NOW'S A
GOOD TIME
TO GET SOME
GOOD ADVICE

BUBBLE TROUBLE?

An asset bubble is characterized by a wave of optimism that lifts prices beyond levels warranted by fundamentals and ends in a crash. Real estate in the U.S. from 1995-2006 and tech from 1995-2000 are recent examples. Bubbles are attributed to irrational investing behaviors characterized by groupthink and herd mentality. The bubbles burst when the outlook is proven to be too optimistic, often becoming the mainstream consensus.

Asset bubbles are not new. Tulipmania was a period in the Dutch Golden Age during which prices for tulip bulbs reached extraordinarily high levels – a single bulb cost 4000 guilders when a skilled craftsman earned 300 guilders a year. Median household income in the U.S. is $60,000 per year which means a comparable tulip bulb today would be worth **$800,000.00!!** Prices collapsed in 1637.

Because of relentless central bank easing over the past eight years, all asset prices have appreciated in value; are we now in bubble land? It's a question many have been asking. Currently, some assets inhabit that region. Bond prices reside considerably above "normal" values since central bankers have purchased some **$10 trillion** of bonds since the recession. One can argue the bubble in U.S. Treasury bonds may have already popped. Over the last 12 months, yields have risen sharply from the 30-year bond low yield of 2.09% touched in July 2016. Today these bonds yield 2.9% when the "normal" yield should be between 4% and 5%.

AVALON
CAPITAL
MANAGEMENT

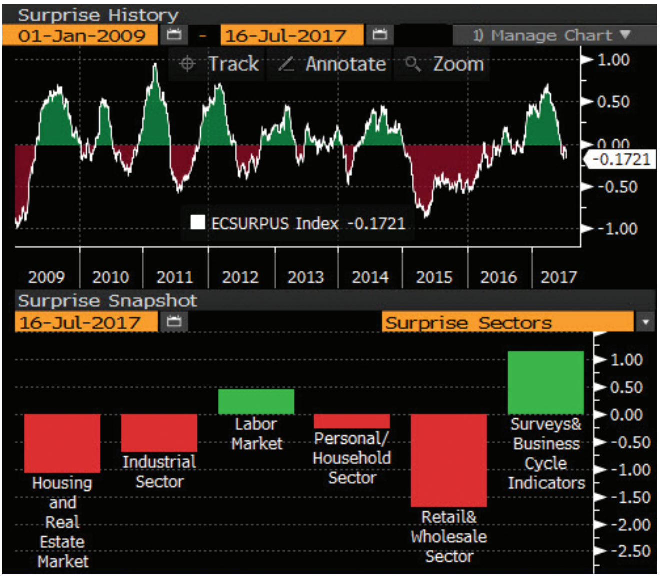
Real estate is booming in China, Canada, Australia and major metropolitan areas around the world. A parking space in Hong Kong sold for HK$5.18 million ($664,000). Certain individual stocks have become materially overpriced because the "dream" of unlimited upside might become reality. For these stocks, the more they go up the more the dream becomes a self-reinforcing fact. In the U.S. one of the dream stocks is Tesla. Facts do not matter – only the story. We are not saying Tesla does not have a future or great ideas. It produces fine cars and is trying to diminish the use of carbon energy. But as a shareholder are you overpaying to participate in the dream? Recently Tesla's market capitalization of $55 billion exceeded General Motors $52 billion. General Motors produced more than nine million vehicles and revenues of $165 billion, while Tesla produced 75,890 vehicles and $8.5 billion in revenues. Tesla lost $397 million in the first quarter alone and pays no dividend. GM had free cash flow of $9 billion and pays a 4.25% dividend. More than 50% of Tesla's cars are sold in California because of generous tax credits in addition to Federal credits -- without those credits and with new commitments to build electric vehicles from every major car maker, Tesla may end up being to the electric car market what AOL was to the internet. A great idea for which investors paid too much until the world caught up with the dream. Time will tell, but dream stocks can reverse quickly once investors really understand the story.

