NOW'S A
GOOD TIME
TO GET SOME
GOOD ADVICE

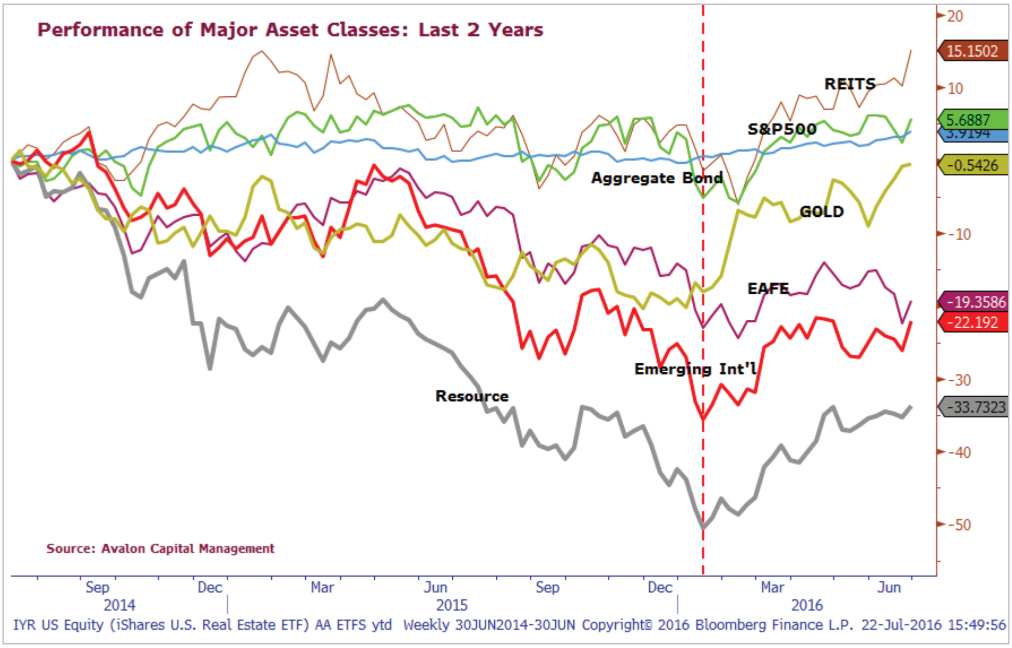
LIQUIDITY BLOW-OFF

Easy money and improving global trends signal better times ahead ...

Investors have waited patiently as markets have essentially been flat or down sharply over the last two years. Exhibit 1 shows why it has been hard to make any money since 2014. The percentage change is shown on the right scale. Intense volatility aside, it has been a mildly positive time for safety plays like bonds, REITs and defensive sectors within the S&P500 and a negative time for developed(EAFE) and emerging international and resource stocks. The S&P500's dividend yield of 2.1% now exceeds the 1.56% yield on the U.S. 10-year Treasury bond. While not normally considered a safe haven due to its volatility, the S&P500 has offered investors some refuge in a world of rising political and global instability, falling global stock and commodity prices and negative interest rates for 40% of the developed world bonds. Caution has been a rational strategy during such unrewarding times. But is now the time to start to tilt away from safety and toward opportunity and growth?

AVALON
CAPITAL
MANAGEMENT

Exhibit 1: *Asset Class Performance for the last 2 years began to improve in Jan/Feb*



