NOW'S A
GOOD TIME
TO GET SOME
GOOD ADVICE

AND THE LAST SHALL BE FIRST

The U.S. stock market shot up 2% on the last day of the third quarter. Despite this attempt at window dressing, it was the worst quarter for investors in four years. All asset classes except cash and bonds were down. Even bonds did not help very much with just small positive results. The hardest hit areas were Biotech down 26%, Natural Resources -20% and Emerging Markets -17%. Small Cap U.S. stocks plunged 13%. Our defensive posture paid off; portfolios equaled or beat their benchmarks.

The YTD returns fared no better. There was no safe haven except for cash. Even bonds, which are usually positive in a declining equity market, lost money. Assets to avoid during the year were Natural Resources down 24% and Emerging Markets down 17%. Sectors hit the hardest were Energy: -17%, Materials: -17%, Transportation: -15% and Industrials: -12%. The New York Composite Index (comprising 1500 stocks) declined 10%. Portfolios benefitted from being defensive. Contrary to the media saying that we were "continually making new highs"; longer term the U.S. market has been stalled for some time. The New York Composite Index is about the same price it was two years ago.

We are now in a global bear market. Bear markets are notoriously hard to navigate. There is no way to know either the duration of the bear or how far it will fall before it bottoms. In addition, the volatility of markets increases dramatically with the increased uncertainty. In August alone there were six trading days where the range for the market was almost 4% for the day. This volatility will continue throughout the bear market. In an ongoing bear, market rallies are steep and most of the gains occur in the first 3 to 5 rally days. At the time it is hard to determine whether it is "just another bear market rally" or the start of another bull market.

AVALON
CAPITAL
MANAGEMENT

The 2007-2009 bear market lasted 16 months. There were eight rallies during that time period of 7% or more and two in excess of 17%, before the final bottom in 2009. The rallies lasted anywhere from one to four months!! It is very difficult to remain a bear when the market is up that much over those time periods. Investors may think if it has appreciated over four months, it has to be a new Bull. While we will try to participate in tradable rallies, we will do so with capital preservation in mind and will not hesitate to flee to the sidelines when we see the rally fade.

Right now we are in a tradable rally that could last until mid-January. And the Last Shall Be First is playing out. The better performing assets have been those hit the hardest over the last twelve to eighteen months; namely Natural Resources (including gold) and Emerging Markets. The better performing sectors have been energy, materials and industrials. Most of these assets and sectors have been in their own bear market for up to eighteen months and the August lows for these areas could well be their lows for this market cycle. However it is premature to assume this.

We removed our hedges and added to positions in early October. We recommend the following allocation: overweight cash, bonds, natural resources and international stocks; neutral weight REITs and underweight U.S. equities. In addition to energy we like gold and gold stocks. Gold peaked in 2011 and gold stocks are down 85% from their highs!! They have not been this low since 2002. We like Europe and Emerging Markets. EAFE (Europe, Australia and the Far East Index) trades at Shiller P/E of 14 compared to the U.S. P/E of 25. Emerging Markets are at an 11 P/E. Both are cheap compared to the U.S. In the U.S. we like staples, technology, materials and consumer discretionary. On any market pullback we will be adding to positions in Emerging Markets, Europe, materials, energy and industrials.

WHAT ARE WE WATCHING?

Among the jumble of global political and socio-economic factors we are watching, we are particularly focused on: the Federal Reserve, U.S Corporate Profits, China's Growth and European Immigration.

FEDERAL RESERVE

The Fed has not raised rates for almost a decade. In the spring of 2013, they stated that rates might be raised at any time. They have repeated this ever since. Yet they continue to find a "data point" that prevents them from doing so. At the last meeting they "worried about how China and other overseas economies impacted our economy." We do not think they will raise rates this year or in 2016 (which is an election year). All current members were appointed by the current administration and will be loath to increase rates as a result. Even if they do raise rates by ¼ of 1% does it mean anything? It is hard to believe that such an increase would break the U.S. economic back. On the other hand, it is difficult to know whether even a small Fed increase has a tightening affect since they have not done so for a decade! In addition, with all other central banks loosening, even a slight increase is a relative tightening and could be disruptive to markets. However, rates are low! For the first time ever, the U.S. government has sold a three month Treasury that pays nothing – 0.00% interest. In fact on a global basis, interest rates has not been this low since 3,000 B.C. – lower than at any time since the ancient Samarians made the first documented loans, payable in either silver or grain.

If these rates are unprecedented, what are the odds that central bankers have anything like a clue as to what the long term unintended consequences of their actions are likely to be? Like it or not, the Fed watch beats on.

U.S. CORPORATE PROFITS

Even with the current market decline, stocks are still more expensive than they have been at any time in the past century (with the exception of 2000 and 1929). This would not a good time for an "earnings recession", but we may be in for one. Profit margins have begun to contract as the factors that caused them to rise are stalling out: cutting costs, holding off on infrastructure spending and borrowing at historically low rates. In addition, sales have begun to stagnate. Sales are forecast to slip 3.4% in the third quarter from a year earlier while earnings are forecast to slip 5.1%. Q2's earnings also declined. Consensus 12-month forward earnings forecast (typically too bullish) now stands at a 2% decline in profits. If earnings are flat or declining it is hard to have a robust equity market.

CHINA GROWTH

China is the second largest economy in the world. During the third quarter investors finally woke up to the fact that it is growing slower than they enthusiastically assumed. The official GDP forecast for the third quarter is 7%. However official numbers are horrendously opaque and most economists think China is actually growing at 3.5% to 4.0%. In any case, China is slowing down and since it is a huge importer as well as exporter, global growth is also slowing down. The Chinese government reported that its imports shrunk by an astonishing 20% in September, the eleventh straight month of falling imports. The other side to the plunging imports is that somebody, somewhere in the world is not selling as much to China as it used to. Germany is an excellent example since it is one of the biggest exporters to China. German exports fell 5.2% in August – the steepest drop since the 2007-2009 financial crisis. Everyone is hoping that China is stabilizing – maybe, maybe not. As with the Fed, we need to monitor China carefully, as it is currently the engine to the world.

EUROPE IMMIGRATION

The influx of refugees into Europe needs to be watched for its effect concerning the political and economic consequences for the E.U. The E.U. has just begun to gain traction on the economic dislocations between the North and South (think Greece), and now political tensions are surfacing between East and West over immigration policies. Brussels forced Hungary, Slovakia, the Czech Republic and Romania to accept refugees against their wishes, and they are not happy about it. Over the long term, immigration could be beneficial to Europe with its population declining. However, over the short term, the expense could be huge. The IMF's current forecast is a cost of over $1 trillion from settling the present flood of refugees. It is estimated that as many as 4 million more people could arrive over the next year or two and this potential cost has not been calculated. The situation in Syria is not improving; there has been a substantial military buildup by Russia and Iran is also sending fighter planes into the melee. This refugee issue will not be resolved overnight and should be closely observed for potential dislocations to the E.U.

SUMMARY

We are presently enjoying a bear market rally that could last until mid-January. We recommend an allocation that over weights cash, bonds, natural resources and international stocks, a neutral weighting in REITs and under weights U.S. stocks. We like gold and gold stocks. Near term, on any market pullback, we will be adding to positions in Emerging Markets, Europe, energy, materials and industrials.

Thank you for your ongoing confidence!

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