NOW'S A
GOOD TIME
TO GET SOME
GOOD ADVICE

VOLATILITY RETURNS

In 2017, markets advanced easily and smoothly in the context of a synchronized global expansion. 2018 was the mirror opposite. A flash crash in late January rattled investor calm and kicked off a year of increasing market volatility and global instability. And the higher volatility is probably here to stay. In 2017 there were only 8 days when the range in the S&P500 exceeded 1% in either direction. This was abnormally low historically and unsustainable. According to Bloomberg, in 2018, there were 92 days in which the price changes in the S&P500 ranged between 1% and 5%. That equates to 40% of the time. Is it any surprise that by the end of the year, investor nerves were raw? This volatility did not happen in a vacuum. It was stoked by concerns about rising interest rates, an escalating trade war with China, a rising US$, a collapse in oil prices and a slowdown in global growth. The news became a national obsession. The Facebook scandal, the Kavanaugh hearings, the murder of Jamal Khashoggi, the climate disasters, the Midterm elections, the yellow vests, Brexit, the shutdown of the US government and the Mueller Investigation, all dominated the national psyche accompanied by rising pessimism, investor selling and rising volatility. A poll by Allianz showed the country's negative political environment was the greatest worry among survey participants topping concerns about falling markets, stagnant wages, climate change, terrorism and cyber security. Illegal immigration concerns didn't even make the top 10. Perhaps that is because illegal crossings are at a 40-year low.

2018 was also a year without winners. It was the first year since 1972 when no asset class except cash produced a return. Among the major asset classes, the worst asset classes lost 13.8%, the best were flat and the average loss was 7.1% Were it not for a breathtaking 6% rebound in the final 4 trading days of the year, the losses would have been far greater.

AVALON
CAPITAL
MANAGEMENT

The portfolio was positioned for safety for much of 2018 and the strategy worked. While no assets really worked for the whole year, in the 4th quarter, the safe-haven plays offset the dramatic declines in the riskier asset classes. We feel good about the results and even more about the 4th quarter when the selling intensified. Our message to you is that the model worked well to mitigate losses at a time when declines were steep. Here we show the global index components of the Avalon Dynamic Allocation (ADA) benchmark and how they performed in the quarter. Your portfolio did far better than this average for both the year and the quarter due to our overweight positions in bonds, gold, cash, REITS, stock hedges and high-dividend, low volatility stocks.

BENCHMARK 4TH QUARTER

Members (12)	Return
ADABENCH (My Portfolios - PRT...	-6.63%
All Members	
1) VANECK VECTORS GOLD MINERS E	14.46%
2) SPDR GOLD SHARES	7.53%
3) ISHARES 20+ YEAR TREASURY BO	4.59%
4) ISHARES CORE U.S. AGGREGATE	1.85%
5) ISHARES US REAL ESTATE ETF	-5.77%
6) ISHARES MSCI EMERGING MARKET	-7.64%
7) SPDR S&P DIVIDEND ETF	-7.89%
8) ISHARES MSCI EAFE ETF	-12.62%
9) SPDR S&P 500 ETF TRUST	-13.52%
10) INVESCO QQQ TRUST SERIES 1	-16.73%
11) ISHARES RUSSELL 2000 ETF	-20.29%
12) ISHARES NORTH AMERICAN NATUR	-23.54%

The key question now is whether it is safe to shift from defense to offense.

Apart from some potentially significant external events like negative revelations from the Mueller investigation or increasing government dysfunction, the key investor concerns are liquidity, trade, earnings and global growth.

POWELL PAUSE

One of the major factors in the 4th quarter meltdown was the fear of increasing interest rates. The Fed raised the Federal Funds Rate to 2.00-2.25% in September and indicated a potential of two more rate increases in 2019. After the markets tanked in December, the Fed went on a media blitz in early January to reassure the markets. Federal Reserve Chairman Powell said the central bank "would be patient" in raising interest rates this year after global growth worries gripped financial markets. "We are in a place where we can be patient and flexible and WAIT and see what does evolve." The markets exploded up on the news. The futures market flipped from a high probability of 2 rate increases to almost no chance of it happening.