Many investors voice concerns that tech is back to the bubbly days of 1999. However, except for a few isolated cases, they are not even close to reaching the absurd valuations of 1999-2000. In 2000, WebVan was worth more than the top 3 grocery chains in the United States, with little sales and no earnings. There were 486 Initial Public Offerings (IPOs) in 1999 and **117 doubled in price** on the first day of trading. Last year IPOs totaled only 105 and more than 50% fell below their offering price. While there is much discussion about asset bubbles and US stocks are reaching full value, we do not see the classic signs of an asset bubble in most stock prices or the likelihood of a major crash of markets around the world.

SUMMER RALLY ...

Globally balanced portfolios grew nicely in the second quarter. All assets appreciated except natural resources as the energy sector plummeted 8.7%. Fortunately, we underweighted this sector during the quarter. After a bumpy start to the third quarter, when **all assets depreciated** in the first ten days of July, the summer rally got underway and all but fixed income is now moving higher. The sell in May and go away trade recently became the sell in August trade instead. The best month of the quarter is July, followed by two months of seasonal headwinds. U.S. markets continue to do an exceptionally good job of correcting internally through tight and mild sideways price consolidation, exhibiting internal sector rotation without meaningful corrections at the index level. This is only bullish for as long as it continues. Consistent upward momentum is exceptionally difficult to reverse quickly because market participants chase performance and become less risk adverse the longer the market remains positive. The S&P 500 2500 -2550 area is a potential stopping point for the summer rally. That equates to another couple percent after which we would expect the August-September pause. We do not see a major market reversal over the near term and remain invested in all asset classes except treasury bonds.

Economic Surprise Monitor



The tone of economic reports in the last three months has softened. Bloomberg's Economic Surprise Index fell sharply over this period and moved below the zero line where it now hovers. This is similar to the third quarter in 2016 after which it turned back up. Should it decline further, it may portend an economy weaker than currently anticipated. For now, we expect it to improve over the next quarter. The retail and wholesale sector contributed most to the decline followed by housing and real estate. The industrial and household sectors improved the most. There is little evidence of a looming recession at this time. Bond yields had responded to the softening and are now beginning to rise again. We think this indicates an improving economy in the U.S.

Growth outside the U.S. picked up, particularly in East and Southeast Asia. China recently announced growth above expectations. The IMF projected global growth of 3.5% in 2017. Thus, economies outside the U.S. bolster the U.S. expansion.

Investments

Major Asset Class Risk/Reward Analysis, a snapshot on relative valuation, shows that energy, gold, emerging markets and REITS still have the best upside reward. A ratio of reward to risk around 1:1 or greater is ideal. The NASDAQ, S&P500 and Russell Small Cap potentially have the most downside risk relative to upside reward even though other indicators remain positive. Valuation is not a timing tool that can be used on its own. An asset class can remain expensive or cheap for long periods of time, but once a trend changes from up to down, it is a helpful tool to set expectations of risk or reward. Our timing model is presently invested in all asset classes except treasury bonds.

ASSET CLASS	PRICE	UPSIDE		DOWNSIDE		REWARD
	7/26/2017	AVG Upper	Avg % UP	AVG Lower	Avg % DOWN	vs RISK(X)
ENERGY	484.56	683.69	41.1%	438.37	-9.5%	4.3112691
GOLD	1,262.73	1,691.62	34.0%	1,045.18	-17.2%	1.9714247
US LONG BOND	123.77	141.91	14.7%	112.69	-9.0%	1.6378551
EMERGING	1,062.29	1,214.89	14.4%	776.18	-25.9%	0.5333502
REITS	681.09	774.91	13.8%	573.98	-15.7%	0.8759228
EAFE	1,929.37	2,142.96	11.1%	1,477.62	-23.4%	0.4727962
R2000 SMALL CAP	1,442.28	1,526.31	5.8%	1,168.96	-19.0%	0.3074326
BONDS	2,029.59	2,128.44	4.9%	1,983.79	-2.3%	2.1582131
SP500	2,477.83	2,548.96	2.9%	2,000.72	-19.3%	0.1490934
NASDAQ	6,422.75	6,358.33	(1.0%)	4,824.27	-24.9%	0.0402988
NASD100	5,950.73	5,840.66	(1.8%)	4,381.34	-26.4%	0.0701361

