

NOW'S A
GOOD TIME
TO GET SOME
GOOD ADVICE

FINAL INNINGS

2019 went out with a bang, with all risk-on assets doing nicely. While REITs and bonds were the winners in the third quarter, they did not do so well in the fourth quarter.

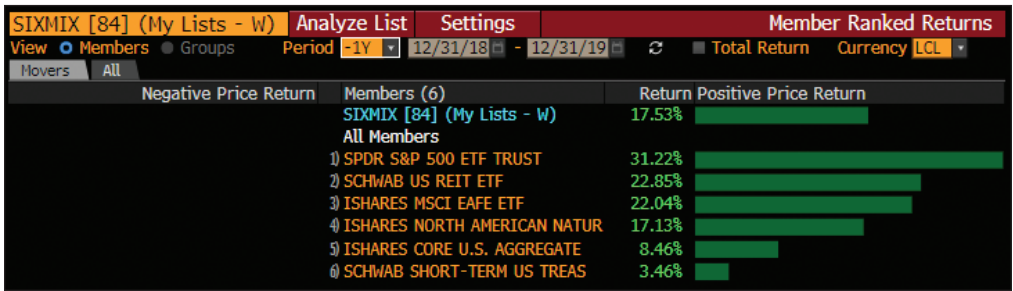
4TH QUARTER SIXMIX BENCHMARK



The S&P 500, EAFE and Natural Resources were strong in the last quarter as the Fed re-ignited quantitative easing; fears of a recession receded and a deal with China appeared to be in the making. Our portfolios made new highs during the quarter and participated nicely in the rally.

AVALON
CAPITAL
MANAGEMENT

2019 SIXMIX BENCHMARK



All assets were up for 2019. The S&P 500 recovered spectacularly from its December, 2018, 20% decline. Despite a poor fourth quarter, REITS and bonds did quite well for the year. EAFE and natural resources finished nicely as well with a strong fourth quarter. Our portfolios made new highs in 2019 but slightly lagged the benchmark due to the “V” recovery that happened earlier in the year and the unrelenting advance from October’s lows. Still it was a good showing in absolute terms.

As 2020 begins, there is some residual strength from the 4th quarter rally, but valuation and sentiment metrics would argue for a first quarter top. We believe we are in the final innings of the advance that began a year ago. After a consolidation/correction in the first half of this year, the ninth inning could occur in the fall going into the election. This would fit the presidential cycle that typically behaves this way during the presidential election year. Our regression analysis would also argue for a first quarter top since the reward/risk ratios for assets decreased markedly last quarter. It is particularly poor for the U.S. equity market. The Fear/Greed Indicator is at all-time highs which is indicating excessive greed from a sentiment viewpoint. While not an exact timing tool it does suggest that the market is vulnerable to unexpected bad news. On the other hand, the domestic and global economies appear to be bottoming, earnings estimates for the S&P are rising and the Fed will remain accommodative during an election year. Thus any correction should be mild, unless geopolitical tensions upset the applecart. The global economy will be bolstered by China. We expect China’s economic strength to continue in coming months, with less uncertainty surrounding the U.S.-China trade deal, credit expansion, reserve requirement ratio cuts and accelerating government-led investments. Gold continues to trade as it should as a counterbalance to the rest of the portfolio during times of geopolitical and market stress.

While anticipating a first quarter top, we are positive on the markets for 2020. We recommend equities over bonds. We are overweight U.S. and international stocks, natural resources (because of gold) and underweight REITS and bonds. In the U.S. we prefer big cap over small cap, growth over value and technology, healthcare, financials and communication services.

GEOPOLITICAL TURMOIL

IRAN — Investors began 2020 with news of the killing of Iranian general Soleimani in a drone attack ordered by President Trump. The repercussions of the airstrike will reverberate long into the New Year and well beyond the borders of each country. Currently, the situation has settled down. We doubt any serious US-Iran negotiations will take shape until 2021 at the earliest — and any negotiations could fail and lead to another, more serious round of military exchanges.