The headlines place more emphasis on the Federal Funds Rate but we think the Fed's changes in its balance sheet are just as important for liquidity. As the Fed sells off assets it reduces financial liquidity; no differently than when they raise interest rates. Estimates indicate that a reduction in reserves of $200 billion is the same as raising the federal funds rate by 0.25% to 0.50%. It is currently reducing its balance sheet by up to $50 billion per month. They are not selling their assets but letting them "roll off" as they mature. And the Fed is not alone. Worldwide, central banks' balance sheets are shrinking at a record 3.5%. The Bank of Japan has slammed on the breaks; Bank of England liquidity continues to decline and ECB liquidity growth has turned negative. Thus, even with a Federal Funds Rate pause, which has certainly assuaged some investor concern, liquidity is still tightening. Watch for statements from the Fed concerning the balance sheet – when they indicate a change in monthly reductions, you can start to believe they are serious about increasing liquidity into the system. As stocks rebound, there will be less pressure on them to change course in terms of either raising rates or slowing the balance sheet reductions. This will ultimately cap the rally.

CHINA SLOWDOWN

For most of 2018, investors were surprisingly willing to shrug off risks posed by the trade war that erupted between China and the United States. Then Apple suddenly brought China concerns to the forefront when they cited weak sales of IPhones in that country. Apple slashed its sales forecast for the first time in 16 years, citing slowing consumer demand in China, where the economy is growing at its slowest pace in a decade. **And it was not only Apple! Samsung, Ford, FedEx, Starbucks and Tiffany have all noted weakness in China as a risk in recent months.**

China's economy is on shaky grounds. The consumer is pulling back its spending. Automotive sales fell for the first time in 28 years in 2018. The car sector represents about 5% of China's GDP and 30% of global market sales. Thus, this is not just a Chinese issue. US and European automakers export vehicles to China and own factories within the country. General Motors sells more cars there than in the United States. Overall retail sales are faltering, given a slowing economy, a slumping property market and a tough job market. It's Purchasing Managers' Index, a measure of factory activity, is now contracting instead of expanding.

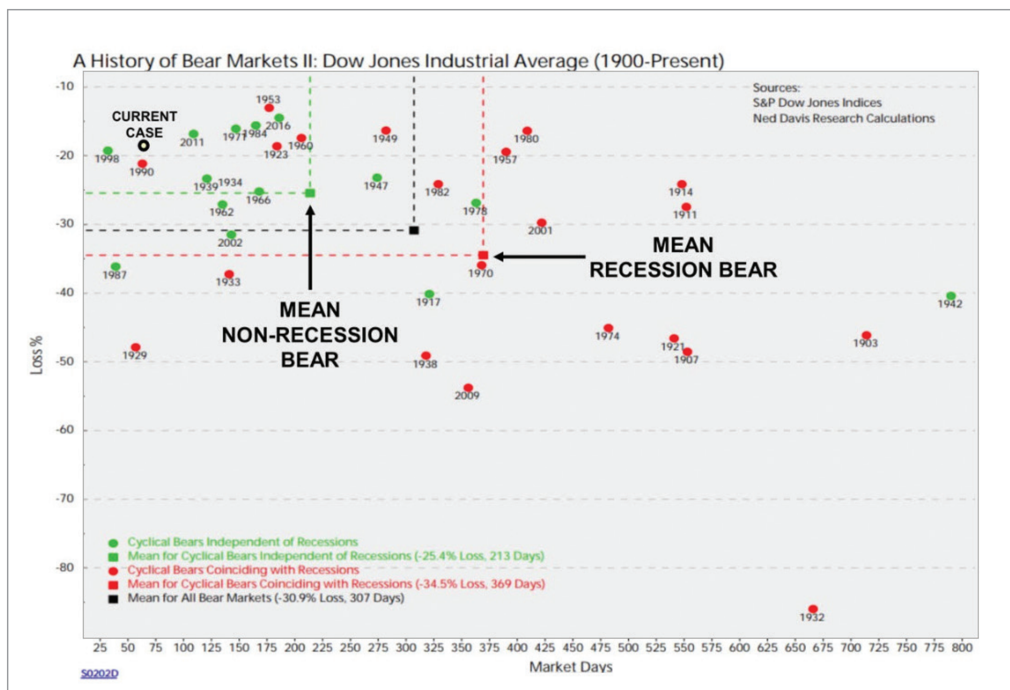
In the past, if the United States economy sneezed, the rest of the globe got a cold. Today it is China. 40% of the worlds' growth over the past 10 years has been due to them. Ten years ago it was growing at 12% - today it is approaching 6%. The uncomfortable fact is that a great deal of world growth is tied to their growth. And not just absolute current growth, but expected future growth. Businesses have built 6% or more, compounded for a long time, into their models. It is baked in the forecasts and if that growth does not meet expectations, we may get a surprise.

