NOW'S A
GOOD TIME
TO GET SOME
GOOD ADVICE

# AFTER THE CALM

After the stock market bottom in February 2016, there were only two periods of market instability. The first was in response to the Brexit vote in June of 2016 and the second was just before the Presidential election. Then a string of low volatility days persisted throughout all of 2017. But after a record January, stocks suddenly tanked 11.1% in ten days into early February. That drop was followed by a rally that re-couped part of the loss, and then another decline that left the S&P500 down 1.0% for the quarter after having been up nearly 7% at the year's high. The long calm in the stock market was broken. The seemingly uninterrupted uptrend has been replaced by wild gyrations in both directions within a single day. Among the reasons cited have been fears of increasing inflation and rising interest rates, Korea, Syria, a White House in chaos, a looming trade war, the Trump-Amazon feud over online sales tax and the Cambridge Analytica links to Facebook. After all that calm, markets are now contending with a host of worries. The last three months marked the first quarterly decline since 2015. The record number of trading days without even a 3% correction, dating back to the 1960's, has been broken. Volatility is back.

And the selling has not been confined to stocks. As the table below shows, nearly all asset classes declined in the first quarter. Except for gold bullion, even the positive returns on the Nasdaq and Emerging markets, disguise the drops of nearly 10% from the early weeks of the quarter.

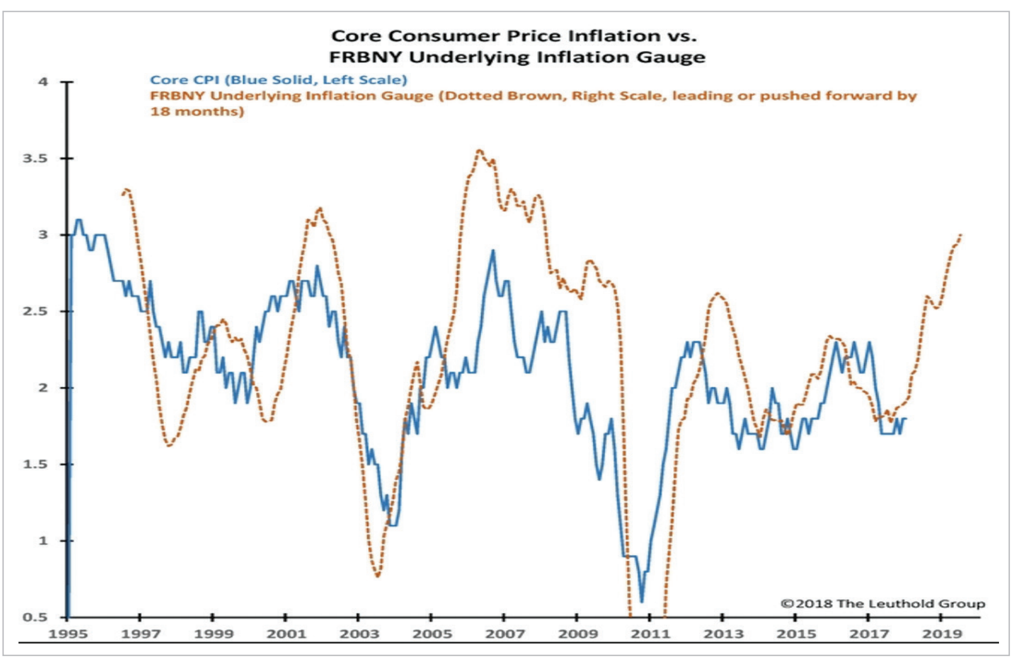
AVALON
CAPITAL
MANAGEMENT

| Negative Total Return | Members (10) | Return | Positive Total Return |
|---|---|---|---|
| | ADABENCH (My Portfolios - PRT... | -1.61% | |
| | All Members | | |
| | 11) POWERSHARES QQQ TRUST SERIES | 2.98% | |
| | 12) ISHARES MSCI EMERGING MARKET | 2.46% | |
| | 13) SPDR GOLD SHARES | 1.73% | |
| | 14) ISHARES RUSSELL 2000 ETF | -0.18% | |
| | 15) ISHARES MSCI EAFE ETF | -0.90% | |
| | 16) SPDR S&P 500 ETF TRUST | -1.00% | |
| | 17) ISHARES 20+ YEAR TREASURY BO | -3.51% | |
| | 18) VANECK VECTORS GOLD MINERS E | -5.42% | |
| | 19) ISHARES US REAL ESTATE ETF | -6.06% | |
| | 20) ISHARES NORTH AMERICAN NATUR | -6.19% | |