This means that today's reprieve may be tomorrow's negative surprise for the markets and will likely continue to fuel volatility. Analyzing financial markets after 20 Middle East crises events over the last three decades, CNBC analysts calculated, that while, on average, the crises resulted in a 7% correction in the S&P immediately after the event, one month later it was up 0.9% and three months was up 2.8%. Gold was up 1.5% one month after the crises and flat three months later. It is usually not a time to panic. That is why we advocate diversified portfolios: REITS, bonds and gold act as a counterbalance to the rest of the portfolio during times of market stress.

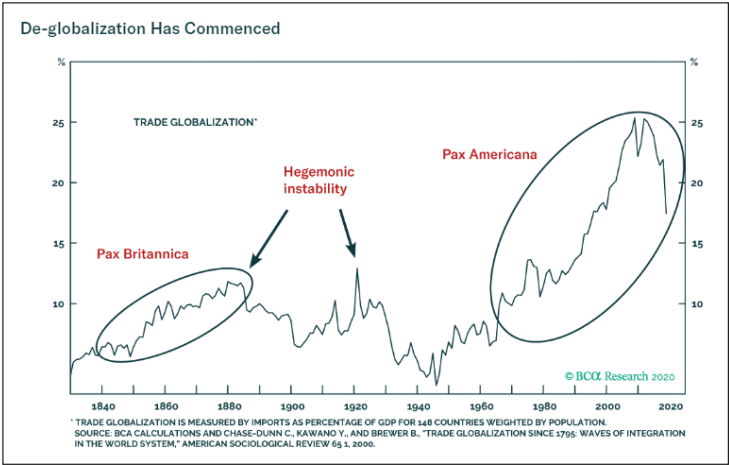


DE-GLOBALIZATION —

An international order built after World War II is unraveling. We believe that one of the major themes for the upcoming decade is the “apex of globalization” or “de-globalization”.

We may be entering a period of hegemonic instability that started

with the 2007-2008 financial meltdowns. Odds are high that countries will continue looking inward as the US adopts a more aggressive and isolated trade policy, China's trend growth continues to slow and US-China strategic differences intensify. The notion that global economic integration amounts to human progress has had a good run. But a new era is underway in which national interests take primacy over collective concerns, with trading arrangements negotiated among individual countries. Britain's voters made it clear that the world's fifth-largest economy will proceed with its abandonment of the European Union.



The above chart shows that we are at the conclusion of a period of tranquility. Globalization is ending because of secular, structural factors, not cyclical ones. These factors are multi-polarity, populism and protectionism. The three pillars of globalization are the free movement of goods, capital and people across national borders. We expect to see marginally less of each in the future. This does not mean that the world economy will stop growing – only that it will grow less than in the past and should be considered when making investment decisions.

CENTRAL BANK MACHINATIONS

Central banks are aggressively adding to their balance sheets and lowering interest rates. The Fed is again implementing quantitative easing, although they refuse to call it that.

FEDERAL RESERVE BALANCE SHEET



The above chart shows the huge turnaround in the Fed's balance sheet in the fourth quarter. The U.S. market had been going nowhere until the Fed started pumping huge amounts of money into the system. The U.S. market peaked in the first quarter of 2018 in line with the Fed drawdown of its balance sheet and its raising of interest rates. The market bottomed a year ago when the Fed reversed to lowering rates instead of raising them. After that initial thrust in the market it went sideways until the latest salvo by the Fed. We no longer have economic cycles but credit cycles manufactured by central bankers. The Fed said they would be doing this latest bout of buying for only six months. We shall see. We think if the economy or market falters, they will continue with current policy. It is hard to believe that the Fed will be anything but accommodative in an election year.

INVESTMENT REVIEW

Opportunities Decreasing

Given the dramatic asset changes in the last quarter, we need to take a look at assets relative to their long-term averages. We do this by regressing prices across a range of price trends since 2000 and creating a matrix. At the end of September, defensive assets (bonds and REITS) moved down in attractiveness while more aggressive areas (energy, small cap U.S., emerging markets and EAFE) moved up the list. Emerging markets led fourth quarter results followed by small cap U.S., EAFE and energy. The S&P 500 also did well even though it was down the attractiveness list. So the move to more aggressive investments was warranted at the end of September. So what does the matrix look like today?

