NOW'S A
GOOD TIME
TO GET SOME
GOOD ADVICE

# TWEET -TO- TWEET

Markets are increasingly dancing tweet-to-tweet. According to the research team at Goldman Sachs, **since Trump assumed office on January 20, 2017, he has tweeted 8,699 times. That's now apace for 9.7 presidential tweets per day.** Several academic studies have been written to assess the effects of tweeting on market behavior. One called *The Impact of Donald Trump's Tweets on Financial Markets from University of Nottingham* concludes **"that positive and negative Trump tweets move stock prices ....These findings suggest that Donald Trump does indeed use Twitter as a strategic tool to influence the stock price."** Whole websites have been devoted to tracking Trump's tweets: www.trumptwitterarchive.com and www.bloomberg.com/features/trump-tweets-market

While most tweets are short-lived they should not be ignored because some may have lasting consequences or indicate pending policy shifts. The constant assault on the Fed and Chairman Powell is one of the reasons interest rates are going down. Same is true on trade and currency war tweets – they are having a long-term deteriorating repercussion on global trade. We know there will be more and more tweets as the election approaches so it is important to try and determine those that will have a lasting impact on markets and those that should be ignored as short-term noise.

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# BOOMERANG EFFECT IN Q2

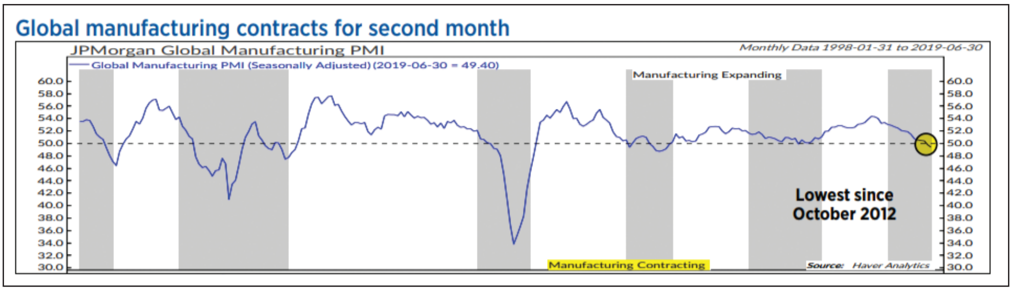
In the second quarter, volatility continued apace in an increasingly news-driven environment of daily tweets and abrupt changes in government policy. In Q1, the massive depreciation in the 4th quarter was reversed with "the Fed does not know what it is doing" tweet and the subsequent Powell Pivot on interest rates from rate increases to rate decreases. Followed by tweets that China trade negotiations were moving along well and that a deal was imminent. This carried markets sharply higher into early May, retracing the steep losses from October through December.
We dubbed this "V" recovery the **Boomerang** in our first 2019 outlook piece. By May, just when it felt like markets were stabilizing, the trade talks were "off" and we were raising new Chinese tariffs and adding 5% tariffs to Mexico unless they secured the border. This sent stocks into a 6.8% correction for the month. By early June, the threat was averted when he tweeted, "no tariffs". Enter the Fed again, when they started jawboning a potential 3 rate cuts by the end of the year and even a possible 0.5% cut in July. There was a smaller **Boomerang** effect when all assets swiftly retraced the steep losses from May and then some. For the 2nd quarter, all assets did well except oil stocks within the Natural Resources category. The leaders in the quarter were a mix of both offense and defense. Defensive asset classes gold and bonds AND offensive US and International equities both did well. Our portfolios participated nicely during this period and have done so over the last nine months when the boomerang effect pattern began. In a period of intense market and psychological instability we are aiming for a smoother ride by holding a balanced asset mix that reflects both defense and offense.

