NOW'S A
GOOD TIME
TO GET SOME
GOOD ADVICE

INCREASING UNCERTAINTIES

Balanced portfolios performed well in the second quarter, recovering from a steep decline in the first quarter. Still, it was not a smooth ride and participation was increasingly selective.

The benchmark portfolio (equally weighted) rose by 2.32% and was bolstered by a powerful rebound in natural resource stocks and REITS which had been dismal performers in Q1. U.S. stock returns were led by small cap and growth stocks in the Nasdaq and S&P500, while the Dow Jones Industrials were mostly flat. International stocks performed poorly, particularly emerging markets.

AVALON GLOBAL BENCHMARK: EQUALLY WEIGHTED Q2

Negative Price Return	Members (10)	Return	Positive Price Return
	ADABENCH (My Portfolios - PRT...	2.32%	
	All Members		
	11) ISHARES NORTH AMERICAN NATUR	11.88%	
	12) ISHARES RUSSELL 2000 ETF	7.[illegible]6%	
	13) ISHARES US REAL ESTATE ETF	7.81%	
	14) INVESCO QQQ TRUST SERIES 1	7.42%	
	15) SPDR S&P 500 ETF TRUST	3.55%	
	16) VANECK VECTORS GOLD MINERS E	1.50%	
	17) ISHARES 20+ YEAR TREASURY BO	0.52%	
	18) ISHARES MSCI EAFE ETF	-1.98%	
	19) SPDR GOLD SHARES	-5.68%	
	20) ISHARES MSCI EMERGING MARKET	-9.67%	

The global equity rebound halted mid-June when the Trump administration upped its willingness to impose additional tariffs. The rhetoric was replaced by actual implementation on steel and aluminum. Almost all major economic blocs retaliated immediately, including China, Europe, Canada, Mexico and India. Big gains in global stocks rapidly disappeared with only the U.S. market showing gains for the quarter. In addition to the trade war, rising inflation, rising interest rates, a strong dollar, anti-EU sentiment in Europe and a slowing world economy, contributed to a rocky 2nd quarter for many sectors and international stocks, particularly Latin American and Chinese stocks.

AVALON
CAPITAL
MANAGEMENT

Four sectors outpaced the S&P 500: energy, consumer discretionary, information technology and REITs. Energy stocks gained on rising oil prices, while REITs benefited from a drop in bond yields in May and June. Growth stocks lead value. Technology retained its role as market leader and was joined by consumer discretionary. Consumers are growing confident again; unemployment is low and retail spending is rising. Two value sectors in the U.S. that were expected to benefit the most from the new tax law, industrials and financials, performed the worst. The industrials were hit by trade concerns and a strong dollar and financials became increasingly sensitive to the risks surrounding a flat yield curve versus the benefits of rising long rates.

S&P 500 SECTORS: Q2 2018

International stocks have tipped into a bear market, but so far the U.S., while not as strong as in 2017 has not confirmed a new down trend. Growth sectors continue to hold up well and the defensive sectors – REITs, consumer staples, healthcare, utilities and telecoms – are still showing mixed leadership. In a bear market, we would expect the defensive sectors to perform the best.

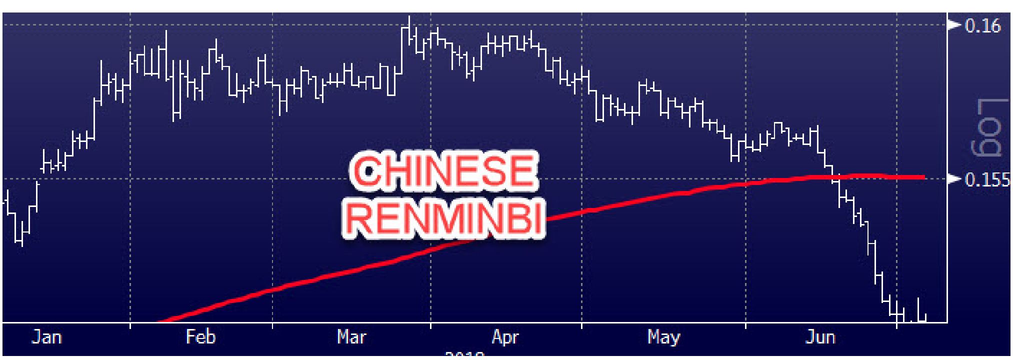
Global stock markets are now oversold and overdue for a rally in July; the character of that rally will help us determine the market's strength. If the current leadership prevails then we will continue to overweight U.S. stocks. In the meantime, sales gains of 7% and earnings gains of 20% should help offset rising uncertainties. For now, our models have us overweight U.S. stocks, REITs and Natural Resources, underweight bonds and short emerging and international markets.

