

# The Avatar Advisor

MEETING THE INVESTMENT CHALLENGE SINCE 1970

## OUR RESEARCH:

One more typical development in the phases of economic expansion is when businesses finally start to see their sales volumes firm. The results for the first quarter strongly suggest that we have begun to enter that phase. More than half of the companies reporting so far have recorded sales revenues in excess of what analysts had forecast. In the prior quarter that same number was about a third of companies and before that less than a quarter. The sectors which are more economically sensitive were the ones with the biggest positive surprises. These results come at a time when job growth seems to be rising into a high enough level to suggest that the overall business cycle is now in a self-sustaining expansion. These milestones are the more remarkable because the first quarter also had what Federal Reserve Chairman Ben Bernanke referred to as a "double whammy:" severe weather disruptions and a jump in oil prices as Middle East turmoil worked its way to the gas pump. No doubt the disruptions from the Japanese catastrophe will impact the current quarter, but when an economy reaches the expansion phase it is able to absorb many more difficulties compared to the earlier quarters when growth is much more fragile. While analyst forecasts are usually wrong at turning points, they tend to be more accurate during the middle phases of expansions. Currently, earnings forecasts suggest about a 20% increase in profits over the next year. If true, that suggests all-time high earnings, above the 2007 level, when the stock market was some 15-20% higher than current levels.

**Our Practical Value model** still leaves enough room for valuations to rise. Over the last two years of the bull market, profits have grown sharply. Valuations on these earnings have not risen commensurately. Expectations are for another twelve months of more than double-digit growth. Other ways of measuring value also suggest equity prices can move higher. For example, corporate insiders are still buying. Companies are also increasing dividends and committing more money to share buybacks. Surveys of investors, particularly professional investors, still show a pretty healthy degree of caution, which, historically, has actually been a good contrary indicator. Both options trading and mutual fund flows similarly suggest the market, while not cheap, is not overvalued, at least over the medium-term.

**Our Economic Liquidity model** again showed some modest improvement, as long-term Treasury rates came down a bit. Even with more signs of energy- and commodity-led inflation,

investors have so far given Treasury bonds the benefit of the doubt. In addition, first quarter GDP growth came in much lower than what was expected at the end of last year. The supply disruptions caused by bad weather are most likely temporary. On the other hand, the elevated crude oil market could easily persist. Both factors have acted like a tax on the economy, pushing growth below where it might have been. For our part we see a much stronger underlying economy than the first quarter depicts. Fortunately, corporations and consumers have gotten their balance sheets in a much healthier position and have decent amounts of liquidity. Commercial banks appear to be in the early phase of making funds available for loans. We do have some concern that the Fed is overstaying its zero interest rate policy. A fair amount is riding on their forecast that the inflation pressures we see are going to also be transitory.

**Our Momentum model** is better than last month's reading, which was already fairly healthy. Many of the major averages have reached their highest levels in some time. The advance has been relatively broad-based, something we think gives strength to the picture. That is, some small- and mid-capitalization stocks have continued to be better performers than the giant companies. There still are some elements in the momentum picture that could be better. We would like to see higher trading volumes and an increase in the number of stocks trading at new one-year highs. In addition, some of the more risky stocks have pulled back and a perfectly healthy market would see them reclaim their prior strength.

**Our Bond model** improved to neutral, but still has a bias against Treasuries. Bonds issued by corporations continue to have solid fundamentals as the economy expands. However, we are concerned that monetary policy is more complex than warranted. It seems reasonably clear that the economy is on much more solid footing. But the Fed has kept short-term interest rates near zero in what they continue to call an "emergency." Such a dissonance with reality is likely to engender, at a minimum, more volatility for fixed income investors. There is the added risk that the Fed falls behind the curve and that will not only hurt Treasuries but could easily rub off on corporates. That time is probably a bit down the road, but it gives us concern.