In the near term, China has made recent moves to keep the economy steady. Authorities announced tax cuts for small businesses and policies to support consumption of vehicles and home appliances. The central bank's governor also mentioned the use of counter-cyclical policies to support the economy in general and private business in particular. These will not be the last of policy issue changes as it attempts to weather the storm. For U.S. investors, keeping as eye on China may be as important as keeping an eye on what is happening here.

GLOBAL GROWTH AND EARNINGS

Globally the probability of a slowdown is very high at 90%. This contrasts with the less than 10% chance of a recession in the United States. The US has gone its own way before, so until the evidence of recession here rises, it is best to look at market returns through a non-recessionary lens.

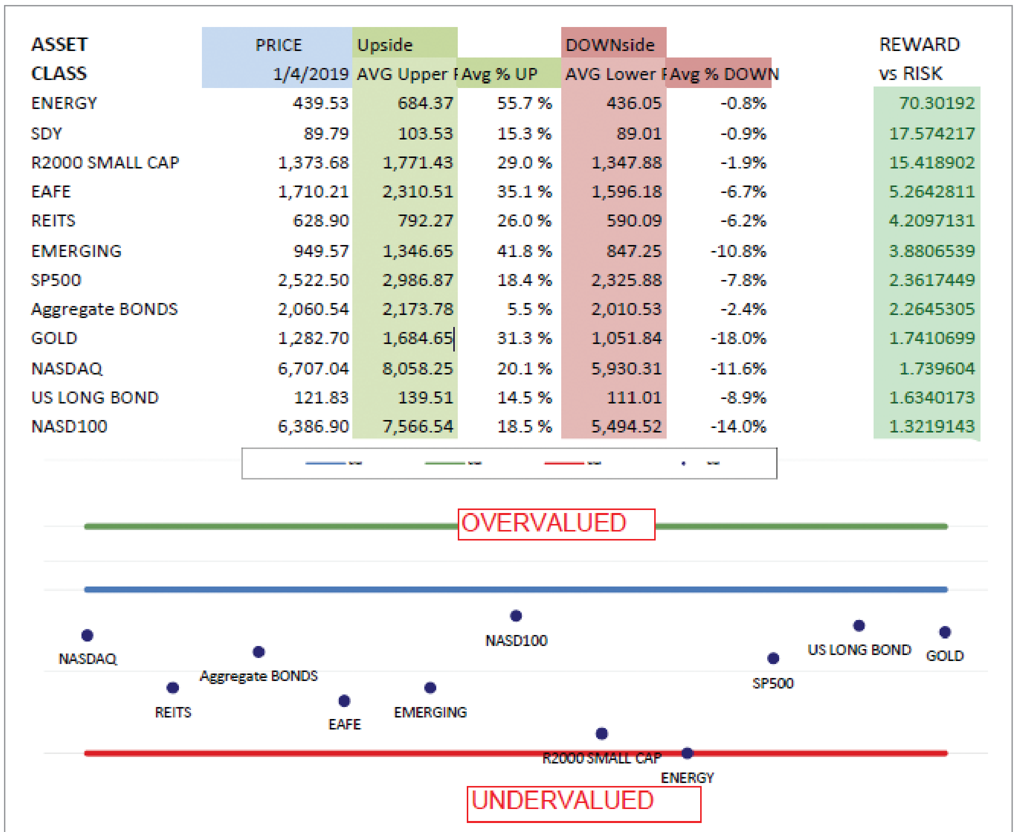
Ned Davis Research sees little threat of a U.S. recession in 2019.



