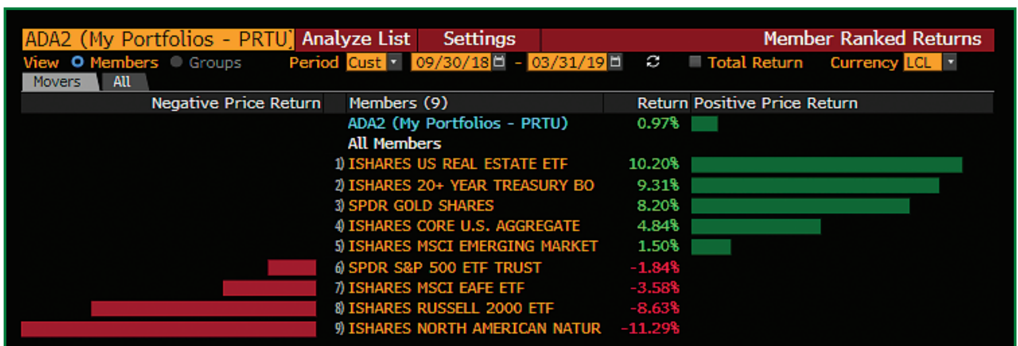
NOW'S A
GOOD TIME
TO GET SOME
GOOD ADVICE

BOOMERANG

2018 ended on a down note and investor's nerves were raw. The only assets up in the 4th quarter were gold, and cash. This massive asset depreciation (the Russell 2000 Small Cap Index was down 20%) 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 first quarter was the exact opposite—all assets were up in value, with Real Estate leading the pack up 17%. What happened? It started with Powell's "Christmas capitulation" announcing that instead of raising rates two more times (which he stated a mere three weeks before), the central bank "would be patient" in raising interest rates in 2019—which immediately became no interest rate increases from some Fed members with others saying there would be cuts. And then they announced that they would no longer be deleveraging the Fed's balance sheet. All stops were being pulled out. All asset markets exploded higher on the news and continued to move ahead as the prior concerns became less onerous: rates might go down, trade war with China was de-escalating, the dollar was flat, oil prices rocketed higher and the global slowdown was bottoming. The end result: for the six months the benchmark was up 1%, roughly the same as in late September. It was a very violent ride with three months down and 3 months back up, ending where it started at the end of September.

BENCHMARK SIX MONTH RETURNS



ADA2 (My Portfolios - PRTU) | Analyze List | Settings | Member Ranked Returns

View: Members / Groups — Period: Cust — 09/30/18 - 03/31/19 — Total Return — Currency: LCL

Movers | All

Negative Price Return	Members (9)	Return	Positive Price Return
	ADA2 (My Portfolios - PRTU)	0.97%	
	All Members		
	1) ISHARES US REAL ESTATE ETF	10.20%	
	2) ISHARES 20+ YEAR TREASURY BO	9.31%	
	3) SPDR GOLD SHARES	8.20%	
	4) ISHARES CORE U.S. AGGREGATE	4.84%	
	5) ISHARES MSCI EMERGING MARKET	1.50%	
	6) SPDR S&P 500 ETF TRUST	-1.84%	
	7) ISHARES MSCI EAFE ETF	-3.58%	
	8) ISHARES RUSSELL 2000 ETF	-8.63%	
	9) ISHARES NORTH AMERICAN NATUR	-11.29%	

AVALON
CAPITAL
MANAGEMENT

So far all of these concerns have been improving. China's reflation seems to be working and that should cause global growth to bottom out and grow again. The IMF just announced they expect 2020 growth to be 3.6%, up from their lowered 2019 projection of 3.3%. Good payroll and manufacturing numbers eased concerns about a recession in the U.S. We see little chance of short-term interest rates going up as the White House will keep up a media blitz about lowering interest rates until the election. There will eventually be a trade agreement with China although it probably won't match expectations but will allow face-saving for both parties. The dollar will flatten out or even decline in the face of stable or lower short-term interest rates and commodity prices will rebound.

We favor equities over bonds, growth over value and big cap over small cap. We are overweight REITs, U.S. Equities, Natural Resources and underweight International Equities and Bonds. This rally probably has a little life left in it but should start a consolidation/retracement pattern during the current quarter. We will take defensive action if it is warranted.

FED CREDIBILITY

Fed credibility fell early this year when Powell's "Christmas capitulation" to pause rate hikes occurred a mere three weeks after he proclaimed at least two rate hikes were in store for 2019. The suspicion is that he caved to White House pressure and the imploding December stock market. There was no meaningful "data dependent" information that changed that quickly to justify such a move. Later the Fed signaled it would desist from reducing its balance sheet and "would soon be a net buyer of Treasuries once again". Some Fed members even suggested that a rate cut was in the cards for 2019. The days of quantitative easing are back; there is little chance of a recession in 2019 and unemployment is at new lows.

