NOW'S A GOOD TIME TO GET SOME GOOD ADVICE

OCTOBER'S REVENGE

Divergences sometimes take a while to manifest, but when they do, it is often with a vengeance. So far in October of 2018, that has been the case for global markets. The most notable stock market crashes have occurred in October; namely, the crashes of 1929, 1987 and 2008. Following a frustrating and challenging 3rd quarter for global asset managers, the US market stood above the fray among only 4 of the 44 global stock markets that were up for the year and far outpacing any other constituents in the Avalon multi-asset benchmark. On average, the global benchmark barely eked out a gain. Five of the nine asset classes declined, with REITs barely positive. Fortunately, an overweight position in US stocks contributed to a better than average return for Avalon portfolios.

AVALON MULTI-ASSET BENCHMARK: 3RD QUARTER 2018

Still, the last few weeks in September were particularly disheartening as even the gains in the US part of the portfolio were suspect. The S&P 500 made nominal new all-time highs (loudly hyped by the media), yet beneath the surface the average stock was declining. Market internal indications were terrible; daily new lows exceeded daily new highs and were accompanied by more daily declining issues than advancing issues. Advancing issues over declining issues peaked in August. By the end of September only 40.7% of the S&P 500 stocks were outperforming the S&P Index itself on a trailing 12-month basis – the lowest in six years (and nearly the lowest in 19 years).

AVALON CAPITAL MANAGEMENT

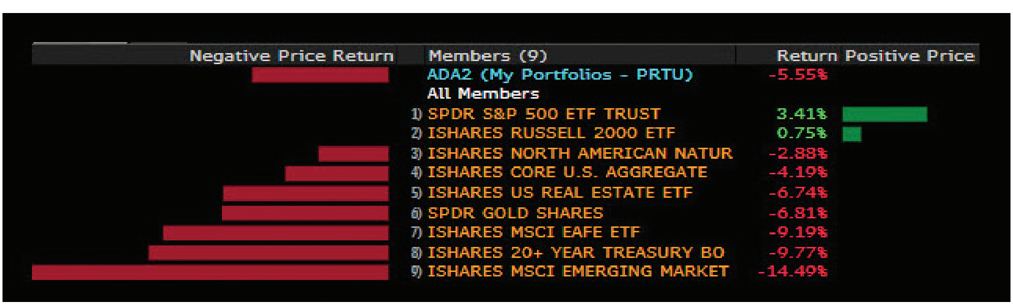
INFLECTION POINT – After months of declining prices in most markets, the meltdown in the US started on Oct 3 as government bond yields broke to the highest level in seven years, surpassing 3.11% for the 10-year US Treasury and 3.25% for the 30-year. Equities everywhere plunged in response to programmed selling from systematic trading strategies. Strong wage numbers and a four- year high in the price of oil stoked fears of increasing inflation. Among other drivers: the lack of visibility on the trade war with China, its negative influence on third-quarter earnings guidance, mounting evidence of a global slowdown outside the US, high stock valuations and deep political polarization in the US, were all cited as concerns. For several days, there was absolutely no place to hide. All assets got hit in the first two weeks of October except gold. The Avalon multi-asset benchmark fell 4%, with U.S. small cap declining the most, losing 8.9%.

AVALON MULTI-ASSET BENCHMARK: FIRST TWO WEEKS OCTOBER

Members (9)	Return
ADA2 (My Portfolios - PRTU)	-4.02%
All Members	
1) SPDR GOLD SHARES	2.19%
2) ISHARES CORE U.S. AGGREGATE	-0.49%
3) ISHARES 20+ YEAR TREASURY BO	-2.17%
4) ISHARES NORTH AMERICAN NATUR	-3.99%
5) SPDR S&P 500 ETF TRUST	-5.08%
6) ISHARES US REAL ESTATE ETF	-5.59%
7) ISHARES MSCI EAFE ETF	-6.09%
8) ISHARES MSCI EMERGING MARKET	-6.13%
9) ISHARES RUSSELL 2000 ETF	-8.87%