RETALIATION

Trade retaliation was instantaneous after the U.S. implemented tariffs on aluminum and steel. All major trading parties imposed tariffs on the U.S. including China, Europe, Canada, Mexico and India. The U.S. Commerce Department is completing a study on import tariffs on cars, as a necessary step toward enhancing presidential authority to place tariffs on car imports. If Trump follows through on his additional threats, roughly $500 billion worth of goods imported from China each year will face American levies. The U.S. effective tariff on all imports would rise to 6.7%, the highest since 1969 and the share of dutiable imports, assessments would be 21% — the highest since 1946! The law of unintended consequences can certainly be applied to protectionist policies. There is no way to predict the outcome at this time. Once a trend is in place it is hard to stop it. It becomes too easy for the opposing sides to misjudge each other's intentions when patriotism takes over rationality and they are pushed into an escalating series of attacks and counter attacks. While hoping for the best, investors must be cognizant that it could be worse than currently anticipated by the markets. This uncertainty is best reflected in the back and forth, knee-jerk style trading of late.

The dollar's surprisingly durable rally has continued longer than expected as growth abroad has slowed and U.S. interest rates rose relative to international rates. But beneath the surface, is it not in the best interest of other counties to have a weak currency to increase their competitiveness? Take China, for example. *The Renminbi has collapsed almost 8% in three months!* Much has been written about how China can only minimally affect our economy with tariffs but they do have other arrows in their quiver if they choose to use them – including weakening their currency. They can also make it more difficult for U.S. companies to operate in their country. Is the current weakness a deliberate attempt at currency manipulation? It is certainly possible and bears watching.

CHINESE RENMINBI/U.S. DOLLAR



POLICY KAPUT

Trade and currency wars are only part of the list of rising uncertainties. For years investors have behaved as if the government has their back. The so-called "policy put" has been an insurance policy on risks to the rally.

The Bank Credit Analysis Research Group succinctly outlined three macro "policy puts" that are in jeopardy of disappearing.

FED PUT – The U.S. economy has run out of spare capacity. The unemployment rate fell to a 48-year low of 3.75% in May. Rising inflation has made the Fed more reluctant to back off from planned rate hikes compared to prior policy restraint at the first hint of slower growth or falling asset prices.

CHINA PUT – In 2015, China saved the day by stepping in with massive new stimulus. As a consequence, fiscal spending and credit growth accelerated to over 15% on a yearly basis. Today, Chinese growth is slowing again and they cannot respond with the usual barrage of infrastructure spending and increased bank lending. Worries about high debt levels, overcapacity and pollution, all mean that the bar for fresh Chinese stimulus is higher than in the past.

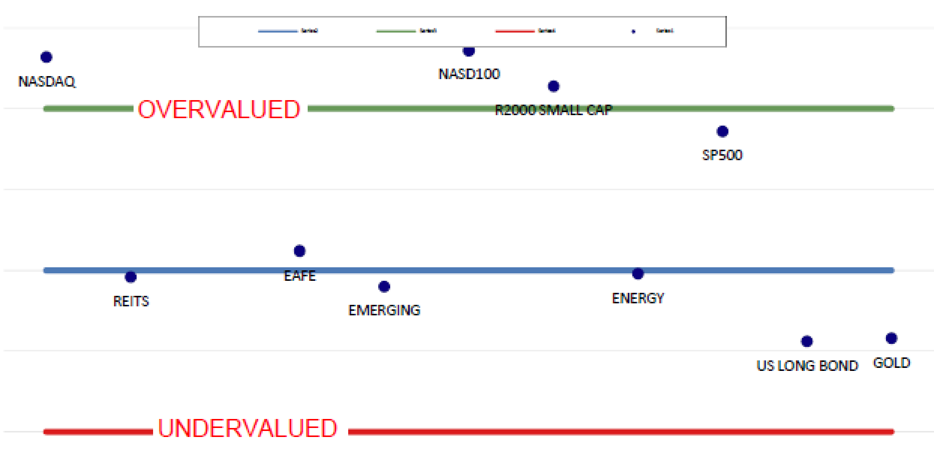
DRAGHI PUT – Italy's shift toward populism is arriving at the same time the European Central Bank is looking to wind down its asset purchase program. This means a key buyer of Italian debt is stepping back just when it may be needed the most. Bailing out Italy was a no-brainer in 2012 when the country was the victim of contagion from the Greek crisis. But now that Italy is the source of the disease, the rationale for intervention has weakened.

