



The Avatar Advisor

MEETING THE INVESTMENT CHALLENGE SINCE 1970

OUR RESEARCH:

There is a rapid unfolding of negative events in the real economy which continue to outrun the expectations of the consensus observers. First, it was felt that the subprime mortgage problem was small and therefore would be "contained." Reality overtook that sanguine assessment last August. Still, it was assumed that the financial system could absorb the troubles. Then, we saw a succession of management failures among the most visible of our financial titans. Even that did not dissuade the majority from thinking the real economy was immune from these upsets. The recent flow of data knocks down that idea. Finally, the strength of the rest of the global system was felt to be so sturdy that our economy would "de-couple" from the others. We now hear that policy makers in China are rapidly pivoting to design a re-inflation of what looks to be a major slowdown. During all this time, we have felt that until the housing market (and not just in the U.S.) reached a trough, these kinds of slippages should be the minimum we can expect. Clearly, both fiscal and monetary policy here are moving aggressively. We wonder whether the car wreck hasn't already happened and all that can be done is to help soothe the pain of the victims.

Our **Economic Liquidity** model continues to improve. The Fed has embarked on an almost unprecedented round of loosening. So far, this process, which began in September, has not helped either the financial markets or the economy. Given the normal lags, it really is too soon to expect monetary policy to change the course of

EQUITY UPDATE:

2008 has not started off well for stocks. Despite a rally beginning in the second half of January, the major indices are still underwater by approximately 5-10%. The Dow Jones Industrial Average is down 4.5%, the S&P 500 Index is down 6%, and the NASDAQ is down almost 10%. The strong performance of "growth" stocks in 2007 has been replaced by better performance by "value" stocks in both small- and large-capitalization classifications. While the economy clearly continues to slow, the Federal Reserve Board and Washington have come to the rescue with powerful stimulus and relief packages. The stock market

business. In fact, given the magnitude of stress in the financial system, it would not be a surprise if it takes even stronger action to even lessen the pain, let alone remove it.

Our **Investor Liquidity** model improved on a short-term basis. We note an increase in pessimism among options traders and in surveys of opinions. As well, the swing from skepticism to somewhat more bullishness among the typically-correct corporate insiders is a welcome sign. However, given the damage taking place in profits, none of these signs is yet at the kinds of extremes which mark major bottoms.

Our **Momentum** model has reflected the enormous increase in market volatility. While there are some signs of extremes (for example, the number of stocks trading at new one-year lows), the kinds of signs that are typical at cyclical low-points have not yet appeared. We continue to worry that the market has a much too-narrow participation.

Our **Bond** model digested the rapid gains of the fourth quarter and then eventually continued to improve. Economic data is increasingly confirming that the U.S. economy has entered a substantial slowdown, if not outright downturn. Unfortunately, the demand for better-quality credit continues to be an obstacle for all bonds other than Treasuries. While there may be some bargains developing in the highest-quality corporate sector, we want to wait for better evidence that this aversion to risk has started to reverse.

has done its part and rallied, at least in the short term, as would be expected.

In this rally, the sectors that underperformed most beforehand have been the out-performers. While ugly news continues to surface for the financial sector, rumors of rescue in one form or another has led investors to believe that the worst for these stocks has occurred. This belief has caused a bounce of approximately 25% for the group thus far. With many of the stocks 25-50% from their highs, the thinking goes, now is the time to buy. While our research has improved in this sector, it is still in the bottom half of



the ranks. We have moved up our exposure approximately from a 50% weight to a 75% weight for the group.

The second best sector for the month was the consumer discretionary group, which had also been beaten up badly last year and into the first few weeks of 2008. The Christmas selling season is generally considered to have been a disappointment. Consumers have become more cautious, and are extremely price sensitive. Big ticket items, like large-screen television sets, are rapidly coming down in price, a sign that consumer spending continues to contract. Finally, many existing home equity lines of credit have been used up, and new ones are extremely difficult to secure. We remain underweight this group, and believe it is still early to be adding to holdings.

