

The Avatar Advisor

MEETING THE INVESTMENT CHALLENGE SINCE 1970

OUR RESEARCH:

The recent report on third quarter GDP showed a healthy amount of investment spending for capital goods. In fact, over the last year, capital spending has carried most of the load for economic expansion, such as it is. During the Great Recession, corporations managed to avoid the long-run damage that was inflicted on consumers. Companies reacted with lightning speed, cutting payrolls, inventories and capital spending. Once inventories were slashed enough and the economy bumped off the bottom, capital spending resumed. Because the recession was extraordinarily lengthy, there was an added need for updating production equipment. In the last month or two, unfortunately, there have been signs that this spurt in business spending is losing momentum. It is not heading down, but it is appearing less likely to be able to carry the whole economy on its back. There is a good explanation for this loss of leadership. An important precondition for capital spending is healthy profits. In this regard, earnings are being reported currently and they make for a very interesting story. While profits have been slightly better than expected (which is the usual pattern, except in recessions), sales and revenues have not commensurately surprised analysts. We know that industrial commodity prices are rising as are other selling prices. So the disappointments in revenues most likely reflect disappointing unit volumes. That is, business can get reasonably good prices for its goods and services, but they are just not selling enough to provide healthy surprises to analysts. As a result, the loss of momentum on capital goods not only is bad news on its own, but it also reflects the need for some kind of growth impulse from somewhere else in order to fill business order books. The obvious risk is that, failing that impulse, capital investments will settle into the lackluster pace of consumer spending.

Our Practical Value model has deteriorated. The rally has brought on a fair amount of bullishness and historically that can be a problem when it is overdone. Surveys of investor opinion reflect much less caution than

in the late summer. We see the evidence of that in mutual fund flows into more risky investments such as high-yield bond funds and emerging country debt. Options traders likewise have moved relatively more heavily into call contracts, seeing higher prices ahead. When both surveys and options trading shift in this more risk-seeking mode, it is important to be alert to when or if the crowd thins out. That will be a sign that markets have become extended. We find it of interest that while company managements have increased the number and size of stock buybacks, individual corporate managers are also engaging in fairly heavy amounts of insider selling. While the decision to buy back company stock may reflect confidence in the company's outlook, it could also just be something management thinks will be popular. Meantime, there is only one reasonable explanation of why managers would sell their own stock.

Our Economic Liquidity model has improved primarily as the dollar has at least paused on its downward path. A weak currency eventually translates into inflation pressures, a particularly negative development for the economy generally and bond investors in particular. With the Federal Reserve Board likely to commence a new round of monetary easing, many expect the dollar to resume its slide. In fact, Chairman Bernanke has remarked that the inflation rate is too low. Through a program of purchasing bonds (dubbed "quantitative easing") the Fed expects the economy to advance enough to begin to meet one of its dual mandates: full employment. At the same time, the Fed has assured the markets that it knows how to keep inflation under a lid. As long as liquidity can expand without a simultaneous increase in inflation, then we think the markets will react positively. Of course, it is clear that many, many observers think such an outcome is unlikely. They fear the worst: no economic growth, but a pickup in inflation. For one thing, such an outcome would be a big negative for the dollar. For another, to the extent that underlying credit conditions also deteriorate, then some of the unfinished business of deleveraging the economy after the spectacular credit bubble will just compound the general difficulties.

Our Momentum model is showing some hesitation after being firmly in the positive zone. The number of stocks participating in the rally is not particularly broad. For example, the percentage of stocks making new trading-range highs has failed to expand even as the market averages inch higher. There are other technical problems. Measures which are designed to detect "selling" have picked up a bit while buying pressures have trailed off. As it is, trading volume overall continues to be very slow. Sector leadership is harder to detect, although there is a modest degree in favor of the more cyclically exposed sectors. The preferences between growth and value, and between big-caps and small-caps are also muted.

Our Bond model is not confirming the new highs in bond prices. Additionally, the bond market is showing a disturbing lack of upward momentum, particularly with longer-maturity bonds. No doubt the rapid rise in commodity prices, particularly in industrial and agricultural goods, is worrying to bond traders. While actual general inflation has remained not only well behaved, but heading lower, fears are fairly widespread that the Fed's new efforts in easing will give the results the Fed wants: higher inflation. Inflation-adjusted bonds have rallied sharply and futures prices for longer-bonds demonstrate a growing effort to discount higher inflation.