## SIXMIX BENCHMARK FOR NINE MONTHS OF BOOMERANG


For the full period, September 2018 through June 30, 2019, defense did better, but for just 2019, the catch-up effect has slightly favored equities, as the two strategies have risen together. This makes sense since the Fed U-Turned from 2 interest rate **hikes** to 3 **cuts** in a blink of an eye. All assets (except natural resources) jumped higher in anticipation of the reductions. At current levels most assets have discounted the interest rate declines (which have not happened yet) and leave little room for more appreciation – unless the Fed indicates even more cuts than currently anticipated. Another key factor is earnings, which have been declining for three quarters. Expectations are low, so if earnings guidance for the fourth quarter is strong, that could further gains in stocks. Second quarter earnings are expected to be down 2.8%, and 0.3% in the third quarter. Market participants are anticipating a 7% rebound in the fourth quarter. Actual second quarter earnings reports should give us a handle on whether the 7% is realistic.

# GLOBAL DECELERATION

Global growth continues to decelerate even though central banks everywhere are pushing money into the financial system to try and offset the decline.




Global manufacturing contracted for the second month. The U.S. is one of the few economies that remain positive on this basis. But a manufacturing recession does not necessarily translate into an overall economic recession, especially for a high-income, advanced economy. The IMF recently cut its outlook for global growth to the lowest since the financial crisis, based on a bleaker outlook in most major advanced economies and signs that tariffs are weighing on trade. The world should grow at 3.3% this year, down from January's 3.5% forecast. China, India and the U.S. are growing but Japan and Europe are in shallow recessions.

China's growth is the key to world growth. Its 2Q GDP was 6.2% from 6.4% in 1Q. This was the *weakest pace since quarterly data began in 1992*. However monthly signs were encouraging that growth might stabilize at these levels. In June, factory output and retail sales growth beat estimates. Nevertheless, China's economy will slow further in the second half as external demand remains the biggest drag, but will likely bottom out from there. The annual growth rate should stay above 6%. While that could stabilize world growth around current levels, it does not necessarily indicate that growth will accelerate over the coming months.

# TARIFF AND CURRENCY WAR

Although investors breathed a sigh of relief when Xi and Trump said they would start negotiating, it is far from over. We think we will be writing about tariffs (and other global trade disruptors) for quite awhile. Once you start down this path it is hard to reverse course as other nations start getting "creative" about what they should do to protect themselves.

Current happenings on the trade front:

1. After Xi and Trump met, the Chinese subsequently said the US has to lift all of the tariffs placed on Chinese goods if there is to be a trade deal.

2. Xi's China is determined to regain its dignity and position as a top-ranked power. In its long-term plan it intends to be number one in 10 identified industries including information technology, communication, health, aerospace and biotechnology. This plan does not entail giving up much to the US, which it considers to be its number one adversary.

3. France and the U.K. will be imposing a "digital" tax on tech giants. The European Union is also mulling a digital tax. Trump says he will put tariffs on automobiles if they follow through.

4. Japan and South Korea – Japan is putting export restrictions on high tech materials. South Korea is calling for a boycott on Japanese consumer goods. Tokyo is considering making South Korea the first county ever to be excluded from Japan's list of 27 "friendly" counties that are exempt from export controls.

5. Trump is threatening tariffs on Europe, India, Vietnam and Taiwan.

And now a currency war as well. If America's trade deficit fails to narrow, Trump will weaponize the dollar. He will have the Treasury pursue a "weak dollar policy" to help exporters and disadvantage importers. In addition to verbal intervention to talk the dollar down, the administration could threaten to label certain countries as currency manipulators. Recently the US Treasury released its latest report on foreign exchange polices which put more countries on a "monitoring list" of potential currency manipulators — China, Germany, Ireland, Italy, Japan, South Korea, Malaysia, Singapore and Vietnam. The main weapon in a currency war is lower interest rates.