What a difference two weeks can make. The benchmark is now **down 5.5%** for the year. The S&P500 Index (market-cap weighted) is still positive for the year – 3.4% -- while the equal weighted S&P 500 Index is **down 0.4%**. The small-cap Russell 2000 Index is up .8% and that is it – everything else is down. The worst performer is the emerging markets with a 14.5% loss. We have entered an inflection point for equities and bonds; both are now in global bear markets and only the US stock market has not fully confirmed. Defensive trades in REITs, short term bonds and Gold may work out as a hedge against the downdraft. Commodities (including oil) sometimes have an end-of-cycle rally as the economic cycle peaks, but investors must approach this trade with care.

BENCHMARK YTD: POST OCTOBER SELL OFF



Members (9)	Return
ADA2 (My Portfolios - PRTU)	-5.55%
All Members	
1) SPDR S&P 500 ETF TRUST	3.41%
2) ISHARES RUSSELL 2000 ETF	0.75%
3) ISHARES NORTH AMERICAN NATUR	-2.88%
4) ISHARES CORE U.S. AGGREGATE	-4.19%
5) ISHARES US REAL ESTATE ETF	-6.74%
6) SPDR GOLD SHARES	-6.81%
7) ISHARES MSCI EAFE ETF	-9.19%
8) ISHARES 20+ YEAR TREASURY BO	-9.77%
9) ISHARES MSCI EMERGING MARKET	-14.49%

Without a strong sign of leadership we remain cautious. Momentum and growth stocks have been the leadership this cycle. Value and Dividend stocks have lagged. Currently neither has a firm footing. It is no easier at the sector level either. Seven of the ten S&P500 sectors are negative for the year and in declining trends; only information technology, health care and consumer discretionary are in the green in 2018, but they have forfeited a lot of gains so far in October. Although we have reduced our exposure, U.S. stocks remain the best of a bad lot.

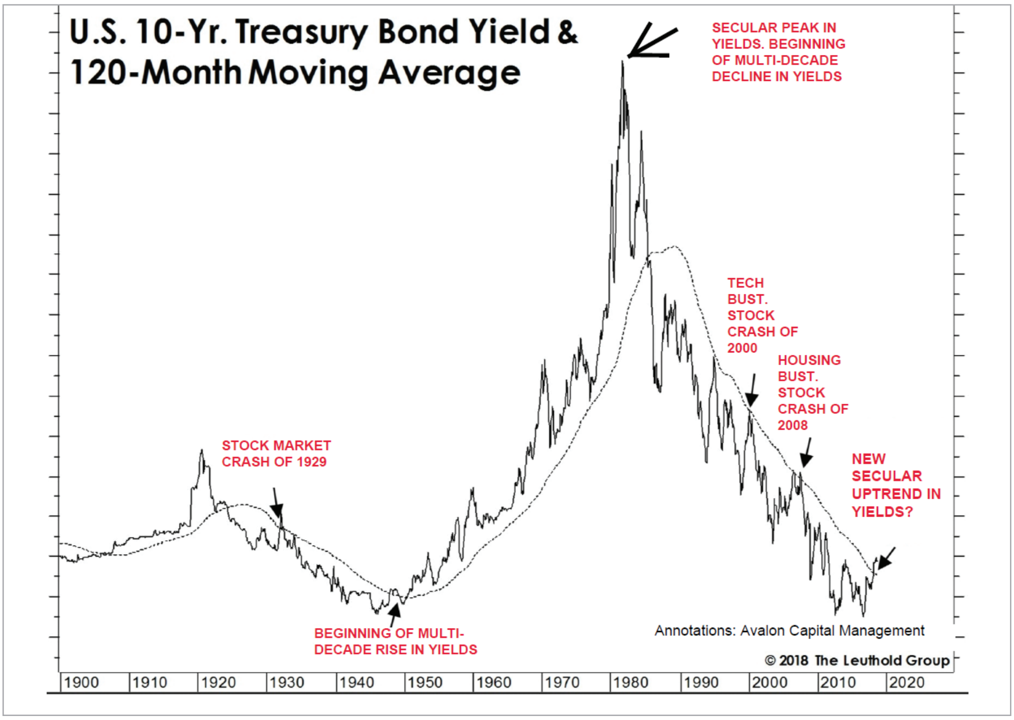
We are carefully monitoring safe-haven sectors like staples, utilities and telecoms for a sign that momentum has peaked and defense is the name of the gain. These could become a new hiding place if the decline really gets out of hand. We are positive on REITS, Natural Resources and gold. We are still underweight bonds and international stocks.

