



## AVALON ASSET MANAGEMENT CO.

### **2011 First Quarter Review and Outlook**

We have rarely seen quarters like the first quarter of this year or price behavior as unusual as it's been in 2011. The index gains in the first quarter were due entirely to a manic rally staged over the last 12 trading days of March.

It was a move that left market participants at a loss to explain, as there were no developments beyond the occasional chart point that would suggest prices should be moving up. We have an explanation: it's called "marking the tape." One usually only sees this phenomenon in December, when there is a kind of informal consensus to lift prices for end-of-year performance: it runs alongside last minute buying by managers trying to catch up in the performance tables.

This is something of a dangerous game, as the foundations of these moves are hardly solid. One needs a certain amount of luck from the headline news flow, along with a willingness of other market participants not to notice that figuratively speaking, the emperor has no clothes. The modern stock market is pretty good at the latter.

In fact, we would say that if anything, the still-oversized financial sector is again deeply engaged in the search for home-run payoffs and the same kind of risky behavior that led to the spectacular crashes we have endured in the last ten years. All of the gains in the market indices this year have come from end-of-month rallies that seem to have a life of their own. And they do have a purpose: lift the indices and keep the game going. The May rally was the weakest and possibly the most dubious: four days of running up prices during light Memorial Day weekend volume, all in the face of a steady flow of discouraging news.

I want to quote something from the Morningstar website: (a company known for mutual fund analysis, it has also branched into individual security analysis) *"in a nutshell...the risk of quality (is) the likelihood of underperformance when the fear/greed pendulum swings toward greed."*

That would sum up our predicament. We've been positioned about as wrong as can be since that March midpoint with holdings that were long on quality and value, and short on momentum and greed. The inexpensive, cash-generating, high-quality names that we've held onto have largely gone nowhere, while the most overpriced names and most faddish sectors have been red-hot, including our short positions (the "dash for trash").

We've been through these kinds of markets before: they don't end well. But that observation may make you wonder – if that's the case, why isn't there a bigger rush to the exits? One reason is performance desperation – money has rushed from one sector to another in search of returns. Although the indices managed to hold up into early May, many darlings of the first quarter corrected sharply, leaving many a portfolio manager crushed and bewildered.

Another reason is that the typical institutional investor – people managing mutual fund and pension fund money – isn't incentivized to avoid losing money. They are incentivized to be better buyers than their competitors.

To take an example, suppose the markets were up 15% one year and down 15% the next (a loss of 2.25% over the two years). Given the choice between being up 20% one year, then down 15% the next - beating the market handily in year one, staying even with it in year two – and being up 10% in year one and down 5% in year two, any manager who wanted to keep his or her job would choose the first option, despite the fact that the latter strategy is more than twice as good (4.5% total return versus 2.0%).

How can that be? It's the way the system is set up. A manager who chose the second strategy outperforms both the market and the competition over the two years – but we measure in one-year units. From the marketing department (and quite often the wealthy client) point of view, the first manager put up a big number the first year and was even with the market in the second - how could it be her fault if the market went down? Meantime, the second manager “underperformed in the first year and lost money in the second.” Gee, what good is that? [Twice as good, actually, but most people won't see it.]

The other part of the large-money investing universe is the hedge-fund community. The classic hedge funds have not done well this year, largely by following strategies similar to ours: buying things that are underpriced, selling what's overpriced. It's been a tough stretch for them. The hedge funds that have done well this year (apart from the specialty trades like oil or gold) are largely what we call “black-box” funds: they use computerized mathematical models and trade based upon price movements, even to the point of algorithms that dissect news flow for the ratio of positive to negative words.

Black-box trading and “high frequency trading” (HFT) now dominate the market action (about one-half to three-quarters of the volume on any day). HFT is also computer-driven, but is based simply on trying to buy and sell nanoseconds ahead of other orders (and if you're wondering about the ethics of this, so do we. We think it stinks, frankly, but the HFT traders generate so much trading volume for the exchanges that they take the money. If it's any consolation, the evidence of their long-term impact isn't conclusive, though we believe the HFT structure to be partly behind last year's “flash crash”).

From what we've seen so far, the main effect of this robot-trading development is for shorter-term moves to become more pronounced. The tendency for pricing towards herding behavior increases, and momentum is a bit stronger and longer.

