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GOOD ADVICE

Half Full or Half Empty?

So far, for 2014 our diversified multi-asset approach has continued to provide positive results with less risk and less volatility. Large capitalization US stocks, international equities, fixed income, gold and REITs have all been adding to returns.

We continue to see significant market risk in US stocks, where this momentum driven market is almost entirely supported by the easy money policies of the Federal Reserve and the investor complacency that it has engendered. There is a disturbing gap between weak underlying economic growth and the stock market's stretched valuations. Stretched valuations alone are unlikely to turn share prices lower, however, a combination of weak seasonal tendencies, a shrinking QE program from the FED and geopolitical instability in Asia, the Middle East and Ukraine, surely suggests a glass no more than half full.

World/US Economy

The global economy remains anemic.

Despite a second quarter rebound in US economic activity (resulting from the unexpected weakness in the first quarter) US economic growth is now forecast to increase by barely 2% for 2014.[1] In China, there is an ongoing deceleration in economic growth, primarily because the Chinese property market is weakening due to excess supply. It remains to be seen whether Chinese authorities can engineer a "soft landing". The Bank Credit Analyst[2] predicts a continuing deterioration in emerging economic growth, a further drag on global growth. Japan hopes that recent stronger growth is sustainable and not just a reaction to the consumer buying binge that preceded the recent sales tax hike.

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Almost six years after the financial crisis, the Euro area is still struggling: overall growth is forecast at 1%, most of which comes from Germany[3]. Faced with the threat of deflation, The European Central Bank cut its deposit rate to minus 0.1%. They have also begun tentative preparations for quantitative easing. Moreover, the economic slowdown in Russia and the Ukraine isn't helping matters.

Some pundits are referring to the current economic environment as the Goldilocks scenario: just enough global growth to generate profit growth, but not too much, which might trigger an increase in global interest rates and inflation. Central Bankers around the world are counting on maintaining this glass half-full sentiment to ensure a sustained recovery. It is a delicate balance.

Unsettling Geopolitics

We are witnessing a relative decline in U.S. global power, which creates uncertainty as Russia and China seek to increase their influence.

Despite the recent election of Petro Poroshenko as the President of the Ukraine, fighting continues in eastern Ukraine, and tensions persist. Of more economic significance, when Russia seized Crimea in March, it also acquired control over vast oil and gas reserves in the Black Sea, which are potentially worth trillions of dollars. Some petroleum analysts have compared the potential of the Black Sea to that of the North Sea. And in May, Russia signed a $400 Billion Deal to sell natural gas to China for the next 30 years, which moves Russia closer to China, and further away from Europe and the US.

Meanwhile, China continues to look globally to satisfy its growing need for energy, particularly cleaner energy, and the deal increased its longer term supply of natural gas. China is now the world's biggest energy importer and user and is now dominating the global resource markets. China continues to increase its control over the South China Sea, despite riots in Vietnam and criticism from the United States. Chinese Leader Xi Jinping has also been unhappy with the Obama administration on issues ranging from support of its military alliance with Japan to increasing tensions on trade and cyber theft, which may have added to his incentive to complete the deal.

Finally, divisions in Iraq have resurfaced with a vengeance, as Sunni Militants have swept into Mosul and further south, and are currently battling the Shi'a government for control of the Baiji refinery, the biggest source of fuel for domestic consumption in Iraq. Crude oil prices have been rising in response.

Global uncertainty is on the rise, particularly for the energy markets. And on a longer term basis, the level of tension between the US, Russia, and China has been rising, and may ultimately spill over to the global financial markets.

Asset Allocation

We continue to be underweight US equities and overweight the other asset classes. We also believe a balanced portfolio will outperform an all-US equity portfolio in 2014.

We published upside and downside targets for the asset classes at the end of 2013 for both moderate and extreme scenarios. In reviewing those targets today, the relative risk/return message is the same. US stocks offer the least upside nearer term. However, double-digit gains in REITS, fixed income and natural resource stocks have now created similarly low single-digit expectations for the rest of the year from current levels. Only gold and gold stocks now offer double-digit return prospects into the end of 2014. US stocks, while stronger than we expected at the end of last year, have still been relatively weaker when measured by all major indices, particularly the Dow Jones Industrials and the Russell 2000 small cap, where returns are barely positive.

In the US, we favor technology stocks. We have already seen significant corrections in some stock market favorites, which often precede a stock market top. However the US stock market, particularly large capitalization stocks, have been relatively steady during the spring decline in the small cap and high flying sectors, and our models indicate a summer rebound for those recently depressed sectors. Again, the upside for the S&P500 is probably no more than 5%, while the downside could be 20% or more.

In 2013 both the bond market and REITs experienced bear market declines. At the end of the year based on improving cycle work we increased our exposure to both. Since we added money, fixed income has been performing well, and we believe that prices may continue to rally modestly. For international investors in Europe and Japan, Treasury bond yields are comparatively attractive. Although the Federal Reserve is gradually reducing their bond purchase program, short term interest rates remain close to zero, and the ongoing hunt for yield continues, despite longer term concerns about rising rates and inflation. We continue to favor high quality bonds, and do not recommend high yield bonds at this time.

REITs have also been performing well this year. Bonds and REITs are sensitive to interest rate changes; when rates go up, bond prices go down, and REIT prices often follow along. Despite this year's rally, many US REITs are still trading at prices that are close to their underlying asset values. These valuations, along with their yield, are continuing to attract investors. Many REITs have taken advantage of low borrowing rates to raise capital and acquire attractive properties. We have also initiated positions in international REITs, which may play catch up to their domestic counterparts. While REIT returns may not be as robust in the second half of the year, the longer term total return prospects (out 2-3 years) remain very attractive

Although gold and gold stocks have given up some of their gains for 2014, gold continues to be in a new cyclical bull market. Historically gold has performed well when global central banks are increasing their assets, and the European Central Bank may soon embark on a quantitative easing program. Gold also responds favorably to geopolitical instability. The upside for gold and gold stocks is greater than 50% from current levels, making it a very attractive risk/reward play. With interest rates remaining at 0% and inflation rising to 2%, the real yield is now negative. A negative real yield environment has been an excellent time to hold gold.

After significantly underperforming since 2010, natural resource stocks have been performing well since the beginning of the year, aided by increases in energy prices. Although this may have begun as a value play, recent strength in response to geopolitics could continue for the remainder of the year.

Finally, international equities generally offer better relative value than US stocks. We are seeing opportunities in Asian emerging markets as well as India, where the election of Narendra Modi may result in a sea change in Indian politics. Emerging markets in general have significantly underperformed the US, and offer long term value for patient investors.

Summary

We expect to see a continuation of weak global growth. We are underweighting cash and US equities and overweighting gold, natural resources, and select international markets. US equities already discount stronger second quarter growth, and are vulnerable to a correction. If geopolitical instability increases, both gold and fixed income offer safety.

Dave | Clara | Bill

Dave Rahn | **Clara Basile** | **Bill Oberman**

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[1] Cass Research Associates
[2] www.bcaresearch.com
[3] Cass Research Associates

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Clara Basile, Bill Oberman, Dave Rahn

Investment management and counseling
for individuals and families

avaloncapital.com

(650) 306-1500