



AVALON ASSET MANAGEMENT CO.

Annual Review & Outlook for 2010 and 2011

Summary

Our 2010 outlook turned out rather well and our portfolios had a good year. The U.S. economy experienced a mild recovery, growing at a modest rate of around 2.8% for the year. Equities bounced around for the first eight months of the year before embarking upon a six-month rally sparked by the Federal Reserve Bank's decision to extend its "quantitative easing" program, popularly referred to as "QE-2." While the full effects of the program won't be clear for years, the stock market was sure that it left equities as the only attractive investment class and money flowed back into the sector.

There were some developments in the last months of the year that we didn't foresee from our vantage point at the beginning, the most significant being QE-2. The Fed program overlaid a cyclical rebound in earnings that was real, though somewhat inflated by cautious management guidance and driven more by cost-cutting than demand. However, the timing of news is everything, and the markets largely decided to treat the modest cyclical recovery as a superstar. The fans may end up being disappointed in the end.

Fueling momentum in the stock market during the last quarter was the competition for year-end performance rankings and the desire to keep prices high. The conventional wisdom – derived in no small amount from the rise in stock prices – became that the wonderfully robust American economy would drive interest rates higher and bond prices down. Treasury bonds were abandoned and municipals were fled in an apparent contradiction – if the economy is to perform robustly, then tax receipts would rise along with it, particularly capital gains.

Yet the municipal bond market produced a significant and unexpected hiccup. Our tax-exempt fund investments rose smoothly and steadily until the last weeks of the year, when a sharp sell-off occurred. It was triggered by an unlucky confluence of unusual factors – a poor holiday auction that wasn't much more than a coincidence of the calendar, combined with an analyst making dramatic warnings on television to rattle the markets.

Although the municipal bonds market is a large one that is generally quite dull, it is thinly traded and individual investors hold about two-thirds of the bonds. The negative publicity came in the wake of a bitter election season filled with sensationalism. It wasn't hard to spook weak hands into selling, and municipal bonds declined about 4.2% in the quarter, their worst performance since 1994. Closed-end funds fared even worse, falling around 20%, though they have since recovered some of their losses.

We didn't flee the municipal markets. We follow state tax data closely, and know that tax collections are rising and have nearly recovered to pre-recession levels, contrary to some careless assertions in the media. Some individual issues will no doubt go under, but a small amount of defaults are typical. It's a three trillion-dollar market with default rates of about one to two percent per year, which equates to about \$30-\$60 billion. A slight uptick would bring the total close to the lurid predictions of "upwards of a hundred billion dollars" without the market being in trouble.

However, headline risk remains. We feel the real danger is fear, not default. Although credit markets are larger than equity markets, their atomized nature means that they can become suddenly illiquid. Every five or ten years something will come along to panic dealers into stepping away from some market until reassured that it's safe to go back into the water. The episodes pass – even subprime mortgage bonds have recovered! – but pricing can be badly damaged in the interim. The solution is to simply wait it out, but panic can be difficult to resist.

For this reason we have reduced our holdings by tactical amounts, and may ease back further. At the same time, we would like to be ready with cash to buy should the market suffer a panic correction. As Warren Buffet likes to say, be fearful when others are greedy, and greedy when others are fearful.

Inflation remained subdued during the year, running at a bit more than 1% excluding food and energy. Considerable slack remains in labor and productive capacity, so classic inflation appears unlikely for now. However, rising commodity prices, heavily fueled by financial speculation, have made the outlook for 2011 more uncertain. If oil prices continue to rise, cost-push inflation could gain some traction.

The taxable bond market appears to have peaked, and retail investors have been pulling money out of the funds. Institutional demand remains strong, however, and Treasury yields are still much lower than generally predicted twelve months ago. The credit markets are completely split in two, with conditions in retail lending, housing and small business extraordinarily tight, while the corporate and institutional markets are not only loose, but approaching the carelessness of 2007.