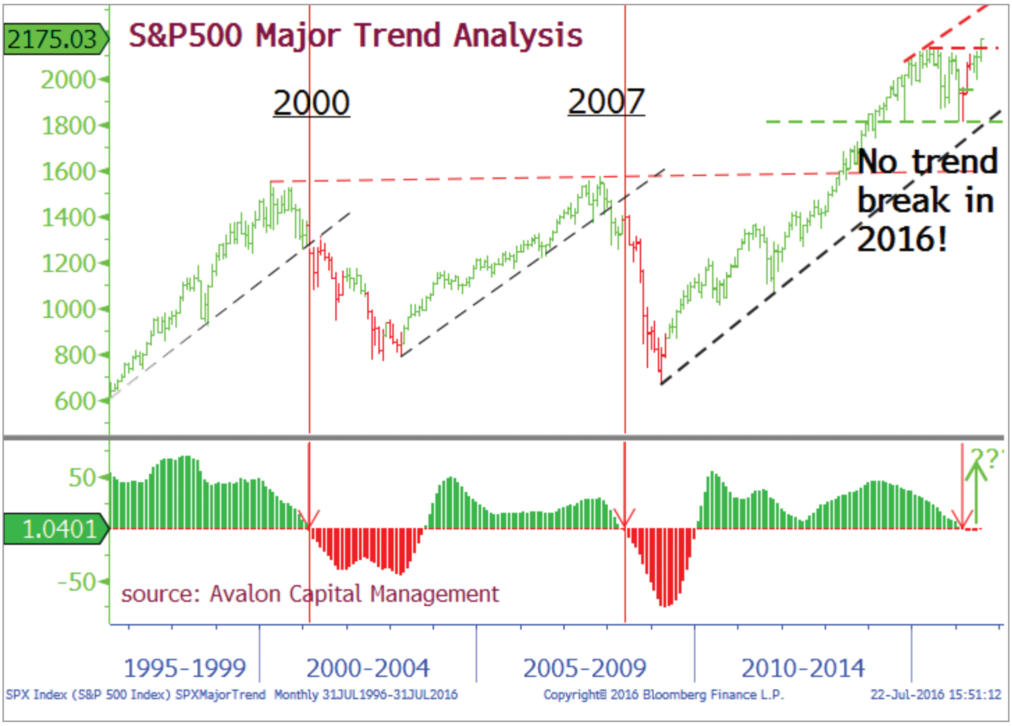
In the 1989 trading classic, **Market Wizards**, champion trader Mark Schwager said, "when your worst fears aren't realized, you probably should increase your position." How fitting for the events surrounding Brexit! All year our portfolios have been in a defensive posture, looking for a cyclical low around election time. The Brexit sell-off was fast, scary, against the conventional wisdom and newsworthy — a perfect storm for a market meltdown. And then the decline halted abruptly after 2 days and $2 Trillion in market losses. A selling panic gave way to a market melt up. Why? Mario Draghi, head of the European Central Bank says in hindsight that there was no visibility into the event. He says, "It's very difficult to understand how these big macro themes affect the recovery" but he stressed a "readiness, willingness and ability" to act if needed. Clearly investor *belief* in this willingness on the part of all central banks restored confidence.

The *abrupt* rally has begun to reverse many of the technical negatives that emerged in 2014. Markets are built on confidence and often lead actual fundamentals. Nothing improves confidence like an uptrend. For the first time in two years, rallies are underway for all asset classes. The post-Brexit recovery has found buyers well above the lows reached in February for ALL markets (See vertical dashed line in exhibit 1) and pushed some markets like the S&P500 to new all-time highs. In technical terms, there are still some things to work out in the coming weeks. Stocks are now overbought and ahead of themselves in the short term and August –September seasonal weakness lies just ahead. Still in practical terms, global stocks are now under accumulation. Technical evidence is improving so rapidly that sell-offs into the FALL, which are still possible, could be followed by the best returns since 2013.

Exhibit 2 shows the updated version of the S&P500 trend model that we first introduced in January. In **Ready For Bear,** we anticipated a replay of the signals shown on the chart in 2000 and 2007 indicated by the down arrows (lower panel) AND the break of the major trend line on the bar chart (upper panel). Those declines were greater than 50%. Now 5 months later, the major trend line has held AND the indicator is going green again after only a 13% drop, as shown on the price bar chart (upper panel).

The green signal is barely visible in the lower panel, but as this 20-year history shows, only one false signal occurred in 2001 during the tech bust. If the current signal reverses, we will reverse our expectations, but given the rare signals from this indicator and its excellent track record (Table 1 below), we are taking notice of the bullish implications.

Exhibit 2: *Major Trend Model for S&P500*



The bear market for the S&P500 has been shallow, while global asset classes and more economically-sensitive U.S. sectors and individual stocks declined by double-digits over the last two years. The low levels reached in January and February (red dashed vertical line in Exhibit 1), probably marked the end of the global bear market. Most global asset classes have remained under pressure since the 2008 recession, never matching gains made by the U.S. stock and bond markets. Table 1 details that the price level for global stocks (EAFE, emerging markets and natural resource stocks) remains below levels of eight years ago.

