

The Avatar Advisor

MEETING THE INVESTMENT CHALLENGE SINCE 1970

OUR RESEARCH:

During periods of market weakness there is often a temptation to consider a stock to be cheaper, merely because it is now at a lower price. That is, many investors who consider themselves guided by fundamental value feel that a price decline is the equivalent of a gift. Once the market returns to a more normal level, a nice gain can be pocketed. It rarely occurs to most of those investors that the market may have retreated because the fundamental elements of value have deteriorated and so no real bargains were actually available. The best example of this illusion was demonstrated in the market crash of 2008-09. Any number of analysts were eager to buy bank stocks after they had declined 10% to 15%. Ultimately the losses in many bank stocks exceeded 90%. The same kind of thing happened to the home builder stocks. As it turns out, value investing is much more difficult than just waiting for stocks to decline. Even so, each market decline brings out the hopefuls. Of course, some market declines are not related to deteriorating fundamentals and do present something of a gift. The trick is to try to understand the driving forces. The recent market selloff appears to be one of those cases where there has been an identifiable slowing in global growth. Additionally, credit conditions, particularly in Europe, have deteriorated as sovereign debt quality has come under question. Against those problems has been a remarkable improvement in the corporate sector. Having experienced serious financial stress in the last recession, corporations moved aggressively to pare costs and improve balance sheets. As a result, the economic expansion over the last year has resulted in the largest cushion of corporate cash inflow to outflow on record. One of the benefits of this strong

position is a pickup both in manufacturing and in capital spending. Businesses have increased the hours of their work week and added temporary help. There has even been a modest rise in new hiring. So in the end, whether these lower equity prices are indeed bargains rests largely on the relative strength of the negative forces in comparison to the positive. Our own assessment is that the volatility and uncertainty involved in the issues is itself a market depressant calling for some caution.

Our **Practical Value model** has improved and is very close to the bullish zone. Insider selling has moderated. Options traders are beginning to be too bearish, buying puts in large quantities. Surveys of investor opinions likewise are reflecting growing pessimism. So part of the evidence is that values have improved. But the issue is by how much. Our indicators are not yet at levels which clearly offset the growing risks to global economic growth. We think the primary cycle of economic and profit growth is still intact so it is possible that those compelling levels are not that far away.

Our **Economic Liquidity model** continues its slow improvement and is just above the neutral zone. The Federal Reserve continues to make funds readily available. The dollar has been generally strong. On the negative side, credit conditions in Europe have deteriorated so much that the U.S. bond market has experienced a bit of a give back in the relative performance of poorer quality corporate bonds.

Our **Momentum model** has dropped into the negative zone. A rally attempt in early June was characterized

by fairly disappointing and volatile leadership. Trading volume, which has been rather low throughout the whole bull market was not supportive. We also note a turn away from stocks which benefit from economic growth. Finally, the breadth of the market, measured as the net between advancing and declining stocks, has rolled over, breaking a fairly strong progression that started in March 2009. Part of this development is that smaller capitalization stocks have begun to underperform the more defensive larger cap stocks.

EQUITY UPDATE:

The major indices were down once again in June, with the Dow Industrials and the S&P 500 down approximately 1%, with the NASDAQ down slightly more. The S&P Volatility Index jumped once again for the month, reflecting the uncertainty in the marketplace. Economic news on the domestic front has been disappointing lately, with additional evidence of sluggishness in the housing and labor markets. Adding to those fears is the realization that the U.S. likely cannot escape the effects of slowing economies in Europe.

For June, there was less than 1% difference in the performance of large-capitalization “growth” versus “value” companies. The difference was greater, however, for mid-sized and small companies, with “growth” performing 2-3% better. For the year, large-capitalization value names outperformed growth by approximately 4%. For mid-sized and small companies, though, the difference was less than 1%. Overall, mid- and small-cap companies have outperformed large-cap ones by over 5% for the year. This is, in some measure, due to negative currency effects upon the larger, more international companies, which are more heavily dependent upon export revenues.

As would be expected in this environment, the less cyclical industries performed relatively better in June. The top two groups were telecom services and utilities. These two were easily on top for the quarter as well,

Our **Bond model** continues to be just within the positive zone. Economic growth is slow enough to permit Treasury issues to continue to perform well. Inflation is not a factor in bond prices and corporate demand for funds is not enough to force Treasury yields higher. We see some modest evidence of concern about credit quality, particularly among very poorly rated corporate bonds. These credit spreads are very much associated with economic expectations.

although both were the worst for the first quarter. While telecom services ranks fourth (neutral) in our SectorStrength model, the utilities group ranks last.

Asset Allocation Highlights		
Asset Class	Position	
Domestic Equities	Underweight	
International Equities	Underweight	
Bonds	Neutral	
Cash Equivalents	Overweight	
Domestic Sector Ranks		
Rank	Sector	S&P 500
1	Consumer Staples	11.61%
2	Materials	3.43%
3	Health Care	12.12%
4	Financials	16.13%
5	Cons Discretionary	10.17%
6	Telecommunication	3.05%
7	Info Technology	18.80%
8	Industrials	10.24%
9	Utilities	3.68%
10	Energy	10.77%
		100.00%

Data as of 7/2/10

The healthcare group was third for the month. Performance for it has been in the middle on a relative basis for the quarter and year-to-date. Within the group, the pharmaceutical names performed better than the device manufacturers, service providers, or biotechnology companies. This sector has moved up in our work recently and we are slightly overweight.

