current environment, the issues abound.

While it is arguable which of the myriad possible factors is most common in the questions, our take is that, fundamentally, investors and analysts want to know whether the economy will enter a period of self-sustaining growth. Even with a couple of quarters of real growth under our belt, there is a lot of doubt about whether and by how much the economy will grow from here.

One of the specific questions in this regard relates to the impact governments can have on the course of business cycles. Many argue that stimulus programs cannot really change that course. Now, as the Obama stimulus package gradually winds down, some expect the economy to dip back into recession.

Other analysts expect growth, but only a very low rate at that. It comes down to the proofs. So far business, particularly small-and mid-size companies have simply not

brought back those workers who were laid off, let alone contemplated actual labor force expansion. Many larger companies, however, are actually beginning to do both. Businesses that have foreign sales are particularly in the lead on this.

Another question relates to the inflation picture. Given the amount of deficit spending and the open floodgates of monetary policy, many analysts believe that an episode of inflation is baked in the cake.

Judging by surveys of attitudes and, yes, recent elections, the level of consternation is very, very high. Part of this is certainly due to the fact that a number of these large issues are inconsistent with each other. For example, how likely is it that inflation will rise if the economy goes back into recession?

We think that given the nature and size of the credit bubble and the damage from the Great Recession, this kind of uncertainty should be expected. While markets often move against the main trend, analysts and economists generally do not like to display their lack of conviction. But it must be pretty high now given these fundamental questions of transition.