BONDS – Bonds are in a cyclical bear market that began in July 2016. They have had a nice recovery so far in 2017 after the drop late last year. That recovery is *ending* now. Bond prices in the near term will continue to underperform other asset classes. The softening in economic conditions that accompanied the bounce is likely shifting back toward better growth. This will further inhibit bond performance.

All central banks recently reversed course and started to remove liquidity from the system. A global convergence of policy is in the cards. The turn in the tide at central banks — whether it be the European Central Bank charting a path to reducing bond purchases, the Federal Reserve preparing to rein its balance sheet, the Bank of Japan's stealth tapering, the Bank of England talking of a rate rise or the Bank of Canada actually raising rates for the first time in seven years – is leading speculation about coordinated action. Bond prices are under pressure world-wide. German 10 year bond yields have soared from a **NEGATIVE 0.145% to 0.506**. They could hit .70% before the end of the quarter.

EURO CURRENCY

YEAR TO DATE the Euro has appreciated 10.8% and is ready to go much higher. If you live in Euro land you have lost a ton of money in U.S. treasuries over this period. The weak dollar is putting additional pressure on U.S. bond prices. Eventually the long-end U.S. bond yields will grind higher given continued growth, a weakening dollar and rising equity prices.

The Federal Reserve has its most direct influence on fixed income rates and change is a coming. Get ready for the Trump Federal Reserve. Fed Governors have a 14-year term, but resignations can affect the balance. There are seven members of the Board of Governors. Trump is going to have the unusual opportunity to appoint six, and more likely all seven, by the middle of next year. The policies of the Fed over the past ten years may have little bearing on future actions so using history as your guidepost will be a waste of time. We have no insight on the Board a year from now – only that anticipation of these changes will increase uncertainty and volatility over the coming year.

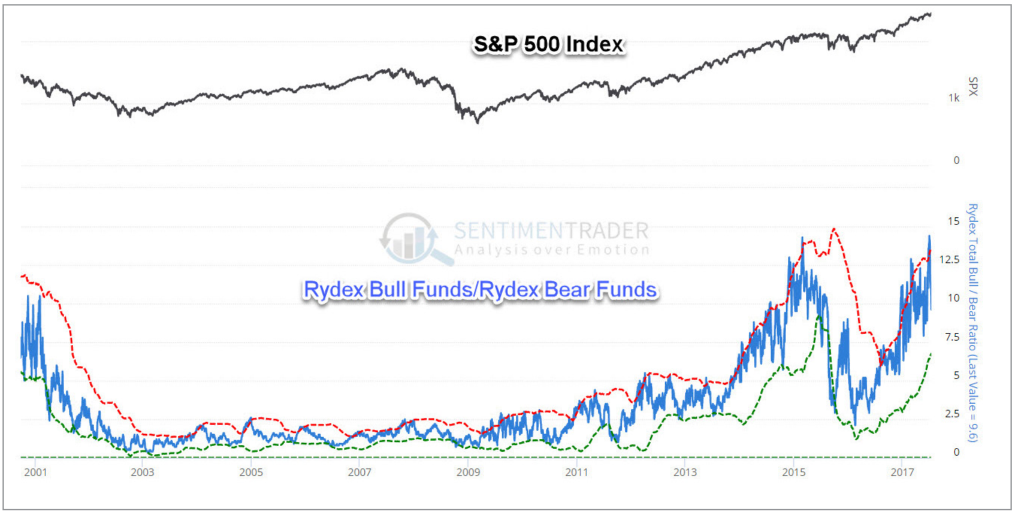
REITS – We are slightly overweight REITS. They are the third worst performing asset for the year – only outperforming bonds and natural resources. Valuations are becoming more attractive and rental income is still robust. While many REIT categories have remained buoyant, the asset class has taken its biggest hit in the Mall REITS. Simon Properties is down 27% over the last year in response to the massive wave of retail closings. We favor REITS over bonds for income.

