NOW'S A
GOOD TIME
TO GET SOME
GOOD ADVICE

WHIPLASH

The third quarter was exhausting for investors. In March, the stock market entered a broad trading range of some 3000 points on the "Dow" (Dow Jones Industrial Average). Since August, The Dow has had eight 300 point up sessions and seven 300 point down days. Even as investors were whiplashed by myriad sharp reversals over this period, there has been little progress made in the overall markets. Early October best exemplified the whiplash environment when a Trump tweet resulted in a 900 Dow point rally in two days, after a meltdown in the prior two day period of almost 1600 Dow points (including overnight trades). There is a tug of war on the positive side between increasing financial liquidity, lower interest rates and strong consumer spending versus the negatives of a widening gap in domestic and global growth, declining earnings and domestic and geopolitical tensions. Through all of the volatility and rising investor concerns, our portfolios performed well and with greater stability than the benchmarks.

3RD QUARTER SIXMIX BENCHMARK

Negative Price Return	Members (6)	Return	Positive Price Return
	SIXMIX [84] (My Lists - W)	1.02%	
	All Members		
	1) SCHWAB US REIT ETF	6.85%	
	2) ISHARES CORE U.S. AGGREGATE	2.34%	
	3) SPDR S&P 500 ETF TRUST	1.75%	
	4) SCHWAB SHORT-TERM US TREAS	0.57%	
	5) ISHARES MSCI EAFE ETF	-0.79%	
	6) ISHARES NORTH AMERICAN NATUR	-4.61%	

The SixMix benchmark was slightly positive for the quarter even after numerous wild gyrations. Defensive assets performed the best. Among the best, U.S. REITs rose 6.9%. Natural Resources (which were underweight except for gold) declined 4.6%. Avalon's barbell approach of balancing defensive assets like REITs, bonds and gold in combination with more offensive U.S. equities, provided a smoother ride and strong returns during a time of high uncertainty.

AVALON
CAPITAL
MANAGEMENT

12 MONTH SIXMIX BENCHMARK

For the 12-month period ending September 30, 2019, results were similar to the recent quarter. Defensive assets did the best. REITs, bonds and gold (not shown) did quite well and U.S. equities were better than the SixMix average. Our defensive orientation helped portfolios get through times of turmoil. For example, in the 4th quarter of 2018, stocks fell as much as 20% before rallying in the final days of the year. The Avalon portfolio experienced only a mild decline. Still, we are getting nervous that the defensive assets have done so well. Investors have been loading the boat on "safety" since the beginning of the year. Consequently, we have recently lowered our exposure to REITs and bonds and increased our exposure to U.S. and international stocks.

The tug of war is still alive and markets remain range bound, but the cost of owning safety has risen dramatically versus 12 months ago. There is good reason. Global growth has been declining for 20 months and more recently U.S. growth has also slowed. Global growth is expected to decline to 3% this year, according to the IMF, down from their 3.2% estimate in July. The IMF attributed the slowdown primarily to rising trade barriers that have stunted manufacturing and investment around the world. The IMF's forecasts show slower growth in **90% of the world**. While there is fear of a recession in the U.S. there is no evidence that one is imminent. Earnings may be a head wind – they are expected to decline 4.1% in the third quarter but rebound in the 4th. Near term market performance may well hinge on 4th quarter earnings guidance from corporations. Domestic political tensions and impeachment news also create uncertainty as well as geopolitical events in Europe, the Middle East and Hong Kong. Offsetting these concerns, the central banks of the world are providing ample liquidity and lowering interest rates to stem the tide. Global financial conditions have eased significantly over the last four months. Looser financial conditions usually bode well for global growth. While manufacturing has been weak, consumer spending has held up quite well. The September jobs report in the U.S. remained firm and the unemployment rate is at multi-decades lows. The recent trade negotiations with China, while not "substantial", are a step forward and financial markets heaved a sigh of relief that the trade war ice may be thawing.

