

# The Avatar Advisor

MEETING THE INVESTMENT CHALLENGE SINCE 1970

## OUR RESEARCH:

While many analysts and economists had expected 2010 to just be a respite between disappointing growth periods, actual results have turned out to be better and the global economy more resilient. For the better part of last year, the sovereign debt crisis in Europe conditioned both debt and equity markets. In the last several weeks however, two, perhaps related, factors are suggesting a better than expected outcome. First, because Germany is by far the largest economy in the zone, its growth has a major impact on overall conditions within it. It is pretty clear that Germany's powerhouse export machine is driving the continent's growth. Second, there now appears to be tacit agreement among disparate political elements that a resolution of the peripheral country debt cannot be delayed much longer. Our sense is that the fix is in and, grudgingly, a way forward will be found. It certainly helps that global growth is still vibrant enough to allow the leaders in the strong European countries to see their way clear to work a little more diligently on the debt problems.

A good part of the global growth story continues to be driven by what is clearly the economic event of our lifetime: the mass movement from agricultural to industry on the part of close to a billion people. Occasionally, things get pretty bumpy in the developing world. We think that is the nature of early development. The U.S. was that kind of country from the 1880s until the 1950s. Our growth rate, on average, was very high, but there were a lot of booms and busts around that high trend. Currently, the developing world is, on average, showing robust real growth. While the same cannot be said for the U.S., the data now show that our economy is expanding rather than merely recovering. Gross domestic product is now above the highest levels reached in 2007. Of course the pace of expansion is not attracting much excitement. The average citizen still thinks that "recession" is the best description of our economy. It is pretty clear that as long as unemployment remains as high as it is, there is little to be

gained by pointing out that things are, actually, better. In fact, with overall expectations still very moderate among economists, analysts and investors of all stripes, continued expansion would probably be a surprise.

**Our Practical Value model** clearly points to a market that is not cheap. In particular, compared to the levels of valuation at the market lows in early March 2009, equity prices now reflect substantially higher multiples of earnings, dividends and book values. For some, a rise in valuations is automatically a negative. Our own view is that rising valuations early in a cycle is actually a bullish sign. As long as the underlying fundamentals continue to rise (as they usually do early on) then the bidding-up process is welcome and reassuring. Of course, there are limits to valuation levels, but the difficulty is trying to decide what they are. Our experience is that "expensive" stocks have gotten more expensive when overall liquidity conditions are favorable. That is, more money in the system gives investors a green light to extend their time horizons and what they would be willing to pay for a dollar of earnings or dividends. Currently, the valuation levels are still expanding. They remain below the historical "too high" zone and, importantly, liquidity is still ample. Still, as valuations rise, it is important to know where the exits are. And when the crowd begins to thin out a bit, that is usually a reliable cue to join them.

**Our Economic Liquidity model** shows both monetary policy and stores of liquidity being still ample. The Federal Reserve continues to expand its balance sheet, directly buying Treasury bonds. Its recent guidelines give no hint of a let-up in its easing policy. As we have pointed out before, corporate cash levels are extremely healthy. Profit growth has led to strong capital spending, but not enough to diminish the growing levels of cash on the balance sheets. Additionally, corporate hiring has only inched along. A third improvement in liquidity comes from, of all places,

American consumers. The degree of leverage of their own balance sheets has diminished fairly dramatically. The amounts of debt-servicing obligations compared to disposable income has dropped sharply. Our model has lost a few points owing to the rise in commodity prices, but inflation at the consumer level is still under control, as are consumer inflation expectations. The dollar has a fairly heavy weight in our model and it has been in a very broad trading range, alternately strengthening and weakening, reflecting the Eurozone troubles and Japan's continued wrestling match with deflation.

**Our Momentum model** is still bullish, but a little less than last month. We continue to like that smaller-capitalization stocks are trading better and that riskier stocks have outperformed defensive ones. We think it is also positive that overall correlations between the prices of stocks and sectors continue to fall off. This means that investors are less concerned with the macro picture and more interested in finding good specific opportunities across a broad segment of assets and regions. A form of corroboration is that expected volatilities (which can be

measured from options prices) are likewise subdued. While not infallible, the lowering of correlations and implied volatilities typically are a mark of a less risky overall market.

