

The Avatar Advisor

MEETING THE INVESTMENT CHALLENGE SINCE 1970

OUR RESEARCH:

In the last two economic expansions (the ones following the 1980 and 1990 recessions), job growth was much slower than in all prior expansions. It was assumed, therefore, that the current expansion would follow the most recent examples. Judging by opinion surveys of workers, politicians and pundits, this expansion is not only like the prior two, but much worse. Given that seven million jobs were lost in the Great Recession, adding back the one million jobs we have experienced over the last year certainly seems like corroborating evidence. On both sides of the political spectrum, the number one focus seems to be on getting new jobs. Interestingly, Federal Reserve Chairman Ben Bernanke has made employment the touchstone of monetary policy. Despite some modest uptick in inflation, the Fed is steadfast in its efforts to get job growth into a higher gear. In a sense, the unemployment rate is the only metric Bernanke would have us focus on. The monthly payroll data has averaged about 120,000 new jobs per month. But about twice that is needed to bring down the unemployment rate. Indeed, at 120,000 jobs per month, this cycle looks more like the last two than the more vigorous ones before that. But we are intrigued by two aspects of this somewhat pedestrian performance. First, the amount of data manipulation the Department of Labor goes through in order to produce these numbers is not a process which engenders confidence. For example, there is a need to estimate how many companies have gone out of business and how many are opening shop. This is called the "birth-death" adjustment. The data, which comes from a sample, is constantly revised, sometimes back over the prior five years. Often, particularly at cyclical turning points, the originally reported data is revised so much that it is almost useless. There is also a requirement to guesstimate who is looking for a job and who is not. That is a crucial aspect of calculating the unemployment rate. While the employment report is critical to policy, the average error in it is extremely wide, exceeding 100,000 jobs per month. So we really do not know where we are with any certainty. But there are many different ways to take the pulse of the labor market, some of which are anecdotal and others which come from industry sources. For example, employment agencies report that their business has been strong, particularly for part-time workers but increasingly for full time positions. Surveys of businesses, large and small, show strong hiring intentions and activity. Taxes collected on payrolls, both at the federal and state level are likewise rising smartly. The University of Michigan's survey of job expectations has just exceeded its high point reached in 2007. The net result is that either the Labor Department data is going to be revised higher and/or we are on the cusp of a pleasant surprise.

Our Practical Value model is suggesting that market gains from here will, more likely, have to come from profit growth rather than from rising valuations. Although the level of valuations has been higher (in 2007 and at the Dot Com peak, 2000), clearly the huge market rally since March 2009 included a major element of valuation markup. Still, profit growth has been very impressive. The full extent of the fall in earnings during the Great Recession has largely been recovered. Consensus estimates of profit growth for the S&P 500 over the next twelve months suggest an increase of more than 15% from current levels. Corporate insiders would seem to support this solid outlook. They have been buying stock in their own company at an elevated rate. Management has also raised dividends and increased share buybacks. Capital spending has also been accelerating and that is just one more example of fairly high levels of confidence in the private sector, particularly among larger companies. An important test for the market will be whether increasing interest rates will put downward pressure on valuations. Since 1998 rising interest rates have actually been bullish for stocks. One final bullish element for stocks is that flows into equity mutual funds have only recently begun to increase. After record redemptions in the spring of 2009, investors have pretty much shunned equity funds in favor of bond funds. In the last several months, that trend has begun to reverse. Historically, the flow into stock funds needs to reach a very elevated level before concerns are warranted that too many people are chasing stocks.

Our Economic Liquidity model continues to suggest that liquidity is readily available. The Fed has forced a much greater quantity of liquidity into the system. Bank assets continue to rise faster than their new loans. Corporations have built up a record amount of liquid assets as a percent of their net worth. And their short-term debt is the lowest fraction of total debt in history. Even households have dramatically reduced their short-term relative indebtedness. Against this formidable array of positives are the negatives that are represented by a dollar which, at best, is in a trading range. History suggests that the environment is much healthier when there is enough of a net foreign inflow of funds to push the dollar higher. Even with the recent turmoil in the Middle East, the dollar has struggled to hold its own. The natural alternatives, the euro and the yen, each have their own challenges. Instead, international flows of funds have begun to find their way into fiscally secure countries like Sweden and those countries that have strong commodity export opportunities like Australia and Canada. The net of all these forces is a modestly positive background for investments.

Our Momentum model finished the month on a somewhat weaker note, but the overall level is still positive. The main prop to the market is that investors are still comfortable in getting exposure to cyclical risk. That is, sectors like industrials, technology and materials continue to outperform more defensive sectors such as telecomm, utilities and health care. This preference for risk was reduced a bit as a number of the emerging stock markets met some fairly heavy selling. These markets typically carry more intrinsic risk, so corrections tend to be more violent than those in the developed world. Still, declines like that always elicit the concern that the party is over. A number of market contrarians are already concerned that flows of capital into emerging markets have been extremely high and may signal that we are closer to the end of their outperformance. The complex calculus, of course, is how to distinguish short-run challenges from the obvious long-run stellar outlook.