Risk-on assets, such as equities, have been declining or sideways for 20 months. Has this been enough to discount what has happened over this period, as well as for the upcoming months? Our indicators seem to think so for now as they have moved to overweight in U.S stocks for the first time in more than a year. We are entering a positive seasonal time frame for equities and the stock market has refused to collapse despite all of the bad news.

TWEETS, TARIFFS AND TURMOIL

Trump's tweets continue to cause huge whipsaws in the stock market that are difficult to ignore.

In early October, a tweet on trade negotiations resulted in a 900 point rally in the Dow in two days. His tweet that "we have negotiated a substantial deal" was subsequently not substantiated by China. No specifics were put to paper. The deal's limited reach is a sign that the U.S. and China really do not agree on any big issues. Still it is a small step forward and financial markets heaved a sigh of relief that the trade war ice may be thawing.

However, non-tariff barriers to trade are starting to come to the forefront. The Huawei ban is still in place and the U.S. recently blacklisted 28 Chinese tech firms. And it is getting harder for U.S. companies to keep a low profile. The National Basketball Association lost almost all of its major Chinese sponsors in the country, as the government flexed its economic muscle after a tweet backing Hong Kong's protestors triggered a backlash. Navigating the potential for backlash in China's commercial landscape involves managing not just products, but also employees and anyone else affiliated with the company. In the long run this may have a bigger effect on trade than tariffs. For the time being, markets have settled down, but friction with China is far from over. Don't be surprised if it roils market again in the future.

INVESTMENT REVIEW

Beware of the Crowd at Extremes

It is time to 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 create a matrix. What was this analysis revealing to us a year ago? At the top of the list on a reward to risk ratio was U.S. Long-Term Bonds. At that time investors were fearful of rising interest rates and the last thing they wanted to do was buy long bonds. Over the next twelve months long-term bonds were one of the best asset classes along with gold and REITs, which were also at the top of the list. Only emerging markets had an attractive risk/reward and did not perform well. This analysis is not always good for short term timing, but it does reveal where the opportunities and risks are on a longer term basis. At the bottom of the list (low upside potential, large downside risk) was the Russell Small-Cap ETF, which proved to be a disaster over the last year. So that was a good call by the model.

THEN – 12 Months ago

ASSET CLASS	PRICE 10/1/2018	Upside AVG Upper F	Avg % UP	DOWNside AVG Lower F	Avg % DOWN	REWARD vs RISK
Aggregate BONDS	2,013.67	2,167.40	7.6 %	2,009.45	-0.2%	36.405734
US LONG BOND	116.52	140.31	20.4 %	112.18	-3.7%	5.4843247
GOLD	1,188.76	1,693.50	42.5 %	1,059.84	-10.8%	3.9151215
EMERGING	1,047.91	1,349.05	28.7 %	873.21	-16.7%	1.7237533
REITS	673.68	790.40	17.3 %	588.26	-12.7%	1.3665108
EAFE	1,973.60	2,311.20	17.1 %	1,632.99	-17.3%	0.9911586
ENERGY	569.94	687.66	20.7 %	446.40	-21.7%	0.9528547
SDY	97.99	102.02	4.1 %	88.25	-9.9%	0.413379
R2000 SMALL CAP	1,681.09	1,741.88	3.6 %	1,362.60	-18.9%	0.1908926
NASD100	7,653.30	7,345.83	(4.0 %)	5,419.45	-29.2%	0.1376437
NASDAQ	8,050.37	7,843.49	(2.6 %)	5,889.14	-26.8%	0.0957222
SP500	2,928.02	2,928.54	0.0 %	2,312.37	-21.0%	0.0008524

So what does this matrix look like today?

