NOW'S A
GOOD TIME
TO GET SOME
GOOD ADVICE

THE BEAT GOES ON

As the end of 2014 approaches, we want to review our investment outlook and results. We began the year concerned that the US stock market was generally overvalued, and that caution was warranted. The US has been printing dollars in unprecedented quantities, but rather than stimulating the economy, those dollars have primarily increased the price of investments. We remain troubled by a lack of investment value, particularly when combined with an environment that lacks economic underpinnings.

As the year passed, the US has slowed its printing presses, but Europe and Japan have increased their own money printing programs. One consequence has been increasing volatility in both the equity and the currency markets. This volatility is a warning sign of increasing risk.

Nothing has changed in our longer term outlook, or our commitment to the value of diversification. Our investment approach remains both diversified and contrarian. This is not a time to become more aggressive. A year ago there was relative value in all but US stocks. Today, with US bonds and REITS having rallied strongly in 2014, there are fewer investments selling at attractive levels and US stocks are even more expensive! Given this reality, capital preservation remains a primary goal, particularly since outcomes have become less and less predictable.

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As part of our investment process, we have reviewed our diversified approach. Returns for 2014 are consistent with global diversified portfolios: half the asset class returns have been very strong while the other half have lagged, but the overall result, in a low inflation, low interest rate, low growth world, is still positive and meets return objectives without taking excessive risk. When longer periods of risk and return are measured, multiple asset, non-correlated investment strategies have continued to produce competitive returns with much less risk than all equity portfolios. For example, since 2000, US equities returned about 5% per annum vs. just under 4% per annum for a global balanced portfolio But the path to that extra 1% per annum for US equities included two drops of more than 50% compared to drops of less than half that amount for a balanced portfolio. One has to ask if the extra 1% is worth the significant increase in risk. In an environment of low inflation, the real investment return (returns after tax and inflation are subtracted) from a balanced portfolio has been sufficient to meet longer term planning goals.

With US equity prices now making their third advance to new highs since 2000, risk could easily outpace returns.

Global Growth and Monetary Policies

Except in the US, fear of renewed slowing global growth has set off another wave of monetary stimulus. Although the stock markets have responded favorably, it remains to be seen whether these additional measures will be effective in actually increasing economic growth and combating deflationary risks. It is a central bank experiment that has never been tried before.

At the end of October, the Federal Reserve finally stopped their presses and short term interest rates have been left at zero. Even with all that monetary stimulus, the US economy continues to grow at a historically low rate. Growth for the fourth quarter is estimated at 2.7%, based upon a survey of 42 forecasters.

Meanwhile a mix of sluggish growth and the elevated risk of price deflation in Europe has renewed concerns that it may be facing another economic crisis. In response, Mario Draghi, president of the European Central Bank, announced plans to start a Quantitative Easing program at the beginning of September, and more recently announced additional monetary stimulus measures.

Japan, faced with back-to-back quarters of declining GDP, increased its already massive monetary stimulus, and deferred a consumption tax increase. Japan continues to weaken the Yen in hopes of stimulating their economy and combating the deflationary expectations in Japan.

In China, authorities hope to engineer a “soft landing” for their economy, and have recently cut interest rates. China’s action was taken in response to growing worries about Chinese and global growth, which have also raised concerns that the sluggish recovery in the United States could falter.

These changes have had a dramatic impact on the currency markets. While the US has stopped Quantitative Easing, other countries are lowering interest rates and engaging in additional monetary stimulus measures in order to stimulate their economies and weaken their currencies. The US dollar has strengthened in response. The depreciation in the Yen is pressuring other Asian countries to devalue their currencies. Everyone can’t devalue their currencies for competitive advantage. Someone has to be a loser in the game.

Asset Allocation

Despite strong advances in 2014, we are continuing to overweight both bonds and REITs. Both are sensitive to interest rate changes, and in an environment of slow growth and low inflation, investors are continuing to look for yield, particularly when the Federal Reserve is keeping short term interest rates at zero. The strength of the US dollar makes US bonds attractive to foreign investors. In addition the nominal yield on a US bond 2.2%, while meager by historical standards, is significantly above that of German 0.77% and Japanese 0.42% bonds.

We have increased our holdings in US stocks, despite high valuations. Strong seasonal tendencies, combined with global monetary stimulus, are moving markets higher. Still, with P/E's at historically high levels, and profit margins at historic peaks, the US market is vulnerable to disappointment at current levels. A strong dollar is going to hurt the profits of international companies. So we will be vigilant about our weighting in US stocks.

We have been underweighting commodity stocks, which have been pressured by weak global growth as well as the strength in the dollar. In addition, despite increasing US shale oil production, OPEC has been unable to agree on a cut in petroleum production, and this has put additional pressure on oil prices. However the dollar may come under some pressure at these levels, and commodity stocks are looking more interesting. Gold has continued to decline in 2014 despite its high expected return ranking at the end of 2013. We continue to favor it in our resource allocation. Gold continues to function as a surrogate currency, and in a world of money printing we expect to see gold prices increase over the long term and believe they offer value at these levels.

Similar comments apply to foreign equities, however we have some exposure to foreign stocks using ETFs that hedge out the currency risk. Our favorite markets have been China and Japan for the reasons outlined above.

Foreign equities generally offer better relative value than US stocks, and offer long term value for patient investors. We will be increasing our exposure as technical indications improve.

Summary

We continue to see a combination of weak global growth coupled with low inflation. We are concerned about the movements in global currencies and are watching closely for signs of more significant problems. A diversified investment approach offers positive real returns with lower risk and volatility. Capital preservation remains a priority.

As year-end approaches, we have been focusing on taking income tax losses where appropriate, making sure that required minimum distributions are taken from IRAs, and facilitating the transfer of appreciated stock for charitable giving purposes.

Please do not hesitate to contact us to discuss our investment outlook as well as any outstanding year-end tax planning issues.

Best wishes for the holidays! Thank you for your continued confidence.

Dave Rahn Clara Basile Bill Oberman

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Clara Basile, Bill Oberman, Dave Rahn

Investment management and counseling
for individuals and families

avaloncapital.com

(650) 306-1500