



Avalon Asset Management Co.

Second/Third Quarters 2011 - Review and Outlook

The story of the second quarter for the US equity markets, and equity markets around the globe, was one of trying to hold off reality. For four months in a row, March through June, prices would steadily deteriorate during the month, only to be bailed out during the final days. Trading money would come into the markets in an effort to prop up prices (and performance, and especially fees).

It doesn't take as much firepower as you might imagine. Hedge funds with a few billions to spend are able to take advantage of the knowledge that high-frequency trading (HFT) programs, which usually make up more than half of the trading volume, exaggerate moves in both directions. It was an effective strategy: sit out the bulk of the month, keeping your powder dry, and then bid prices up towards the end. The phenomenon of "robots chasing robots," or automated trading programs following each other up and down the tape, became firmly established this year.

If you're wondering how such a thing could happen, it isn't that the markets are rigged, just that it's easier to implement certain strategies during years like 2011. The usual flow of money into equities has been almost non-existent, the economy lacks momentum, and trading volume is light relative to market size. It's easier to work the tape under such conditions. and so we have the "black box" (algorithm-based) and HFT traders trying to ride trends, nudge them, or both. The rallies have often been narrowly based, concentrated on index ETFs and a few key names.

We were quite exasperated by the whole game at the end of June, writing sardonically in July about "fairy dust" infecting the markets and predicting that some very difficult times would follow. After one last rally, a brief one we thought, one of two scenarios would ensue: "bloodbath" or "look out below".

We were pessimistic for the reasons we cited in our last quarterly report: Europe, the Chinese property bubble, an overhyped growth rate, and the impending debt ceiling battle. The markets managed to slip through to the end of the quarter without any of those issues coming to a head, but since that time all of them have made their presence felt.

The second quarter was also characterized by high food and energy prices, a housing market that continued to go nowhere, slowing employment growth and the after-effects of the Japanese tsunami. The last problem particularly affected

the manufacturing world. An advantage of the modern economy is that we don't have inventory excesses as big as the ones we used to have; the offset is that shortages can occur much more quickly.

The main industries affected by the tsunami were autos and semiconductors, both of which use select components from Japan. Despite the disaster's tragic human cost, it was not a long-term issue for either sector. Unlike housing, there is plenty of credit available for autos, and with an aging car fleet there is much pent-up demand. In the case of semiconductors, it was the catalyst for yet another cycle of over-ordering and oversupply, but in practical terms that's intrinsic to the sector anyway. There's always something unexpected happening somewhere in semis.

Underneath the apparent strength of the indices, though, many sectors were ravaged and stocks pummeled. Money rotated out of small caps and into big caps, out of value and into growth. The search for growth became increasingly difficult, and hedge funds began to obsess on liquidity. Although the Russell 2000 Index - the most widely accepted small cap index - hit an all-time high in April, that was driven as much by charts and ETF traders as anything else. From its peak in April to the trough in early October, the same Russell 2000 index fell over 30%! They were still down about 15% from April as this report was written.

The "look out below" scenario came to pass in the third quarter. It was an ugly quarter for stocks, with the S&P down (-14.3%) in the quarter. According to data supplied by Morningstar to the *New York Times*, the average U.S. stock fund was down (-16.2%), while the average international stock fund fared even worse off by (-18.3%). Those who might have thought that betting on Chinese economic growth was the safest bet got crushed even more, as the sector was down about (-23%), with some China funds losing as much as a third of their value. The small and micro-cap value sectors, where we frequently hunt for our best ideas and which has the best long-term performance over the decades, got punished as well, to the tune of about (-22%).

So what happened? Two words: sentiment and robots . The first few months of the year were marked by the usual seasonal optimism in the markets about how good of a year we might have. This had been borne along by residual momentum from the fourth quarter of 2010: at the end of August of that year, the Federal Reserve began a program of quantitative easing, popularly known as "QE-2," in an effort to help the economy by keeping long-term interest rates low and adding money to the system.

The equity markets, you may recall, were immediately infatuated by the notion of the Fed coming to their aid, and subsequently became infatuated with their own infatuation. If you're wondering what that means, it's that the upward momentum trend on charts of stock prices looked so good that the path of least resistance

was up. It's human nature for auction markets to fall into trends, and to also prefer going upward to downward.

Market trends also tend to overshoot, and that happened by 2011. The strength of the move had really been hollowed out by March, but that series of last-minute rallies at the end of each month succeeded in camouflaging the breakdown through the end of June. It was as if some big tree had been sawn clean through its base: every time it started to lean dangerously, someone would rush in and push back on it for a few more minutes. From a distance, it appeared as if nothing was wrong.