## EQUITY UPDATE:

In April, stocks climbed a “wall of worry,” which is defined as a market in which the bullish trend occurs in the face of negative uncertainties. The two biggest worries, supply shocks from the earthquake and tsunami in Japan, and higher fuel prices due to unrest in the Middle East, dampened expectations for global growth. Despite these concerns, however, the market produced solid returns for investors with the S&P 500 appreciating 2.9%, the Dow Jones Industrials 4.1%, and the Nasdaq Composite 3.3%. This strong performance continued that of the first quarter, with the S&P500 up 9.0% for the year-to-date, the Dow Jones Industrials 11.4%, and the Nasdaq Composite 8.5%.

The VIX, also known as the “fear index,” is a popular measure of the implied volatility of the S&P 500. The VIX declined over 50% from the highs in March as the Japanese nuclear situation became less severe. As global fears receded, the market rallied, and by the end of April, the market closed at its highest levels since the financial crisis.

The dollar has been weak all year. As such, it increases demand for exports because it makes US products more competitively priced overseas. Large capitalization companies tend to benefit from a weak dollar, since they generate more revenues overseas from exports than the typical smaller capitalization company. In addition, when overseas profits are translated from the appreciating currency back into dollars, there is a positive impact on earnings. April was the first month since last fall in which large-capitalized companies have outperformed small- and medium-capitalized ones.

The strongest sector in April was healthcare, up 6.4% for the month, and 11.7% year-to-date. Because pharmaceutical and medical device companies generate a significant percentage of revenues overseas, their earnings were positively impacted by a weaker dollar. In the first quarter, this group led all the other S&P500 sectors in terms of reporting positive sales and earnings surprises. In addition, nineteen merger and acquisition deals worth \$42 billion have been announced in 2011. The strongest sub-sector has been small- to mid-capitalization biotechnology companies. We own the SPDR S&P Biotech ETF (XBI), which appreciated 10.5% in April.

The second best group was consumer staples, up 5.0% for the month, and 6.8% year-to-date. This defensive category tends to do best when there are concerns about the economy. Although first quarter reported company earnings have been good, and the economy has been on a more solid footing, investors have been jittery. In particular, they are concerned about declining home values, higher gasoline prices, and higher unemployment claims which threaten to slow things down in the US. This environment tends to reward stable companies that provide items of necessity.

Consumer discretionary stocks came in third, up 3.8% for the month and 8.4% year-to-date. Even though gasoline prices are high, the consumer continues to spend. Upscale, higher income shoppers are less impacted by gasoline prices and are spending at better rates than other income levels. As employment has improved, consumers have increased their spending. We will monitor this area closely and weigh the impacts of higher fuel prices versus improving consumer balance sheets and employment opportunities.

Utilities were the next best sector, up 3.8% for the month, and 5.5% year-to-date. This small group benefitted from merger and acquisition activity. Numerous utility companies have been buying their competitors to increase their market share in the hopes that their size will help them weather potential future EPA regulations.

Fifth was information technology, up 2.9% for the month and 6.2% year-to-date. This sector was led by National Semiconductor Corporation (NSM), up 68%. NSM is being bought by Texas Instruments (TXN) with cash, and at a significant premium from where the stock was trading before the deal was announced. Strong corporate balance sheets in technology and other groups have enabled significant merger and acquisition activity in 2011.

Asset Allocation Highlights	
Asset Class	Position
Domestic Equities	Overweight
International Equities	Overweight
Bonds	Underweight
Cash Equivalents	Neutral
Sector Over/Underweights	
Sector	Position
Information Technology	Overweight
Energy	
Industrials	
Consumer Discretionary	
Materials	Neutral
Utilities	
Telecom Services	
Financials	Underweight
Health Care	
Consumer Staples	

Data as of 5/1/11

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The industrial sector was sixth, up 2.6% in April, and 11.1% year-to-date. Due to surging global demand for machinery, equipment, and tools, this group is leading the rebound in the US economy. Many companies have strong balance sheets and announced stock buy-backs and dividend increases. A large percentage of companies had revenue and earnings surprises in the first quarter and raised outlooks for the future. We are overweight the sector.

Next, the materials sector appreciated 2.0% for the month, and 6.2% year-to-date. Chemicals were the leading sub-sector. In the early phase of oil price increases, chemical companies are usually able to raise prices. Although oil is a significant input for these businesses, they generally benefit at this stage from rising oil prices. We continue to like the processors, such as the chemical companies, as well as the raw material and mining companies. We are overweight here.