Was the decline the "pause that refreshes" or the beginning of a new bear market decline? It is too early to tell. The character of the short-term rally that began in early April will help us decide whether this is just a normal correction or the start of something more severe. If the old leadership re-asserts itself – information technology, financials, consumer discretionary and industrials – then it will have been a correction in a bull market. If the defensive sectors –consumer staples, healthcare, utilities and telecom gain strength, then a change in leadership is underway that will signal the need for a more defensive strategy. In the meantime, the extreme overvaluation of January has improved, even if the market is still not cheap. Sentiment is no longer ebullient and first quarter sales and earning will be very robust – sales gains of 7.1% and earning gains of 18.3% should bolster the market over the coming weeks. For now, our models have us overweight equities and slightly underweight bonds, (up from zero bonds just a few months ago), underweight REITs and Natural Resources (except for gold).

## INFLATION AND SHORT-TERM INTEREST RATES

The fear of higher inflation and short-term interest rates was one of the main factors behind the market slide in February. Accelerating inflation is here. The Fed's targeted "Core" inflation broke above 2.0%, to 2.1% in March and the highest level in 13 months. The annual Producer Price Index inflation rose to a 74-month high of 3.03%. A study by the Leuthold Group shows the core CPI will hit north of 2.5% sometime next year based on the NY Fed's Underlying Inflation Gauge (UIG), which leads the core rate by 18 months.



The UIG has moved above 3%, which is the highest level since before the Financial Crisis. The current gap between the UIG and CPI is at the highest level in over a decade. Higher inflation rates are on the way.

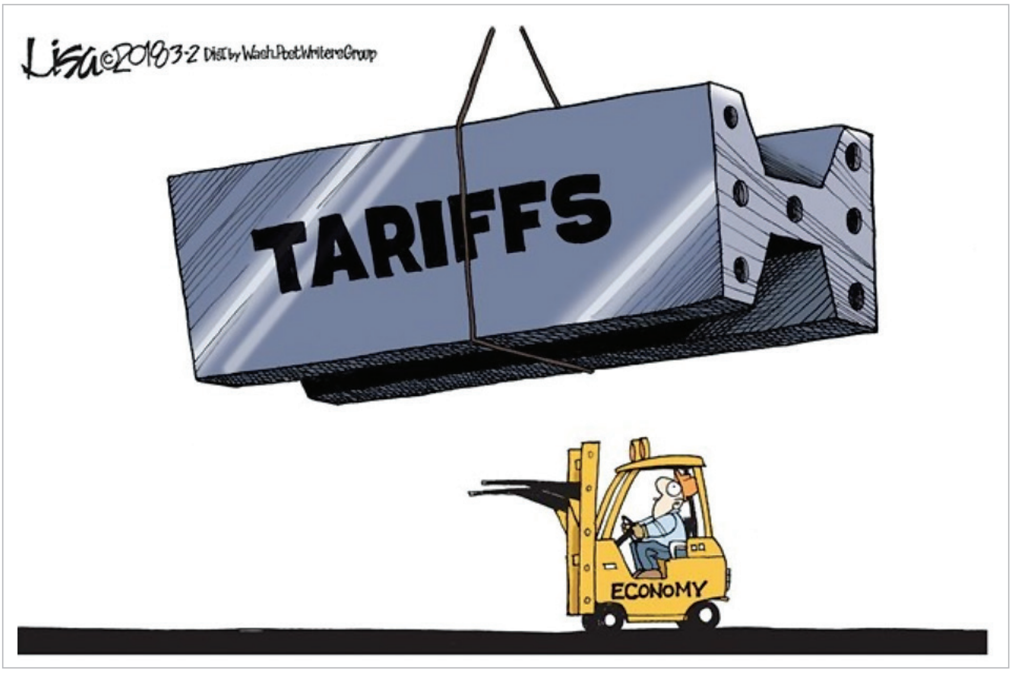
If the UIG is right about inflation, then short-term interest rates will continue to rise. Currently, the market expects two more Fed hikes by the end of this year to a range of 2% - 2.25%. If inflation surprises on the upside, then a third hike could be in the cards unless the Fed considers the increase to be temporary. The Fed notoriously lags actual interest rate changes, particularly when they are going up. So, a better gauge for assessing short-term interest rate changes that most professionals follow is the London Interbank Offered Rate (LIBOR). LIBOR is an average of the estimated interest rate that a high-quality bank in London would be charged to borrow from other leading banks.