But in the end, the tree fell over. The drop came in the latter half of July, set off mainly by a combination of three factors: corporate earnings, the US debt ceiling impasse, and Europe's ongoing crisis. Although second-quarter earnings were respectable, management caution about growth prospects for the remainder of the year took some of the romance out of a market also beset by recurring worries over Europe.

The financial sector, in particular the big banks, struggled to produce much in the way of quality earnings. Plagued by problems with bubble-era loans, they remain fearful of lending and have seen most of their favorite gaming venues shut by regulators. Worries about European exposure has further depressed prices. How worried we *should* be is difficult to say, but a genuine European meltdown would certainly hurt any big international bank.

Probably all of the "Gang of Four" (Wells Fargo, Citigroup, JP Morgan, Bank of America) have significant derivative exposure to Europe (we worry about their credit default swaps), but their positions aren't disclosed. So we avoid them.

The ugly political spectacle over the U.S. debt ceiling added the *coup de grace* to market confidence, and we woke up the morning of August 6th to find that the Standard & Poor's (S&P) rating agency had cut the U.S. "AAA" rating for the first time in seventy years. Prudence dictates that we leave out polarizing accusations of whom to blame, but the situation did point out a flaw in the usual Wall Street preference for a divided government: sometimes the only way to get things done during difficult times is with one party holding all the cards (of course, that doesn't mean the right ones will get played, but that's another discussion).

Was the size of the fall justified? Despite the heavy moralizing precipitated by the downgrade and subsequent market decline, it's hard to answer on a strictly analytical basis. The downgrade itself was something of a sideshow, prompted more by fears about the political process and the *will* to pay debts and address fiscal issues, rather than the *ability* of the United States to do either. So said the rating agency itself, which went ahead with its change in spite of making a \$2 trillion error (!) in its initial presentation.

Moody's, the other principal ratings agency, and S&P are now behaving very much like the big banks - having given out credit to anybody who asked for it a few years ago, they are now trying to atone by emphasizing pessimism. It's also worthwhile to note that ratings changes tend to lag trends rather than lead them, so while we wouldn't want to suggest that you dismiss headlines about downgrades, do take them with a grain of salt.

For their part, the Europeans would probably like to kill the ratings agencies off altogether, or better yet bring them under government control. It's partly out of a conviction that they are biased, and partly out of a wish to control the flow of information (and thus action). Many felt that a major contributing factor to S&P's downgrade of the U.S. was indeed a desire to appease European governments, and we wouldn't be surprised if that played a role. You can be certain of one thing - none of these objections would have arisen if the ratings changes had been positive instead of negative.

U.S. debt *is* a legitimate cause for concern, and we will address this issue in greater depth in our 2011 annual review. For now though, we will simply say that it has not yet reached the tipping point, nor is it inevitable that it will (we have some experience here, having argued this point quite a lot the last time it was in vogue during the 1970s). The main problem is the weak economy, not scary notions of out-of-control government spending. Attempts to balance the budget while the economy is still weak, however well-intended, would most likely repeat the experience of 1937 (it backfired disastrously).

Which brings us back to Europe. The markets do have reason to be worried about this situation, a point we have tirelessly been making in our weekly columns and in our reports. In our outlook for 2011, we said that whereas before we had been worried, this year we would be astonished if the situation didn't get ugly. Well, ugly arrived, and we should all be worried.

Europe is not insolvent. However, its inability to get a firm grip on its own debt crisis has led it into a perilous situation and a budding liquidity crisis that *could* trigger degrees of insolvency for some of its member states, thereby causing a systemic panic that could conceivably spread around the globe.

Europe's path to this parlous state of affairs is not quite the same as the one the U.S. took to its own crash. We built a massive pyramid of debt on top of our housing sector and were still busy leveraging it up as late as the spring of 2007. The game could survive as long as prices kept rising, but every bubble must pop eventually. Once inflated, we had no easy way out.

Europe also had a real estate bubble, notably in Spain, Ireland, and the UK, but the larger issues lay in the global credit bubble and subsequent recession. Too much money was lent out on easy conditions. Just as Americans raided the notional value of their houses to keep up their own way of life, so hedge funds

over-leveraged themselves to chase eye-popping payoffs and banks borrowed money to buy other banks. Some European governments borrowed to maintain a certain standard of living. When the recession hit and tax revenues fell at the same time as social payments increased (here as well as in Europe), strained budgets, excessive borrowing and shelved reforms were pushed into plain view.