EQUITY UPDATE:

In October the stock market continued its rally, but with declining momentum. While the S&P 500 was up 3.8% and the Dow Jones Industrials 3.2%, the NASDAQ outperformed both, rising 5.9%. In anticipation of Quantitative Easing (QE2), or the purchasing of bonds to pump liquidity into the slowing economy, investors ignored negative data. They feared "currency wars", devaluing of the dollar, and inflation. As a result, the dollar declined while commodities and stocks rose.

Information technology was the second best performing sector, up 6.4% for the month. Although it displayed its traditional fall seasonal outperformance relative to the S&P 500, the 6.4% number doesn't reflect the wide variation in individual issues in October. The best performing company, Monster Worldwide Inc., was up 41%, while the worst, JDS Uniphase, was down 16%.

Correlations between individual stocks and the S&P 500 declined further. The market was a stock picker's market, as investors looked for returns that had not been fully exploited. "Growth" outperformed "value" in small, medium and, especially, large-sized companies. Year-to-date, growth has outperformed in small and medium companies but value has marginally outperformed in larger ones.

The month was tilted towards cyclical sectors as commodity prices rose. The top group for October was materials. The two companies in it with the best performance (CF Industries and Monsanto) were both agricultural materials companies. Agricultural commodities rose not only due to the declining dollar but Mother Nature, with droughts in some places, floods in others. Farmers were more confident investing for the future with high prices for their production. CF Industries, which produces fertilizers and agricultural chemicals, rose 29%. Monsanto, one of the largest seed companies in the world, rose 23.1%. They use genomics to develop seeds that are weed or pest resistant. We are overweight the group and currently own an agribusiness ETF (ticker MOO).

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

Data as of 10/29/10

The third best performing sector for the month was energy, up 5.5%. However, the group has lagged the S&P 500 year-to-date. Over the last year, crude has traded in a range of between \$70-85/barrel. During October, though, it traded at the high end of this range, reflecting fears of dollar weakness, and, as a result, energy companies rallied. Our Sector Strength Model does not rank this group highly, and we are underweight it.

Consumer discretionary was a close fourth in sector performance, rising 5.3% for the month, while maintaining its position as the top sector year-to-date. The high-end, luxury side of the consumer discretionary market continued to do well, especially in China. The top performer for the month was Wynn Resorts, which operates luxury hotels and destination casinos in Las Vegas, Nevada and Macau, China, where the average casino had revenue increases of 50% in October due to Chinese holidays. In the U.S. there appears to be a structural change in spending patterns. Consumers are investing less in their homes but they appear willing to spend on new clothes or a hot new gadget. If the economy continues to languish, we will monitor this sector closely for any signs that they are moderating their spending habits.

The fifth sector was consumer staples, up 2.8% for the month and 8.0% year-to-date. As commodity prices rose, some of the companies in this sector have had difficulties passing on rising input costs. The top performer was Estee Lauder, the cosmetics company, for which Asia accounts for 40% of its total sales. According to the CEO, "the most affluent consumer is back to normal and the less affluent consumer is having a bit more [trouble] normalizing [their] behavior." The tobacco companies, with steady earnings and high dividend yields, also performed well in October.

The Industrials sector performance came in sixth up 2.5% for the month, and is the second best performing sector year-to-date. John Deere, another agribusiness play, was the top performing stock in the sector. Industrial companies

have significant exposure to emerging markets where growth is higher than in developed markets. We are overweight the sector.

The healthcare sector came in seventh for the month, up 2.0%, but was the worst performing sector year-to-date, down 0.3%. It was weak earlier in the year due to the uncertainties of Healthcare reform, and has remained so as investors reached for yield and invested in riskier assets such as emerging markets, commodities and more cyclical investments.