## CENTRAL BANKS U-TURN

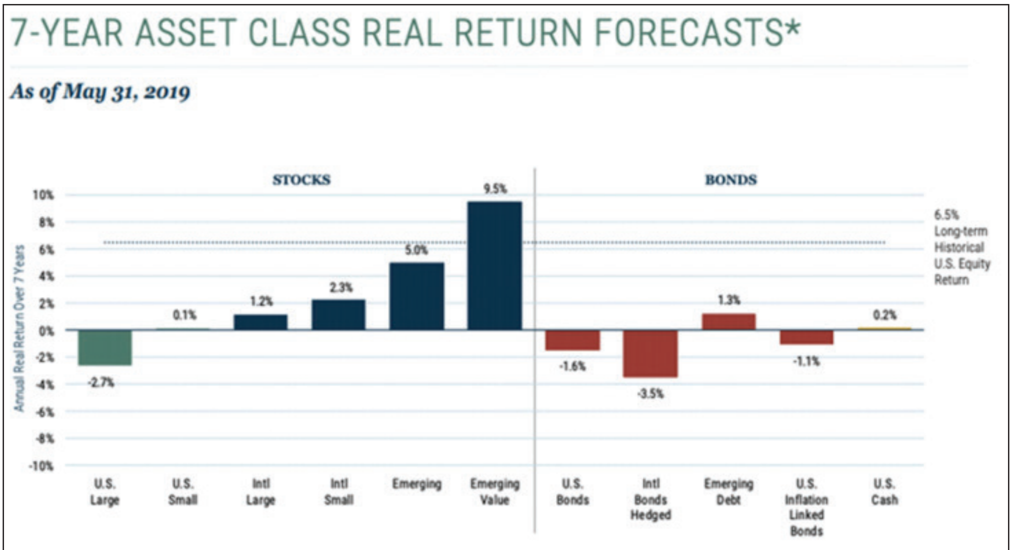
In response to the economic slowdown, central banks around the world have abandoned the path of monetary policy normalization and are now back to lowering rates and enacting quantitative easing. With public and private debt at record highs, they are in a debt trap. They know they want to raise rates to bring the expanse of debt to an end, but they can't because raising rates will cause all sorts of problems, for example, hurt growth and increase debt servicing costs. There are also political constraints. High government debt and deficits mean that higher rates are going to hit the government's pocketbook.

The world's central bankers entered the markets in 2008/2009 to save the financial system. What they learned is that they could dominate and control the markets, by lowering interest rates and employing quantitative easing, which is exactly what they have been doing ever since. Which brings us to the question of independence – the reality is that most of them are not independent – they represent countries that have a budget, and social programs, that must be paid for and so these nations have learned what the central banks can do for them. Countries have pushed them to lower interest rates so the nation's budget and social programs can be afforded, and most of the world's central bankers aren't anywhere close to being as "independent" as the US Fed. They are controlled by their governments and are manipulating interest rates for their own benefit while, at the same time, it is to the detriment of the United States.

So what does this mean? It means that US interest rates are heading lower as the United States has to compete with all of these other nations. The Fed is going to get "forced," by the other central bankers into lowering our rates just to protect American interests. And to make matters worse, the Fed will be harangued by Trump to lower rates until Election Day. His recent nominations to the Fed are both for lower rates and Judy Shelton believes we should have zero rates, right now, irrespective of the data.

So think about the current situation – it is hard to justify a rate cut using traditional metrics. The unemployment rate is at a five decade low, inflation is not that far below the Fed's target, financial conditions are very loose, the S&P is at record highs, and interest rates are already at low levels. Yet the Fed is under tremendous market and political pressure to cut. AND it will do so citing the *concept of an "insurance cut" — that is, increasing monetary stimulus now in order to reduce the risk of future damage.* What happened to data dependency? RATES ARE GOING LOWER.

