Avalon
CAPITAL MANAGEMENT

Invest Smarter. Live Better.

Hindsight is 2020

Portfolio Performance

For the quarterly period ended 9/30/2020 (Q3, 2020), Avalon client portfolios were positive as gains from every asset class more than offset modest losses from equity hedges. Year to date, client portfolios are at or near their all-time highs while most major equity indices, particularly those in the value and international sectors, are negative.

Before discussing the third quarter, we do want to highlight the wide dispersion among the six major asset classes so far this year. As the pandemic has exposed the fragility across many areas of the economy (and broader society), it has created a set of winners and losers within the markets.

ASSET CLASS	1/1 - 9/30/20
Barclays US Intermediate Bond Index	6.0%
S&P 500 Index	5.6%
Cash / Short-Term US Treasury Index	0.8%
MSCI EAFE Index	−7.1%
NAREIT Index	−12.2%
GS Commodity Index	−35.1%

Source: Bloomberg

And while we continue to seek long-term investment opportunities for client portfolios, we acknowledge that 2020 has been a roller coaster in almost every way. The market's behavior in the third quarter was a microcosm of that wild ride. What began as a torrid July and August for most risk assets finished with a September decline that left most of this year's best performing asset classes, namely high growth stocks, well off their highs.

The set-up at September's high was almost the mirror image as the set up to the March lows. In March, we saw a combination of undervaluation in stocks, investor over-pessimism, an overvalued US Dollar and unprecedented fiscal and monetary stimulus packages. These conditions lead to an S&P 500 recovery of all the losses from the lows of March to the highs of early September. By September, over-confident investors and overvalued stocks set the stage for a market that has become increasingly skeptical of the government's ability and willingness to drive the economy and markets higher. A new wave of coronavirus infections also raised concerns that the fledgling economic recovery might be on shaky ground.

Since the early September peak, the US Dollar has rallied as the Federal Reserve has decelerated their asset purchase programs. While the Federal Reserve's balance sheet has almost doubled this year (from $4 Trillion to over $7 Trillion), the balance sheet has effectively held steady since mid-May. As the US Dollar has rallied off the Fed's throttling back of the balance sheet, risk assets have sold off.

> "We continue to be vigilant with our risk levels in client portfolios."

Our analysis indicates that September's retracement is a temporary setback in what is setting up to be a longer-term rally in risk assets to include stocks, gold, and even bonds. With that as backdrop, there are several factors that could change our view. The bond market, the US Dollar, and this November's election could each play an outsized role in the continuance (or reversal) of the rally.

As a result, we continue to be vigilant with our risk levels in client portfolios.

Technology Then, Technology Now

The NASDAQ and particularly the FAANGM stocks have led the market higher this year. While the FAANGM stocks are up over 30% YTD, the average stock in the S&P 500 is down 4.5%. With valuations stretched (even as some of these stocks have sold off 20% in September), many are pointing to the late 90s tech bubble and subsequent 2000-2002 crash as a possible model for what comes next. We note a few things that are market truisms. The first is that overvaluations can last a lot longer (and stretch a lot farther) than any individual could imagine. The second is that when the bubble does burst in an overvalued market, it tends to result in pain and agony for those fully committed to buy and hold. Sometimes this can lead to stagnant long-term returns as valuations slowly catch up to fundamentals. Sometimes it can result in a persistent decline. The most notable for the NASDAQ was a decline of 89% from 2000-2002.

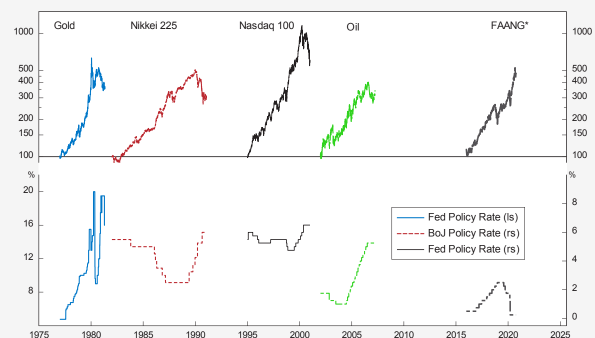
To compare 2000 vs today is a healthy exercise for both generating return and managing risk. In both markets, absolute valuations were/are stretched. Earnings multiples, price-to-sales, and market cap-to-GDP were/are all near historic highs. In 2000, the talk was all about a paradigm shift. Today, it is about game changers and disruptors.

What is different from 2000 to today is valuations relative to interest rates. When comparing current earnings yields (inverse of price-to-earnings ratio) to the current yield on the 10-year US Treasury, the S&P looks reasonably priced. This is an intended byproduct of the Federal Reserve's moving the target Federal Funds Rate to 0% while indicating that rates will stay that low until at least 2023.

The Federal Reserve's actions are, to date, in stark contrast to the events of 1999-2000. In the 12-month period between June 1999 to May 2000, the Federal Reserve under Alan Greenspan hiked the Federal Funds Rate six times, moving it from 5.0% to 6.5%. This tightening of monetary conditions skewed relative valuations and created the conditions for a market crash and subsequent bear market.

The reason this history matters is that the largest determinant of a further sell-off appears to be the tightening of monetary conditions. From our analysis of other asset class bubbles and what pops them, it historically tends to be rising interest rates that forewarns a frothy market's decline.

Tight Money and Rising Rates Have Pierced Major Bubbles



Note: All series in the top panel are rebased to 100 at the starting point.
*Market-Cap weighted average of Facebook, Amazon, Apple, Netflix and Google

Source: AlpineMacro

While interest rates are likely the biggest factor in future market outcomes, the economy is becoming increasingly dependent on further fiscal stimulus. A Democratic sweep has some concerned about higher taxes. While that might be the case, a Democratic sweep is likely to drive more fiscal stimulus which could bolster consumer spending. Even as unemployment remains high in the pandemic, consumer spending has helped maintain a strong housing market, higher auto sales and robust retail spending.

Failure to stoke an uneven recovery could lead to investor disappointment about the prospects for a V-shaped recovery and a narrowing of the performance differential for Growth vs. Value, International vs U.S., and Large Cap vs Small Cap, all of which offer opportunity in a sustained cyclical rebound.

Seeing All of You

While we are not completely Zoomed out, we do prefer seeing all of you in person! We have enjoyed our socially distanced meetings with many of our clients and look forward to seeing more of you under clear blue skies.

Our business remains healthy. We brought on five new clients this quarter all of whom our existing clients referred. We are thankful to work with each and every one of you and take pride in our client's recommending their friends to us. Thank you.

Clara Basile   David Rahn   Bill Oberman   Ross Revenaugh

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info@avaloncapital.com | +1 650.306.1500 | 495 Seaport Court, Ste 106, Redwood City, CA 94063