That government deficits rise during recessions is neither new nor a political judgment; indeed it is one of the best ways to get out of a recession. But some debts rapidly became too large for that particular medicine to work - that is, so long as one wants to remain within the euro currency union. First Ireland was forced to ask for a bailout, then Portugal, then Greece.

There is an essential point about the European Union that seems to be obscured by all the name-calling and pontificating about "lazy southerners" (though Ireland is hardly in the south of Europe), "socialism" (Germany's government is much more socialist than our own), "budget cheaters" (both France and Germany have at times cheated on targets in the past) and debates about moral hazard (why should I rescue a drowning person without first being assured that they will never try to swim again?).

At the risk of boring you with a bit of economics, it bears making the point: ***the creation of the eurozone gave the richer states, particular Germany, access to a cheaper currency. In exchange, the poorer states got access to cheaper credit.*** It was a trade in which there are no innocent victims.

Consider that Germany's exports rose from 29% of GDP in 1999 to 47% in 2008. Several factors were at work. First, give credit to the Germans for improving productivity and making wage sacrifices to stay competitive (partly done in the name of integrating the two formerly separated halves). Second, the southern countries got substantial access to cheaper credit, partly used to expand government-related incomes. Some of that income went to buy German goods.

A third factor is that those German goods stayed relatively inexpensive because of the euro - had they remained denominated in marks, they would have become more expensive, not only for their southern neighbors but for everyone outside Germany. The Swiss Franc, for example, has soared in the last few years, causing considerable grief for Swiss industry. A fourth factor is that although the euro was cheaper than the mark would have been, it was really still too expensive an export currency for countries like Greece and Portugal, which had much less developed manufacturing bases. There is only so much olive oil they can sell (Ireland, by contrast, has a fairly well-developed manufacturing base).

The crowning irony stems from how nervous the German people were about giving up their beloved Deutsche mark. To placate them, stringent conditions were written into the EU constitution, the most important from the German view being price stability and (probably thinking of Greece and Italy at the time) *no*

bailouts. The Germans romanticized their sound, respectable currency, but had they kept it, the country's export boom would have stalled and the country would be much worse off today. Try telling that, however, to the average person in the street. It's no easier to explain how much worse off we would be without the TARP program.

So Germany has steadily dragged its feet throughout the deteriorating conditions, pulled back on the European Central Bank (ECB), and let the problem fester. Looking past the deprecating coughs about "moral hazard," the political reality is that the average German thinks the Greeks are lazy and is scandalized by talk of Germany backstopping the eurozone. Each successive so-called solution has been hobbled by an attempt to do things on the cheap and have nobody stuck with the bill. Thus the EU keeps "lending" more money to countries that can never pay it back. It makes no financial sense, but it has suited domestic politics.

The ceaseless German demands for ever-greater austerity (in particular, discipline and punishment) as a condition of aid have only succeeded in further debilitating the affected economies (Greece, Portugal, Ireland; and soon Spain and Italy), thus ensuring that their fiscal targets aren't met, thus provoking demands for more austerity as a condition of support. It's been a vicious downward spiral that has inflamed national tensions.

The problem runs much deeper than Greek debt, though. We keep making that point in our column every week. It's reminiscent of the early days of the subprime meltdown, when the *Wall Street Journal* was running stories on its front page suggesting that the real problem lay in gangs of predatory borrowers that had scammed the poor innocent banks. Besides letting the banks off the hook, the approach played down the damage.

But the real problem is that there is too much bad debt all over the eurozone, and Greece is simply the leading edge. Even if all of its debt was forgiven tomorrow, attention would only turn to the next country. Europe needs a comprehensive program that involves writing off more of the bad debt, along with financial support from the richer countries and a less restrictive monetary policy. It needs a joint effort that goes beyond German wants and fears.

We need hardly point out that such a program will not be immediately popular in the richer countries. In that respect, the EU finds itself in the same situation the US did in the fall of 2008. Having "bailed out" Bear Stearns, the administration was hyper-sensitive to accusations of further "bailing out" more "rich bankers" and allowed Lehman Brothers to collapse. The biggest policy mistake since the Great Depression, it was a total, utter fiasco that plunged the globe into the biggest recession in over seventy years.

Bear Stearns was *not* bailed out; it's gone. It was simply wound up in an orderly fashion, with its assets sold to another bank. However, the press and certain

political actors were obsessed with the \$30 billion backstop the Treasury and Fed agreed to in order to get the deal done. Winding up Lehman Brothers in an orderly way would have required a larger backstop, on the order of \$50 billion, and both the Fed and the administration feared the political fallout from the number (the Bear Stearns backstop has since turned out not to have cost anything, except to its employees and shareholders).