Many expect bond yields to rise and credit conditions to tighten when (and if) the Federal Reserve Bank ends quantitative easing, scheduled for June of this year. The markets have often frustrated such expectations, though. If growth remains moderate and no further easing is put into effect, investors may find a reason to retreat from equities back into the Treasury market, at least temporarily. One more bond rally may yet be in store.

Such a rally would certainly be welcomed by the housing market, which remains in a moribund state. High unemployment and historically tight credit are unlikely to change soon, keeping a lid on demand and pricing.

The modest rate recovery rate of 2010 looks set to remain modest in 2011. An apparent improvement from the third to the fourth quarter of 2010 combined with the rising stock

market to lead many to raise their forecasts for U.S. growth to a range of 3%-4% for 2011. That looks quite ambitious to us, and rather dubious. Recent developments have cast those numbers into doubt, and first quarter growth will be seen to have not lived up to predictions.

As we look at the rest of the year, the markets are struggling to come to grips with the notion that the growth rate will remain modest, rather than robust. As one wag put it, the strategists wrote a check that the economy couldn't cash. Yet the equity markets are still being driven by liquidity and so long as that persists, prices will tend to rise, presenting a clear enticement to buy more equities.

In the midst of the stock market race to make trading profits and/or be at the front of the performance pack, threats to the global economy have clearly multiplied. The exuberant confidence of January and February has weakened, and 2011 is shaping up as a more challenging year than believed a few months ago.

- 1) The uncertainty of the outcome in the Middle East and North Africa – and by extension, oil prices - is nearly total. Gasoline could reach \$4 or even \$5 a gallon this summer, which would surely impose another slowdown on the economy. There is still a chance that prices might yet fall back before reaching those levels, though it isn't a good one.
- 2) Debt and currency crises usually take 12-18 months to ripen. The one in Europe appears to be getting ready to mature on schedule. An enduring flaw in market reactions to crises is that after an initial flutter of worry, they typically ignore them until the decisive calamity strikes.
- 3) The Fed's monetary easing program is supposed to end in June, with debatable consequences for the economy and markets. The psychological impact on the equity markets should be minimal, given all the months to prepare, but modern markets have a way of ignoring tomorrow's hurdles in favor of today's trend. It is probably safe to say that the Fed itself is uncertain of what will happen.
- 4) There are substantial political risks to the recovery, including another budget impasse and possibly a temporary shutdown of operations. Deep cuts in government spending, if enacted, are likely to slow the economy further. While popular anguish over the deficit and government is understandable, attempts to balance the budget during the Depression backfired disastrously.
- 5) Unemployment is likely to remain quite elevated. Most of the recent improvement in the unemployment rate has come from people dropping out of the labor force, and thus no longer being counted as unemployed. Absent another bubble of some sort, or a major technological breakthrough, it's very difficult to make a case for anything but modest progress this year.

- 6) Profit growth looks set to slow, but the outlook is uncertain. A decent pickup in demand would have an outsized impact on profits, but we have trouble seeing where it would come from.
- 7) The recovery process in Japan is highly uncertain, as are many of the after-effects upon global supply chains. Yet the equity markets have already discounted a quick and complete recovery.
- 8) We believe that China has a property and lending bubble on its hands. The country's economy is slowing, yet western fund managers seem to have an unlimited faith in the ability of the central government to engineer a soft and smooth landing (or tell us there is one, which apparently would suffice).
- 9) Despite the above concerns, ample liquidity and a lack of appealing alternatives mean that the stock market will retain an upward bias unless and until something happens to disrupt investor complacency. The problem with markets dependent upon liquidity is that it can disappear so quickly, resulting in brutal corrections. We will not chase prices.

Looking back at our outlook for 2010 was rather intimidating – how are we going to get that lucky again two years in a row? Our views – or perhaps we should call them educated guesses – turned out rather well. Part of this is due to the fact that we weren't so silly as to propose year-end targets for the indices or anything else, something like trying to predict the day's weather a year in advance.