After taking a severe beating of more than 15% in the early part of January, the materials sector has rebounded nicely and remains only a few percent away from its highs of last year. Pricing remains reasonably firm, and end use has not slowed enough yet to completely spook investors. However, Alcoa, normally the first blue chip company to report, did note that higher energy and freight costs, and a weak dollar contributed to a tougher outlook going forward. Analysts have downgraded estimates for the company's earnings as demand for aluminum begins to slow. Clearly this sector is at risk if domestic economic growth continues to deteriorate, but it will be especially problematic if growth slows internationally.

The industrials sector was the fourth best performing sector in January. While it is clear the economy has peaked, the Federal Reserve Board has delivered a powerful message that it will do everything it can to minimize the downside. General Electric, the biggest company in the group, reported a strong quarter and indicated that growth would be double-digit going forward—hardly a disaster.

Healthcare, our current favorite, has delivered average performance for the month. While we partially avoided the pharmaceutical sub-sector last year by overweighting the other components of the group, it is still too early to know when the big drug companies will begin to outperform. Until then, we would recommend underweighting this portion of the group.

Also in the middle of the pack were the staples and utilities groups, exactly what you would expect from a market that is in the middle of a sharp correction followed by an oversold bounce.

Telecom, energy, and technology rounded out the bottom. Telecom fourth-quarter earnings were lackluster due to the slowing economy and to customer defections to cable. After a stellar performance in 2007, energy stocks fell as oil prices slipped and economic woes accelerated. Earnings reports for technology stocks were very mixed, with strong reports from Microsoft, and weak reports from some of the smaller players. Intel claimed that it was not seeing a global slowdown, and that the U.S. might be simply “talking itself into a recession”.

Our work (still) tells us we may be doing more than talking. As a result, we expect to remain in a high risk environment for the foreseeable future. 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.

Asset Allocation Highlights		
Asset Class	Position	
Domestic Equities	Neutral	
International Equities	Neutral	
Bonds	Neutral	
Cash Equivalents	Neutral	
Domestic Sector Ranks		
Rank	Sector	S&P 500
1	Materials	3.44%
2	Energy	12.23%
3	Industrials	11.77%
4	Financials	18.75%
5	Cons Staples	10.29%
6	Utilities	3.60%
7	Health Care	12.11%
8	Technology	15.57%
9	Cons Discretionary	8.81%
10	Telecom Services	3.43%
		100.00%

Data as of 2/4/08



FIXED INCOME UPDATE:

The U.S. corporate sector has entered a recession. Earnings for the recently ended fourth quarter will be down, as they were in the third quarter. The lion's share of this deterioration is occurring in the largest economic sector, financial services. These companies grew from about 7% of the corporate income pie 25 years ago to a high point of over 23% just recently. The reversal of fortune has been nothing short of stunning. To add emphasis to the fall, high profile corporate leaders of these companies have been sacked.

Some observers think that we need to analyze corporate profits on a "core" basis, much the way economists dismiss the inflation of energy and food prices and proclaim a core inflation rate. On this view, we should be looking at earnings outside the financial services group as representing the "real" economy. That certainly has a lot of appeal for those strategists who completely missed the rapidly collapsing results in finance. But the logic of this approach holds no water. It has been very clear for a long time that the markets, with finance in the vanguard, were calling the tune for the real economy, not the other way around. If anything, finance was the "core."

Many of the methods and tools of the financial services industry now lay in ruins. There are few signs that this

sorry episode is finished. In fact, new "strains" of the malady show up almost weekly. The current concerns are for insurers who bet their companies on questionable ways of calculating the odds for trouble. In addition, other areas of debt are slowly getting attention: credit card debt, automobile credit, commercial real estate structured finance, and corporate securitized debt.

The key implication of these stresses is that not only are frivolous projects not going to receive financing, but, increasingly, legitimate ideas are going to go begging as well. This adds up to an unavoidable hit to the economy's growth rate. Most probably, monetary policy will continue on its path of ease with obvious benefit for both short- and long-term interest rates.

While recognizing that long-term Treasury bonds have already performed exceedingly well at the expense of all other lesser credits, we do not see compelling evidence to tempt us into what many think are bargains in the non-treasury arena. We would need to see more clearly how the economy can fashion a bottom and how the financial risks can recede. There have been any number of "value traps" in this market cycle and we think the risks here are not yet outweighed by the reasonable prospect of returns.

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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 \$1.3 billion 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.