**Our Bond model** is still bearish, but particularly so in offshore markets. Most of the negative elements deal with the very sharp rise in commodity prices around the globe. In the U.S., commodity inflation has yet to find its way into consumer prices, particularly those which the Fed monitors closely. Our concern about bonds mostly targets the Treasury segment. Corporate bonds, on the other hand, are still benefitting from continued improvement in profits and balance sheets. There still appears to be room for a further narrowing in yields between corporates and Treasuries. One element that bears close watching is if the domestic economy surprises on the upside, then the Fed may decide to end its emergency measures. Just a "normalization" of its short-term interest rates would have a likely indirect negative impact on longer-term Treasury maturities. That, in turn, could make corporates less relatively attractive. For now, we see that as a low probability event.

## EQUITY UPDATE:

In January, the S&P 500 was up 2.3%, the Dow Jones Industrials 2.8%, and the NASDAQ 1.8%. January was a low-drama, slowly-rising stock market until the end of the month, when tensions and political instability started to rise in the Middle East. Investors were reminded of the possibility of a "fat tailed" event, or one that isn't expected to happen, causing the S&P Volatility Index (VIX) to spike 25% at the end of the month. So far, the protests in Egypt have been relatively peaceful, and the VIX has retraced a large portion of the move up.

Data on the US economy continues to improve. During January, the market continued to favor cyclical companies, or ones with leverage to an improving economy, instead of more stable, or defensive, companies that are not as affected by changes in economic activity.

The best performing sector in January was energy, up 7.3%. Many commodity prices were up strongly during the month, and the price of crude oil was no exception. The backdrop of an improving US economy, robust growth in emerging markets, and potential supply disruptions in the Middle East, created a strong tail-wind for these companies.

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
Industrials	
Consumer Discretionary	
Materials	
Energy	Neutral
Utilities	
Telecom Services	
Financials	Underweight
Health Care	
Consumer Staples	

Data as of 1/31/11

Coming in second was industrials, up 4.2%, which was also one of the strongest groups in 2010. Some of the worst performing companies in this category that year were the best performing companies in January, including Quanta Services (PWR), Lockheed Martin (LMT), ITT Corp. (ITT), and L-3 Communication Holdings (LLL). Generally, the aerospace and defense subsector underperformed its industrial peers in 2009. Many in the group reversed this underperformance in 2010. This strength could be a reflection of less concern on the part of investors about defense budget cuts as a result of increasing political instability in the Middle East. Additionally, some defense companies have been able to grow the non-military portions of their businesses. We continue to be overweight here.

The next group was information technology, up 4.2%. This sector continues to provide opportunities for stock pickers. The top-ten companies here had performance gains that ranged from 12% to 55% for the month. Overall, the group reported strong 2010 fourth quarter earnings. Bellwether companies Apple Computer (AAPL) and Microsoft (MSFT) reported robust earnings. These gains are partially due to hot products like the tablet computer at Apple, and Kinect, a hands-free controller for Microsoft's popular Xbox gaming system. We continue to be overweight information technology.

The fourth-best performing sector was financials, up 2.7%. Banks and others are currently undergoing another round of "stress tests" that will be concluded in March. At that point, large banks will know if they will be allowed by regulators to re-instate or increase their dividends. In the past, the "stress tests" have been set up to produce a positive outcome. Many analysts expect that several large banks will be allowed to increase their dividends. This would be a positive catalyst for the sector in the short-term. On a longer-term secular basis, however, these institutions are digesting the impacts of increased regulation, and the end of certain businesses that were highly profitable in the past. As a result of this latter concern, we continue to underweight the group.

Utilities came in fifth, up 1.0%. Traditionally, these companies have been highly correlated to changes in interest rates, due to both relatively high levels of debt

service obligations and their significant dividends. Interest rates have been moving up since the fourth quarter of 2010 as the economy is normalizing, and this is producing a headwind for these companies.

Healthcare was sixth, and basically flat for the month, at a positive .3%. Drug manufacturers have had weak pipelines of new drugs, and virtually none have "blockbuster" potential. In addition, they are facing a harder-to-please FDA, and more competition from generics.

Materials was the seventh-ranked sector with performance basically flat for the month. This group should benefit from an improving US economy and seemingly insatiable emerging markets demand for raw materials. Although the sector was flat in January, it has already shown nice price momentum in February. The supply and demand fundamentals are excellent and, as a result, we are overweight the group.