No, we stuck to the major themes and tried not to get too far ahead of ourselves: inflation would remain subdued, and so it was. Home prices would be under pressure for the rest of the year and likely decline, homebuilding might recover by the fourth quarter, but it really didn't and we never did make any investments in the area. Unemployment would remain over nine percent over the year. The market would remain range-bound for the first half of the year or so.

We said that Internet and mobile video-related stocks were poised to do well and they did, generally doubling from where we bought them. It would be of course foolishly risky to invest a portfolio into just a handful of names, but there is nevertheless always a twinge of regret for not having done just that.

Price appreciation led to trimming holding in some of our names, but we still retain positions in Triquant (TQNT), RFMD and to a lesser extent Skyworks (SWKS), which had a very good year but reached stretched valuations. Continued growth in smartphones and tablets will benefit these names.

Tablets started eating at PC and notebook/netbook sales, but one thing all the devices have in common is an increasing reliance on using more memory to run quickly. We've

also noticed new releases of popular software are using much bigger chunks of memory than previous versions, over 50% more in many cases. We've starting building positions in a leading memory vendor, Micron (MU) to take advantage of this thirst for more memory.

We also worried about China (bubble) and the European debt situation. The latter threatened to boil over, but a series of cobbled-together rescue plans and assurances from the fractious EU partners has managed to keep a lid on the problem. Every time the markets have started to panic, the various ministers and in particular the Germans have lurched into some sort of funding plan that has mollified traders.

However, whereas last year we were worried that the situation could get ugly, this year we will be astonished if it doesn't. We are short the euro versus the dollar, because the EU periphery countries have an insurmountable amount of debt. In Ireland, Greece and Portugal, the debt is crushing; in Spain the amount of home loans that are deeply underwater – likely for good – is stupendous.

The German and ECB (European Central Bank) price for help to the debtor nations is grinding austerity, making their debt load more unbearable, their recessions more prolonged and essentially guaranteeing that the populations will in time reject the conditions imposed upon from without. To make matters worse, the recent surge in energy and food prices – entirely imported, by conditions entirely out of their control – has led the ECB to talk about raising interest rates.

The European economy is barely limping along as it is, and an increase in interest rates that has already made the euro more expensive will hurt its ability to export even more. It will do nothing to combat food or energy inflation, but the ECB is dominated by old German fears of the hyper-inflation of the 1920s, and so it will probably raise rates. That will hasten the troubled-debt nations into demanding an exit from their chains. They need to restructure their debt or exit the euro mechanism. We think it will be the former, but at least one should occur, if not both.

The irony of all of this is that a breakdown of the euro would be highly beneficial to Europe (even Germany, but only after much wailing by the bankers). If the periphery countries could restructure their debt and the euro was to fall, say 30%, it would do much for growth prospects in Europe and alleviate the recessions in the debtor nations. There would still be the formidable obstacle of negotiating what the periphery owes the ECB, but a solution would be found. The U.S. stock market would surely find a way to rally on the improved growth prospects for the globe, though a euro decline wouldn't be that good for the U.S: it would make our exports less competitive and be a drag on the earnings of most of our big companies. However, our markets like to rally first and think later.

Another concern we had a year ago was credit, and are actually more worried about it now. We thought it would come back by the fourth quarter, which it did easily, but not the way we were looking for. A huge influx of money into bond funds opened up the

credit spigot to professional corporate borrowers – the sorts of entities that can pay law firms six figures to write term sheets for hundred-million-dollar-plus offerings.

That part of the credit markets is drowning in cash, too much for its own good. Sloppy deals, loose covenants (“covenant-lite”), pay-in-kind (“PIK”) bonds (they can pay interest with more bonds instead of cash), and highly complex derivative products are all being done again. The bill always comes due in the end. In the meantime, it helps fuel speculative activities in the stock market – another bill that will come due.

The rest of the credit market isn’t doing well; residential mortgage lending is suffering. Although the refinancing market has periodically shown some legs when rates drop, the pool of homeowners eligible to refinance is starting to dry up. Purchase standards have become brutally tight. A constant stream of problems and negative publicity about the poor lending practices of the boom years and the sloppy foreclosure practices of the lean years is complicating matters more for an overly concentrated, fearful industry.