The 3-month LIBOR rate has soared over the last couple of years from less than 0.5% to 2.35%. You may think 2.35% is still a relatively low rate, but it is the highest rate in 9.5 years. More importantly, it is used as a benchmark reference rate for other financial debt instruments globally, such as mortgages, student loans and credit cards. According to Bloomberg, about **$350 trillion** of derivatives and loans are linked to the LIBOR rate, which is why the rate is vital in determining borrowing costs.

For example, if you had a variable rate mortgage with a margin rate of 2.5% plus the LIBOR rate, a mortgage that cost you 3.0% in 2015 will currently reset at 4.8% - an increase of 60%! Our view is that the quickening of LIBOR rates and the tightening up of private markets is the story of the year, not the Fed. So far, the stock market is comfortable with the two-rate forecast and will not react negatively until and when it becomes apparent that a third hike may be in the works. We will continue to monitor inflation and LIBOR over the coming months.

# WHITE HOUSE CHAOS

Despite post-election fears of an imminent stock market collapse, up until February and March of this year White House chaos was ignored by investment markets—NO MORE. Now the revolving door and weekly firings (sometimes 2 or 3 a week) have cast a pall over the stock market. Investors now fear the potential consequences of an Administration inadvertently making a big mistake. The turnover rate is the highest among White House staff over the last forty years when they started keeping records. The real issue is that Trump is getting rid of anyone who disagrees with him. His latest appointees have been less than stellar. State Department pick, Mike Pompeo, is known for his hawkish foreign policy. John Bolton, his **third** national security advisor, is an outspoken advocate of military action against Iran and North Korea. Recent market declines have discounted the bedlam so far, but the political uncertainty has certainly increased market uncertainty and volatility.




In addition to the White House revolving door issue, the potential imposition of tariffs by Trump in early March shook the markets. Now he wants to slap tariffs on an additional $100 billion in Chinese imports in response to Beijing's plan to retaliate with their own tariffs. There is a strong case to be made that the United States needs to do all it can to get Chinese officials to change economic policies that have hurt American businesses and workers. For example, China has forced foreign businesses to transfer technology to local joint-venture partners as a condition of doing business in China. But it is hard to see this administration striking an effective and comprehensive deal with China. Will Trump and his officials be capable of putting in the time and hard work required to hammer out such agreements? So far, they have displayed little of the finesse and diplomacy needed to strike international deals.

As scary as all the jawboning has been, thus far, actual policy has been modest and appears politically motivated. It does not mean a trade war is likely. Also, as expected, the Chinese response to his moves have been modest. If all we are seeing is a blunt negotiating tactic, the next move will be toward some sort of trade agreement for which the administration can claim victory. In such a scenario, tensions will subside, and markets will calm down. Remember, the process is slow – after a list of targeted products is released the U.S. industry will have 30 days to comment, after which the U.S. has **180 days** to decide which products to put tariffs on. Tariffs will continue to be headline news for many months to come and may jolt the market from time to time, but we do not think the war of words will turn into a nasty trade war.

## DEFAANGING THE FAANG STOCKS

Facebook led tech stocks down in March in response to revelations that Cambridge Analytica, a political consulting firm that worked with the Trump campaign, had improperly harvested the data of up to 87 million users. At its low FB was down 23% from its all-time high price.


