AVATAR
ASSOCIATES

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The Avatar Advisor

MEETING THE INVESTMENT CHALLENGE SINCE 1970

OUR RESEARCH:

Economic recovery began two years ago. For equity analysts, this is the part of the cycle where they have demonstrated their best forecasting abilities when it comes to making company earnings estimates. Historically, analysts have never correctly predicted the onset of a recession. Similarly, it takes several quarters before analysts hit a groove for growth. Cynics will say this is just analysts becoming lucky by putting a ruler on the current trend. Regardless, any misses now would be of particular import. The reason is that economists have lowered their estimation for the level of growth the US experienced in the second quarter. With growth of less than 2% in the first quarter and a sense that the second quarter might have been even slower, the historical record suggests that the US economy is near stall-speed. For now, the consensus looks for an acceleration in the second half of the year. The reason is that the depressing factors of the last six months are seen as temporary. So it is not surprising that, in this setting, we will all be looking for as many clues as we can about the course of business. One of the things that will be watched especially closely will be how business leaders characterize their prospects. That is, the "guidance" for the next period may be even more important than the reporting of results for periods already past. While second quarter profits may be encouraging against a shaky background, if managers suggest that their expectations for the immediate future have moderated, then the hoped-for second half revival will face a serious challenge. Incidentally, analysts are strongly guided by these management assessments. And if analysts have never correctly forecast trouble ahead, perhaps it is because neither has management. It is usually a case of going over the waterfall together. So if management actually does see a slowdown ahead, we should all take note.

Our Practical Value model provides some short-term support for stocks, primarily because the level of bearishness increased fairly rapidly. Both surveys of investors and options trading revealed that kind of pattern. And stock market investors had moved fairly far away from what they probably were seeing as the rising risk of having too much exposure to the economic cycle. But we like that company managements have increased their buybacks of stock and that, for their own accounts, insiders continue to be marginally bullish. Balanced against this, on the other hand, the second quarter saw the beginning of what might be a slowing in capital spending. This kind of expenditure is an important window into management assessment of the future.

Our Economic Liquidity model continued to improve as the Federal Reserve pushed liquidity into the system. For all its efforts, however, economic growth has not been nearly as strong as was expected. While there are clear temporary factors at work, the Fed has admitted to some uncertainty about why the "temporary" factors have not been replaced by more normal growth. Until the Fed gets a better handle on what is going on, it is likely that it will stay on a course of very easy monetary accommodation. Part of the puzzle is that, since 1998, whenever interest rates have risen, so have stocks. And, contrary to most expectations, when rates have declined, so have stocks. Our research suggests that when inflation is extremely low, this kind of relationship usually persists. We also have noted that these are also periods when economic cycles are not as extended and we tend to get stunted growth. Economists call this kind of environment a "liquidity trap." In popular parlance, the Fed is seen as "pushing on a string" and unable to get business to perk up.

Our Momentum model was quite weak for most of the past month. Riskier stocks, in particular, were shunned. Trading volume continued very subdued. A good deal of the damage was reversed, however, with a particularly strong showing in the last week of the month. An extremely important juncture could lie ahead if the popular averages manage to rise above their April highs, which has been the high-water mark for the market since its major March 2009 lows. We mentioned last month that there are not many bull market tops where the breadth of stocks is making new highs. Rather, trouble typically comes when the generals are leading fewer troops and breadth therefore lags. Another similar issue for a market breaking out to new highs is when the rate of change of price fails to match its earlier high points. Literally, momentum in this case peaks before prices do. A rising market at this juncture, therefore, should not be treated complacently.

Our Bond model continued its course of improvement. Commodity prices retreated as did inflation expectations. Most of the gains in bonds were in the Treasury sector. In fact, for the first time since the market lows of March 2009, the bond market started to be a little more cautious toward credit risk. Most investment grade bonds performed well, but junk bonds did not. There were many other signs, globally, of fixed income investors beginning to make sure that their risk exposures are appropriate for the state of the economy. Many of the metrics which record expectations for volatility have shown a similar firming. But if the economy begins a second half acceleration, then credit concerns and fears of volatility should once more recede, especially if the hints of retreating inflation are correct.