The mortgage industry is in a sad state. Most of the big specialists have permanently disappeared or were swallowed up by big banks now sitting on more bad paper than they care to think about. The largest banks (Bank of America, Citicorp, Wells Fargo, JP Morgan) control nearly two-thirds of the mortgage market. The desire to create economies of scale out of huge size - and no small amount of megalomania – have created institutions with an industrial assembly-line structure well-suited to problem-free, reliably rising markets and not much else.

The government-sponsored enterprise (GSE) lending agencies, Fannie Mae and Freddie Mac, along with the FHA, are all planning tougher and more expensive lending standards. That won’t energize the market (one should tighten in boom times and loosen in lean, but it never seems to happen that way). What’s more, they are all under attack from elements of the right wing who wish to blame the agencies for the housing bubble and eliminate them (at one point we included a rather lengthy explanation here of why the agencies aren’t to blame, but thought better of it. Feel free to ask).

In sum, we expect housing to continue to struggle. Yet we are also making our first investments in homebuilders – carefully selected, and (of course) with the intention of hedging them. Some of the homebuilding companies – Hovnanian Enterprises is one – are trading at attractive valuations based up cash flow and book value, and are near their all-time lows. The write-offs have all (mostly) been taken, the bad news mostly priced in and the stocks are practically friendless. It’s a good time to buy cheap! Perhaps most importantly, homebuilding operations are finally making money again. Not a lot, but enough to pay the bills until the market picks up again.

If the economy is able to keep adding jobs, even at a below-average recovery rate that is too slow and of little help to the long-term unemployed, nonetheless distressed homes (which undercut the pricing and demand for new homes) will get taken off the market bit by bit. In the meantime, the supply of new homes for sale is at a low that probably goes back to the Depression (the data only goes back to 1963).

It's true that home prices could decline further, and the next quarter or even three might feel like Chinese water torture to the homebuilders, yet so long as some modest recovery continues, the market is slowly, invisibly healing itself. At the first real whiff of recovery (we've endured a hundred false alarms), traders will pile into the stocks like wild beasts. They probably shouldn't, because it will be a more modest recovery than in the past, but the lure of trying to replicate the past is quite powerful on Wall Street. The stock market as a whole looks overbought right now and homebuilder stocks wouldn't be immune to a correction, so we are taking our time to build positions in the sector.

In a similar vein, we have been looking at some recapitalized regional banks, rather than the Gang of Four behemoths, where it also appears that the stocks are washed out, the losses are behind them and even a slow improvement in the economy will benefit their earnings. The interest-rate spread is still favorable for banks and we don't expect the Fed to raise rates this year. Two of the names include Flagstar Bancorp (FBC) and Central Pacific Financial (CPF). Another appeal to both of these names is that management has invested a great deal of its own money into the banks. That makes for better lending.

Turning to geopolitics, including our own, we want to try to make observations rather than judgments. We don't have much to add on the Middle East, save that there are a great many balls in the air and it seems that in that part of the world, a few of them always fall to the ground. This uncertainty is being reflected in the move in current oil prices, but not stock prices. If oil prices continue to rise, stocks and our economy will eventually pay the price.

China was able to make it through last year without much damage. Still, we are more convinced now than twelve months ago that the country has a property and lending bubble on its hands. The equity markets are largely ignoring it because quite honestly, it's a problem that the globe really doesn't need right now.

It isn't exactly a secret that the Chinese are content to print the data that they need. The general attitude in the West is that their releases are at least directionally correct, even if heavily massaged. We say that if growth in the U.S. slows mildly, and Europe slows a bit more than that – and they are both on track to do so, especially with higher oil prices – China will feel the effects.

So far as the U.S. is concerned, the conventional wisdom on Wall Street is that gridlock in Washington is good for the markets. We seem to be headed for another chance to test that saying, while faced with some long-term challenges.