Consumer discretionary was number eight, down 0.7% for the month, after being the strongest sector last year. In the past, these companies have suffered when the price of oil has traded around \$100 per barrel or higher because consumers are acutely aware of what they spend at the gasoline pump. We will be monitoring consumer behavior closely, as the price of oil has risen sharply, and is at levels that have deterred consumer spending in the past.

Ninth was consumer staples, down 1.7% for January. This defensive sector was also an underperformer in 2010. Agricultural commodity prices have risen strongly as increasing global demand and natural disasters have reduced supply. In turn, margins for many of these companies have been squeezed. We are underweight the sector.

Telecom services came in last, down 3.8%. Last year, these stocks were rewarded for the rapid adoption of the iPhone and Android smart-phones. In January, investors became concerned about capital expenditures, or the lack there-of, and the costs associated with the usage of these phones.

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:**

At the beginning of the Great Recession, January 2008, crude oil was trading at about \$100 per barrel. Despite the sharpest drop in overall economic activity since the Depression, oil, nonetheless, reached \$140 per barrel at the end of 2008. Eventually it collapsed to about \$40 at the recession trough in June 2009. During the subsequent recovery, oil rose and then settled in at around \$80. In the last several months, crude oil has firmed once more to around \$90. Other energy commodities like coal have had even more spectacular advances. Copper and aluminum have helped pushed the average raw industrial commodity price to sharp advances.

In agriculture, prices have had similar volatility. During 2008, the price of a bushel of corn rose from \$4 to \$7.50 but then lost more than 50% in the next year-and-a-half. Corn is now trading at around \$6.40. Wheat, soybeans and rice are similarly elevated.

It is little wonder that many fixed-income investors are getting queasy. The magnitude of the gains in commodities has been pretty spectacular. However, more context is needed. First, the percentage gains should be seen in the light of the collapse in these prices during the recession. Beyond that, however, commodity prices have always been the most volatile element in the factors making up the economic cycle. As well, the importance of commodities varies dramatically from economy to economy: In the U.S. in 1900, food consumption was 35% of household budgets. Today, those costs are less than 10% of income. In general, this percentage averages about 15% in high-income countries, 35% in middle-income countries and 55% of budgets in low-income ones. In the U.K., about 12% of income goes to food. In Japan and France it is about 16%. In Venezuela and China it is approximately 35%, while in India it is 53%.

Another necessity, apparel, has a similar pattern. In the United States 35 years ago, about 10 of every 2,000 workers were employed in the clothing industry. Now only one worker is needed. Productivity advances and “off-shoring” have reduced the relative costs of apparel fairly dramatically. While global cotton prices have in the last 15 years experienced annualized gains of close to 80% and annualized drops in price of about 60%, the final cost of clothing to the American consumer has hardly budged beyond a plus or minus 1-2%.

The incidence of inflation is currently spotty all around the globe. In the U.S., core inflation is less than 2%, while in Europe it is around 2%. In Japan, consumer prices are actually going down a bit. In the developing world, inflation is running around, as a very broad average, 5-6%. For the latter countries, this actually represents amazing progress. During the financial crisis that proceeded the emerging market crash in 1994, inflation for them was running at 100%. Not only have the enormous benefits of productivity cushioned the swings in raw materials prices, but central bank policies in the developing world have been more akin to the practices followed in the developed world.

Because there is such an uneven distribution of inflation around the world, the global trading system can act as an automatic governor on prices as buyers change their sources for goods. A further limit on inflation is the still large quantities of unutilized labor and productive capacity that was created when the floor fell out of the global economy.

In the U.S., expectations of inflation continue to be modest. This is corroborated in surveys of consumers and from the structure of bond prices. In other countries, as mentioned, where inflation has crept up, central banks have begun tightening their monetary policies.

When the U.S. was going through its maturation, booms and busts were frequent. But the powerful rising tide of the country's long-run growth elements effectively turned those episodes into mere cyclic, volatile events rather than the end of progress. We suspect the same thing is happening around the world in country after country as they become more and more sophisticated and specialized.

In sum, we do not yet see the elements that would cause a global inflation episode that could turn into a game changer.

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