This is a double-edged sword for the intelligent investor. On the one hand, it increases the likelihood of being out of step with the market over short periods. On the other hand, though, unless the market goes straight up forever, it increases the chances for the intelligent investor to outperform over longer periods. We're not going to worry about the market going straight up.

Looking ahead, for some time we have been fretting about two supertanker-sized problems lying on the horizon: European debt, and the Chinese property & lending bubble. It's difficult to estimate an accurate time frame for the resolution of any financial mess, and the task isn't made any easier by the special nature of such predicaments. They are the smoldering volcanoes of the economy, able to simmer and smoke for such long periods that the markets simply forget about them so they can go about their business. The problem is that the eruption can come any time, and tends to be devastating.

Our guess is that the situation in China won't reach the critical stage for some time yet. It might be this fall, more likely next year or the year after, but it is only a guess. One of the things that bothers us the most is the familiar concept that "it can't happen." During the housing bubble, the mantra was that housing prices never go down – but housing had never been drowned in a tidal wave of money before. Looked at dispassionately, there was no logical reason not to expect problems when the tide receded, but the credo that housing prices never go down took the place of thinking.

There is ample evidence of a bubble in China. Prominent investors have called attention to it. In recent weeks, we have seen familiar signs of bubble behavior: separate stories in the Financial Times reporting that China has passed India as the largest buyer of gold, was the largest factor in the recent silver bubble, and hordes of Chinese shoppers are now spending an average of about \$5500 per person on shopping sprees at Harrod's department store in London, where special extra staff has been added to accommodate them. The Chinese have blown the market for top-shelf French wines up to spectacular levels. Bubble-licious.

However, the guiding belief is that a hard landing or bubble explosion can't happen in China, because the government won't allow it. Apparently the Chinese government can simply order a soft landing by edict, an opinion that curiously enough is shared by many who are simultaneously convinced that government is the root of all evil in our own (and any other) economic system. The fallout is going to reach a long way.

More pressing is the European debt problem. There is no real solution outside of some sort of default for the periphery countries. The northern Europeans are politically less and less inclined to bail out their southern neighbors or Ireland. They want them punished for their lack of prudence, but there are some rather large obstacles in the way. It's nearly impossible to cut one's way to prosperity – one needs a bit of growth as well. But the austerity medicine that the troubled countries are obliged to swallow keep their economies in the hole, prolonging the crisis and giving both lender and borrower more and more time to dislike both each other and the arrangement.

The problem isn't only with the borrowers. If it were, the Germans would likely have already pulled the plug. The catch is that most of the big European banks hold lethal amounts of troubled-country debt. Were any of these countries to take steps to pay back less than the full amount, it would mean real damage to Europe's banking system and possibly another financial crisis.

Politics and popular opinion will play decisive roles in the outcome. The options for Europe, in brief, are one, to simply go on extending and pretending, lending the countries whatever is needed for as long as possible. This would give the banks a chance to earn some capital cushion against the eventual reckoning. In exchange, more austerity. But while the bankers are willing to live with this arrangement indefinitely, the populace on both sides is rapidly getting fed up with it. Divorce looks more and more likely.

A second option is closer fiscal union. It's a good idea, but likely to be pulled off under only two conditions: total prosperity, or total chaos. The former is not imminent, the latter cannot be ruled out.

The third option is a solution that includes some of both and tries to muddle through. But while the headlines are mostly about whether or not the next bond issue will come off and how expensive it will be, they miss the heart of the problem: there is just too much bad debt. The countries have too many bad loans and too much bad paper. The real question is, who takes the pain? New lines of credit are only so much morphine that treats the pain but not the disease.

The present approach has the economies of the guilty countries in debtor's prison with hopes they earn their way out. In other words, they take the pain. That may seem morally satisfying on the surface (especially to the ones who lent the money) but it neglects a bit of realpolitik. The people living in the affected countries may want to do the right thing, but their willingness to endure years, if not decades, of austerity in order to protect banks domiciled outside of their own borders isn't likely to last.

The moral aspects are debatable, but reality and history both suggest that the debtor countries will not long be on the side of the banks – even their own. We recently saw a news report summarizing German attitudes, and one local

observed that the only thing that would be less popular in Germany than bailing out the peripheral countries is bailing out the German banks.