Dan Wasserman/Tribune Content Agency

The FAANG (Facebook, Apple, Amazon, Netflix and Google) stocks have been the leaders for the tech boom for the last five years. The whiplash that has spread through leading tech stocks has left investors facing an uncomfortable reality: Wall Street can no longer take the invincibility of the Big Tech for granted. Investors have been nervous for months that the political backlash against technology would lead to a new wave of regulation or taxes – now they have something to attach their fears to. This potential regulatory movement did not begin here. Things have been rough in Europe for a while. Having levelled a fine of $2.7 billion against Google in 2017, the European Commission wants to go further.

Germany and France are threatening to fine Facebook and a handful of state attorney generals have launched probes into Google and Facebook. Momentum for new regulations is on the way. **Let us be clear – we do not think big tech businesses will be materially affected any time soon. Information technology is our biggest weight in the portfolio.** However, this might cast a damper over the group in its market leadership role.

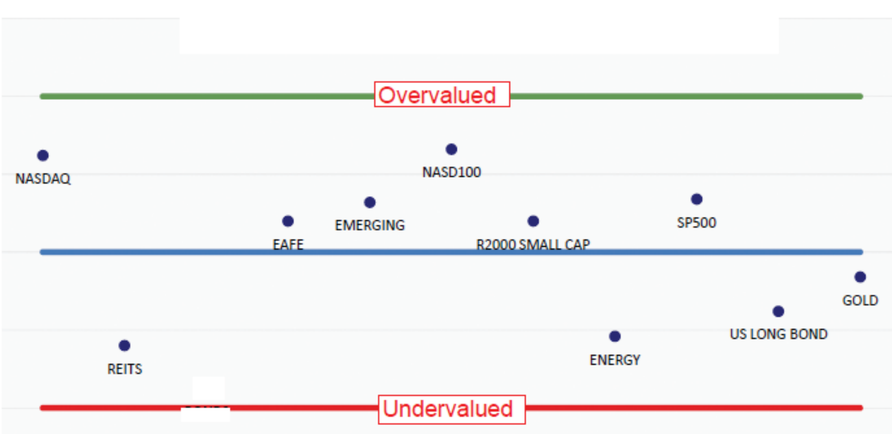
Why is this important? Because the tech giants now carry an outsized weight in the major averages – 25% in the S&P, for example. Including Microsoft, six tech stocks out of 500, (1.2% of the companies), account for 15% of the S&P500. Four tech stocks are more valuable than all the Russell 2000 Small Cap Index. The market has been led up by these stocks – what if the narrative is changing? What will take their place? The demise of the blue-chip Nifty Fifty in the early 1070s; the technology, media and telecom implosion in 2000; and the blowup of banks and real estate stocks in 2008 make awful precedents. We need to be cognizant of this potentiality and observe whether a shift is taking place.

## INVESTMENT REVIEW

After a large correction in asset classes it is useful to look at their valuations relative to their own longer-term trends. We do this by regressing prices across a range of price trends since 2000. When we discussed valuations in late 2017, all the US stock benchmarks were at or above the green line, indicating limited upside.

