A Shifting Perspective

For the quarterly period ended 3/31/2021 (Q1 2021), Avalon client portfolios were positive as gains from holdings in Natural Resources, International and US stocks, and other risk assets led portfolios higher. While Q1's returns extended the strong returns from prior quarters, this quarter saw a fundamentally different market than the one from the past few years. With Natural Resources leading the way and high growth stocks and bonds lagging, we want to take the opportunity to look at what story the markets are telling and what this might mean for the client portfolios going forward.

We mentioned in our Q4 2020 client letter that we could be seeing a changing of the guard in terms of equity leadership. Q1 only reinforced our view on that trend as more traditional economy stocks (Dow Jones Industrials, US Small Cap Value) and International stocks handily outperformed the NASDAQ. Within US equities, the reflation trade tied to re-opening expectations and a rise in interest rates contributed to the movement to old-line assets with more attractive valuations.

Outside of equities, the performance of both Natural Resource and fixed income assets, and their negative correlation to each other, suggests a different economic regime is afoot. Within fixed income, the first quarter of 2021 was the worst quarter for U.S. Treasuries since 1980. The 10-Year U.S. Treasury Bond began the year yielding just under 1% and closed the quarter yielding 1.7%. With the 10-Year reaching a low of 0.5% in August of 2020, it seems likely that last year marked the end of the 40-year bull market in U.S. Treasury Bonds.

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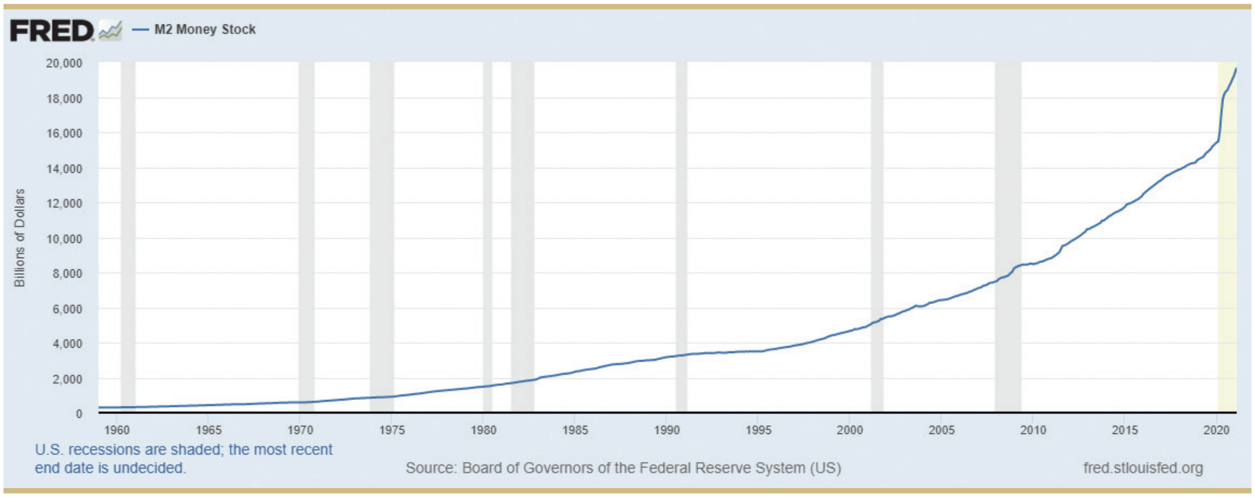

As it relates to client portfolios, a big factor in this quarter's performance was in avoiding U.S. Treasury bonds which, last year, were one of our big winners. While the rise in bond yields is partly related to the reflation trade, it is also impacted by what is massive fiscal and monetary stimulus. While a lot of attention is being given to the recent $1.9 Trillion stimulus package (the third of the Covid era), we note the unprecedented rise in M2 Money Supply growth.

While fixed income suffered, the largest beneficiary of reflation and fiscal/ monetary stimulus was Natural Resources. Economically sensitive commodities handily outpaced major equity indices this quarter, seeing a gain of over 22%. Similarly, Real Estate assets rebounded from a dismal 2020 and saw almost double digit growth for the quarter. In addition to our position in Natural Resources, our inclusion of more real estate than we have held for some time is in-line with our belief that higher growth and reflation are long-term and investable trends.