Sovereign debt crises follow the same script. Denial, then guilt, then a noisy determination to pay off the debts and fight one's way out. It always ends the same way: the realization that the debts are too large and need to be restructured.

The final act and its consequences are unclear, but one thing that seems certain is that the lending banks – and the Germans have lent considerable sums – are going to take some kind of hit. Government and central banks may or may not come to their aid, but the recapitalization will come at a price, and growth will pay a price.

Now there is another supertanker problem on the horizon: the battle over the US debt ceiling. From the point of view of practical economics, we should simply abolish the debt ceiling and get on with a more practical discussion of how to improve the economy. The biggest cause of the current deficit, after all, is the crash of 2008 and the subsequent severe downturn in tax receipts. Less economic activity means less revenue.

Ah, it's nice to dream, isn't it? The outcome is uncertain, but one scenario we aren't holding our breath for is a simple, pragmatic solution. Have no fear; we aren't going to lecture you on the debt ceiling or its highly charged politics. But we do want to briefly discuss the possible outcomes.

There are several paths the conflict could follow, but essentially it boils down to a series of combinations: default or no default, government shutdown yes or no, big cuts yes or no. As to default, if the Treasury misses any interest payments, it will rock credit markets around the globe. We could see markets freeze again, and that's not an exaggeration.

Most people, including the majority of investment professionals I meet, don't appreciate how close we came to a complete breakdown of the financial system in 2008. Perhaps it's too difficult to grasp. Yet a Treasury default would give us all the chance to see what we missed. A just-released Pew research poll revealed that the majority in the survey fear raising the debt ceiling more than default. That worries us. A lot.

We don't think the government will let Treasury miss an interest or principal payment. But we didn't think the government would let Lehman slide into an unmanaged bankruptcy, either. We're not saying it will happen, but if it does, it will be very, very bad.

Another possibility is that Congress defiantly goes to its August recess with the notion that Treasury has to sort its own way out (very close to the attitude on

Lehman - “it’s their problem, let them fix it.”). There’s a better chance of this happening, and it wouldn’t be good for the markets either.

We hope that Congress does stick around to raise the debt ceiling (it would be nice). It would appear that such an act will be combined with a program of massive cuts, or more typically put together with promises of lots of future cuts down the road, so that both sides can claim victory.

Either of these last two outcomes would almost certainly spark a rally in the stock market (traders reflexively hate taxes first and the government second). The first option, a real package of massive cuts, would put us into recession shortly afterwards (it’s been tried before, and with the same result). The second option is less clear because the mix of real-time and delayed cuts is impossible to speculate on, but we will say this – sizable cuts in government spending will make the economy worse before it gets better. Either program will mean a stock market rally first, but then a bigger decline afterwards.

Some observations to consider: in the recently released study on financial crises, “This Time is Different,” the authors (Rogoff and Reinhart) wrote that *“efforts to sustain a balanced budget in the wake of massive decreases in tax revenues were deeply counterproductive, and attempts to cling to a gold standard deflationary.”* They were referring to the 1936 attempt to balance the budget. The effort arrested the recovery (seven years after the crash) and plunged our economy back into a tailspin.

More recently, the *Financial Times* observed, *“bitter quarrels over [US] fiscal policy have delayed a bill to raise the statutory debt ceiling, causing talk of a possible default – amazing irresponsibility for an economy so deeply in debt.”* The article went on to say that *“big tax increases and/or severe cuts in public spending lie ahead for the US, assuming that another financial-market reverse does not collapse the recovery...premature fiscal tightening is already dragging on the recovery.”* (5/9/2011)

Will Congress do the right thing? In the post-Lehman crash of 2008, Congress initially refused to pass the TARP legislation. It was only when the stock market dropped about ten percent in two days that our august members began to wonder if maybe they had done the right thing.

The TARP parallel is indeed a useful one, because the crash and its aftermath taught us some sobering lessons about the financial system. One is how little most people in the markets understand the economy, and how little economists understand the markets (though both have strong opinions on how the other sector *should* work).