### REGRESSION ANALYSIS

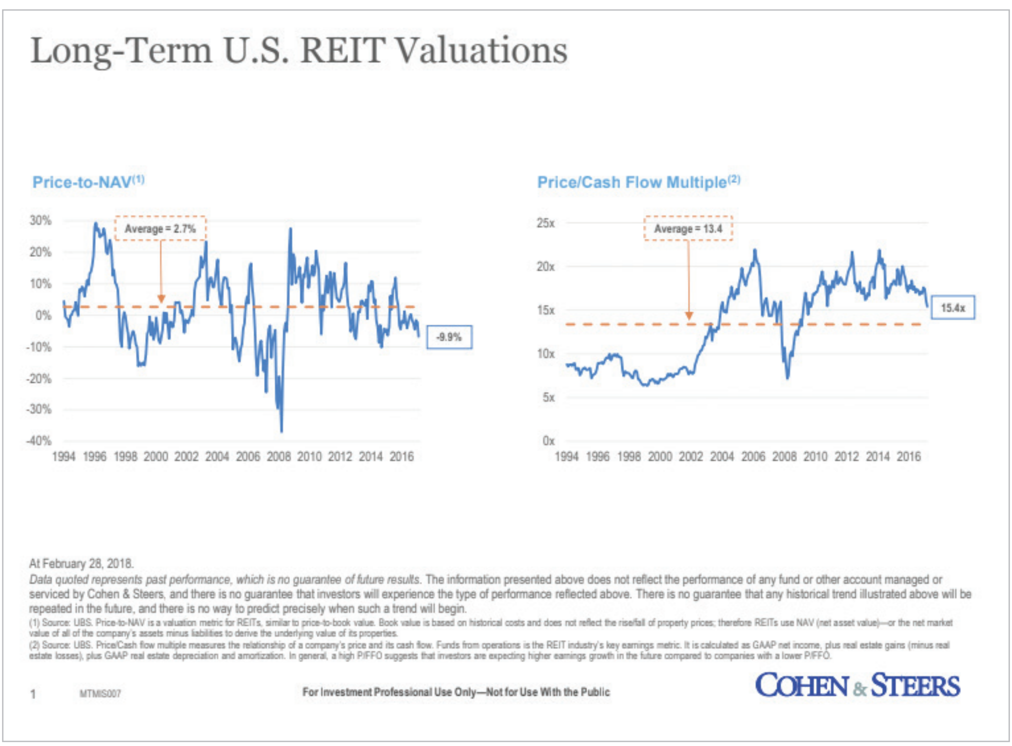
| ASSET CLASS | PRICE 4/2/2018 | Upside AVG Upper F | Avg % UP | DOWNside AVG Lower F | Avg % DOWN | REWARD vs RISK |
|---|---|---|---|---|---|---|
| REITS | 622.52 | 784.41 | 26.0 % | 581.62 | -6.6% | 3.9585171 |
| ENERGY | 488.35 | 677.87 | 38.8 % | 433.17 | -11.3% | 3.4349397 |
| US LONG BOND | 121.88 | 141.55 | 16.1 % | 113.22 | -7.1% | 2.2705224 |
| GOLD | 1,338.48 | 1,703.64 | 27.3 % | 1,072.68 | -19.9% | 1.3738191 |
| R2000 SMALL CAP | 1,492.53 | 1,639.26 | 9.8 % | 1,274.23 | -14.6% | 0.6721224 |
| EAFE | 2,005.39 | 2,274.63 | 13.4 % | 1,597.54 | -20.3% | 0.66015 |
| EMERGING | 1,169.43 | 1,322.78 | 13.1 % | 866.68 | -25.9% | 0.506512 |
| SP500 | 2,581.88 | 2,780.95 | 7.7 % | 2,183.81 | -15.4% | 0.5000908 |
| NASDAQ | 6,870.12 | 7,202.08 | 4.8 % | 5,426.89 | -21.0% | 0.230012 |
| NASD100 | 6,390.84 | 6,691.75 | 4.7 % | 4,964.98 | -22.3% | 0.2110387 |



After 2 months of declines, there is nothing pressed against the green, overvalued extreme. U.S. stocks are still not at a bargain, but from current levels there is room for modest upside and the downside risk is now in the 20% range versus the 40% range of just a year ago. Another important question is if the assets in the bottom half of the chart near the red, undervalued line, will assert new leadership at the expense of the more overvalued asset classes, indicating increasing probably of the downside targets over the upside ones. For now, we are using the emerging strength in some of the undervalued areas to shift more toward a balanced portfolio over the U.S. centric portfolio of 2017. Tactically, we recently added back to some bonds and Gold and will be looking to add to REITs and Energy if they improve their capital flow rankings.

**BONDS –** We were short bonds for part of the quarter but covered when stock market gyrations moved capital into bonds as a safe-haven. Bonds are now in a quandary. On the one hand, rates should be going up with the strong economy, increasing inflation and an increasing supply of Treasuries due to a burgeoning fiscal deficit. On the other hand, money is attracted to high quality bonds when volatility increases in the equity market. From a long-term perspective we still think there is risk in holding long bonds but for the time being our model is telling us that equity volatility is not going away anytime soon, and bonds will continue to appeal to nervous investors. The bond dilemma revolves around a starting point without historical precedence. We are at the lowest level of interest rates in the history of humankind and the highest amount of leverage. The outcome is highly uncertain. We are slightly underweight bonds.