INVESTMENT REVIEW

Each quarter we step back and look at price trends relative to their longer-term averages. We do this by regressing prices across a range of price trends since 2000 and creating a matrix. This was helpful at the beginning of last quarter because energy stocks and REITs were at the top of the list for the best reward/risk. They turned out to be among the best performers for the next three months. When our models turned positive on them during the quarter, it gave us additional confidence to overweight them given their depressed valuations.

AVALON PRICE VALUATION MATRIX

ASSET CLASS	PRICE 7/2/2018	Upside AVG Upper	Avg % UP	DOWNside AVG Lower	Avg % DOWN	REWARD vs RISK
GOLD	1,241.93	1,703.89	37.2 %	1,078.25	-13.2%	2.8223743
US LONG BOND	121.35	140.81	16.0 %	112.56	-7.2%	2.2143393
EMERGING	1,069.52	1,342.15	25.5 %	882.24	-17.5%	1.4556822
REITS	673.97	784.45	16.4 %	580.42	-13.9%	1.1809967
ENERGY	552.86	683.69	23.7 %	439.93	-20.4%	1.158483
EAFE	1,958.64	2,298.75	17.4 %	1,624.12	-17.1%	1.0167168
SP500	2,726.71	2,846.24	4.4 %	2,242.39	-17.8%	0.2467962
R2000 SMALL CAP	1,655.09	1,686.67	1.9 %	1,316.08	-20.5%	0.0931755
NASD100	7,097.82	6,987.00	(1.6 %)	5,181.06	-27.0%	0.0578182
NASDAQ	7,567.69	7,496.04	(0.9 %)	5,646.51	-25.4%	0.0372936



There are currently no extremely undervalued asset classes. Traditional safe-havens, Gold and Long Bonds are the cheapest. Gold has been falling since 2011 and U.S. Long Bonds have been falling for two years. Energy and REITs still have a positive reward/risk ratio. We will continue to overweight them as indicated by our capital flow models. Emerging markets are attractive but our models say underweight or avoid for the time being. This could be an area of positive surprise if capital flows improve. U.S. stocks have performed very well during this unsettling period and still have some upside from current levels. A summer rebound in emerging markets could extract that last bit of value from U.S. stocks. We will closely monitor technical signs over this critical period.

BONDS – Long term Treasury Bonds have been going down for two years, sideways for three.

U.S. LONG TERM TREASURY PRICES

It is rare for bonds to be so indecisive for such a long period. However, the triangle pattern formed during this period would indicate that this dilemma should be resolved in a matter of months. If prices break to the upside (yields will be going lower), then this may be an indication that the current strong economy is losing momentum faster than is widely anticipated or that a recession may be sooner than late 2019. It could also be that a weak stock market forces investors to seek the safe haven of Treasury securities even though the economy continues to perform well. However, if prices break to the downside, out of the triangle pattern, this might portend a continuing strong economy, rising inflation expectations and an increasing supply of Treasuries due to a burgeoning fiscal deficit. Until this pattern is broken, one way or the other, we are inclined to sit on the sidelines with a low exposure to bonds.

REITs – In our last letter we discussed the attractive valuations that could lead to a positive shift in the technicals. When the model turned positive, we over weighted REITs in the second quarter. REITs benefitted as investors moved to more defensive sectors. They also benefitted from a flattening yield curve. Short-term rates have risen nearly twice as much over the past year as have long rates, with a 140 basis point (1.4%) increase in the yield on the 2-year Treasury note compared to a 75 basis point increase in the 10-year yield. This has narrowed the gap between the 10- and 2-year yields to 50 basis points, **the lowest in 17 years!!** This environment is beneficial to the REIT industry. Financing conditions in real estate markets are quite attractive with Treasury yields and mortgage rates still at the low end of the historical spectrum. They are well positioned for the interest rate environment ahead, as they have reduced their leverage and locked in low interest rates for many years into the future. And the flatter yield curve is consistent with the type of mid-expansion financial conditions that have fostered long real estate expansions in the past.

INTERNATIONAL STOCKS – Emerging market stocks were down 9.7% in the 2nd quarter, the worst asset class after being the second-best in the first quarter. EAFE was down 2%.

International markets were crushed in June as tariff concerns came to the forefront. China bore the brunt of the decline by declining more than 12% in less than three weeks and **over 20% since its January high**. From their highs, Latin America is down 26%, emerging markets are down over 18% and all international markets, excluding the U.S., are down 11%. Clearly the tariff chaos is affecting international markets more than the U.S.

