

The Avatar Advisor

MEETING THE INVESTMENT CHALLENGE SINCE 1970

OUR RESEARCH:

There is now a fairly steady stream of economic data suggesting, similar to early summer last year, that the global economy has slowed. What is interesting is that immediately prior to these developments there were very clear signals that the economy had entered into a self-sustaining expansion period. The main signs of this were a string of monthly employment increases of decent size, indications that temporary job assignments were being turned into permanent employment, and a batch of corporate earnings and sales results that were particularly strong on the revenue side. Now comes some disappointing data relating to that same employment issue and even the corporate sector. As best as can be gleaned from the reports, weakness is definitely attributable to several known factors: adverse weather here and abroad, the disruption in the oil markets as political turmoil grows in the Middle East and, sadly, the impact of the horrific destruction in Japan. In each of the cases, there is a good probability that the worst has passed. The question is whether this poke to the economy will be enough to knock it down. A big part of the assessment has to be made in the light of the previous positive developments in employment and business activity. A fundamentally stronger base in the economy should help absorb these more recent stresses. But, for sure, investor caution has risen and given the fact that all of the leverage hangover from the bust in the credit boom has not been swept away, the possibility of adverse outcomes just has to be higher than might be considered if the system was carrying much lower loads of debt.

Our Practical Value model is a little less supportive of the stock market. Flows of investments into riskier assets have moderated. Surveys of investor opinion, having previously reached levels which signal their bullishness, backed off a bit in the last several weeks. Options trading suggests somewhat higher risk potential. Against these signs, however, there are some very good indications from corporations that they believe stocks have value: insider buying is still at a high level; dividends are being increased; stock buybacks are increasing; and capital spending is strong. The net result is that while stocks are not cheap, they are not looking all that expensive either.

Our Economic Liquidity model has improved as the Federal Reserve continues to make ample funds available through its program of quantitative easing. The Fed has indicated that it

will end that program on schedule in a month or so. Still, the markets seem to be prepared for the next phase of Fed policy which, apparently, is a period of no further changes. That is, short-term interest rates will stay at their extremely low level for at least several more months. In effect, this is a subsidy to the economy and helps overall liquidity. It also appears that commercial banks are in the early stages of beginning to make business loans. Surveys of bank officers indicate a more comfortable assessment of credit risks.

Our Momentum model experienced some additional sub-surface deterioration. In a continuation from last month, stocks with more risk, particularly economic-cycle risk, underperformed the less risky segment of companies. In a complementary sign, stocks which do not have heavy reliance on sector membership (that is, those with special attractions of value and visibility) performed relatively strongly. We also note the inability of the market to produce an increase in the number of stocks trading at new one-year highs, even as the market averages managed to do so. In general, some of the lack of risk taking on the part of equity investors is pretty evident. On the other hand, it should be noted that the cumulative index of net advancing stocks (the market's "breadth") reached a major new high level at the end of April. Breadth tends to be a leading indicator. Thus, some comfort can be taken from the historical record: very few major market tops have seen breadth achieve trading range highs coincident with the market averages.

Our Bond model showed improvement across the board, including, for the first time in a while, Treasury bonds. During the month, most raw and processed commodities experienced a fairly substantial decline in price. Crude oil, for one, had a 15% price correction. Many food commodities suffered even larger declines. In recent years, with the increased presence of investors in commodities as a class, there have been a growing number of volatile periods that represent the kind of periodic exuberance and correction that is typical in the stock market. So it is getting harder to determine how much of the price change in a commodity is purely supply and demand related from the users and processors and how much is temporary financial volatility caused by speculators. For now, the pull back in these prices has provided a nice rally to bonds.

EQUITY UPDATE:

In May, stocks reached their highest levels of the year at the beginning of the month, and then declined on concerns that the economy is slowing. At this point, it is hard to discern if any slowness is temporary and due to short-term supply shocks, or the start of something that will continue. For the month, the S&P 500 was down 1.1%, the Dow Jones Industrials 1.5%, and the NASDAQ Composite 1.2%. Despite a slightly down month, the year-to-date performance for stocks continues to be strong with the S&P 500 up 7.8%, the Dow Jones Industrials 9.8%, and the NASDAQ Composite 7.2%.