Our Bond model continues in its negative zone, again exclusively because of the weakness in Treasuries. For the first time in a while, however, there are some signs that the rise in

Treasury rates may have gone a little too far too fast. Sovereign bonds in other developed countries have been even poorer performers but they, too, seem to be catching a breather. This is all the more interesting because, if anything, inflation concerns have certainly ratcheted higher. The leap in oil prices as the Middle East has embarked on something of a revolutionary wave has already worked its way into the data and the gasoline pumps. For now, however, most fixed income investors are seeing the rise in the price of crude as a tax and, therefore, ultimately a depressant on economic activity. Indeed, there is very little evidence that rising energy (and agricultural) prices have worked into wages in the developed world. That is not as much the case in a number of developing countries. Apart from inflation, policies there have been toward increased wages as a way to reward huge leaps in productivity as those societies move from an agrarian base to the industrial world. While still cautious about sovereign debt, the outlook for corporate bonds continues to be positive in our view.

EQUITY UPDATE:

During February, the S&P 500 appreciated 3.2%, the Dow Jones Industrials 2.8%, and the NASDAQ Composite 3.0%. Most of the gains came early in the month. Toward month-end, the historic unfolding of events in the Middle East began to dominate investor calculations.

In the meantime, economic activity in the U.S. and around the globe continued to forge ahead. There are reliable indications that the growth in this country's manufacturing, industrial and export markets is more like the strong expansions in the 1980s and before, rather than the slow-growth recoveries of 1990 and 2002. On the other hand, financial and government service sectors are lagging even those two recent slow recoveries. As a result, over the last six months or so, the stock market has been favoring those sectors with a cyclical exposure at the expense of more defensive groups.

Continuing its recent trend, the energy sector was the best performing group in February, rising 6.8%. For the year-to-date, this group was up almost 15%. The strength in the industrial side of the global economy has pushed up the demand for energy at a time of rising geopolitical tensions in a number of the oil producing countries. Within the energy sector, refiners and exploration companies have enjoyed the best success.

After a modest correction early in the year, the consumer discretionary sector regained lost ground and appreciated 5.8% in February. The winning stocks were the retailers which concentrate on the discount and "dollar" segment. There also was strong media and entertainment stock performance, which is

a good sign for the gradual revival in consumer spending. Surveys of consumer expectations have firmed up across the board.

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

Data as of 2/28/11

The next group was health care, which gained 2.8% in February and was up 3.2% for the year-to-date. Most of the strength in the sector was in companies that specialize in medical devices. Drawing up the rear were the big pharmaceutical stocks. The hospital companies were about in the middle. Investors still are trying to sort out the winners and losers from the health care reform legislation. But an added issue is the continued dearth of new compounds being explored in the research labs of the big drug companies. Some of the smaller companies in that space are doing much better and are, naturally, getting some take-over feelers.

The financial sector was the fourth-best performing group in February, as in January. For the month the group was ahead 2.7% and the year-to-date, 5.6%. A good deal of the strength was in the insurance sector with Aon, as an example, advancing more than 12% for the month. There was also a flurry of activity around the stock market exchanges, including NYSE Euronext and NASDAQ OMX, as they responded to merger and acquisition activity. The mega banks are still wrestling with the changing landscape of lower proprietary trading activity and disposition of underperforming loans. As the economy expands, our expectation is that credit quality will recede as a negative.

Materials were in fifth place, advancing 2.5%, after a flat performance in January. There was a broad range of returns in the group with the more processed commodities doing better than the intermediate and crude goods. Thus, the chemical group was the strongest, while steel and other metals companies fell behind. Given the historic surge in growth in the developing world, the long-term picture for this sector as a whole looks very bright. But this group has always been among the more volatile sectors and the current environment is no exception.

The consumer staples sector was the sixth-best performing in February of the ten major sectors. The group was up about 2.4%, fully reversing a decline in January. The performance of Wal-Mart is dominant in this sector and the stock was down more than 7% in February as it continues to try to fine-tune its merchandising strategy. That is no easy task given the size of the company and some of the historic changes that are riling American consumers. A number of the food producers and food retailers had a better February performance. No doubt these companies are beginning to respond to, and pass along, higher raw material and purchasing prices. The most recent consumer price index report showed a larger-than-normal increase in this area.

Telecom service companies are the smallest S&P sector by weight of capitalization. The largest companies had a difficult

month as new product introductions in mobile telephones are causing major short-run disruptions. The sector was up about 2% in February, regaining about half its losses in January. Ultimately, the growth in mobile phones should provide some profit results worth the effort, but the task of adapting new technology on a global scale is a big challenge for these companies.