I have worked my way through four separate studies of the crisis and crash, and the thread that runs through all of them is how few people ever saw what was

coming, how few *senior* people understood what was going on around them, and how poorly even to this day people understand what happened. TARP was flawed and remains horribly unpopular, but some version of it was necessary or the entire global economy would have gone up in flames. Few remember the Cuban missile crisis anymore, and even fewer appreciate how desperately close we were to intercontinental nuclear war. TARP was the equivalent.

While the benefit of televised hearings has shown how little members of Congress understand either the economy or the markets – depressingly enough, including the members of the Senate and House finance committees - the crash and its aftermath has made me realize that our political leaders are for the most part as well-placed to referee the economy as I am to sit on a doctoral committee in particle physics – and I have never taken a course in physics.

That doesn't bode well for the debt ceiling battle. The market expectation seems to be that in the end, the two parties will work out some kind of compromise that isn't too radical and the problem will be worked on over the course of the next year and election cycle. We hope so. One unfortunate truth of economies as large as our own, being very large objects with lots of inertia, is that they are laborious to turn, even harder to steer, but nonetheless can be wrecked with surprising speed by policy blunders.

So what does this mean for your intrepid portfolio manager? If we were a mutual or pension fund manager, we would talk piously about our great country and how there are always great opportunities somewhere, because the truth is we would do very little. A fund manager whose portfolio is down 18% when the market is down 20% basks in victory.

We don't like to lose capital. Being early with an investment is an occupational hazard and we are accustomed to buying out-of-favor names on the way down. Sometimes that puts us out of synch with the market over shorter periods. Nevertheless, we do *not* want to have our portfolios go down with the ship while we shrug and talk philosophically about "market conditions."

The markets are *not* efficient. If anything, the recent dominance of computerized algorithmic trading has strengthened what has always been the market's chief weakness, its predilection for herding behavior. The tendency to ride the trend at times overwhelms any ability to act rationally, with the most recent examples being the market rally of August 2008 and market bottom of March 2009.

The pendulum almost always swings too far where money is concerned, and since markets normally have a structural bias to the upside (investors want to invest), overvaluation tends to happen more than undervaluation. The net result is that traders will keep looking for *something* to bet on, and so long as the traders persist in trying to squeeze one more dollar out of the trend, institutional investors fear to leave the game. They all go down together.

We don't want to go down with them, however. This usually means missing the last few percent of upside (in 1999, it meant giving up a lot). Believe me, we would love to be able to get that last few percent and then bail out at the top. But we can't. No-one can. Inflection points of complex systems are inherently unknowable in advance – more simply, there is an element of chance that can't be predicted.

In sum, the markets could rally further from current levels, despite the growing dangers. Although the economy is clearly slowing, second-quarter earnings for the main body of S&P 500 companies are likely to beat estimates. Though this is something of a given – the long-term average is that about 65% of companies beat estimates in any given quarter – it's a game the market never tires of.

Management guidance should matter during the next earnings season (July), but I simply can't tell you whether companies will give upbeat guidance or not for the rest of the year. For one thing, the line between trying to protect the share price (let's not be too honest) and avoiding litigation (better not hide too much either) is subjective. For another, sometimes when investors are running out of alternatives – as they are now – they ignore guidance anyway.

We are lightening up on corporate bonds – prices are at historic highs – and we are lightening up on stocks. We are also easing back on municipal bonds – they still represent very good value, but there are some obstacles coming up. To begin with, there is the ongoing battle over the debt ceiling that could set off panic in the credit markets. It's more likely to happen after July, but exactly when is unpredictable.

Another issue is that the fiscal year ends for most government bodies on June 30<sup>th</sup>. At the moment, demand is strong and supply is very light, but after the fiscal year ends the situation could reverse. It's a thin market, sleepy in most years, but at times quite volatile. With the credit markets set up for perfection – and you know how often perfection happens - we would rather be a little too early than a little too late.

It's possible that the stock market decline that began in May continues right through the rest of the summer. We could also get a defiance rally in between with the final reckoning in the fall - trend-followers can be surprisingly tenacious. The point is that a correction is pending, one that will wipe out all of the year's gains, at least for a time. When the pendulum swings to the other extreme, we want to be ready. We ask your patience, and remember – it is far better to be on the outside, wishing you were in, than to be on the inside, wishing you were out.