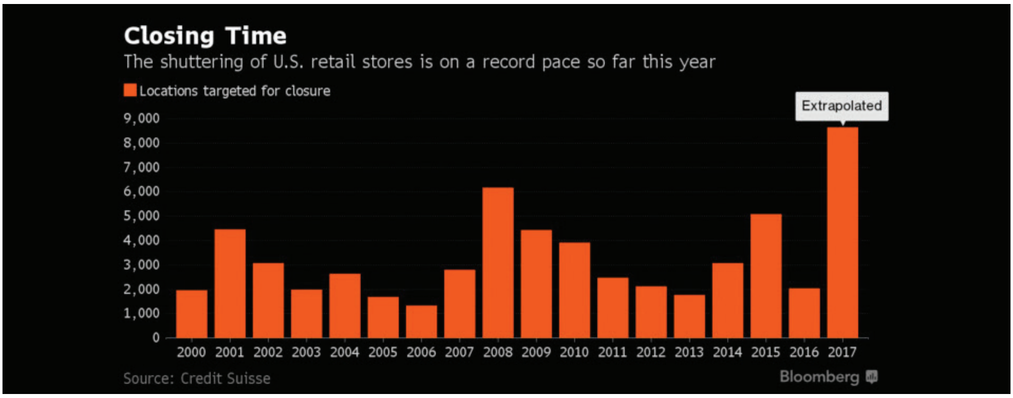
NOW'S A
GOOD TIME
TO GET SOME
GOOD ADVICE

BRICK AND MORTAR CRACKS

Since the 50's there seemed to be an insatiable demand for retail space that significantly outpaced population growth. Who would have thought that upstart Amazon would change the landscape so meaningfully! Now, in contrast, the momentum of store closings is accelerating as a generational shift is occurring. This shift will cause ramifications and economic dislocations that will last for decades. Malls have added way too many stores in recent years which has created a bubble, and (like housing), that bubble has now burst. Year-to-date store closings are already outpacing those of 2008, when the last U.S. recession was raging. Some 8,640 stores could close this year compared to 6,200 at the 2008 peak. Retail space in the U.S. is more than six times per capita than that of Europe or Japan so there is plenty of space that could disappear. There are roughly 1200 malls in the U.S., and recent estimates say 30% could close in the next 3 to 5 years.