One is the production of goods: we have sent too much of our production abroad. It's a long-term structural problem whose effects the credit and housing boom was able to put off for another day, but no more. You can see it in the record numbers of long-term unemployed. Although manufacturing is recovering here, it only employs a third of the people it did twenty years ago. There is no quick policy fix for this.

A more obvious, yet related challenge is the deficit. It is large and growing, and we need to start working on how to rein it in. Running large deficits is manageable, so long as they are temporary in nature, but the trick is keeping them temporary. As the economy recovers, it will bring growth in tax receipts and that will help, but it is unrealistic to hope that we can simply grow our way out of the current situation.

The United States has run much larger deficits (as a percentage of GDP), specifically during World War II, but were able to cure them with a post-war production boom and high tax rates (on high earners). Today we are faced with a much smaller production base and tax rates that are less than half those of the Kennedy-Reagan days. Common sense would suggest that there isn't much, if any juice left in squeezing the tax rates anymore (sorry, but numbers is numbers). What's to be done?

The two ways for a private business to improve its bottom line are to increase revenues and cut expenses. But raising tax revenues in any meaningful way is going to be politically very difficult, while cutting spending in any meaningful way is not only politically contentious – most of the cutting talk seems to be centered around ideology rather than efficiency - but apt to increase unemployment and slow the economy in the short term. Ergo, we don't see much progress on the deficit in the near term.

As economist types, we want to make one thing clear: there is no painless solution to the deficit. We cannot cut *or* tax our way to prosperity. If we were to abruptly balance the budget with expenditure cuts, it would plunge the country into recession and the resultant rally in the dollar would hurt our export business. Neither would last forever, of course, but considering our current economic position, there is a genuine risk that such a program would bring on a second depression.

Economically speaking, there is more room to raise taxes, but it would have to be gradual and the initial reaction of the stock market would be negative. The political fallout is unpredictable, but a “blowback” effect cannot be ruled out and there is a risk that the political backlash could lead us into a position worse off than we were before. Consumption of luxury goods and services would be affected.

Despite the frequently far-fetched claims by the assorted talking heads, however, neither tax changes nor spending cuts can restore us to health, cure baldness or make us all thin, rich and beautiful. The real long-term solution is to restore America's productive output. Otherwise we will suffer a never-ending erosion of our standard of living. It won't be as simple or catchy as cutting (raising) corporate taxes or cutting Medicare. How to do it is a subject rarely broached beyond a handful of stock phrases, but either we get to it, or we will all lose.

Then there is Japan, with its earthquake and radiation problems. The stock market has already discounted a quick v-shaped recovery. Nations usually do recover from such problems, although the speed of this particular recovery may be less than hoped for. What troubles us is adding a Japanese slowdown, with its supply-chain ramifications for the technology sector, on top of a manufacturing growth slowdown already happening in the

U.S., a deteriorating debt situation and weakish economy in Europe, and spiraling oil prices. That seems like quite a lot to navigate without some bumps along the way.

Many insist that equities are cheap, based upon a multiple of predicted 2011 earnings – and the fact that stock prices have risen strongly for two quarters in a row. The stock market can't be wrong, can it? But it isn't cheap by several measures, including the current price-earnings ratio. We're skeptical about the earnings outlook, we think the market has gotten ahead of itself, but we're aware that we don't move the markets. Liquidity does, and will have everything to do with whether prices rise or not.

We've been in front of every serious correction the last ten years. On the other hand, we've always been early. Value types usually are. We were even ahead of the 1987 crash, believe it or not, and went all into cash before it happened – but two months early, and watched the market go up without us. When it comes to corrections, though, it is like driving your car off a cliff – it's better to jump out a little too early than a little too late.

Should the economy grow more than we expect, then our investments in retail and technology should do well, while our investments in homebuilders and regional banks could really catch fire. That said, we feel that current share prices leave very little room for error during a period when pitfalls are cropping up everywhere.

We can't time the markets, but the point is that we can stick to something we do know how to do – buy what's cheap, sell what's expensive, and protect your capital. It won't beat the market every quarter or even every year, but it works very well over the long term.