NOW

ASSET CLASS	PRICE 9/19/2019	Upside AVG Upper Price	Avg % UP	DOWNside AVG Lower F	Avg % DOWN	REWARD vs RISK
ENERGY	452.33	666.31	47.3 %	408.55	-9.7%	4.8873179
EMERGING	1,021.36	1,342.74	31.5 %	843.13	-17.4%	1.8032487
EAFE	1,905.01	2,302.22	20.9 %	1,591.67	-16.4%	1.2676524
R2000 SMALL CAP	1570.502	1,815.97	0.156296	1,373.28	-0.125576	1.244633
GOLD	1,500.70	1,720.31	14.6 %	1,080.92	-28.0%	0.5231586
SDY	103.39	107.92	4.4 %	93.54	-9.5%	0.4601555
REITS	783.49	825.56	5.4 %	619.26	-21.0%	0.2561873
NASDAQ	8,186.38	8,601.95	5.1 %	6,384.90	-22.0%	0.2306826
SP500	3,011.27	3,135.75	4.1 %	2,460.29	-18.3%	0.2259235
Aggregate BONDS	2,205.95	2,239.28	1.5 %	2,051.39	-7.0%	0.215635
NASD100	7,897.57	8,165.13	3.4 %	5,981.67	-24.3%	0.1396478
US LONG BOND	140.93	144.07	2.2 %	112.91	-19.9%	0.1122482

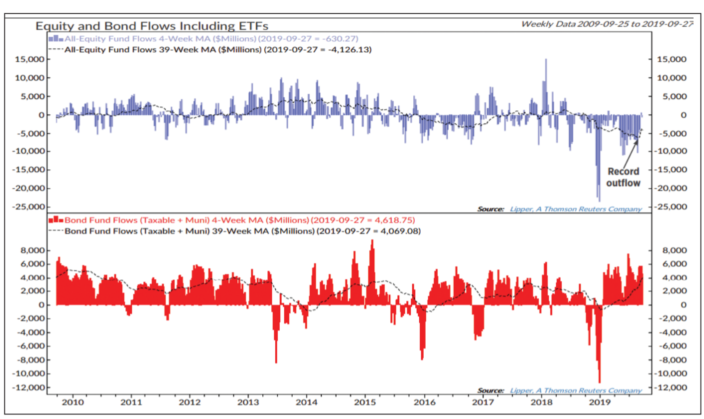
As you can see, for the most part, defensive assets have moved down in attractiveness while more aggressive assets have moved up the list. At the bottom are U.S. long bonds, which were at the top of the list 12 months ago. Other defensive areas have moved to a less favorable reward to risk ratio such as aggregate bonds, REITs, while SDY (S&P dividend ETF) is still one of the most attractive of the US stock categories. Perhaps this is because relative to very low interest rates, the income available from high quality US stocks is very attractive. Also of note are the candidates at the top of the matrix. These are the areas that have done poorly over the last 12 months and even several years, such as Energy, Emerging Markets, EAFE (International developed markets) and the Russell 2000 Small Cap ETF. This does not mean you should jump into these more aggressive areas with both feet, but it reveals the best reward and risk relative to the asset's own history. When our other indicators say it is time to buy or sell, it solidifies our conviction about the implied value. A year ago, everyone was fearful of bonds. Today they are just as fearful of international investing and bonds are loved. In investing the lowest risk / highest reward returns come because investor sentiment temporarily creates a mispricing of the underlying asset. Knowing where you are relative to the mean informs an understanding of that mispricing.

BONDS – We are underweight bonds and are reducing our exposure. They have had an unprecedented rally even as the economy has been relatively strong. Long Treasury bonds are close to their peak made in August and may be forming a double top in the short term. Nevertheless, we remain overall positive on long Treasuries from a long-term perspective as they still give investors a positive return relative to the negative returns offered in the rest of the world. In August, negative yielding debt rose to $17 trillion worldwide, while 95% of investment grade credit with POSITIVE YIELDS came from the U.S. While pricy shorter term, bonds still offer a safe-haven counterbalance against any volatile stock market shocks, thereby reducing the overall risk of the portfolio. We have reduced, but have not gone to zero.

TREASURY BONDS

Sentiment is another reason for our near-term caution. After being one of the best asset classes of the last year, everyone is now bullish. Positive bond flows have been massive for 2019 while stock outflows have been just the opposite. Maybe we need more of a correction to get rid of some of the excess enthusiasm toward bonds. It is possible that TLT could correct back to its breakout price which would imply a decline of 8% from current levels. If the economy shows strength in the near term, that could be the catalyst for the correction.