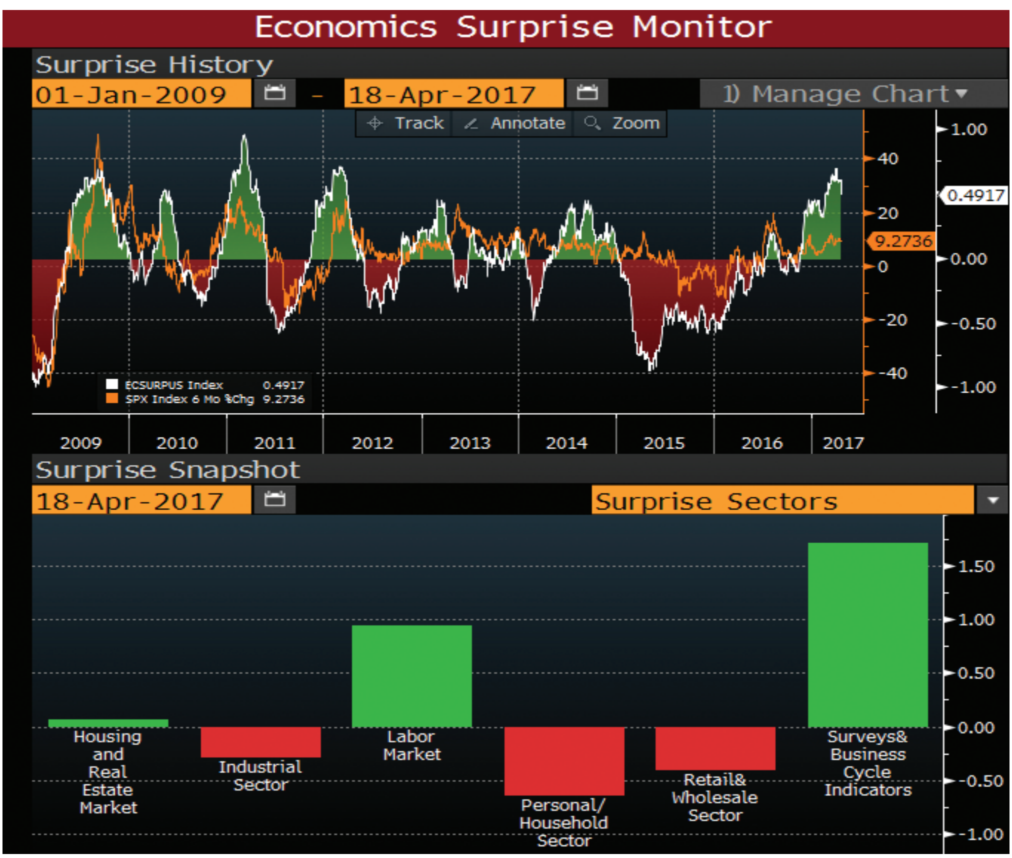


AVALON
CAPITAL
MANAGEMENT

One reason this is important is the potential negative effects on mall property values. Hundreds of malls across the country owe an aggregate $47.5 billion on loans taken out during a 1990s "borrowing binge" for mall construction. More than $1 billion of mortgages tied to shopping malls soured in February up from $884 million in January. However the real impact will be on jobs. Retail employs some 14 million workers or 1 in 10 jobs in the country. Retail payrolls are currently shedding jobs, not adding them: 30,000 in February and 34,000 in March. Retail jobs serve as an entry point into the labor force, especially for those with less education and fewer skills. Yes, new jobs are being created in distribution centers and delivery but they in no way replace the jobs being lost. This is an additional structural challenge that could hamper the new administration's goal of adding new jobs and increasing GDP above 2%.

Economic Surprise Monitor

The tone of economic reports in the last three months has turned decisively up. Bloomberg's Economic Surprise Index is at the highest level since the end of 2011 and near the upper band where it normally turns down. It has been expanding since its bottom in early 2015. Momentum appears to have topped out. It could be approaching a potential turn, where future surprises will be down rather than up. So far, the strongest positive readings have come from "soft" economic data points, such as consumer confidence surveys compared to the "hard" data like capital spending, manufacturing and retail sales. On the other hand, labor has remained strong and new building and home sales have buoyed housing and real estate.



The U.S. economy is still operating below potential output so the current expansion could become one of the longest on record. For now there is little evidence of a recession in the U.S. until 2018 or even 2019. Helping the domestic economy, for the first time in many years, is a synchronized global expansion which should last into 2018. Ample liquidity is available; all central banks are being very accommodative. The IMF projects 2017's global growth at 3.4% versus 2016's 3.1%.

Although the Fed is hiking short term rates, the increases are very gradual and start at a low level (massively under what a "normal" rate would be at this point in the cycle). The fed funds rate is currently 0.75% and most economists define a "neutral" rate at 2.0% to 2.5%. Additionally increases have a lag of 12 to 24 months before they affect the underlying economy. The Fed might reach 1.5% by year end if they follow through on their intentions – a considerable "if" by past standards. Longer term, Fed concerns revolve around the composition of the next Fed and the speed with which they reduce their balance sheet. Three seats will be up for change next year, including that of Chairman, which may be a game changer for Fed actions. Investors are also concerned that the Fed will begin to reduce its balance sheet at the end of 2017. The only historical precedent is Japan and their action had no discernable effect on rates or the yen. However there is a high correlation between U.S. stock prices and changes in the Fed's balance sheet since 2009. The additions to reserves definitely provided a boost to stocks and could prove to be a tailwind as reserves decline.