Ned Davis Research (NDR) published an analysis of stock market performance and recessions. With less than a 10% probability of recession in the US for 2019, the recent 20% drop in stocks would represent much of the expected decline without a recession. Still, earnings are clearly decelerating and could even go negative as they did in 2015. Earnings estimates have fallen from 12% growth expectations in November to the current 5% growth projection. Reports are just beginning to come out. So far the results have been mixed. The NDR report goes on to show that the S&P500 can actually rise about 7% in a year when earnings growth is 5%. A lot of the visibility has been clouded by the trade war. A resolution is expected in the first quarter of the year. Anything less would be a big negative as earnings growth could turn negative and an already weak global economy would experience increased pressure.

INVESTMENT REVIEW

Each quarter we step back and look at assets 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 bonds and gold were at the top of the list for reward/risk. They turned out to be the only assets that were up for the next three months. When our models turned positive on them during the quarter, it gave us additional confidence to overweight them given there depressed valuations.



ASSET CLASS	PRICE 1/4/2019	Upside AVG Upper F	Avg % UP	DOWNside AVG Lower F	Avg % DOWN	REWARD vs RISK
ENERGY	439.53	684.37	55.7 %	436.05	-0.8%	70.30192
SDY	89.79	103.53	15.3 %	89.01	-0.9%	17.574217
R2000 SMALL CAP	1,373.68	1,771.43	29.0 %	1,347.88	-1.9%	15.418902
EAFE	1,710.21	2,310.51	35.1 %	1,596.18	-6.7%	5.2642811
REITS	628.90	792.27	26.0 %	590.09	-6.2%	4.2097131
EMERGING	949.57	1,346.65	41.8 %	847.25	-10.8%	3.8806539
SP500	2,522.50	2,986.87	18.4 %	2,325.88	-7.8%	2.3617449
Aggregate BONDS	2,060.54	2,173.78	5.5 %	2,010.53	-2.4%	2.2645305
GOLD	1,282.70	1,684.65	31.3 %	1,051.84	-18.0%	1.7410699
NASDAQ	6,707.04	8,058.25	20.1 %	5,930.31	-11.6%	1.739604
US LONG BOND	121.83	139.51	14.5 %	111.01	-8.9%	1.6340173
NASD100	6,386.90	7,566.54	18.5 %	5,494.52	-14.0%	1.3219143

Reflecting the 4th quarter decimation in all assets except bonds and gold, everything is now below the median and relatively attractive on a valuation basis. For the first time in a long time all assets have a positive reward to risk ratio and the downside risk is below 20% for every asset class for the first time since 2016. Energy, small cap and the S&P Dividend ETF are the most undervalued. Emerging markets and the international developed markets (EAFE) also look good and our models have given them a buy signal so we are currently overweight. The rest have a good reward/risk ratio so we will be shifting to a more offensive strategy as our trend and momentum model improves.