INTERNATIONAL STOCKS – We are overweight international stocks. They continue to outperform the U.S. The strength in the Euro is starting to affect their markets as concerns about competiveness and exports begin to grow. Most of our investments are in Asia. Asia is half of global GDP and two-thirds of all middle-class spending. Asia will grow at 6.4% this year versus 2.0% for the U.S. and 1.6% for Europe. Emerging market P/E's are 45% below USA's. China's growth recently exceeded expectations. We particularly like India, China and South-East Asia ex-Japan.

NATURAL RESOURCES – YTD natural resources collapsed 10.6%; the energy sector crashed 13.5%. With the weaker dollar commodity stocks are starting to find support at current levels and doing much better since the beginning of the third quarter. They are in a cyclical bear market and sharply oversold in the near term. As shown in our Reward/Risk Analysis they have the best ratio of all asset classes at this time. Commodity stocks topped out in 2008 and relative to the S&P are at levels last seen in 1999 and 1960. Then they started multi-year outperformance. We are adding back to this area recognizing that it may be a countertrend bounce in an ongoing bear market. Value is good, but uptrends need to resume.

U.S.STOCKS – We are overweight U.S. stocks. Valuations expanded over the last three months but the market keeps chugging along. CMG Investment Research's 20 indicators commonly used for valuation shows 55% rated extremely overvalued, 15% moderately overvalued and 30% moderately undervalued. Slowing earnings momentum and high valuations will eventually become a headwind for this market and until it does we will keep participating.

Sentiment indicators show investor complacency and lack of fear. The volatility index is close to all-time lows and mutual fund cash levels are at record lows. The Rydex Bull Funds Assets divided by Bear Funds Assets recently hit new highs similar to 2015. This indicates that most bears have left the market licking their wounds. This latter indicator includes relatively new instruments with a short history but still has important information. Sentiment indicators, like valuation are not good for precise market timing – only an indication that the environment for investments is getting overconfident and vulnerable to a negative surprise.



Portfolios are overweight finance, health, biotech, materials, industrials and information technology; avoiding staples and telecommunications.

Washington

Can anyone get away from the constant barrage from our dysfunctional federal government? While it may be affecting your mental health, the investment markets do not care what is going on. Trying to marry political news to financial markets is dubious at the best of times. There is usually a very low correlation between them, and even when the correlation is high, we don't know if it's cause-and-effect or just happenstance. The last nine months prove the point. Trump's poor approval rating did not correlate at all with the market over the last nine months. If the market does start to pay attention our indicators will react accordingly. For now, from a market perspective, it is better to ignore the antics from Washington and enjoy your day.

SUMMARY

The summer rally is underway. It should continue into mid-August and then pause through the rest of the quarter. Seasonally, August and September tend to be the weakest months in the quarter. Although valuations are high and there are some indications of asset bubbles, we do not think a market crash is imminent. Central banks appear to be finished with extreme easing so this will prove to be a headwind for the bond market and interest rates will continue to rise over the next year. This will eventually be a problem for stocks, but not immediately. It is too soon for the market to begin worrying that Fed members will be significantly different a year from now, which may produce new uncertainties for the markets. While we think asset appreciation from current levels is limited over the near term, our models currently advocate being fully invested by overweighting stocks and significantly underweighting the bond market. In the U.S. we are underweight consumer staples and telecommunications while overweighting finance, health, biotech, materials, industrials and tech.

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