The eighth sector was energy, up 1.48% for the month. This performance is on top of an exceptionally strong first quarter of 16.2%. Emerging markets continue to have insatiable demand for energy resources, and concerns about supply disruptions (potential and real) in the Middle East and Africa have supported higher oil prices. We are overweight the sector.

## **FIXED INCOME UPDATE:**

At the first ever Federal Reserve press conference, Chairman Ben Bernanke made note of the special factors at work in the economy during the first quarter. He made reference to the disruptions caused by the severe winter weather. Undoubtedly, those are transitory. He also mentioned that the political turmoil in the Middle East has had a particularly negative impact on the energy equation and that the sharp rise in crude oil prices is also likely temporary.

But there were other inflationary pressures that the Chairman seemed less sure would fade. In particular, commodity prices for a wide variety of goods have moved sharply higher over the last six to nine months. Where the products are primarily agricultural, the normal ebb and flow of supply and demand typically moves prices back towards an equilibrium. In the current instance, much of the upward pressure seems to be traced to the rapid renewal of growth in the developing world. It is much more difficult to be sure that, indeed, these kinds of price increases will moderate.

The Chairman would certainly like for all of these special factors to recede so that the true contours of the global economy will become evident. In the Fed's official view, the most desirable is one of a moderate pace of growth with still enough excess capacity to absorb price pressures without becoming embedded in a broader group of prices and, especially, wages.

Telecom was the ninth group, up 0.6% for the month, 4.2% year-to-date. This small sector was the top performer last month due to the announcement of a potential mega merger within the sector, and then speculation of other mergers. This month has been quiet in terms of merger and acquisition deals.

Last and least is the financial sector which was basically flat for the month, and only up 2.6% year-to-date. Despite the fact that many banks have either raised their dividends or their dividend payout ratios this year, the sector continues to underperform. Many large banks managed to post decent quarterly numbers by reversing loan loss reserves. The use of these reserves to meet or exceed quarterly earnings estimates is generally considered to be a clever accounting trick resulting in earnings of poor quality. The sector continues to face headwinds as it deals with increasing capital ratios and regulation. We are underweight the group.

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.

Investors have good reason to be less confident. First, the Fed's forecasts have too often been wrong. This is not to single out the Fed. The consensus of economists very rarely is able to foresee turning points in the economy. In fact, the consensus has never accurately anticipated a recession. But the point is that the Fed is faced with substantial uncertainty at the moment. In addition to not really knowing if the impulses of inflation that are evident around the world are going to translate into something more virulent, there is still plenty of worry about the strength of the real economy. The absolute level of unemployment is very high and many thoughtful analysts believe that we have a more structural long-term employment challenge.

Because the Fed is worried about high unemployment, it has chosen to keep its very accommodative policy in place. But, to complicate matters even further, many critics believe that the Fed itself has caused the inflation, that it sees as transitory, as a result of the policy it adopted in August of last year.

Bond investors have justifiable reason to be skeptical about all of the analyses, no matter who supports them. Our own additional concern stems from the observation that no matter who is right, the Fed has chosen to operate monetary policy in an unconventional way. It has insisted on keeping short-term interest rates at "emergency" levels (essentially zero) and will

conduct monetary policy over the intermediate-term by manipulating its own portfolio of Treasury bonds acquired during the last nine months of "quantitative easing." We believe this introduces an element of opacity to the understanding of policy, directly opposite to the Fed's recently stated desire to be more transparent.

In all, we believe we may be entering a period of volatility in the bond market. The volatility might be caused by economic developments, misperceptions, or policy mistakes. If we're really unlucky, we could have a combination of all three.

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**Investment Philosophy:**

- 1) Avatar believes that a portfolio's stock/bond/cash mix has the greatest impact on risk and performance.
- 2) Avatar employs quantitative, top-down, macro-economic models in its decision-making process.
- 3) Avatar uses a disciplined and flexible asset allocation approach designed to generate solid returns by reducing the perils of volatility.
- 4) Avatar implements its quantitative discipline according to the clients' needs, utilizing futures, ETFs, stocks, bonds, and mutual funds.

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