NOW'S A
GOOD TIME
TO GET SOME
GOOD ADVICE

A NEW FOCUS

Since The Great Recession of 2008, market participants have been obsessed with any utterance about monetary policy from the Federal Reserve. For eight years, interest rates remained at "emergency" levels in order to sustain a fitful recovery. Even in the early days of 2016, fearing a drop back into recession, the Fed suspended its fledgling program of rate increases (begun in December 2015) thereby defending the U.S. stock market from an emerging bear market. A strong recovery ensued in early February 2016 as investors were emboldened by the ongoing easy monetary policy even as the economy was approaching full employment. By June, the S&P500 was roaring past the highs of May 2015. Then an unexpected vote in England to leave the European Union "Brexit" unleashed a negative global market reaction that gave the Fed yet another reason to stay the course: maintaining historically low interest rates. As a result, stocks recovered quickly and advanced again. The wave of rising populism globally and the shocking outcome of the Brexit vote should have been a "tell" that the upcoming presidential election in the U.S. could offer a similar surprise. In the early seconds after Donald Trump appeared to be winning in the Electoral College the S&P500 index futures traded down 5% and gold rallied 5%, mimicking the overnight drops in the UK pound and European stock markets post-Brexit. But by morning, the rout had not only reversed, but a new wave of buying enthusiasm took hold.

AVALON
CAPITAL
MANAGEMENT

A surprisingly inclusive acceptance speech from the president-elect coupled with promises of corporate tax reform, regulation rollbacks and infrastructure spending to create working-class jobs, was just what Wall Street needed. This so-called Trump rally was not like the rallies of the last eight years, built on easy money policy, a healing economy and technological innovation. It was built on the hope of improving profitability from a pro-business president promising a return to the US manufacturing and financial services economy of old, unobstructed by regulatory, environmental or consumer protection concerns. Buy first, ask questions later! The Fed was no longer needed to lead the way. Markets and the world were finding a new focus on the policy tweets of Donald Trump.

The early phase of the post-election Trump rally was selective. Among the major asset classes, only Natural Resource and US stocks rose in the 4th quarter.

MAJOR ASSET CLASSES (TOTAL RETURN %)	4th Quarter 2016	January 2017	Current Model View
US SMALL CAP	9.02	0.28	+
NATURAL RESOURCE	4.8	–0.75	+
S&P500	3.95	1.79	+
NASDAQ100	0.09	5.14	+
EAFE (EUROPE, AUSTRALIA AND FAR EAST)	–1.36	3.29	+
REITS	–3.23	0.13	N
EMERGING MARKET STOCKS	–5.44	6.66	+
US LONG TREASURY BOND	–12.64	0.81	N
GOLD BULLION	–12.76	5.42	N
GOLD STOCKS	–20.62	14.4	+

For a multi-asset portfolio, the 2017 start has been very positive after a sluggish finish in 2016. We are extending the year-end returns to reflect those results given the dramatic one month change. Through the end of January those asset classes and sectors that underperformed in the fourth quarter are now doing very well as investors sort out the implications for corporate profits, the U.S. dollar, global trade and a developing global recovery. Recent strength favors cyclical over defensive strategies. For now, we are bullish on the markets and are fully invested. Valuations suggest the greatest upside in developed and emerging international stocks, natural resource and gold stocks. We expect a bounce in US treasury bonds following the 20% decline that started in July 2016. Eventually, we would expect rising inflation and global improvement to support an environment where interest rates begin to go back up. At the sector level: financials, industrials, materials and technology should do the best. While the Risk/Reward ratio for US stocks is now less favorable than other asset classes, the model components of trend, momentum and relative performance remain positive. Valuation is a guide to look at potential risk/reward but it is not a timing tool until the other model components reverse direction. In addition, U.S. stocks are now in the early stages of a profit recovery after nearly a 2-year decline. This will help valuations even if U.S. stocks are not cheap. For now all asset classes except cash are positive or neutral in the model.