The eighth sector was financials, which were up 1.3% for the month, and are the second worst performing sector year-to-date, up 1.06%. It suffered from more bad news on the mortgage front as it became clear that many banks had problems with sloppy foreclosure procedures, slowing down the process of cleansing their books of toxic assets. Although it appears that no borrowers lost their homes without first being seriously delinquent on their mortgages, the cost and time to correct the problems are unknown. We are currently underweight the sector.

Utilities came in ninth up 0.9%, and Telecom came in tenth down 0.1% for the month. These numbers do not reflect the total return or the dividend yield of these sectors. Both have fairly stable earnings and are the top dividend payers of the ten S&P 500 sectors. The utilities sector has a 4.2% dividend yield and the telecom sector has a 5.3% yield. These yields are higher than treasuries and comparable corporate bond yields. We like the "bird in the hand", defensive nature of these sectors and are currently overweight both.

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:

The Federal Reserve Board is laying the groundwork to engage in a second round of monetary easing. Because short-term interest rates, which the Fed controls, are already near zero, other policy tools would need to be put in motion to provide for that easing. In the current case, the Fed will be "expanding" its balance sheet which is a euphemism for buying bonds for its own account. Under

its legal powers, the Fed does not need to have the assets needed to make the purchase in the first place. It merely creates the money it pays to those who sell the bonds to them. In the modern era, they will not actually be "printing money" or currency but, rather, just crediting the accounts of the sellers in the form of a wire to them.

This will be the Fed's second round of quantitative easing (QE). The elements surrounding this policy initiative are as important as they are interesting. When Chairman Ben Bernanke began to lay out his thinking on the matter, he was very careful to first point to the Fed's very strong record in containing inflation. While that institution's track record was very spotty in the 1970s, Paul Volcker took the reins of the Fed at the end of that decade and forcefully steered the nation to a course of ever-lower inflation rates in the ensuing decades. Bernanke now invokes those credentials to assure us that, if worse comes to worse, we need not worry about inflation.

With that said, the Chairman went on to indicate that the current rate of inflation is actually too low and threatens to turn into deflation. Bernanke is perhaps the leading scholar on the Great Depression and has indicated that the Fed in those days made matters worse by contracting the money supply. There are many things to fear in a deflation. Wages go down and, probably, employment too. Of additional concern are debts. Interest and principal payments are typically fixed. During an inflation episode, future interest and principal payments are serviced with dollars that purchase fewer things, thus benefitting the debtor. In a deflation, revenues are typically declining and one dollar will buy more than before and is therefore much more burdensome to use to service debts. So the Fed is rightly concerned that in a deflation, debt defaults will soar.

This time Bernanke knows, through intimate previous involvement, that the country's banking system still carries huge quantities of toxic assets and loans. The first round of QE was sizeable, but it did not eliminate those bad bank debts entirely. Rather, the plan was to give as much aid as possible and hope that a recovering economy would lift the price of the impaired assets. That is, the policy essentially just kicked the problem down the road.

When Bernanke laid out his reasoning for QE2 he followed his recitation of the Fed's inflation-fighting credentials with a reminder that the Federal Reserve has two mandates in law. First, it must try to keep a stable purchasing power for

our money. But, simultaneously, the Fed is also required to try to keep the economy fully employed. The Fed is clearly worried that higher unemployment and debt deflation are merely two sides of the same coin.

Nevertheless, many economists, analysts and investors fear this new round of QE. Massive policy intervention of any type is invoking concerns. In this particular case, most of the fears revolve around the dollar. At a time when the administration is vocally active in wanting to partner with China, with whom we have the biggest trade deficit, to push their currency higher, QE is thought to directly push our currency lower, contributing to the process of getting one of the Fed's main goals: upward inflation pressures to offset any potential deflation impulses.

When the Fed purchases bonds, their price could rise, at least for a while. Interest rates for longer maturities could thus fall. The uncertainties are that a lower dollar will push bond prices in the other direction. Our sense is that much of the money in the markets is "bet" on a weaker dollar. That is corroborated in surveys of investors as well as actual transactions, particularly in futures trading.

This fundamental set of disagreements cause one of the bigger uncertainties facing investors in some time. At a minimum, the volatilities of bonds and currencies should rise. As we have remarked so often over the last three or four years, the consequences of negative outcomes still appear greater than the consequences for positive outcomes.

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