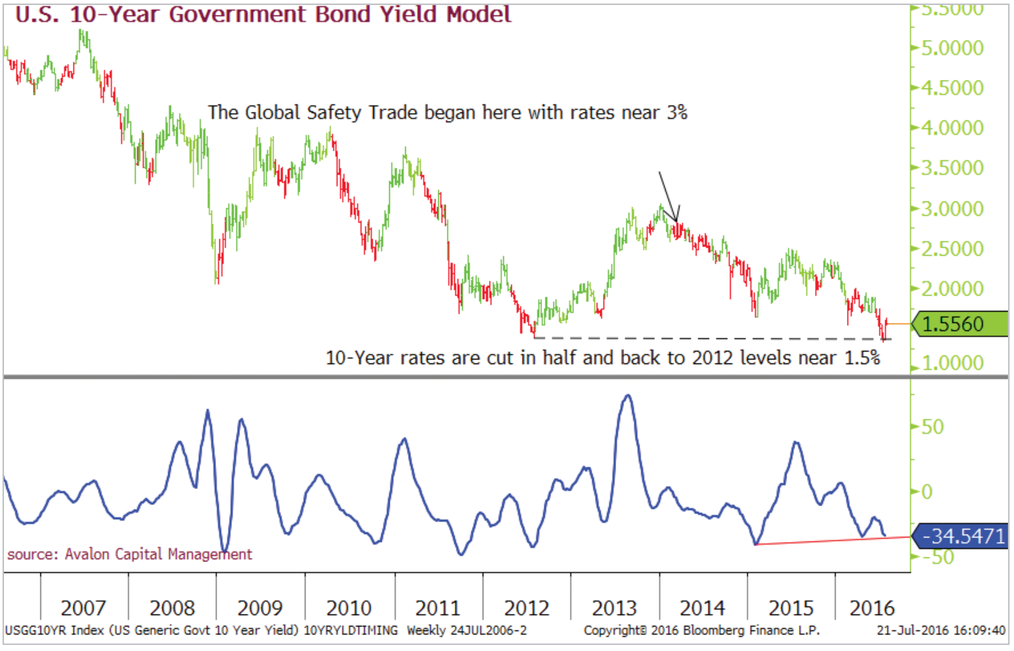
Table 1: *Avalon Capital Management Trend Model since 3/31/08.*
Asset Class Returns and Current Signals. (Price only)

3/31/2008 - 7/15/2016 Asset Class	% Return from Buy & Hold	% Return from Trend model	Current Model Signal
S&P 500	56.5	115.1	BUY
20+ YEAR US BOND(model 2)	46.2	91.8	BUY
GOLD	39.8	66.7	BUY
US REITs	20.6	41.9	BUY
MSCI EAFE	-24.5	28.3	BUY
NATURAL RESOURCES (model 2)	-24.6	42.0	BUY
MSCI EMERGING MARKET	-25.1	21.5	BUY

The Avalon trend model results since 03/31/08 have shown significant improvement versus a Buy/Hold strategy for each asset class. These models are the result of an extensive research project over the last 18 months. Currently the model is signaling a BUY on ALL asset classes. Confirmation from the emerging markets, EAFE and natural resources strengthens the signal because greater participation equals greater breadth and greater breadth equals a healthier, more buyable trend.

Markets this highly correlated are the exception and not the rule. Diversification works over the long term because something will go up even if something else goes down. Money will eventually shift to the greatest value and leave an asset class that is overloved and overpriced. There is nothing more loved in this market than yield. The so-called "safety trade" has been the place to be since the 2008 crisis. The enthusiasm for safety has grown even more pronounced in the last two years. The mantra "lower for longer" refers to the yield on bonds. It has become the justification for paying almost any valuation for anything with yield; namely, utilities, staples, telecom and REITs. We have advocated these markets for some time, but the clock is now ticking on lower yields. Exhibit 3 shows that since 2014, the yield on the US Treasury has fallen by almost half and now rests on the low yields of 2012, the last cyclical trough in the economy. While our yield timing model (Exhibit 3 and Table 1) has not yet turned, there is a mania in safety, now overvalued, that is probably a sign that the falling yield game may be running its course.