THE S&P500 ECHOES THE PATH OF THE FED'S BALANCE SHEET

Politics and Geopolitics

It has been a long time since politics and geopolitics have had such a day-to-day, and longer lasting, effect on an investor's sense of well-being and their investment strategy. While most political news is daily noise to be ignored, it is also true that over time, themes do emerge that should be investigated. Fortunately our models help us distinguish between the wheat and chaff; that said, the level of uncertainty has certainly escalated since the beginning of the year.

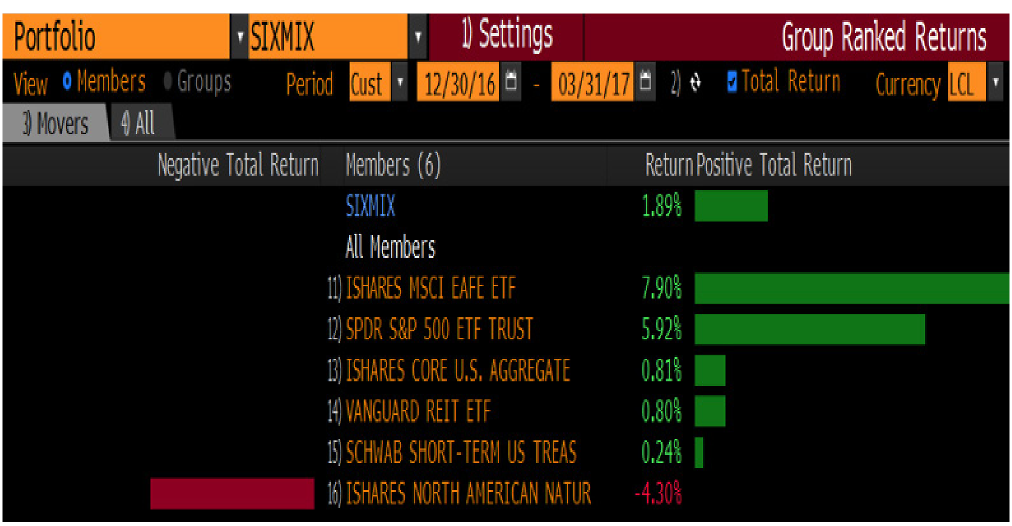
On the domestic front, the politics are not going particularly well. What started out for some as hope and relief has started to move to concern and even fear, on some issues. Trump's opening gambit has been marred by legislative and executive stumbles, legal setbacks, senior staff kneecapping one another, the resignation of his national security advisor and daily headlines about links to Russia. In late January he promised an "astounding" budget in the next two weeks. In mid-April we are still waiting. Currently he is still reassuring us about a health care bill before he attacks tax reform. A useful test for how things are really going will be the looming April 29th government shutdown and how it is handled. This would touch the entire federal government, if it happens. This would be the first same-party shutdown in 37 years. If some voters did not think he was in over his head before, a lot more would likely come to that conclusion if there is a shutdown.

Geopolitics has come back on the front burner with a vengeance: the US Tomahawk strike on Syria and a warning from Trump to North Korea that if Beijing won't help solve the nuclear weapons program then "we will" go it alone. Some Avalon clients have voiced concern about a potential conflict in the Far East. While we share that concern, most of these events never materialize and the world goes on to another crisis. We are watching but taking action prematurely for an event that may never happen can be costly. Another big worry is the upcoming French elections. March's global fund-manager survey showed European elections as the biggest risk facing global markets. Moreover, the French risk has changed shape. Markets appeared comfortable with centrist Macron facing Le Pen. But now, far-left candidate Melenchon is gaining ground and he wants to radically change Europe as much as Ms. Le Pen. This would intensify worries around whether the euro can hang together.