Emerging markets are also contending with higher inflation, higher oil prices, higher interest rates, a strong dollar and a slowing global economy. The recent decline drove the MSCI Emerging Markets Index below 1050, a level first seen **ELEVEN YEARS AGO**. Investors are fleeing this area – even bonds; the largest emerging market local currency bond ETF (EMLC) was hit with massive redemptions on June 21, 2018, worth $485 million and representing 11% of outstanding shares. This bond fund is now down 15% from recent highs. We are short emerging markets. Oversold on a short-term basis, they could well rally coinciding with a U.S. recovery in the coming weeks. We may cover part or the entire short if warranted.

Europe is the weak horse in the EAFE Index. It has the same problems as the rest of the international community plus one unique to them: potential disintegration of Europe as we now know it. The European Union was sold to its citizens on cheaper products, easier transit, prosperity and security. A grander goal was to transcend the nation-state – separate blocs that, in time, would cast off the autonomy and identities to form a unified nation. Established leaders insist on open borders within the bloc – free movement is meant to transcend cultural barriers, integrate economies and lubricate the single market. With recent elections in Italy and Germany these borders may eventually be closed. Ms. Merkel and Germany have been the backbone of the European movement. Her near political meltdown may mark the end of the European experiment and a possible end of Europe's open-border era. While this goes on, the uncertainty is not healthy for the economy (which is already slowing) or the investment markets. We are short international stocks; short-term oversold but longer-term not looking healthy. We may cover part or the entire short if warranted.

NATURAL RESOUCES – From doghouse to hero – natural resources were the worst performer in the first quarter, down 6.2%, to BEST asset class in the recent period – up 11.9%. During the quarter we over weighted natural resources and continue to do so. The price of oil surged to new highs of $75 per barrel. Near term, a pullback is to be expected. But if global economies continue to grow (even though slowing) oil prices will remain firm. Fundamentals continue to improve with inventories down at 2015 levels and Trump pressing countries to end purchases of Iranian crude. Spare capacity within OPEC is already below 3 million barrels a day for the first time since 2008. Even though production is increasing in the U.S., the problem is how to get all that oil to market. Refineries are running flat out, with no plants idle for the first time since 1982. Exports from the Gulf coast appear to be butting up against levels short of 2.5 million barrels a day; due to lack of pipeline capacity and to a shortage of port berths that means the majority of VLCC (Very Large Crude Carriers) must be expensively filled offshore from small ships. For the moment, the U.S. oil patch does not look like it is heading to the rescue of American drivers.

U.S. STOCKS – In the face of all the headwinds noted above, the U.S. market continues to be genuinely resilient. It was the only major stock market up in the last quarter. The quality of the upcoming rally will say a lot about the long-term health of stocks. Anything less than new highs on the advance will signal a peak from the advance that started in 2016. Our regression work shows that the S&P could still rise 6% or more before peaking out.

Along with major flip-flops in asset-class performance, such as in natural resources and REITs, performance discontinuities across major U.S. indices and sectors are striking. While the NASDAQ is up 11.4% YTD, the NYSE Composite Index is down 1.1%. A similar gap exists between the Russell 2000 (up 10.9%) and the DJIA (down 1.1%). This is just another indication as to how uncertain the market has become. On a YTD basis the disparity among sectors is just as great.

S&P 500 SECTORS YTD 7.06.2018

Information technology was up 12.75% while Telecommunications was down 8.9%. Two months ago the U.S. market was very skewed and only two sectors were overweight in our work: information technology and consumer discretionary. With the rebound in natural resources and REITs and the recent positive traction in defensive stocks (health care looks the best), the sectors have become more balanced. Of the eleven sectors, our model is only underweight four of them: telecommunication services, financials, industrials and materials. We favor growth stocks over value and remain overweight U.S. stocks.

SUMMARY

Global equities were rebounding nicely until mid-June when the Trump administration upped its willingness to impose additional tariffs. Big gains in stocks rapidly disappeared, with only the US market showing gains for the quarter. In addition to the trade war, rising inflation, rising interest rates, a strong dollar, anti-EU sentiment in Europe and a slowing world economy, all contributed to a rocky second quarter and increasing uncertainty. The benchmark portfolio was bolstered by huge gains in natural resources and favorable returns from U.S. stocks. This offset considerable losses in international stocks. All equities are oversold and investor sentiment has reached significant lows from which recoveries take place. Positive sales and earnings will be reported starting in mid-July and a rebound will occur into August. The quality of the upcoming rally will say a lot about the long-term health of stocks. Anything less than new highs on the advance will signal a peak from the advance that started in 2016. For now, our models have us overweight U.S. stocks, REITs and Natural Resources, underweight bonds and short emerging and international markets.

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