BONDS – A cyclical bond bear market started in July 2016, but a secular (very long-term) rise in yields is signaling now!

The U.S. Treasury 10-year bond yield soared to a new 7 year high and broke out of a long base by rising over 40 basis points (0.4%) in a little over a month. The 30-year Treasury Yield also broke out of a 3 year base. Bonds were reacting to increasing inflation fears due to strong wage numbers and new four year highs in the price of oil. There were also concerns that the Fed would continue to tighten throughout 2019 and that a dramatic increase in supply would occur over the next 12 months. As a result of the 2017 Tax Act, Treasury borrowing will increase and the Fed, by reducing its balance sheet by $50 billion a month, will add to the supply. It all adds up to the need for new funding on the order of $2 trillion on a yearly basis. Contrast this with the current outstanding debt of $22 trillion. And we are not alone – global bonds are also hitting new lows. There are signs that even Japan is tightening policy! Our view is that 10-year rates are heading for 3.5% to 4.0% over the next year. This certainly has implications for mortgage rates as well as for other consumer, commercial and corporate rates. And at 4%, bonds will become stiffer competition for highly valued stocks.

We may have seen a secular inflection point for rising bond yields that is the mirror image of the inflection point in 1981 when rates began a 35 year decline. By implication, inflation is also likely to rise.

THE VERY LONG-TERM TREND IN BOND YIELDS



This chart tells us nothing about the short-term trend; only what the primary trend may be in the coming decades. Notice that even though rates have been in a long-term declining trend since 1981, there were many times (4-year cycle impact) when rates went up dramatically over shorter time periods. Thus, even if we are entering a new secular uptrend in yields, you should expect rates to decline during recessionary periods and periods of stock market weakness when bonds become a safe haven. The chart's "false signals" came in 1929, 2000 and 2007. These were ominous times for stocks that resulted in a flight to safety that delayed the rise in rates as the economy slid into recession in response to declining asset prices. According to Ned Davis Research (NDR), the US economy now shows only a 10% chance of recession. Still this is an extreme contrast to the NDR Global Recession probability that recently jumped to an alarming 80%. If the world pulls the US down and stocks continue to drop, the rise in rates will pause for now. Correlations between global stocks fell from 2009 until earlier in 2018. They are now rising, a late cycle indication that the US is the outlier and not the other way around.

Even if a correction in stocks slows the rate of advance in rates, the secular trend is turning up. James Paulson of the Leuthold Group argues that the "real yield" will increase as well over the coming decades. The average real yield (nominal yield minus the consumer price inflation rate) is 2.2%. However, with rising inflation not having been a problem for over 30 years, the real rate currently is 0.85%. Investors not only face the risk of higher bond yields because inflation is rising, but perhaps, investors may demand a larger inflation buffer, thereby causing yields to increase even faster than the rise in the inflation rate. Real yields could return to 2.25% to 2.50%. That is some 1.5% higher than real yields today. This will take many, many years to happen but will put gradual increasing pressure on interest rates.

We are underweight bonds. The positions we own have short maturities or are floating-rate ETFs. We will lengthen maturities and exposure as the probability of a deep bear market and or US recession increases.

REITS – We are slightly overweight REITs. Valuations continue to be attractive with the current discount of 3.7% to net asset value versus an average 2.7% premium. Historically, REITs have defensive characteristics versus other equities due to higher dividends. Relative valuations to both stocks and bonds are now attractive. In a mildly inflationary trend, REITs can still do well as long as the economy is holding up. Still, in the short run investor concerns that rising interest rates could mean slowing growth has pressured prices. We reduced into recent strength, but continue to see this as a better yield alternative to bonds. This is not the REIT market of 2008. Today balance sheets are strong and leverage is low. REITs advanced strongly after the 2008 meltdown but have mostly gone sideways since 2014. With few excesses evident, we expect them to perform more normally this cycle.