EQUITY UPDATE:

In June, the stock market was characterized by uncertainty. First, Greece had to overcome many hurdles to avoid a debt default, an event which would have had serious negative consequences for European banks. Even worse, the reality of a Greek default, the thinking went, could cause a contagion that might easily spread to other markets. For the moment, Greece has managed to "kick the can" down the road. Second, the economy hit a "soft patch," or slow period of economic growth. It is too early to discern if this "soft patch" is temporary or more persistent.

The market had a strong "risk-off,"or defensive bias, for most of June. In this environment, stocks traded down and lost value. Late in the month, it became increasingly clear that Greece had, at least, a short-term solution. At the same time, a couple of economic indicators came in better than expected. The market quickly switched to a "risk-on" bias with stocks rebounding strongly, recouping some of their losses for the month. As a result, the S&P 500 Index was down 1.7% for the month, the Dow Jones Industrials Index off 1.0%, and the NASDAQ Composite Index down 2.1%.

Despite the increased volatility during June, the S&P 500 Index was flat for the second quarter, the Dow Jones Industrials Index was up 1.4%, and the NASDAQ Composite Index was down 0.3%. All indices remain positive for the year with the S&P 500 Index up 6.0%, the Dow Jones Industrials Index 8.5%, and the NASDAQ Composite Index 4.5%.

All S&P 500 sectors had negative performance during June. The strongest sector, or in this case the least negative, was consumer discretionary, down 0.3%. Since consumers are generally very sensitive to gasoline prices, they quickly reduced their driving miles in response to rising gasoline prices during the Arab uprisings. Gasoline prices have continued their trend lower since the peak in May. Slightly lower gas prices, along with some signs that the "soft patch" may be temporary, allowed this economically sensitive sector to recover most of its monthly losses.

The second strongest group was materials, down 0.4% for the month. Materials are levered to the global growth story, especially China. Many emerging economies, including China, have been battling inflation. Their efforts have led to a slowing of their economies, and a reduced demand for materials. The Chinese Premier, Wen Jiabao, recently declared victory on inflation. Now China is considering stimulative policies to boost its economy. Additionally, inventories of copper and other materials in China are down significantly from earlier in the year. Reduced inventories and an end to tightening policies should be positive for this sector.

Utilities were third, down 0.5%. This small sector benefitted from market uncertainty in June. By definition, most utility business is local, and therefore lacks exposure to both Greece and the general uncertainty surrounding the global growth story. Additionally, since utility companies tend to carry higher dividends, the stocks continue to be attractive from a yield perspective in the current, low-interest rate environment.

Fourth was the industrial sector, down 0.8% for the month, and up 6.9% for the year-to-date. This group, which has driven the US economic recovery since the financial crisis, is sensitive to changes in the global economy. Exports are a large component of company earnings. The sector sold off hard during the "risk-off" phase of June, then recovered when the market switched to a "risk-on" bias.

Asset Allocation Highlights

Asset Class	Position
Domestic Equities	Underweight
International Equities	Underweight
Bonds	Overweight
Cash Equivalents	Neutral

Sector Over/Underweights

Sector	Position
Information Technology	Overweight
Industrials	
Consumer Discretionary	
Health Care	Neutral
Materials	
Utilities	
Telecom Services	
Financials	Underweight
Energy	
Consumer Staples	

Data as of 7/1/11

Healthcare was fifth, down 1.3% for the month, and up 7.3% for the quarter. Healthcare benefitted in the second quarter from strong earnings, merger and acquisition activity, and as a defensive play as the economy moved into what appeared to be a slowdown. This sector has had strong positive earnings estimate revisions relative to others in the S&P 500. However, the group was extended and overbought going into June and experienced some profit taking.

Sixth was the telecom services group, down 1.4% for the month, and up 0.8% for the quarter. Verizon (VZ) was the only company in this small sector with positive returns for the month, up only 0.8%. In terms of news, analysts have become more attuned to the fact that revenues from texting are rapidly declining. This is due to the fact that consumers are switching to free instant messaging services instead of texting plans. Earlier this year, the sector was driven by merger and acquisition activity. No significant deals were announced for the group in June.