1/02/2020 MATRIX

ASSET CLASS	PRICE	Upside		DOWNside		REWARD vs RISK
	1/2/2020	AVG Upper Price	Avg % UP	AVG Lower F	Avg % DOWN	
ENERGY	459.11	657.63	43.2 %	396.00	-13.7%	3.1456772
EMERGING	1,114.64	1,342.43	20.4 %	846.63	-24.0%	0.8499032
R2000 SMALL CAP	1,655.40	1,835.21	10.9 %	1,393.04	-15.8%	0.6853825
EAFE	2036.96	2,309.52	13.4 %	1,608.64	-21.0%	0.636357
REITS	765.39	842.92	10.1 %	634.20	-17.1%	0.5909678
GOLD	1,526.30	1,750.62	14.7 %	1,105.63	-27.6%	0.5332367
US LONG BOND	136.79	147.08	7.5 %	114.82	-16.1%	0.4685479
Aggregate BONDS	2,225.00	2,272.25	2.1 %	2,075.44	-6.7%	0.3159511
SDY	106.84	110.20	3.1 %	95.82	-10.3%	0.304896
NASD100	8,838.47	8,470.29	(4.2 %)	6,225.86	-29.6%	0.140927
NASDAQ	9,054.83	8,869.16	(2.1 %)	6,613.47	-27.0%	0.0760517
SP500	3,245.10	3,216.04	(0.9 %)	2,531.84	-22.0%	0.0407416

Not surprisingly, the reward/risk ratio has decreased for all aggressive assets. The upside has decreased dramatically while the downside risk has increased. The U.S. market has the poorest ratios. This does not mean the market needs to take a nose dive but that it may be due for some consolidation beginning sometime in the first quarter. The only attractive U.S. market is small cap stocks and REITS and bonds have moved up since they were down in the fourth quarter. Energy, emerging markets, EAFE and gold are still relatively attractive. While not compelling it may now be appropriate to think about moving some money to defensive areas such as bonds and REITS sometime during the first quarter.

BONDS — We are underweight bonds, having been overweight into late summer.

LONG TREASURY BONDS

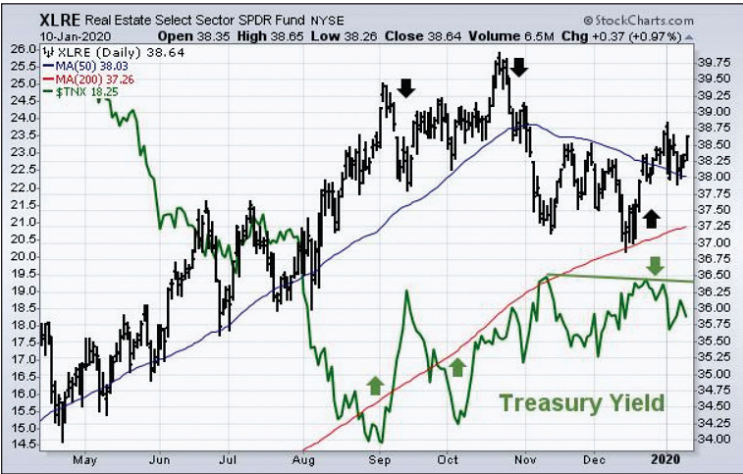
Bond prices broke out to new highs in August and have since retreated back to their breakout level as funds flowed from safe-haven assets back into risk-on investments. They were **down** almost 5% for the 4th quarter, at the bottom of returns



for that period, and down almost 10% from recent highs. If the equity market tops in the first quarter and consolidates or declines into the summer months, treasury bonds should see an inflow of funds and could get back to their August highs. Bonds offer a counterbalance against any volatile stock market shocks, thereby reducing the overall risk of the portfolio. We could move back into bonds during the first quarter if so warranted.

REITS — We are underweight REITs. They were the second best asset class in the third quarter and the worst in the fourth quarter (down 1.4%) as money moved to riskier assets.

REITS AND TREASURY YIELDS



REITs pulled back after bond yields rose during September and October. They started to recover in December as yields started to weaken. If interest rates continue to decline, this should help the REIT portfolio. Return on Assets is stable for this asset so current price

movements are swayed by interest rate changes and investors switching into or out of a perceived safe-haven asset. Interest rates do not pose a fundamental threat with all central banks keeping interest rates low. If the overall equity market starts to weaken we will add to our REIT positions.