# LONG-TERM EXPECTATIONS




Source: GMO

From time to time we show GMO's 7-Year Asset Class Real Return Forecast. The firm was started by Jeremy Grantham, in Boston 40 years ago, a well-known value investor. The purpose is to get away from the day-to-day tweets, short-term forecasting and "what did the market do today" syndrome. The returns are real returns per year for the next seven years. The assumed inflation rate is 2.2% so you have to add this back to the return numbers to get nominal returns. It is not surprising US Large Cap stocks show one of the poorest expected returns since recently having the best returns. Also, since international stocks have underperformed the U.S. for the last 12 years, it is not surprising that the international area shows the most promise. U.S. assets, in contrast, are not as attractive. The starting point is crucial. Thus all of these numbers will look better if we get a nice correction in the given asset.

**BONDS –** We are overweight bonds but may scale back a bit as they have had an unprecedented rally during a strong economy.

The collapse in bond yields has been stark, swift and global, upending expectations that the world's economy would be strong enough to support a return to "normal monetary policy" after years of easy money. In less than nine months the 10-Year Treasury Yield went from 3.2% to less than 2% (a 32% decline). And you thought the stock market was volatile! It started with the 20% decline in the stock market in the fourth quarter as investors sought a safe haven in government bonds. Then it accelerated this year as the Fed pivoted from a 2 rate increase stance to a 3 rate cut by the end of 2019. However, U.S. rates were also impacted by declining rates in the rest of the world. Note that the German yield has been in decline since early 2018. It is clear that international rates have put pressure on rates in the U.S. and will continue to do so as central bankers accelerate their easy money policies.

| @CharlieBilello | The Negative Bond Yield Matrix | | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Country | 6-Mo | 1-Year | 2-Year | 3-Year | 4-Year | 5-Year | 6-Year | 7-Year | 8-Year | 9-Year | 10-Year | 15-Year | 30-Year |
| Switzerland | -0.75 | -0.64 | -0.89 | -0.91 | -0.89 | -0.87 | -0.79 | -0.76 | -0.69 | -0.63 | -0.52 | -0.29 | -0.01 |
| Germany | -0.58 | -0.68 | -0.74 | -0.76 | -0.74 | -0.68 | -0.64 | -0.58 | -0.46 | -0.40 | -0.31 | -0.10 | 0.27 |
| Netherlands | -0.59 | | -0.72 | -0.70 | -0.64 | -0.61 | -0.50 | -0.42 | -0.32 | -0.25 | -0.15 | -0.01 | 0.30 |
| Japan | -0.13 | -0.17 | -0.20 | -0.22 | -0.23 | -0.22 | -0.22 | -0.22 | -0.21 | -0.16 | -0.12 | 0.07 | 0.36 |
| Denmark | -0.66 | | -0.70 | -0.70 | | -0.68 | | | -0.45 | | -0.28 | | |
| Austria | | -0.54 | -0.65 | -0.63 | -0.57 | -0.47 | -0.39 | -0.28 | -0.22 | -0.14 | -0.03 | 0.31 | 0.70 |
| Finland | | | -0.66 | -0.63 | -0.61 | -0.54 | -0.45 | | -0.19 | | -0.01 | | 0.56 |
| Sweden | -0.40 | | -0.62 | | | -0.55 | | -0.26 | | | -0.01 | 0.18 | |
| France | -0.59 | -0.60 | -0.68 | -0.66 | -0.62 | -0.53 | -0.41 | -0.31 | -0.21 | -0.10 | 0.02 | 0.38 | 1.15 |
| Belgium | -0.57 | -0.58 | -0.60 | -0.66 | -0.60 | -0.54 | -0.42 | -0.25 | -0.14 | -0.06 | 0.09 | 0.40 | |
| Slovakia | | -0.33 | | | | -0.24 | -0.50 | | 0.00 | 0.18 | 0.26 | | |
| Ireland | -0.41 | -0.55 | -0.45 | | -0.46 | -0.39 | -0.24 | -0.14 | 0.45 | | 0.22 | 0.58 | 1.16 |
| Slovenia | | -0.48 | -0.30 | | | -0.31 | | -0.14 | | | 0.25 | | |
| Spain | -0.41 | -0.39 | -0.40 | -0.34 | -0.27 | -0.21 | -0.06 | 0.08 | 0.20 | 0.29 | 0.43 | 0.80 | 1.47 |
| Portugal | -0.38 | -0.34 | -0.37 | -0.25 | -0.17 | -0.14 | 0.05 | 0.16 | 0.28 | 0.44 | 0.55 | 0.95 | 1.50 |
| Malta | -0.23 | -0.20 | | -0.10 | | 0.02 | | | | | 0.74 | | |
| Bulgaria | | -0.13 | | -0.01 | | 0.05 | | 0.37 | | | 0.58 | | |
| Italy | -0.16 | -0.02 | 0.22 | 0.71 | 1.03 | 1.31 | 1.53 | 1.61 | 1.77 | 1.82 | 2.12 | 2.45 | 3.17 |
| United States | 2.19 | 2.03 | 1.81 | 1.75 | | 1.78 | | 1.89 | | | 2.03 | | 2.52 |