We think these trends deserve a bit more explanation as to why we reshaped client portfolios and why client portfolios might continue to reflect this non-traditional allocation. And we highlight this graph from Van Eck which outlines which asset classes tend to outperform when inflation runs above expectations.

For the last few decades, the rise of technology was not only great for technology stocks, it was great for bond prices and holding down bond yields given the disinflationary nature technology had on the economy. While this disinflationary force continues, we have highlighted new factors at play that could push inflation higher. And while there is vigorous debate around the permanency of some of these inflationary forces, we think it is worth analyzing market returns in environments featuring unexpectedly higher inflation rates.
What is clear is that inflationary surprises lead to outsized returns for Commodities, Precious Metals, and Natural Resource stocks.

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What is also clear from the above chart is that the traditional 60% stock, 40% bond portfolio does exceptionally well when inflation is falling or muted. What's also clear is that that same traditional portfolio severely lags when inflation starts to rise above expectations. To manage through that environment requires an ability and a willingness to be different from the traditional approach.

Are we there yet?

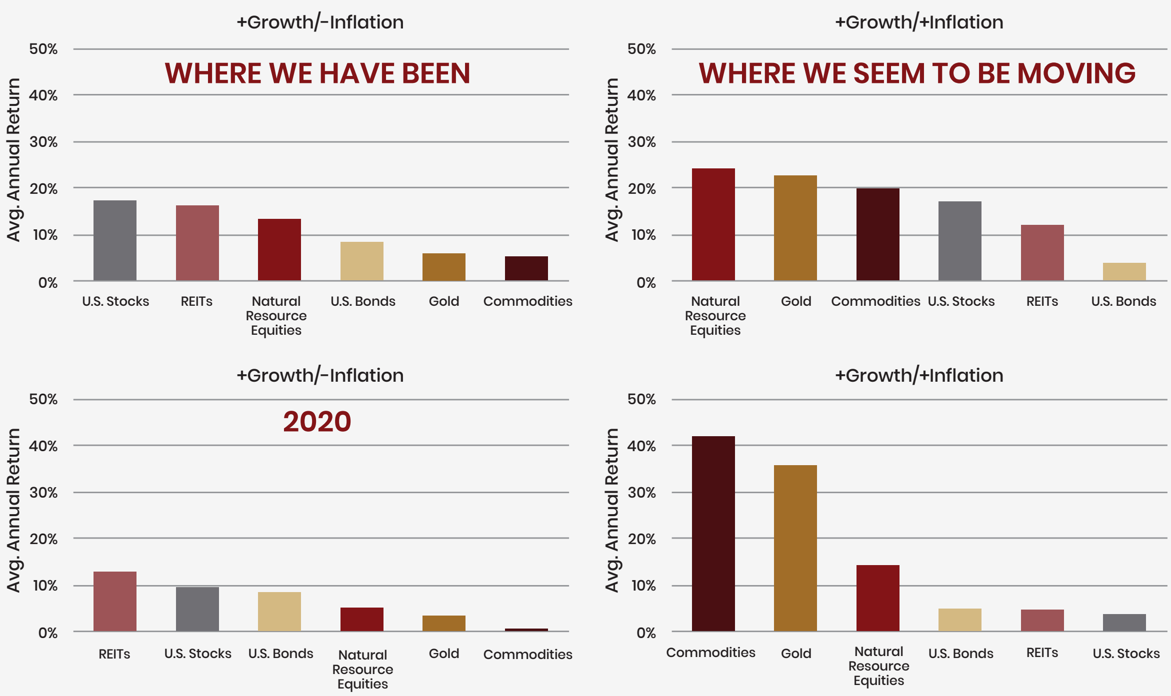
All of us are looking forward to in-person visits with you. We have almost all been vaccinated and are hopeful that this means a return to seeing all of you soon.

Please reach out if you have questions about this letter or your account.

Surprise Inflation = Boon For Resources, Commodities

Natural resources and commodities have historically outperformed in periods where there was unanticipated inflation

Average Annual Return In Growth/Surprise Inflation Environments (1970 – 2021)



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

The opinions expressed are those of Avalon Capital Management as of April 13, 2021 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.

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