The asset class has some developing negatives as well. Real estate, on the whole, may be topping out starting with the housing market. Sales of new homes are now below their March peak and sales of existing homes are now down 2.2% from a year age. Overall, homes are less affordable today than they have been in about a decade. The average rate on the 30-year fixed sat at just below 4% a year ago – it just crossed 5.1%. If 10-year treasuries get to 3.5% - 4.0%, then you could easily see a mortgage rate of 5.5% or more. Major homebuilding and construction ETFs are reflecting the risk of a housing peak – down more than 30% from their highs earlier this year.

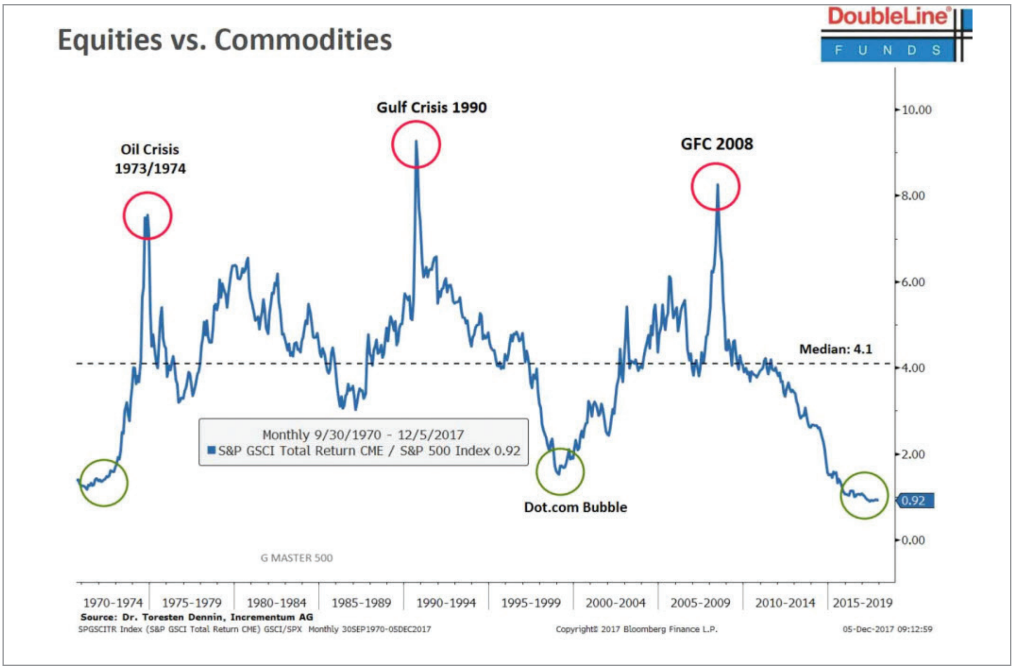
INTERNATIONAL STOCKS – International stocks hit their inflection point in January. Emerging market stocks tanked 25% from their highs in January and EAFE (Europe, Australia and the Far East) sank 15% in response to the rise in US rates and a stronger US dollar. The divergence in their returns and the U.S. market is stark. Beginning in June, the US continued recovering from the January sell-off while EAFE drifted lower and Emerging markets plunged. Much of the decline intensified as China, the largest weight in the EM index, responded negatively to the trade war with the US. Emerging markets now appear undervalued relative to their own history and relative to the US. EM trades at its steepest discount to the S&P Index since 2004! EAFE also offers good relative value but the European component of the index makes it less attractive than emerging markets.