EQUITY AND BOND FLOWS



REITS – We have a neutral weighting in REITs. We took some profits in our REIT portfolio as they were the second best asset class in the third quarter–up 6.9%. After such a nice run our regression model shows 5% upside from current levels verses 21% downside so it makes sense to take a little off the table.

REITS

REITs have done well as a safe haven from volatile equity markets. While a protracted fight between the world's largest economies would likely be risky for most risk assets, including real estate, we believe REITs have several factors in their favor that help in a difficult investment environment:

1. REITs have little international exposure.
2. They have predictable revenue and relatively high dividend yields.
3. A strong job market and rising wages support demand for many types of real estate.
4. The emergence of new property types over the last decade such as cell towers and data centers have shifted the U.S REIT market to be less cyclical.
5. Interest rates do not pose a threat with all central banks keeping interest rates low.

We are also considering replacing some of our US-based REITs with international REITs where the risk/reward is now relatively attractive. With the US$ now very overvalued, this is also a way to lock in some cheap foreign currency.

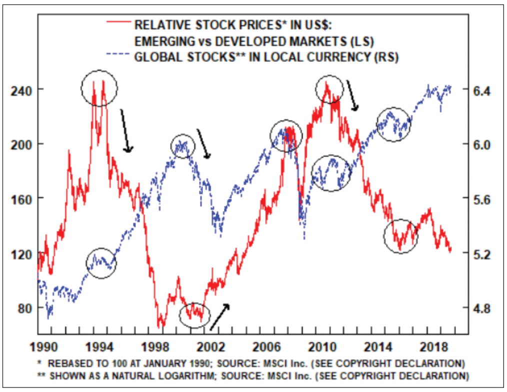
NATURAL RESOURCES – We are overweight natural resources because of our exposure to gold and gold stocks. We are underweight energy.

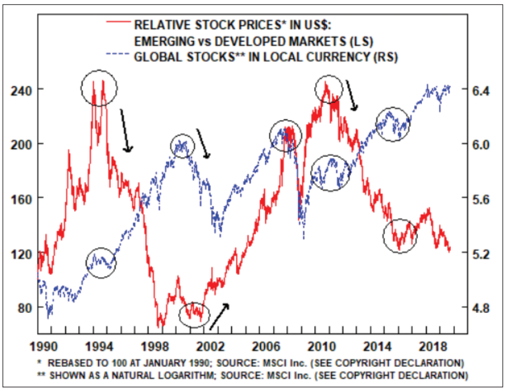
GOLD

Gold broke out of a major base that has been building for over six years. Over the last year, while equities have been flat to down, gold is up 26% and gold stocks are up 52%. Over the last five weeks it has been consolidating its recent gains and could even retrace some more before regaining its uptrend—even down to where it broke out around $1400.

We believe that gold and gold stocks have started a new bull market and have a potential target of $1740-$1890—up 16% to 26% from current levels. In this era of negative interest rates, volatile stocks, unprecedented economic and monetary policy, international tensions and diminishing gold production, gold has everything in its favor. Gold also has a negative correlation to equities thereby reducing the overall volatility of a portfolio.

INTERNATIONAL STOCKS – We are overweight international equities. We prefer emerging markets on a long term basis over developed markets but they face a headwind as long as the dollar stays strong, so we are underweight emerging markets. They have relatively underperformed developed markets since 1994 and may be making a double bottom in relative strength similar to 1998-2002. They are certainly due versus the developed markets.





Developed markets have underperformed the U.S. since early 2018, so they too, are starting to be attractive but we are worried about Europe, particularly Germany.

Germany is potentially entering an official recession and the Eurozone is hovering above 0% growth. After being the stronghold of Europe throughout most of the century, Germany's economy has truly fallen from grace. Several factors are accountable for this:

1. Global slowdown and trade war. The global slowdown, which has been exacerbated by the US/China engagement, has been a key reason for Germany's recent economic demise.
2. European geopolitical risk such as the rise of previously fringe groups, such as the far-right AFD, and then there is Brexit.
3. Auto decline. From a secular perspective, German's standing as the world's most renowned auto manufacture could be at stake as the world drifts to electric vehicles.
4. Secular weakening in manufacturing which is Germany's strong point.
5. Demographics. Germany is among the world's fastest aging economies.