40% of all government bonds now have a negative yield. 85% of German bonds have a negative yield. And it is not just sovereign debt either; in the investment grade market, negative yielding debt now comprises almost 25% of the total amount outstanding. Negative yields will continue to spread over the next couple of years, and it is not inconceivable that the amount of negative yields could double over this period, including some government bonds in the U.S. The U.S. 10-Year Treasury Yield could easily approach the low of 1.4% in 2016 and conceivably break below that level. This is reason enough for us to stay overweight in bonds – particularly U.S. government bonds, which still have some of the highest yields of the major countries in the world

**REITS —** We have a neutral weighting in REITs. We took some profits in our REIT portfolio as they were the best performing major asset class for the nine months ending in June. Consequently, they became overvalued relative to other asset classes and needed to be rebalanced relative to those assets. They were a major beneficiary of the interest rate yield collapse and will give up some of their gains if interest rates backup.

This would represent a good buying opportunity in REITs as they provide an excellent defense against trade and currency wars since real estate is largely a domestic play with solid fundamentals, attractive yields and solid balance sheets. They also provide strong diversification characteristics with an equity correlation at a low level of 0.52.

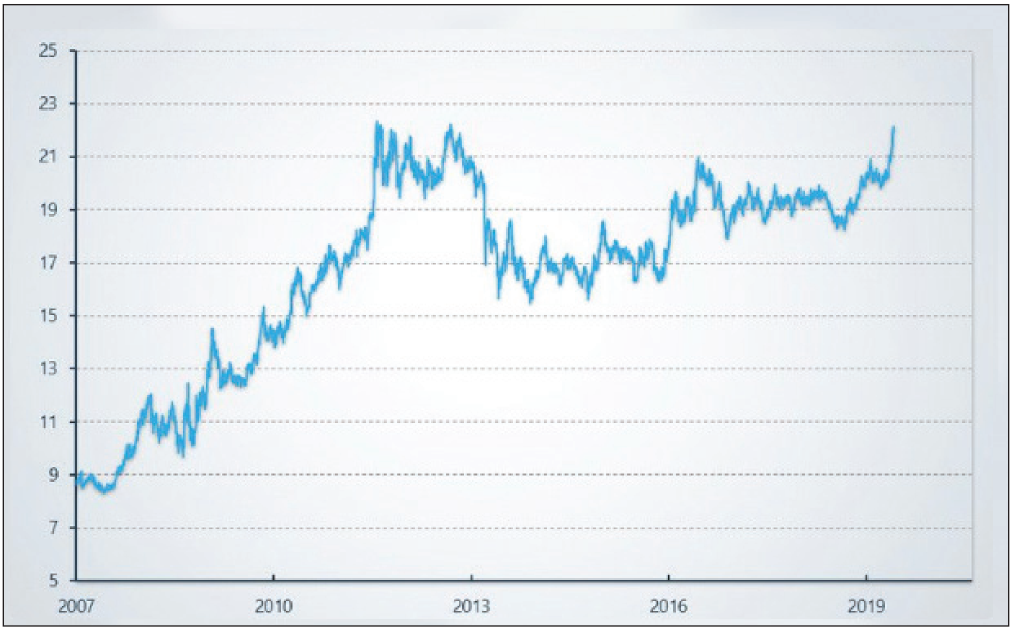
**NATURAL RESOURCES —** We are overweight natural resources because of our exposure to gold and gold stocks. We believe that gold and gold stocks have started a new bull market. The price of gold shows strong technical momentum. Gold broke above $US 1,400 for the first time in nearly SIX YEARS. Storing capital in gold-backed ETFs is now cheaper with recent declines in interest rates and with roughly $13 trillion of global debt now offering a negative yield, making the "gold does not pay a coupon or dividend" barrier less relevant. And there is increasing central bank demand. Net purchases of gold by central banks, led by China and emerging markets, which had be running at around 10% from 2010-2017, reached a *50 year record in 2018 of 15%.* In Q1' 2019, the trend continued with central banks buying 14% of demand.