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

GOLD



Gold jumped to its highest level in almost seven years with tensions between the U.S. and Iran escalating. The advance extends a rally that began last year, when uncertainty about global trade policy, fears about an economic slowdown, and lower interest rates propelled gold to its best annual performance since 2010. While we see the strong January move as a kneejerk reaction to Middle East issues, the longer-term gold outlook remains positive.

Central bankers are likely to keep printing money, and mine supply will decline because of reduced exploration. A weaker dollar is also beneficial to the price of gold. We believe that gold and gold stocks have started a new bull market and gold has potential near-term target of \$1740-\$1890.

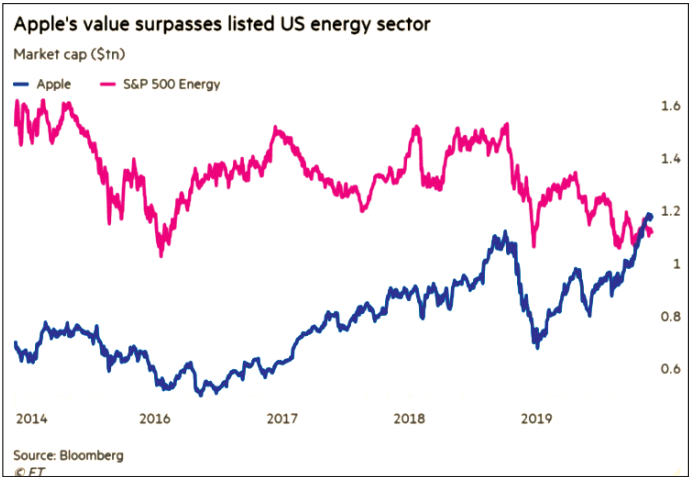
OIL



While the price of oil spiked to prices seen last April, oil stocks continue to underperform the price of oil as well as equities in general. Our regression analysis shows energy stocks to have the best reward/risk ratio of all asset classes. Nevertheless, until stock prices start acting better relative to oil and other assets, we will continue to underweight this sector.

APPLE VERSUS OIL STOCKS

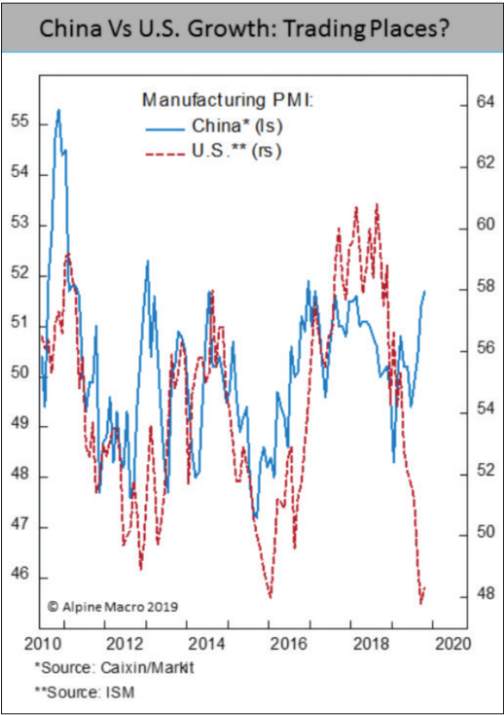
On a very long-term basis, energy stocks look very compelling from a contrarian viewpoint. Apple stock, for example, is now worth more than all of the energy stocks in the S&P 500. Hard to believe that in the 70's the oil patch was **over 30%** of the S&P 500 and is now less than 5%. Oil stocks could be a big surprise in 2020 so we need to keep our eye on them for a possible buying opportunity.



INTERNATIONAL STOCKS —

We are overweight international stocks. We prefer emerging markets on a long term basis as they have relatively underperformed developed markets since 1994 despite having superior economic and earnings growth rates. This area is certainly currently unloved by investors. China is the key to emerging market performance, not only from an economic viewpoint, but also a stock market viewpoint. Most emerging market ETFs have a hefty weighting in China. For example, China is 35% of the Ishares MSCI Emerging Market ETF (EEM).