Investments

Trumponomics continues to play havoc with asset classes. In the fourth quarter of last year the S&P 500 and natural resources were the only asset classes that were up, with treasury bonds losing some 12.6%. In the first quarter all asset classes were up except natural resources (down 4.3%). International stocks, EAFE, showed the best numbers +7.9% and the six-asset composite rose 1.89%. For a multi-asset portfolio, the start to 2017 was powerful, but started to fade as the quarter wore on. This softening is likely a pause and not a trend reversal.

PERFORMANCE OF THE SIX MAJOR ASSET CLASSES FOR Q1 2017



Major Asset class Risk/Reward Analysis, a snapshot on relative valuation, shows that energy, gold, bonds, emerging markets and EAFE still have the best upside reward while the NASDAQ, Russell 2000 and S&P500 potentially have the most downside risk. Valuation is not a timing tool that can be used on its own and an asset class can remain expensive or cheap for long periods of time. Three months ago we were fully invested and underweight only in bonds. Our timing model is presently fading equities and adding to bonds. It is underweight cash and natural resources, but value is returning to Energy and may soon warrant a shift. It is neutral on bonds, REITS and U.S. stocks and overweight international stocks.

ASSET CLASS	PRICE	REWARD		RISK		REWARD
	4/18/2017	Estimated Upper Price	Avg % UP	Estimated Lower Price	Avg % DOWN	vs RISK(X)
ENERGY	505.94	717.54	41.8 %	439.63	-13.1%	3.191105
AGG BONDS	2,016.63	2,133.52	5.8 %	1,976.77	-2.0%	2.932467
GOLD	1,289.45	1,787.88	38.7 %	1,023.51	-20.6%	1.874209
US LONG BOND	124.70	144.75	16.1 %	113.44	-9.0%	1.780376
EMERGING	957.70	1,229.10	28.3 %	711.64	-25.7%	1.102968
EAFE	1,774.47	2,149.63	21.1 %	1,375.92	-22.5%	0.941297
REITS	685.60	781.02	13.9 %	553.68	-19.2%	0.723319
R2000 SMALL CAP	1,361.89	1,484.30	9.0 %	1,072.01	-21.3%	0.422246
SP500	2,342.19	2,483.60	6.0 %	1,841.85	-21.4%	0.282623
NASDAQ COMP	5,849.47	6,047.10	3.4 %	4,321.37	-26.1%	0.129331

BONDS – Treasury bonds rebounded 1.78% in the first quarter from the disastrous loss in the fourth quarter. However, for the last three months, they have been range bound unable to gain any traction to the upside until recently. Geopolitical events and a fading confidence in administrative mandates finally shoved investors toward bonds as a safe haven. We have added to bonds but will stay neutral until our longer term indicators signal an end to the bear market that began in July. Since bonds are presently in a bear market rally, we expect muted returns over the near term. Eventually the long-end yield should grind higher given improving growth, rising equity prices and renewed "animal spirits."

REITS – We are neutral REITS. Relative performance just reversed its downtrend that started last summer. Valuations are becoming more attractive and rental income is still robust. Like bonds, REITS are currently benefiting from a return to the safety trade. While many REIT categories have remained buoyant, the asset class that has taken the biggest hit is the Mall REITS. Simon Properties is down 25% from its high last July in response to the massive wave of retail closings.

INTERNATIONAL STOCKS – This is the only area we are currently overweighting. International earnings are growing at 12% to 20% compared to our 10%. The world P/E is almost 30% below USA's while emerging markets are 45% below. The upside reward is considerably more than the U.S. – in the neighborhood of 3-4X. However, the downside risk is comparable to ours, so there is no free lunch. While the political risks in Europe are not going away, the relative performance of total returns between the Eurozone and domestic equities is at its lowest since 1987. So, much of the political risk may be already discounted.

The ECB is likely to maintain its easy monetary policies while the Fed is on track to normalize interest rates here. Eurozone stocks are trading at a 22% discount to the U.S. China's growth is picking up again which is helping emerging markets. We particularly like India and South-East Asia ex Japan. The dollar has been weak since December and this has helped returns in the international area. Near term the dollar looks ready to strengthen, which would be a potential tailwind for investments overseas, but we would likely hedge the currency risk.