## GOLD

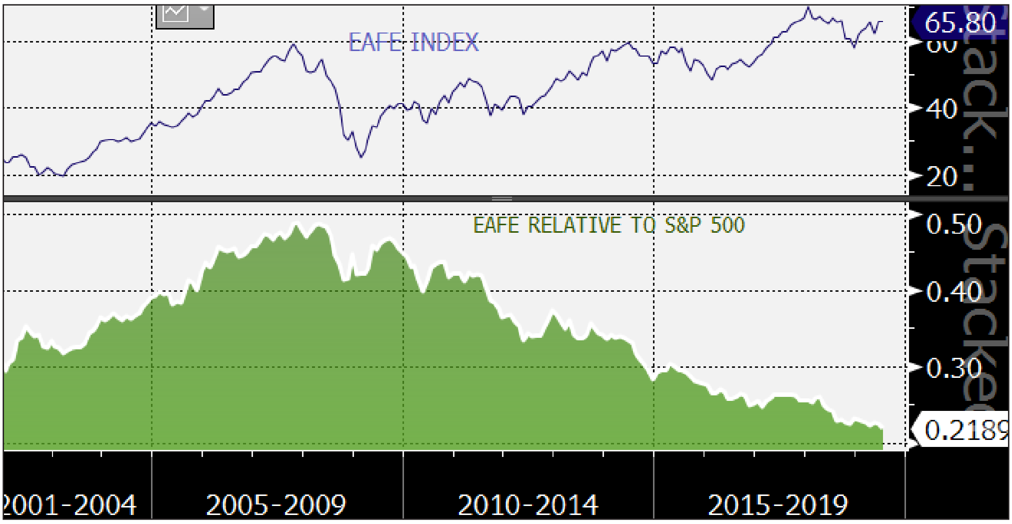

## GOLD STOCKS

The above charts are in U.S. dollars. The fact is that gold is also trading at multi-year highs when quoted in major foreign currencies. The chart below shows that gold is right at all-time highs versus a basket of 27 currencies, equally weighted, excluding the U.S. dollar. The main message is that gold has now become the world's strongest currency. That may be the price for global central bankers racing to see who can lower rates the most (or go the deepest into negative territory). Thus Gold is also viewed as an alternate currency. When global traders lose confidence in their currency, they often turn to gold as an alternative store of value. The true hallmark of a bull market in gold is its ability to rise relative to other major currencies. And it is doing just that.