May was a “risk-off” month. The US dollar rallied over renewed concerns about sovereign issues in Europe. Investors sold cyclical assets that tend to do better in a rising economy and bought defensive sectors that tend to do better in a slowing environment. The slowing of the economy was due in part to temporary factors such as bad weather in the Midwest and the Deep South, supply chain disruptions due to the earthquake and tsunami in Japan, and the high price of gasoline due to uprisings in the Middle East.

The strongest sector in May was consumer staples, up 1.9% for the month, and 9.4% year-to-date. Generally speaking, earnings have been rising in this category. Some companies have been able to pass along price increases to consumers. Others are benefitting from a decrease in their costs due to lower commodity prices. Therefore, margins have been stable or increasing. This defensive group tends to outperform in a “risk-off” environment.

Coming in second was another defensive group, healthcare, which was up 1.5% for the month and a strong 14.1% year-to-date. This sector is benefitting from several tail winds. First, there has been significant, strategic merger and acquisition activity in this sector. Large companies, especially in the pharmaceutical area, are buying smaller drug or biotech companies to increase their pipelines of new drugs. Secondly, these companies have significant overseas exposure and have benefitted from a weaker dollar. In addition to the SPDR S&P Biotech ETF (XBI) that we mentioned last month, we continue to own the Powershares Dynamic Pharmaceuticals Portfolio ETF (PJP) which was up 3.5% for the month.

Utilities came in third, up 1.3% for the month, and 7.2% year-to-date. Utilities tend to outperform during periods of declining interest rates. Recently, rates have been declining on fears of a slowing economy. Also, some feel that if the US government’s debt ceiling isn’t raised that there could be a shortage of treasury securities in the marketplace. They think this potential outcome is helping to support demand for treasury securities. Although the latter is speculation, there was a rally in treasury securities over the last month, which benefitted this small defensive group.

The fourth group was telecom services, up 1.2% for the month, and 5.9% for the year. The top performer in this sector was Sprint Nextel (S). The company has been very price competitive with Verizon and AT&T, and has done well with its Android platform. In addition, it is also gaining traction in its fight against the AT&T and T-Mobile mega-merger. The best performers in this small sector continue to be companies that are thought to be potential buyout targets as the industry consolidates.

Coming in fifth, consumer discretionary was the strongest of the cyclical sectors, down 0.8% in May, and up 7.9% year-to-date. Consumers are very sensitive to the price of gasoline, and tend to cut back on discretionary spending when gas prices are rising. Energy prices peaked in early May, and employment was up, helping the sector. Consumer balance sheets have been improving and credit card delinquency rates are down, which is a positive for the sector as well. We are watching housing prices closely as they appear to be softening. Consumers may cut back on spending if they believe their houses will continue to decline in value. We will monitor this situation closely as we are overweight the sector.

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

Data as of 6/1/11

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The sixth group was information technology, down 2.7% for the month, and up 4.3% for the year. This sector has been providing the best opportunities for stock picking. The top stocks were up 20-plus percent in the month, and the worst were down the same amount. The largest technology companies are well capitalized and have extremely large cash reserves. Some of this cash is trapped overseas due to US tax regulations. One way for these companies to bring the cash home is for cross-border merger transactions. This strategy works well when they can find companies that are a good strategic fit. We expect to see more merger and acquisition activity in the technology area.

Materials were seventh, down 3.4% for the month, and up 3.1% year-to-date. This group had the largest first quarter net earnings surprises on a percentage basis relative to all the other S&P sectors. These companies have significant portions of their business outside of the US, and therefore benefit from a weak dollar. Although China has been raising bank reserve requirements to slow inflation, the country continues to grow at a robust (albeit slower) pace. Emerging market demand for materials continues to be strong. We are overweight the sector.