So why do we care? This action in the short-term is certainly beneficial to financial assets and the economy. The long-term consequences for the dollar and long-term interest rates is a bigger question. In the early 70's, the Fed under Arthur Burns caved to Nixon's wishes to keep interest rates low even though the economy was booming. But it was in those years that inflation pressures were building up and within a few years the rate of inflation reached double digits. We are not predicting a meaningful rise in inflation over the near-term — just saying the risks are getting higher.

If the Fed succumbed to pressure in January what will they do as Trump plans to nominate not one, but two obviously unqualified people for seats on the Federal Reserve Board? Neither has monetary experience and they have been appointed primarily for their political support of the President and a call for lower interest rates. No one would argue that the Fed is divorced from politics. But there is a difference between acknowledging that there are choices that must be informed by political values and putting those political values ahead of what are often highly technical decisions.

Bottom line is that the Fed will be pressured heavily to cut interest rates over the next two years — we cannot imagine Trump not harassing Powell continually to lower rates until the election. Our guess is that you have seen the last of Fed hikes for at least the next two years — but we could be wrong if the Fed attempts to keep its independence or inflation rises rapidly.

1998 ALL OVER AGAIN?

Powell's "Christmas capitulation" has rekindled hopes of a stock market melt-up along the lines of 1998-99, which followed a late-cycle correction that was nearly identical to the one seen last year. Because of Long Term Capital Management's bankruptcy, Greenspan was frightened into cutting the Funds rate three times, even though the economy remained strong. Powell is doing the same. Like now there had been a temporary inversion in the yield curve, stoking fears of a recession. There are also striking market parallels between the post-Christmas rally and the first three months of the October 1999 market low—U.S. Large Cap Growth (led by technology) is again the big winner, while Small Caps, Value, Cyclical, and EAFE lag. There was a special counsel investigation of then President Bill Clinton underway. Markets had retreated in advance of the "Star Report" but rose strongly when fears of a presidential indictment were extinguished.

Finally the Initial Public Offering (IPO) boom is on, as it was in 1999, starting with Lyft. In 1999, 547 companies had initial public offerings totaling $108 billion. Of the 856 IPOs from 1999 and 2000, 272 (32%) lost more than 90% of their value after five years. The potential IPO market is now huge—there are at least 333 companies valued at $1 billion or more waiting in the wings. There are certainly differences this time around—the companies have been around for a longer period of time, actually have revenues and have raised billions in capital from private equity and venture capital firms. What has not changed is that most are losing money while hoping to become another Amazon. The big question is whether the latest generation of technology companies is just a bunch of chronic cash-eaters that would have gone out of business without a plentiful supply of venture capital; watch but don't play as the animal spirits are reviving.

BONDS— We are underweight bonds. We had been overweight long treasury bonds in the 4th quarter. They played their safe haven role by appreciating 4.5% in a very negative investment environment, appreciating 14.2% from their lows in November to their highs in late March.

20 YEAR TREASURY BOND

Funds are currently moving from fixed income to equities as the slowdown in the economy seems to bottoming and the FED eases up on short-term credit. We now favor equities over bonds.

REITS— We are overweight REITs. We expect the backdrop for REITs to remain positive in 2019: supply/demand fundamentals are healthy, balance sheets are stronger than ever, equity correlations remain low at 0.52—providing nice diversification, and earnings multiples are at discounts to broad equities. A significant tailwind for all real estate is the unprecedented drop in mortgage rates from 5.01% in November to todays 4.03% -- down a whopping 19.4%.

Although in the short term we expect some consolidation from the recent run-up, on a longer term basis, REITs have broken to new highs and should continue to do well this year.

US REAL ESTATE

NATURAL RESOURCES— We are overweight natural resources because of our exposure to gold and gold stocks. Over the last two quarters gold was one of the better performing assets—up 8.2%. Gold will continue to benefit from heightened uncertainty, from rising U.S. budget deficits, Trump administration turmoil, Brexit and European anxiety, as well as the worrisome trade war. Over the near term we anticipate price consolidation until sometime this summer.

We are currently underweight oil stocks but they may be on the verge of breaking out; if they do we will add to this area. Positives for the price of oil: inventories are down, supply is weakening and demand has continued to increase. As the US $ weakens, which we expect, this will also support natural resource prices like gold and oil.