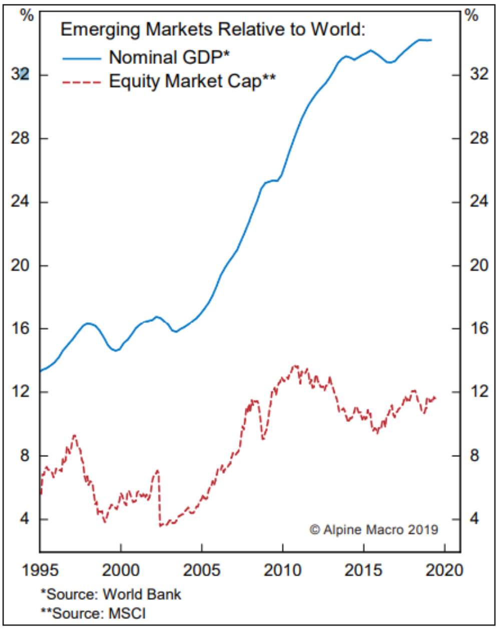
## GOLD PRICE VS. GMI CURRENCY BASKET




**INTERNATIONAL STOCKS —** We are underweight international stocks. Developed markets have been underperforming U.S. stocks for 12 years due to a strong dollar and relatively slow growth in Europe and Japan. This is also true for emerging markets; a strong dollar headwind plus a contraction in P/E's.



On an absolute basis international developed markets appear to be in a long-term bottoming process. However they are still underperforming on a relative basis to the U.S. and until that changes we will stay underweight developed international equities.




We prefer emerging markets over the developed markets. There is a huge gap between emerging markets GDP and equity market capitalization relative to the world. While nominal GDP is 34% of the world's GDP, capital markets for these countries are only 12% of the world's total. This gap will decrease over time – the question is when. The big picture for EM assets is supportive. First, EM equities are attractively valued both compared with developed counties and from an historical perspective. On average, EM stocks are trading at a 30% discount to DM. They are also trading at a substantial discount to historical norms. Currently, the forward P/E for EM stocks is roughly on par with the late 1990s, even though interest rates are now substantially lower. Second, EM stocks' relative performance against the developed world is deeply depressed. This, together with a stronger structural growth outlook and cheaper valuation indicators, makes a compelling long-term case for EM equities against their DM counterparts. All we need is for out indicators to signal that money is starting to flow in their direction and we will jump on board.

**U.S. STOCKS —** We are overweighting U.S. stocks. After a May that was down 6.8%, the market roared back on expectation from the Fed that 3 interest rate cuts were in the works, with a potential 0.5% cut in July. It was also boosted by a hope that a meeting between Xi and Trump at the end of June would be fruitful for trade negotiations.

## S&P NINE MONTH SECTOR RETURNS

| Negative Price Return | Groups (11) | Return | Positive Price Return |
|---|---|---|---|
| | S&P 500 ECO SECTORS IDX | 0.95% | |
| | All Groups | | |
| | 1) S&P 500 UTILITIES INDEX | 13.38% | |
| | 2) S&P 500 REAL ESTATE IDX | 12.91% | |
| | 3) S&P 500 CONS STAPLES IDX | 7.65% | |
| | 4) S&P 500 INFO TECH INDEX | 3.82% | |
| | 5) S&P 500 COMM SVC | 2.29% | |
| | 6) S&P 500 MATERIALS INDEX | 1.11% | |
| | 7) S&P 500 CONS DISCRET IDX | 0.78% | |
| | 8) S&P 500 FINANCIALS INDEX | 0.16% | |
| | 9) S&P 500 INDUSTRIALS IDX | -1.12% | |
| | 10) S&P 500 HEALTH CARE IDX | -2.62% | |
| | 11) S&P 500 ENERGY INDEX | -15.98% | |

Over the nine month period defensive sectors – utilities, real estate and consumer staples – gave the best returns. Energy was the loser at -16.98%. We were heavy in the defensive sectors going into the quarter but they started to fade so we added to more pro-cyclical areas such as information technology, consumer discretionary and industrials. So stepping back where does that leave the big picture?