Major Asset Class Risk/Reward Analysis

(a high Avg ratio is favorable for risk/reward)

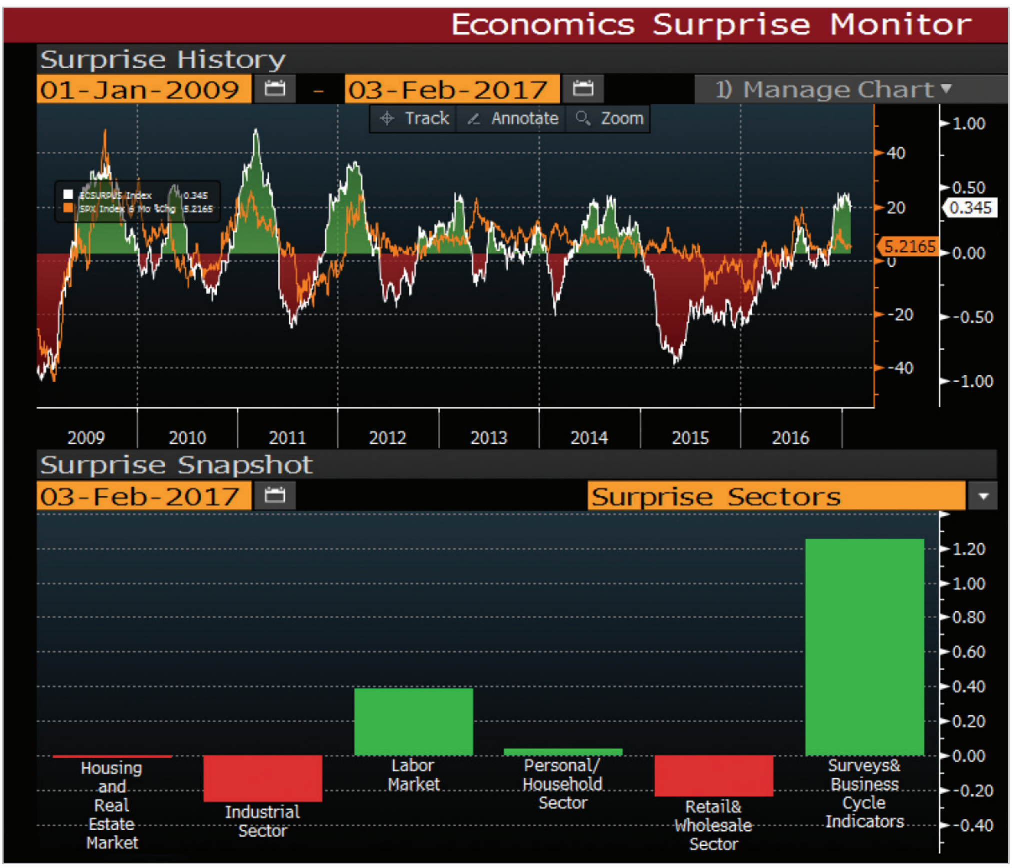
Upside	Current Price	AVG Upper Price	Avg % UP	AVG RATIO
GOLD	1,219.44	1,794.06	47.1%	2.97081
ENERGY	537.79	719.08	33.7%	1.837699
EMERGING	915.21	1,219.67	33.3%	1.421205
EAFE	1736.42	2,134.12	22.9%	1.063827
US LONG BOND	119.13	145.32	22.0%	5.849818
REITS	657.59	776.27	18.0%	1.073613
AGGREGATE BONDS	1,978.88	2,126.32	7.5%	30.27239
SP 500	2,297.11	2,427.97	5.7%	0.260542
R2000 SMALL CAP	1,373.93	1,450.07	5.5%	0.228149
NASD100	5,155.81	5,324.11	3.3%	0.12226