OIL AND OIL STOCKS

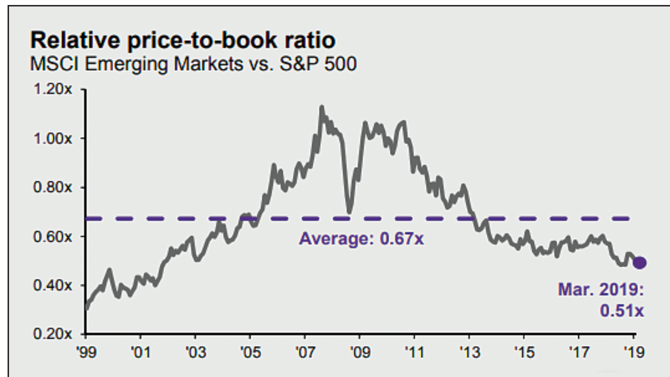
Oil prices have continued to inch up and appear to be heading for $80.00 per barrel. Oil stocks have lagged the price of oil so far this year but if oil continues to advance, oil stocks should play catch-up. We have taken the safe route so far by investing in Master Limited Partnerships (MLPs) that yield over 10%. They provide a unique way to participate in the continued growth in North American energy production, offering the potential for high, inflation-linked income and total return potential. MLPs represent the midstream energy sector and consist of companies that own and operate infrastructure assets (mostly pipelines) from supply regions to demand centers.

INTERNATIONAL STOCKS— We are underweight international stocks but with the Chinese market starting to hum we anticipate adding more to this area in the current quarter. Chinese economic indicators have been in the trough for 15 months and are starting to turn up.

Europe is the big question mark. Germany's manufacturing index recently hit a 7 hear low and they may show negative growth for the first half of 2019. Italy is preparing a stimulus package, hoping to reverse the recession it entered into last year. Retail figures released in the U.K. showed the biggest decline in 17 months. This paints a picture of slowing growth in the south, flagging optimism in the north, and a struggling financial system across Europe. However a significant portion of their exports go to China and if China is starting to bottom out, this could enable Europe to grow more than 1% this year.

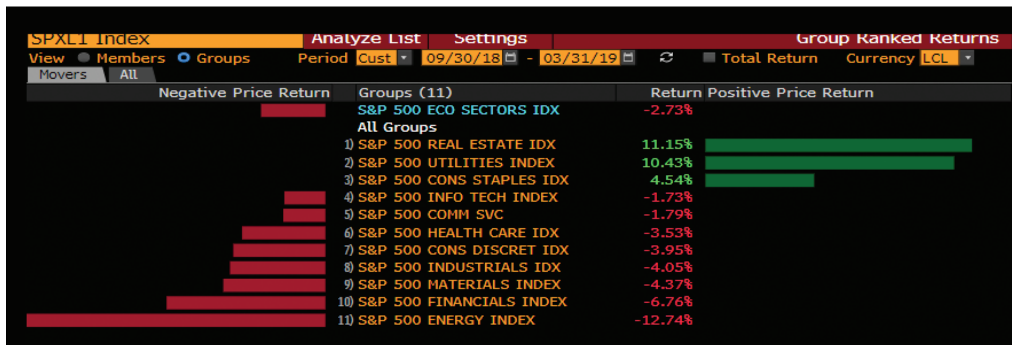
China is the key for Europe and more so for emerging markets. China is in the midst of intensifying its policy reflation and it seems to be working. Manufacturing data came in solidly positive for March, surprising consensus expectations to the upside. Additional easing by the central bank would be significant for market participants, as it would likely be greeted positively by investors and could further stoke the belief that China credit growth may overshoot to the upside over the coming 6-12 months.

We are emphasizing emerging markets over the developed markets. They will materially benefit if China continues to show renewed growth. Valuation are 11.9x forward earnings and sell at a 30% discount to the U.S. Their relative price to book ratio is at the lowest point since 2000 and has been declining since 2007. China is reflating, U.S. interest rates have peaked, valuations are attractive and the dollar is weakening – all a huge plus for emerging markets.



U.S. STOCKS— We are overweighting U.S. stocks. The V-shaped rebound in the 1st quarter almost matched the decline in the 4th quarter. The S&P 500 Index was down 14.0% in the 4th quarter, the worst in 70 years. The 13% gain in the 1st quarter was the best gain since September 2009. Volatility ramped. The big losses of the 4th quarter tended to be the big winners of the first quarter. The net result: portfolios are back to September levels while the S&P 500 was **down 2.7% for the six months**.