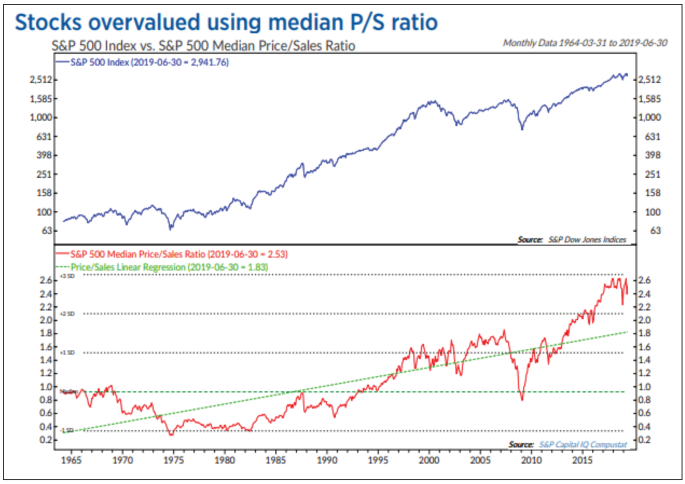

In our April piece, we thought you could see slightly new highs in the S&P as it approached the top of the channel but to expect retracement back to the 2600-2800 level (260-280 on the above chart). The May selloff hit 2730 before the June rebound. The current rally may get to 3050 but that should be it before we get weakness in late July into August. What weakness we get may depend on the upcoming earnings season that is just beginning. How the market reacts to those earnings reports is crucial. Expectations are for earnings to decline 2.8% in the second quarter and third quarter estimates are for a 0.3% decline with a rebound in the fourth quarter.

## SMALL CAP INDEX


While the S&P 500 is at new highs, other measures of the market such as the NYSE, Small Cap Stocks and Value Stocks, are not at new highs. If this were a truly strong market small caps would be leading the parade.

Financial markets have heavily discounted renewed Fed policy easing. Current market levels assume 3 Fed cuts between now and the end of the year. So far the market has been propelled by P/E expansion due to anticipated rate cuts. The Fed may be forced to yield to market pressures for even lower rates to keep the P/E expansion in place, unless earning growth begins to kick in.

Market participants are hoping that fourth quarter earnings will rebound but there is no evidence of that to-date. Many metrics show that the market is stretched at current valuations, including the median Price/Sales Ratio.




## SUMMARY

The second quarter turned positive after a 6.8% correction in May as the Fed went to work jaw-boning a potential 3 rate cuts by the end of the year and even a possible 0.5% reduction in July. All assets did well for the 2nd quarter except Natural Resources (although Gold and Gold Shares did quite nicely). At current levels most assets have discounted the anticipated Fed reduction in rates (which has not happened yet), which leaves little room for more appreciation – unless the Fed indicates even more cuts than currently anticipated or earnings exceed expectations.

We favor a balance of equities and bonds, growth and dividend/value, big cap over small cap. We are underweight developed International Equities, neutral on emerging markets and REITs, overweight Gold and underweight oil. While the rally may have a little left in it we think it is due for a retracement into August.

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

*The opinions expressed are those of Avalon Capital Management as of July 17, 2019 and are subject to change. There is no guarantee that the forecasts made will come to pass. This material does not constitute investment advice and is not intended as an endorsement of any specific investment. Investment involves risk of loss, especially in volatile markets. Past performance is no guarantee of future results. Investing in foreign markets involves currency and political risks. Data contained here is obtained from what are considered reliable resources; however, its accuracy, completeness or reliability cannot be guaranteed. Indexes are unmanaged, do not incur fees or expenses, and cannot be invested in directly. Investment strategies such as diversification do not assure a profit and do not protect against losses in a declining market. Other than the research noted by footnotes, the research underlying this piece represents Avalon Capital Management's proprietary research activities. Most indices we mention are well known and full descriptions can be found at wikipedia.org.*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