**REITs –** During the quarter we had minimal exposure to REITs, the second worst asset class for the quarter. Since the top in December 2017, to their lows in February, they plummeted 13.6%. **On a relative basis they have underperformed the S&P since February 2007.** Are they ready to be bought? Our regression analysis shows them to be the most attractive asset class with a 3.9 reward to risk ratio. Are they undervalued? Cohen & Steers shared this chart with us on valuation.



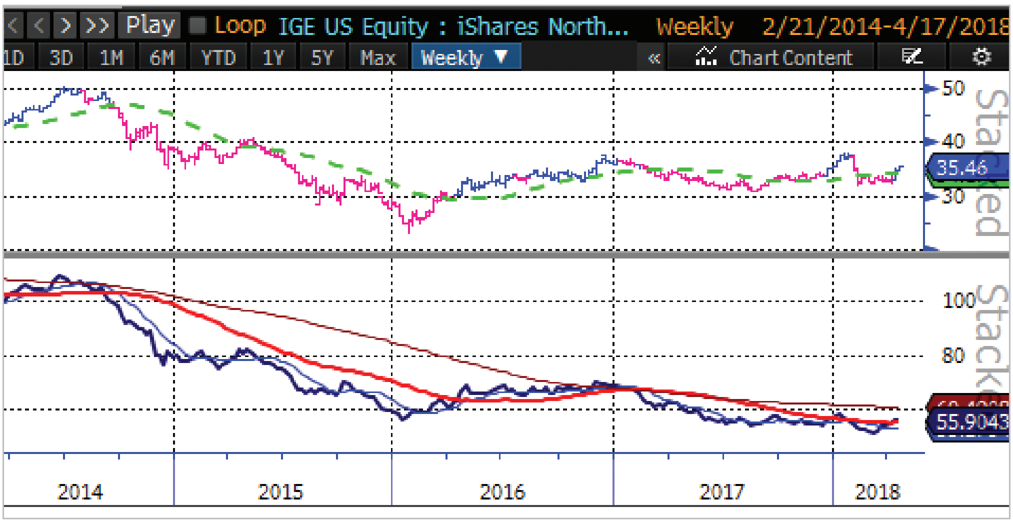
On a Price-to-Net Asset Value basis they would certainly seem undervalued. **Their current discount of 9.9% versus an average 2.7% premium is quite compelling** – a price rarely seen since 1994 except for the crash of 2000 and 2007-2009. This will attract value buyers who wish to own assets below current market prices. On a Price/Cash Flow Multiple they are near the lower band established since 2003. Not as compelling as Price-to-NAV but attractive nevertheless. Equity earnings multiples have expanded to near cycle highs while REIT multiples are at 2013 levels. While there is no way of knowing exactly when a bottom will occur, we believe an opportunity is shaping up for increasing the REIT allocation. REITs have done relatively better than the market since February as money has sought a safe haven during the recent market turbulence. Our model currently is at a zero allocation but that could change quickly as indicators begin to fall into line.

**NATURAL RESOURCES –** Natural resource stocks were a perfect example of the extreme volatility and sector rotation that took place in the first quarter. We made a case in our last letter that commodities were at a 20-year relative low and overdue for outperforming the major indices. We also stated, "While such a long-term view cannot be used as a short-term timing tool, we thought 2018 could well be the year for commodities, natural resources, gold and energy". Well, we were half right. Gold was the third best asset class for the quarter and natural resources were dead last. Fortunately, we held on to our gold, but took some losses on a small allocation to energy. Gold continues to perform well, and we are overweight the bullion and stocks. Our recommended mix is half bullion and half gold stocks.

We currently have zero exposure in oil stocks, even though the price of oil recently hit 3-year highs.