S&P SIX MONTH SECTOR RETURNS



SPXL1 Index | Analyze List | Settings | Group Ranked Returns

View Members Groups | Period Cust 09/30/18 - 03/31/19 | Total Return | Currency LCL

Movers | All

Groups (11)	Return
S&P 500 ECO SECTORS IDX	-2.73%
All Groups	
1) S&P 500 REAL ESTATE IDX	11.15%
2) S&P 500 UTILITIES INDEX	10.43%
3) S&P 500 CONS STAPLES IDX	4.54%
4) S&P 500 INFO TECH INDEX	-1.73%
5) S&P 500 COMM SVC	-1.79%
6) S&P 500 HEALTH CARE IDX	-3.53%
7) S&P 500 CONS DISCRET IDX	-3.95%
8) S&P 500 INDUSTRIALS IDX	-4.05%
9) S&P 500 MATERIALS INDEX	-4.37%
10) S&P 500 FINANCIALS INDEX	-6.76%
11) S&P 500 ENERGY INDEX	-12.74%

Over the six month period defensive sectors – real estate, utilities and consumer staples – gave the best return. Energy was the big loser at -12.7%. We were heavy in the defensive sectors going into the quarter but they started to fade mid-March. We then added to more pro-cyclical areas such as information technology, consumer discretionary and industrials.

So are we still in a bear market rally or have we seen the low for this cycle? The jury is still out. 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 a couple of months.

S&P 500 MEGAPHONE

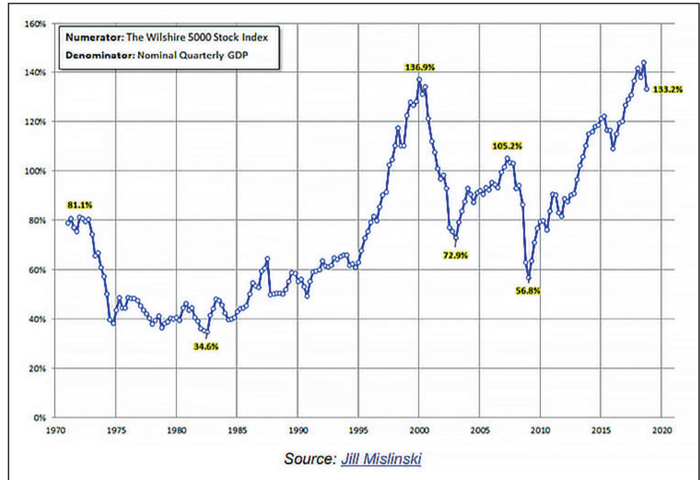
The megaphone chart above would support a case that we are still in a broad trading range that started in January, 2018. In our January letter we expected the rally to last into the second quarter and here we are. Near-term we could see slightly new highs in the S&P as it approaches 3000 but the next major move should be retracement of the current advance. We are not expecting it to break the lows in December but a retracement to between 2600-2800 would not be unreasonable.

While the S&P 500 may be near new highs, other measures of the market such as the NYSE, Small Cap Stocks and Value Stocks are lagging in the run-up.

NEW YORK STOCK EXCHANGE

The New York Stock Exchange is still below its September high as well as its high in January. The same is true for the Small Cap Index. There are still headwinds for the market. Corporate profits will be in an earnings recession for at least the first half of the year. Earning are forecast to drop 3.8% in the first quarter and less than 1% in the current quarter. But the outlook for information technology companies is particularly bearish. Tech sector earnings are seen falling 10% in the first quarter but less in the second quarter. Also, since stocks have rebounded, valuations are still at record highs. The Wilshire 5000 stock index relative to GDP is still at levels last seen in 2000.

WILSHIRE 5000 TO GDP



SUMMARY

The first quarter was a mirror image of the fourth quarter and the benchmark portfolio was essentially unchanged since late September. Powell's "Christmas capitulation" sparked an explosive rally in all assets and assets continued to advance during the quarter as prior concerns became less onerous: rates might go down, trade war with china was de-escalating, the dollar was flat, oil prices rocketed higher and the global slowdown was bottoming. It was a very violent ride, ending up at the same place as six months ago. Have we seen the low for this cycle? The jury is still out. Bear market rallies are sharp and swift. So far it appears we are in a broad trading range that started in January, 2018. In the meantime, we are favoring equities over bonds, growth over value and big caps over small caps. We are overweight in REITs, U.S. Equities, Natural Resources and underweight International Equities and Bonds. This rally probably has a little life left in it but should start a consolidation/retracement pattern during the current quarter. We will take defensive action if warranted.

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

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Clara Basile, Bill Oberman, Dave Rahn

Investment management and counseling for individuals and families

avaloncapital.com

(650) 306-1500