For want of a nail, the ship was lost. The Fed immediately had to bail out AIG, was forced to guarantee the commercial paper market, and ended up expanding its balance sheet by over \$2 trillion to try contain the damage. Then there's the money we spent on TARP, plus the aid to the states, and not to mention all the lost wages and production. We would have a recession anyway, but not the brutal shutdown of the last quarter of 2008 and the ugly first quarter of 2009. Some savings.

Europe and Germany are facing the same kind of choice - put up money to backstop the system now, or make a "principled" stand (in other words, politically chicken) to let it all go. The first option would involve some inevitable criticism about bailing out those lazy Greeks and violating sacred principles. The second will involve another tab in the trillions. So far the course has been to keep postponing the hard decisions about money and talk about all the good things that will get done in the future.

Sooner or later - and we think it is a question of days or weeks at the most - any more postponements will begin to fail. *Yet it may be that the principal actors, in particular Chancellor Merkel of Germany, are simply going to wait until the crisis is boiling over before taking action that would otherwise be too unpopular to gain parliamentary approval.* Many of the EU politicians fear that supporting a joint restructure-and-fiscal effort might mean being voted out of the office. What they will find out by standing aside and watching instead is that it will not only guarantee defeat, but historical infamy. However, that doesn't mean they won't do it.

If the EU gets it wrong, the markets will get very ugly, very fast. Because of the massive uncertainty surrounding this political decision, we have been keeping very high balances of cash in the portfolios. If they get it right, having all that cash will likely mean missing the first few percent of the rally, but we find that to be a more than reasonable trade-off. We also hold the long-dollar/short-euro ETF known as EUO wherever possible.

That still leaves China on our ongoing worry list. Its property bubble is slowly collapsing, and the damage won't be avoided. However, we have been predicting all year that the authorities will try the same thing as every other country ever in that situation: they will start to ease monetary policy. It's the correct thing to do because it heads off a more damaging panic, but it still only cushions the fall. The

bill still has to get paid in the end. Authorities began easing this week, and markets rallied. They always do.

Unfortunately, easing never begins until the financial authorities are scared: in other words, there's a good reason for it. In time, all of the rally is given back and then some, because the economic decline cannot be halted so simply. However, if Europe gets it right, China's day of reckoning is unlikely to come before the second half of 2012. We expect that if form holds, markets will rally once more on loosening Chinese monetary policy, and the hopes for a "soft landing." But the final day of reckoning will still come.

Absent external shocks, the U.S. economy should keep chugging along at an annual rate of around 2% growth, with some quarters looking better and some worse. It's lower than what policymakers would like, but there is no magic fix to our debt hangover. It's still coming off in increments. Although US equity markets are about flat on the year (but could be up or down another five percent by the time you see this), they are nevertheless near the top in global performance this year.

However, all of this uncertainty has, not surprisingly, altered our investment approach. Clearly the risk of external shocks is high, whether from Europe or China. The small-cap value sector has fallen almost completely out of favor, and is likely to remain so long as anxiety and trading rule the day. Although the market averages may yet finish in the black on the year, they conceal huge disparities in performance as money has rushed in and out of sectors, making one quarter's darling the next one's orphan.

Mutual funds have suffered net outflows on the year, leaving trading money and hedge funds in charge of flying the plane (and you wondered why there was so much turbulence). Energy has been one of the steadier performers this year, but if the EU blows itself up, the price of oil - which continues to have record amounts of speculative money supporting it, the main reason for energy stocks hanging in there - will collapse again and the sector will be wiped out virtually overnight.

Therefore we continue to carry high cash balances, keep short positions on where possible, maintain index puts at all times and keep a shorter-term trade horizon than what we are accustomed to. We too have more emphasis on larger, more liquid names, though we haven't completely given up on small caps.

The good news is that if Europe bites the bullet, 2012 could be a pretty good year, at least compared to 2011. It's unlikely that Europe could head off any recession, but it might be shortened. There is already a good deal of worry built into prices, which could be supportive of a rally. However, a potential meltdown or panic is *not* built in, regardless of what strategists say.

Homebuilding in the US is showing some tender little signs of life, as the number of new homes for sale has been hitting a new record low every month for years. Smartphones should continue to take over the mobile phone market. Many retail stocks are cheap and could come roaring back to life with a nudge to employment. The euro should eventually correct to a more manageable level, even with a post-fix rally. If the U.S. were to finally do something about margin and/or position limits in oil futures, we could get a stock rally that didn't immediately undermine the economy with soaring energy prices (we're not holding our breath for that one, but it *might* happen).

For now, we watch and wait. Thank you for your trust.