The problem is that the stocks have materially underperformed the underlying commodity. While the price of oil has doubled over the last couple of years, energy stocks are only up some 40%. Earnings lagged the oil price as well in 2016 and 2017 but are finally catching up. Earnings in the first quarter will be up 76%, the biggest increase for any asset or sector. Our regression analysis shows energy stocks as the second most attractive reward vs. risk behind REITs. Fundamentals continue to improve with inventories down at 2015 levels with conflicts in the Middle East taking center stage. It is doubtful that recent missile strikes against Syria will be the last. If the oil price continues to rally, the stocks may start to play catchup. It is not unusual for oil stocks to lead at this stage in the market cycle. Stay tuned!

## Oil stocks (upper panel) and Oil stock vs the S&P500 (lower panel)




**INTERNATIONAL STOCKS –** Emerging market stocks were the second-best asset class in the first quarter. However, all the gains occurred in January and most of the increases disappeared in February. Same was true for developed markets such as the EAFE index. On a long-term basis, we still think this could be one of the most attractive markets in the coming years. Developing nations benefit from younger populations, a rapidly growing middle class and a shift away from manufacturing toward more consumer-based economies. International stocks have been very sensitive to shifts in the U.S.$. Recent dollar weakness, while supporting the currency component of the return, has capped the strength in the local shares. This trend may soon abate and push the model more heavily into the relatively attractive international shares.

**U.S. STOCKS –** There has been no place to hide in the U.S. stock market in 2018.

## S&P500 Tier 1 Sector performance 12/3117-4/2/18


| Groups (11) | Return |
|---|---|
| S&P 500 ECO SECTORS IDX | -3.43% |
| All Groups | |
| 11) S&P 500 INFO TECH INDEX | 0.64% |
| 12) S&P 500 CONS DISCRET IDX | -0.15% |
| 13) S&P 500 FINANCIALS INDEX | -3.48% |
| 14) S&P 500 HEALTH CARE IDX | -3.67% |
| 15) S&P 500 INDUSTRIALS IDX | -4.04% |
| 16) S&P 500 UTILITIES INDEX | -4.92% |
| 17) S&P 500 REAL ESTATE IDX | -6.99% |
| 18) S&P 500 MATERIALS INDEX | -8.00% |
| 19) S&P 500 ENERGY INDEX | -8.45% |
| 20) S&P 500 TELECOM SERV IDX | -10.01% |
| 21) S&P 500 CONS STAPLES IDX | -10.03% |

Of the 11 sectors, only information technology was positive. Even the safe-haven utilities were down 4.92%. So far, we are giving the benefit of the doubt to the bullish case -- that this is just a correction in a bull market. Capital spending, tax reform, EPS growth and share buybacks should outweigh the risks we delineated above. Recession is unlikely as deregulation and tax reform have lifted consumer confidence and business optimism to the highest level in years. From a contrarian point of view, most surveys show fleeing bulls with the least optimism in at least a year. Ned Davis Research has five steps to assure investors that the uptrend has resumed: oversold, positive divergences, rebound that fails, a retest of prior lows and a breadth thrust. All have occurred except the breadth thrust. Until that happens we are stuck in a sideways consolidation. We are overweight U.S. equities. With the ongoing struggle between prior leaders and defensive stocks, except for information technology, there is no sector that deserves an overweight. Much better to be in the market with ETFs that represent the market such as SPYs, QQQs and IWM (small cap).

## SUMMARY

The first quarter of 2018 was the first quarterly decline since 2015 and volatility is now at levels where bottoms are usually struck as in 2009 and 2015. The long calm was broken by fears of increasing inflation and interest rates, White House chaos, a looming trade war and a tech-wreck led by Facebook. We think most of these fears have been discounted at current prices. A period of volatility after the calm does not necessarily mean a new bear market. For now we favor the view that it is a chance to refresh a tired advance. We are now overweight equities and slightly underweight bonds. We have minimal exposure to REITs and Natural Resources (except for gold), underweight international stocks and overweight U.S. stocks. As the market cycle matures, momentum leaders are likely to resume their leadership, but undervalued sectors will compete for capital toward a more balanced outcome.

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