Industrials were eighth, down 3.5% for the month, and up 7.7% year-to-date. This sector has significant overseas business. The cheap dollar is making these products more competitive on a global basis. Large corporations have historically strong balance

sheets, and low cost of borrowing, which should be a catalyst for them to invest in more capital equipment. The group came in second in terms of first quarter earnings surprises. We continue to be overweight here.

Financials came in ninth, down 3.8% for the month, and the worst, and only, negative sector year-to-date, down 0.7%. Banks continue to be mired in mortgage and regulatory issues. There is still a significant number of underwater homes on bank balance sheets that has yet to go through the foreclosure process. Home prices have been softening, which will also increase the pressure on banks. It is interesting to note that of the top ten stocks in this sector in May, none were either traditional or investment banks. We continue to underweight the sector.

Energy was last, down 4.8% for the month, but up 12.5% year-to-date. The price of gasoline did reach a tipping point in early May, and consumers started cutting back on their driving. This "demand destruction" due to high prices along with improved stability in the Middle East led to higher inventories, and then lower energy prices.

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:

When it comes to current monetary policy, the US is about as far away from "normal" as might be imagined. This policy affects not only the interest rate that the Fed directly administers---the overnight bank rate known as the fed funds rate---but, typically, even longer-dated maturities of Treasury debt. The reason for this is that all along the spectrum of maturities, each issue is influenced by its adjacent maturity. Thus, there is some kind of related range of rates that usually is anchored at the overnight end.

Fed policy has remained maximally accommodative since July 2007, or almost four years. This really has no precedent in postwar history. But the Fed continues to describe monetary conditions as being in an "emergency." It is true that not all of the huge debt overhang that was first created by the build-up of the credit bubble has been dealt with. Banks continue to carry large amounts of toxic assets. Nonetheless, market indicators are dramatically improved from the worst days of the credit bust. In particular, the spread between yields on high- and low-quality debt has narrowed dramatically. Other, even more sensitive metrics of conditions in the short-term money market are almost, if not totally, normal.

The Fed knows all of this but continues to feel that these debt indicators are more likely to turn sour than improve. Not only is there still a large pool of impaired loans, but economic activity does not seem fast enough in the Fed's eyes for the system to gradually "earn" its way out of the potential reigniting of systemic risk. They argue that the evident degree of inflation in a large swath of goods and services is transitory and that, in any event, there is just too much excess productive and labor capacity to permit a round of inflation to get going in any meaningful (i.e. non-transitory) way.

This policy has had remarkable consequences in the bond market. Normally, the fed funds rate would be set at about the inflation rate. Currently the official rate is zero to one-quarter of a percent. That suggests that the administered rate could be as much as, say, 2 full percentage points below what it might normally be. To put it another way, the "real" funds rate is about minus 2 percent.

At the other end of the spectrum, 10-year Treasuries now yield about 3%. Under normal conditions the rate would approximate the nominal growth of GDP. If we assume the current growth

rate is about 2% and the inflation rate another 2%, then the 10-year notes are about 1 percentage point below normal. The yield curve, then, is clearly not normal. If the 10-year note "should" be about 4% and the fed funds rate 2%, the spread between the two would be 2 percentage points. In reality the spread is now 3 percentage points.

Our thought is that, under normal conditions, there will be more room on the upside for short-term rates than for long-term rates. Thus, one might expect the yield curve to narrow eventually. And that is typically what happens as economic cycles mature. The challenge, especially now, is to determine two different

things. First, whether the economy soon returns to "normal" conditions and second, whether inflation is likely to stay under some degree of control.

As it turns out, there is currently both a concern that the economy is, in fact, slowing once more but, simultaneously, that inflation is heating up.

While we doubt anyone has the crystal ball to call winners and losers on these questions, it seems likely that uncertainty and volatility will continue to be a part of the bond market. And maybe that is normal.

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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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