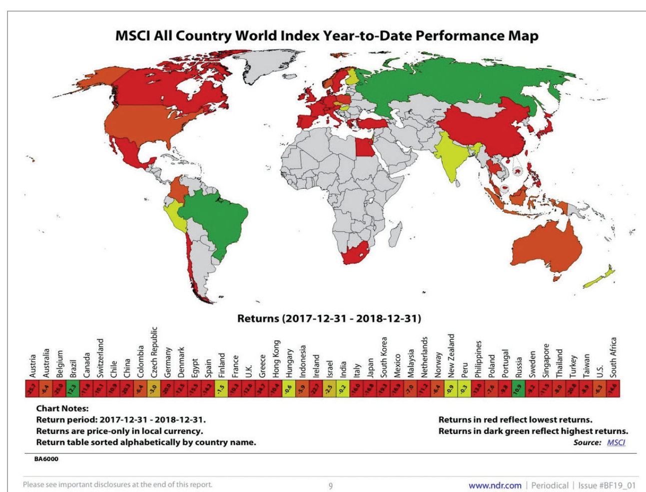
BONDS – We are overweight bonds – primarily US Treasuries. What a reversal for bond prices! In late September bond prices were on the verge of breaking to new lows. Then the stock market nosedived in the first two weeks of October and Treasury bonds reverted to their safe-haven status. While all assets tanked in the 4th quarter, **Treasury bonds were up 4.6%**. They had rallied 11% from their lows but faded in the last week as the stock market surged in the last four days of the year. Our model quickly switched to being long bonds in the 4th quarter which helped our portfolios beat their benchmark. Bond prices may slightly fade some if the market continues to hold or rally in the first quarter. From a longer term perspective we have seen the lows in Treasury bond prices for this cycle. The steep asset sell-off and global slowdown in the 4th quarter has taken pressure off inflation. Should the current rally phase in equities fail, bonds will be a major beneficiary.

REITS – We are slightly underweight REITS. While valuations are attractive our technical models are mixed. Balance sheets are strong and leverage is low. However, there are some developing negatives. Real estate, on the whole, may be topping out, starting with the housing market. Overall, homes are less affordable today than they have been in a decade. Sales of newly built homes fell 18% in December compared with December of 2017. **They were down 40% in Northern California and 49% in Southern California. In New York prices have tumbled between 10 and 20 percent, since peaking in 2015.** There may be some relief in the near term as mortgage rates have eased from 5% to 4.4%.

NATURAL RESOURCES – We are overweight natural resources because of our exposure to gold and gold stocks. Gold is finally glittering – and don't be surprised if it continues to shine. It proved to be a safe-haven in the fourth quarter — **gold was up 7.53% and gold stocks were up 14.5%**. There is an inverse correlation between gold and the dollar, which means gold moves contra to the dollar. The inverse one-year correlation is the strongest since 2010. Since its high in mid-November, the dollar has weakened while gold has rallied. We expect the dollar to continue to weaken as the impact of tax reform fades; the negative trade implications become more apparent and future Fed rate hikes are in question. The U.S. budget deficit has implications that are also negative for the dollar and positive for gold. From the U.S. government shutdown to Trump administrative turmoil to Brexit anxiety and the unknowns surrounding the mounting trade war, gold stocks should benefit from all the worry and uncertainty.

We are underweighting energy stocks. At the end of September prices were hitting 4 year highs. Three months later prices were down 45% on the fear of oversupply and worries about slowing demand in a weakening global economy. Then in late December Saudi Arabia came to the rescue. They announced a reduction in production and *prices surged 27% in three weeks.* Understandably oil stocks were down 25% in the 4th quarter, the worst performing economic sector. But they rebounded the most so far in the first quarter, up 8%. Energy stocks are one of our better reward/risk assets but we will wait for an all clear sign from our indicators before diving into such a volatile area. One attractive area in the energy space is MLPs. They currently yield 8% and are less sensitive to the price of oil.

INTERNATIONAL STOCKS – We are overweight international stocks and prefer emerging markets over developed markets. 2018 was a disaster for international equities. As shown below there were only two stock markets in the world that showed positive results – Brazil and Russia, who would have thought!