China's economy is bottoming at a **growth rate** around 6%. The above chart shows that manufacturing turned around in the first quarter of 2019, while it is still declining in the U.S. Improvement was broad-based across business surveys, external and domestic demand, and market sentiment. The prospect of a phase-one trade deal boosted market and business sentiment and will lead to improvement on the demand and production side. We expect the economy's strength to continue in coming months, with less uncertainty surrounding the U.S.-China trade deal, a low year ago base, credit expansion, reserve requirement ratio cuts and accelerating government-led investments. Also Chinese consumer spending will stay strong in 2020. This is important because the consumer and services part of the economy accounts for 75% of Chia's GDP. Household consumption rose 9.9% in the third quarter of 2019, up from 7.3% in the first quarter.



SHANGHAI COMPOSITE INDEX



The Shanghai Composite Index may be breaking out of a huge four year base. China's market is due for a sharp advance. **It has been declining for ten years, 6.9% from December, 2009**, even though the economy has more doubled over that time period. There is room for optimism this year and beyond, particularly as institutional capital, both Chinese and foreign, plays a bigger role. Only about 3% of China's locally listed stocks are owned by foreign investors, compared with 22% in the U.S., 30% in Japan, and 38% in the U.K. China's growing presence in influential global indices is likely to draw in more international investments. Also the market is cheap, trailing price/earnings and price-to-book ratios sit well below the long-term averages over the past 15 years. Short-term sentiment toward China and Asia is yet again in the doldrums. With such a strong U.S. market, U.S. investors have all but abandoned China and Asian markets. And yet experience indicates that when sentiment is at its weakest, Asian markets make their lows. Maybe the current environment is also one where Asia's market may be unduly depressed relative to its own history and even to the rest of the world. We will keep an eye out for additional buying opportunities if given the right entry levels.

U.S. STOCKS — We are overweight U.S. stocks. The stock market did quite well in the fourth quarter with a tailwind from the Fed's injection of liquidity, reduced fears by investors of a recession and anticipation of a trade deal with China.

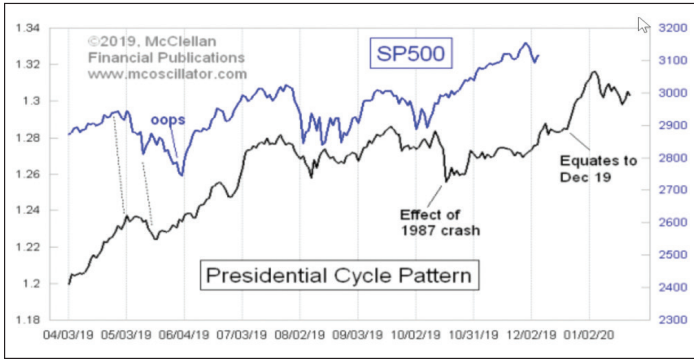
4th QUARTER S&P SECTOR RETURNS



Risk-on areas led the parade with technology, healthcare, financials and communication services in the lead and the safe havens such as utilities and REITS pulling up the rear. For the year, major averages hit new all-time highs. Since lower risk sectors did better through the third quarter, for the year, most sectors performed well except for energy stocks. Valuations are certainly stretched with the recent upsurge in prices and investor sentiment is at bullish extremes so what do we see for the first quarter and the rest of the presidential cycle year?

We can potentially glean some information from the effect of the presidential cycle on the U.S. market, even though it is just one influential factor. The Presidential Cycle pattern is an average of the S&P's behavior over the 4 years of each presidential term.

PRESIDENTIAL CYCLE PATTERN



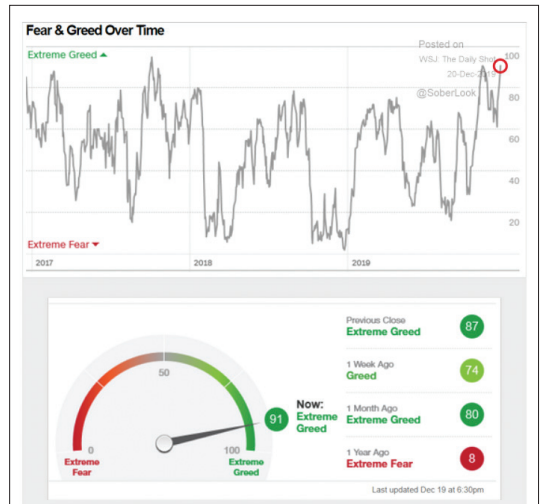
On average, elections years are up. Election years hold the risk that we all might have to get used to some new President taking office. The year prior to the election year tends to end on a strong note as it has this year (above chart does not show December's

strength), which continues into the first quarter. Then the market goes quiet with a consolidation or retracement of the prior quarter as uncertainty surrounds the election and then starts to move up into the election. Our work indicates that could be the pattern for this year; an intermediate correction into the summer with a resumption of the uptrend in the fall. Thus we are in the final innings from the huge move in 2019 but the ninth inning could be in the third or fourth quarter.