Liquidity is pouring into the global economy and may offset many of the current negatives. Developed markets have outperformed the U.S. since August and may be reversing the downtrend that has been in place since January 2018.

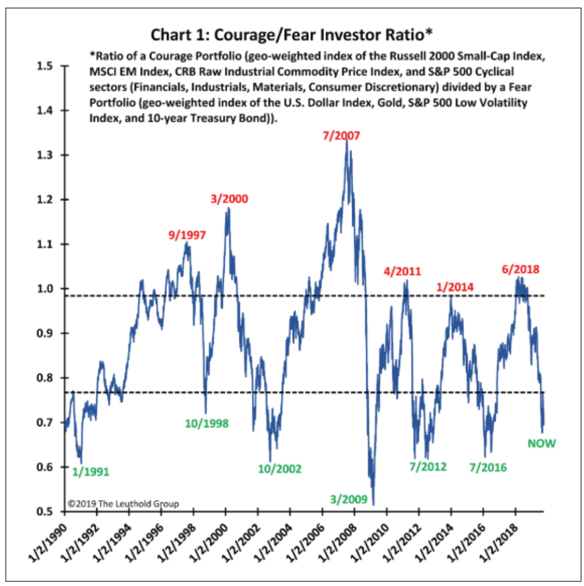
U.S. STOCKS – We are overweighting U.S. stocks. Investors have been whiplashed so often in the last three months, exhaustion is setting in. Through all of the turmoil big caps held up quite well.

S&P ONE YEAR RETURN

Negative Price Return	Groups (11)	Return	Positive Price Return
	S&P 500 ECO SECTORS IDX	2.15%	
	All Groups		
	1) S&P 500 UTILITIES INDEX	22.90%	
	2) S&P 500 REAL ESTATE IDX	20.68%	
	3) S&P 500 CONS STAPLES IDX	13.42%	
	4) S&P 500 INFO TECH INDEX	6.91%	
	5) S&P 500 COMM SVC	4.18%	
	6) S&P 500 FINANCIALS INDEX	1.61%	
	7) S&P 500 CONS DISCRET IDX	0.96%	
	8) S&P 500 MATERIALS INDEX	0.42%	
	9) S&P 500 INDUSTRIALS IDX	-0.63%	
	10) S&P 500 HEALTH CARE IDX	-5.27%	
	11) S&P 500 ENERGY INDEX	-22.07%	

For all of the tumultuousness, the S&P was essentially flat over the last twelve months. The defensive sectors were the winners: Utilities, REITs and Consumer Staples. Technology also did well. So far our barbell approach of defensive sectors plus some technology has played out well. We are getting concerned that defensive assets are long in the tooth and may be heading for a reversal. While it has not happened yet it is worth keeping an eye out for this transition.

Leuthold Research did a nice piece on this subject with their Courage/Fear Investor Ratio.