Industrial stocks as a group were up 1.8%, only good for eighth place in February's performance derby. But the group had a strong January, so for the year these stocks are ahead by 6.4%, second behind the energy sector. This kind of volatility is typical of the industrials. In February the best segment was in domestic transportation, like Norfolk Southern, which rose 4.5%. Other good performers included companies which service the mining industries worldwide. Demand from China for raw materials has been steady and strong. The mining equipment and infrastructure group has responded.

Ninth place for performance in February was the technology sector. Like the industrials, the tech group had a pretty good January. Individual stock movements were extremely broad in February with JDS Uniphase up more than 42% while Akamai dropped almost 25%. The one theme that seems to be consistent is that large businesses (the "enterprise" group of customers) continues to be a source of strength to information technology vendors. Many companies are moving ahead with both upgrading technology as well as adding new capacity and capabilities. The drivers continue to be the need to keep up on mobile computing as well as computing over the Internet (in the so-called "cloud").

The utility group drew up the rear, advancing less than one-percent. The sector also had a modest gain in January, leaving the year-to-date appreciation at less than two-percent. Volatility in interest rates typically hurts this group because of its dependence on fairly large quantities of debt and the regulatory presumptions that returns on investment should be tied to prevailing interest rates. While the industry is only lightly regulated compared to the past, this kind of concern is fairly typical in economic cycles when monetary policy starts to get into the headlines. We continue to 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.

FIXED INCOME UPDATE:

A year ago the big question was whether the economy would face either a low growth rate due to enormous credit concerns or, worse, dip back down into recession. In reality, economic growth has proved stronger and more resilient than the two dour and limited choices available at the time.

Today's big question is, will a combination of easy Federal Reserve Monetary policy along with skyrocketing commodity prices lead to a serious bout of inflation, or will the degree of slack still present in production and labor markets absorb these pressures? In a sense, this is a test of theories of what causes inflation.

The late Nobel Laureate economist Milton Friedman reportedly said that inflation is always and everywhere a monetary phenomenon. If there was too much money chasing too few goods, then inflation was inevitable. This "monetarist" view of inflation has created a heightened worry about the current insistence of the Fed in its pursuit of quantitative easing. Many see the rise in global food prices as a sign that the seeds of inflation have already been sown.

On the other side of the argument are economists who point to the relationship between supply and demand for goods and services as the ultimate driver of inflation. In this view if there is an excess of labor and/or productive capacity, inflation will not take hold. In the current instance, those who, like Fed Chairman Bernanke, see vast underutilized labor and factory capacity, are not that worried about an inflation episode setting in. If anything, many of these analysts have a wary eye out for too much excess capacity turning into a dangerous bout of deflation. Given how much leverage is still in the financial system, debt defaults would likely accelerate.

The current argument is clouded by the additional problem of the definition of terms. What is the inflation? What rate of change has there been? Over what period?

The biggest of these questions right now is the first one, the definition of inflation. There is a controversy currently and it deals with the issue of inflation in energy and food prices. Most economists in the U.S., and certainly at the Fed, believe that those two items should be deemphasized and that the inflation rate which excludes energy and food is a better metric for measuring inflation. The argument is that the volatility of energy and food is much greater than for other items and are, in any event, transitory. So the so-called "core" inflation rate is the one to focus on.

It just so happens that the European Central Bank does not typically focus on core inflation. Rather it usually reacts to

"headline" inflation, including energy and food prices. In the United Kingdom, there is not as much consistency in approach. In Japan, deflation has been the concern so that some inflation is actual welcome, regardless of its cause.

Normally, these differences in policy approach are not large because energy and food prices (particularly the latter) have not moved in tandem during the last several decades. But, as is obvious, the rise in these prices now is truly headline news.

Regardless of the details about the definition of terms, there are some metrics in the market place that typically confirm and even foretell the bigger picture on inflation. For example, the structure of yields over various maturities in the bond market has been a reliable judge of inflation. Right now, while there has been a bit of a rise in concern, the overall level of these indicators is still benign. While a little bit more obscure, the individual segments of the bond market (governments, corporates, mortgages and the like) have a relatively low correlation of performance between them. This suggests that the market is not yet concerned about the one thing which would unite all of the sub sectors: inflation. Finally, we also note that a broad sampling of surveys of consumers and business leaders show only subdued inflation expectations.

As of now, the weight of the evidence sides with the group that sees too much slack in the system for an inflation episode. Still, the theory of monetary influence is strongly held and will contribute to volatility in bond prices both because of Fed policy moves and commodity price increases.

We also think that, as the global economy continues to expand, the pressure will grow on the Fed to move away from its emergency levels of short-term interest rates. And that will happen quite apart from the course of inflation.

In sum, the crosscurrents in the bond market continue to be, in our opinion, unusually volatile. For the last six months or so we have expressed that concern by having a reduced weight in Treasuries and a relatively heavier commitment to corporate debt.

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