Current investor sentiment is at all-time highs at the same time valuations have been stretched to new highs because the market is up 29% over the last year, while earnings have been flat. Sentiment readings, along with our regression analysis, would indicate that the market is due for a rest in the first quarter, which also fits with the presidential cycle.

FEAR AND GREED INDICATOR

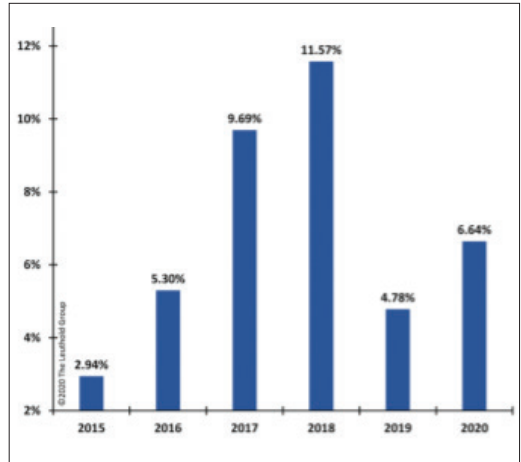
Investors are driven by two emotions, fear and greed. Too much fear can sink stocks well below where they should be. When investors get greedy, they can bid up stock prices way too far. The index is comprised of 7 indicators and looks at how far they have varied from the average relative to how far they normally veer. The scale is 0-100. The higher the reading, the greedier stock buyers are becoming with 50 being a neutral reading. This indicator is now showing extreme greed at 91 versus a reading of 11 last December, when it was showing extreme fear. This would indicate that the market is susceptible to unexpected bad news but it is not a timing tool that says "get out now". However, the first quarter may be a time to shift some money to safer assets such as bonds and REITS.



Excessive greed and high valuations are certainly a reason to be concerned. Yet, what really matter for stocks this year is profits. Corporate earnings were flat last year. (The chart below was made before recent adjustments to the 2019 estimate.) This year, the stock market will need to be pushed higher from rising earnings. Fortunately, there are some favorable signs suggesting that earnings growth may soon turn up.

S&P EARNINGS ESTIMATE FOR 2020

Analysts' earnings estimates have turned higher in the New Year. The EPS estimate for 2020 is 6.6% above the final estimated gain in earnings for 2019. This is not necessarily robust but is higher than it was last year, implying most analysts expect that the earnings slowdown experienced in 2019 is over. If profits continue to languish, the stock market will struggle. On the other hand, profits do not need to be flourishing this year for the stock market to do well. Nevertheless, earnings need to show life soon or "end of cycle anxieties" will resurface.



SUMMARY

2019 went out with a bang, with all risk-on assets having a field day. Our portfolios made new highs during the quarter and participated nicely in the rally. All assets were up in 2019 and our portfolios made new 2019 highs, but slightly lagged the benchmark due to the "V" recovery that happened earlier in the year and the unrelenting advance from October's lows. Still it was a good showing in absolute terms. As 2020 begins, there is some residual strength from the 4th quarter rally, but valuations and sentiment metrics would suggest a first quarter top. We believe we are in the final innings of the advance that began a year ago. After a consolidation/correction in the first half of the year, the ninth inning could occur in the fall going into the election. The Fear/Greed indicator is at all-time highs which indicates excessive greed from a sentiment viewpoint and potential market vulnerability. On the other hand, the domestic and global economies appear to be bottoming, earnings estimates for the S&P are rising and Fed will remain accommodative during an election year. While anticipating a first quarter top, we are positive on the markets for 2020. We recommend equities over bonds. We are overweight U.S. and international stocks, natural resources (because of gold) and underweight REITS and bonds. In the U.S. we prefer big cap over small cap, growth over value and technology, healthcare, financials and communication services.

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