NATURAL RESOURCES – We are underweight natural resources. Trumponomics whipsawed this sector: up 18% after the election, down 13% from its high in January as the Trump rally faded. Infrastructure spending, if it happens, will be a long time in coming. Also a slowdown in Chinese construction activity, coupled with unfavorable global demographics, will continue to constrain demand for commodities. This slack in demand, coupled with excess capacity, will continue to limit the upside in resource prices and prolong the commodities bear market which began in 2011. We have added to gold as it recently broke out above a two month consolidation on geopolitical concerns. Valuation is attractive, but the secular trend remains down. For now, this is just a trade.

U.S.STOCKS – We are neutral on U.S. stocks. For the U.S., the big question would be: Is the market marching toward a cyclical peak? Ned Davis Research posed this very question. Looking through their technical, sentiment, macroeconomic, and fundamental indicators they concluded that "warning signs are accumulating, but the majority of indicators **are not at levels seen at bull market peaks."** They distinguished cyclical bear markets that have over-lapped with recessions and those that have not. Non-recession bears are shorter and shallower. So far there is no recession on the horizon.

Their technical indicators, specifically market breadth, were stronger on March 1 than at previous market peaks. The percent of stocks above their 50-day and 200-day moving averages were all above average. Until more divergences develop, the technical support a continuation of the cyclical bull.

Perhaps the biggest shift since the election has been an increase in optimism. Consumer Confidence is at its highest level since December 2000. Sentiment is strong enough to support a peak but we need to see what happens to it during market pullbacks before we can count it as a negative.

The macroeconomic indicators (monetary, fiscal and unemployment rate) are not sending major warning signs. A question is whether the economy will heat up enough to force the Fed to accelerate its pace of interest rate increases. There is little evidence to support this scenario.

Regarding the fundamentals, the big question is how long earnings growth supports valuations. The 15% year/year growth in S&P GAAP EPS is higher than all but three previous bull market peaks. But as year/year comparisons become more difficult, earnings momentum should slow, leaving the market with both elevated expectations and valuations. Valuations are not useful for stock market timing. However they do reveal potential risk or reward that does exist in the market. Unfortunately there are so many valuation methods that you can always find one to support either your bullish or bearish case. CMG Investment Research tries to overcome this by showing 20 indicators commonly used for valuations. Of these, 55% were rated extremely overvalued, 15% moderately overvalued and 30% moderately undervalued. Take your pick. However, the combination of slowing earnings momentum and valuations should eventually become a headwind for the market.

The Trump rally is on pause. Specifically, we are talking about those sectors and groups that surged after the election: financials, industrials, energy and materials. They are now retracing those gains with a vengeance as the Trump pledges of health reform, tax reform, deregulation and infrastructure spending are mired in politics. Financials and energy are now down for the year. Also small-cap stocks, which sizzled in the fall, have fizzled ever since and are also down for the year. These small-cap companies were supposed to benefit most from Trump's tax cuts, infrastructure spending and deregulation. In addition, small-caps are not cheap. Their trailing P/E during that rise went to all-time highs and 30% of the companies in the Russell 2000 index **have no earnings!** We are neutral financials and consumer stocks and overweight health care, biotechnology and technology.

SUMMARY

The global expansion is gaining traction and should eventually support higher equity prices. There is no evidence of a global recession until 2018 or even 2019. A U.S. recession is also off the table until 2018. The Trump trade of financials, industrials, energy, materials and small-caps is fizzling but will likely rear its head as policy issues wax and wane. Geopolitics is hording the headlines. Is it an accident waiting to happen? — Or just noise that will soon recede? We are currently underweight cash and natural resources, neutral bonds, REITS and U.S. stocks and overweight international stocks.

Dave Clara Bill

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

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