GLOBAL STOCK MARKETS -- 2018

We are underweight international markets but prefer emerging markets over the developed markets – particularly over Europe. EM will continue to show above average earnings and GDP growth over developed markets. EM's share in GDP already exceeds 50% and is expected to rise to 63% by 2023 while the market cap is a fraction of the contribution to global GDP. However, rising U.S. interest rates and a strong dollar are anathema for EM assets. While improved visibility on the trade war with China and an interest rate pause/ short-term dollar weakness could provide the impetus for a substantial rally, to have a solid long-term revival in EM assets would require a meaningful easing in U.S. rates and long-term stabilization or decline in the U.S dollar. This does not seem likely at this time. Nevertheless, given the long-term expected return, we have taken a small position in EM at this time, even if there are still many uncertainties.

Europe is another story. It now has an Italian problem. Another debt/currency crisis will probably center on Italy and Italy is much bigger than Greece. It could become a big problem for the euro, global bond markets, and European banking stocks. Italy's new government has increased its 2019-2023 deficit projections, which are now **three times bigger than the target it pledged just last year**. The Italian sovereign debt market is the world's third – largest, with impact far beyond the Eurozone and EU. Its debt as a percentage of GDP is 133% -- only Greece is higher at 180%. Brussels must decide just how tough it means to get with Italy. If the EU gives in, its authority may be weakened. But if it tries to treat Italy the way it did Greece, there might not be much of an EU left to govern. And then there is Brexit that remains unresolved. What a mess. Stay tuned.

NATURAL RESOURCES – We are slightly overweight natural resources. They were a star performer in the second quarter but we cut back our exposure in the third quarter. They have been an up and down sector this year: worst performer in first quarter, best in second and at the bottom of the pile in the third. However, we do believe commodities are slowly attempting a secular inflection point that is just beginning. The chart shows the last major opportunities relative to equities that began in 1970, 1987 and 2000. Commodities are often inversely related to stocks and bonds. Along with Cash, this is a likely hiding place in the next major decline for stocks and bonds as supplies are now constrained and demand remains healthy.



Oil markets continue to tighten and the price of oil recently hit new 4 year highs. The loss of -2 million barrels per day of Iranian and Venezuelan exports is compounded by additional supply side concerns in Iraq and Libya, and razor-thin OPEC spare capacity. Global demand remains strong while inventories have declined.

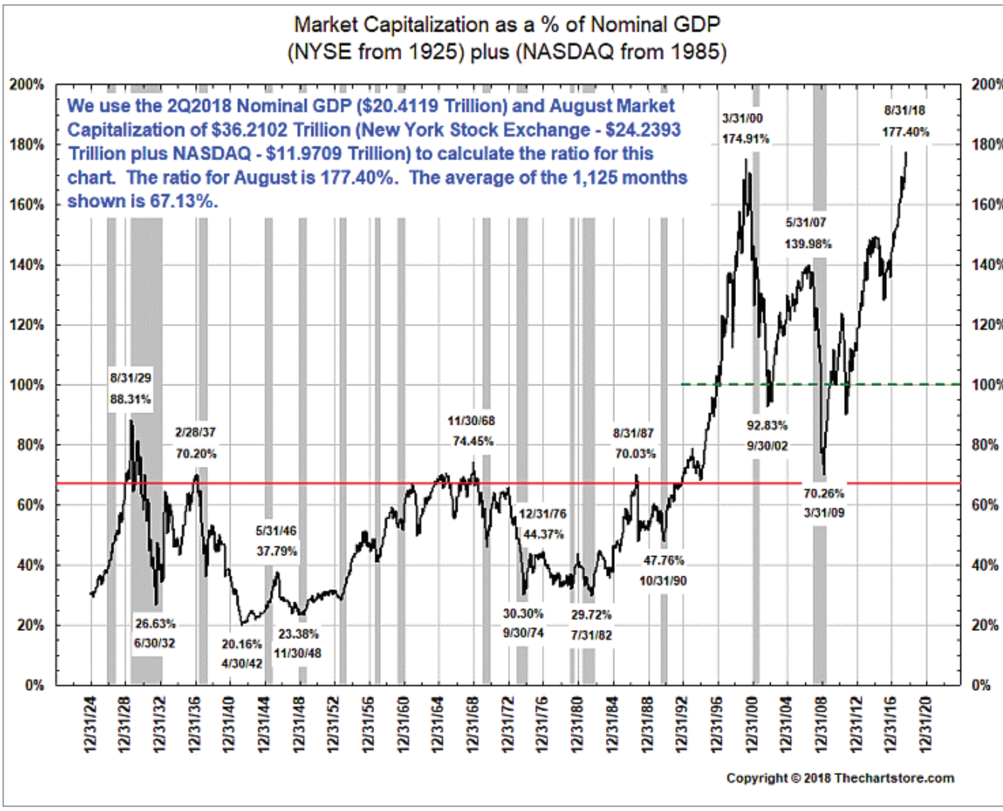
We are overweight gold and gold shares. Over the short-term we expect the dollar to weaken which is positive for the price of gold. Gold also got a boost with announcement that the fiscal 2018 federal deficit had jumped 17% to $779 billion from $666 billion in 2017. The deficit is headed toward $1 trillion in the current fiscal year. And this is with a strong economy! What will it be if we do have a recession?