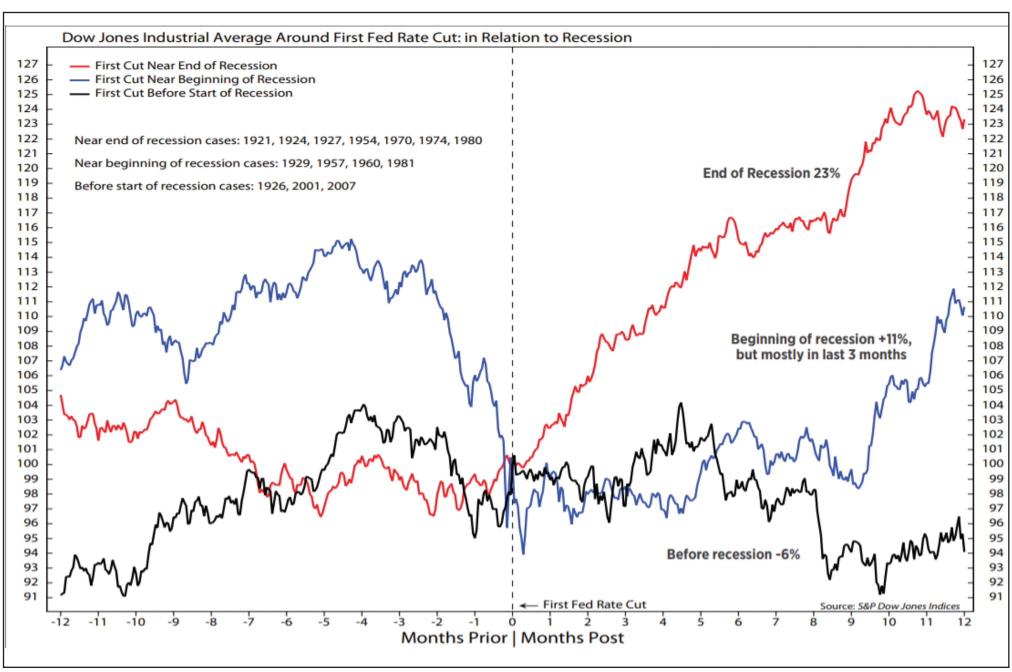
This ratio is the relative price performance of a "Courage Portfolio" divided by the performance of a "Fear Portfolio." Stock market cycles can be described as "runs" of courage or fear. The above chart shows that fear has been dominant since June of 2018. It is now positioned where previous times indicated it was time to switch to the courage portfolio. Most investors now believe that a pending stock market collapse is imminent and are fully positioned for that nightmare. Fear creates opportunity. While not a perfect timing tool it tells us to start looking for opportunities in the courage portfolio: the Russell 2000 Small-Cap Index, Emerging Markets, Financials, Industrials, Materials and Consumer Discretionary.

S&P 500 TRADING RANGE SINCE MARCH

The S&P has been in a trading range since March. We must assume that it will stay in this range until proven otherwise. Short term it appears likely that it might slightly break the top of the range but unless it does so decisively and stays above the range, the overall market has to be approached cautiously. Our regression work would suggest that the S&P could get to 3134 (5.9% above current levels) before meeting headwinds. It is possible this could be the year-end inflection point for a significant move higher out of this trading range but we have to let the market action show us the way.

The Fed has already started cutting interest rates before we are even in a recession. And the markets have soared to the upside in anticipation of this easing. What has happened to markets in prior periods when the Fed has lowered rates before a recession began rather than at the beginning of a downturn or at the end of one? In other words, how much upside is left if the market has already anticipated the ease? Ned Davis Research did such a study that covered periods since 1921. The conclusion was that you would be down 6% one year after the first cut. While that might not be the case this time, it does imply limited upside over the next year from current levels.

What happens to stocks when the Fed cuts before a recession begins?



Financial markets have heavily discounted Fed easing. Further easing, near term, will be offset by a 4.1% earnings decline in the 3rd quarter. 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. Nevertheless the market is acting like it does not want to go down.

SUMMARY

The third quarter was exhausting for investors as they were whiplashed with many sharp reversals with little progress in the overall markets. The same was true for the last 12 months; lots of action but little progress. Since March the market has been in a broad trading range of some 3000 Dow points. The tug of war is between increasing financial liquidity, lower interest rates and strong consumer spending versus a decline in domestic and global growth, declining earnings and domestic and geopolitical tensions. Through it all, our portfolios participated nicely during the volatility. Over the quarter and last 12 months, defensive assets such as REITs, bonds and gold did the best and U.S. equities did well. We are getting nervous that the defensive investments have done so well over the last year and may need a rest. Consequently we have lessened our exposure in REITs and bonds and increased our investments in U.S. and international stocks. We are still favoring big cap and growth but have begun to add some small cap and value stocks that are now relatively attractive. We are overweight the international asset class, favoring developed countries over emerging markets. We are overweight natural resources because of gold while underweight energy. We are underweight bonds and neutral on REITs.

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

The opinions expressed are those of Avalon Capital Management as of October 19, 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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