For the year, EAFE (Europe, Australia and Far East) was down 13.8% and the emerging markets were down 15.3%. Most markets topped out in January, far ahead of the U.S. market, and should, therefore, bottom ahead of the U.S. This started to happen in December when the

international markets did not go to new lows while the U.S. did. From the 1st of December, to the low on December 24th, emerging markets and EAFE were down 6% to 8% whereas the S&P 500 was down close to 15% and small cap stocks were down 17%. That was the beginning of the positive divergence for international versus domestic equities which continues into the New Year.

Emerging markets are our favorite way to participate internationally. Prices were down 25% from the top in January and at the same level as in 2007, even though earnings have grown substantially. Valuations are 11.3X forward earnings and sell at a 30% discount to the U.S. Emerging markets fell primarily over China growth concerns, rising U.S. interest rates and a strong dollar. China is in the midst of intensifying its policy reflation; U.S. interest rates have peaked; and the dollar may be weakening --all a plus for developing markets.

We are also overweight EAFE. It is at an attractive valuation and has been outperforming U.S. stocks since December. While our model has us overweight developed markets we are not as comfortable with this position as we are with developing markets, primarily because of Europe. While valuations are attractive, Europe is a mess. Italy is probably in a recession and Germany's economy is faltering – contracted in the 3rd quarter and may have contracted in the 4th. China is the major export market for Europe which does not help in the near term. Expectations are for Europe to grow 1% in 2019 but it would not take much to get to 0% or less. There will continue to be heightened anxiety about a Euro breakup. Eurozone economic growth will stay anemic as the underlying economy is plagued by an aging population, slow productivity growth, popular resistance to reforms and continual fiscal retrenchment. Call us nervous bulls.

U.S. STOCKS – We are underweight U.S. stocks. They suffered one of the largest, swiftest pullbacks in 70 years, with a 19% to 24% loss in less than four months. The percentage of securities falling to a 52-week low on the NYSE and NASDAQ spiked to the most since 1987 and 2008. There is no question that the market had a short-term selling climax on December 24th. We show December carnage below to remind us all what a bear market look and feels like. The S&P was down 15.7% in less than three weeks – if you had not anticipated and taken action as we did before the debacle, it was too late.

Then the Santa Claus rally began in the last 4 days of December and continues into January. We consider this to be a bear market rally until proven otherwise. Our job is to protect capital as our top priority until that risk for lower lows is significantly reduced. The risk is not reduced by how far markets have already fallen as they could fall further. Rather, we need to see strong and sustained price action improvement and for the foundation for lower lows broken.

Bear market rallies are sharp and swift. In the 2000-2002 crash, there were four rallies of 12% or more lasting up to three months. In the 2007-2009 devastation there were three rallies of 12% or more lasting up to a couple of months. The current rally is up 12% in three weeks. It is currently at the point where it broke down and is hitting resistence for going higher. In the near term we expect a retracement of this gain but do not expect the December lows to be broken at this time. For now we are looking for that to happen later this year. On the retracement we will be adding to U.S. equities as our models are returning to neutral from massively underweight. For now we expect an intermediate term rally that could last into the second quarter. It is premature to forecast beyond the next couple months. No matter what the outcome, volatility is likely to stay high.

SUMMARY

Markets plumeted in the fourth quarter on concerns about rising intest rates, a global slowdown and an increasingly dysfunctional White House. We feel good about the quarter since we had taken early defensive measures and our portfolios handily beat their benchmarks -- even with a 6% market rally in the last four days of the year. We are presently overweight bonds, natural resources (because of gold) and international stocks. Even so we remain defensive. Bonds have seen their cyclical lows. International markets led the parade to the downside and may lead on the upside. Gold is glittering and should continue to do so given a weakening dollar. We are underweight REITs and the U.S. market. We do not forsee a economic recession in 2019, but earnings are decelerating. We do not expect the December 24th lows to be broken in the near term. We will add to U.S. positions on a pullback. The intermediate rally underway could last into the second quarter.

Thank you for your ongoing confidence and for letting us do the worrying for you.

Happy New Year!

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

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