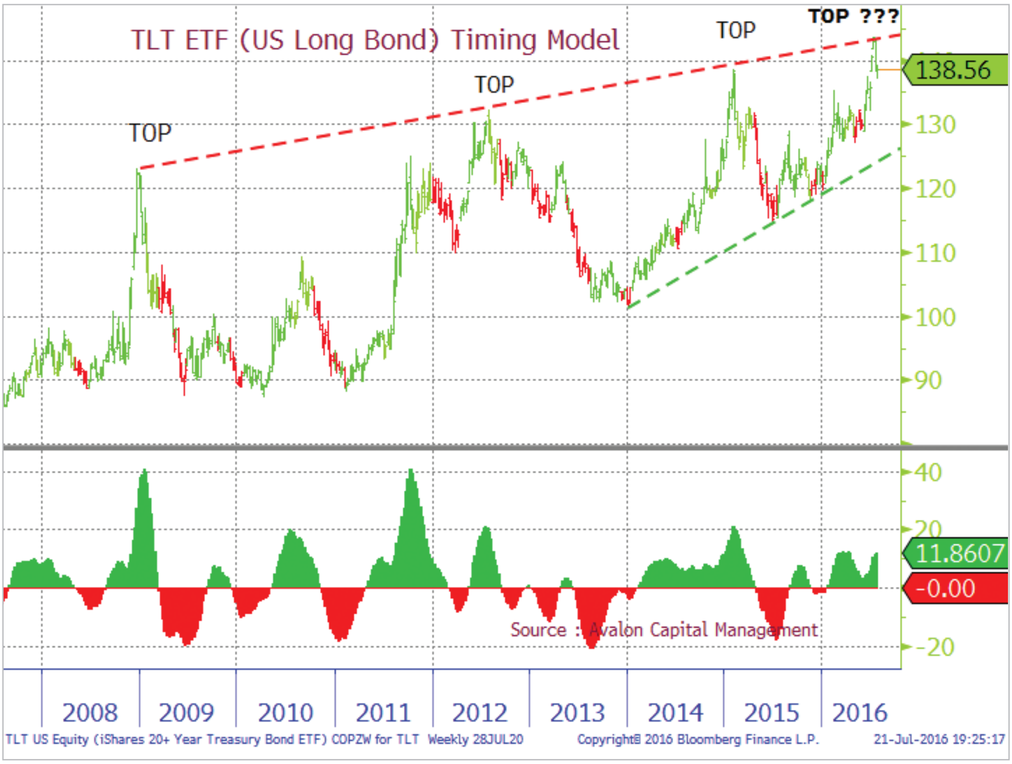
Exhibit 3: *Major Trend Model US 10-Year Bond Yields*



Ironically a rise in yields now would likely signal higher global stock prices since it would signal an improving economy and confidence. Central bankers have committed to doing whatever it takes to reflate dormant economies and asset markets. It might mean an eventual bubble in everything, but how else will they force investors out of hiding. Confidence is still so lacking that rather than buy bonds at negative yields, investors in Japan have been installing home safes for their cash. It will take rising stock prices to suck that cash back into the markets.

Another way to view overvaluation in bonds is the very long-term price chart (Exhibit 4) of the U.S. 30-yr bond price (TLT ETF). Remember as yields fall, bond prices rise.

Exhibit 4: *Major Trend Model US 30-Year Bond Prices*



Asset flows have favored bonds for 8 years and 'safe', bond-like stocks over growth and cyclical stocks for 18 months, but the easy money from bonds and bond proxies like utilities, consumer staples and low-volatility ETFs may now be coming to an end in favor of technology and industrials. As the chart in Exhibit 4 shows, this rising dashed red line has been formidable resistance to rising bond trends for the last 8 years. It may not be THE TOP for bonds, but it could be and warrants close monitoring given the relatively lackluster reward potential (Table 2).

Table 2 displays the ranks of the major asset classes by their upside reward and downside risk over the next 12-24 months. A higher ratio of reward versus risk is a greater value and a lower ratio is a lower value. Based on this ratio, it is time to shift some exposure away from bonds due to the low expected return and more toward natural resources, emerging markets and small cap, where the reward to risk is more favorable. The trend model for bonds is still positive but there is not much value left unless you wish to use negative interest rates as your competition. Other asset classes offer double-digit potential relative to the downside risk. It is ironic that bonds are perceived as "safe" at a time when reward to risk is so unfavorable.