DOWNside		AVG Lower Price	Avg @ DOWN
AGGREGATE BONDS	1,978.88	1,974.01	-0.2%
US LONG BOND	119.13	114.65	-3.8%
GOLD	1,219.44	1,026.02	-15.9%
REITS	657.59	547.04	-16.8%
ENERGY	537.79	439.14	-18.3%
EAFE	1,736.42	1,362.58	-21.5%
SP 500	2,297.11	1,794.86	-21.9%
EMERGING	915.21	700.98	-23.4%
R2000 SMALL CAP	1,373.83	1,039.67	-24.3%
NASD100	5,155.81	3,779.26	-26.7%

Whether we like the election result or not, the reality is that a Trump regime has begun. This is a sea change in U.S. economic and foreign policy, something that has not happened in 35 years. There are immense implications for future investments. We do not pretend to know all of the consequences but we do know that the prospective changes need to be objectively monitored; closely and carefully. In a post on LinkedIn in late December, Ray Dalio, one of the world's richest and most successful hedge fund managers, offered some thoughts on the incoming Trump Administration.

He wrote "if you haven't read Ayn Rand lately, I suggest that you do so as her books pretty well capture the mindset. This new administration hates weak, unproductive, socialist people and policies, and it admires strong, can-do profit makers. It wants to shift the environment from one that makes profit makers villains with limited power to one that makes them heroes with significant power."

Dalio views himself as an analyst and investor rather than a partisan, his post suggests a world where Trump can have it both ways: run for office as an economic populist and protector of the working stiff, win the office and then stuff his cabinet with billionaires, bankers, and conservative political ideologues. “This will not just be a shift in government policy, but also a shift in how government policy is pursued,” Dalio wrote. “Trump is a deal maker who negotiates hard and doesn’t mind getting banged around or banging others around. Similarly, the people he chose are bold and hell bent on playing hardball to make big changes happen in economic and foreign policy (as well in other areas such as education, environmental policies, etc.) .” In moments of dramatic political change (similar to 1978-1982’s shift to the right that saw Margaret Thatcher, Ronald Reagan and Helmut Kohl elected) --one of the big questions is whether the new policies can successfully be implemented AND if they will succeed. At this point we can’t answer those questions but we do know that the investment environment will be more volatile until those answers begin to form. In the meantime we will keep a careful watch.



The negative economic momentum reflected by 18 months in red between Jan 2015 and June 2016 was already turning positive prior to the election. The Economic Surprise Index is now solidly green. This is mostly due to that burst in confidence after the election. Still, even the most optimistic investors have begun to express some concerns that the new administrations protectionist rhetoric could quickly unravel the hopes of the early days after the election. Wall Street loves profits but it hates uncertainty and chaos. With huge potential shifts on one side and marching in the streets on the other, we make no forecasts for the outcomes, but will instead search for growth and value following our indicators and hoping for the best outcome for the country.

Happy New Year!

Clara Dave Bill

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

The opinions expressed are those of Avalon Capital Management as of February 8, 2017, and are subject to change. There is no guarantee that the forecasts made will come to pass. This material does not constitute investment advice and is not intended as an endorsement of any specific investment. Investment involves risk of loss, especially in volatile markets. Past performance is no guarantee of future results, and the past performance of the models shown or referred to do not guarantee future performance. Investing in foreign markets involves currency and political risks. Data contained here is obtained from what are considered reliable resources; however, its accuracy, completeness or reliability cannot be guaranteed. Indexes are unmanaged, do not incur fees or expenses, and cannot be invested in directly. Investment strategies such as diversification do not assure a profit and do not protect against losses in a declining market. Other than the research credited, or noted by footnotes, the research underlying this piece represents Avalon Capital Management's proprietary research activities. Most indices mentioned are well known and full descriptions can be found at wikipedia.org.

AVALON
CAPITAL
MANAGEMENT

Clara Basile, Bill Oberman, Dave Rahn

Investment management and counseling
for individuals and families

avaloncapital.com

(650) 306-1500