U.S. STOCKS – We think the U.S. market is flirting with a bear market, where it may soon join the rest of the world. Select stocks are masking the performance of the average stocks. The NYSE Composite Index (2800 stocks) may be a better indicator of the overall market at this time.

The NYSE index hit a high (with all other global stocks) in January but did not hit a new high in September - another one of those nasty divergences. It is below its 200 day moving average and is below its trend line from the bottom in 2016. At its recent low it was down 3.9% for the year. With a strong earnings reporting cycle coming up, it would not be unusual to see this index get back up above its 200 day moving average and even test its down trend line that started in January. The most positive seasonal time of the year is approaching and stocks tend to do well after the mid-term elections. The expected returns are low, but a late cycle dash for the old highs is not out of the question.

Over the last three months, value or defensive sectors as a group (health care, utilities, consumer staples and communication services) have held their own against the other sectors. It may be premature to get excited about value over growth but an inflection point may be in the making. We still prefer growth over value but have added to the value area. If defensive and value stocks start to outperform, this will be further evidence that the trend in the US is shifting from up to down.

Is the U.S. market overvalued? Most relative-valuation gauges suggest record expensiveness. It is not any single valuation metric which stands above all others. The median U.S. stocks' trailing P/E multiple is currently about 50% higher than it was at the dot-com top. The market is also at a record high compared to bonds, home prices and foreign stocks. Today it takes a U.S. worker a record 106 hours to purchase the S&P 500 index; compare this to 89 hours at the top in 2000 and only 36 in 2009. The one we like the best is the New York Stock Exchange Index market cap to GDP ratio (which is equivalent to the price-to-sales ratio for a stock) that is now at the highest level in history.



Valuation risk does not imply an imminent end to the market. However, it does suggest limited upside potential and eventually a "revaluation process".

We are neutral U.S. stocks. Momentum has peaked for this cycle, but a year-end recovery from the October decline is still likely, particularly in a mid-term year. We are overweight big cap stocks over small cap. We like core high tech, health care, utilities, consumer staples and communication services.

SUMMARY

The third quarter proved to be the calm before the storm. All global equities and bonds plummeted in the first two weeks of October. The meltdown began with government bond yields breaking to the highest level in seven years. They were reacting to increasing inflation fears due to strong wage numbers and four- year highs in the price of oil. All assets got hit but gold. We have entered an inflection point for global equities and bonds; both are now in global bear markets and the US is flirting with one. At its low the Avalon multi-asset benchmark was down 5.5% for the year. After such a downdraft it would not be unusual to have a counter rally against the downtrend. Should the decline in asset classes intensify, we will raise more cash given the risk of a more severe drop. For now we are neutral U.S. stocks, REITs, Natural Resources and gold and underweight bonds and international stocks.

Clara Dave Bill

Clara Basile **David Rahn** **Bill Oberman**

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Clara Basile, Bill Oberman, Dave Rahn

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avaloncapital.com

(650) 306-1500