Consumer staples, another non-cyclical group, came in fourth for June. Because of its defensive nature, it has managed to stay among the top five groupings for both the first and second quarters in 2010. For the third and fourth quarters of last year, though, when the market was moving upward, the group remained in the bottom half.

The energy sector came in fifth for the month. It got badly beaten up in May for several reasons. Domestically, oil companies have been dealing with fallout from the BP disaster. On the international front, the potential for slowing global economies brought the price of oil from \$90/barrel to below \$70. For June, however, oil prices ended up relatively flat. To the extent things have heated up between Israel, Iran, and surrounding countries in the Middle East, those concerns have not yet been reflected in oil prices. We are watching fleet movements into that region very carefully. Energy ranks poorly for us and we are underweight.

The financial group was sixth for the month. Concerns about fresh regulation weighed heavily on the sector,

FIXED INCOME UPDATE:

Our main theme for the year 2010 continues to play out. After the traumas of the credit collapse, the stock market crash and the Great Recession, a year of "transition" would be natural, to the extent history can be referenced. The main notion behind the transition is that a range of conflicting outcomes become credible and part of the dialogue. For example, entering the year, economists and analysts were widely divided on the prospects for inflation. Many feared an acceleration, reflecting the record amount of fiscal and monetary stimulus that had been applied to the system. Others were at the opposite end, expecting a renewal of deflationary forces once the stimulus-aided cycle ran its course.

but as the House and Senate struggle to reconcile their separate versions of the bill, it looks like much of the reform will not be as specific as many had expected. The tailwind of cheap money for the banks will continue to allow them to kick the can down the road on their balance sheet issues. The group's rank in our SectorStrength model has improved lately and we are currently neutral in our portfolio weightings.

The technology group has been a disappointment so far this year. The cyclical nature of the sector has certainly weighed upon it, as well as continued deferral of spending plans by companies, as they wait for increased demand. Outsourcing has been largely completed, and they are not yet willing to spend to grow the top line. The group has been slipping in our ranks.

The materials and industrials groups landed the eighth and ninth spots on the list, with the consumer discretionary bringing up the rear. As three of the most cyclical sectors in the list, this is not surprising, given the fear of a renewed economic slowdown.

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.

This kind of wide-ranging views was apparent in the parallel expectations for bonds. Following the dichotomy of inflation views, many expected interest rates to rise as demand for loans rose. But others, fearing an economic "double dip", thought bonds would do quite well.

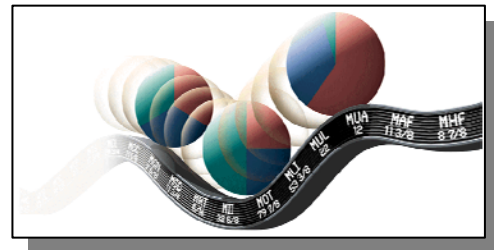
During a recession, the difference between short-term interest rates and long-term rates is usually very large. Then, as the recovery takes hold, this spread typically narrows. Interest rates rise, but more quickly at the short end.

As part of the complexities of "transition 2010," the spread of long vs. short rates has narrowed, but in an entirely unexpected way for most observers. In fact, rates have generally fallen, not risen, and they have fallen more for long-dated maturities. The history of such a "bull flattener" is not that reliable because there are not that many instances. Typically, however, there is some sense that this kind of development might signal an impending economic slowing. Indeed, there is more than enough evidence that employment growth has slowed fairly dramatically. Some sensitive industrial commodity prices, such as copper and lumber, have also softened.

Despite these signs of a "soft patch", there is still a degree of forward economic momentum. In particular, and of great importance, the condition of American corporations is especially strong. Their cash positions, particularly for the larger companies, are at record levels. And capital spending and other outlays for inventories and some extra labor are confirming signs of this strength. Despite an engineered policy slowdown in Asia, growth from that region is still above average and has led to a good growth in our exports.

Our sense is that it is too soon to declare which side wins in this tug of war. There is only one case of a double-dip recession: 1982, following the 1980 recession. But even though the historical odds are against that kind of outcome, there is not enough conclusive proof so far to settle the issue.

We think it is important to be patient as these forces play out. Our portfolio exposure to bonds is about neutral. Having been underweighted Treasuries earlier in the year, over the last several months we moved back into a more normal exposure, reducing our overweight in credit. As the cycle moves forward, the transition issues of the year will move toward resolution. Again, history suggests a continued economic expansion and a further improvement in credit conditions. But the risks have risen and a more neutral posture is suggested by our indicators. Fortunately, the forces of inflation have been muted and that risk is not as important as it might typically be a year or so after the trough of the economy.



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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 \$775 million 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.

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