Energy was seventh, down 1.9% for the month. In late June, Obama announced that the US and its partners in the International Energy Agency had decided to release a total of 60-million barrels of oil onto the world market over the next thirty days to offset the disruption in oil supplies caused by unrest in the Middle East. The US would release 30-million barrels from its Strategic Petroleum Reserves. This announcement came as a surprise, resulting in a decline in energy company stock prices.

The eighth sector was information technology, down 2.6%. With the exception of the software and services sub-sector, we are generally seeing downward estimate revisions in this category. These companies have been impacted by supply disruptions due to the horrific earthquake and tsunami in Japan. Fortunately, the Japanese economy is rebounding. As these disruptions, and any temporary slowdowns in the economy subside, technology companies should recover.

Consumer staples were ninth, down 2.8% in June, and up 6.2% year-to-date. This defensive sector started outperforming other categories of the S&P 500 during the nuclear crisis in Japan, and continued during the “soft patch.” After rallying for two months, consumer staples companies were in an overbought condition going into the month, and underperformed significantly in June.

Financials were the worst performing group for the month, down 2.9%, and for the last year, down 11.4%. Banks have been lobbying hard to reduce the impact of the Dodd-Frank Wall Street Reform Act. On the margin, they have had some wins. None of their successes changes the fact that banks’ business models will be more regulated and less profitable going forward. In June, we saw some flattening of the yield curve, which generally reduces the profit, or spread, that banks make on loans relative to their costs. This is simply another headwind for financial companies, and we continue to underweight the sector.

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:

Virtually no economic cycle proceeds totally smoothly. There have always been periods within an economic expansion when the growth rate accelerates and then slows down and, clearly, times when a slowing is quickly followed by a reacceleration. But there is often a secondary pattern that accompanies these mini-cycles. Near the peaks of business cycles are sectors which typically fail to catch back up to the main trend. This thinning out of the leadership is characteristic of an underlying vulnerability for the whole economy.

It is important to realize that such a sequence could be unfolding currently. During the early days of the expansion, public construction projects were growing as part of the stimulus plan. After a slowing a year ago, this activity has accelerated again, but, importantly, at nowhere near the rate of growth that had been recorded earlier in the cycle.

Similar observations can be made about the private manufacturing sector. First quarter slowing seems attributable to the supply disruptions following the disaster in Japan. But recent measures of manufacturing show that the rate of growth has not approached the previous mini-peak. The transport sector has a similar pattern, including both for truck tonnage and rail traffic.

Against this general pattern of waning momentum, there is an expectation that the factors which have hurt growth, namely the Japanese disaster, horrible winter weather, and crude oil price spikes during the Arab Spring, have been only temporary depressants which are bound to reverse.

Time will tell whether the current slowdown persists. The Federal Reserve expects a revival, but Chairman Bernanke admits that it does not have a good handle on why the slowdown has lasted as long as it has. Perhaps the theory of temporary challenges is missing a bigger issue. An obvious candidate is the deceleration in the emerging economies as they fight a bout of commodity inflation with tighter and tighter monetary policies.

But even before the upswing began two years ago a number of prominent analysts had forecast a very slow growth rate owing to the amount of debt and leverage that had to be worked off after the bust in the credit cycle.

Whatever the reason, the pattern of narrowing sector leadership looks to be unfolding, with the risks that it has historically carried.

As long as the business expansion remains at risk, it will be harder for a period of inflation to set in as many had earlier thought. That could be good news for bond investors. Simultaneously, however, a weaker than expected economy already is raising questions about credit quality. The poorest-rated corporate bonds have seen their interest rates rise relative to investment grade corporates and Treasuries. If that overhang of debt is about to get "re-mobilized" then these worries will only get larger.

The generalized level of risk has clearly risen over the last several months. And even if there is some reacceleration, the important standard to meet is if all of the sectors are joining in. If not, then the risks rise even more.

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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.

Avatar Associates specializes in tactical asset allocation and manages approximately $1.142 billion in assets. Clients include institutions, wrap brokerage sponsors, financial planners, and private clients. Product offerings include overlay, sector rotation, fixed-income, defensive equity and core equity. Avatar Associates employs a quantitative, top-down, macro-economic model, refined qualitatively by a seasoned research and portfolio management team. For more information about Avatar Associates, please visit www.avatar-associates.com.