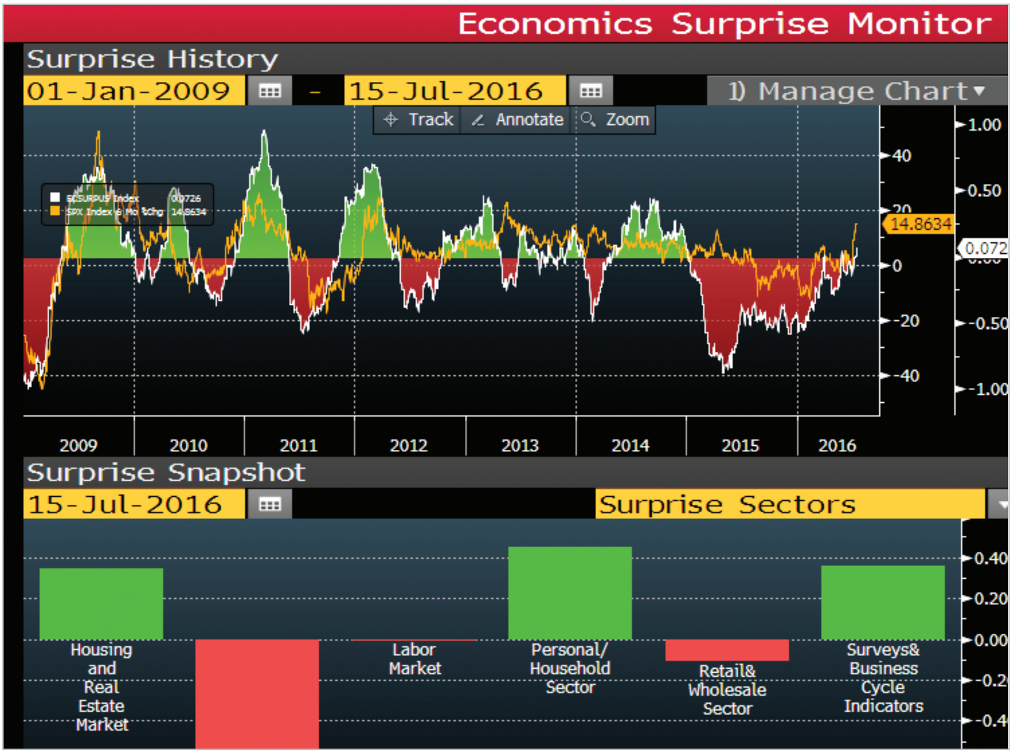
Developed international (EAFE) remains an underweight in portfolios despite a new positive major trend BUY signal due to other lagging model indications from Europe. Still, it is a top candidate for upgrade given the reward potential. We await further confirmation to increase the weightings in Europe, but have begun to increase Asia and emerging markets and continue to hold natural resources and gold.

Table 2: *Asset Class Reward/Risk Ratios*

	Reward	Risk	Ratio
MSCI EAFE	33%	-2%	17.889
NATURAL RESOURCES	54%	-12%	4.29358
Russell 2000 (small cap)	21%	-5%	3.984295
MSCI EMERGING	36%	-16%	2.276183
S&P500	10%	-7%	1.551654
NASD100	10%	-8%	1.280114
GOLD	38%	-34%	1.111227
US REITS	9%	-14%	0.627782
20+ YEAR US BOND	4%	-19%	0.229163

Improving Economic Expectations ...

The U.S. Economic Surprise Index just went positive for the first time since January 2015. The Economic Surprise Index measures all major weekly economic releases across Housing, Industrial, Labor, Retail, Manufacturing and Confidence. It then scores if the readings are above or below consensus and adds (or subtracts) that to the index. This index has been in the red since Jan 2015 and only just went positive. Six-month performance of the S&P500, as shown by the yellow line, tends to track this economic composite.



When the economic consensus and stocks are out of sync, the indices eventually converge. In 2016, the S&P500 and economic estimates have tracked each other all year and are gradually improving. It is the direction of the change that carries weight as much as the magnitude. While the industrial and retail sectors still remain negative, ALL sectors are improving and the overall composite is now above zero. As this index moves higher it will be another indication that interest rates may be reaching their lows and stocks and the economy are improving. According the Ned Davis research, when the ECSU is in this position, the S&P500 is normally 10% higher over the next 12 months. This lines up well with our own reward/risk model.

Closing Thoughts ...

In the wake of Brexit and voter mandates around the world to stimulate growth, fiscal spending and excess liquidity from central banks will ignite a rally in lagging global stocks and fuel a final leg up in U.S. stocks that began in 2009.

- There has been an 8-year hiatus in returns for most global markets. Enthusiasm for "safety" is overdone. Negative interest rates in 40% of the world and historically low levels in the U.S. indicate a risk to bond markets and bond proxies.

- The cyclical global bear market in stocks is ending. Relatively attractive valuations, ample liquidity, improving profits and economic expectations will support higher prices for international and resource markets.

- High U.S. stock valuations will be a persistent problem in the U.S. until a deeper bear market ensues, but a recovery in profits over the next several quarters will provide some downside cushion and prices will move higher in a liquidity driven blow-off phase that push valuations and cresting longer-term cycles to even more negative extremes.

As always, we will defer to our models. For now they point higher for all major asset classes. We will use any weakness in the next few weeks to complete our reallocation.

Enjoy the summer!

Clara Dave Bill

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

AVALON
CAPITAL
MANAGEMENT

Clara Basile, Bill Oberman, Dave Rahn

Investment management and counseling
for individuals and families

avaloncapital.com

(650) 306-1500